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Chapter 1:
The five Cs of business litigation risks

Sharks have been on my mind over the past several years. It all started when I spontaneously decided to join two litigation associates in training for a triathlon off the coast of Malibu. Thus began six months of training, motivated in large part by vanity – specifically, not wanting to be thought of as the old, out-of-shape guy in the office – and a desire not to forfeit the registration fee for the event.

Although it was one of the best decisions I ever made, training for the triathlon was a grueling and terrifying process. Of the three events – swimming, biking, and running – the swim was by far the most daunting. This was not just because of my less-than-stellar freestyle stroke. After months of training, including swimming in a local lake and doing laps in a pool, I recognized the need to venture into the chilly Pacific to learn the skills necessary to complete an open-water swim.

There was not one time I entered the water – including on race day – that the fear of a shark bite or worse did not enter my psyche. The fear did not leave me when crashing past the breakers at the beginning of the swim. I thought about sharks the entire time, especially when a piece of seaweed would brush up against my leg or I spotted a dark shadow in the water when my face was submerged. I found myself reading with renewed interest news reports about shark attacks off the coasts of Orange County and San Diego, paying particular attention to those incidents involving triathletes doing open-water swims.

For the first time in my life, I gave serious consideration to the question of whether there are ways to mitigate the risk of a shark attack – other than just staying out of the water and sticking to running and cycling. I shared my anxiety with one of my clients, an avid triathlete who regularly swims near his home in Cape Cod. He confessed that he is constantly nervous about sharks and uses an iPhone app that tracks at least those sharks tagged by marine biologists. I immediately downloaded the app to see what it might reveal lurking near Southern California beaches. The app showed nothing. That was little comfort given that my limited understanding of sharks is that

they are loners and do not typically swim in schools. Surely marine biologists cannot tag and track more than a small sliver of the shark population. It follows that, just because the few tagged sharks are not in the vicinity, one cannot conclude that that their brothers, sisters, or cousins are not.

In the end, I decided to concentrate on the statistics, overcome my anxiety, and just dive into the ocean – mind over matter. This decision was based on the reluctant realization that precisely zero precautions can be taken to meaningfully mitigate the risk of a shark attack. Each ocean swimmer and surfer in the water embraces roughly the same risk that every other one encounters.

Such is not the case with owning and running a business and avoiding the risks of a devastating attack in the form of a lawsuit. Meaningful and deliberative steps can be undertaken to avoid, if not eliminate, the risks of costly litigation. That is the purpose of this book and the emphasis of the first of its two parts.

Creating a business litigation risk profile

Any student of business understands that the critical first step in launching a successful enterprise is to create a sound business plan. Successful entrepreneurs not only carefully chart out their initial launch, they also revisit and revise the business plan regularly. Enormous amounts of time and consulting dollars are spent assessing the niche the business intends to fill, the costs of operation, and countless other factors. A business plan worth its salt not only focuses on the opportunities, but also the risks that the business will encounter, which may cause the entire enterprise to fail. Only after being persuaded that the upside of a proposed venture outweighs the ever-present risk of a failure does a prudent entrepreneur take the dive.

What is often neglected in this otherwise careful and deliberative process, is the consideration of how litigation will affect the venture. Think about the businesses you have been a part of in your career. How often have the C-suite executives taken time during an off-site retreat or planning session to engage in serious contemplation of this precise question: If we are hit with a devastating lawsuit next year, where will it start, what will it cost, and what is the worst-case outcome? The unvarnished truth is that if you do not understand your litigation risk profile, you do not fully understand your business.

The closest that many companies come to engaging in this introspective process is obtaining insurance coverage for certain known and obvious risks. Securing an adequate general liability insurance policy is a step in the right

direction, but it does nothing – or is certainly insufficient – to address other litigation risks. When insurance brokers request information about the company in order to make a coverage recommendation, they are solely interested in the risks that are being insured. For example, if the insurer is writing a policy for workers' compensation insurance, the focus might be on reducing the risk of a claim by enhancing workplace safety. This could include recommendations or acknowledgments of existing workplace safety equipment ranging from ergonomic chairs to assessing air quality and making sure adequate first aid kits are readily available. Product liability insurance entails other assessments of the safety of the product.

While these exercises may reduce the insurer's exposure to a narrow set of claims, a vast array of litigation risks are not insured. Most general liability policies have pages of exclusions. The insurer could not care less about claims that might be asserted against the company if its coverage is effectively excluded. With that in mind, who is responsible for focusing on those risks and, devising ways to mitigate or avoid them? The answer: management with the help of in-house outside counsel. This book is intended for this audience.

We must approach litigation risks with as much diligence, contemplative foresight, and care as the insurance underwriter approaches covered claims. It is these uninsured risks that will directly hit the bottom line of the company, both in terms of a potential judgment and the litigation costs.

How can this daunting task be accomplished when the sources and types of litigation are so varied? As the following pages show, this can be done through an effective litigation risk management approach. To illustrate some of these concepts, we will turn to our first of many case studies.

A case study: Sarah's seaside inn

Suppose that Sarah is opening a new inn, converting a dilapidated and rundown motel into an attractive seaside tourist destination. She will need a commercial general liability (CGL) policy before welcoming her first guest. In order to write that insurance policy, the underwriter will ask a host of questions focused on those risks within the policy.

He or she will ask about slick floors, steep staircases, and unlit paths, as there are substantial risks of slip-and-fall and trip-and-fall claims. They will next inquire about asbestos and related environmental hazards, each assessment of risk following the contours of the coverages in the policy.

After the underwriter has obtained answers to these questions,

addresses concerns and issues the policy, Sarah should focus on potential claims for which there will be no coverage. These non-covered claims pose the greater risk to the business because, if they materialize into real lawsuits, Sarah's bottom line will be impacted by having to pay for the defense of the claims and any settlement or judgment out of her operating budget.

Here are a few claims that Sarah might consider:

She will hire employees. Those employees are vested with substantial rights such that a failure to meticulously comply with dozens of state, federal, and local regulations will trigger costly claims. These include violating wage-and-hour laws, not informing an employee of his or her rights, and invading the privacy rights of an employee. Employee litigation claims are at the top of the list.

Sarah will welcome guests at the inn, some with disabilities possessing certain rights under the federal Americans with Disabilities Act (ADA) and parallel state laws. Are the counter levels too high, does the inn require an elevator, is the ramp on the property too steep? Claims from customers, including those whose access needs are not met, are another litigation risk.

Several commercial contracts will be signed with vendors and suppliers of everything from room furnishings to roofing materials for the remodel. Each vendor will be a contracting party. Contracts are the lifeblood of almost any business, each creating a potential for a breach of contract claim that might end up in court or arbitration.

To attract new customers, Sarah may issue gift cards with expiration dates. She may advertise to the general public that her rates are substantially discounted over a "rack" rate even though she has never actually sold a room at that rate. These and other marketing activities create the risk of claims for false advertising and unfair business practices.

As part of her digital marketing strategy, she may have a marketing firm set up a website that advertises the inn. The marketing firm may implement technology that learns when web users go to the website and then transmits a "cookie" or "pixel" so that there are pop-up advertisements that show up for that user and adverts in their social media feeds. Although perhaps essential to marketing the property, this is another litigation risk relating to website user privacy.

Sarah understands the power of social media and internet advertising.

But does she also understand the litigation risks that come from posting on Pinterest or Instagram a photo of a guest at the inn without their express authorization? Does she understand the issues that may arise by obtaining guests' email addresses and cell phone numbers to notify them of weekend specials or discount rates? Did Sarah contemplate what would happen if credit card or other private information is hacked? Has she paid a travel blogger with a large online following to post, pin, and tweet about his stay at the inn without disclosing that this is native advertising and influencer marketing?

Suppose Sarah obtained most of the funds to open the inn from Brian, an investor who has a 70 percent interest in a limited liability company (LLC) formed to operate the inn. Sarah may now owe Brian, and any other investors, certain duties – including fiduciary duties, the highest form of duty recognized in the law. While Sarah is busy choosing the right wine and cheese for the evening reception and the other tasks necessary to operate the inn, she needs to think of herself as a person owing fiduciary duties to Brian and other investors.

As this parade of horribles illustrates, the litigation risks in this business venture are extensive and varied. Few of these potential lawsuits are likely to be covered by a CGL policy. A further point this case study illustrates is that the litigation risks are not limited to businesses that make reckless decisions. Sarah has no desire to rip off customers, mistreat or underpay employees, cheat her investors or breach any contracts. Her culpability level is zero but her vulnerability level is still high. Even if Sarah does everything right and exercises unquestionable prudence and integrity in all her dealings with employees, customers, contracting partners, and investors, significant risks of litigation lurk beneath the surface.

Having touched on the qualitative natures of these risks, let us also consider the quantitative aspects.

Suppose that the business plan anticipates netting $80,000 a month in taxable income through distributions from the LLC. Suppose further that just one of these potential claims materializes into an ugly lawsuit with a plaintiff represented by a motivated attorney paid on a contingency. As Sarah has done nothing wrong, she believes this is a shakedown for money and will fight off the shark "for the principle of the matter".

Rather than settling, the parties fight on and the lawsuit becomes

protracted over many months. That single claim erases all the revenue the inn is generating. Worse yet, if the source is one of the risks discussed above (other than Brian and the investors) and that litigation risk could have been identified and eliminated, Sarah may have another problem.

Suppose that Brian, who has known Sarah for many years, thinks that she did nothing wrong in whatever act or omission caused the lawsuit to be filed, but Alice, a minority investor, does not take the same deferential view. Alice invested far less than Brian but had far less money to lose. She is eager for a return of her capital. She is incensed and now suggests that Sarah breached her duties to the entity and her investors, jeopardizing their substantial investments in the new business by her mismanagement. Alice has now retained a lawyer to assert that her investment has been destroyed through Sarah's malfeasance. Hindsight being what it is and plaintiff lawyers being who they are, Alice's attorney thinks the malfeasance is obvious and that any trier of fact will surely find liability.

This sad tale is not an exaggerated summary of litigation risks. Though often on a larger scale in both the amounts of money at stake and the complexities of the claims, these are the very types of lawsuits filed, litigated, and settled or tried every day all over the country. Like many illustrations throughout this book, these facts and claims are similar to the lawsuits over which I have commiserated with clients including business owners, entrepreneurs, and in-house counsel.

Sarah's litigation woes illustrate several points we will further unpack in the first part of this book. But the threshold point is this: carrying insurance to cover a guest's slip and fall is not the end of the risk analysis, but only the beginning. Sarah would be well-served to thoughtfully consider and guard against all the other litigation risks.

If this is true for Sarah and the rather modest enterprise she is launching, consider the litigation exposure for a midsize to large company with hundreds of employees and more complex business relationships, services, products, and infrastructure. Although the litigation risk assessment is exponentially more complicated for such companies, the same litigation-avoidance measures can be taken by adopting the concepts discussed in the following pages.

The closely related regulatory risk profile

The risk of civil lawsuits brought by aggrieved parties is not the end of the

story; there are also a host of regulatory risks. Statutes are enacted by the legislature and regulations are promulgated by the executive branch and are typically enforced by various agencies.

A few decades ago, regulatory concerns posed manageable issues for small business owners, particularly those in an enterprise like Sarah's seaside inn. Secure a business license, pay your taxes, comply with minimum wage laws, see if a city code has any other requirements, and the boxes are checked. Such is not the case today.

Whether we like it or not, and irrespective of what politicians say about rolling back unnecessary regulations, they are here to stay. It is amusing when lawmakers and political commentators discuss "de-regulation". That term is often a misnomer at best. There is no such thing as a de-regulated industry today. I have never heard of any industry that went from being regulated to truly unregulated. True, some regulations are cut back, but layers of regulations remain in virtually every industry. All indications are that the number of regulations, as well as laws, will continue to explode. Supreme Court Justice Neil Gorsuch observed:

> *"At the most basic level, the law in our country has simply exploded. Think Congress is wracked by an inability to pass legislation. Less than a hundred years ago, all of the federal government's statutes fit into a single volume. By 2018, the US Code encompassed 54 volumes and approximately 60,000 pages. Over the last decade, Congress has adopted an average of 344 new piece of legislation each session. That amounts to 2 to 3 million words of new federal law each year. Even the length of the bills has grown – from an average of around 2 pages in the 1950s to 18 today.*
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> *"When the Federal Register started in 1936, it was 16 pages long. In recent years, that publication has grown by an average of more than 70,000 pages annually. Meanwhile, by 2021 the code of Federal Regulations spanned about 200 volumes and over 188,000 pages."*1

Let us return to Sarah's seaside inn, an operation that no one would consider a heavily regulated business. Even so, consider some of the regulations and regulatory bodies that Sarah should ponder:

- The Occupational Safety and Health Administration (OSHA) and Cal/OSHA regulate workplace safety, including equipment in the kitchen that could cause injuries.
- State and federal environmental protection agencies will have a keen

interest in whether guests and employees are exposed to carcinogens or other chemicals that might cause cancer or reproductive harm.

- Various civil rights regulators such as the Department of Fair Employment and Housing will ensure that Sarah engages in no discriminatory practices. Even a seemingly benign advertisement for a "Ladies' Getaway" special is, on its face, gender discrimination.[2]
- Certain consumer protection agencies will be interested in whether advertisements relating to discounts and incidental charges are fairly disclosed to consumers and whether the "fine print" in a promotional advertisement constitutes a bait-and-switch tactic prohibited by law.
- State, county, and municipal agencies must be consulted to ensure that dishes and drinks served to guests are sanitary and safe and that proper licenses have been obtained relative to food safety, as well as alcohol.
- Local, state, and federal taxing authorities will obtain their pound of flesh at various levels, from guest check-ins to the revenue generated, and will require proper documentation and filings.
- Corporate governance regulations will apply to the formation and maintenance of the business entities and the rights of the investors, here members of an LLC.
- Consumer privacy and the risks of a computer hack compromising personal information of customers, including credit card numbers, will interest agencies charged with protecting the privacy of the public.

As this list illustrates, regulations proliferate at every level of government – federal, state, county, and city. The degree and intensity of local regulations is a relatively new phenomenon. There are increasingly overlapping and apparently redundant regulations. Perhaps the best example of this new breed of local regulations is in the employment area. Major cities in California and other states have in recent years enacted ordinances that go far beyond state standards.[3] Cities and local governments are also passing ordinances relating to environmental exposures and other areas of concerns. This trend of expansive local regulations will continue, particularly in large cities where local government is typically more progressive.

Meanwhile, the scope of state regulations in California continues to expand. California has a massive bureaucracy of over 200 separate regulatory agencies. The regulatory thicket is so dense that California even has a government agency, the Office of Administrative Law, tasked with keeping

track of all of the other agencies, and reviewing and publishing the deluge of regulations they enact. There might be an overregulation problem if a "regulator of the regulators" is necessary because of the proliferation of these bureaucracies and the regulations they spawn.

The disposition and enforcement philosophy of many regulators has also evolved. In a bygone era, the quintessential local regulator was the rough equivalent of Andy Griffith strolling the streets of Mayberry. The regulatory cop might occasionally protect public health and safety by nudging along a small business owner to comply with a commonsense ordinance. In place of the Mayberry regulatory approach, today's regulators meticulously enforce cumbersome regulations and appear to take pleasure in harshly punishing the most trivial nonconformities, seemingly channeling Inspector Javert pursuing Jean Valjean.

There is one final point to understand about regulations. In addition to the risk of a regulatory action, including investigations and fines, a violation of a regulation may also serve as a predicate for a civil lawsuit, including presenting a standard of care. For example, in the context of food and beverage consumer class actions, FDA regulations on food labeling (which are voluminous and detailed) are cited as a basis for a claim under a consumer protection statute. The claim is that consumers were deceived because the product was mis-branded. Thus, regulations create the dual risk of regulatory action and validation of other legal theories brought in civil litigation.

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Returning to our hypothetical, if Sarah is cognizant of these litigation and regulatory risks, she might have second thoughts about the prudence of wading into these scary waters, where shark fins are not just exaggerated fears, but a real part of the watery landscape. Like my first foray into the ocean for a distance swim, Sarah assumes the risk of sharks and plunges into the murky waters. Unlike me, she can take steps to be a savvy business owner and reduce the risks of litigation and regulatory violations. This book is designed to assist in that navigation.

Assessing commercial litigation risks – a five-part framework

In light of the overwhelmingly broad litigation risks companies face, how does one thoughtfully approach the task of identifying litigation risks? It begins with a framework. Over ten years ago, I was invited to speak about business litigation risks to a group of entrepreneurs and other executives.

Preparing for those presentations led me to think about how to present the major categories of business litigation in a coherent manner. This process and countless conversations with other lawyers, loss-prevention professionals, and business owners led to a categorization that I call the "five Cs" of ligation risks. Within each of those five categories are countless sub-categories, the applicability of which will depend on the nature of the business.

We begin with these five fundamental pillars. Not all apply to every type of business, but one of these types of claims more than likely represents your company's next lawsuit.

1. Corporate governance failures lead to lawsuits by stakeholders and others

The first business litigation risk is that the ultimate owners of the business will bring claims, direct or derivative, for corporate governance failures. Potential plaintiffs include shareholders in a corporation, the members of an LLC, or partners in a partnership. These are constituents of the business. They are owed certain duties by management which controls the enterprise. The root of many of these lawsuits is often a basic failure by management to understand the scope and extent of corporate governance and the duties imposed – the fiduciary and loyalty duty, the obligation to provide information, the need to avoid claims of self-dealing. In some instances, these claims are brought as a direct claims, and in other instances the shareholder or member brings derivative action in the name of the corporate entity.

While most of these litigation risks relate to claims by the corporate constituents, implementing good corporate governance also mitigates other risks and legal pitfalls. These include third parties seeking to pierce the corporate veil through an alter ego theory, creditors asserting claims for fraudulent transfers, and state and federal regulators inquiring whether there has been a prohibited sale of unregulated securities.

Notwithstanding the proliferation of these claims and the eagerness with which some shareholders or joint venture partners will rush to assert claims of malfeasance, there are several practical steps that can be taken to avoid these types of lawsuits. These efforts fall under the general heading of implementing and refining a robust corporate governance strategy and practicing what has been referred to as good "corporate hygiene". From the time that corporate documents are created describing shareholders' rights to the implementation of a corporate compliance program and sales force training, a variety of best practices in this area can reduce these potential liabilities.

Following an introduction to some of the corporate structural concepts in chapter two, we will explore in chapter three the ten most common corporate governance mistakes. I will explain how I see these acts or omissions creating litigation risks in the form of claims typically brought by shareholders, members, partners, stakeholders, regulators, and third parties.

2. Contract disputes that lead to lawsuits

The second area of litigation risks for almost any company arises from the wide variety of contracts that are formed as part of the business. These contracts include standard agreements needed to run any business (office leases, contract for a new equipment, and other vendor contracts) and more complicated commercial agreements with customers. Notwithstanding the wide variety of contracts, most lawsuits claiming a breach of contract fall into a few categories of claims and are based in fundamental contract principles that are introduced in chapter four. This discussion is followed by chapter five, which surveys 17 strategies to consider in reducing contract liabilities or being in a better position in litigation arising from contractual rights and obligations. These contract provisions and concepts include merger or integration clauses; consent-to-jurisdiction, choice-of-law and forum-selection clauses, arbitration provisions, and limits on damages and remedies. Such contract provisions are often overlooked when the deal is being negotiated but become paramount once a dispute arises and the parties are racing to the courthouse.

It is essential that responsible parties understand the significance of these contract provisions, which are sometimes buried deep in a voluminous agreement. Understanding why these provisions matter and how to negotiate more favorable terms can reduce the risk of a contract claim down the road or at least make it less difficult to defend against a claim. Chapter six addresses the implied covenant of good faith and fair dealing and the various types of lawsuits and claims brought by jilted parties after contract negotiations do not materialize into a final deal.

3. Customer lawsuits

The very lifeblood of most businesses – the customers who acquire the products and the services every day – represents the next type of business litigation. Customers often bring their lawsuits using contract theories, but not always. Contract claims are but one of the types of claims that customers often bring. Some lawsuits ostensibly brought by customers claiming

"injury" present no real injury at all and are propelled by consumer class action attorneys who send their client into a grocery store or online to buy a product or engage in a transaction solely for the purpose of filing a class action. If your business sells products or services to consumers, being aware of the consumer protection claims de jour is the first step in avoiding these types of lawsuits. These claims have become a significant burden to businesses in the last few decades, and nowhere are class actions more prevalent, and in some cases specious, than in California. Supported by robust consumer protection statutes designed to protect the public from unfair business practices, consumer plaintiff attorneys bring these claims on a regular basis and demand sizeable settlements. Chapter seven introduces some fundamental concepts relating to consumer protection and class actions, followed by chapter eight which presents a framework for mitigating the risk of these types of lawsuits.

Many customers buy products which create unique liabilities, three of which are addressed in chapter nine: breach of warranty claims, including enhanced remedies under state and federal warranty protection statutes. Chapter nine also explores the concepts underlying modern product liability, including how juries determine whether a product fits within one of three types of actionable defects. If a customer (or even a third party) is injured or dies from a product, a claim for product liability can be brought under a variety of theories. The chapter ends with a discussion of Prop 65 claims for consumer exposures to certain chemicals and an emerging form of liability for chemical exposures, per- and polyfluoroalkyl substances (PFAS) litigation. Chapter ten outlines 14 risk-mitigation steps relating to sales of products or the provision of services to customers.

The final type of customer lawsuit, which is a relatively recent phenomenon, is addressed in chapter 11 – the risk of litigation and regulatory action from data privacy claims and data breaches. As the headlines frequently remind us, the mere retention of customer data – credit card information, personal identifying information, health records and financial records – triggers significant risks that must be weighed.

4. Competitors searching for a reason to bring lawsuits

The fourth of the five Cs of litigation risks is defined by the source of the threat. As the business grows and market share increases, competitors often sit up and take notice. These potential plaintiffs are likely to sharpen their focus on your business and consider a variety of potential lawsuits, just to

set you back. Chapter 12 explores the eight most common types of lawsuits brought by competitors and practical steps that can be taken to avoid these predatory lawsuits, often brought for no purpose other than to flex muscles and send a message to a market participant.

Competitor lawsuits include claims for misappropriating trade secrets, raiding employees, infringing intellectual property, false advertising that provides a competitive advantage, trade defamation and similar disparagement, antitrust claims, unfair competition claims under state statutes, and interference torts including interference with prospective economic advantage. An aggressive competitor with a creative and knowledgeable trial lawyer can wreak havoc, even if the claim is ultimately unsuccessful. These lawsuits consume valuable time and financial resources. Competitor litigation also creates the risk that a competitor will obtain access to proprietary information through the discovery process. Such lawsuits are to be avoided at all costs.

5. Crewmembers – the employees in the organization – are a source of lawsuits

The fifth and final risk to any business, addressed in chapter 13, is claims brought by employees. Employees – who are essential to the business – often bring claims ranging from sexual harassment to wage-and-hour class actions. These broad claims reflect expansive federal, state, and local regulations which, perhaps more than any other area of law, evolve every year. Certainly in California, as well as other jurisdictions, the start of each new year brings a new list of employee protections, imposing new obligations on the employer and, with that, new litigations risks. In this chapter, we will look at the most common employee claims and several preventive measures to avoid these types of lawsuits and government investigations.

* * *

Merely understanding the five Cs of business litigation risk is not a simple proposition. The material in the pages that follow is at some points challenging. To obtain the full benefit of this book, you must apply these concepts to your unique business model, paying close attention to the categories of risk that are most significant. In doing so, you will learn how these lawsuits emerge and what measures might be taken to avoid getting bitten by the sharks.

Swim safely, my friends.

References

1 Neil Gorsuch and Janie Nitze, *Over Ruled: The Human Toll of Too Much Law*, pp. 16-17 (Harper Collins 2024).
2 *Koire v. Metro Car Wash*, 40 Cal. 3d 24, 29 (1985) (holding that California's civil rights statute applies not merely where businesses exclude individuals, but also "where unequal treatment is the result of a business practice" including offering discounts on car washes for women customers).
3 http://sfgov.org/olse/formula-retail-employee-rights-ordinances

This chapter 'The five Cs of business litigation risks' by KENT SCHMIDT is from the title *US Business Litigation Risks: A Comprehensive Handbook for Business Owners and the Attorneys Who Advise Them, Second Edition*, published by Globe Law and Business.

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