EXECUTIVE RISKS PRACTICE

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NEWSLETTER

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AARA EXPANDS HIPAA: BUSINESS ASSOCIATES AND BREACH NOTIFICATION REQUIREMENTS

Once 45 U.S. states passed data breach notification requirements, it was only a matter of time before the federal government once again got into the act. The American Recovery and Reinvestment Act of 2009 (ARRA) amended the Health Insurance Portability and Accountability Act of 1996 (HIPAA) to expand security and privacy requirements to *business associates* of health care providers. The term *business associate* encompasses entities that provide data transmission of protected health information or that require access on a routine basis to protected health information. This includes health information exchanges, regional health information organizations and vendors that contract with covered entities to provide personal health records. These entities will now be subject to potential civil and criminal penalties and enforcement proceedings for violations of HIPAA.

Going forward, covered entities will be required to notify individuals when security breaches occur with respect to "unsecured" information. Unsecured information means information not protected through technology or other methods designated by the federal government. If a breach involves 500 or more individuals, notice to the federal Department of Health and Human Services and the media is also required.

HIPAA set national health information privacy standards for health care providers, health plans and health care clearinghouses. In the years that followed state legislatures and other jurisdictions passed expanded data breach notification laws.

CONTENTS

AARA Expands HIPAA: Business Associates and Breach Notification Requirements 1

Surprise Win for Directors in $13B M&A Case 1

When Does the Clock Start on Securities Fraud Claims? 2

Contacts 3

SURPRISE WIN FOR DIRECTORS IN $13B M&A CASE

The D&O world was surprised – to put it mildly – when the Delaware Supreme Court not only overturned last year's Delaware Court of Chancery decision in *Lyondell Chemical Company v. Ryan*, but handed the directors a big win by dismissing the case outright.

The action was a surprise largely because under Delaware law, the duties of corporate directors change considerably when the company is on the verge of being sold or broken up or when control is otherwise being transferred. In such cases, the board has an overriding duty to maximize shareholder value. The duties imposed on directors in these situations are known as "Revlon duties," for the case, *Revlon Inc. v. MacAndrews & Forbes Holdings*. When Revlon duties are triggered, directors must focus on getting the best available price for the company.

The Delaware Supreme Court determined that the lower court was incorrect when it imposed Revlon duties on the directors **before** they decided to sell or the sale became inevitable. The court held that the Revlon duties do not arise whenever a company is merely "in play" and that the duty to seek the best price attaches only when a company itself embarks on a transaction or in response to an unsolicited offer that will result in a change in control.

A key factor in the case was the short timeframe imposed by the buyer – the $13 billion deal was done in less than a week. The plaintiffs had alleged that "unexplained inaction" of the directors after the acquisition was initiated amounted to a conscious failure in their duties to the company to negotiate better terms. The defendants sought summary dismissal, which the Chancery court denied. The Delaware Supreme Court saw the situation differently.

The Delaware Supreme Court found that the directors were independent and disinterested – but in a good way, meaning they were not operating under any conflicts of interest. Given the timeframe, they could spend a total of seven hours considering the sale, but did take into account the advice of financial and legal advisers. The court concluded that there was no evidence that the directors knowingly ignored their responsibilities or breached their duty of loyalty.

The "unexplained inaction" alleged by the plaintiffs was accepted by the supreme court as a legitimate wait-and-see response to the acquirer's filing of a Schedule 13D form signaling its interest in the company. Since the Supreme Court of Delaware now tells us that Revlon duties don't begin until directors actually begin negotiating the company's sale, their earlier inaction could not be held against them. As the court further concluded that there are no legally required steps (such as soliciting alternative bids) that directors must follow to satisfy their Revlon duties, the lack of any such specific steps during the sales process could not be equated with a conscious disregard of their duties.

WHEN DOES THE CLOCK START ON SECURITIES FRAUD CLAIMS?

The law says two years – that much is clear. But when does the clock start running? Federal circuit courts have varying opinions but now the Supreme Court has agreed to settle the much-argued question of when the statute of limitations begins on federal securities fraud claims.

The Court agreed to consider the issue in *re Merck & Co. Securities, Derivative & ERISA Litigation*. Lower courts agree that the clock is triggered by discovery of an alleged violation, commencing when a plaintiff either directly learns of an alleged violation or constructively discovers the relevant facts. Problems arise in trying

to nail down the meaning of *constructive discovery*.

Determining constructive discovery generally involves two questions. First, when did the plaintiffs receive enough information of a possible wrongdoing that a reasonable investor would investigate to determine if a potential legal claim exists? This is known as being put on inquiry notice. Second, when, in using reasonable diligence to perform such an investigation, should the plaintiffs have discovered the facts constituting the violation? The subjective nature of these questions underscores that fact that these are *very* fact-specific tests. No wonder the circuit courts have been divided.

A chief point of confusion is that being put on inquiry notice occurs *before* all the facts are known, and arguably can't be the starting date for the limitations period – but simply the point at which an investigation needs to begin. The problem in *Merck* is that the Third Circuit, where the suit was brought, requires an investigation, but none was made – making inquiry notice a crucial date in trying to sort out the constructive discovery question.

In some circuits, the statute of limitations begins to run as soon as a plaintiff receives *storm warnings of possible fraud*. In others, the statute runs from the point of inquiry notice if a reasonably diligent inquiry could have uncovered the facts underlying the fraud within the limitations period. In still others, the statute begins to run only at the time a plaintiff using reasonable diligence could have discovered the facts underlying its claim. According to one circuit, a plaintiff on inquiry notice must actually conduct an investigation or the plaintiff may find that the clock will be deemed to have started on the date that the *duty* to investigate arose. This is the rule in the Third Circuit.

What will the Supreme Court do? In trying to address the differing views in the lower courts, the High Court is likely to articulate guidance for inquiry notice that provides an incentive to investigate fraud at an early stage and may impose a duty to investigate. Failure to carry out that duty could bar claims. The Court is also likely to point out the importance of providing investors with sufficient time to investigate and uncover fraud.

You'll have to stay tuned to find out.

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