

Document Preservation Notices — 4th Amendment Violation?

Law360, New York (January 10, 2014, 10:56 AM ET) -- The enforcement staffs of many federal regulatory agencies can compel document production — but only if a relatively senior agency official approves a formal investigation. Anecdotal evidence suggests, however, that enforcement staff are increasingly issuing document preservation notices during an investigation’s early stages, before any formal order of investigation. These preservation notices can saddle recipients, even mere witnesses, with broad, far-reaching and expensive document retention obligations. Without any practical redress available, recipients have little choice but to comply.

Such notices arguably have become an unrestrained interference with a property right — the right to manage one’s own data. The practice of regulatory preservation notices therefore may be contrary to fundamental Fourth Amendment protections against unreasonable seizures without due process, and at the very least, they seem to run afoul of traditional regulatory investigative processes. If regulators do not rein in these expensive violations of private rights, Congress should.

Preservation Letters and the Duty to Preserve

The enforcement staff of several federal regulatory agencies may initiate informal investigations, but often they may not issue subpoenas before a more senior official (such as a director of enforcement) approves and issues a formal order of investigation.[1] This structural limitation maintains discipline on enforcement staff’s ability to issue subpoenas absent approval from a higher level. Commissioners are sensitive to this purpose. Indeed, CFTC Commissioner Scott O’Malia recently criticized the Commodity Futures Trading Commission’s enforcement division for attempting to circumvent the formal approval requirement.[2]

Issuing a preservation notice, however, allows the enforcement staff to compel immediate and extensive document retention, which in turn buys time to launch a formal investigation.

The requirements to issue a preservation notice are few and opaque. At the U.S. Securities and Exchange Commission, for example, these notices may arise from a “matter under inquiry,” initiated only on a “quick look at readily available information,” based on a “low” threshold.[3] Regulators can thus subject a corporation to the costs of document retention for that entire time, only later to determine that there was no viable basis for a formal investigation.[4]

A Fourth Amendment Right to Delete

The Fourth Amendment is a bulwark against arbitrary and indiscriminate governmental interference with property and privacy: “The right of the people to be secure in their persons, houses, papers, and

effects, against unreasonable searches and seizures, shall not be violated, and no Warrants shall issue, but upon probable cause, supported by Oath or affirmation, and particularly describing the place to be searched, and the persons or things to be seized.”

The Fourth Amendment is violated when “there is some meaningful interference with an individual’s possessory interests in that property.”[5] Fundamental to a “possessory interest” is the right to destroy one’s own property. As the Supreme Court has held, “[i]t is, of course, not wrongful ... to comply with a valid document retention policy under normal circumstances.”[6] Absent a duty to preserve, a company is free to destroy its data and information as it pleases.

Given the proliferation of data produced by the modern corporation[7], routine document destruction serves important financial and practical purposes. In most companies, sources say, 69 percent of data has no business, legal or regulatory value whatsoever.[8] With storage needs doubling every two years, storage costs alone for most large corporations will consume almost 20 percent of the typical IT budget in 2014.[9] For the financial services industry, a frequent regulatory target, IT spending was 6.5 percent of 2011 revenue.[10] Data destruction — in accordance with a transparent, sensible and routinely followed policy — thus minimizes this tremendous cost to maintain data with no ongoing business purpose.

The cost of implementing a document hold can be enormous. For General Electric Co., the bill for preservation in one matter totaled \$5.4 million, approximately \$100,000 per month — excluding legal review — before any case was even filed.[11] The matter in question involved a single business, confined to GE’s U.S. operations. Given this relatively “limited” scope, the hold involved “only” 96 custodians — compared to the more typical “hundreds or even thousands of individuals” involved in many GE matters.[12] Despite this “limited” scope, GE identified some 3,800,000 documents, totaling 16,000,000 pages of data, subject to the hold.[13]

In addition to these costs, ongoing compliance obligations require employee attention, a significant expense that requires a shift in focus and personnel from the company’s normal operations. Exxon Mobil Corp. employees collectively spend more than 200,000 hours per year on compliance, costing tens of million dollars in year in employee time alone.[14]

It is clear that the preservation is vastly overbroad. One Microsoft lawyer stated that the average employee preserves over 30 gigabytes today, up from 17 gigabytes just two years ago.[15] But of the approximately 60 million pages the company stores in each document hold, an average of just 88 pages are relevant enough to make it into court.[16]

This overbreadth is a significant deadweight drain on the U.S. economy.

Preservation Notices and the Fourth Amendment

Determining the appropriate bounds of preservation from the face of the notice is frequently difficult. An SEC request to preserve all documents “related to or concerning” a trade could signal a wide array of securities laws issues. Without knowing the true nature of the inquiry, it is impossible to craft a narrowly targeted hold. The result is usually a sweeping retention.

In private litigation, overly broad preservation requests are common, but can be remedied. The Federal Rules of Civil Procedure require parties to confer regarding preservation of electronically stored information[17], permitting litigants to craft reasonable and proportional holds that encompass only

those subject matters, time frames and custodians likely to be relevant. Further, because private parties have mutual obligations, each is incentivized to be reasonable, or risk having to comply with an equally unreasonable counter-demand. If the parties cannot agree, they can seek judicial relief.

In a regulatory investigation, however, a recipient lacks similar opportunities. Without a concomitant burden regarding their own data retention, regulators lack incentive to craft a limited preservation notice. Moreover, a preservation notice is a signal of potential further investigation. Few corporations (or their lawyers) believe it advisable to challenge the regulator's retention requirements, for fear of foregoing cooperation credit, or worse, looking as if their goal is to dispose of incriminating evidence. These dynamics make the usual give-and-take negotiations of private litigation virtually impossible.

The consequences of noncompliance are disastrous. Regulators are typically empowered to impose monetary sanctions for noncompliance with a preservation request. And the Sarbanes-Oxley Act provides criminal penalties of up to 20 years imprisonment and fines of up to \$10 million for anyone who "knowingly alters, destroys, mutilates, conceals, covers up, falsifies, ... any record, document, or tangible object with the intent to impede, obstruct, or influence [an] investigation ..." [18]

Another potentially harsh penalty is an "adverse inference" ruling. If a defendant's document was destroyed, a judge may instruct the jury to infer that the information in that document was whatever plaintiff suggests it was — inevitably an awful fact for the company. Such an instruction can easily be outcome-determinative. [19] All these penalties make implementing a far-reaching document hold a recipient's only practical option.

To our knowledge, no court has ruled whether a document preservation notice alone violates the Fourth Amendment. Given the significant structural disincentive to challenging such notices, the dearth of such cases is unsurprising.

Suggested Reforms

The practice of sending blanket preservation notices in the absence of a formal investigation should end. Senior regulators should act consistent with the guidance of the Fourth Amendment by imposing meaningful limitations on their enforcement staffs' ability to restrain an entity's data without appropriate process. Destruction of evidence is already punishable by civil and criminal sanctions, and thus the burdensome retention warnings are redundant.

Even if regulatory agencies were unwilling to surrender what they see as a useful tool, the agencies should limit the duration of any preservation notice to a short period — six months, perhaps — thus prompting enforcement staff to swiftly address violations as soon as possible. If the enforcement staff cannot develop a viable basis for obtaining authority within that reasonable time, a recipient's preservation obligation should automatically lapse.

Regulators should also act with greater transparency during these open-ended investigations, including active communication with a subject or witness about the status of an investigation and whether it is narrowing in scope, thereby providing the recipient with some relief from an overly broad preservation obligation.

At the very least, each agency that utilizes such notices should perform a basic cost/benefit analysis to investigate (and publish) the prevalence and duration of preservation notices, and assess the true burden on recipients. What is the total economic deadweight loss attributable to these preservation

notices, and what are the investigative benefits to the agency (if any) beyond the traditional process of initiating a formal investigation and then issuing a subpoena?

If the agencies do not weigh the reasonableness of the burden imposed on a recipient and on the industry against any benefit afforded to the regulators in actually achieving their objectives, Congress should undertake its own investigation of these issues. While congressional action seems daunting in these polarized times, statutory guidance may be necessary to prevent encroachment of the basic Fourth Amendment principle that forbids unreasonable interference with property rights.

Conclusion

In the quantities of data that flood most business entities, the burdens of document retention are significant: rooms full of hard drives and other storage media, and salaried technical personnel to capture, catalog and maintain all that data. Accordingly, a preservation notice imposes a tremendous burden. The regulatory practice of issuing broad preservation notices without a subpoena forces a recipient to surrender its possessory interest in managing its data.

Data is property, and it should be afforded procedural protections from uninhibited regulatory interference. The spirit of the Fourth Amendment demands reform.

—By Eliot Lauer, Jason P. Gottlieb and Alyssa Astiz, Curtis Mallet-Prevost Colt & Mosle LLP

Eliot Lauer is a partner, Jason Gottlieb a counsel and Alyssa Astiz an associate in the New York office of Curtis Mallet-Prevost Colt & Mosle LLP. Lauer is co-chairman of the firm's litigation group.

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[1] Before 2009, the SEC's Division of Enforcement required approval from the Commission to launch formal investigation. In 2010, the Commission made permanent the delegation of this authority to the Director of Enforcement, citing "increased efficiency" as the purpose. Delegation of Authority to the Director of its Division of Enforcement, Release No. 34-62,690, 17 C.F.R. 200 (Aug. 16, 2010).

[2] The Future of the CFTC: Commission Perspectives: Hearing Before the S. Comm. on Gen. Farm Commodities and Risk Mgmt. House Comm. on Agriculture, 113th Cong. 17 (2013).

[3] Letter from Robert S. Khuzami, Dir. of Enforcement, SEC, to Senator Charles E. Grassley, Ranking Member, Comm. on the Judiciary (Sept. 14, 2011), available at <http://www.grassley.senate.gov/about/upload/Khuzami-to-Sen-Grassley-9-14-2011.pdf>.

[4] Frank Tang & Douwe Miedema, U.S. ends long-running silver market probe, taking no action, REUTERS, Sept. 25, 2013, available at <http://www.reuters.com/article/2013/09/25/us-cftc-silver-idUSBRE98O0SR20130925> (reporting that after five years and 7,000 staff hours of investigation, the CFTC closed its investigation into alleged manipulation of the silver trading market).

[5] *United States v. Jacobsen*, 466 U.S. 109, 113 (1984).

[6] *Arthur Andersen LLP v. United States*, 544 U.S. 696, 704 (2005).

[7] Globally, data generation is expected to grow at a compounded annual rate of 41% between 2009 and 2020. NASSCOM, Big Data The Next Big Thing (2012), <http://www.nasscom.in/sites/default/files/researchreports/softcopy/Big%20Data%20Report%202012.pdf>.

[8] Deidre Paknad, Defensible Disposal: You Can't Keep All Your Data Forever, FORBES (July 17, 2012, 10:30 PM), <http://www.forbes.com/sites/ciocentral/2012/07/17/defensible-disposal-you-cant-keep-all-your-data-forever/>.

[9] Stacey Vanek Smith, Big Data creates big industry for storing data, MARKETPLACE (Apr. 4, 2013), <http://www.marketplace.org/topics/business/big-data-creates-big-industry-storing-data>.

[10] Gartner, IT Key Metrics Data 2012 IT Enterprise Summary Report, <http://www.softline.ro/wp-content/uploads/2013/03/ITKMD12ITEnterprisesummaryreport.pdf>.

[11] Costs and Burdens of Civil Discovery: Hearing Before the House Subcomm. on the Constitution of the Comm. on the Judiciary, 112th Cong. 326 (2011) (testimony of GE Associate General Counsel Thomas Hill).

[12] Id.

[13] Id.

[14] Joe Palazzolo, Firms Push for Protection Over Preserving Documents, WSJ.com, Nov. 24, 2013, <http://online.wsj.com/news/articles/SB10001424052702304607104579214322182549600>. See also William H.J. Hubbard, Preliminary Report on Preservation Costs Survey of Major Companies (Sept. 8, 2011) (draft), available at http://www.uscourts.gov/uscourts/RulesAndPolicies/rules/DallasMiniConf_Empirical_Data/Civil%20Justice%20Reform%20Group.pdf.

[15] Palazzolo, supra note 15.

[16] Id.

[17] Fed. R. Civ. P. 26(f).

[18] 18 U.S.C. § 1519.

[19] Palazzolo, supra note 15.