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Concurrent Session

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Soliciting Employment in the Wake of *Universal Building Products*

Andrew Z. Schwartz
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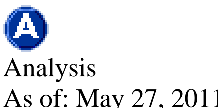
In In re Universal Building Products, Inc., 2010 Bankr. LEXIS 3828 (Bankr. D. Del. Nov. 4, 2010), Judge Walrath disqualified Arent Fox LLP ("AF") and Elliot Greenleaf & Siedzikowski, P.C. ("EG") from representing the creditors committee in Universal Building Products' Chapter 11 case. The court found that AF and EG deployed an intermediary, Dr. Haishan Liu, to contact Universal's largest Chinese creditors, who were not clients of AF or EG, to obtain their proxies at the committee formation meeting: "AF, EG and Dr. Liu were acting in concert to cold-call creditors that Dr. Liu did not represent for the purpose of being retained by them to attend the Committee formation meeting and to cast a proxy in favor of AF and EG for counsel." Id. at *24. Subsequently, Dr. Liu was hired as the committee's translator.

The court concluded that AF's and EG's conduct violated, among other things, Rule 7.3 of Delaware's Rules of Professional Responsibility, which governs lawyers' solicitation of employment, warranting their disqualification. The court also determined that AF and EG did not sufficiently disclose in their Rule 2014 applications their extensive prior dealings with Dr. Liu.

The ruling raises the specter of heightened judicial scrutiny and more exacting procedural safeguards to prevent improper solicitation of creditors and undue influence in hiring of professionals.



Analysis
As of: May 27, 2011

In re: UNIVERSAL BUILDING PRODUCTS, Debtor.

Chapter 11, Case No. 10-12453 (MFW) Jointly Administered

UNITED STATES BANKRUPTCY COURT FOR THE DISTRICT OF DELAWARE

2010 Bankr. LEXIS 3828; 53 Bankr. Ct. Dec. 259

November 4, 2010, Decided

CASE SUMMARY:

PROCEDURAL POSTURE: The Official Unsecured Creditors' Committee filed applications to retain two law firms as counsel. Those applications were opposed by the United States trustee and the debtors, who asserted that the law firms engaged in improper conduct through the use of a third party to contact unrepresented, mostly Asian, creditors, to induce them to vote for the law firms' employment.

OVERVIEW: After a global settlement of all issues collapsed, the committee, which had previously opposed the debtor-in-possession financing and sale procedures, sought to retain the law firms. Debtors moved to compel discovery related to the retention applications, and challenged the propriety of their relationship with the individual whom the committee had retained as a translator. The trustee asserted that the law firms' disclosures under Fed. R. Bankr. P. 2014 were incomplete. The court found that the law firms, among several other non-party law firms, had provided information about the creditors to the translator, with the proviso that he vouch for the hiring of the law firms by the committee. The court held that the law firms were permitted to advertise their abilities, their actions in soliciting employment through the third party translator, who had no previous relationship with the creditors, violated Del. Law. R. Prof. Conduct 7.3. Although one firm had disclosed that it had a prior relationship with translator, having served as committee counsel in cases where he represented a creditor or acted as a translator to the committee, that disclosure was deficient.

OUTCOME: The applications for employment as counsel to the committee were denied.

COUNSEL: [*1] For Universal Building Products, Inc., dba UBP, Debtor: Dawn L. Johnson, Harley J. Goldstein, Sven T. Nylen, K&L Gates LLP, Chicago, IL; Mark Minuti, MaryJo Bellew, Michael J. Farnan, Saul Ewing LLP, Wilmington, DE; Teresa K.D. Currier, Saul Ewing, Wilmington, DE.

For Official Committee of Unsecured Creditors, Creditor Committee: Andrew I. Silfen, David John Kozlowski, James M. Sullivan, Arent Fox LLP, New York, NY; Carol C. Cohen, Arent Fox, PLLC, Washington, DC; Carol Turner English, Jeffrey N. Rothleder, Arent Fox LLP, Washington, DC; Henry F. Siedzikowski, Elliott Greenleaf & Siedzikowski, P.C., Blue Bell, PA; Rafael Xavier Zahralddin-Aravena, Shelley A. Kinsella, Elliott Greenleaf, Wilmington, DE.

JUDGES: Mary F. Walrath, United States Bankruptcy Judge.

OPINION BY: Mary F. Walrath

OPINION

MEMORANDUM OPINION[1]

1 This Opinion constitutes the findings of fact and conclusions of law of the Court pursuant to Federal Rule of Bankruptcy Procedure 7052, which is made applicable to contested matters by Federal Rule of Bankruptcy Procedure 9014.

Before the Court are the Applications of the Official Unsecured Creditors' Committee (the "Committee") to retain Arent Fox LLP ("AF") and Elliot Greenleaf & Siedzikowski, P.C. ("EG") [*2] as counsel (collectively the "Committee Retention Applications"). The Committee Retention Applications are opposed by the United States Trustee (the "UST") and the Debtors. For the reasons set forth below, the Committee Retention Applications will be denied.

I. GENERAL CASE BACKGROUND

On August 4, 2010, Universal Building Products, Inc., and several of its affiliates (collectively, the "Debtors") filed voluntary petitions for relief under chapter 11 of the Bankruptcy Code. At the same time the Debtors filed a motion to approve a sale of substantially all of their assets to their pre-petition lenders (the "Lenders") and a motion for approval of DIP financing to allow for the sale process to continue with a projected sale hearing date in early September. At the first day hearing held on August 5, 2010, the Court set a hearing for August 23, 2010, to consider the Debtors' request for bid procedures related to the sale motion.

On August 13, 2010, the UST held an organizational meeting to determine whether there was sufficient creditor interest to form a Committee. At that time a Committee was formed and it selected AF and EG as counsel. The Committee Retention Applications were filed on August [*3] 24 and 30, 2010.

In the interim, on August 19, 2010, the Committee filed preliminary objections to the motions for approval of the sale procedures and the final DIP financing. The Committee also filed an emergency motion seeking to prohibit the Lenders from credit bidding at the proposed sale. At the August 23 hearing on the DIP financing and sale procedures motions, a global settlement among the Debtors, the Committee and the Lenders was announced pursuant to which the sale to the Lenders would proceed, with a sale hearing scheduled for September 7, 2010. (Tr. 8/23/10 at 5-6.) [2] In exchange, the Lenders would allow any excess funds from the DIP budget and the avoidance actions to be transferred to a liquidating trust for the benefit of the unsecured creditors pursuant to an agreed plan of reorganization. (Id.) After additional notice and hearing, the Court approved the proposed procedure and ultimately the sale was approved on September 7, 2010.

2 References to the record are as follows: "Tr. [date] at" refers to the transcript of the hearing held on the referenced date; "Liu Dep." refers to the transcript of the deposition of Dr. Haishan Liu held on September 17, 2010; "Ex. L-[#]" refers [*4] to the Liu deposition exhibits; "Ex. [letter]" and "Ex. [#]" refer to the exhibits of the Committee and the Debtors, respectively, admitted into evidence at the October 7, 2010, hearing.

On September 3, 2010, the Debtors filed an emergency motion to compel discovery related to the Committee Retention Applications. The Debtors sought discovery, inter alia, of the relationship between proposed counsel for the Committee and Dr. Haishan Liu whom the Committee had retained as a translator. [3] The Court did not grant the Debtors' motion to expedite the hearing on the emergency motion but noted at the sale hearing held on September 7, 2010, that the motion appeared to be premature because no discovery had even been served. (Tr. 9/7/10 at 8.)

3 No separate application was filed with respect to Dr. Liu's retention. Rather, in the application to retain AF, the Committee sought approval of Dr. Liu's retention and payment of his fees subject to section 503(b)(3)(F). (See proposed form of order attached to AF retention application.)

In the interim, the global settlement apparently fell apart. When the Committee filed an objection to the Debtors' emergency motion to compel discovery on September 6, 2010, [*5] it also filed an emergency motion for the appointment of a chapter 11 trustee and to terminate the Debtors' exclusivity contending that the Debtors had filed a plan and disclosure statement on August 31, 2010, which did not comply with the parties' agreement. On September 30, 2010, the Committee filed an objection to the Debtors' disclosure statement. Most recently, on October 27, 2010, the Committee filed an emergency motion to convert these cases to chapter 7, inter alia, because the Lenders have now taken the position that the Debtors are in default of the DIP financing budget and Order and the Lenders, therefore, are under no obligation to fund a plan of liquidation.

On September 16 and 30, 2010, the UST filed an objection and supplemental objection to the Committee Retention Applications contending that counsel's disclosures under Rule 2014 were incomplete. On September 30, 2010, the Debtors filed an omnibus objection to the Committee Retention Applications contending that proposed counsel had (1) violated the applicable Codes of Professional Conduct by having Dr. Liu solicit creditors to serve on the Committee and give him their proxy so that he could vote for counsel in exchange [*6] for being

retained as a translator by the Committee and (2) violated the applicable provisions of the Bankruptcy Code and Rules by failing to disclose adequately their relationship with Dr. Liu.

A hearing was held on October 7, 2010, to consider the Committee Retention Applications and objections. After hearing evidence, the Court took the matter under advisement. [4] The parties filed post-trial briefs on October 21, 2010. The matter is now ripe for decision.

4 At the hearing on the Committee Retention Applications in this case, the Debtors moved into evidence pleadings filed in bankruptcy cases in Texas in which it was alleged that AF had a financial advisor, with which it had a relationship, solicit creditors for proxies to serve on the creditors' committee for the purpose of supporting AF as counsel to the committee. The Committee filed a motion to strike the Debtors' references in their pleadings to those unrelated cases and opposed the admission of those pleadings into evidence in this case on numerous grounds. The Court took that issue under advisement as well. (Tr. 10/7/10 at 105-08.) Because the Court finds that it is not necessary to consider those pleadings to sustain the Debtors' [*7] objection, the Court finds it unnecessary to consider whether those pleadings are admissible.

II. FACTUAL BACKGROUND RELEVANT TO RETENTION MOTIONS

As a result of the evidence presented, including the deposition of Dr. Liu and testimony of representatives of the respective firms proposed to be retained by the Committee, the Court finds that the following occurred between the filing of the Debtors' petition on August 4, 2010, and the Committee formation meeting on August 13, 2010.

On the day the Debtors filed their bankruptcy petitions, attorneys at both AF and EG faxed copies of the petitions and the list of the thirty largest creditors to Dr. Liu. [5] (Liu Dep. at 51-52; Exs. L-2, L-23.) Dr. Liu testified that he received the same information from three other law firms that same day. (Id.) Dr. Liu's main business is as an authorized distributor for Fujifilm, but he also consults with Asian creditors who may have a collection problem in the United States. (Id. at 11-12.) Each of the firms who sent the information to Dr. Liu had a prior relationship with him, representing him or his Asian clients in collection or preference cases. (Id. at 115-20; Tr. 10/7/10 at 69.) Several had worked with [*8] him in cases where they served as Committee counsel while he acted as a translator or a representative of an Asian creditor. (Liu Dep. at 115-20.)

5 EG sent additional information about its analysis of the case to Dr. Liu and to several other clients and contacts known to have relationships with foreign entities. (Tr. 10/7/10 at 68-69, 96.)

Dr. Liu understood that counsel were sending him the information because they were interested in making a pitch for the Committee representation in this case. (Liu Dep. at 50-51, 58, 70, 134.) AF emailed Dr. Liu "[w]e are definitely interested in pursuing this case." (Ex. L-19; Tr. 10/7/10 at 45-46.) The attorney at EG emailed "I am sending this to you first in order to get your support early. I would like to pitch this as lead or co-counsel - no more local." (Ex. L-23.)

At the time of the bankruptcy filing, neither AF nor EG had any prior relationship with any of the Asian creditors. (Tr. 10/7/10 at 39-40, 84-85.) Nor did AF or EG have any knowledge that Dr. Liu had a relationship with any of those creditors. (Id. at 40, 85-87.) In fact, Dr. Liu did not represent any of the creditors on the creditor list at the time it was sent to him. (Liu Dep. at [*9] 46-51, 83, 155.)

In response to the information sent to him by AF and EG on August 4, 2010, Dr. Liu responded by email "As usual, at this probing stage, let's find out what those Asian creditors are going to respond and their representation status in the USA prior to the petition." (Ex. L-2.) Dr. Liu further noted that AF and EG "desire me to get a certain support from Asian Chinese exporters who might recommend [Dr. Liu] as a pending committee member in the case. . . . Before recommending you, I need some one and some groups to commend me to one or more of those prospective committee participants." (Ex. L-27.) Dr. Liu noted that "the grand cultivation of a support base from Chinese exporters" was "an invaluable asset." (Id.)

Notwithstanding having no relationship with the Asian creditors on the list, Dr. Liu made extensive efforts to contact them to educate them about the intricacies of the United States Bankruptcy Code and to see if they would give him a proxy to represent them at the Committee formation meeting. (Id. at 42-43, 46-51, 71-72, 74-78, 83-85.) Throughout this process, Dr. Liu sent almost daily emails to AF and EG reporting on his efforts to locate creditors on the list [*10] and get their proxies. (Ex. L-3, L-7, L-8, L-9, L-18; Tr. 10/7/10 at 89-90.) The AF partner involved in this process emailed Dr. Liu "Let me know if you need any assistance." (Ex. A at HL-391.) In fact, AF did assist Dr. Liu in his efforts to find contact information for the creditors. [6]

6 Dr. Liu asked AF to contact the Debtors' counsel or the UST to obtain contact information

> for the fourth largest creditor, but AF advised him that neither would give an attorney that information. Instead, AF recommended that Liu call them directly and gave him their phone numbers. (Tr. 10/7/10 at 41-42; Ex. L-4, L-5, L-6.) In addition, an attorney at AF forwarded to Dr. Liu an address for one of the creditors that he had obtained through an internet search. (Ex. L-11.)

While seeking to persuade the creditors to give him their proxies, Dr. Liu asked AF and EG for legal advice regarding the creditors noting that "getting a proxy is a two way traffic." (Liu Dep. at 78-81, 210-18; Ex. L-17, L-18.) The questions related specifically to how the creditors could improve their chances of getting paid for product in transit. (Liu dep. at 213, 216-18; Tr. 10/7/10 at 50-51.) AF advised Dr. Liu that the creditors [*11] could claim administrative status for that product under section 503(b)(9). (Liu Dep. at 213, 216-18; Ex. L-17.)

Ultimately, Dr. Liu was "rewarded" for his efforts when two of the creditors, Eastern Accessories Corporation ("EAC") and Shanghai Hualin Hardware ("SHH"), agreed to give him their proxies. (Liu Dep. at 83, 227-28; Exs. L-8, L-22.) When Dr. Liu reported that he had secured the representation of SHH, AF responded "Excellent. That is great. Thanks." (Ex. L-10.) Dr. Liu reported to AF and EG that "I'll hold the proxy [for the larger creditor, EAC] to cheer everyone up. I strongly suggest [AF] may co-pitch with his colleagues." (Ex. L-22.)

Because he felt that the UST would not allow him to act as a proxy for both creditors, Dr. Liu decided to act as proxy only for the larger creditor, EAC, because he felt it was more likely to get on the Committee. (Id. at 74, 86, 227-28.) Dr. Liu asked AF and EG to get him a "reliable" person to hold the proxy for SHH. (Liu Dep. at 164-65; Ex. L-12.) EG responded that it could "call in a favor" and recommended a person to whom EG had recently referred business and noted that the person was not interested in making a pitch for business from the [*12] Committee (as a financial advisor) and that he "knows the rules and will serve us well." (Tr. 10/7/10 at 90, 93-94; Ex. L -14.) AF was aware of the recommendation and approved it. (Liu Dep. at 171-72; Exs. L-13 & L-15; Tr. 10/7/10 at 44.) EG also sent Dr. Liu a form of proxy that it said complied with the UST's requirements. (Exs. L-30, L-35; Tr. 10/7/10 at 79, 92.)

EG advised Dr. Liu that the UST would ask the proxy holder questions about how it was obtained and would disqualify the holder if he had not actually communicated with the creditor before the committee formation meeting. (Exs. L-14, L-28.) This comported with Dr. Liu's experience. (Liu Dep. at 182.) As a result, a conference call was arranged among SHH, Dr. Liu, AF, EG, and the proxy holder to discuss whether the creditor wished to give its proxy. (Liu Dep. at 200-03; Tr. 10/7/10 at 45, 78, 90-91.)

The proxies that Dr. Liu obtained included the right to vote on the creditors' behalf for counsel for the Committee. (Liu Dep. at 84-85; Ex. L-14.) Dr. Liu did not discuss with the creditors which professionals he would support; the proxies gave him the discretion to decide. (Id. at 86, 313.)

At the Committee formation meeting, [*13] EAC (whose proxy Dr. Liu held) was chosen by the UST to serve on the Committee. (Tr. 10/7/10 at 79.) After it was formed, the Committee interviewed attorneys and financial advisors. Ten law firms, including AF and EG, gave presentations seeking to be retained as counsel for the Committee. (Id. at 80; Liu Dep. at 311-12.) Liu told the other Committee members that he had had dealings in other cases with AF and EG and the other law firm that was a finalist. (Tr. 10/7/10 at 11.) However, Dr. Liu did not advise the other members of the Committee of the email and other communications he had had with AF and EG leading to the formation meeting. (Id. at 16.) AF and EG were ultimately chosen as counsel by unanimous vote. (Id. at 15-16.)

Thereafter, on AF's recommendation, the Committee decided to hire Dr. Liu as a translator so that EAC could participate in Committee meetings. (Id. at 14.) Dr. Liu advised EAC that, in light of his retention as a translator, he could no longer act as its representative on the Committee and referred it to another attorney he knew. (Liu Dep. at 87-88.) However, no one advised the Co-Chair of the Committee that Dr. Liu was no longer acting as EAC's representative [*14] on the Committee. (Tr. 10/7/10 at 14-16.)

On August 30, 2010, the Committee filed the Committee Retention Applications. In its retention application, AF filed a declaration disclosing that (1) at AF's recommendation, Dr. Liu had been selected by the Committee to serve as a translator for the Committee and (2) AF had been involved in many cases where Dr. Liu served as a translator for the creditors' committee or acted as a representative of a creditor on the committee. (Ex. D at ¶ 11.) The declaration also disclosed that Dr. Liu had held a proxy for a creditor in that case. (Id.) On September 13, 2010, AF filed a Supplemental Declaration identifying two additional cases in which it was involved where Dr. Liu was the committee translator or a creditor representative, one of which had happened very recently. (Tr. 10/7/10 at 37; Ex. E.) On September 22, 2010, AF filed a Second Supplemental Declaration advising that it had "contacts" with EAC and SHH through Dr. Liu and that those creditors had "inquiries relating to the Debtors." (Tr. 10/7/10 at 38; Ex. F.) There was no

revelation, however, as to the content of those communications. [7]

7 On September 29, 2010, AF filed a Third Supplemental [*15] Declaration regarding an unrelated connection with the Debtors' CRO. (Ex. G; Tr. 10/7/10 at 38.)

Attached to its retention application, EG's original Affidavit did not reveal any connection with Dr. Liu, EAC or SHH. (Ex. O; Tr. 10/7/10 at 97-98.) In a Supplemental Affidavit filed on September 15, 2010, EG revealed it had been involved in a number of cases in which Dr. Liu was involved as a translator or creditor representative. (Ex. P.) In a Second Supplemental Affidavit, filed on September 23, 2010, EG revealed that it had had contacts with Dr. Liu and EAC and SHH prior to the formation meeting, including providing a proxy and introducing a proxy holder for SHH. (Ex. 52.)

At the hearing, the Committee offered a declaration which contained a chart of all seventeen bankruptcy cases in which Liu had been involved. (Exs. J & K.) AF had been counsel to the Committee in six of those cases, Lowenstein Sandler had been counsel in five, and six different firms had been counsel in the other six cases. (Tr. 10/7/10 at 16-19; Ex. K.) A second chart detailed the seventy bankruptcy cases in which AF had been counsel to the committee since 2003. (Ex. M.) Dr. Liu was involved in only six of them. (Id.) [*16] If one considers only the cases since June 4, 2008, when Dr. Liu apparently first became involved in bankruptcy matters with AF, however, there are twenty-seven cases in which AF served as committee counsel including three in which Liu served as translator for the committee and three in which Liu acted as a representative of committee members. (Exs. K, M.)

III. JURISDICTION

The Court has jurisdiction over this matter which is a core proceeding pursuant to 28 U.S.C. §§ 1334 & 157(b)(2)(A) & (O).

IV. DISCUSSION

A. Standing

As a preliminary matter, EG asserts that the Debtors have no standing to object to the Committee Retention Applications because they have no interest in whom the Committee chooses to represent them. Specifically, EG argues that to have standing to be heard on the issue presented in this case the Debtors must show that resolution of the issue will diminish the Debtors' property, increase their burdens, or impair their rights. See, e.g., In re ANC Rental Corp., 57 Fed. Appx. 912, 2003 U.S. App. LEXIS 2159, at *7 (3d Cir. Dec. 13, 2002); Newspaper & Mail Deliverers' Union, 1991 U.S. Dist. LEXIS 16337 (S.D.N.Y. Nov. 12, 1991).

The Court rejects this argument. Section 1109 expressly grants the [*17] Debtors the right to appear and be heard on any issue in their cases. 11 U.S.C. § 1109. In addition, any attorney with knowledge of a violation of applicable rules of professional conduct by another may be obligated to report that violation. [8] Therefore, the Court finds that the Debtors do have standing to object to the Committee Retention Applications.

8 Rule 8.3 Reporting Professional Misconduct provides that:

> (a) A lawyer who knows that another lawyer has committed a violation of the Rules of Professional Conduct that raises a substantial question as to that lawyer's honesty, trustworthiness or fitness as a lawyer in other respects, shall inform the appropriate professional authority.

B. Violation of Rules of Professional Conduct

The Debtors contend that the Committee Retention Applications should be denied because proposed Committee counsel violated the applicable rules governing attorney conduct. Specifically, the Debtors cite Rule 7.3 of Delaware's Rules of Professional Responsibility which provides:

> A lawyer shall not by in-person, live telephone or real-time electronic contact solicit professional employment from a prospective client when a significant motive for the lawyer's doing [*18] so is the lawyer's pecuniary gain, unless the person contacted: (1) is a lawyer; or (2) has a family, close personal, or prior professional relationship with the lawyer.

Del. Lawyers' R. of Prof. Cond. 7.3. This rule is identical to Rule 7.3 of the Model Rules of Professional Conduct. Rule 7.3 of the New York Rules of Professional Conduct is similar: "[a] lawyer shall not engage in solicitation by in-person or telephone contact, or by real-time or interactive computer-accessed communication unless the recipient is a close friend, relative, former client or existing client. . . ."

The comments to Rule 7.3 make it clear that a lawyer is also prohibited from using another as an intermediary to solicit prospective clients. The Annotations to Model Rule 7.3 provide:

> Lawyers may not use other people to solicit for them, and Rule 7.3 is sometimes invoked along with either Rule 7.2(b) (prohibiting paid recommendations) or Rule 8.4 (prohibiting use of third parties to violate Rules) to prohibit the practice. See, e.g., In re O'Keefe, 877 So. 2d 79 (La. 2004) (lawyer disbarred for paying "runners" to find and refer personal injury cases); Miss. Bar v. Turnage, 919 So. 2d 36 (Miss. 2005) (lawyer [*19] suspended for hiring former insurance salesperson to solicit clients for potential class suit against insurer); Md. Ethics Op. 98-30 (1988) (lawyer may not have bail bondsman pass out bondsman's business cards with lawyer's contact information printed on back); see also Cincinnati Bar Ass'n v. Rinderknecht, 79 Ohio St. 3d 30, 1997 Ohio 309, 679 N.E.2d 669 (Ohio 1997) (lawyer indefinitely suspended for setting up direct marketing service to solicit accident victims as clients for himself and chiropractor; decided under Ohio Code); cf. Crook v. State, No. 08-020003820CR, 2005 WL 1539187 (Tex. App. June 30, 2005) (lawyer convicted of felony barratry for hiring chiropractor's assistant to solicit auto accident victims; court invokes Rules 7.3 and 8.4 in analyzing offense).

Annotations to ABA-AMRPC Rule 7.3. See also Thomas E. Ray, Solicitation of Clients: Are There Any Guidelines?, 21 NOV Am. Bankr. Inst. J. 12 (2002) (suggesting that direct solicitation by phone or in person of creditors on the debtor's schedules by counsel hoping to be retained as counsel to the committee was unethical).

AF and EG argue that the Rule cannot be constitutionally applied to them to prohibit their activities in this case. They argue that, [*20] because committee members are often sophisticated business entities, restricting attorney solicitations to them runs afoul of the First Amendment. See, e.g., Edenfeld v. Fane, 507 U.S. 761, 774-75, 113 S. Ct. 1792, 123 L. Ed. 2d 543 (1993) (striking Florida statute which prohibited CPAs from directly soliciting accounting clients and noting that business clients are different from the "unsophisticated, injured or distressed lay person" often targeted by attorney's solicitations). See also Samuel L. Bufford, Attorney Solicitation of Legal Work in Business Settings, County Bar Update, Vol. 26, No. 4 (April 2006) (arguing that California's disciplinary rule prohibiting direct solicitation of prospective unrelated clients by attorneys in the business context is unconstitutional).

The Court disagrees. The issue in this case is not the propriety of written "advertising" issued by AF and EG. In fact, the Court finds nothing wrong with AF and EG sending the list of creditors to their clients and contacts with whom they have a professional relationship. Nor does the Court object to EG's sending its "analysis" of the Debtors' case to those same entities. See generally Michael P. Richman, Chasing Committees: the Ethics of Entertainment [*21] Solicitation, 22 OCT Am. Bankr. Inst. J. 18 (2003) (noting that written solicitation of prospective clients - giving counsel's qualifications - is permissible but that entertainment solicitation - wining and dining prospective committee members before the formation meeting - was unethical).

What the Court finds improper in this case is that once AF and EG learned that Dr. Liu did not represent any creditor on the list, they actively encouraged and assisted him in his efforts to solicit creditors to get their proxies to attend the formation meeting and vote for counsel. The Supreme Court has expressly held that state bar associations may prohibit direct oral communications with prospective clients by an attorney or by someone on his behalf. Ohralik v. Ohio Stat Bar Ass'n, 436 U.S. 447, 464-66, 98 S. Ct. 1912, 56 L. Ed. 2d 444 (1978) (upholding states' right to prohibit direct solicitation by attorneys given states' compelling interest in preventing abuses and significant potential for harm to prospective clients by attorneys "trained in the art of persuasion"). That precedent has not been changed in the business context. Further, the Court finds it particularly unwise to change it in the context of this case. In this [*22] case the prospective clients who were solicited were foreign creditors unfamiliar with our bankruptcy laws and particularly with the system of forming creditors' committees. They are no less vulnerable to direct solicitation by someone on behalf of an attorney than an individual. [9]

9 In fact, Dr. Liu himself (a sophisticated businessman who is familiar with our bankruptcy laws and procedures) said he felt uncomfortable when attorneys sent him emails and approached him at formation meetings asking for his support. (Liu Dep. at 205-09, 271.) Dr. Liu also complained that many proxy holders only showed up at the formation meeting (ostensibly to vote for professionals) and then never participated in the case again. (Id. at 208.) Ironically, that is exactly what Dr. Liu himself did; he directly solicited EAC and SHH for their support with the intention

of only representing them at the formation meeting and not thereafter.

Further, the practice at issue here has been a matter of criticism under the Act and the Bankruptcy Code was enacted to change some of those practices (or at least to shed some light on them by requiring disclosures). See, e.g., H.R. No. 595, 95th Cong., 2d Sess. 93, reprinted [*23] in 1978 U.S. Code Cong. & Ad. News 6054 (criticizing the practice of "creditors' attorneys with proxies participat[ing] actively in the election of the members of the committee in order that they may be selected as counsel to the committee" which "is a lucrative position."). Cf. In re ABC Auto. Prods. Corp., 210 B.R. 437, 443 (Bankr. E.D. Pa. 1997) (criticizing committee counsel for using members' proxies to conduct committee business without any input from committee members).

AF and EG argue further, however, that their activity did not violate any ethical rule. At the hearing on the instant motion, the partner at AF leading the engagement testified that he never asked Dr. Liu to solicit clients for AF or creditors to serve on a creditors' committee "on behalf of AF." (Tr. 10/7/10 at 23.) He explained the language in his emails thanking Dr. Liu for his efforts and asking if he needed any assistance as simple common courtesy. (Id. at 27-28.) He further denied having any discussion with EG regarding what they expected Dr. Liu to do for them, other than to allow them to demonstrate that they were the best firm for the Committee to hire. (Id. at 28-29.) The partner in charge of the EG [*24] engagement also denied that he asked Dr. Liu to solicit any clients on its behalf and also stated that he was just hoping for a recommendation and "a fair shot to go in and present our case as to why we should be Committee counsel." (Id. at 72, 81-82.) EG also denied offering Dr. Liu or the proxy chosen for SHH anything of value for voting for them. (Id. at 82.) Both firms vehemently denied asking Dr. Liu to solicit creditors for them.

The Court finds that the evidence proves otherwise and finds that, in fact, AF, EG and Dr. Liu were acting in concert to cold-call creditors that Dr. Liu did not represent for the purpose of being retained by them to attend the Committee formation meeting and to cast a proxy in favor of AF and EG for counsel. This is demonstrated by the following facts: (1) as a result of the communications between Dr. Liu, AF and EG, it was clear to counsel that Dr. Liu did not represent any of the creditors at the time he first endeavored to contact them; (2) Dr. Liu kept AF and EG apprised (on at least a daily basis) of his efforts to locate and obtain proxies from the creditors and noted that he would act "as usual" in doing so; (3) Dr. Liu asked for assistance in [*25] locating the creditors and AF provided advice and some assistance; (4) Dr. Liu expressly stated that he understood that counsel wanted him to get "support" from the creditors and that they were interested in serving as Committee counsel; (5) to persuade the creditors to provide proxies, Dr. Liu asked for (and AF provided) legal advice relevant to those creditors' rights as part of the "two way traffic;" (6) Dr. Liu asked for a nominee to serve as a proxy for one of the creditors and EG made a recommendation (approved by AF) of someone who "will serve us well;" (7) when Dr. Liu got EAC's proxy he said he would serve as the proxy which would "cheer everyone up" and that AF and EG should definitely make a pitch for the Committee now; (8) both AF and EG were on the conference call with one of the creditors, SHH, to discuss the case and persuade it to execute a proxy; (9) Dr. Liu did vote the EAC proxy in favor of AF and EG at the committee formation meeting; and (10) AF immediately recommended that the Committee retain Dr. Liu as a translator.

AF and EG note, however, that they were not the only attorneys seeking Dr. Liu's assistance or asking him to vote any proxies he held for them as [*26] counsel. Rather than excusing the behavior of AF or EG, however, it simply evidences that others may not be complying with the rules either. [10] The Court is only able to address the issue before it: the conduct of AF and EG. The Court would caution other counsel who observe violations of the Rules of Professional Responsibility or Model Rules of Professional Conduct in other cases to bring it to the Court's attention for proper action. See Rule 8.3 of the Model Rules of Professional Conduct. See generally Thomas E. Ray, Solicitation of Clients: Are There Any Guidelines?, 21 NOV Am. Bankr. Inst. J. 12 (2002) (noting that attorneys who are aware of ethical violations are obligated by Model Rule 8.3(a) to report such violations).

10 In fact, Dr. Liu testified that counsel for the Debtors had approached him at an organizational meeting of creditors in another case ostensibly to get his support when he made a pitch. (Liu Dep. at 314.)

Therefore, the Court concludes that there are sufficient facts to suggest that AF and EG did violate Rule 7.3 and Rule 8.4 of the Model Rules of Professional Conduct and of Delaware's Rules of Professional Responsibility. The Court finds this conduct sufficient [*27] reason to disqualify AF and EG from serving as counsel to the Committee in this case. See, e.g., In re Vanderbilt Assoc., Ltd.., 117 B.R. 678, 680 (D. Utah 1990) (noting that ethical rules apply to question of whether an attorney can be employed pursuant to § 327 of the Bankruptcy Code); Berger McGill, Inc. v. Capozzoli (In re Berger McGill, Inc.), 242 B.R. 413, 423 (Bankr. S.D. Ohio 1999) (disqualifying law firm from representing debtor in action against creditor/former client where creditor had previously consulted and provided

confidential information to counsel about the subject of the law suit); In re Soulisak, 227 B.R. 77, 80 (Bankr. E.D. Va. 1998) ("Attorneys who practice before a bankruptcy court must not only concern themselves with the obligations set forth in the Bankruptcy Code and the Federal Rules of Bankruptcy Procedure, but also with the application of state ethical rules."); In re RKC Dev. Corp., 205 B.R. 869, 873 (Bankr. S.D. Ohio 1997) (concluding that appointment under § 327 should be refused where retention is at variance with ethical and disciplinary rules); In re Sauer, 191 B.R. 402, 407 (Bankr. D. Neb. 1995) (disqualifying counsel for failure to observe applicable [*28] state ethics code).

C. Failure to be Disinterested

The Debtors also contend that AF's Retention Application should be denied because AF is not disinterested. While section 1103(b) of the Bankruptcy Code provides only that Committee counsel may not represent an entity with an interest adverse to the Committee, [11] the Debtors contend that section 328 imposes the additional requirement that Committee counsel be disinterested. [12] In this case, the Debtors contend that AF is not disinterested because it provided legal advice to several creditors that they could assert administrative claims for goods in transit, which is contrary to the interests of the general unsecured creditors represented by the Committee.

11 "An attorney . . . employed to represent a committee . . . may not, while employed by such committee, represent any other entity having an adverse interest in connection with the case." 11 U.S.C. § 1103(b).

12 Section 328(c) provides that the Court may disallow counsel fees "if, at any time during such professional person's employment . . . such person is not a disinterested person, or represents or holds an interest adverse to the interest of the estate with respect to the matter on [*29] which such professional person is employed." 11 U.S.C. § 328(c).

At the hearing the AF partner admitted that he responded to Dr. Liu's email regarding the question of what creditors' rights were with respect to in-transit goods. (Tr. 10/7/10 at 29.) He denied, however, that he was providing legal advice to the creditors, stating that Dr. Liu often asked counsel who were interested in pitching for Committee representation "hypothetical" questions to see who was the most knowledgeable. (Id. at 29.) Further, he noted that he gave the "advice" to Dr. Liu not to the creditors and that there was no attorney/client relationship ever established between AF and the creditors. (Id. at 31.) He stated that it was no different from the hundreds of questions he gets from acquaintances at cocktail parties and in the hall. (Id. at 31, 53.)

The Court disagrees. The emails were far from hypothetical cocktail party conversation; they expressly referenced the names of the creditors and amounts of their claims in the "re" lines and in the text. (Tr. 10/7/10 at 53-58; Ex. L-17, L-18.) Further, the legal advice was given in the context of AF's effort to win Dr. Liu's support for its pitch to become Committee [*30] counsel. Even if AF did provide legal advice to the creditors (through Dr. Liu), however, the Court concludes that AF is not disqualified from serving as Committee counsel on the basis that it is not disinterested.

The Court disagrees with the Debtors' argument that committee counsel generally cannot be retained if they are not disinterested. Section 1103 specifically provides only that committee counsel shall not hold or represent an interest adverse to the committee. That section expressly states that the representation of a creditor in the case (which would make the attorney not disinterested [13]) is not a per se disqualifying factor as suggested by the Debtors. [14] See, e.g., In re Firstmark Corp., 132 F.3d 1179, 1182-83 (7th Cir. 1997) (finding no disqualification where counsel for committee represented former president of the debtor - who was a possible creditor and avoidance action defendant - in matters unrelated to the debtor); In re Nat'l Century Fin. Enters., Inc., 298 B.R. 112, 118 (Bankr. S.D. Ohio 2003) (finding firm not disqualified from representing committee although it concurrently represented two members of the committee).

13 Disinterested is defined in the Code to include [*31] "a creditor" or anyone with "an interest materially adverse to the interest of the estate." 11 U.S.C. § 101(14).

14 Cf. 11 U.S.C. § 327(c) (counsel is not per se disqualified from representing the trustee simply because of its prior representation of a creditor).

The fact that committee counsel also represents an individual creditor has been found to be at most a potential conflict.

> Congress implicitly determined that the inherent tension between a committee and one of its creditors, standing alone, was immaterial and any conflict too theoretical to warrant being classified as an adverse interest. That is, merely the remote potential for dispute, strife, discord, or difference between a committee and one of its creditors does not give rise to any conflict of interest or appearance of impropriety that would bar an attorney from representing both parties.

In re Nat'l Liquidators, 182 B.R. 186, 192-93 (S.D. Ohio 1995) (concluding that only when "evidence suggest[s] the existence of possible challenges to a creditor's claim, the existence of a possible recovery action against the creditor, or the existence of any possible dispute between a committee and one of its constituents or members" would [*32] counsel be disqualified under § 1103).

A potential conflict alone does not mandate disqualification of counsel for the Committee. See, e.g., In re First Jersey Sec., Inc., 180 F.3d 504, 509 (3d Cir. 1999) (stating that the Bankruptcy Code "mandates disqualification when there is an actual conflict, allows for it when there is a potential conflict, and precludes it based solely on an appearance of a conflict.").

Furthermore, the time to evaluate whether AF is disqualified, because it represents an interest adverse to the Committee, is at the time of retention. Prior representations, even if adverse to the interests of the committee or unsecured creditors, do not disqualify committee counsel. See, e.g., In re Enron Corp., No. 02 Civ. 5638 (BSJ), 2003 U.S. Dist. LEXIS 1442, 2003 WL 223455, *6-7 (S.D.N.Y. Feb. 3, 2003) (finding committee counsel did not hold an adverse interest because it had previously represented debtor-related entities and stating that the "argument under § 1103 fails because [counsel's] alleged adverse interests . . . predated [counsel's] representation of the committee"); In re Diva Jewelry Design, Inc., 367 B.R. 463, 473-74 (Bankr. S.D.N.Y. 2007) (finding that discussions that proposed trustee's [*33] counsel had with creditors regarding their possible consignment claims prior to retention by trustee did not disqualify counsel from employment); Nat'l Century Fin., 298 B.R. at 118 (finding firm not disqualified from representing committee although it had previously represented the debtor in a discreet matter that ended before bankruptcy).

Therefore, even if AF "represented" EAC and SHH as a result of the legal advice given to Dr. Liu on their behalf, that is insufficient to disqualify it per se. Further, the Court finds that there is no evidence that AF actually entered into an attorney/client relationship with either EAC or SHH or that that legal representation continued to the time of AF's retention by the Committee.

D. Failure to Disclose

The Debtors (and the UST) argue, however, that the Committee Retention Applications should be denied because proposed counsel failed to disclose adequately their connections with Dr. Liu and with EAC and SHH in their original retention applications. Rule 2014(a) requires that

> The application [of any professional person seeking retention by the debtor or committee] shall be accompanied by a verified statement of the person to be employed setting forth [*34] the person's connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee.

Fed. R. Bankr. P. 2014(a). Delaware Local Rule 2014-1(a) also requires that additional disclosures be made "[p]romptly after learning any additional material information relating to such employment (such as potential or actual conflicts)."

"Defective disclosure is not a minor matter. It goes to the heart of the integrity of the bankruptcy system. . . ." In re B.E.S. Concrete Prods., Inc., 93 B.R. 228, 236-38 (Bankr. E.D. Cal. 1988) (disqualifying special counsel who failed to disclose that it represented co-defendants in litigation it was handling for debtor). The professional must disclose all contacts, not pick and choose which to disclose and which to ignore or leave the court to search the record for such relationships. In re BH&P, Inc., 949 F.2d 1300, 1317-18 (3d Cir. 1991) (finding failure to disclose potential conflict which counsel had discussed with UST was inadvertent but violative of Rule 2014 nonetheless); In re Jore Corp., 298 B.R. 703, 732 (Bankr. D. Mont. 2003) [*35] (disqualifying counsel for debtor for failure to disclose that conflicts waiver obtained from DIP lender prohibited debtor's counsel from undertaking litigation adverse to it); In re Granite Partners, L.P., 219 B.R. 22, 35 (Bankr. S.D.N.Y. 1998) (noting that "professional's duty to disclose is self-policing . . . . [and court] should not have to 'rummage through files or conduct independent factfinding investigations' to determine if the professional is disqualified") (quoting In re Rusty Jones, Inc., 134 B.R. 321, 345 (Bankr. N.D. Ill. 1991)).

Failure to disclose connections itself is enough to warrant disqualification of counsel from employment. See, e.g., In re Crivello, 134 F.3d 831, 839 (7th Cir. 1998) (stating that "a bankruptcy court should punish a willful failure to disclose connections under Fed. R. Bankr. P. 2014 as severely as an attempt to put forth a fraud on the court."); Rome v. Braunstein, 19 F.3d 54, 59 (1st Cir. 1994) (warning that "[a]bsent the spontaneous, timely and complete disclosure required by section 327(a) and Fed. R. Bankr. P. 2014(a), court-appointed counsel proceed at their own risk.") (emphasis in original); In re Filene's Basement, Inc., 239 B.R. 845 (Bankr. D. Mass. 1999) [*36] (disqualifying counsel because of false 2014 disclosures alone without deciding whether

counsel was disinterested); In re Tinley Plaza Assoc., L.P.., 142 B.R. 272, 280 (Bankr. N.D. Ill. 1992) (firm disqualified from representing debtor where original retention application failed to disclose that "of counsel" to firm was president of investment banking firm providing services for debtor). But see In re Leslie Fay Cos., Inc., 175 B.R. 525, 539 (Bankr. S.D.N.Y. 1994) (finding that failure of counsel to disclose potential conflicts did not warrant disqualification but did warrant sanction requiring counsel to pay the substantial fees incurred in having an examiner investigate its potential conflicts).

In this case the Court finds that the evidence supports disqualification of both AF and EG from representing the Committee. Although AF at least disclosed that it had a prior relationship with Dr. Liu, having served as committee counsel in cases where he represented a creditor or acted as a translator to the committee, the Court finds that disclosure deficient. AF argues that complete disclosures were ultimately made, before the hearing on consideration of the Committee Retention Applications. [*37] The Court agrees with the UST, however, that the subsequent disclosures by AF and EG (filed only after concerns about them were expressed by the Debtors and the UST and after discovery revealed what had occurred) were not enough to cure the original deficiencies. [15] AF (and EG) should have fully disclosed at the outset their efforts in support of Dr. Liu's attempt to obtain proxies from creditors to attend the Committee formation meeting. Further, while it was not a disqualifying factor, the fact that AF had provided legal advice to two creditors on their right to seek administrative claims is a fact that should have been revealed to the Committee and to the Court. Because AF and EG did not make sufficient disclosures in their original retention applications, the Debtors and the UST were obligated to engage in discovery to garner the facts and bring them to the Court's attention. The failure to provide complete and accurate disclosure at the outset warrants denial of the Committee Retention Applications. [16]

15 Although AF did disclose it had communications regarding two of the creditors, it did not provide details about those communications or provide any details about other communications [*38] it had with Dr. Liu in an effort to obtain creditor proxies.

16 The Court finds that this disclosure requirement applies to all professionals under Rule 2014. Although a financial advisor and others are not bound by the same Rules of Professional Responsibility that attorneys are, the Court concludes that, because solicitation efforts go to the integrity of the process, all professionals should disclose any direct calls they made (or others made on their behalf) to creditors (who were not their respective clients) in an effort to be employed in a bankruptcy case.

F. Further Recommendations

The Court hopes that by requiring disclosure of the practice of using others to solicit proxies to act at a committee formation meeting will go a long way to discourage that improper practice. The Court would also urge the UST to consider implementing procedures to reduce the likelihood of undue influence on the decision of a committee to hire professionals. Specifically, the Court recommends that the UST adopt the suggestion by Dr. Liu that the creditors be kept in a separate room from prospective professionals (who do not represent a client eligible to serve on the Committee) before the committee formation [*39] meeting. Further, the UST might consider amending the questionnaire it sends to prospective committee members to include questions regarding whether they were solicited by anyone in connection with the case.

V. CONCLUSION

For the reasons set forth above, the Court will deny the Committee Retention Applications.

An appropriate order is attached.

Dated: November 4, 2010

BY THE COURT:

/s/ Mary F. Walrath

Mary F. Walrath

United States Bankruptcy Judge

ORDER

AND NOW, this **4th** day of **NOVEMBER, 2010**, upon consideration of the Applications of the Official Unsecured Creditors' Committee (the "Committee") to retain counsel, the opposition thereto and for the reasons set forth in the accompanying Opinion, it is hereby

ORDERED that the Applications are **DENIED**.

BY THE COURT:

/s/ Mary F. Walrath

Mary F. Walrath

United States Bankruptcy Judge

Comparison of Rule 7.3 of Professional Conduct Across Jurisdictions

Model Rules of Professional Conduct	A lawyer shall not by in-person, live telephone or real-time electronic contact solicit professional employment from a prospective client when a significant motive for the lawyer's doing so is the lawyer's pecuniary gain, unless the person contacted: (1) is a lawyer; or (2) has a family, close personal, or prior professional relationship with the lawyer.
Delaware	Identical to Model Rule.
Maine	A lawyer, in person, by live telephone, or by real-time electronic contact, shall not solicit professional employment from a non-commercial client if such solicitation involves or has substantial potential of harassing conduct, coercion, duress, compulsion, intimidation or unwarranted promises of benefits. The prospective client's sophistication regarding legal matters; the physical, emotional state of the prospective non commercial client; and the circumstances in which the solicitation is made are factors to be considered when evaluating the solicitation.
Massachusetts	Except as provided in paragraph (e), a lawyer shall not solicit professional employment for a fee from a prospective client in person or by personal communication by telephone, electronic device, or otherwise. Rule 7.3(d). The following communications shall be exempt from the provisions of paragraph[. . .] (d) above: (1) communications to members of the bar of any state or jurisdiction; (2) communications to individuals who are (A) the grandparents of the lawyer or the lawyer's spouse; (B) descendants of the grandparents of the lawyer or the lawyer's spouse; or (C) the spouse of any of the foregoing persons; (3) communications to prospective clients with whom the lawyer had a prior attorney-client relationship; and (4) communications with (i) organizations, including non-profit and governmental entities, in connection with the activities of such organizations, and (ii) with persons engaged in trade or commerce as defined in G. L. c. 93A, § 1(b), in connection with such persons' trade or commerce. Rule 7.3(e).

New Hampshire	A lawyer shall not initiate, by in-person, live voice, recorded or other real-time means, contact with a prospective client for the purpose of obtaining professional employment, unless the person contacted: (1) is a lawyer; (2) has a family, close personal, or prior professional relationship with the lawyer; (3) is an employee, agent, or representative of a business, non-profit or governmental organization not known to be in need of legal services in a particular matter, and the lawyer seeks to provide services on behalf of the organization; or (4) is an individual who regularly requires legal services in a commercial context and is not known to be in need of legal services in a particular matter.
New York	A lawyer shall not engage in solicitation: (1) by in-person or telephone contact, or by real-time or interactive computer-accessed communication unless the recipient is a close friend, relative, former client or existing client; or (2) by any form of communication if: (i) the communication or contact violates Rule 4.5, Rule 7.1(a), or paragraph (e) of this Rule; (ii) the recipient has made known to the lawyer a desire not to be solicited by the lawyer; (iii) the solicitation involves coercion, duress or harassment; (iv) the lawyer knows or reasonably should know that the age or the physical, emotional or mental state of the recipient makes it unlikely that the recipient will be able to exercise reasonable judgment in retaining a lawyer; or (v) the lawyer intends or expects, but does not disclose, that the legal services necessary to handle the matter competently will be performed primarily by another lawyer who is not affiliated with the soliciting lawyer as a partner, associate or of counsel.
Rhode Island	A lawyer shall not by in-person, live telephone or real-time electronic contact solicit professional employment from a prospective client when a significant motive for the lawyer’s doing so is the lawyer’s pecuniary gain, unless the person contacted: (1) is a lawyer; (2) has a family, close personal, or prior professional relationship with the lawyer; or (3) is a business organization, a not-for-profit organization, or governmental body and the lawyer seeks to provide services related to the organization.

2011 Northeast Bankruptcy Conference

Bankruptcy in an Electronic Age

"The Dangers of Robowork"

John P. McVeigh
Preti Flaherty, LLP
Portland, Maine

We are all now familiar with the self-inflicted wounds of the residential mortgage industry, summarized by the rubric "Robosigning," in which large banks or investor groups have been prevented from foreclosing because the documents submitted to the courts have been produced by poorly paid foreclosure mills whose only instructions were to process cases as quickly and cheaply as possible, resulting in affidavits and documentation that were false, inaccurate, or asserted ownership of debts not in fact owned by the putative foreclosure plaintiff. The topic will have some resonance for the audience here from Maine, because a retired Maine lawyer, Tom Cox, in a pro bono case, pursued the matter relentlessly and exposed the whole sorry national scheme. Maine and other state legislatures eventually passed laws and rules forcing the banks and other lenders to show proof of actual ownership of a mortgage, proof of the actual debt claimed, certifications of default notices being sent, and the like.

The state courts also acted to rein in these practices. In Massachusetts, in United States Bank, N.A. v. Ibanez, 458 Mass. 637, 941 N.E.2d 40 (2011), the Supreme Judicial Court voided a foreclosure because, at the time of the foreclosure, the putative mortgage holder failed to demonstrate it held an actual assignment of the mortgage it had foreclosed on. (At least one Bankruptcy Court in Massachusetts has applied Ibanez similarly. See Schwartz v. Homeq Servicing (In re Schwartz), 2011 LEXIS 1228 (Bankr. D. Mass. April 7, 2011), to prevent relief from stay.) Earlier, Maine's Supreme Judicial Court, in Mortgage Electronic. Registration

System v. Saunders, 2010 ME 79; 2 A.3d 289 (the "MERS" decision), held that the effort of the national banks to by-pass the system of recording in county registries by using the Mortgage Electronic Registration System to track ownership of mortgages and represent the banks in foreclosures, would not be tolerated. The MERS decision flatly held that MERS itself could have no standing to prosecute a foreclosure, no matter whom MERS claimed to be representing as the actual owner of the mortgage at issue.

What, you may ask, does all of the above have to do with ethics? It turns out that the electronic age has created pitfalls not only for the banks, but for the lawyers representing them as well, and a series of bankruptcy cases anticipated these and similar issues, with bad consequences for the lawyers as well as for their clients. The fundamental lesson for all bankruptcy lawyers is that they take their clients' "electronic word" at the lawyers' peril.

In In re Taylor, 407 B.R. 618 (Bankr. E.D. Pa. 2009), in an opinion derived after extensive evidentiary hearings commenced sua sponte by the court, the Bankruptcy Judge excoriated several law firms engaged in what appears to have been robowork for lenders. The firms filed routine relief from stay motions based on the materials provided by an electronic registry service (needless to say, not accurate information) called "NewTrak", filed multiple proofs of claim for the lender on the mortgage debt that misstated ownership of the mortgage and misstated the debt, and the court attacked generally the practice of relying on "electronic" information provided through NewTrak, a MERS-like system, to which the lender subscribed.

The firms and the lawyers were all sanctioned under Rule 9011, for the failure of the lawyers to make reasonable investigations into their client's claims and, as a result, filing pleadings that turned out to be blatantly false on multiple fronts. In Taylor, the lawyers were engaged by and received all their directions only from persons employed by NewTrak, with

instructions from the lender at the start that NewTrak was to be the lawyers' only source of information. Further, in reality, because the sanctioned lawyers were operating a foreclosure and relief from stay mill, only paralegals at the firms actually got the information from NewTrak, and the paralegals then drafted the pleadings. The lawyers barely reviewed the pleadings, and would have had no way of finding out whether the information from NewTrak was or was not correct. (One of the more startling terms of their retention was that they were forbidden to speak to the lender itself. Only NewTrak could communicate with the lenders.) As a result, the attorneys for the lender couldn't even function in responding to a document request, because the bank had completely insulated itself and left everything about the cases to administration by the electronic information service.

I am sure that most in the audience are not foreclosure mill lawyers, and most have direct relationships with someone in authority with their clients. Before we file the Taylor lawyers away as aberrations, however, it might be humbling to ask a few questions of ourselves[1]:

Has anyone ever taken a short cut because a large institutional client has insisted that a legal act occur quickly and that results be achieved soon?

Has anyone ever taken on faith the information given by a client?

Has anyone ever relied on electronic records supposedly produced by one's client or by someone with apparent authority from the client to supply the records?

Has anyone ever had a client with repeat business whose claims could be reduced to a standard form of pleading that could be filled out by a paralegal?

Has anyone had a paralegal who could create pleadings that the lawyer felt were trustworthy?

[1] The discussion, however, is NOT intended to be a confessional, so these are questions to be asked, but we do not call on anyone to answer them as a personal matter.

Is it now to be the rule that, no matter what, every lawyer in every case must have in possession the actual signed note and security document, and the entire originals of the chain of assignments, and direct contact with the green eyeshades at the client to be sure the numbers are correct, and direct access to someone in real authority who has real knowledge of the facts, before the lawyer files any pleadings at all?

In Taylor, the sanctions were heavy hours in ethics courses and mandated in-house training for paralegals. The Taylor judge was far kinder than the judges in the next two cases.

In In re Ulmer, 363 B.R. 777 (Bankr. D.S.C. 2007), the bankruptcy court sanctioned a firm and an attorney $34,000 for submitting electronically signed affidavits that had not in fact been physically signed, submitting affidavits that were notarized, but not at the same time that the witness signed and thus the notarizations were invalid, and also, as in Taylor, failing to review pleadings that the lawyer signed and filed. Once again, this was a robosigning kind of case, by a firm with form pleadings and pressures on the lawyer to move things along as cheaply as possible. It's clear that the availablity of electronic filing by PACER lead the third-year associate involved down a slippery slope. It was just too easy to cheat. The firm itself, however, was fined for lack of oversight over the associate, who filed all the unreviewed pleadings and invalid affidavits.

Once again, let us ask ourselves some questions:

Has any one of us ever filed an affidavit on PACER when we did not in fact have the actual executed original in the file?

When we get that pdf affidavit from the client that we have to have for the emergency filing, are we certain that the notary saw the witness sign?

Have we always remembered to make sure the client follows up with the hard copy?

Has anyone ever relied on a third-year or more-year associate to handle a stack of apparently cookie-cutter cases?

A third case might be seen as a true outlier, in that the firm involved appears, through institutional pressure, to have seriously crossed the line. In In re Rivera, 342 B.R. 435 (Bankr. D.N.J. 2007), a firm was fined $125,000 for submitting "pre-signed" certifications of default, required under a Local Bankruptcy Rule 4001-1 to be filed in relief from stay motions. The problem was, the signer of the pre-filed certifications had not worked for the creditor for over a year when the certifications were submitted. This was, it turned out, standard practice for this firm. Once again, Rule 9011 was the basis for the sanction. The court held that the need for efficient use of electronic services can never trump the need for "dependable, ethical" performance from lawyers.

It's obvious how the firm got to the ethical place it did. Of course the debtor was in default; the debtor was in bankruptcy! Was the debtor there because the debtor was paying its bills? Why not have a bunch of default certifications signed in advance and just fill in the blanks when the time came? Just a bothersome, pointless detail created by a stupid local rule. It's not as if the certification was not true when the relief from stay motion was filed, even if the signer signed in advance. And of course, once again, the ease of electronic filing and the pressure to process multiple cases for an institutional client paved the road to hell. Can we have sympathy for this firm? Probably not, but we can still humble ourselves with some more questions:

Who has ever had to work with a large lender with multiple cases?

Who has ever bent a rule?

Who has ever decided that a filing, perhaps stretching it, is ok because "no harm, no foul."

Who has ever discovered after the fact that someone whose actions or statements pleadings were based on was no longer employed by their client?

The lesson from all these cases and cases like them is that shortcuts are not acceptable, and that the lawyer has actually to check out the information the lawyer is given. The lesson seems obvious, in the abstract. Just because you see it on your client's computer records (just like what you see on the internet), the information might not be true, and woe unto the lawyer who repeats it. The realities of modern bankruptcy practice, however, speeded up grotesquely by the wholesale conversion of our financial dealings and our litigation practices to electronic formats, puts all practitioners in danger of failing to meet the abstract rule.

Presented by: Thomas O. Bean and Joe Looby

Preservation and Production of ESI in Bankruptcy Cases: Reconciling Non-Bankruptcy Legal and Ethical Obligations with Estate Functionary Fiduciary Duties.

General Topics.

1. What are attorneys' obligations with respect to preservation and production of ESI? What are the potential ethical and legal consequences of failure to comply with those requirements?

2. Should (i) counsel to the estate and (ii) a trustee/management conduct a cost/benefit analysis with respect to preserving some or all of the estate's ESI at or about the commencement of a bankruptcy case?

3. Should the requirements for preservation and production be modified by Court order in a bankruptcy case in light of estate functionaries' fiduciary duties, the dollars at stake in the case, the parties resources, and/or the concept of proportionality? If so, how should they be modified, and when during the case?

ESI Principle

Counsel to a potential litigant and management have a duty to preserve ESI when they should have known that the evidence might be relevant to future litigation. Kronisch v. U.S., 150 F.3d 112, 126 (2d Cir. 1998) overruled on other grounds, Rotella v. Wood, 528 U.S. 549 (2000).

Q. Based on the above test, does the preservation duty automatically arise on Day 1 of a bankruptcy case for all estate ESI? Does it automatically arise with respect to claims counsel and management believes are disputed?

Bankruptcy Principles

Both the debtor and counsel to the debtor are fiduciaries to the estate.

Estate representatives have a duty to preserve assets of estate and must exercise the measure of care and diligence that ordinarily prudent person would exercise under similar circumstances.

Estate representatives' duty is to maximize the value of the estate, which is to say net assets.

Trustees are entitled to broad immunity from suit when acting within the scope of their authority and pursuant to court order, but they may be liable for intentional or negligent violations of duties imposed upon him by law. Bennett v. Williams, 892 F.2d 822 (9th Cir. 1989).

Q. What should bankruptcy counsel do at the outset of the non-mega case to preserve ESI while managing the costs of preservation of ESI?

Q. What should bankruptcy counsel do in reviewing ESI before production to avoid waiving a privilege while also managing the costs of review?

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re LEHMAN BROTHERS INC., Debtor.	Case No. 08-01420 (JMP) SIPA
LEHMAN BROTHERS INC., Plaintiff, -against- CITIBANK, N.A., CITIGROUP, INC., CITIGROUP GLOBAL MARKETS, INC., CITIBANK JAPAN LTD., CITIBANK EUROPE PLC, CITIBANK INTERNATIONAL PLC, CITIGROUP PTY LIMITED, BANCO DE CHILE, BANCO NACIONAL DE MEXICO SA, CITIBANK DEL PERU SA, BANK HANDLOWY, ZAO KB CITIBANK, CITIBANK AS, CITIBANK MAGHREB, and CITIBANK AFFILIATES 1-5, Defendants.	Adv. Proc. No. 11-01681 (JMP)

SCHEDULING ORDER AND DISCOVERY PLAN

Plaintiff Lehman Brothers Inc. ("LBI") having filed an adversary complaint against defendants Citibank, N.A. and its respective affiliates (collectively “Citibank” and, together with Plaintiffs, the “Parties”) on March 18, 2011 (the “Complaint”), and the Parties having reached agreement on the terms of this Scheduling Order and Discovery Plan, the Court hereby adopts the following schedule and discovery plan.

1. **Schedule for Pleading Motions and Responses**

a. Citibank shall respond to the Complaint on or before May 26, 2011.

b. If Citibank responds to all or part of the Complaint with a motion in lieu of an answer (a “Pleading Motion”), then Citibank’s time to answer any and all parts of

the Complaint shall be extended for a period ending on the date 30 calendar days after the Court's issuance of an order determining the Pleading Motion.

c. Plaintiff shall file its opposition to any Pleading Motion on or before August 5, 2011.

d. Citibank shall file its reply in further support of any Pleading Motion on or before September 2, 2011.

2. **Discovery Schedule:**

a. **Fact Discovery:**

i. The parties shall serve initial disclosures pursuant to Fed. R. Civ. P. (26)(1) on or before April 20, 2011.

ii. The parties may serve initial document requests with respect to the Complaint from May 4, 2011 through May 26, 2011, and supplemental document requests on or before June 15, 2011. The parties may serve document requests with respect to any additional parties, claims or counterclaims added without leave of Court until July 8, 2011.

iii. Document discovery shall be substantially completed on or before September 26, 2011, with documents produced on a rolling basis.

iv. Privilege logs shall be served within 30 days of the production from which the logged documents have been excluded, and the logging of privileged documents shall be substantially completed on or before October 26, 2011.

v. The parties have not reached agreement on the date on which depositions may begin.

vi. All fact discovery, including depositions, shall be completed on or before February 6, 2012.

vii. The parties are entitled to take third party discovery on the same schedule as party fact discovery.

b. **New Parties and Claims:**

i. Any party may assert additional claims or counterclaims or may seek to add additional parties without leave of the Court on or before May 26, 2011. The parties reserve their rights to move to dismiss any such additional claims, counterclaims, or parties. Within 20 days from the date of service of a pleading, including the Complaint, the party receiving the pleading shall notify the serving party in writing of any additional necessary parties not named in the pleading. If additional necessary parties are identified, the party shall amend its pleading to include any additional necessary parties within 45 days of receiving such notification.

ii. After May 26, 2011, any Party may apply to the Court in accordance with applicable Federal Rules of Bankruptcy Procedure, Federal Rules of Civil Procedure, and Local Rules to amend the pleadings or to add new claims or parties. The parties reserve their rights to move to dismiss any such additional claims or parties.

iii. Plaintiff shall respond to any counterclaims filed by Citibank not later than 60 calendar days following the date of filing of such counterclaims.

iv. Citibank shall file its opposition to any motion directed to any such counterclaims not later than 60 calendar days following the filing of such motion.

v. Plaintiff shall file its reply in further support of any motion directed to any counterclaims not later than 30 calendar days following Citibank's filing of its opposition to such motion.

c. **Expert Discovery:**

i. The Parties shall disclose the identities of any testifying expert

witnesses and serve any expert reports pursuant to Fed. R. Civ. P. 26(a)(2)(B) (made applicable to this matter pursuant to Fed. R. Bankr. P. 7026) on any issue(s) as to which that party bears the burden of proof no later than March 6, 2012.

ii. Any Party's expert report intended to rebut any other expert report shall be served no later than April 6, 2012.

iii. All expert depositions shall be completed on or before May 7, 2012.

d. **Dispositive Motions:**

i. Any dispositive motions shall be filed and served on or before June 6, 2012.

ii. Oppositions to any dispositive motions shall be filed on or before 60 days after a dispositive motion is filed.

iii. Reply briefs in further support of any dispositive motions shall be filed on or before 30 days after opposition is filed.

e. **Modification of Schedule:**

i. The fact and expert discovery schedule (including with respect to Requests for Admission) may be modified without leave of Court by agreement of the parties.

ii. The Parties, separately or by agreement, may apply to the Court for modification of any part of the schedule.

3. **Discovery:**

a. **Discovery Pursuant to the Rules:** All discovery in the above-captioned action shall proceed in accordance with applicable Federal Rules of Bankruptcy

Procedure, Federal Rules of Civil Procedure, and Local Rules, except as otherwise ordered by the Court or as specified herein.

b. **Depositions Without Leave:** The limit of 10 depositions per side without leave of Court imposed by Fed. R. Civ. P. **30**(a)**(2)(A)**(i) shall not apply to these proceedings. Each party shall be entitled to 20 depositions without leave of Court.

c. **Requests for Admission:** Requests for admissions shall be served on or before March 6, 2012. No response to any request for admission shall be required of any party until April 25, 2012, by which time responses to all requests for admission must be served.

d. **Document Production and E-Discovery:**

i. **Custodians and Search Terms:**

(1) **Search Filters.** The Parties shall meet and confer and agree on search filters to be employed in searching for and collecting responsive documents before any such search filters are used. Each party shall disclose the custodians whose files it has searched for responsive documents. The Parties shall meet and confer and make their best efforts to agree on search terms and custodians whose files shall be searched.

(2) **Electronic Searches.** Each Party shall search the e-mail files and other electronic documents of each of its designated custodians for all e-mails and other electronic documents satisfying the designated search filters. With regard to electronic documents other than emails, each Party shall search for responsive documents in (i) the files of the designated custodians that are reasonably accessible by the Party and (ii) the general shared files of departments, divisions or business units in which any designated custodian is a member that are reasonably believed to hold potentially responsive documents and are reasonably accessible by the Party, and which shall be identified by the Party.

(3) **Supplementation of Search Filters.** If a Party is or becomes aware that it has potentially responsive documents in its possession, custody or control which would not otherwise be produced and which (i) employ terms (such as synonyms, misspellings, idioms, code words or non-English terms) equivalent in meaning to keywords employed in the search filter, and (ii) would satisfy the filter if such equivalent terms were included in the search filter, it must promptly disclose that fact and meet and confer with opposing counsel to discuss appropriate means to identify, review and produce such responsive documents.

ii. Form of Production:

(1) **Emails.** E-mails shall be produced as single-page TIFF images with accompanying full text and load file (DAT). Metadata fields included with the load file should be provided in accordance with *Appendix A*. E-mail attachments shall be produced in the form provided for loose electronic documents as set forth in the subsection below and shall not be separated from the emails to which they are attached. Native files for all e-mails shall be maintained, and such files shall be produced if the receiving party can demonstrate a need for such native files.

(2) **Electronic Documents**. Word and other electronic documents shall be produced as single-page TIFF images with accompanying full text and load file (DAT). Metadata fields included with the load file should be provided in accordance with *Appendix A*. For Excel or other spreadsheet files, the native file shall be produced, along with a single-page TIFF placeholder. Native files for all other electronic documents shall be maintained, and such files shall be produced if the receiving party can demonstrate a need for such native files.

(3) **Hard copy documents**. Hard copy documents shall be produced as single-page TIFF images with accompanying full OCR text and load file (DAT). Metadata fields included with the load file should be provided in accordance with *Appendix A*.

(4) **TIFF Images Generally**. Any TIFF images produced by the Parties shall consist of (a) single-page, black and white, 300dpi group IV TIFF images with extension ".tif" and (b) text files, named after the bates number of the document, with extension ".txt". TIFF images may not be compressed using JPEG compression. Metadata shall be provided in a delimited file with a ".dat" file extension and the following delimiters: record delimiter (ASCII 10 followed by ASCII 13); field delimiter (ASCII 20); multi-value delimiter (ASCII 59); and text qualifier (ASCII 254). The first line shall be the header with field names, and each subsequent line shall contain the fielded data for each document.

(5) **Image Load/Cross Reference Files.** Along with its productions, each party shall provide either an lPRO (.lfp) or Opticon (.opt) single-page image load/cross reference file. Image filenames should contain the bates number information of the image.

(6) **Electronic data productions.** May be transmitted electronically via Secure File Transfer Protocol (SFTP), FTP over SSH or physically transported using electronic storage media such as flash memory devices, CDs, DVDs or hard drives. The physical media label should contain the case name and number, production date, and bates range being produced. Each party may encrypt any data produced using standard encryption software.

e. **Inadvertently-Produced Material:** In accordance with Fed. R. Civ. P.26(b)(5)(B) and Fed. R. Evid. 502(b), any inadvertent disclosure of document(s)

shall not be deemed a waiver of, nor prejudice to, any privilege or immunity with respect to such information or document(s) or of any work product doctrine or other immunity that may attach thereto, including without limitation the attorney-client privilege, the joint defense privilege, and the work product doctrine, provided that the producing party notifies the receiving party in writing promptly after discovery of such inadvertent production. All copies of such document(s) shall be returned to the producing party or destroyed within five days of such notice. Also within five days of such notice, the producing party shall serve a privilege log for the document(s). The producing party shall maintain the referenced documents) until the parties resolve any dispute concerning the privileged nature of the document) s) or the Court rules on any motion to compel the document(s). No Party shall use or refer to any information contained within the document(s) at issue unless and until the producing Party agrees or a motion to compel is granted by the Court.

f. **Confidentiality:** Each document produced shall include a confidentiality label designating it consistent with the terms of the confidentiality stipulation agreed upon by the parties.

g. **Cost of Production:** The parties shall bear the costs associated with their own productions.

Dated: March 30, 2011
New York, NY

JAMES W. GIDDENS, ESQ., AS TRUSTEE
FOR THE SIPA LIQUIDATION OF
THE BUSINESS OF LEHMAN BROTHERS INC.

By: /s/ Richard G. Menaker______
Richard G. Menaker
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Special Counsel to James W. Giddens, Esq.,

as Trustee for the SIPA liquidation of
the business of Lehman Brothers Inc.

CITIGROUP, INC., CITIBANK, N.A., and
CITIGROUP GLOBAL MARKETS INC.

By: /s/ Stephen J. Shimshak___
Stephen J. Shimshak
Douglas R. Davis
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Attorneys for Citigroup, Inc. Citibank, N.A. (including all of its branches), and Citigroup Global Markets Inc.

IT IS SO ORDERED:

Dated: New York, New York
April 14, 2011

s/ James M. Peck
Honorable James M. Peck
United States Bankruptcy Judge

Appendix A

The DAT file should have a header line with field names and include the following fields:

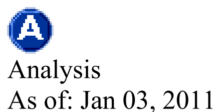
Field	Comments
Beginning Bates Number	Include prefix.
Ending Bates Number	Include prefix.
Beginning Bates Range	First page of family range, e.g., first page of an email.
Ending Bates Range	Last page of family range, e.g., last page of last attachment to an email.
Page Count	Number of pages in document.
File Extension	Loose files, attachments and email.
File Size	Loose files, attachments and email (in bytes).
Title	Loose files and attachments only.
Custodian	Loose files, attachments, and email. Custodian full name.
Author	Loose files and attachments only.
From	Email only.
To	Email only.
CC	Email only.
BCC	Email only.
Subject	Email only.
Date Created	Loose files and attachments only. MM/DD/YYYY
Date Modified	Loose files and attachments only. MM/DD/YYYY
Date Sent	Email only. MM/DD/YYYY
Time Sent	Email only. HH:MM:SS AM/PM
Date Received	Email only. MM/DD/YYYY
Time Received	Email only. HH:MM:SS AM/PM
FilePath	Loose files. Original path to the file at collection time.
FolderPath	Email only. Path within the mail container file (e.g., PST file) to the message at collection time.
TextPath	The path to the extracted text or OCR for the document, including the file name.
NativePath	The path to the native-format file for the document, including the file name (if a native-format file is provided).

Sample DAT file

þBeginning Bates Numberþ þEnding Bates Numberþ þBeginning Bates Rangeþ
þEnding Bates Rangeþ þPage Countþ þFile Extensionþ þFile Sizeþ þTitleþ þCustodianþ þAuthorþ þFrom
þ þToþ þCCþ þBCCþ þSubject þ þDate Createdþ þDate Modifiedþ þDate Sentþ þTime Sent
þ þDate Receivedþ þTime Receivedþ þFilePathþ þFolderPathþ þTextPathþ þNativePathþ

þMSC00000001þ þMSC00000001þ þMSC00000001þ þMSC00000002þ þ1þ þþ þ2354þ þJohn H. Smithþ þþ þþ
þJohn H. Smithþ þJane Doeþ þJane W. Schmidt; Mark Doeþ þþ þChecks Payableþ þþ þþ þ12/
25/2008þ þ9:30:01 Amþ þ12/25/2008þ þ9:30:11 Amþ þþ þ\Inbox\Payable\þ
þText\SAMPLE\0000\MSC00000001.txtþ þþ

þ þMSC00000002þ þMSC00000002þ þMSC00000001þ þMSC00000002þ þ1þ þxlsþ þ46444þ þAccounts
Receivableþ þJohn H. Smithþ þ John H. Smithþ þþ þþ þþ þþ þþ þ12/22/2008þ þ12/25/2008þ þþ þþ
þþ þþ þþ þþ þText\SAMPLE\0000\00000002.txtþ þNatives\SAMPLE\0000\MSC00000002.xlsþ



Analysis
As of: Jan 03, 2011

ORBIT ONE COMMUNICATIONS, INC., and DAVID RONSEN, Plaintiffs/Counterclaim Defendants, - against - NUMEREX CORP., Defendant/Counterclaim Plaintiff. NUMEREX CORP., Plaintiff/Counterclaim Defendant, - against - SCOTT ROSENZWEIG, GARY NADEN, and LAVA LAKE TECHNOLOGIES, LLC, Defendants/Counterclaim Plaintiffs. GARY NADEN, DAVID RONSEN, SCOTT ROSENZWEIG, ORBIT ONE COMMUNICATIONS, INC. and LAVA LAKE TECHNOLOGIES, LLC, Plaintiffs/Counterclaim Defendants - against - NUMEREX CORP., Defendant/Counterclaim Plaintiff.

08 Civ. 0905 (LAK) (JCF),08 Civ. 6233 (LAK) (JCF),08 Civ. 11195 (LAK) (JCF)

UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

2010 U.S. Dist. LEXIS 123633

October 26, 2010, Decided
October 26, 2010, Filed

PRIOR HISTORY: *Orbit One Communs. v. Numerex Corp., 692 F. Supp. 2d 373, 2010 U.S. Dist. LEXIS 36609 (S.D.N.Y., 2010)*

CORE TERMS: server, drive, destroyed, discovery, preservation, adverse inference, laptop, e-mail, spoliation, relevance, desktop, backup, disk, missing, destruction, electronic, spoliator, deleted, innocent party, harmful, preserved, network, relevant information, duty to preserve, removal, stored, destruction of evidence, bad faith, discovery-relevant, favorable

COUNSEL: [*1] For Orbit One Communications, Inc., David Ronsen, Plaintiffs, Counter Defendants: John D. McFerrin-Clancy, LEAD ATTORNEY, Lowenstein Sandler PC (NYC), New York, NY; R. Scott Thompson, LEAD ATTORNEY, Matthew M. Oliver, Lowenstein Sandler PC (NJ), Roseland, NJ; Khizar A. Sheikh, PRO HAC VICE, Lowenstein Sandler PC (NJ), Roseland, NJ; Matthew Richard Savare, Lowenstein Sandler PC, Roseland, NJ.

For Numerex Corp., Plaintiff: Kent A. Yalowitz, LEAD ATTORNEY, Emily A. Kim, Arnold & Porter, LLP, New York, NY.

For Numerex Corp., Defendant, Counter Claimant: Brandon Herbert Cowart, LEAD ATTORNEY, Pillsbury Winthrop Shaw Pittman, LLP (NY), New York, NY; Kent A. Yalowitz, LEAD ATTORNEY, Emily A. Kim, Arnold & Porter, LLP, New York, NY.

For Scott Rosenweig, Defendant, Counter Defendant: R. Scott Thompson, LEAD ATTORNEY, Matthew M. Oliver, Lowenstein Sandler PC (NJ), Roseland, NJ; John D. McFerrin-Clancy, Lowenstein Sandler PC (NYC), New York, NY.

For Gary Naden, Defendant, Counter Defendant: John D. McFerrin-Clancy, Lowenstein Sandler PC (NYC), New York, NY; Matthew M. Oliver, R. Scott Thompson, Lowenstein Sandler PC (NJ), Roseland, NJ.

JUDGES: JAMES C. FRANCIS IV, UNITED STATES MAGISTRATE JUDGE.

OPINION BY: JAMES C. FRANCIS IV [*2]

OPINION

MEMORANDUM AND ORDER

JAMES C. FRANCIS IV
UNITED STATES MAGISTRATE JUDGE

There is a pervasive risk that electronic information will be lost during the course of litigation, whether through inadvertence, intentional spoliation, or failure to institute and properly implement a litigation hold. Consequently, the law provides a range of sanctions and remedies that may be imposed when the destruction of evidence occurs. No matter how inadequate a party's efforts at preservation may be, however, sanctions are not warranted unless there is proof that some information of significance has actually been lost.

In these related cases, Numerex Corporation ("Numerex") contends that the jury should be instructed that it may draw an adverse inference against Orbit One Communications, Inc. ("Orbit One") and David Ronsen on the ground that these parties are responsible for the spoliation of electronically stored information. Numerex further seeks an award of attorneys' fees and costs incurred in connection with this motion. Because Numerex has been unable to demonstrate that relevant information has in fact been destroyed, its motion is denied.

Background[1]

1 The factual background is set forth in detail in [*3] three prior opinions: *Orbit One Communications, Inc. v. Numerex Corp., No. 08 Civ. 905, 2008 U.S. Dist. LEXIS 61548, 2008 WL 3361376 (S.D.N.Y. Aug. 12, 2008)* ("Orbit One I"); *Orbit One Communications, Inc. v. Numerex Corp., 255 F.R.D. 98 (S.D.N.Y. 2008)* ("Orbit One II"); and *Orbit One Communications, Inc. v. Numerex Corp., 692 F. Supp. 2d 373 (S.D.N.Y. 2010)* ("Orbit One III").

A. Origins of the Litigation

In 2000, David Ronsen established Orbit One, a corporation dedicated to selling satellite communications services and manufacturing tracking devices that rely on satellite technology. *Orbit One III, 692 F. Supp. 2d at 375-76*. The business operated out of a facility in Bozeman, Montana. *Id. at 375*. Although Mr. Ronsen was initially the sole shareholder, two other company executives, Scott Rosenzweig and Gary Naden, later became equity owners, though Mr. Ronsen retained eighty-four percent of the stock. *Id. at 376*. Prior to joining Orbit One, Mr. Naden had been an engineer at Axonn, the communications company that supplied Orbit One's satellite transmitters. Id.

Beginning in 2006, Numerex, a satellite communications company, began negotiations to acquire Orbit One. Id. These discussions culminated with the execution [*4] of an asset purchase agreement on July 31, 2007. (Asset Purchase Agreement dated July 31, 2007 (the "APA"), attached as Exh. 1 to Declaration of Dorothy N. Giobbe dated April 17, 2009). Pursuant to the APA, Numerex, through a specially created subsidiary, acquired substantially all of Orbit One's assets in return for approximately 5.5 million dollars. *Orbit One II, 255 F.R.D. at 101*. In addition, Numerex agreed to provide Orbit One with "earn out" payments if the new division of Numerex that had been Orbit One met a series of revenue and earnings targets for 2007 through 2009. *Id. at 101-02*. Based on the success of the new division, these payments could amount to up to 4.5 million dollars in cash and 2.5 million shares of Numerex stock. *Id. at 102*.

At the same time that the parties executed the APA, Numerex and the principals of Orbit One entered into employment agreements pursuant to which Mr. Ronsen would continue as President of the new division, with Mr. Rosenzweig as Vice President of Business Development and Mr. Naden as Chief Technology Officer. *Orbit One III, 692 F. Supp. 2d at 376*. The agreements contained non-competition covenants that varied in duration depending upon whether [*5] the executives departed from their employment for "good reason" or "other than good reason." *Id. at 376-77*. In addition, Mr. Ronsen's employment agreement provided that he could be terminated for cause, which included failure to meet the performance targets set forth in the APA. *Orbit One II, 255 F.R.D. at 102*. On the other hand, if he were terminated without cause or if he resigned "for good reason," he would be entitled to the full earn out. Id.

During the fall of 2007, Orbit One's sales were poor, and its revenues were not meeting projections. Id. On January 7, 2008, Orbit One and Mr. Ronsen filed an action in New York State Supreme Court, New York County, alleging that Numerex had interfered with Mr. Ronsen's ability to receive compensation from the earn out by impeding his management of Orbit One. Numerex removed the case to this Court and asserted counterclaims. [2] In April 2008, Mr. Ronsen resigned from Numerex, and Mr. Naden and Mr. Rosenzweig departed in June 2008. Numerex then sued Mr. Naden and Mr. Rosenzweig in this Court, asserting, among other things, that they had stolen proprietary information from Numerex upon their resignation. [3] The defendants filed counterclaims, [*6] alleging that Numerex had violated

the APA as well as their employment agreements. Finally, in July 2008, Mr. Ronsen, Mr. Naden, and Mr. Rosenzweig filed an action in the United States District Court for the District of Montana contending that their covenants not to compete were overbroad and therefore unenforceable. That action was transferred to this Court on Numerex's motion, and Numerex filed counterclaims. [4]

2 This is the case designated 08 Civ. 905 (LAK) (JCF).

3 This case was filed as 08 Civ. 6233 (LAK) (JCF).

4 Following transfer, this case was designated 08 Civ. 11195 (LAK) (JCF).

B. Information Management

Prior to the sale of Orbit One's assets to Numerex, Mr. Ronsen utilized a laptop computer and a desktop computer in his office at Orbit One's facility in Bozeman. (Tr. at 3-4, 104). [5] The desktop was initially purchased on behalf of another of Mr. Ronsen's companies, Bridger Fire, Inc. (Tr. at 9; Deposition of David Ronsen ("Ronsen Dep."), attached as Exh. A to Declaration of Emily A. Kim dated March 8, 2010 ("Kim Decl.") at 413, 426). [6] Both the Orbit One laptop (when it was in the office) and the desktop were linked to Orbit One's network of servers. (Tr. at 4, 104). This network [*7] included an exchange server for e-mail, a shared server where electronic documents resided (the "U-drive"), and a portion of a server that could be accessed by anyone at the facility (the "O-drive"). (Tr. at 4-5, 104-05; Declaration of David A. Ronsen dated Oct. 3, 2008 ("Ronsen Decl."), attached as Exh. D to Kim Decl., ¶¶ 8-9).

5 "Tr." refers to the transcript of an evidentiary hearing held in connection with the instant motion on July 28, 2010.

6 He also possessed a laptop that had been issued to him by the Federal Emergency Management Agency, which he used in connection with Orbit One business as well. (Tr. at 5).

Mr. Ronsen's laptop and desktop were both synchronized with the shared drive on the server. (Tr. at 105). Consequently, whenever he logged on or off, anything he had saved to a folder on the shared drive (including his "My Docs" folder) would automatically be saved on the server as well. [7] (Tr. at 105). There was no backup for local hard drives. (Tr. at 106). The servers were backed up to disks on a daily basis, and the disks were preserved for a two-week period before being rotated and written over. (Tr. at 106). In addition, two additional disks were used for monthly and [*8] yearly backups. (Tr. at 106).

7 Documents saved only to a local folder, on the C-drive of his laptop, for example, would not be synchronized with the server. (Tr. at 106).

In August 2007, shortly after its acquisition by Numerex but before Numerex physically took over the Bozeman facility, Orbit One received a communication from Axonn, Mr. Naden's former employer, threatening litigation, apparently because Axonn believed that Orbit One had misappropriated certain intellectual property. (Tr. at 13-14). Axonn's letter demanded that Orbit One preserve all documents, including electronic information, relevant to the issues that Axonn had raised. (Tr. at 14). Mr. Ronsen consulted with an attorney, Antoinette M. Tease, regarding Axonn's letter. (Tr. at 14). Ms. Tease, in turn, orally advised Mr. Ronsen on August 27 to retain relevant information, and she subsequently issued a litigation hold in the form of an e-mail addressed to Mr. Ronsen and copied to Mr. Naden and Mr. Rosenzweig. (Tr. at 14-15; Exh. U-7). [8] The e-mail, dated September 17, 2007, directed Orbit One to "take all steps necessary to preserve all hard copy and electronic files, including, but not limited to, emails" relating to [*9] Axonn's concerns. (Exh. U-7). It further stated:

> If possible, it would be advisable to back up all electronic files (including emails) using an external hard drive or some other method so that those files are preserved in the event of litigation. Please forward this email to anyone else in your company who may be in possession of relevant files, and please let me know if you have any questions.

(Exh. U-7).

8 This document was introduced at the evidentiary hearing on July 28, 2010, and referred to by its exhibit number in the pretrial order. It bears bates number ORBIT00022830.

Beginning in August 2007, Christopher Dingman, Orbit One's information technology administrator, began requesting Orbit One executives, and particularly Mr. Ronsen, to remove data from the servers. (Tr. at 18-22, 101, 112-13; Ronsen Decl., ¶ 18). The purpose of this initiative was to increase available storage space and improve computer performance. (Tr. at 18, 20, 113; Ronsen Decl., ¶ 18). According to Mr. Ronsen, Mr. Dingman asked for the removal of "personal information or older information that wasn't needed on a day-to-day basis." (Tr. at 18). Mr. Dingman did not specifically direct the deletion of business-related [*10] information. (Tr. at 22, 113). He did, however, ask Mr. Ronsen to remove

and archive e-mail dated prior to 2007. (E-mail from Chris Dingman to David Ronsen dated Oct. 17, 2007, attached as Exh. 1 to Ronsen Decl.). At the time Mr. Dingman requested that data be removed from the servers, Mr. Ronsen did not advise him of the litigation hold that Ms. Tease had imposed. (Tr. at 22, 113-14).

During the first week of December 2007, Mr. Ronsen, with Mr. Dingman's assistance, archived over six gigabytes of data. (Tr. at 22-23, 27, 33, 75, 114; Ronsen Decl., ¶¶ 22, 27, 29). According to Mr. Ronsen, "over eighty percent (80%) of that information was very old, personal, and not related in any way to Numerex, the APA, or Orbit's business or operations." (Ronsen Decl., ¶ 29). Furthermore, "[o]f the remaining files, the vast majority were files created before August 1, 2007 (i.e., prior to the closing of the APA), and some of the files were pre-acquisition, confidential, and privileged communications between Orbit and its counsel relating to the drafting and negotiation of the APA." (Ronsen Decl., ¶ 30). Mr. Ronsen stored the archived files on an external hard drive that he had obtained for that purpose. [*11] (Tr. at 23; Ronsen Decl., ¶ 21). He then deleted from the server personal items, such as music files. (Tr. at 22-24). He also deleted at least some of the business e-mails that predated the acquisition by Numerex; however, he insists that he simply copied many of these e-mails, such that they remained on the server. (Tr. at 23-27). In response to a request by Numerex's counsel for the archived documents, Mr. Ronsen eventually gave the external hard drive to his attorneys. (Tr. at 71; Ronsen Decl., ¶ 32).

Meanwhile, Mr. Dingman had also requested that Mr. Ronsen remove his personal desktop computer from the network and use only the laptop. (Tr. at 108). This change was intended to bring the company into compliance with a computer security protocol known as ISO 27001 and also to improve performance. (Tr. at 108). In October 2007, Mr. Dingman assisted Mr. Ronsen with the transition by instructing him how to save any files that he wanted to retain. (Tr. at 108-10). Mr. Ronsen did not inform him of the Axonn litigation hold. (Tr. at 109). Nevertheless, because the desktop and the laptop were synchronized with each other through the network, the folders that resided on the desktop remained [*12] on the laptop and the server when the desktop was removed. (Tr. at 68-70). According to Mr. Dingman, the desktop computer was then moved to a storage area next to his work space. (Tr. at 110). Mr. Ronsen, however, states that he removed the computer directly from his office to the garage at his home. (Tr. at 29-30). Later, sometime after he left Numerex, Mr. Ronsen gave that computer along with two others he owned to a technician to cannibalize the best components and build one computer. (Tr. at 60-61). The reconstituted computer did not contain the hard drive from the desktop. (Tr. at 61). However, when the preservation of information became an issue in this case, Mr. Ronsen contacted his technician, recovered the hard drive, and turned it over to his counsel. (Tr. at 61-62).

On November 28, 2007, Mr. Ronsen had set up a meeting with attorneys at Lowenstein Sandler PC to discuss his legal options in light of his view that Numerex was violating the APA by impeding his ability to do his job. (Email from David Ronsen to Anthony O. Pergola dated Nov. 28, 2007, attached as Exh. B to Kim Decl.). That meeting took place on December 6, 2010; at that time, Mr. Ronsen did not tell his counsel [*13] about the steps he had taken a few days before to remove data from Orbit One's servers. (Tr. at 27). On December 19, 2007, Mr. Ronsen's attorneys sent a letter to Stratton Nicolaides, the Chief Executive Officer of Numerex, threatening litigation in the event that Numerex did not resolve the issues raised by Mr. Ronsen (Tr. at 35; Letter of John McFerrin Clancy dated Dec. 19, 2007, attached as Exh. H to Kim Decl.), and on January 7, 2008, the plaintiffs made good on this threat and filed the first of the related actions. On January 28, 2008, counsel for Numerex sent plaintiffs' counsel a comprehensive preservation letter, demanding that the plaintiffs implement a litigation hold. (Letter of Kent A. Yalowitz dated Jan. 25, 2007, [9] attached as Exh. I to Kim Decl.). In response, Mr. Dingman took several then-current backup disks out of rotation and stored them in what he considered the safest location in the Bozeman facitlity: the safe in Mr Ronsen's office. (Tr. at 1006-08, 115). Mr. Ronsen subsequently took the disks home. (Tr. at 115).

9 This date is obviously a typographical error, as is confirmed by the fact that the header of the second page of the letter contains the correct date, [*14] January 25, 2008.

Mr. Ronsen remained employed by Numerex even after he filed suit. However, by late March or early April of 2008, he was contemplating resigning. (Tr. at 45-46; Ronsen Dep. at 417). At about the same time, he reported to Mr. Dingman that he was experiencing difficulties with his laptop computer. (Tr. at 44-45, 116; Ronsen Dep. at 416). When Mr. Dingman conducted an analysis and discovered "bad sector" errors, Mr. Ronsen asked him to replace the hard drive, and Mr. Dingman complied. (Tr. at 49, 116; Ronsen Dep. at 417). According to Mr. Dingman, he loaded operating system programs onto the new hard drive and synched the laptop to the shared drive so that the laptop acquired Mr. Ronsen's files. (Tr. at 117). At that time, Mr. Ronsen did not tell Mr. Dingman that he was on the verge of leaving Numerex. (Tr. at 117; Ronsen Dep. at 417).

As part of this litigation, a forensic expert, Robert Bolstad of Daylight Forensic and Advisory, LLC, conducted an analysis of information obtained from Orbit One, and specifically of the laptop and its new hard drive. (Tr. at 83, 87). The data was collected in September 2008 and analyzed in November 2008. (Tr. at 93). Mr. Bolstad first observed [*15] that although the laptop contained Mr. Ronsen's e-mail file, there were few if any user-created word processing documents. (Tr. at 87-88). Second, Mr. Bolstad compared the backup disk for January 3, 2008 with e-mail contained on the laptop, on the shared drive, and on the exchange server. (Tr. at 90). He determined that there were some 2,089 unique items on the backup disk that did not exist on any of the active files. (Tr. at 91, 93).

Following his resignation in April 2008, Mr. Ronsen asked Mr. Dingman to fix a forwarding protocol that Mr. Ronsen had previously established that forwarded e-mail that he received at Numerex to his personal Yahoo account. (Tr. at 64-65, 118). Mr. Ronsen told Mr. Dingman that he wanted to stay current with events at Numerex because he had only resigned to prove a point and expected to return. (Tr. at 119). Approximately 200 e-mails were forwarded to the Yahoo account, which Mr. Ronsen deleted because they were "useless" to him. (Tr. at 64-65; Ronsen Dep. at 429-34). Sometime shortly thereafter, Mr. Dingman deleted the forwarding rule. (Tr. at 125). A few days after his resignation from Numerex, Mr. Ronsen also returned the backup disks that Mr. Dingman [*16] had taken out of rotation in January 2008. (Declaration of Stephen Black dated Oct. 10, 2008, attached as Exh. C to Kim Decl., ¶ 4).

Discussion

A. The Law of Sanctions

Spoliation is "'the destruction or significant alteration of evidence, or the failure to preserve property for another's use as evidence in pending or reasonably foreseeable litigation.'" *Byrnie v. Town of Cromwell, Board of Education, 243 F.3d 93, 107 (2d Cir. 2001)* (quoting *West v. Goodyear Tire & Rubber Co., 167 F.3d 776, 779 (2d Cir. 1999))*; accord *Pension Committee of the University of Montreal Pension Plan v. Banc of America Securities, LLC, 685 F. Supp. 2d 456, 465 (S.D.N.Y. 2010)*; *Richard Green (Fine Paintings) v. McClendon, 262 F.R.D. 284, 288 (S.D.N.Y. 2009)*. Where a party's spoliation violates a court order, *Rule 37(b) of the Federal Rules of Civil Procedure* empowers the court to impose various sanctions, including dismissing the complaint or entering judgment by default, precluding the introduction of certain evidence, imposing an adverse inference, or assessing attorneys' fees and costs. *Fed. R. Civ. P. 37(b)*; see *Residential Funding Corp. v. DeGeorge Financial Corp., 306 F.3d 99, 106-07 (2d Cir. 2002)*; *Richard Green (Fine Paintings), 262 F.R.D. at 288*; [*17] *Metropolitan Opera Association, Inc. v. Local 100, Hotel Employees and Restaurant Employees International Union, 212 F.R.D. 178, 219 (S.D.N.Y. 2003)*. "'The determination of an appropriate sanction for spoliation, if any, is confined to the sound discretion of the trial judge, and is assessed on a case-by-case basis.'" *Zubulake v. UBS Warburg LLC, 229 F.R.D. 422, 430 (S.D.N.Y. 2004)* ("Zubulake V") (quoting *Fujitsu Ltd. v. Federal Express Corp., 247 F.3d 423, 436 (2d Cir. 2001))*; see *Harkabi v. SanDisk Corp., No. 08 Civ. 8203, 2010 U.S. Dist. LEXIS 87483, 2010 WL 3377338, at *8 (S.D.N.Y. Aug. 23, 2010)*.

A party may be sanctioned for violating a preservation order directly; but it may also be liable for sanctions under *Rule 37(b)* if it fails to produce information when ordered to do so because it has destroyed the evidence. See *Residential Funding, 306 F.3d at 106-07*; *Richard Green (Fine Paintings), 262 F.R.D. at 288*. Sanctions are appropriate even where a party's spoliation occurred before the issuance of the discovery order -- thus rendering compliance impossible -- because the inability to comply with the order was "self-inflicted." *Turner v. Hudson Transit Lines, Inc., 142 F.R.D. 68, 72 (S.D.N.Y. 1991)*; accord *Pipes v. United Parcel Service, Inc., Civ. A. No. 07-1762, 2009 U.S. Dist. LEXIS 62942, 2009 WL 2214990, at *1 n.3 (W.D. La. July 22, 2009)*; [*18] *In re NTL Securities Litigation, 244 F.R.D. 179, 192 (S.D.N.Y. 2007)*, aff'd, *Gordon Partners v. Blumenthal, No. 02 Civ. 7377, 2007 U.S. Dist. LEXIS 35895, 2007 WL 1518632 (S.D.N.Y. May 17, 2007)*. Furthermore, a court may impose discovery sanctions even absent an order pursuant to "its inherent power to manage its own affairs." *Residential Funding, 306 F.3d at 106-07*; accord *Richard Green (Fine Paintings), 262 F.R.D. at 288*; *NTL, 244 F.R.D. at 191*; *Metropolitan Opera, 212 F.R.D. at 220*.

Where, as here, a party seeks an adverse inference instruction based on the spoliation of evidence, it must establish:

> (1) that the party having control over the evidence had an obligation to preserve it at the time it was destroyed; (2) that the records were destroyed "with a culpable state of mind"; and (3) that the destroyed evidence was "relevant" to the party's claim or defense such that a reasonable trier of fact could find that it would support that claim or defense.

Residential Funding, 306 F.3d at 107; accord *ACORN (New York Association of Community Organizations for*

*Reform Now) v. County of Nassau, No. 05 CV 2301, 2009 U.S. Dist. LEXIS 19459, 2009 WL 605859, at *2 (E.D.N.Y. March 9, 2009)*; *Richard Green (Fine Paintings), 262 F.R.D. at 289*; *Treppel v. Biovail Corp., 249 F.R.D. 111, 120 (S.D.N.Y. 2008)*; [*19] *Zubulake V, 229 F.R.D. at 430*. I will address each of these factors in turn.

1. The Preservation Obligation

One court has observed that "[i]dentifying the boundaries of the duty to preserve involves two related inquiries: when does the duty to preserve attach, and what evidence must be preserved?" *Zubulake v. UBS Warburg LLC, 220 F.R.D. 212, 216 (S.D.N.Y. 2003)* ("Zubulake IV"). There are also two additional questions pertinent to satisfying preservation requirements: how must a party go about fulfilling its ultimate obligation, and who is responsible for seeing that it is fulfilled?

a. When

With respect to the first inquiry, the

> obligation to preserve evidence arises when the party has notice that the evidence is relevant to litigation -- most commonly when suit has already been filed, providing the party responsible for the destruction with express notice, but also on occasion in other circumstances, as for example when a party should have known that the evidence may be relevant to future litigation.

Kronisch v. United States, 150 F.3d 112, 126 (2d Cir. 1998), overruled on other grounds, *Rotella v. Wood, 528 U.S. 549, 120 S. Ct. 1075, 145 L. Ed. 2d 1047 (2000)*; see *Fujitsu Ltd. v. Federal Express Corp., 247 F.3d 423, 436 (2d Cir. 2001)*. [*20] Thus, the preservation requirement arises when a party "reasonably anticipates litigation." *Pension Committee, 685 F. Supp. 2d at 466*; *Treppel, 249 F.R.D. at 118*; *Zubulake IV, 220 F.R.D. at 218*.

b. What

Although some cases have suggested that the definition of what must be preserved should be guided by principles of "reasonableness and proportionality," *Victor Stanley, Inc. v. Creative Pipe, Inc., 269 F.R.D. 497, 2010 WL 3703696, at *24 (D. Md. 2010)*; see *Rimkus Consulting Group, Inc. v. Cammarata, 688 F. Supp. 2d 598, 613 (S.D. Tex. 2010)*, this standard may prove too amorphous to provide much comfort to a party deciding what files it may delete or backup tapes it may recycle. [10] Until a more precise definition is created by rule, a party is well-advised to "retain all relevant documents (but not multiple identical copies) in existence at the time the duty to preserve attaches." [11] *Zubulake IV, 220 F.R.D. at 218*. In this respect, "relevance" means relevance for purposes of discovery, which is "an extremely broad concept." *Condit v. Dunne, 225 F.R.D. 100, 105 (S.D.N.Y. 2004)*; see *Oppenheimer Fund, Inc. v. Sanders, 437 U.S. 340, 351, 98 S. Ct. 2380, 57 L. Ed. 2d 253 (1978)*; *Convolve, Inc. v. Compaq Computer Corp., 223 F.R.D. 162, 167 (S.D.N.Y. 2004)*; [*21] *Melendez v. Greiner, No. 01 Civ. 7888, 2003 U.S. Dist. LEXIS 19084, 2003 WL 22434101, at *1 (S.D.N.Y. Oct. 23, 2003)*. "Relevant information need not be admissible at the trial if the discovery appears reasonably calculated to lead to the discovery of admissible evidence." *Fed. R. Civ. P. 26(b)(1)*.

> 10 Reasonableness and proportionality are surely good guiding principles for a court that is considering imposing a preservation order or evaluating the sufficiency of a party's efforts at preservation after the fact. Because these concepts are highly elastic, however, they cannot be assumed to create a safe harbor for a party that is obligated to preserve evidence but is not operating under a court-imposed preservation order. Proportionality is particularly tricky in the context of preservation. It seems unlikely, for example, that a court would excuse the destruction of evidence merely because the monetary value of anticipated litigation was low.
>
> 11 It may not always be obvious, however, what constitutes an "identical" copy. For example, there may be multiple copies of an e-mail, all containing the same text. However, it may be important in the litigation to identify who actually received the communication. Therefore, [*22] it would be necessary to preserve, if not all copies of the document, at least the data (or, more precisely, the metadata) identifying the recipients.

c. How

To meet its obligations, the litigant "must suspend its routine document retention/destruction policy and put in place a 'litigation hold' to ensure the preservation of relevant documents." *Zubulake V, 229 F.R.D. at 431*; accord *NTL, 244 F.R.D. at 194*. This step, however, is only the beginning of a party's discovery obligations. *Zubulake V, 229 F.R.D. at 432*. "Once a 'litigation hold' is in place, a party and [its] counsel must make certain that all sources of potentially relevant information are identified and placed 'on hold' . . . ." Id. Then, "[c]ounsel must take affirmative steps to monitor compliance so that all sources of discoverable information are identified and searched." Id. Thereafter, the duty to preserve discoverable information persists throughout the discovery proc-

ess; a litigant must ensure that all potentially relevant evidence is retained. *Id. at 432-33*; see also *Fed. R. Civ. P. 26(e)*; *R.F.M.A.S., Inc. v. So, No. 06 Civ. 13114, 2010 U.S. Dist. LEXIS 83247, 2010 WL 3322639, at *6 (S.D.N.Y. Aug. 11, 2010)*; *Richard Green (Fine Paintings), 262 F.R.D. at 289*.

There [*23] is something of a split of authority with respect to whether permitting the downgrading of data -- for example, deleting information from active files but preserving backup media containing the same data -- constitutes spoliation. In *Treppel v. Biovail Corp., 233 F.R.D. 363, 372 n.4 (S.D.N.Y. 2006)*, I found that "permitting the downgrading of data to a less accessible form ? which systematically hinders future discovery by making the recovery of the information more costly and burdensome -- is a violation of the preservation obligation." Accord *Scalera v. Electrograph Systems, Inc., 262 F.R.D. 162, 175 (E.D.N.Y. 2009)*. By contrast, in *Quinby v. WestLB AG, No. 04 Civ. 7406, 2005 U.S. Dist. LEXIS 35583, 2005 WL 3453908, at *8 n.10 (S.D.N.Y. Dec. 15, 2005)*, the court "decline[d] to sanction defendant for converting data from an accessible to inaccessible format, even if they should have anticipated litigation." This disagreement, however, seems to be more semantic than real. Even those courts that do not denominate downgrading as a violation of the preservation obligation appear prepared to remedy any prejudice that it causes. Indeed, in a subsequent decision in Quinby, the court refused to shift discovery costs in [*24] favor of the party that had allowed the downgrading, reasoning that:

> if a party creates its own burden or expense by converting into an inaccessible format data that it should have reasonably foreseen would be discoverable material at a time when it should have anticipated litigation, then it should not be entitled to shift the costs of restoring and searching the data.

245 F.R.D. 94, 104 (S.D.N.Y. 2006).

d. Who

"'The preservation obligation runs first to counsel, who has a duty to advise his client of the type of information potentially relevant to the lawsuit and of the necessity of preventing its destruction.'" *NTL, 244 F.R.D. at 197-98* (quoting *Heng Chan v. Triple 8 Palace, Inc., No. 03 Civ. 6048, 2005 U.S. Dist. LEXIS 16520, 2005 WL 1925579, at *6 (S.D.N.Y. Aug. 11, 2005)* (internal quotation mark omitted)); see also *Zubulake V, 229 F.R.D. at 433 n.80*; *Fayemi v. Hambrecht and Quist, Inc., 174 F.R.D. 319, 326 (S.D.N.Y. 1997)*. Moreover, this responsibility is "heightened in this age of electronic discovery." *Qualcomm Inc. v. Broadcom Corp., No. 05 Civ. 1958-B, 2008 U.S. Dist. LEXIS 911, 2008 WL 66932, at *9 (S.D. Cal. Jan. 7, 2008)*, vacated in part on other grounds, *2008 U.S. Dist. LEXIS 16897, 2008 WL 638108 (S.D. Cal. March 5, 2008)*. Indeed,

> for the current "good faith" [*25] discovery system to function in the electronic age, attorneys and clients must work together to ensure that both understand how and where electronic documents, records and emails are maintained and to determine how best to locate, review, and produce responsive documents. Attorneys must take responsibility for ensuring that their clients conduct a comprehensive and appropriate document search.

Id.; see also *Phoenix Four, Inc. v. Strategic Resources Corp., No. 05 Civ. 4837, 2006 U.S. Dist. LEXIS 32211, 2006 WL 1409413, at *5-6 (S.D.N.Y. May 23, 2006)* (emphasizing counsels' affirmative duty to search for sources of electronic information); *Zubulake V, 229 F.R.D. at 433* (noting that "active supervision of counsel" is of particular importance when electronically-stored information is involved). Where the client is a business, its managers, in turn, are responsible for conveying to their employees the requirements for preserving evidence. See *id. at 433* & n.80; *Turner, 142 F.R.D. at 73*.

2. Culpability

In this circuit, a "culpable state of mind" for purposes of a spoliation inference includes ordinary negligence. *Residential Funding, 306 F.3d at 108*. This standard protects the innocent litigant from the destruction of [*26] evidence by a spoliator who would otherwise assert an "empty head, pure heart" defense:

> "[The] sanction [of an adverse inference] should be available even for the negligent destruction of documents if that is necessary to further the remedial purpose of the inference. It makes little difference to the party victimized by the destruction of evidence whether that act was done willfully or negligently. The adverse inference provides the necessary mechanism for restoring the evidentiary balance. The inference is adverse to the destroyer not because of any finding of moral culpability, but because the risk that the evi-

> dence would have been detrimental rather than favorable should fall on the party responsible for its loss."

Id. (quoting *Turner, 142 F.R.D. at 75*); accord *Harkabi, 2010 U.S. Dist. LEXIS 87483, 2010 WL 3377338, at *4*; *Pension Committee, 685 F. Supp. 2d at 464*. It is cold comfort to a party whose potentially critical evidence has just been destroyed to be told that the spoliator did not act in bad faith. [12]

12 The rationale of the adverse inference in this context is sometimes misconstrued. For example, in *Victor Stanley, 2010 U.S. Dist. LEXIS 93644, 2010 WL 3703696, at *27*, the court stated that:

> an adverse inference instruction makes [*27] little logical sense if given as a sanction for negligent breach of the duty to preserve, because the inference that a party failed to preserve evidence because it believed that the evidence was harmful to its case does not flow from mere negligence -- particularly if the destruction was of ESI and was caused by the automatic delete function of a program that the party negligently failed to disable once the duty to preserve was triggered. The more logical inference is that the party was disorganized, or distracted, or technically challenged, or overextended, not that it failed to preserve evidence because of an awareness that it was harmful.

But an adverse inference need not require the finder of fact to impute any particular state of mind to the spoliator. An adverse inference is imposed to ameliorate any prejudice to the innocent party by filling the evidentiary gap created by the party that destroyed evidence. The logical link suggested by *Victor Stanley* -- that the spoliator destroyed evidence because it was harmful to his case -- is simply unnecessary. Of course, that link is present in cases where there is proof of the deliberate destruction of evidence. But where there is not, an [*28] adverse inference may nevertheless be critical to assisting the innocent party in establishing the nature of the evidence that has gone missing.

3. Assistive Relevance

Sanctions are not warranted merely because information is lost; the evidence must be shown to have been "relevant." As the Second Circuit has explained in connection with an application for an adverse inference,

> "[R]elevant" in this context means something more than sufficiently probative to satisfy *Rule 401 of the Federal Rules of Evidence.* Rather, the party seeking an adverse inference must adduce sufficient evidence from which a reasonable trier of fact could infer that the destroyed or unavailable evidence would have been of the nature alleged by the party affected by its destruction.

Residential Funding, 306 F.3d at 108-09 (quotation marks, citations, and alterations omitted); see also *Zubulake V, 229 F.R.D. at 431* ("[T]he concept of 'relevance' encompasses not only the ordinary meaning of the term, but also that the destroyed evidence would have been favorable to the movant.").

When evidence is destroyed in bad faith, that fact alone is sufficient to support an inference that the missing evidence would have been favorable [*29] to the party seeking sanctions: that it would have been of assistive relevance. *Residential Funding, 306 F.3d at 109*. Indeed, under certain circumstances "a showing of gross negligence in the destruction or untimely production of evidence" will support the same inference. Id. (citing *Reilly v. NatWest Markets Group, Inc., 181 F.3d 253, 267-68 (2d Cir. 1999))*. The conduct, however, must be egregious. See *Toussie v. County of Suffolk, No. 01 CV 6716, 2007 U.S. Dist. LEXIS 93988, 2007 WL 4565160, at *8 (E.D.N.Y. Dec. 21, 2007)* (declining to award adverse inference even though defendant failed to implement litigation hold and delayed litigation through "foot dragging"); cf. *Cine Forty-Second Street Theatre Corp. v. Allied Artists Pictures Corp., 602 F.2d 1062, 1068 (2d Cir. 1979)* (finding preclusion of evidence justified where plaintiff's gross negligence froze litigation for four years); *Cordius Trust v. Kummerfeld, No. 99 Civ. 3200, 2008 U.S. Dist. LEXIS 1824, 2008 WL 113664, at *4 (S.D.N.Y. Jan. 11, 2008)* (defendant's "long-term and purposeful evasion of discovery requests," standing alone, was sufficient to support a finding of relevance for purpose of imposing sanctions).

In the absence of bad faith or other sufficiently egregious conduct, [*30] "'it cannot be inferred from the conduct of the spoliator that the evidence would even have been harmful to him.'" *Zubulake IV, 220 F.R.D. at*

221 (quoting *Turner, 142 F.R.D. at 77*); accord *Harkabi, 2010 U.S. Dist. LEXIS 87483, 2010 WL 3377338, at *6*; *Pension Committee, 685 F. Supp. 2d at 467-68*; cf. *Rimkus, 688 F. Supp. 2d at 607-08* (finding that loss of relevant evidence may be harmful as well as helpful to spoliator). The party seeking sanctions in such cases must therefore affirmatively "demonstrate that a reasonable trier of fact could find that the missing [evidence] would support [his] claims." *Zubulake IV, 220 F.R.D. at 221*; see also *Residential Funding, 306 F.3d at 109* ("[T]he party seeking an adverse inference must adduce sufficient evidence from which a reasonable trier of fact could infer that the destroyed or unavailable evidence would have been of the nature alleged by the party affected by its destruction.") (internal quotation marks, citation, and alterations omitted). Such a showing can be made on the basis of extrinsic evidence. *Residential Funding, 306 F.3d at 109* ("purposeful sluggishness" in turning over e-mails suggests that they were supportive of opponent's position); *Byrnie, 243 F.3d at 109-10* [*31] (relevance of missing interview notes could be inferred from weakness of defendant's purported reasons for not hiring plaintiff, suggesting that the reasons were a "pretext [for] the real explanation that would be disclosed by the [notes]"); *Harkabi, 2010 U.S. Dist. LEXIS 87483, 2010 WL 3377338, at *6* (affidavits describing contents of missing laptops); *Great Northern Insurance Co. v. Power Cooling, Inc., No. 06 CV 874, 2007 U.S. Dist. LEXIS 66798, 2007 WL 2687666, at *11 (E.D.N.Y. Sept. 10, 2007)* ("'[W]here the culpble party was negligent, there must be extrinsic evidence to demonstrate that the destroyed evidence was relevant and would have been unfavorable to the destroying party.'" (quoting *Reino de Espana v. American Bureau of Shipping, No. 03 Civ. 3573, 2007 U.S. Dist. LEXIS 41498, 2007 WL 1686327, at *6 (S.D.N.Y. June 6, 2007))*; *Heng Chan, 2005 U.S. Dist. LEXIS 16520, 2005 WL 1925579, at *8-9* (relevance of spoliated employment and business records could be inferred from other documentary and testamentary evidence of defendant's business practices); *Zubulake V, 229 F.R.D. at 427-29* (relevance of deleted e-mails inferred from other e-mails that had been recovered and eventually produced); *Barsoum v. New York City Housing Authority, 202 F.R.D. 396, 400-01 (S.D.N.Y. 2001)* (notes of meeting between [*32] employment discrimination plaintiff and supervisor suggesting non-discriminatory motive for adverse action tended to show that audiotape of meeting destroyed by plaintiff would have been unfavorable to her). Without such evidence, severe sanctions are not warranted. See *Great Northern, 2007 U.S. Dist. LEXIS 66798, 2007 WL 2687666, at *12* (adverse inference not warranted without showing that missing evidence was favorable to plaintiff); *Reino de Espana, 2007 U.S. Dist. LEXIS 41498, 2007 WL 1686327, at *8* (adverse inference inappropriate because "[t]here is no evidence that [party seeking sanctions] asked any deponent whether lost or destroyed e-mails included information concerning its proposed adverse inferences"); *Sovulj v. United States, No. 98 CV 5550, 2005 U.S. Dist. LEXIS 46700, 2005 WL 2290495, at *5 (E.D.N.Y. Sept. 20, 2005)* (same result where any assertion that missing evidence was relevant was "pure speculation"); *Zubulake IV, 220 F.R.D. at 221* (same result where there was no evidence that missing e-mails were "likely to support [plaintiff's] claims"); *Turner, 142 F.R.D. at 77* (in personal injury action regarding motor vehicle accident, plaintiff not entitled to adverse inference where there was "no evidence that the destroyed records would have shown whether [*33] the brakes were in good working order"). It is not sufficient for the moving party merely to point to the fact that the opposing party has failed to produce requested information. See *Mitchell v. Fishbein, No. 01 Civ. 2760, 2007 U.S. Dist. LEXIS 67268, 2007 WL 2669581, at *5 (S.D.N.Y. Sept. 13, 2007)*; *Cortes v. Peter Pan Bus Lines, Inc., 455 F. Supp. 2d 100, 103 (D. Conn. 2006)*.

Nevertheless, "[T]he burden placed on the moving party to show that the lost evidence would have been favorable to it ought not be too onerous, lest the spoliator be permitted to profit from its destruction." *Heng Chan, 2005 U.S. Dist. LEXIS 16520, 2005 WL 1925579, at *7*; see also *Residential Funding, 306 F.3d at 109*; *Kronisch, 150 F.3d at 128* ("[To] hold[] the prejudiced party to too strict a standard of proof regarding the likely contents of the destroyed evidence would subvert the prophylactic and punitive purposes of the adverse inference, and would allow parties who have intentionally destroyed evidence to profit from that destruction."). Thus, "it is not incumbent upon the plaintiff to show that specific documents were lost." *Treppel IV, 233 F.R.D. at 372*.

4. Discovery Relevance

Use of the term "relevance" in *Residential Funding*, where the court was referring to [*34] assistive relevance, should not be confused with broad discovery relevance; for discovery purposes, information is relevant to the extent that it "appears reasonably calculated to lead to the discovery of admissible evidence." *Fed. R. Civ. P. 26(b)(1)*. Thus, prior to assessing whether a party has breached a preservation obligation, whether it did so with a culpable state of mind, and whether the lost information would have been helpful to the innocent party, a court considering a sanctions motion must make a threshold determination whether any material that has been destroyed was likely relevant even for purposes of discovery.

Some decisions appear to omit such a requirement. In Pension Committee, for example, the court stated that "[r]elevance and prejudice may be presumed when the

spoliating party acted in bad faith or in a grossly negligent manner." [13] *685 F. Supp. 2d at 467* (emphasis added). Indeed, the court drew a distinction between the types of sanctions available based on whether information had in fact been lost at all:

> For less severe sanctions -- such as fines and cost-shifting -- the inquiry focuses more on the conduct of the spoliating party than on whether documents were [*35] lost, and, if so, whether those documents were relevant and resulted in prejudice to the innocent party. . . . [F]or more severe sanctions -- such as dismissal, preclusion, or the imposition of an adverse inference -- the court must consider, in addition to the conduct of the spoliating party, whether any missing evidence was relevant and whether the innocent party has suffered prejudice as a result of the loss of evidence.

685 F. Supp. 2d at 467. The implication of Pension Committee, then, appears to be that at least some sanctions are warranted as long as any information was lost through the failure to follow proper preservation practices, even if there has been no showing that the information had discovery relevance, let alone that it was likely to have been helpful to the innocent party. If this is a fair reading of *Pension Committee*, then I respectfully disagree.

13 As authority for this proposition, Pension Committee cites *Residential Funding, 306 F.3d at 109*. *Pension Committee, 365 F. Supp. 2d at 467 n.31*. That decision, however, dealt solely with a presumption of prejudice -- that is, with assistive relevance. The court made clear that when it spoke of "relevance" in connection with [*36] sanctions, it meant evidence likely to be harmful to the spoliator and helpful to the innocent party. *Residential Funding, 306 F.3d at 108-09*. The court did not address the need to demonstrate the relevance of the information for discovery purposes because there was no dispute: the missing (and tardily produced) evidence was directly responsive to discovery requests. *Id. at 102-06*.

"[F]or sanctions to be appropriate, it is a necessary, but insufficient, condition that the sought-after evidence actually existed and was destroyed." *Farella v. City of New York, Nos. 05 Civ. 5711 & 05 Civ. 8264, 2007 U.S. Dist. LEXIS 7420, 2007 WL 193867, at *2 (S.D.N.Y. Jan. 25, 2007)*. To be sure, once it has been established that discovery-relevant material has been destroyed in bad faith or through gross negligence, it may be presumed that it would have been harmful to the spoliator. See *Residential Funding, 306 F.3d at 109*. But that is a far cry from presuming that evidence is discovery-relevant merely because it has been destroyed as the result of a party's failure to abide by recommended preservation practices.

It is difficult to see why even a party who destroys information purposefully or is grossly negligent should be sanctioned [*37] where there has been no showing that the information was at least minimally relevant. Demonstrating discovery relevance is not a difficult burden to meet, even in the face of spoliation. Thus, for example, in Pension Committee, the court concluded that relevant records had been lost on the basis of the failure of fiduciary parties to produce documents that they must "surely" have maintained: "records . . . documenting the due diligence, investments, and subsequent monitoring of these investments." *685 F. Supp. 2d at 476*.

The consequences of omitting any requirement that a party seeking sanctions demonstrate the loss of discovery-relevant information could be significant. Because of the likelihood that some data will be lost in virtually any case, there is a real danger that "litigation [would] become a 'gotcha' game rather than a full and fair opportunity to air the merits of a dispute." *Id. at 468*. In order to avoid sanctions, parties would be obligated, at best, to document any deletion of data whatsoever in order to prove that it was not relevant or, at worst, to preserve everything.

Nor are sanctions warranted by a mere showing that a party's preservation efforts were inadequate. [*38] In Pension Committee, the court held that "[a]fter a discovery duty is well established, the failure to adhere to contemporary standards can be considered gross negligence." *Id. at 471*. Those standards, according to the court, include issuing a written litigation hold, identifying all key players to ensure that their records are preserved, ceasing the deletion of e-mails or otherwise preserving the records of relevant former employees, and preserving backup tapes that contain unique relevant information from key players that is not otherwise readily available. Id. Indeed, the court found one set of parties grossly negligent precisely because they failed to issue a written litigation hold in a timely manner. [14] *Id. at 476-77*.

14 As the court pointed out in Victor Stanley, if the the showing of a failure to follow a preferred practice leads both to a presumption that relevant and prejudicial material has been destroyed and also warrants a finding that the producing party was grossly negligent, then the innocent party

may be immediately entitled to a sanction as severe as an adverse inference. *2010 U.S. Dist. LEXIS 93644, 2010 WL 3703696, at 35 n.34*.

But, depending upon the circumstances of an individual case, the failure [*39] to abide by such standards does not necessarily constitute negligence, and certainly does not warrant sanctions if no relevant information is lost. For instance, in a small enterprise, issuing a written litigation hold may not only be unnecessary, but it could be counterproductive, since such a hold would likely be more general and less tailored to individual records custodians than oral directives could be. Indeed, under some circumstances, a formal litigation hold may not be necessary at all. See *Victor Stanley, 2010 U.S. Dist. LEXIS 93644, 2010 WL 3703696, at *25*; *Haynes v. Dart, No. 08 C 4834, 2010 U.S. Dist. LEXIS 1901, 2010 WL 140387, at *4 (N.D. Ill. Jan. 11, 2010)*. Rather than declaring that the failure to adopt good preservation practices is categorically sanctionable, the better approach is to consider such conduct as one factor, see *Haynes, 2010 U.S. Dist. LEXIS 1901, 2010 WL 140387, at *4*, and consider the imposition of sanctions only if some discovery-relevant data has been destroyed.

B. Application to the Facts

There are numerous respects in which Mr. Ronsen and Orbit One failed to adopt appropriate preservation procedures in this case:

o The initial litigation hold for Axonn documents was established by counsel without any apparent input from persons familiar [*40] with Orbit One's computer system; it lacked detailed instructions; there is no indication that it was disseminated to all persons who might have possessed relevant data; and the attorney who issued the hold evidently did not monitor compliance in any way.

o There is no evidence that litigation counsel imposed any formal litigation hold when the instant litigation was commenced.

o When information was deleted from servers, archived, or otherwise manipulated, the employee responsible for information technology was not informed of the Axonn litigation hold or of the pendency of the instant case.

o Primary responsibility for safeguarding information often remained with Mr. Ronsen, the very individual with the greatest incentive to destroy evidence harmful to Orbit One and to his own interests.

o Mr. Ronsen's treatment of the information within his control was cavalier: he removed computer hardware from Orbit One's premises, he permitted it to leave his control, and he failed to document his archiving practices.

Nevertheless, as will be discussed in further detail, there is insufficient evidence of any loss of discovery-relevant information.

1. Removal of Data from Servers

Numerex's application [*41] for sanctions relates first to Mr. Ronsen's purging of some six gigabytes of information from the Orbit One servers during the first week of December 2007. In a number of respects, this process was poorly designed to preserve information for litigation. First, when Mr. Dingman requested that Mr. Ronsen remove data from the servers, Mr. Ronsen failed to advise him that Orbit One was subject to a litigation hold in connection with Axonn's threat of litigation. By the time Mr. Ronsen implemented Mr. Dingman's request and actually began purging information, there is little doubt that he was contemplating litigation against Numerex and should have so advised Mr. Dingman as part of a further litigation hold. Then, after archiving the removed files on an external hard drive, Mr. Ronsen apparently kept possession of the hard drive for some period before turning it over to his counsel.

However ill-advised this conduct might be, it does not amount to spoliation. First, Mr. Dingman requested the removal of data from the servers for reasons entirely independent of any potential lawsuit; indeed, he was unaware that any litigation was anticipated. Although the purge was undertaken without regard [*42] for the Axonn litigation hold then in effect, a violation of a preservation obligation in that matter does not provide a basis for sanctions in this case. [15] More to the point, although Mr. Ronsen removed information when he was under a duty to retain it because he was then contemplating litigation, he did not breach his obligation because the data was archived and there is no evidence that any of it was lost. There has also been no showing that the information on the external drive was more expensive or burdensome for Numerex to obtain in discovery by virtue of its having been deleted from the servers. To be sure, once Numerex took physical possession of the Bozeman facility, it could no longer simply download that information from the servers. But it was in no worse position than

any litigant who obtains discovery at arm's length from an adversary.

15 Evidence of "serial" spoliation would of course be relevant to establishing the willfulness of any destructive conduct. See *Victor Stanley, 2010 U.S. Dist. LEXIS 93644, 2010 WL 3703696, at *3 n.10*.

2. Removal of the Desktop Computer

Next, Numerex contends that Mr. Ronsen's removal of the desktop constituted spoliation. Again, his conduct was less than exemplary. When [*43] Mr. Ronsen complied with Mr. Dingman's request to take the desktop off the network, he again failed to inform Mr. Dingman of the Axonn litigation hold. He removed the computer to his home and retained it there, apparently after this litigation was commenced and certainly after it was contemplated. Then, he actually permitted the hard drive to be extracted and removed from his possession.

As cavalier as this conduct might be, it again did not amount to spoliation. As with the culling of data from the servers, the request to remove the desktop originated with Mr. Dingman. Because the desktop was part of the network, it was synchronized with the servers and, through them, with the laptop. Consequently, any information not stored exclusively on the desktop's local drive would have been preserved in those locations. Furthermore, the hard drive from the desktop was ultimately recovered and provided to counsel. Again, though Mr. Ronsen was careless with this information, there is no basis for finding that any of it was destroyed.

3. Removal of the Laptop Hard Drive

The "swapping out" of the hard drive from Mr. Ronsen's laptop computer also did not result in spoliation. It is true that the exchange [*44] occurred when Mr. Ronsen was about to resign and that he did not tell Mr. Dingman, who effected the swap, of his intentions. In addition, it was ultimately determined that as of September 2008, neither the reconstituted laptop nor the servers contained certain information that had been on the system in January 2008 and was retained on the backup drive from that time.

However, there is no credible evidence that the need to replace the hard drive was fabricated. The idea that Mr. Ronsen would damage the hard drive and then seek its replacement in order to destroy evidence is far-fetched. And there is no dispute that Mr. Dingman properly diagnosed a serious malfunction. Furthermore, the process of swapping the drives was conducted by Mr. Dingman, not Mr. Ronsen, and he explained that he synched the laptop with the servers both before and after the exchange so that it should have acquired all of the information that had been on the old hard drive.

It is, of course, conceivable that, after January 3, 2008 but prior to swapping the hard drives, Mr. Ronsen deleted the "missing" documents from the laptop and synched the laptop with the network so that they were removed from the servers as well. [*45] The documents would then be retained only on the backup tape from January 3, 2008. But Mr. Bolstad, Numerex's own forensic expert, testified that it would be "speculative" to conclude that this is what happened. (Tr. at 89). Furthermore, when Numerex proffered 114 documents as examples of the "missing" files, Mr. Ronsen's counsel demonstrated that every one had previously been produced by the plaintiffs in discovery with the exception of a very few privileged or non-substantive documents. (Letter of R. Scott Thompson dated July 30, 2010 & Exhs. 1-114; Declaration of Robert Bolstad dated March 5, 2010, Exh. A).

Of course, it is always possible that other documents were deleted from the system but did not appear on the backup disk because they were created after January 3, 2008. But there is no evidence that this in fact is the case. No witness has identified any significant document that has not been produced in discovery. This is true even though former employees of Mr. Ronsen's, like Mr. Dingman, are now employees of Numerex and might well be expected to provide such information if it would assist their current employer.

4. Preservation of Backup Disks

It is not clear whether Numerex [*46] is contending that any spoliation took place with respect to the backup disks. At the time the disks were removed from rotation, this litigation had already been commenced. Yet there is no indication that Mr. Ronsen, Orbit One, or plaintiffs' counsel initiated any formal litigation hold at that time. Instead, it was Numerex, and specifically Mr. Nicolaides, who directed that the backup disks be preserved. Yet Mr. Dingman stored them in the office of Numerex's litigation adversary. Moreover, that adversary, Mr. Ronsen, removed them from the premises and took them home.

Still, there had been no showing that the integrity of the disks was compromised in any way, and therefore there is no basis for sanctions.

5. E-mail Forwarding Protocol

Finally, it is not clear whether Numerex considers the e-mail forwarding protocol to be a ground for spoliation sanctions. Whatever the propriety of Mr. Ronsen's continuing an e-mail forwarding rule after he had resigned from Numerex, his perpetuation of that protocol is not spoliation, since the rule created copies of informa-

tion rather than destroying it. And there is no allegation that the 200 forwarded e-mails that Mr. Ronsen did delete were lost; they [*47] remained not only in the individual accounts of the senders, but also on the Numerex exchange server.

* * *

The plaintiffs did not engage in model preservation of electronically stored information in this case. But they are not liable for spoliation sanctions, much less a severe sanction such as an adverse inference, because there is insufficient evidence that any relevant information has been destroyed.

Conclusion

For the reasons set forth above, Numerex's motion for sanctions is denied.

SO ORDERED.

/s/ James C. Francis IV

JAMES C. FRANCIS IV

UNITED STATES MAGISTRATE JUDGE

Dated: New York, New York

October 26, 2010