FALL 2020

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The PRACTICAL GUIDANCE Journal

DATA VISUALIZATION AND INTEGRATION ACCELERATE ATTORNEY EFFICIENCY

SOFR Loan Documentation: Eight Considerations for Borrowers

A Surge of SPACs in a Turbulent Economic Climate

Public Company Reporting and Corporate Governance

LexisNexis®

Fall 2020

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PRACTICAL GUIDANCE Journal

Fall 2020 (Volume 5, Issue 4)

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Eric Bourget, Editor-in-Chief

AS LEGAL TECHNOLOGY CONTINUES to disrupt the practice of law, productivity is more important than ever. Attorneys are under tremendous pressure to generate positive results for clients in the most efficient and cost-effective manner possible. Harnessing data to drive legal strategy is paramount to reaching successful outcomes. This edition of the Practical Guidance Journal shows how you can use data-driven tools to save time and improve efficiency, and includes content demonstrating how data visualization will support and strengthen your work.

While the economy continues to make adjustments brought on by the ongoing impacts of the COVID-19 pandemic, we are featuring content in the practice areas of Finance, Corporate and Mergers & Acquisitions, and Capital Markets & Corporate Governance. This guidance is designed to help you navigate as your clients' business needs evolve and shift in the current turbulent economy.

For example, practitioners are seeing a surge in Special Purpose Acquisition Companies (SPACs.) These companies are formed to raise capital through an initial public offering (IPO,) then subsequently acquire businesses or target companies using the IPO proceeds. This edition includes guidance explaining the factors that are driving the resurgence of these investment vehicles. In addition, you can read about some of the risks associated with SPAC transactions before advising your clients to proceed.

A financing option many businesses are turning to during the pandemic is the Main Street Lending Program. It is a source of funding now available to assist small and medium-sized businesses that were in good financial shape before the pandemic but may be experiencing difficulty as its impacts continue. The program is available as part of the Coronavirus Aid, Relief, and Economic Security Act (CARES Act.) This edition includes practice tips for attorneys whose clients are considering seeking this special type of financing, and outlines the eligibility and repayment requirements.

Financial professionals anticipating the imminent demise of the London Interbank Offered Rate (LIBOR) and the installation of its heir apparent, the Secured Overnight Financing Rate (SOFR), are focusing on loan documentation strategies that provide for interest accruing at a rate based on SOFR. This edition includes guidance about what may occur after LIBOR ends. It also features insight into some current trends for dealing with the transition to SOFR in loan documentation, as well as several issues future borrowers may raise in the negotiation of a SOFR credit agreement.

The Securities and Exchange Commission continues its efforts to simplify and reduce the amount of disclosure public companies must provide while improving the usability of those disclosures. Read about some of the notable market trends in corporate governance and public company reporting during 2019 and early 2020, and gain insight on what may lie ahead—including issues related to COVID-19 disclosures and related governance concerns arising from the pandemic.

We hope you and your clients are moving forward successfully as the pandemic continues. We offer our concern for your families, friends and colleagues. Best wishes for your health and safety.

Our mission

The Practical Guidance Journal is designed to help attorneys start on point. This supplement to our online practical guidance resource, Practical Guidance, brings you a sophisticated collection of practice insights, trends, and forward-thinking articles. Grounded in the real-world experience of our 850+ seasoned attorney authors, The Practical Guidance Journal offers fresh, contemporary perspectives and compelling insights on matters impacting your practice.

Daniel Lewis V.P. PRACTICAL GUIDANCE & ANALYTICAL CONTENT, LEXISNEXIS

Data Visualization and Integration Accelerate Attorney Efficiency

Q&A with Daniel Lewis

It's Friday afternoon and a client calls about a potential merger, or a partner asks for extensive due diligence research. Kiss your weekend goodbye and settle in for endless hours of research. On top of that—if the assignment is in an unfamiliar practice area, the task becomes that much more ominous. Rather than having to parse through thousands of SEC filings and evaluate endless numbers of clauses and terms, imagine a tool that, with just a few clicks, provides you with detailed summaries of all the relevant M&A transactions and charts that help you identify market standards and trends.

DATA-DRIVEN INSIGHTS ARE TRANSFORMING THE LEGAL industry while leading to better customer outcomes, increased efficiency, and access to information presented in ways that were unimaginable less than a decade ago.

Daniel Lewis is an innovator in the world of legal data visualization. As co-founder of Ravel Law, he launched a legal research, analytics, and visualization platform. He now leads the Practical Guidance and Analytical business at LexisNexis and provides these insights about how integration of legal research products with data analytics can significantly improve efficiency and research results.

Q According to a recent legal analytics study conducted by ALM Intelligence and LexisNexis, 90% of legal professionals agree that using data analytics makes them a better, more efficient, and effective legal practitioner. The study also reveals that adoption of legal analytics is rapidly increasing—and that growth is expected to continue.[1] How does the new deal analysis and data visualization tool in Practical Guidance address this increasing need for more and better legal analytics?

A Within Practical Guidance, we've launched a new tool called Market Standards to help M&A attorneys draft and negotiate more effectively by enabling them to search and compare transactions using 150 detailed deal points, easily find precedent language, and see deal point and transactional trends with data visualizations. Market Standards can do in a few clicks what would otherwise take hours of manual research.

Q How do you evaluate attorneys' needs in order to develop tools such as Market Standards and others designed to improve efficiency and accuracy?

A We do a great deal of research into mapping in detail the day-to-day work that lawyers are doing and trying to spot opportunities to make that work more efficient. At the same time, it is important to identify the broader themes about where legal practice is going that we can then build around. Lawyers have long been asking for ways to accomplish their everyday tasks more efficiently and to be fast without sacrificing quality. Those themes are really reflected in the new Lexis+, which integrates Practical Guidance.

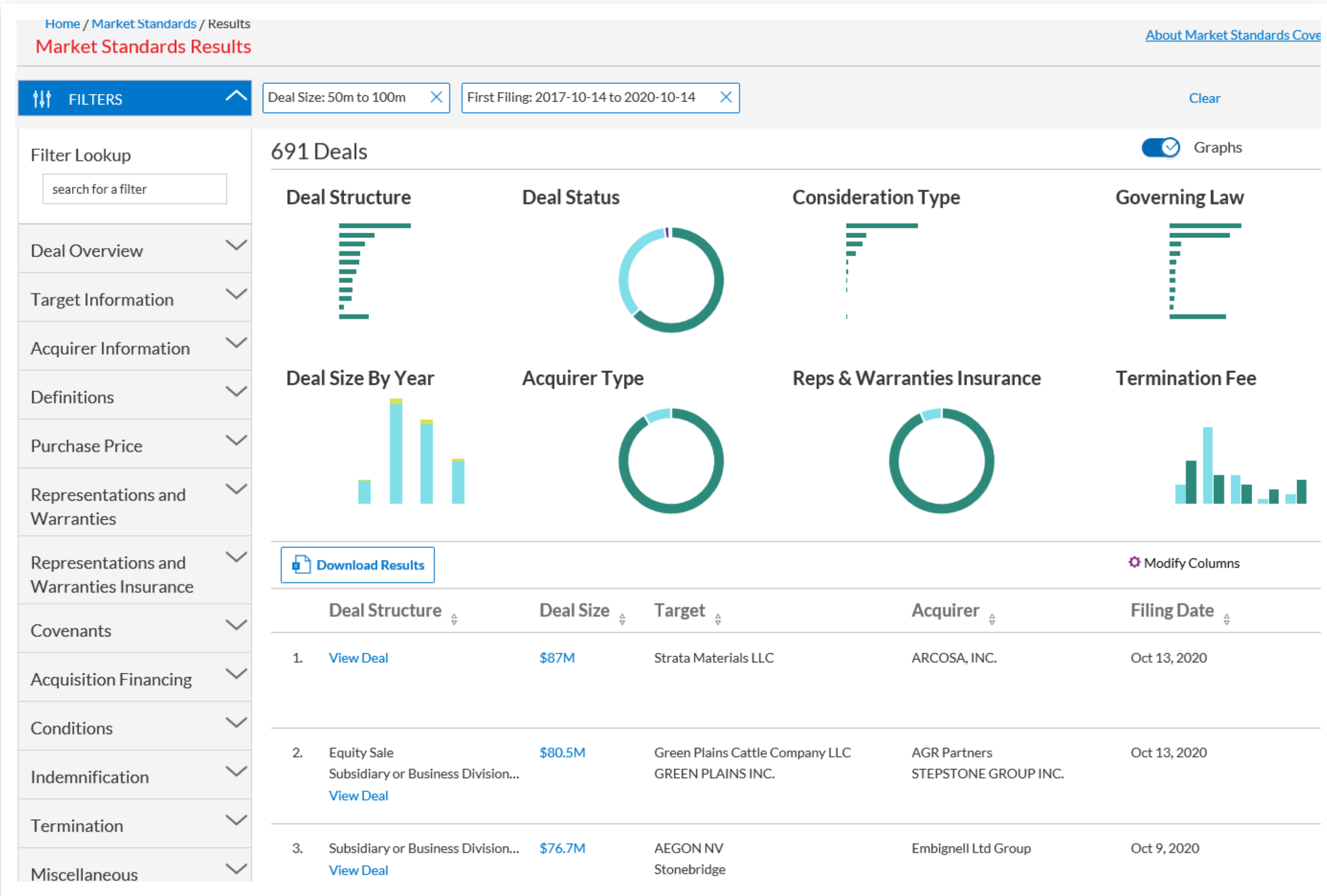
One of those themes is the dramatic increase in demand for data-driven tools. That takes many forms, including litigation analytics, language analytics, and the embedding of data into practical guidance materials—like the Market Standards tool. That's a theme that we've seen at the forefront for the past several years.

The constant drive to enable faster, more confident research and task completion is also at the heart of Practical Guidance. Practical Guidance is fundamentally about helping an attorney start and finish tasks quickly and confidently, giving them the experience of what it would be like to have a whole firm of attorneys and an expert right down the hall that they can go ask, "How do I do this? Why is it done that way? Or, can you provide me with a sample document, or give me a checklist?" With the tools and content we provide in Practical Guidance, attorneys are able to take on new tasks that they otherwise would have had to spend a lot of time learning, and they are able to accelerate tasks that benefit from having things like a sample document or comparison chart.

1. 2020 Legal Analytics Study: Bringing Value Into Focus," ALM Intelligence & LexisNexis, December 2019.

Q Is there a way to quantify the time savings created by these tools?

A Yes, and the time savings are significant. For example, Market Standards searches across 33,000 deals—public transactions filed with the SEC. The results shown here analyze deals between 50-100 million dollars over the last three years.



Source: Market Standards[2]

Before Market Standards, researchers had to perform hours of manual labor searching through the SEC deals, reading them and trying to pull out specific deal points to create a manual spreadsheet that illustrates these things. This tool does that automatically, in just a few clicks. It helps you narrow down and evaluate the deals using 150 deal points – everything from industry to escrow amount. It also visualizes the data about important deal points so that you can easily spot patterns. We expect regular users will save dozens of hours annually, or more. Then, in the time saved, we get to ask how much further can attorneys go? For example, if they were previously willing to dedicate five hours to this task, we can give them a lot more information and insight in those same five hours. They are now way ahead—they are more prepared than they were before. Or, they can take the same five hours and do the task in two, then use those other three hours to devote to the next high-value task that they have.

Q Can legal tech like this serve as an equalizer to help smaller firms compete?

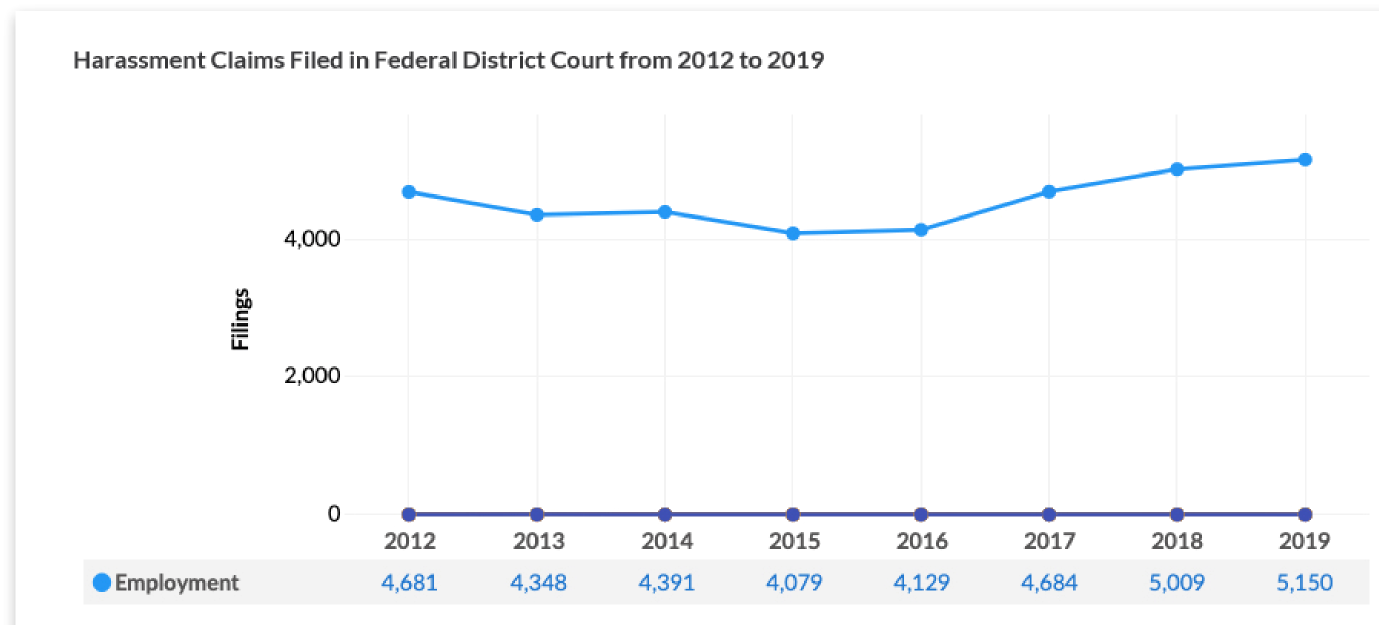
A To me, when leveling the playing field—the common theme is really about preparation. When you think about what money buys you in the legal context, one important thing it buys is time and preparation. Lexis+ brings more preparation into the hands of users, big or small in this context. Practical Guidance, for example, is like having a whole firm to learn from. Whether you are a small firm or a large firm, there are experts to learn from at your fingertips.

Another example of leveling the playing field is around data driven tools. So, whether it is Market Standards, or litigation-centered analytics, those tools bring forward to an individual new insights that would otherwise take an army of associates to uncover. Like the earlier example of a large firm trying to look at all of these SEC transactions—they have a team doing that. If you are an individual practitioner, you don't have that team, but you can do the same kind of work with this tool. I think there are real consequences of having all of that at your fingertips as a smaller firm. I think being able to do these kinds of things and execute the same preparation is a pretty powerful equalizer.

> Practical Guidance is like having a whole firm to learn from. Whether you are a small firm or a large firm, there are experts to learn from at your fingertips.

Q Can you offer an example of how Integration enhances efficiency?

A One example is what we've done to integrate analytics into some of our practice notes. We've integrated analytics from the broader LexisNexis ecosystem—in this case, Lex Machina® and Context. We've brought in data, in one instance, about the number of harassment claims filed in district courts over the past few years.[3] This is an interesting and powerful example of how all of these different pieces of technology and content from across the legal universe can come together in new and insightful ways.



Source: Lex Machina®

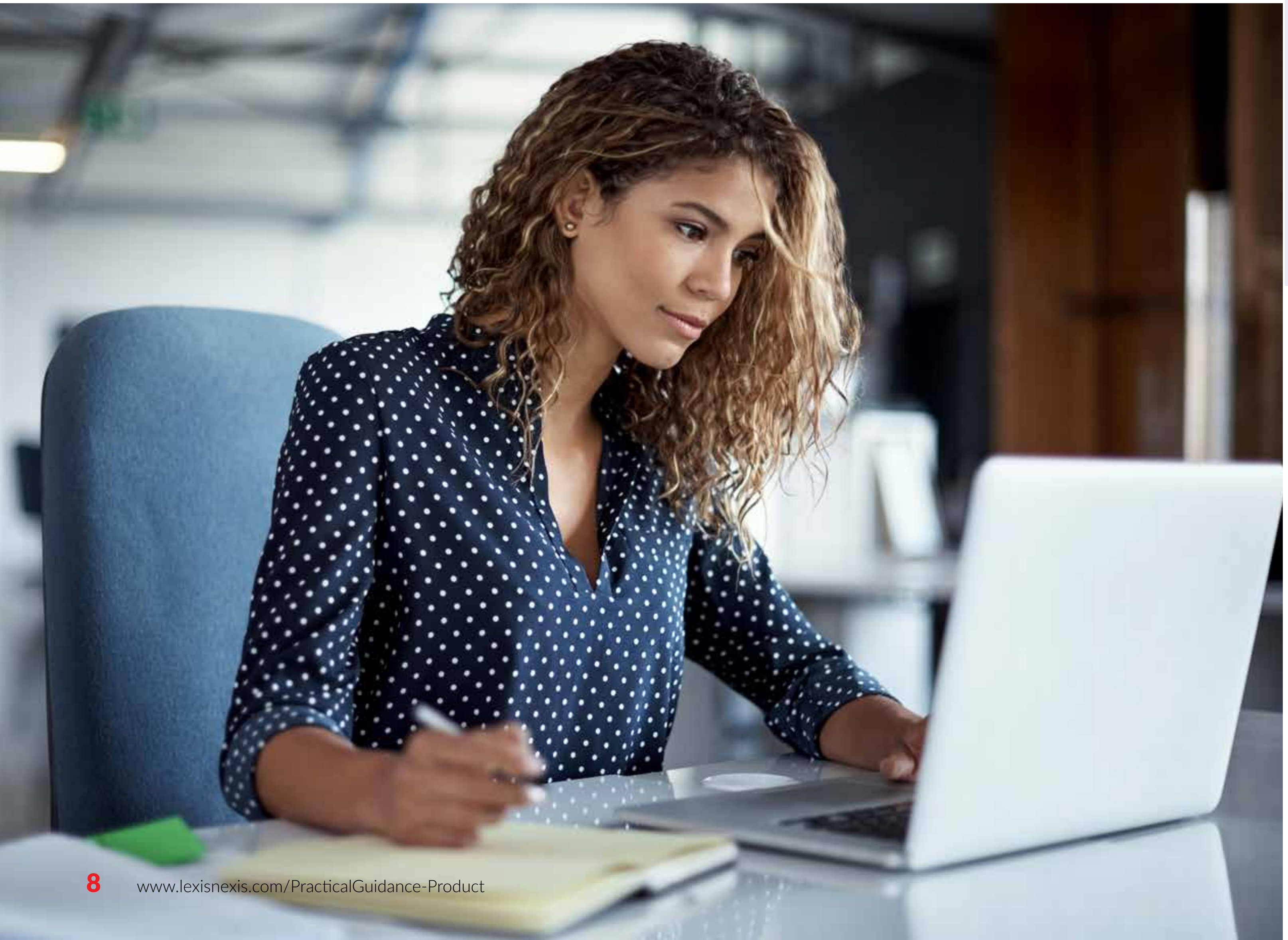
2. *Source: Market Standards (Current as of 10/14/2020.)*

3. Source: Lex Machina® (*current as of 2/4/2020*). For more information on Lex Machina and to sign up for a live demo, click here.

Nobody else is integrating litigation analytics into practical guidance. The ability to say "here's how to handle this dispute, here's what happens if it goes wrong, here are the litigation outcomes, and here's the number of lawsuits being filed"—it's a really new, powerful perspective that lawyers haven't had easy access to before—and we're bringing that together in one place, one subscription—easy to use.

For me, the most striking element of what these tools can bring to bear is speed and confidence. Whether you think about research or executing a task like drafting an agreement, the law is often complex, there are usually angles of it that an attorney may not fully understand, there are often edge cases, and there are always questions about what's common or typical. Anytime we are able to speed up that process while also adding confidence to it—that is powerful. And that to me has been the evolution of the last 10 years—why data driven intelligence is really impactful and why practical guidance is impactful. Bring them together, and data-driven practical guidance gives you a jumping off point that makes it quick to start, quick to finish, and gives you confidence that you actually understood the landscape and did not misinterpret something or miss the bigger picture. The attorney practicing today vs. ten years ago is getting a lot more information in the same amount of time and either finishing that task sooner or finishing it with a lot more confidence. L

Daniel Lewis** leads the Practical Guidance and Analytical business at LexisNexis. He previously led Lexis's legislative and regulatory tracking business, State Net. He was CEO and co-founder of Ravel Law, which Lexis acquired in 2017. Daniel holds a J.D. from Stanford Law and a BA from Johns Hopkins. He is a visiting professor for IE Law School's Master in Legal Tech program and from 2012 to 2018 was a fellow at Stanford's CodeX center. His past experience includes work with the Bipartisan Policy Center in Washington, DC; Cooley, LLP; Passport Capital; the Natural Resources Defense Council; and United States Senator Barbara Boxer.* ***Forbes *named Daniel to their* **30 under 30** *list in 2015 and to their* **All-Star Alumni** *in 2017.*



Randi-Lynn Smallheer PRACTICAL GUIDANCE

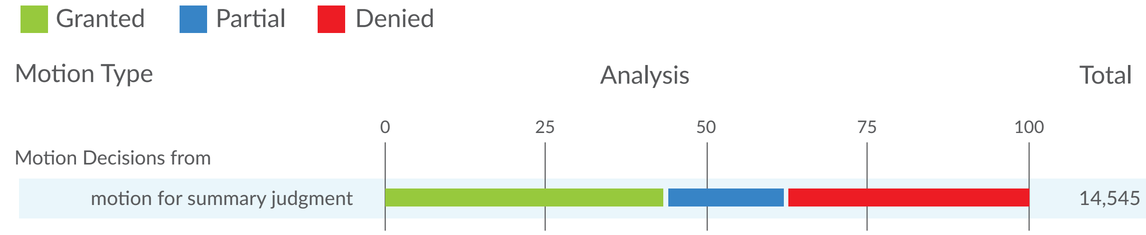
Summary Judgment: Making the Motion in New York

This article is for attorneys making a motion for summary judgment in New York state court under Rule 3212 of the Civil Practice Law and Rules. It provides an overview of summary judgment and addresses the summary judgment standard, motion deadlines, types of cases for which summary judgment is and is not favored, what evidence to submit with the motion, the trial court's role on summary judgment, and special requirements in the Commercial Division of the New York Supreme Court.

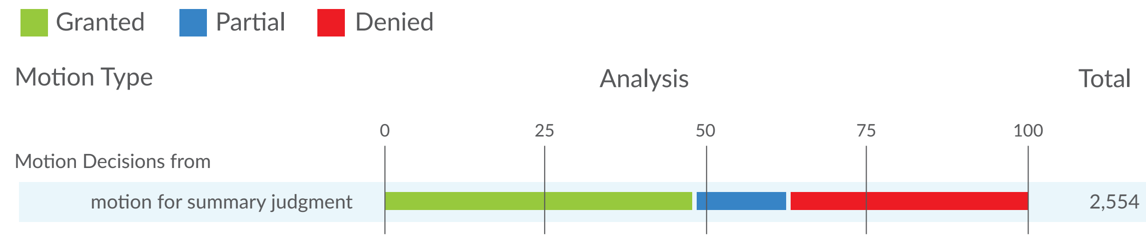
Overview of Summary Judgment

Summary judgment enables a party to subject its adversary's claims or defenses to the scrutiny of the presiding judge, who may resolve some or all of the issues in the case. Properly utilized, summary judgment motions save significant time and expense by limiting the scope of the case or disposing of it entirely. But making a summary judgment motion is itself expensive and time consuming. Therefore, be sure you understand the motion standards and procedures this article discusses and carefully evaluate your likelihood of success on the motion before proceeding. For example, Context analytics reveal the following rates of summary judgment success in various New York counties:

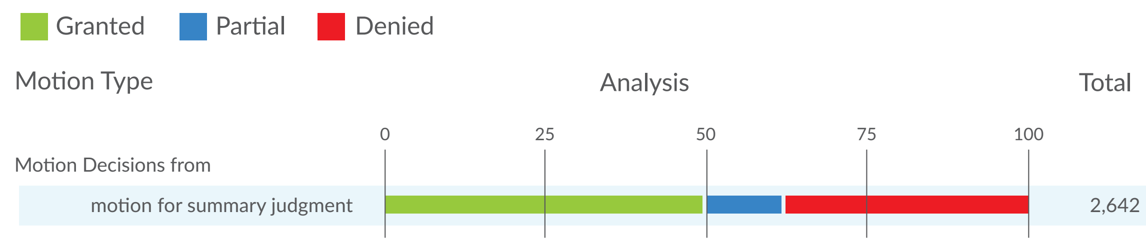
Motion Decisions from New York Supreme Court, New York County's Cases



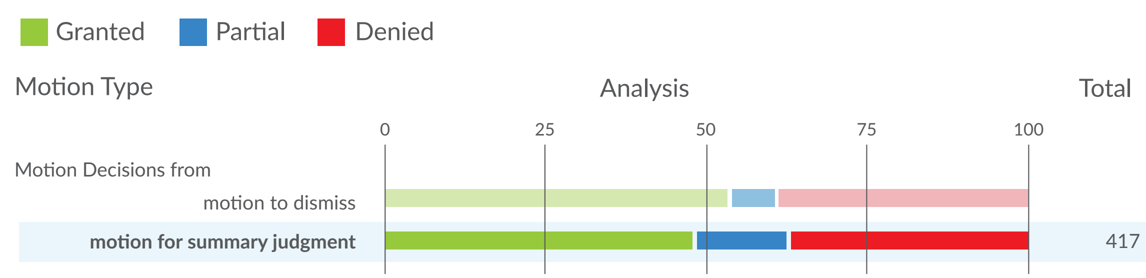
Motion Decisions from New York Supreme Court, Queens County's Cases



Motion Decisions from New York Supreme Court, Nassau County's Cases



Motion Decisions from New York Supreme Court, Albany County's Cases



Source: Context.[1]

1. Source: Context (New York County) (*current as of 10/01/2020*), Context (Queens County) (*current as of 10/01/2020*), Context (Nassau County) (*current as of 10/01/2020*), and Context (Albany County) (*current as of 10/01/2020*). For more information on Context, click here.

Motion for Summary Judgment Outcomes—New York Supreme Court, New York, Queens, Nassau, and Albany Counties

In New York, summary judgment is governed by N.Y. C.P.L.R. § 3212, which allows a court to resolve some or all of the issues in a case before trial. Full summary judgment results in a final judgment in favor of the moving party, while partial summary judgment resolves some of the claims and issues in the case and leaves others to be decided at trial.

The Summary Judgment Standard

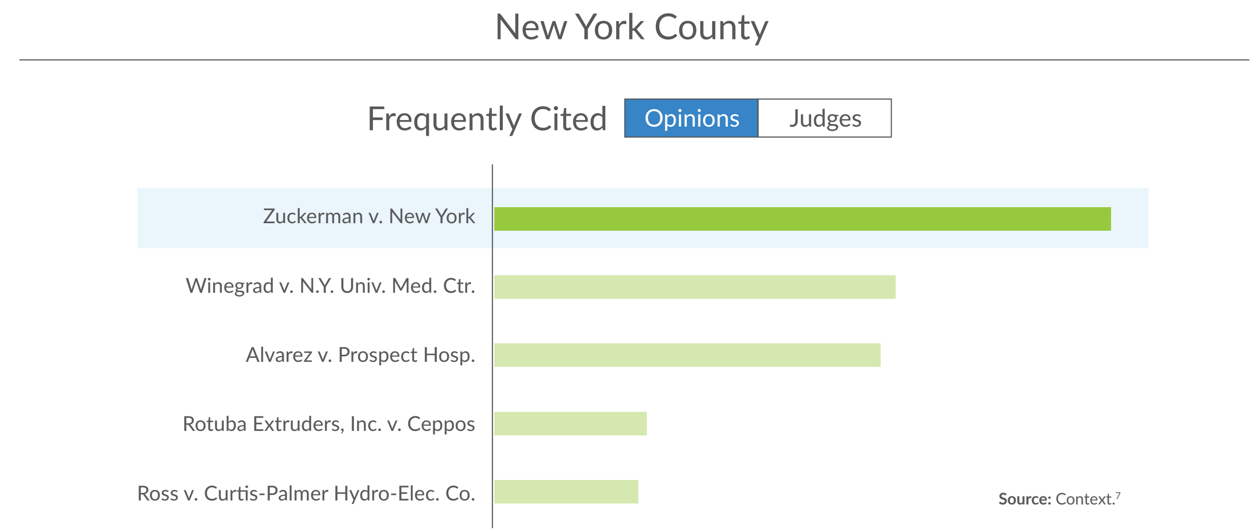
Any party may move for summary judgment in any action.[2] A court will grant summary judgment if, upon review of the record, the moving party sufficiently establishes the cause of action or defense at issue to warrant judgment in its favor as a matter of law.[3] The court will deny summary judgment if any party shows "facts sufficient to require a trial on any issue of fact" unless the case qualifies for immediate trial.[4]

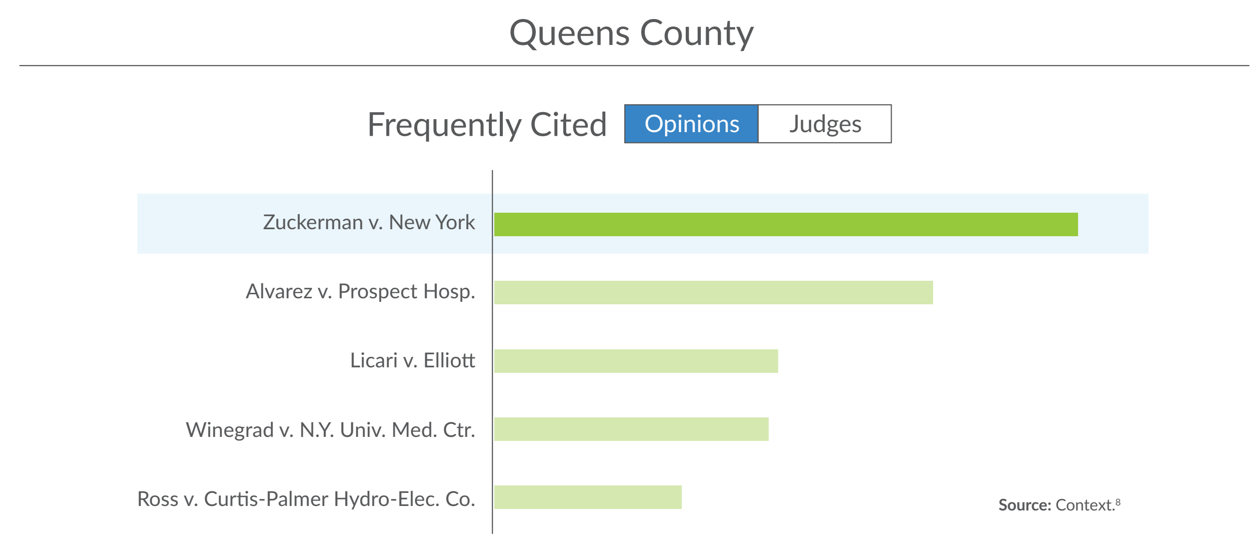
Motions for summary judgment in New York state court follow a burden-shifting approach. First, the moving party must demonstrate that there is no triable issue of fact and that the party is entitled to judgment as a matter of law.[5] Once the moving party satisfies its initial burden, the burden shifts to the party opposing summary judgment to submit evidence that raises the possibility of a factual issue and/or that the moving party is not entitled to judgment as a matter of law.[6]

As you prepare your motion papers, consider highlighting legal authority most frequently cited by your local court on a motion for summary judgment. For example, Context analytics show the following summary judgment citation patterns in the New York Supreme Court in New York County:

2. N.Y. C.P.L.R. § 3212(a). 3. N.Y. C.P.L.R. § 3212(b). 4. N.Y. C.P.L.R. § 3212(c). 5. *See* Winegrad v. N.Y. Univ. Med. Ctr., 64 N.Y.2d 851 (1985). 6. *See, e.g.*, Alvarez v. Prospect Hosp., 68 N.Y. 2d 320 (1986); Zuckerman v. New York, 49 N.Y.2d 557 (1980); Piccolo v. De Carlo, 456 N.Y.S.2d 171, 173 (3d Dep't 1982).

Motion for Summary Judgment Citation Patterns—New York Supreme Court, New York County and Queens Counties





If the moving party fails to establish its initial burden, the court will not grant summary judgment, even if the opposing party does not contest the motion.[9] When opposing a motion for summary judgment, however, you should never assume that the moving party has failed to meet its burden and should always submit a comprehensive opposition.

Due to the drastic nature of summary judgment, which deprives the parties of a trial on the merits, the court will deny the motion if there is bona fide doubt as to the existence of a triable issue.[10]

In determining what constitutes a triable issue of fact, the court must accept the allegations of the party opposing summary judgment as true.[11] To be sufficient to deny summary judgment, the factual issues must be genuine and not speculative.[12]

The court will also deny summary judgment if a determination depends upon the credibility of evidence or upon a choice between several reasonable inferences the court could draw from extrinsic evidence.[13]

7. Source: Context (New York County) (*current as of 10/1/2020*). For more information on Context, click here. 8. Context (Queens County) (*current as of 10/1/2020*) (click here for the latest analytics). To learn more about Context, click here. 9. Gallo v. Higgins Erections & Haulers, Inc., 357 N.Y.S.2d 152 (3d Dep't 1974). 10. Rotuba Extruders, Inc. v. Ceppos, 46 N.Y.2d 223, 231 (1978). 11. Rizk v. Cohen, 73 N.Y.2d 98, 103 (1989). 12. Dougherty v. Kinard, 626 N.Y.S.2d 554, 555 (2d Dep't 1995). 13. IBM Credit Fin. Corp. v. Mazda Motor Mfg. (USA) Corp., 542 N.Y.S.2d 649 (1st Dep't 1989).

Note that while proof of damages is essentially an issue of fact, the court will not grant summary judgment merely because the plaintiff has difficulty proving them.[14]

Making Timely Application for Summary Judgment

Generally, summary judgment motions are submitted after all relevant discovery has been completed, but well in advance of trial. In New York, a party may move for summary judgment any time "after issue has been joined," meaning after service of a responsive pleading.[15]

Courts can set a date—no earlier than 30 days after the note of issue is filed—by which summary judgment motions must be made.[16] The note of issue places the case on the court's trial calendar. It is filed after the parties have completed discovery and the case is ready for trial.[17]

If the court sets a summary judgment deadline, it will likely be contained in the preliminary conference order or compliance conference order. You should also look at the judge's individual rules and other local rules for deadlines.[18]

If the court does not set a deadline, summary judgment motions must be made no later than 120 days after a party files the note of issue, unless good cause is shown to extend the deadline.[19]

In New York, a summary judgment motion is made when the notice of motion or order to show cause is served on the other parties and not when the motion is filed.[20]

The parties may stipulate to a different procedure than set forth above (e.g., requiring the parties to file summary judgment motions no more than 60 days after the note of issue is filed), but be careful to strictly adhere to these procedures to avoid filing an untimely motion.[21]

N.Y. C.P.L.R. § 2214 sets the motion timetable for all motions, including summary judgment motions. The statute sets forth two separate schedules:

- **The 16-7-1 rule.** If the moving party wants to file a reply brief, it must serve the initial motion papers at least 16 days before the date the moving party selects for the court to hear the motion (i.e., the return date). Provided that the notice of motion demands it, the opposing party then must serve its answering papers at least seven days before the return date. The moving party must serve its reply papers at least one day before the return date.
- **The 8-2 rule.** If the moving party does not wish to file a reply brief, it must serve the motion papers at least eight days before the return date. The opposing party must then serve its answering papers at least two days before the return date.[22]

Good Cause

- As stated above, a court may grant a party leave to make a motion for summary judgment more than 120 days after the note of issue was filed upon "good cause shown."[23] To find good cause, there must be a satisfactory reason for delay.[24] For example, courts have found good cause in the following instances:
- New York State Unified Court System's public website incorrectly stated that the note of issue was filed five days after it was in fact filed; the movant reasonably relied upon the website, and the movant had no reason to believe that information contained on the website was not correct.[25]
- The defendants were never served with the note of issue and did not learn of it until after the period to make the motion had expired.[26]
- The action against the third-party defendant who filed the motion for summary judgment was not commenced until well after the note of issue was filed.[27]
- The defendant served the motion two days late because of the attorney's and his secretary's family emergencies on the last day to serve the motion.[28]

14. *See, e.g.*, A.W. Fiur Co. v. Ataka & Co., 422 N.Y.S.2d 419 (1st Dep't 1979). **15.** N.Y. C.P.L.R. § 3212(a). **16.** *Id.* **17.** *See* N.Y. C.P.L.R. § 3402. **18.** *See, e.g.*, New York County Supreme Court, Civil Branch, Rules of the Justices. **19.** N.Y. C.P.L.R. § 3212(a). **20.** N.Y. C.P.L.R. § 2211. **21.** *See, e.g.*, Corchado v. City of New York, 883 N.Y.S.2d 33, 34 (1st Dep't 2009). **22.** N.Y. C.P.L.R. § 2214. **23.** N.Y. C.P.L.R. § 3212(a). **24.** Coneo v. Washington Heights Hellenic Orthodox Church, Inc., 822 N.Y.S.2d 443 (1st Dep't 2006). **25.** Adika v. Dramitinos, 904 N.Y.S.2d 461 (2d Dep't 2010). **26.** McFadden v. 530 Fifth Ave. RPS III Assoc., LP, 812 N.Y.S.2d 88 (1st Dep't 2006). **27.** Callegari v. Davis & Partners, LLC, 2011 N.Y. Misc. LEXIS 1150 (Sup. Ct. New York County Mar. 22, 2011). **28.** Stimson v. E.M. Cahill Company, Inc., 778 N.Y.S.2d 585 (4th Dep't 2004).

Courts have held that the following reasons do not alone constitute good cause for a late motion:

- The parties were engaged in settlement talks.[29]
- The defendants switched counsel.[30]
- There were perfunctory law office failures.[31]

The fact that the summary judgment motion has substantive merit does not amount to good cause to make the motion after the statutorily prescribed 120-day period.[32] Courts are divided on whether that rule applies to cases where the court shortens the time to make the motion.[33]

Note that at least one court has found that parties may stipulate to waive their right to file an untimely motion upon good cause.[34]

In practice, it is best to seek leave to make a late motion before the court- or statutorily-imposed deadline passes and not in the late-filed papers themselves. This way, you do not face the possibility that the court will not find good cause for your late filing and deny the motion outright. However, when making or opposing an untimely motion, review the cases discussed in this section and assess whether good cause exists for the infraction.

Unfinished Discovery

Another common justification for making an untimely motion is that more discovery is needed before the court can rule on summary judgment. This situation often occurs where a party files the note of issue—signaling the end of discovery—before the parties have actually completed all discovery. The parties have several options to deal with a prematurely filed note of issue, such as striking the note of issue under 22 N.Y.C.R.R. § 202.21(e) or obtaining the court's permission to proceed with discovery even after the note of issue is filed.

If the court refuses to strike the note of issue and there is insufficient time to complete discovery and prepare a summary judgment motion before the deadline, seek leave from the court to extend the time to file summary judgment motions until a specified amount of time after discovery has concluded. Generally, courts find good cause for belated motions where the outstanding discovery is relevant or essential to the issues to be resolved on the motion.[35]

If the court refuses to extend the time to file motions for summary judgment, the cautious approach is to file a timely motion with the discovery available.

Related Content

For the basics on filing motions in New York state courts, see

> MOTION PRACTICE: INITIAL CONSIDERATIONS (NY)

RESEARCH PATH: *Civil Litigation > Motions > Motion Practice Fundamentals > Practice Notes*

For detailed information on making a motion on notice in New York state courts, see

> MOTION PRACTICE: MAKING A MOTION ON NOTICE (NY)

RESEARCH PATH: *Civil Litigation > Motions > Motion Practice Fundamentals > Practice Notes*

For a discussion of serving and filing papers in New York state court, see

> MOTION PRACTICE: SERVING AND FILING MOTION PAPERS (NY)

RESEARCH PATH: *Civil Litigation > Motions > Motion Practice Fundamentals > Practice Notes*

29. *See* State Farm Fire & Cas. v. Parking Sys. Valet Serv., 849 N.Y.S.2d 891 (2d Dep't 2008). **30.** Breiding v. Giladi, 789 N.Y.S.2d 449, 449 (2d Dep't 2005). **31.** *See* Quinones v. Joan & Sanford I. Weill Med. Coll., 980 N.Y.S.2d 88 (1st Dep't 2014). **32.** Brill v. City of New York, 814 N.E.2d 431 (NY 2004). **33.** *Compare* Bouilland v. Angulo, 799 N.Y.S.2d 158 (Sup. Ct. New York Cty. 2004), *with* Hernandez v. 620 West 189th Limited Partnership, 792 N.Y.S.2d 822, 824 (Sup. Ct. New York Cty. 2005). **34.** *See* Bennett v. St. John's Home & St. John's Health Care Corp., 8 N.Y.S.3d 774, 775 (4th Dep't 2015). **35.** *See, e.g.*, Courtview Owners Corp. v. Courtview Holding B.V., 978 N.Y.S.2d 859 (2d Dep't 2014).

Be aware that if discovery closes before the opposing party has obtained sufficient evidence for its answering papers, it can ask the court to utilize its authority under N.Y. C.P.L.R. § 3212(f) to deny summary judgment without prejudice to renew the briefing after it has obtained the necessary discovery. Courts regularly exercise this prerogative when necessary information is in the hands of the moving party (or a third party).[36]

Defenses Available

A defendant moving for summary judgment has the regular panoply of defenses available to it, save that it may not bring affirmative defenses it failed to raise in its responsive pleading.[37] As a result, it is imperative to raise in your answer to the complaint all defenses that you anticipate in good faith that you might raise at summary judgment.

Types of Cases Where Summary Judgment Is or Is Not Favored

New York does not place any restrictions on cases in which a party may move for summary judgment, with the sole exception that a court may not grant summary judgment in favor of a non-moving party in a matrimonial action.[38] However, as discussed below, certain types of cases are ill-suited for summary judgment due to their fact-specific nature.

Negligence Cases

Negligence cases are one example of actions that turn on factual determinations, making courts hesitant to grant summary judgment. In such an action, determining whether a party was negligent requires the court to assess whether the defendant acted reasonably under the circumstances, a mixed question of fact and law that courts often opt to leave to a jury to work out at trial.[39]

While not unheard of, it is particularly difficult for plaintiffs to succeed on summary judgment in negligence cases because they must demonstrate all of the fact-specific factors in the affirmative. Defendants moving for summary judgment have an easier task insofar as they need only demonstrate that the plaintiff cannot meet its burden with respect to at least one of the factors necessary for negligence.

Contract Cases

Contract disputes also do not readily lend themselves to resolution upon summary judgment. Deciding a contract action often requires the court to assess the intent of the parties regarding the terms of the agreement, a question of fact appropriate for a jury to determine. However, when the dispute depends solely on contract interpretation without reference to extrinsic or parol evidence, a court may grant summary judgment on the question of law.[40]

Thus, in negligence and contract cases (as in all cases), be sure to consider the elements for each cause of action and whether they are too fact-intensive to be appropriate for summary judgment.

Drafting, Serving, and Filing the Motion: Procedural Requirements

You can find technical requirements for drafting, serving, and filing motions in New York state courts in N.Y. C.P.L.R

36. *See, e.g.*, Salameh v. Yarkovski, 64 N.Y.S.3d 569 (2d Dep't 2017). 37. *See, e.g.*, Eschen Steel & Iron Works Co. v. John T. Brady & Co., 461 N.Y.S.2d 843, 844 (1st Dep't 1983). 38. N.Y. C.P.L.R. § 3212(e). 39. *See, e.g.*, Hoey v. City of New York, 590 N.Y.S.2d 434 (1st Dep't 1992); *see also* Hain v. Jamison, 46 N.Y.S.3d 502 (2016) (noting that issues of proximate cause and foreseeability in negligence actions "are generally questions for the factfinder"). 40. *See* Mallad Constr. Corp. v. County Fed. Sav. & Loan Ass'n, 32 N.Y.2d 285, 293 (1973).

> Attorney affirmations should be used solely to introduce evidence into the record as exhibits to the affirmation, such as deposition transcripts and important documents. Because attorneys do not have personal knowledge of the underlying facts of the case, they cannot testify to these facts as would a witness.

§§ 2101–2103 and the Uniform Rules for N.Y. State Trial Courts. The procedural requirements for motion practice generally in New York state court apply to summary judgment motions. However, be sure to check local rules or rules of individual judges as well, as they may have additional procedural requirements for summary judgment motions or general motion practice.[41]

Submitting Appropriate Proof in Support of a Summary Judgment Motion

To prevail on summary judgment, you must submit admissible evidence supporting your motion that is sufficient to merit judgment as a matter of law.[42] The evidence may take any of several forms. The motion may be supported by:

- Affidavits
- A copy of the pleadings
- Other available proof, such as depositions and written admissions[43]

Although the statute does not explicitly authorize them, you should also submit any relevant responses to written interrogatories. You may make supplemental submissions as well, but do so sparingly.[44]

Affidavits and Affirmations

Parties often submit evidence in the form of affidavits, which generally take three forms. One type of affidavit is a witness statement that the moving party uses as evidence to support its summary judgment motion. Be sure these affidavits are:

- Based on personal knowledge
- Truthful
- Particular
- Clear

Courts will disregard any affidavits that are conclusory or simply restate allegations in the complaint.[45]

A second type of affidavit contains a statement from an expert witness. These affidavits contain testimony pertaining to issues that require specialized knowledge in a particular field, such as medicine or forensics. Courts may not refuse to consider an affidavit from an expert witness supporting a summary judgment motion on the grounds that the parties did not conduct an expert exchange pursuant to N.Y. C.P.L.R. § 3101(d)(1)(i) prior to summary judgment.[46]

The third form of affidavits are actually affirmations that come from the attorneys representing the parties. Attorney affirmations should be used solely to introduce evidence into the record as exhibits to the affirmation, such as deposition transcripts and important documents.[47] Because attorneys do not have personal knowledge of the underlying facts of the case, they cannot testify to these facts as would a witness.[48] The attorney's affirmation also should not make legal arguments, which belong in the briefs or memoranda of law.[49]

Note that the court may not weigh the credibility of the affiants on a motion for summary judgment unless it clearly appears that the issues are not genuine but feigned.[50]

Evidence Other than Affidavits and Affirmations

Use the pleadings and written admissions to your advantage. For example, if the complaint contains a statement that is damaging to the opposing party's claim, bring it to the court's attention in your briefing. The court may consider it a formal judicial admission upon which it can base its dismissal of the case.[51]

Similarly, written admissions can include records of stipulations made in open court.[52] If the opposing party made a damaging statement on the record, submit it as evidence.

Do not submit hearsay or other inadmissible evidence in support of your motion.[53] Also, do not rely on defective pleadings (i.e., complaints and answers) to win summary judgment, as you would on a motion to dismiss. Even if a

41. *See, e.g.*, New York County Supreme Court, Civil Branch, Rules of the Justices. 42. N.Y. C.P.L.R. § 3212(b). 43. *Id.* 44. *See* Ostrov v. Rozbruch, 936 N.Y.S.2d 31, 35 (1st Dep't 2012) ("While such supplemental submissions may be appropriate in particular cases, they should be sparingly used and then only for a limited purpose."). 45. *See* N.Y. C.P.L.R. § 3212(b); Vermette v. Kenworth Truck Co., 497 N.E.2d 680 (N.Y. 1986). 46. N.Y. C.P.L.R. § 3212(b). 47. *See* Simplex Grinnell, LP v. Ruby Weston Manor, 873 N.Y.S.2d 210 (2d Dep't 2009). 48. *Id.* 49. In re Taylor, 37 N.Y.S.2d 675, 676 (2d Dep't 1942). 50. Glick & Dolleck, Inc. v. Tri-Pac Exp. Corp., 22 N.Y.2d 439, 441 (1968). 51. *See* Performance Comercial Importadora E Exportadora Ltda v. Sewa International Fashions Pvt. Ltd., 915 N.Y.S.2d 44, 45 (1st Dep't 2010). 52. *See* N.Y. C.P.L.R. § 2104. 53. Borough Hall-Oxford Tobacco Corp. v. Central Office Alarm Co., 313 N.Y.S.2d 431, 432 (2d Dep't 1970) (holding hearsay cannot support summary judgment).

complaint mischaracterizes a cause of action or is otherwise insufficient, the claim may still withstand summary judgment if the plaintiff's evidence on summary judgment supports the claim.[54]

Additionally, file and rely upon only the evidence that is necessary to support the motion for summary judgment. Burdening the courts with nonessential information is unwise and generally makes it easier for the opposition to identify disputed issues of fact.

Finally, note that unlike in New York federal courts, there is no requirement in the New York Supreme Court that the moving party include a statement of material facts in its papers unless the case is in the Commercial Division or local rules require it.

The Trial Court's Role on Summary Judgment

Once the parties' submissions are complete, the trial court judge has an array of options besides simply granting summary judgment in full and disposing of the case or denying summary judgment in full and allowing all claims to proceed to trial. This section discusses the various statutory powers granted to the trial court on summary judgment under New York law.

Grant Partial Summary Judgment

First, the court may order partial summary judgment on a subset of the claims or defenses at issue.[55] Moreover, if a single cause of action is divisible into multiple elements, the court may grant summary judgment with respect to part of that individual claim.[56] The court may either enter partial summary judgment immediately or hold the entry of summary judgment in abeyance pending the determination of any remaining cause of action.[57]

Search the Record and Find for the Non-moving Party

The court may also search the record and direct summary judgment in favor of the non-moving party, even if the non-moving party has not brought a cross-motion requesting such relief.[58] However, the court may not order summary judgment on claims or issues that are not before it.[59] Nor may the court grant summary judgment sua sponte in the absence of any motion at all by the parties.[60] Nevertheless, the court's power in this regard is significant. Give it due consideration when assessing the risks of bringing a summary judgment motion that is less than meritorious.

Order an Immediate Trial

The trial court also has the power to order an immediate trial before a referee, the court, or a jury on certain factual issues that a party raises in its summary judgment motion.[61] The court may order an immediate trial with respect to:

- The amount or extent of damages, if that is the only triable issue of fact–or–
- In motions based on any of the grounds enumerated in N.Y. C.P.L.R. § 3211(a) or (b), any other issue of fact the motion raises when appropriate for the expeditious disposition of the controversy[62]

Establish Facts and Limit the Issues for Trial

If the motion for summary judgment does not dispose of the case, the court may ascertain which facts are undisputed or incontrovertible by examining the papers before it and, in its discretion, interrogating counsel.[63] The court may then deem certain facts established without requiring a party to prove them with additional evidence at trial.[64]

Make Other Orders

Finally, the court has the sweeping, catch-all power to "make any order as may aid in the disposition of the action."[65] This prerogative is limited, however, by other restrictions on the court's powers.[66]

54. *See* Alvord & Swift v. Stewart M. Muller Constr. Co., 46 N.Y.2d 276, 280-81 (1978). 55. N.Y. C.P.L.R. § 3212(e). 56. *Id.*; Amaducci v. Metro. Opera Ass'n, 304 N.Y.S.2d 322, 323-24 (1st Dep't 1969). 57. N.Y. C.P.L.R. § 3212(e). 58. N.Y. C.P.L.R. § 3212(b). 59. *See* Dunham v. Hilco Constr. Company, 89 N.Y.2d 425, 429–30 (1996). 60. Berle v. Buckley, 869 N.Y.S.2d 679, 681 (3d Dep't 2008). 61. N.Y. C.P.L.R. § 3212(c). 62. *Id*. 63. N.Y. C.P.L.R. § 3212(g). 64. *Id*. 65. *Id*. 66. *See, e.g.*, N.Y. C.P.L.R. § 3212(c) (limiting the issues on which the court may order an immediate trial).

Related Content

For information on considerations and procedures for preliminary conferences in New York state courts, see

> PRELIMINARY CONFERENCES (NY)

RESEARCH PATH: *Civil Litigation > Case Management > Practice Notes*

For the steps to follow when requesting, preparing for, and attending a preliminary conference in New York state courts, see

> PRELIMINARY CONFERENCES CHECKLIST (NY)

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For an overview of making counterclaims and crossclaims in New York state courts, see

> COUNTERCLAIMS AND CROSSCLAIMS: ASSERTING AND RESPONDING TO COUNTERCLAIMS AND CROSSCLAIMS (NY)

RESEARCH PATH: *Civil Litigation > Initial Pleadings and Documents > Responding to a Civil Action > Practice Notes*

For guidance on responding to a summons and complaint in New York state court, see

> RESPONDING TO THE COMPLAINT (NY)

RESEARCH PATH: *Civil Litigation > Initial Pleadings and Documents > Responding to a Civil Action > Practice Notes*

Res Judicata

The court's order granting summary judgment is a final determination on the merits of the claim or the entire case. Thus, it has res judicata and collateral estoppel effect. The court's denial of the motion as to certain claims and issues is not preclusive, however, as it simply means that there is some uncertainty regarding these matters.

For instance, if the court denies the summary judgment motion, but the moving party subsequently uncovers new evidence that was not available to it at the time of its original motion, the court should not deny the second motion on res judicata grounds.[67] However, a court will generally deny summary judgment to a party that has previously lost on summary judgment if the moving party does not present new evidence or the new evidence was available (though not presented) in the original motion.[68]

Summary Judgment in the Commercial Division

Special requirements apply to summary judgment motions in cases assigned to the Commercial Division of the New York Supreme Court, which hears various enumerated claims—including breach of contract or fiduciary duty, fraud, misrepresentation, business torts, and other alleged violations arising from business dealings—that meet a certain monetary threshold.[69]

Specifically, the court in such cases may direct the moving party to annex a statement of material facts to the notice of motion. In some counties the statement of material facts is mandatory.[70] The statement of material facts should be a separate and concise statement, in numbered paragraphs, of the material facts as to which the moving party contends there is no genuine issue to be tried.[71] Each statement of material fact must be followed by a citation to the evidence that supports it.

The opposing party must respond with a correspondingly numbered paragraph responding to each of the moving party's numbered paragraphs and, if necessary, additional numbered paragraphs containing material facts and citations of its own.[72] The court will deem each of the movant's material facts to be admitted unless the opposing party specifically controverts them in this manner.[73] L

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RESEARCH PATH: *Civil Litigation > Motions > Dispositive Motions > Practice Notes*

67. *See* Green Harbour Homeowners Assn., Inc. v. Ermiger, 8 N.Y.S.3d 705, 707 (3d Dep't 2015). 68. *See* Keating v. Town of Burke, 962 N.Y.S.2d 804, 805 (3d Dep't 2013); Ralston Purina v. Arthur G. McKee & Co., 572 N.Y.S.2d 125, 126 (4th Dep't 1991). 69. *See* 22 N.Y.C.R.R. § 202.70(a)–(b). 70. *See, e.g.*, Kings County Supreme Court Uniform Civil Term Rules, Part I, Rule 15; 22 N.Y.C.R.R. 202.70(g), Rule 19-a.). 71. 22 N.Y.C.R.R. § 202.70, Rule 19-a(a). 72. 22 N.Y.C.R.R. § 202.70, Rule 19-a(b), (d). 73. 22 N.Y.C.R.R. § 202.70, Rule 19-a(c).

The Practical Guidance Attorney Team

Market Trends: Representations and Warranties Insurance

This article discusses trends in provisions relating to representations and warranties (R&W) insurance in acquisition agreements for transactions announced in the first half of 2020 as compared to transactions announced in the first half of 2019.

THE ITEMS DISCUSSED INCLUDE THE PREVALENCE OF representations and warranties insurance generally, which party pays the policy premium, retention amounts, and the effect of representations and warranty insurance on selected agreement provisions.

R&W insurance is used in M&A transactions to supplement or replace traditional indemnification methods in the event of a breach of the seller's representations and warranties. Most R&W policies cover breaches of general and fundamental representations and warranties within a purchase agreement (e.g., misstated financials, unknown third-party claims over intellectual property, failure to obtain environmental permits, etc.), which are unknown to the buyer's deal team at the time of execution of the agreement.

The data analyzed in this article was obtained using Market Standards, the searchable database of publicly filed M&A deals from Practical Guidance that enables users to search, compare, and analyze more than 33,000 transactions using up to 150 detailed deal points to filter search results.[1]

Prevalence of R&W Insurance

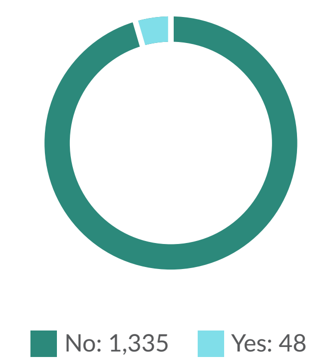
As one might expect, given the economic uncertainty from the COVID-19 pandemic, deal-flow in the first half of 2020 was down when compared to the same period in 2019. Between January 1, 2019, and June 30, 2019, 1,383 new deals were

announced, and between January 1, 2020, and June 30, 2020, 1,053 new deals were announced, a decline of about 24%.

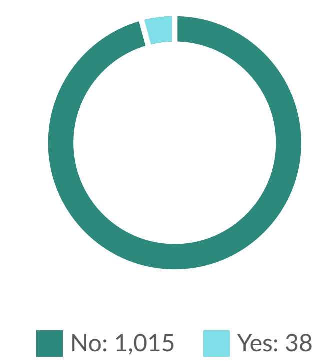
Of all transactions in the first half of 2019, 48 (3.5%) contained reference to a R&W insurance policy. Of all transactions in the first half of 2020, 38 (3.6%) contained reference to a R&W insurance policy. In 2019, insurers underwrote approximately $65 billion of R&W insurance.

1. For more information on Market Standards, click here.

R&W Insurance Referenced (H1 2019)



R&W Insurance Referenced (H1 2020)



Source: Market Standards.[2]

Breaking these transactions down by target type, in the first half of 2020, 586 private-target transactions were announced. Of these, 29 (5%) included reference to R&W insurance. For the same period in 2019, 37 out of 744 private-target deals (5%) included reference to R&W insurance. Note that these numbers are likely underreporting the total percentage of deals with R&W insurance, as many acquisition agreements may not explicitly reference R&W insurance policies that have been obtained and the terms of many private-target transactions are not publicly disclosed.

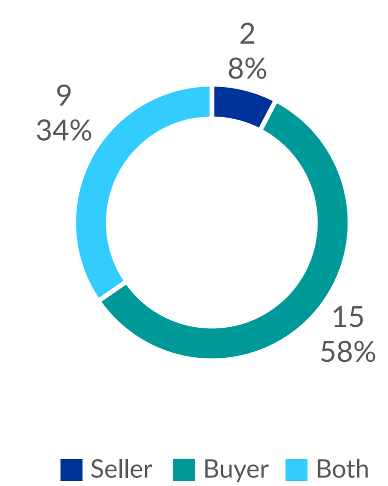
Premium Payor

As with any insurance policy, a R&W insurance policy requires payment of a premium to purchase the policy. The premium amount depends on the complexity of the transaction and policy and is usually between 2.5% and 4% of the total coverage amount of the policy. This premium is typically paid by the buyer, as the main beneficiary of the policy, but like any other deal term, it is subject to negotiation.

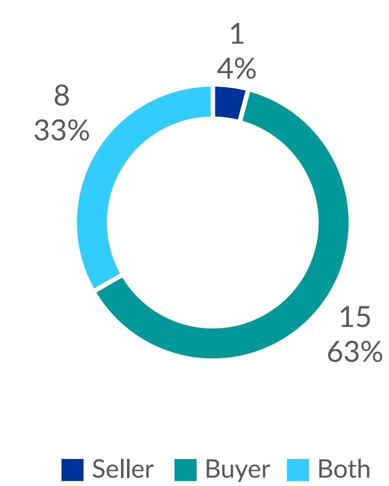
For the 48 transactions in the first half of 2019 that included reference to R&W insurance, 26 agreements included information on which party would pay the premium for the insurance policy. In most transactions (58%) the purchaser paid the entire premium for the policy. In 34% of transactions, the premium cost was split between buyer and seller 50-50 and in 8% of transactions, the seller paid the cost of the policy premium.

In the first half of 2020, the breakdown remained relatively stable, with the buyer paying the policy premium in 63% of deals, the parties splitting the cost in 33% of deals, and the sellers paying in 4%.

R&W Insurance Payor (2019)



R&W Insurance Payor (2020)



Source: Market Standards.

2. Source: Market Standards. (Current as of 09/17/2020.)

Retention Amount

The loss threshold that must be met before a R&W insurance policy may be drawn on (the equivalent of the deductible in other types of insurance) is known as the retention amount.

It is not common for a publicly filed acquisition agreement to state the retention amount for a R&W insurance policy. For the agreements in each period where a retention amount was stated, such amount was typically 1% of the deal value. In the first half of 2019, the minimum disclosed retention amount was 0.75% and the maximum amount was 1.9%. In the first half of 2020, the minimum disclosed retention amount was 0.99% and the maximum amount was 1%.

Effect of R&W Insurance on Deal Terms

10b-5/Full Disclosure Representation

Including a 10b-5 and/or Full Disclosure representation in an acquisition agreement can significantly increase the likelihood that the seller may have an unknown breach of representations and warranties. In such a provision, the seller represents that the representations and warranties in the agreement contain no misstatement of material fact and do not omit any material fact necessary to make the statements in the representation not misleading. These representations are becoming less common over time and have been particularly uncommon in deals with R&W insurance, as they present increased risk to the insurer and therefore result in higher policy premiums.

In the first half of 2019, 11% of all deals contained a 10b-5 or Full Disclosure representation. Only 8% of deals that referenced R&W insurance included such a representation.

The first half of 2020 has turned this trend on its head. While 10b-5 and Full Disclosure representations are still very uncommon, they appeared in 5% of deals with R&W insurance. The prevalence of these representations in deals as a whole, however, dropped to just 1.6%.

Non-Reliance Clause

Transactions with R&W insurance are historically more likely to include a non-reliance clause. In this provision, the buyer acknowledges that it is not entering into the transaction in reliance on any representations made other than those contained in the acquisition agreement.

In the first half of 2019, 8.2% of deals announced included a non-reliance clause. In contrast, 46% of deals with reference to R&W insurance included a non-reliance clause.

This trend held in the first half of 2020, with 7.8% of announced deals including a non-reliance clause. For deals referencing R&W insurance, that percentage increased to 55%. L

Related Content

For a broad overview of R&W insurance, see

> REPRESENTATIONS AND WARRANTIES INSURANCE

RESEARCH PATH: *Corporate and M&A > M&A Provisions > Practice Notes*

For guidance on drafting provisions related to R&W insurance, see

> REPRESENTATIONS AND WARRANTIES INSURANCE DRAFTING AND COUNSELING CONSIDERATIONS

RESEARCH PATH: *Corporate and M&A > M&A Provisions > Practice Notes*

For information in using R&W insurance as a negotiating tool, see

> REPRESENTATIONS AND WARRANTIES INSURANCE POLICIES STRATEGIC USES

RESEARCH PATH: *Corporate and M&A > M&A Provisions > Practice Notes*

For examples of indemnification clauses for use in R&W policies, see

> INDEMNIFICATION CLAUSES (REPRESENTATIONS AND WARRANTIES INSURANCE)

RESEARCH PATH: *Corporate and M&A > M&A Provisions > Clauses*

For a sample R&W covenant clause, see

> REPRESENTATIONS AND WARRANTIES INSURANCE COVENANT CLAUSE

RESEARCH PATH: *Corporate and M&A > M&A Provisions > Clauses*

For a discussion of using insurance coverage as a risk allocation tool during the coronavirus pandemic, see

> CORONAVIRUS (COVID-19): IMPLICATIONS FOR REPRESENTATIONS AND WARRANTIES INSURANCE

RESEARCH PATH: *Corporate and M&A > M&A Provisions > Articles*

RESEARCH PATH: *Corporate and M&A > Trends and Insights > Market Trends > Practice Notes*


Debbie Yoon Jones and Lisa Garcia ALSTON & BIRD LLP

Discovery in **Single-Plaintiff Employment Discrimination Cases (CA)**

This article excerpt containing legal analytics from Context® provides guidance to employers' attorneys who need to request and respond to discovery in single-plaintiff employment discrimination cases brought under California's Fair Employment and Housing Act (FEHA).[1]

THIS EXCERPT ADDRESSES THE FOLLOWING TOPICS:

- Resolving discovery disputes
- E-discovery in California—best practices

The unabridged version of this article addresses the following additional topics:

- What is the permissible scope of discovery in FEHA cases?
- Discovery employers should seek from plaintiff employees
- Discovery employers should seek from nonparty sources
- Responding to written discovery[2]

Resolving Discovery Disputes

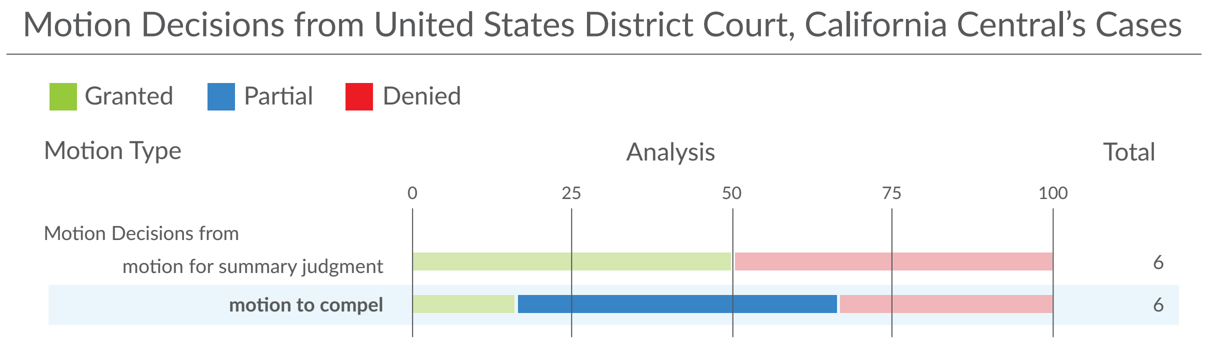
If you reach a point in the discovery process where there is a disagreement that cannot be resolved consensually, then you must engage in discovery motion practice to either (1) move to compel the production of information or responses by the plaintiff or (2) move for a protective order to prevent the production of information or responses by the defendant.

Be sure you have the law and argument on your side before you move to compel or move for protective order—a meritless motion will irritate the judge and could result in sanctions.[3]

According to data provided by Context, in discrimination law cases, the U.S. District Court for the Central District of California has granted fewer than 25% of the motions to compel discovery since January 1, 2010 (current as of 9/11/2020).

1. Cal. Gov. Code § 12900 et seq. 2. To read the unabridged version of this article, go to Discovery in Single-Plaintiff Employment Discrimination Cases (CA). 3. *See* Cal. Code Civ. Proc. §§ 2023.010–2023.040, 2025.420(h), 2025.450(g), 2030.090(d), 2030.300(d), 2031.060(d), 2031.310(d), 2033.080(d), 2033.290(d).

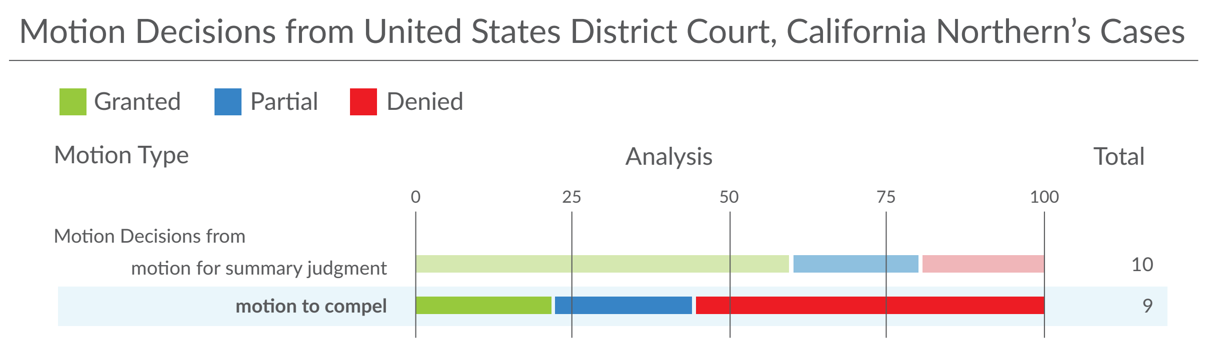
Motion to Compel Discovery Decisions in Discrimination Cases Since January 1, 2010—U.S. District Court, Central District of California



Source: Context.[4]

Similarly, according to data provided by Context, in discrimination law cases, the U.S District Court for the Northern District of California has also granted fewer than 25% of the motions to compel discovery since January 1, 2010 (current as of 9/11/2020).

Motion to Compel Discovery Decisions in Discrimination Cases Since January 1, 2010—U.S. District Court, Northern District of California



Source: Context.[5]

Meet and Confer Requirement

In moving to compel or for a protective order, you must meet and confer and discuss the issues with the other side in an attempt to resolve disagreements before making a motion.[6] You should always confirm the meet and confer discussions in a letter so that your position is clearly stated in writing and sent to the other side.

When filing your motion, you must include a declaration attesting that you met the meet and confer requirement.[7] You should include as an attachment to the declaration the written confirmation of your meet and confer discussion.

Deadlines to File

You must file and serve a motion to compel written discovery within 45 days of the service of a verified response (although you get additional time if the responses were served by mail per Cal. Code Civ. Proc. § 1013).[8] If you get an extension of time to move to compel, always confirm this in writing.

You should file any motion for a protective order before any discovery response is due to preserve your objections.

4. Source: Context (U.S. District Court, Central District of California) (current as of 9/11/20) (click here for updated analytics). To learn more about Context, click here. 5. Source: Context (U.S. District Court, Northern District of California) (current as of 9/11/20) (click here for updated analytics). To learn more about Context, click here. 6. *See* Cal. Code Civ. Proc. §§ 2016.040, 2025.420(a), 2025.450(b), 2030.090(a), 2030.300(b), 2031.060(a), 2031.310(b), 2033.080(a), 2033.290(b). 7. *Id.* 8. *See* Cal. Code Civ. Proc. §§ 2030.300(c), 2031.310(c), 2033.290(c).

E-Discovery in California—Best Practices

The Electronic Discovery Act became law in California in June 29, 2009. Its purpose was to eliminate uncertainty and confusion regarding the discovery of electronically stored information (ESI). ESI is broadly defined as "information that is stored in an electronic medium."[9] Common examples of ESI include emails, computer files, Microsoft Word and Excel documents, and electronic images.

Any party may obtain ESI discovery by inspecting, copying, testing, or sampling ESI that is in the possession, custody, or control of any other party to the action.[10]

In practice, employers are most often on the receiving end of requests for ESI since they control the servers on which most ESI resides. When plaintiff employees in FEHA cases request emails and other computer files relating to the plaintiff and other key custodians in the case, the employer must understand and comply with its obligations under California law in preserving and producing its ESI. This section discusses those obligations.

ESI Preservation and Spoliation

As with physical records, employers must retain certain ESI to be used as evidence in litigation. Failure to do so is known as spoliation.

In California, "spoliation occurs when evidence is destroyed or significantly altered or when there is a failure to preserve property for another's use as evidence in current or future litigation."[11]

The exact time at which employers must begin to preserve evidence in California is not yet clear. However, destroying evidence in response to or in anticipation of a discovery request after litigation has commenced "would surely be a misuse of discovery."[12]

In FEHA cases where an employee worked for the company for a long period of time, some relevant information may no longer exist. When plaintiffs discover that the employer no longer has responsive ESI, they may petition the court for relief, claiming the employer knew that the documents might be used but nevertheless destroyed them.

The remedies in California for spoliation of evidence can be severe, and include:

- A discretionary jury inference against the party who destroyed the evidence or rendered it unavailable[13]
- Various discovery sanctions ranging from monetary and contempt sanctions, to issue, evidentiary, and even terminating sanctions[14]
- Injunctive relief
- An obstruction of justice charge and criminal penalties[15]
- State bar discipline against any attorney involved in spoliation of evidence[16]

California courts may also draw adverse evidentiary inferences and impose other orders against a litigant who benefitted from a third-party's spoliation when a sufficient relationship existed between the litigant and third party.[17]

9. Cal. Code Civ. Proc. § 2016.020(e). 10. Cal. Code Civ. Proc. § 2031.010. 11. Strong v. State, 201 Cal. App. 4th 1439, 1458 (2011) (quoting Hernandez v. Garcetti, 68 Cal. App. 4th 675, 680 (1998)); *see also* Kearney v. Foley & Lardner, LLP, 590 F.3d 638 (9th Cir. 2009) (applying California law). 12. *See* Cedars-Sinai Med. Ctr. v. Superior Court, 18 Cal. 4th 1, 12 (1998). 13. *See* Cal. Evid. Code §§ 412, 413; Walsh v. Caidin, 232 Cal. App. 3d 159, 164–65 (1991); Bihun v. AT & T Information Systems, Inc., 13 Cal. App. 4th 976, 994–95 (1993). 14. *See* Cal. Code Civ. Proc. § 2023; Puritan Ins. Co. v. Superior Court, 171 Cal. App. 3d 877 (1985). 15. *See* Cal. Pen. Code § 135; Smith v. Superior Court, 151 Cal. App. 3d 491, 497–500 (1984). 16. *See* Cedars-Sinai Med. Ctr., 18 Cal. 4th 11–13. 17. *See* Temple Cmty. Hosp. v. Superior Court, 20 Cal. 4th 464, 473–74, 476–77 (1999).

To avoid sanctions and adverse inferences resulting from spoliation claims, consider whether the information was intentionally destroyed. For instance, California trial courts only instruct juries with a spoliation inference where a litigant is found to have willfully destroyed or concealed evidence during the underlying litigation.[18] Specifically, the party seeking the benefit of an inference from spoliation "must demonstrate first that the records were destroyed with a culpable state of mind (i.e., where, for example, the records were destroyed knowingly, even if without intent to violate [a] regulation [requiring their retention], or negligently)."[19]

In practice, plaintiffs often lack evidence of any willful spoliation and courts do not seem eager to impose sanctions without some egregious behavior. California law also provides a safe harbor for employers that destroy ESI as part of their routine operations.[20] Be sure to marshal these defenses when faced with spoliation allegations.

ESI Meet and Confer Requirement

Unless the court orders another time period, no later than 30 calendar days before the date set for the initial case management conference, the parties must meet and confer, in person or by telephone, to consider a number of ESI-related issues, including:

- Issues relating to the preservation of discoverable ESI
- The form or forms in which information will be produced
- The time within which the information will be produced
- The scope of discovery of the information
- The method for asserting or preserving claims of privilege or attorney work product, including whether such claims may be asserted after production
- The method for asserting or preserving the confidentiality, privacy, trade secrets, or proprietary status of information relating to a party or person not a party to the civil proceedings
- How the cost of production of ESI is to be allocated among the parties
- Any other issues relating to the discovery of ESI, including developing a proposed plan relating to the discovery of the information[21]

Responding to Requests for ESI

Employers must follow general California discovery rules when responding to requests for ESI, but you should be aware of certain requirements that pertain specifically to the production of electronic information.

Reasonable Accessibility

If the plaintiff requests ESI from a source that is not reasonably accessible because of undue burden or expense, the employer may object. The employer must identify in its response the types or categories of sources of ESI that it asserts are not reasonably accessible to preserve the objections.[22] The employer may also seek a protective order.[23] Whether a source is reasonably accessible is a factual question for the court to decide, but factors can include:

- The media on which the ESI is stored
- The volume of the ESI
- The time and cost required to restore, search, and review the ESI
- The amount at issue in the case
- Whether the ESI is cumulative and/or available from other sources
- The relevance of the ESI to key issues in the case[24]

ESI Format

While not required, most plaintiffs specify in their demands the form in which they want the employer to produce ESI (e.g., native format or TIFF images). If the employer objects to that form, or if no form is specified, the employer must state in its response the form in which it intends to produce each type of information.[25] If no form is specified, the employer must produce the information in the form in which "it is ordinarily maintained" or in "a form that is reasonably usable."[26] Parties need not produce the same ESI in more than one form.[27] Additionally, the requesting party has to bear the "reasonable expense" of "translat[ing] any data compilations included in the demand into reasonably usable form."[28]

Inadvertent Disclosures of ESI

One concern when producing ESI is the inadvertent production of privileged or work product materials. In California, there are procedures in place to address the inadvertent production of ostensibly privileged information.

18. *See, e.g.*, Cedars-Sinai Med. Ctr., 18 Cal. 4th at 12. 19. Reeves v. MV Transp., Inc., 186 Cal. App. 4th 666, 681–82 (2010) (quoting Byrnie v. Town of Cromwell, Bd. of Educ., 243 F.3d 93, 107, 109 (2d Cir. 2001)). 20. *See* Cal. Code Civ. Proc. § 2031.320(d)(1) ("absent exceptional circumstances, the court shall not impose sanctions on a party or any attorney of a party for failure to provide electronically stored information that has been lost, damaged, altered, or overwritten as the result of the routine, good faith operation of an electronic information system."). 21. Cal. Rules of Court, Rule 3.724(8). 22. Cal. Code Civ. Proc. § 2031.210(d). 23. Cal. Code Civ. Proc. § 2031.060. 24. *See* 8 California Points & Authorities § 85A.07[3]–[4]. 25. Cal. Code Civ. Proc. § 2031.280(c). 26. Cal. Code Civ. Proc. § 2031.280(d)(1). 27. Cal. Code Civ. Proc. § 2031.280(d)(2). 28. *See* Cal. Code Civ. Proc. § 2031.280(e).

Specifically, if a responding party discovers the inadvertent production of privileged material and notifies a party who received the information, the receiving party must sequester the information immediately, and either return the information or present it to the court under seal for a ruling on the claim of privilege.[29]

The party in possession is precluded from using or disclosing the information until the claim of privilege or protection is resolved by the court.[30] Note, however, that these provisions govern only the procedure for dealing with inadvertently produced materials pending a determination of whether they are in fact privileged—they do not affect the actual analysis of whether such inadvertent production waived the asserted privilege. To ensure the employer does not waive the privilege with respect to any privileged documents it inadvertently produces, be sure to enter into a clawback agreement with the plaintiff prior to producing ESI.

Differences between California ESI Rules and the Federal Rules of Civil Procedure

While California's ESI rules closely follow the FRCP, there are a couple of notable differences:

- Federal rules do not require the production of ESI that is "not reasonably accessible because of the undue burden or cost,"[31] and the requesting party bears the burden of showing good cause before a claimed inaccessible data source has to be searched. As discussed above, California law presumes that all ESI is accessible and the burden of showing inaccessibility falls on the responding party.[32]
- The Federal rules expressly require discussion of e-discovery matters no later than 21 days prior to the first scheduling conference.[33] California rules require specific topics relating to e-discovery be discussed no later than 30 days prior to the first case management conference.[34] L

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RESEARCH PATH: *Labor & Employment > Discrimination, Harassment, and Retaliation > Claims and Investigations > Practice Notes*

Related Content

For more information on electronic discovery in employment litigation, see

> ELECTRONIC DISCOVERY IN EMPLOYMENT LITIGATION

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For an overview of federal e-discovery, see

> E-DISCOVERY: PLANNING FOR AND CONDUCTING E-DISCOVERY (FEDERAL)

RESEARCH PATH: *Civil Litigation > Discovery > E-discovery > Practice Notes*

For a discussion of e-discovery in California, see

> E-DISCOVERY: PLANNING FOR AND CONDUCTING E-DISCOVERY (CA)

RESEARCH PATH: *Civil Litigation > Discovery > E-discovery > Practice Notes*

For a sample clawback agreement in federal court, see

> STIPULATED PROTECTIVE ORDER (WITH CLAWBACK PROVISION) (FEDERAL)

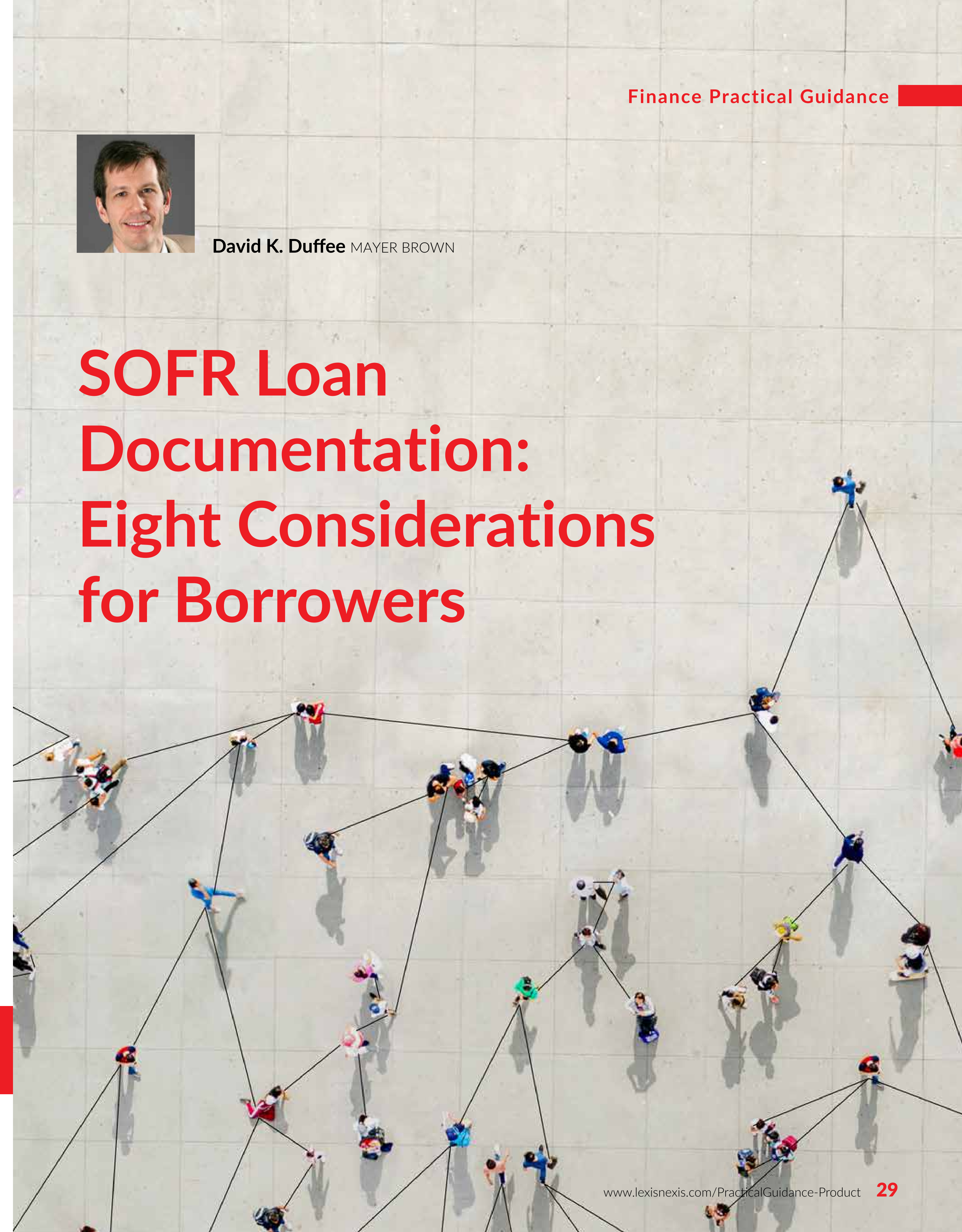
RESEARCH PATH: *Civil Litigation > Discovery > Privileges and Protections > Forms*

For a review of evidence preservation generally in California, see

> EVIDENCE PRESERVATION (CA)

RESEARCH PATH: *Civil Litigation > Discovery > Privileges and Protections > Practice Notes*

29. Cal. Code Civ. Proc. § 2031.285(b). 30. *See* Cal. Code Civ. Proc. § 2031.285(c)(1), (d)(2). 31. Fed. R. Civ. P. 26(b)(2)(B). 32. Cal. Code Civ. Proc. §§ 2031.060(c) and 2031.310. 33. Fed. R. Civ. P. 26(f)(3). 34. Cal. Rules of Court, Rule 3.724, 3.727.



David K. Duffee MAYER BROWN

SOFR Loan Documentation: Eight Considerations for Borrowers

Bankers, lawyers, and others involved in the loan market's transition from the London Interbank Offered Rate (LIBOR) to another reference rate have spent much of the past two years thinking about and drafting fallback provisions—the section of a loan agreement that describes what happens if LIBOR is not available.

NOW THAT THE LIKELY DISAPPEARANCE OF LIBOR IS less than a year and a half away, and the Alternative Reference Rates Committee (ARRC) has identified the Secured Overnight Financing Rate (SOFR) as the likely successor to U.S. dollar LIBOR, market participants are spending more time thinking about how to document loans that provide for interest accruing at a rate based on SOFR.

There are not many sources of guidance for developing SOFR loan documentation, but here are a few:

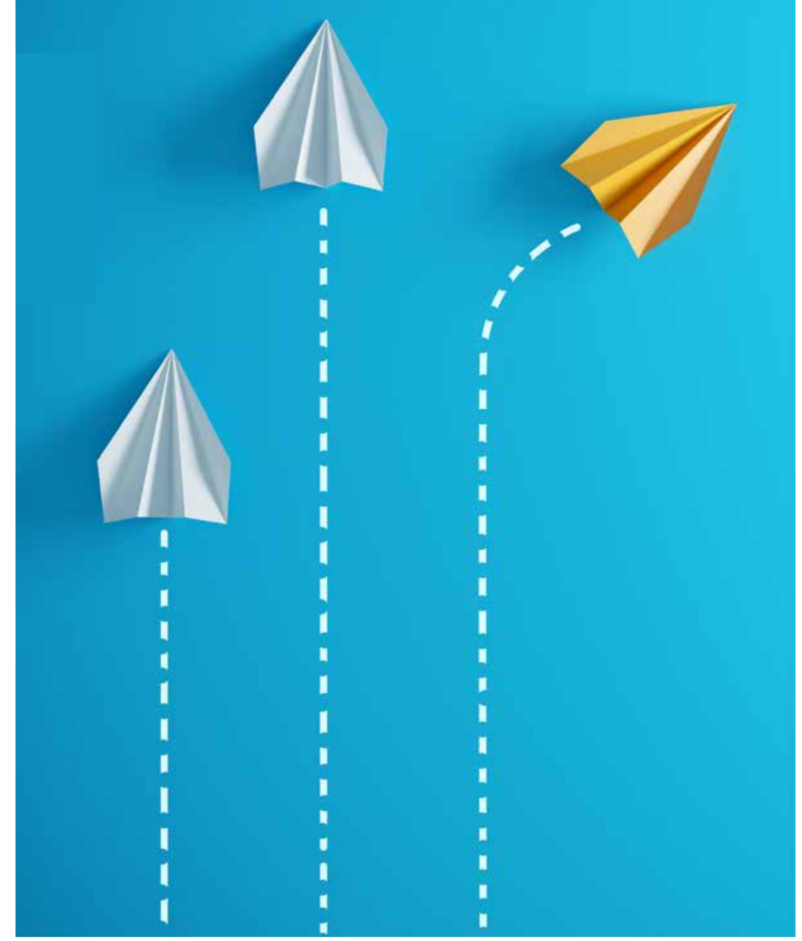
- There are a handful of precedent deals, including credit facilities for Royal Dutch Shell plc and British American Tobacco. Their utility in preparing documentation in the United States is limited since they are governed by English law; they are somewhat dated (from December 2019 and March 2020, respectively); and, instead of providing for SOFR pricing at the outset, each has a so-called switch mechanism providing for a change in pricing from U.S. dollar LIBOR to SOFR in the future. It is also possible that these financings were provided by relationship lenders and thus unlikely to be traded in the secondary market, making them less useful precedents for transactions in which such trading is anticipated.[1] The Loan Syndications and Trading Association (LSTA) has prepared various draft concept documents—model credit agreements (governed by New York law) that provide for loans priced at a rate based on SOFR.[2] The most recent of these forms includes provisions for loans bearing interest at daily simple SOFR (the Draft Simple SOFR Credit Agreement). Insofar as we know, these models have not yet been used for actual SOFR financings. Similarly, the Loan Market Association has prepared an exposure draft (governed by English law) of a compounded SOFR-based U.S. dollar term and revolving facilities agreement.[3]
- On June 30, 2020, the ARRC published revised recommendations for fallback language in syndicated credit agreements (the Refreshed Hard-wired Recommendations). The revised recommendations provide solely for the hard-wired approach (and eliminate the amendment approach as an alternative).[4] Although this language provides for the automatic replacement of LIBOR with SOFR, it also acknowledges that conforming changes will need to be made to implement that replacement. The ARRC has also published a note on "SOFR "In Arrears" Conventions for Syndicated Business Loans."[5] This note discusses mechanical issues that must be addressed in documentation for SOFR loans (and, for many of the issues, the ARRC does not make a recommendation on how it should be resolved).

Although the borrower community has been actively involved in the negotiation of fallback provisions, borrowers in the United States have not had much of an opportunity to express their views on documentation for SOFR-priced loans. Here is a list of things that may be proposed by borrowers in the negotiation of a SOFR credit agreement and, in a syndicated financing, may be the subject of possible disagreement among lenders:

1. Eliminate term SOFR from waterfall.

The first level of the waterfall in the Refreshed Hard-wired Recommendations is term SOFR. Term SOFR refers to a possible risk-free reference rate, based on SOFR, that is a forward-looking term rate (both attributes of LIBOR that some market participants would like to see in a reference rate). The ARRC has made it clear that there's no guarantee that it will be possible to develop term SOFR. Although there appears to be a strong preference by some banks for term SOFR (rather than daily SOFR), it is possible that some borrowers and lenders may prefer daily SOFR (the second level of the waterfall) since interest rate hedges (both for existing LIBOR hedges when they fall back and for new SOFR hedges) will likely be based on daily SOFR and not term SOFR. Those borrowers and lenders may fear potential basis risk and may want to eliminate the term SOFR level from the waterfall of possible fallback rates. The ARRC notes in the Refreshed Hard-wired Recommendations that parties may wish to eliminate term SOFR from the waterfall for this reason. Other borrowers may well prefer to keep term SOFR as the first level of the waterfall (if term SOFR is in fact available) since its use will enable the parties to determine at the beginning of an interest period the exact amount of interest that will be payable at the end of the interest period—a determination that will not be possible for interest accruing at a rate based on daily SOFR in arrears (the second level of the waterfall in the Refreshed Hard-wired Recommendations).

1. For more on these precedents, *see* "List of RFR referencing syndicated and bilateral loans," published by the Loan Market Association on July 21, 2020. 2. The July 13, 2020, draft Daily Simple SOFR or Daily Compounded SOFR (Compound the Balance) Concept Document and other LSTA forms of SOFR credit agreements are available here. 3. https://www.lma.eu.com/libor/documents. 4. *See* ARRC Recommendations Regarding More Robust Fallback Language for New Originations of LIBOR Syndicated Loans, dated June 30, 2020. 5. https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ARRC_SOFR_Synd_Loan_Conventions.pdf.



2. Permit movement from daily SOFR to term SOFR.

It is possible that term SOFR (the first level of the waterfall) will not exist at the time a SOFR-priced loan agreement is entered into, and the loans will thus be priced at a rate based on daily SOFR (the second level of the waterfall). The parties to a credit agreement may want to provide that, if term SOFR is subsequently available, the daily SOFR interest rate will be automatically replaced with an interest rate based on term SOFR. That might require a significant amount of additional drafting, including (a) the possibility of different interest margins that would apply to loans priced at term SOFR (which may be difficult to agree on in advance if the calculation of term SOFR is not yet determined) and (b) provisions for the mechanics of pricing loans at term SOFR (such as day count and business day conventions, holiday and weekend conventions, and the payment of broken funding compensation).[6] Such a transfer from daily SOFR to term SOFR might also require modification of hedging arrangements to avoid or minimize basis risk. The ARRC, in the Refreshed Hard-wired Recommendations, rejected the inclusion of a mechanic to change the pricing from daily SOFR to term SOFR, citing, among other things, "potential operational challenges."[7] As noted above, many lenders have expressed a preference for term SOFR, and borrowers may also prefer a term interest rate. The Draft Simple SOFR Credit Agreement does provide language for the possible replacement of daily SOFR with term SOFR but notes that an objective trigger may be required and that term SOFR may have limited availability for syndicated loans.[8] The minutes of the ARRC's October 22, 2019, meeting state: "Federal Reserve staff delivered a presentation . . . showing that while SOFR futures volumes have grown significantly since inception, current market depth and trading volumes significantly lag fed funds futures and do not yet appear sufficient to create a robust IOSCO compliant SOFR term rate."

3. Compound daily SOFR.

The waterfall in the Refreshed Hard-wired Recommendation provides that the second level of the waterfall is simple SOFR rather than compounded SOFR. The use of simple SOFR may facilitate sales of loans in the secondary market. It is possible that some lenders and some borrowers may prefer compounded SOFR so that the calculation of the interest rate on the loans is consistent with the way SOFR is calculated in any related interest rate hedges.

Related Content

For a sample LIBOR replacement amendment clause, including practical guidance, drafting notes, and optional clause, see

> LIBOR REPLACEMENT CLAUSE (AMENDMENT)

RESEARCH PATH: *Finance > The Credit Agreement > Credit Agreement Guide > Clauses*

For assistance in drafting a LIBOR replacement clause (hardwired), including practical guidance and drafting notes, see

> LIBOR REPLACEMENT CLAUSE (HARDWIRED)

RESEARCH PATH: *Finance > The Credit Agreement > Credit Agreement Guide > Clauses*

For a description of the two pricing options currently available for syndicated credit agreements, see

> INTEREST RATE PROVISIONS IN CREDIT AGREEMENTS

RESEARCH PATH: *Finance > The Credit Agreement > Credit Agreement Guide > Practice Notes*

For an explanation on the use of yield protection clauses, see

> YIELD PROTECTION CLAUSES IN CREDIT AGREEMENTS

RESEARCH PATH: *Finance > The Credit Agreement > Credit Agreement Guide > Practice Notes*

6. *See* Refreshed Hard-wired Recommendations at note 23. 7. *Id.* 8. *See* the Draft Simple SOFR Credit Agreement at note 34.

4. Reduce or eliminate interest rate floors.

Many recent credit agreements have a floor on LIBOR (i.e., if LIBOR is actually less than a specified rate, LIBOR will be deemed to equal the specified rate for purposes of calculating interest). These floors generally range between zero and one percent and protect lenders in the event that LIBOR falls below the floor. The Refreshed Hard-wired Recommendations provide that, for purposes of a SOFR-based fallback rate, the sum of SOFR plus the spread adjustment cannot be less than the floor. That is appropriate because the sum of SOFR plus the spread adjustment is the replacement for LIBOR. In negotiating new SOFR credit agreements, borrowers may take the view that whatever floor was agreed to in the context of a LIBOR-priced loan should be reduced (or eliminated) in determining a floor for a SOFR loan since SOFR will almost always be a lower rate than LIBOR.[9]

5. Eliminate breakage cost compensation.

Credit agreements currently provide that if a borrower repays a LIBOR-priced loan on a day other than the last day of an interest period, or if it fails to borrow a LIBOR loan that it requested, it must pay to the lenders any applicable broken funding cost. Note that generally, that is an amount that is equal to the difference (if any) between the amount of interest that would have accrued during the unelapsed portion of such interest period had there been no prepayment and the amount of interest that would accrue on the prepaid principal for that unelapsed portion of the interest period at a rate equal to LIBOR in effect on the date of the prepayment. The obligation to pay breakage for LIBOR-priced loans arose out of the structure of the London interbank market, in which banks made loans by buying certificates of deposit that did not permit prepayments. If a loan made by a bank that had funded itself in the LIBOR market were prepaid, that bank would not be able to prepay its funding source and would run the risk that interest rates in the interim had declined and interest that the bank could obtain on the amount of the prepayment would be less than the bank would owe on the certificate of deposit at maturity. Of course, lenders do not now fund themselves in the London interbank market, and borrowers nevertheless agree to pay broken funding compensation as if they did. That notwithstanding, borrowers may well balk at agreeing to breakage provisions when the historical explanation for breakage payments does not exist for a loan priced at a rate based on SOFR. The Draft Simple SOFR Credit Agreement notes that "[i]nclusion of breakage indemnities for SOFR-based loans is an ongoing discussion point in the market."[10] The Refreshed Hard-wired Recommendations provide that modifications to the broken funding provision are one of the Benchmark Conforming Changes that can be made unilaterally by the Administrative Agent. Note that the modifications could be to terminate the breakage provision or to modify it so that it works in the context of a SOFR-priced loan.

9. *See generally* SOFR "In Arrears" Conventions for Syndicated Business Loans at pages 4 and 5. **10.** *See* Draft Simple SOFR Credit Agreement at note 43.

6. Eliminate yield protection.

Credit agreements will usually have provisions requiring the borrower to pay additional amounts to a lender to compensate the lender for additional costs it incurs as a result of changes in applicable law (and certain other circumstances). These provisions were originally included in credit agreements because of the loan pricing theory that a lender should be paid its cost of funds (i.e., LIBOR) plus the agreed-upon margin (the cost-plus loan pricing theory). Although these provisions now customarily apply to both base rate loans and LIBOR loans, borrowers may object to them being applied to SOFR loans, arguing that since SOFR is not a cost-of-funds rate, the cost-plus pricing theory does not apply to SOFR-priced loans (and that it would be anomalous to ask a borrower to reimburse a lender for an increase in the lender's funding cost when the SOFR-based pricing of the loan is not related to the lender's funding cost).

Related Content

For a discussion of credit agreement provisions that allow for a transition to replacement reference interest rate, see

> MARKET TRENDS 2019/20: LIBOR SUCCESSION CLAUSES

RESEARCH PATH: *Finance > Trends & Insights > Market Trends > Practice Notes*

For an overview of increase costs and yield protection provisions in credit agreements, see

> MARKET TRENDS 2020: YIELD PROTECTION AND INCREASED COSTS

RESEARCH PATH: *Finance > Trends & Insights > Market Trends > Practice Notes*

For guidance on drafting or amending a credit agreement to replace LIBOR as the baseline reference interest rate, see

> LIBOR TRANSITION TO SOFR IN CREDIT AGREEMENTS

RESEARCH PATH: *Finance > The Credit Agreement > Credit Agreement Guide > Practice Notes*

For a recommendation on how to advise a client on the impact of LIBOR's cessation on their loan documents, see

> THE CLIENT ASKS: WHAT HAPPENS WHEN LIBOR ENDS?

RESEARCH PATH: *Finance > The Credit Agreement > Credit Agreement Guide > Practice Notes*

7. Eliminate illegality provision.

Although they are becoming less common (as noted, for example, in The LSTA's Complete Credit Agreement Guide), some credit agreements still provide that a lender is released from its obligation to lend LIBOR-priced loans if it becomes illegal for the lender to make loans at an interest rate based on LIBOR. Those provisions arose out of fears that the U.S. government might prohibit LIBOR loans as an attempt by banks to avoid U.S. regulation by funding themselves outside of the United States. Although the Draft Simple SOFR Credit Agreement includes an illegality provision tied to SOFR loans, it is likely that borrowers will object to an illegality provision for loans priced at an interest rate published by the U.S. government.[11]

8. Eliminate SOFR prong to base rate.

Credit facilities typically provide that borrowers are able to borrow either at a rate based on LIBOR or a rate based on the base rate or adjusted base rate. That is typically defined as the greatest of (a) the U.S. prime rate, (b) the federal funds rate plus 50 basis points, and (c) some variant of LIBOR (usually one-month LIBOR as determined on any day) plus 100 basis points. The LIBOR prong of this definition is a recent addition that reflects the anomalous circumstance during the 2008 financial crisis in which there was a risk that a LIBOR-priced loan would have a lower interest rate than a loan priced at the base rate (for which the spread would typically be 100 basis points less than the spread for LIBOR-priced loans). The Draft Simple SOFR Credit Agreement contemplates a SOFR prong (in lieu of the LIBOR prong) but does not express a view on whether the additional spread should be 100 basis points or something else. It may be that borrowers will push back on the inclusion of a SOFR prong since the circumstances that led to the increase of LIBOR in 2008 are unlikely to happen with respect to SOFR (since it is a risk-free rate). L

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RESEARCH PATH: *Finance > Trends & Insights > First Analysis > Articles*

11. *See* Draft Simple SOFR Credit Agreement, § 2.18.

Jason Amster PRACTICAL GUIDANCE

What Happens When LIBOR Ends?

This article describes how you should proceed when your client calls and asks what happens to their loan documents after the pending cessation of London Interbank Offered Rate (LIBOR) at the end of 2021.

LENDER AND BORROWER CLIENTS WITH CREDIT AGREEMENTS that extend past that date and borrowers entering into new financings are asking their lawyers how their financings address the potential loss of LIBOR. This article explains what to look for to ensure that your credit agreement contemplates the end of LIBOR—and what to do if it does not.

The End of LIBOR

LIBOR (often referred to as the Eurodollar Rate in credit agreements) is the baseline pricing mechanism in loan agreements and many other contractual arrangements. It is flexible and widely accepted, being available for several maturities ranging from overnight to one year and is calculated in five currencies. However, following the LIBOR manipulation scandal of 2012, banks themselves no longer wanted to report LIBOR, for fear of also becoming embroiled in LIBOR-related trouble. The UK's Financial Conduct Authority (FCA), the regulator overseeing LIBOR, said that it would no longer require banks to provide LIBOR estimates at the end of 2021.

One of the first questions that came up was what would replace the reference rate in the $200 trillion in contracts that use LIBOR. Of that, there are about $1.5 trillion in syndicated loans and $800 billion in non-syndicated loans that would need to be converted to a rate other than LIBOR (the derivatives market makes up about 95% of the outstanding gross notional value of all financial products referencing LIBOR). The Secured Overnight Financing Rate (SOFR), a broad credit-risk measure,

has emerged as the frontrunner. The FCA confirmed in March 2020 that, despite the challenges posed by the COVID-19 pandemic, the transition will move ahead as scheduled.

To address this problem and find a replacement for LIBOR, in 2014, the Board of Governors of the Federal Reserve System and the Federal Reserve Bank of New York established the Alternative Reference Rate Committee (ARRC), comprising financial institutions and banks, trade associations (such as the Loan Syndication and Trading Association), and official sector members. The ARRC initially recommended as an alternative rate the Broad Treasuries Financing Rate, which subsequently became known as SOFR. Other currency areas, outside the U.S. dollar, are looking at replacements as well (including the Sterling Overnight Interbank Average, backed by the Bank of England). ARRC has also turned its attentions to cash markets—that is, helping loan markets make the operational transition to a replacement rate.

LIBOR Fallback Language

ARRC has taken several steps to assist in the transition away from LIBOR, specifically "to encourage a voluntary adoption of SOFR, rather than to mandate a transition away from USD LIBOR." Among these is a paced transition plan, which walks through steps and provides timelines to foster adoption of SOFR. With this encouragement, ARRC introduced fallback language to use in contracts.

Fallback language anticipates the unavailability of the underlying reference rate, or benchmark—in this case, LIBOR. The fallback language describes the triggers (or events) that must occur before the parties can consider LIBOR done and move forward with a replacement. The fallback language explains how the parties and documentation must address the discontinuation and at that point the fallback language bifurcates. The first option is called the amendment approach. This allows for a speedy amendment to the credit agreement to universally replace LIBOR with an acceptable replacement (such as SOFR). The amendment process is streamlined in that, so long as the amendment addresses only those items described in the credit agreement, it becomes effective with the negative consent of required lenders. That is, the administrative agent posts the form of amendment, and it becomes effective five business days later unless the required lenders expressly reject it. Obviously, this is a vastly easier approach than trying to amend interest rate provisions otherwise (see Step 4, below).

The second option is called hardwired. This approach obviates the need of an amendment (other than for administrative and operational conforming changes). Once the same benchmark transition event is triggered, the fallback language prioritizes what to use to replace LIBOR. The first choice—that is, the cleanest and closest replacement for LIBOR—is term SOFR along with a credit spread adjustment to bring that rate closely in line with the cost of capital that LIBOR represents. Term SOFR is an application of SOFR that has the same tenor as LIBOR in the credit agreement. If this is not available, the fallback language settles for daily simple SOFR for business loans. Once the replacement is determined in accordance with this waterfall, the change is automatic with no need for an amendment (other than for conforming changes).

Right now, the ARRC recommends that all financings—and amendments to financings—incorporate the hardwired approach. This is because SOFR has now crystalized as the replacement, and the amendment approach poses the risk of an amendment traffic jam in the market as we approach the end of 2021.

Related Content

For a resource kit that provides Practical Guidance materials on the methods and process for replacing LIBOR, including detailed practice notes, forms, and articles, see

> LIBOR REPLACEMENT RESOURCE KIT

RESEARCH PATH: *Finance > The Credit Agreement > The Loan > Practice Notes*

For guidance on creating or amending a credit agreement to replace LIBOR as baseline reference interest rate, see

> LIBOR TRANSITION TO SOFR IN CREDIT AGREEMENTS

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For a sample LIBOR replacement amendment clause, including practical guidance, drafting notes, and optional clause, see

> LIBOR REPLACEMENT CLAUSE (AMENDMENT)

RESEARCH PATH: *Finance > The Credit Agreement > Credit Agreement Guide > Clauses*

With that introduction in mind, we turn to the analysis of your loan documents.

Reviewing Your Loan Documents

Fallback language is the most critical part of this analysis. In short, your answer about what to do about the end of LIBOR depends on whether your credit agreement has fallback language, and if so, what kind of fallback language (Step 3). And if not, you will need to amend the credit agreement or refinance before the end comes (Step 4). The steps below show where in the credit agreement to look for these provisions, what to look for to distinguish between them, and what to do if your agreement has no fallback language. This guideline also includes examples from loan documentation.

Document Analysis

Step 1. Assemble a full set of the documents to be reviewed, which in this case will likely include only the credit agreement and its amendments. You may also want to review any intercreditor agreements, as any modifications and amendments to the credit agreement will ultimately have to comply with the intercreditor agreement as well.

If your firm is the sole representative of this client, you should be able to gather the necessary loan documents (including final executed agreements and amendments). Otherwise, you should ask the client to provide these documents, and in any event ask the client to confirm whether there have been any intervening amendments.

Step 2. Determine how your credit agreement would treat the inability to determine LIBOR in the absence of any fallback language.

Agreement and sections. Does the credit agreement include an increased costs or inability to determine interest rates clause (generally in an article appearing early in the credit agreement, dealing with the mechanics of lending and borrowing)?

What to look for. One section that will likely not save the day, but that is a good illustration as to why the fallback language is so important to all parties, is the yield protection section and the clause addressing an inability to determine LIBOR. This provision is intended to protect lenders' expected yield from making the loan. It provides that if a change in law imposes on the lenders additional costs or expenses—or makes them subject to unforeseen taxes—then the borrower will reimburse the lender for those amounts.

This section provides additional protection to the lenders if "Administrative Agent shall have determined in good faith (which determination shall be conclusive and binding upon Borrower) that, by reason of circumstances affecting the relevant market, adequate and reasonable means do not exist for ascertaining" LIBOR. This language was significantly bolstered in the wake of the financial crisis of 2008, specifically to capture the regulations put in place at that time.

> "…what to do about the end of LIBOR depends on whether your credit agreement has fallback language, and if so, what kind of fallback language. And if not, you will need to amend the credit agreement or refinance before the end comes."

Of course, if LIBOR ceases to exist entirely—and in the absence of any fallback provision—the inability to determine interest rates would be the operative provision to determine how to calculate interest. Whether as a result of a change in law or an inability to calculate LIBOR, the result is to default to the alternate base rate. Doing so protects the lenders' expected yield, but it penalizes the borrower, as the base rate is more expensive than LIBOR. This is because a spread or margin is built into the base rate and not the adjusted LIBOR rate. The applicable margin in the credit agreement tries to account for this by being priced at 100 basis points lower than that for LIBOR, but this is not enough to make up the difference.

Applying this provision in the absence of LIBOR would therefore be unacceptable to borrowers—and would have a stifling effect on the loan market. This, then, illustrates why the fallback language is so important and has come into play. Fortunately, while this section may not help much in addressing the end of LIBOR, you are in the correct article of the credit agreement to find the appropriate transition sections.

Step 3. Determine whether your credit agreement has fallback language for loss of LIBOR.

Agreement and sections. The credit agreement may include an article dealing with the mechanics of loans and borrowing (generally the second article of credit agreement), or may include sections that address the effect of a benchmark transition event.

What to look for. The first question is whether your credit agreement already has LIBOR fallback language, other than standard yield protection clauses as described above. If your credit agreement already has fallback language, your answer is easy, and the below description describes what would happen under those clauses. But, unfortunately, clients rarely call with easy questions. Therefore, the description of the fallback clauses is also instructive for the following step—addressing amendments to loan documents to insert such clauses. First, we will look at provisions in common between these two approaches, and then the differences between the amendment and the hardwired approach.

The amendment and the hardwired approach are each triggered by the same benchmark transition event, and in both cases, LIBOR is replaced upon the occurrence of the same benchmark transition start date. What specifically happens at that time is where the approaches mainly differ. A standard formulation of the benchmark transition event from a recently publicly filed credit agreement using the amendment approach is:

1. A public statement or publication of information by or on behalf of the administrator of the Screen Rate announcing that such administrator has ceased or will cease to provide the Screen Rate, permanently or indefinitely, provided that, at the time of such statement or publication, there is no successor administrator that will continue to provide the Screen Rate
2. A public statement or publication of information by the regulatory supervisor for the administrator of the Screen Rate, the U.S. Federal Reserve System, an insolvency official with jurisdiction over the administrator for the Screen Rate, a resolution authority with jurisdiction over the administrator for the Screen Rate, or a court or an entity with similar insolvency or resolution authority over the administrator for the Screen Rate, which states that the administrator of the Screen Rate has ceased or will cease to provide the Screen Rate permanently or indefinitely, provided that, at the time of such statement or publication, there is no successor administrator that will continue to provide the Screen Rate
3. A public statement or publication of information by the regulatory supervisor for the administrator of the Screen Rate announcing that the Screen Rate is no longer representative

In short, an event precipitates a replacement for LIBOR on the date when it ceases to be published. The third trigger covers a deterioration in the quality of LIBOR, in the words of the ARRC: A "determination by a regulatory supervisor that the quality of the Benchmark has deteriorated such that it would likely have a significant negative impact on its liquidity and usefulness to market participants." The regulatory supervisor in this case is the FCA.

The ARRC recently recommended a somewhat broader approach in its official form language for the hardwired approach. The new language added clarity around the regulatory agencies empowered under the credit agreements to announce a cessation of LIBOR to trigger replacement of the rate, in addition to linking the trigger to unavailability of all available tenors of LIBOR (raising the bar on that trigger). With this update, ARRC now recommends that all loan originations use the hardwired approach, rather than the amendment approach, which had been more widely embraced by the market.

For either the amendment or the hardwired approach, the occurrence of the benchmark transition event first triggers a requirement for the administrative agent to notify the borrower and lenders of that fact. After that, for the amendment approach, the administrative agent and borrower are authorized to amend the credit agreement to replace LIBOR with a benchmark replacement. The amendment is a highly streamlined process—it automatically becomes effective upon the negative consent of required lenders five business days after posting (i.e., the amendment becomes effective if a majority of lenders in interest do not proactively object to the amendment). An example of such language from a recently filed credit agreement is:

> Notwithstanding anything to the contrary herein or in any other Loan Document, upon the occurrence of a Benchmark Transition Event or an Early Opt-in Election, as applicable, the Administrative Agent and the Borrower may amend this Agreement to replace the Screen Rate with a Benchmark Replacement. Any such amendment with respect to a Benchmark Transition Event will become effective at 5:00 p.m. on the fifth (5th) Business Day after the Administrative Agent has posted such proposed amendment to all Lenders and the Borrower so long as the Administrative Agent has not received, by such time, written notice of objection to such amendment from Lenders comprising the Required Lenders of each Class.

The actual date on which LIBOR is replaced is the benchmark replacement date, which is tied directly to the benchmark transition event:

1. In the case of clause (a) or (b) of the definition of Benchmark Transition Event, the later of (i) the date of the public statement or publication of information referenced therein and (ii) the date on which the administrator of the Screen Rate permanently or indefinitely ceases to provide the Screen Rate
2. In the case of clause (3) of the definition of Benchmark Transition Event, the date of the public statement or publication of information referenced therein

The amendment must set forth the exact replacement rate, the parameters of which are set forth in the credit agreement. This is left intentionally open-ended in the amendment approach, which could reference SOFR but is not tied to that. For example, an ARRC-approved definition of benchmark replacement from a recently filed credit agreement is:

> The sum of (a) the alternate benchmark rate (which may include Term SOFR) that has been selected by the Administrative Agent and the Borrower giving due consideration to (i) any selection or recommendation of a replacement rate or the mechanism for determining such a rate by the Relevant Governmental Body or (ii) any evolving or then-prevailing market convention for determining a rate of interest as a replacement to the Screen Rate for U.S. dollar-denominated syndicated credit facilities and (b) the Benchmark Replacement Adjustment; provided that, if the Benchmark Replacement as so determined would be less than zero, the Benchmark Replacement will be deemed to be zero for the purposes of this Agreement.

In addition to notifying the lenders and borrower of the benchmark replacement event and posting the amendment, the administrative agent is also required to give notice of the implementation of the benchmark replacement, the effectiveness of benchmark replacement conforming changes (i.e., clean-up changes through the credit agreement to reflect the removal of LIBOR and insertion of its replacement), and the beginning and end of any benchmark unavailability period (i.e., the period of time between the benchmark replacement date and the imposition of a benchmark replacement, a period which suspends conversions or continuations of LIBOR loans).

The hardwired approach is even more seamless than the streamlined amendment approach and is the approach recommended by the ARRC going forward. However, there is less discretion allotted to the administrative agent using this approach, with the parameters of the replacement more clearly defined. For the hardwired approach, a benchmark transition event does not trigger an amendment but rather imposes a global replacement in the credit agreement, swapping LIBOR for a defined benchmark replacement throughout. This definition presents a waterfall of options, with the first being most desirable. The ARRC recommends the following language for this:

1. The sum of: (a) Term SOFR and (b) the related Benchmark Replacement Adjustment
2. The sum of: (a) Daily Simple SOFR and (b) the related Benchmark Replacement Adjustment
3. The sum of (a) the alternate benchmark rate that has been selected by the Administrative Agent and the Borrower as the replacement for the then-current Benchmark for the applicable Corresponding Tenor giving due consideration to (i) any selection or recommendation of a replacement benchmark rate or the mechanism for determining such a rate by the Relevant Governmental Body or (ii) any evolving or then-prevailing market convention for determining a benchmark rate as a replacement for the then-current Benchmark for U.S. dollar-denominated syndicated credit facilities at such time and (b) the related Benchmark Replacement Adjustment

If the triggering event occurs, the replacement is made globally without need for an amendment, but the replacement is still subject to the negative consent of required lenders. The ARRC's suggested language for this is:

> If a Benchmark Transition Event or an Early Opt-in Election, as applicable, and its related Benchmark Replacement Date have occurred . . . such Benchmark Replacement will replace such Benchmark for all purposes hereunder and under any Loan Document in respect of any Benchmark setting at or after 5:00 p.m. (New York City time) on the fifth (5th) Business Day after the date notice of such Benchmark Replacement is provided to the Lenders without any amendment to, or further action or consent of any other party to, this Agreement or any other Loan Document so long as the Administrative Agent has not received, by such time, written notice of objection to such Benchmark Replacement from Lenders comprising the Required Lenders.

Note that under both the hardwired and the amendment approach, a benchmark replacement adjustment is necessary to make LIBOR and SOFR comparable. This is a spread adjustment resulting from the different ways in which each rate is calculated. The adjustment may be positive, negative, or zero and is also determined by means of a priority waterfall in its definition.

Also take note of the early opt-in election, which ARRC considers optional language. This trigger allows a switch away from LIBOR even while that benchmark rate is still being published, so long as the market has moved firmly in that direction. The language for both approaches is similar, though the hardwired approach—as is typical—affords the administrative agent less discretion. Specifically, the first prong enumerates the number of credit agreements in the market that would allow for an early opt-in, while the amendment approach requires simply a determination on the part of the administrative agent or lenders without reference to a critical-mass threshold.

If your credit agreement does not have any fallback language like this, then your deal is not yet ready for the LIBOR transition. In that case, your client will have to amend its financing—either the agreement itself or through a refinancing—to prepare for the transition.

Step 4. Review the amendment and refinancing provisions of your credit agreement to see how to incorporate the appropriate fallback language.

Agreement and sections. This section will outline amendment provisions in the credit agreement (generally found toward the back of the credit agreement, in the miscellaneous section), along with restrictions in the intercreditor agreement regarding amendments and modifications to loan documents.

What to look for. As described above, standard clauses that address inability to determine LIBOR are insufficient for the permanent cessation of LIBOR. These provisions are meant as protective stopgaps and not to reflect or replace LIBOR-like cost of capital. The more robust fallback language is needed for a permanent replacement in your financing. If this language is not there—and the tenor of the financing goes beyond the end of 2021—you need to amend the credit agreement to include these provisions or enter into a new credit agreement with these provisions.

A critical factor in determining the next step is the level of consent necessary to amend your credit agreement. Generally, the highest level of consent is necessary to reduce the rate of interest payable to lenders. Under those circumstances, the consent of each lender adversely impacted is required. However, switching LIBOR for, say, SOFR ideally does not even change the rate of interest (at least that's the goal)—and in any event should not reduce the rate payable to lenders. In that case, a lower threshold, such as a required lender vote, is all that is necessary to amend your credit agreement. You should review the amendment section of your credit agreement to confirm the level of consent necessary and the intercreditor to make sure that any such amendment is permitted by the other tranches of lenders (which, given that the interest rate is not increasing, should also not raise an issue). Indeed, in the wake of the COVID-19 lockdown and subsequent economic downturn, amendment activity has been very high in the past few months, and this has proven fortuitous for bundling in the appropriate fallback option. Many covenant-relief packages now also contain the standard LIBOR fallback language.

And along the same lines, if your credit agreement is nearing maturity—or your borrower is otherwise contemplating a refinancing—this should also be a consideration as a means to incorporate the appropriate fallback.

Related Content

For examples of credit agreement provisions that allow for a transition to replacement reference interest rate, see

> MARKET TRENDS 2019/20: LIBOR SUCCESSION CLAUSES

RESEARCH PATH: *Finance > Trends & Insights > Market Trends > Practice Notes*

For a description of the two pricing options currently available for syndicated credit agreements, see

> INTEREST RATE PROVISIONS IN CREDIT AGREEMENTS

RESEARCH PATH: *Finance > The Credit Agreement > Credit Agreement Guide > Practice Notes*

For an overview of increase costs and yield protection provision in credit agreements, see

> MARKET TRENDS 2020: YIELD PROTECTION AND INCREASED COSTS

RESEARCH PATH: *Finance > Trends & Insights > Market Trends > Practice Notes*

For a discussion of yield protection clauses, see

> YIELD PROTECTION CLAUSES IN CREDIT AGREEMENTS

RESEARCH PATH: *Finance > The Credit Agreement > Credit Agreement Guide > Practice Notes*

Fortunately, at this point, choosing the type of fallback language should be relatively straightforward. While either the amendment approach or the hardwired approach is available—and in fact the amendment approach remains the overwhelmingly popular choice—the ARRC and its constituent organizations are strongly recommending going with the hardwired approach. This will eliminate uncertainty going forward but possibly at the expense of the greater flexibility offered by the amendment approach.

Step 5. Review the analysis with the client and determine the next steps.

Once you have an answer to your client's question, you should go over it with your client and discuss possible next steps. This could include an analysis as to the type of fallback language currently in the document (see Steps 2 and 3), the options available if there is no fallback language (see Step 3), and the means to incorporate this language into the credit agreement (see Step 4).

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RESEARCH PATH: *Finance > The Credit Agreement > Credit Agreement Guide > Practice Notes*

   

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Main Street Lending Program: Key Practice Points

This article describes the terms of the facilities available under the Main Street Lending Program, in addition to providing practice tips to lawyers whose clients are (or are considering) entering such financing.

Background

As part of the Coronavirus Aid, Relief, and Economic Security Act (CARES Act)[1] enacted by the U.S. Congress and signed into law by the president in late March 2020, the Federal Reserve (Fed) announced the Main Street Lending Program (the Program). Under the Program, the Fed agreed to purchase participations in loans from a special purpose vehicle (SPV) established by the Fed as a conduit to make such loans. Pursuant to the most recent terms, the Program made available up to $600 billion in liquidity to eligible lenders that would in turn provide direct loans to eligible businesses. The Program was deployed through the Main Street New Loan Facility (MSNLF); the Main Street Expanded Loan Facility (MSELF); and the Main Street Priority Loan Facility (MSPLF and, together with MSELF and MSNLF, the Program Facilities and each a Program Facility).

To provide more direct and prioritized support to small businesses, the CARES Act also established a new Paycheck Protection Program Flexibility Act of 2020 (PPP)[2] under Section 7(a) of the Small Business Act to provide small businesses with forgivable, low-interest, nonrecourse loans to be used for traditional Section 7(a) purposes, including plant acquisition, construction, conversion, or expansion, and loans for any qualified small business concern, in addition to special designated purposes such as payroll, healthcare, and

rent. Unlike the Program Facilities, the PPP loans are fully guaranteed by the Small Business Administration (SBA) and are forgivable if they are used for the aforementioned purposes during either an 8-week period (if the loan was disbursed prior to June 5, 2020) or a 24-week period (if the loan was disbursed on or after June 5, 2020) and the borrower has maintained or rehired recently laid off employees prior to the end of the applicable 8- or 24-week period (provided that in no event will such period extend past December 31, 2020). Access to the Program Facilities and the PPP is not mutually exclusive, as both programs are intended to work together to provide both immediate and medium/long-term support to smaller businesses.

Businesses seeking to promptly access the facilities under the Program will need to work with counsel and lenders to carefully assess how eligible loans will integrate with existing capital structures. As such, this article will first provide a brief summary of the most recent terms of the MSNLF, MSPLF, and MSELF, which will be followed by some guidance on practical issues that should be considered by borrowers and lenders that desire to participate in the Program Facilities.

Borrower Eligibility

While the PPP and the also newly created Primary Market Corporate Credit Facility (PMCCF) are designed to provide immediate liquidity support for a range of small, medium, and large businesses, the Fed has indicated the purpose of the Program is to support lending to small and medium-sized businesses that were in sound financial condition prior to the onset of the COVID-19 pandemic.

The Program is intended for certain businesses that meet the below characteristics:

- Businesses that are for-profit, legally formed entities created or organized in the United States, or under the laws of the United States prior to March 13, 2020, with significant operations in and a majority of its employees based in the United States, though it should be noted that the Fed is considering expanding the Program to include not-for-profit businesses
- Businesses that have not received support pursuant to Section 4003(b)(1)–(3) of the CARES Act nor are participating in the PMCCF or constitute businesses of the type listed in 13 C.F.R. § 120.110(b)–(j) and (m)–(s) (as modified and clarified by regulations implementing the PPP on or before April 24, 2020), which include a wide range of businesses primarily engaged in lending, insurance services, gambling, speculation (e.g., oil wildcatting), and so on –and–
- Businesses that have either (1) 15,000 employees or fewer (based on the average total number of employees for each pay period over the 12-month period prior to the origination of the loan) or (2) annual revenues (based on either the applicant's audited financials under GAAP or annual receipts reported to the Internal Revenue Service) of no greater than $5 billion for 2019 (note these eligibility requirements are subject to the Small Business Act's affiliation rules, which generally require borrowers to aggregate their employees and revenues with those of its affiliates)

It is worth noting that despite the fact that the Program was expanded beyond its original formulation to include companies with higher revenue and employment thresholds, it will likely be unavailable to private equity and venture capital-backed companies due to the required application of the Small Business Act's affiliation rules. In addition, since earnings before interest, taxes, depreciation, and amortization (EBITDA) is the key underwriting metric for determining the size of the loan available under one of the Programs, businesses that have in the past borrowed based on recurring revenues (because they have low or negative EBITDA) or on an asset-based basis may not be able to avail themselves of one of the Programs.

Lender Eligibility

To participate in the Program, each lender must meet certain eligibility requirements. To be eligible, such lender must be a U.S. federally insured depository institution (including any bank, savings association, or credit union); a U.S. branch or agency of a foreign bank; a U.S. bank holding company; a U.S. savings and loan holding company; a U.S. intermediate holding company of a foreign banking organization; or a U.S. subsidiary of any of the foregoing. Nonbank lenders (e.g., BDCs or other private capital providers) are not currently eligible to participate in the Program. However, the Fed has said that it is considering expanding the lender eligibility criteria in the future. In addition, an eligible lender will need to be eligible under the Program's conflict of interest prohibitions as well as being able to certify that it is not insolvent.

Loan Deployment and Key Documentation

The Fed has informed lenders that want to make loans under one of the Programs that they should view the eligibility criteria in the term sheets as the minimum requirements for the Program, and lenders are expected to conduct a customary review and due diligence of the potential borrower's financial condition at the time of the loan application based on their typical underwriting standards. Lenders will need to carefully assess the impact of the COVID-19 pandemic on such borrower and its business and consider its future prospects of being able to repay the loan on a current basis when determining whether a borrower should be granted a loan and at what size, notwithstanding that the provisions of the term sheets would permit such loan.

Lenders should use their own standard loan documentation with respect to Program Loans, which loan documents should be substantially similar to the loan documentation lenders use for similarly situated borrowers as adjusted to include Program required provisions. The Fed has provided model language for certain of the provisions it requires to be in loan documents (as well as a list of required financial information borrowers are required to deliver on an ongoing basis), but lenders are

1. Pub. L. 116-136, 134 Stat. 281 (Mar. 27, 2020). 2. Pub. L. 116-142, 134 Stat. 641 (June 5, 2020).

permitted to use their own provisions. In addition, as described below, borrowers and lenders will be required to make various certifications in connection with each loan.

Funding and Assignments

Lenders will have two options for funding loans. A lender can extend a loan under the Program and then can seek to sell a participation in such loan to the SPV by submitting the required paperwork to the Fed within 14 days of making the loan. Once the Fed has determined that such loan was made in compliance with the Program requirements, the SPV would purchase its participation interest. The other way a lender could extend a loan under the Program is to enter into documentation for the loan with the borrower and make it contingent upon receiving a binding commitment from the SPV to purchase the participation. If such a commitment is received, the lender will be required to fund such loan within three business days of the date of such commitment letter and notify the SPV of the date the funding occurred (and the SPV will generally be able to advance funds to purchase its participation within one business day).

Operationally, each time an eligible lender sells a participation to the SPV, such lender will be required to enter into a loan participation agreement, a servicing agreement, an assignment in blank, and a co-lender agreement with the SPV (in addition to making the required certifications and covenants).

The participation agreement (which also incorporates standard terms and conditions) governs the funding and sale mechanics of a Program loan. In addition, the participation agreement also provides for the SPV's transfer and voting rights. Except in certain limited circumstances, the SPV cannot elevate its interest into an assignment of the loan without the prior consent of the lender. Following such elevation, the SPV may transfer its rights without further consent from the lender.

In general, the lender is granted sole authority for most decisions and votes relating to the loan other than with respect to certain enumerated core rights acts. Such core rights acts include customary lender sacred rights that ordinarily require each lender's consent (such as delaying the time to make payments and reductions in the principal and the rate of interest) as well as additional items relating to Program-mandated provisions (such as waivers of conditions precedent, amendments to mandatory prepayments relating to borrower certifications, adding restrictions on the ability of any lender to assign or pledge its rights or obligations under any loan document, and amendments to periodic financial and notice reporting).

Additional Documentation

The servicing agreement sets forth the lender's and the SPV's rights in connection with the administration of the loan, as well as requiring the delivery of certain documentation and information by the lender to the SPV. The assignment in blank is to be used by the SPV to elevate its interest in a loan to become a lender of record. The co-lender agreement is executed in connection with bilateral facilities to provide mechanics for a multi-lender facility if the SPV elevates its participation interest to that of a lender of record.

As described above, the ultimate decision to extend a loan to the applicant will rest with the eligible lender, which is expected to conduct an assessment of the financial condition and creditworthiness of the potential borrower. If the eligible lender decides to extend the requested loan to the applicant, the terms of such loan will be based on the terms set forth in the term sheet of the applicable Program Facility (each of which is summarized below), and the eligible borrower should expect that its participation in the Program will be publicly disclosed by the Fed.

OVERVIEW AND COMPARISON OF CERTAIN MAIN STREET LENDING PROGRAM FACILITY TERMS

	MSNLF	MSPLF	MSELF
Eligible Loan	New term loan. Note that if the eligible borrower had other loans outstanding with the eligible lender as of December 31, 2019, such loans must have had an internal risk rating equivalent to a pass in the lender's supervisory rating system as of such date.	Same as MSNLF.	Existing term loan or revolving credit facility that the borrower has with the same lender that will be providing an upsize tranche loan under MSELF.
Term	Five years.	Same as MSNLF.	Same as MSNLF.
Rate	Adjustable rate of LIBOR (one or three month) + 300 basis points (bps).	Same as MSNLF.	Same as MSNLF.
Amount	Minimum loan size is $250,000. Maximum loan size is the lesser of (1) $35 million or (2) an amount that, when added to the borrower's existing outstanding and undrawn available debt, does not exceed four times the borrower's adjusted 2019 EBITDA.	Minimum loan size is $250,000. Maximum loan size is the lesser of (1) $50 million or (2) an amount that, when added to the borrower's existing outstanding and undrawn available debt, does not exceed six times the borrower's adjusted 2019 EBITDA.	Minimum loan size is $10 million. Maximum loan size that is the lesser of (1) $300 million or (2) an amount that, when added to the borrower's existing outstanding and undrawn available debt, does not exceed six times the borrower's adjusted 2019 EBITDA.

OVERVIEW AND COMPARISON OF CERTAIN MAIN STREET LENDING PROGRAM FACILITY TERMS

	MSNLF	MSPLF	MSELF
Existing Outstanding and Undrawn Available Debt	It includes all amounts borrowed under any loan facility, including unsecured or secured loans from any bank, nonbank financial institution, or private lender, as well as any publicly issued bonds or private placement facilities, provided that no outstanding debt that is being refinanced under the MSPLF program will be considered as part of the existing outstanding and undrawn available debt. It also includes all unused commitments under any loan facility, excluding (1) any undrawn commitment that serves as a backup line for commercial paper issuance, (2) any undrawn commitment that is used to finance receivables (including seasonal financing of inventory), (3) any undrawn commitment that cannot be drawn without additional collateral, and (4) any undrawn commitment that is no longer available due to a change in circumstance. This calculation must be made as of the date of the loan application.	Same as MSNLF.	Same as MSNLF.
EBITDA Calculation	Adjusted 2019 EBITDA calculation is based on the methodology used by the lender to calculate EBITDA when extending credit to the borrower or to similarly situated borrowers on or before April 24, 2020.	Same as MSNLF.	Adjusted 2019 EBITDA calculation is based on the methodology previously used for adjusting EBITDA when originating or amending the underlying loan on or before April 24, 2020. Note that this may not include all EBITDA adjustments contained in the borrower's existing loan documents.
Amortization	Principal is amortized with 15% due at the end of the third year, 15% due at the end of the fourth year, and a balloon payment of 70% due upon maturity at the end of the fifth year.	Same as MSNLF.	Same as MSNLF.
Deferral	Principal payments are deferred for two years and interest payments are deferred for one year (unpaid interest will be capitalized).	Same as MSNLF.	Same as MSNLF.

OVERVIEW AND COMPARISON OF CERTAIN MAIN STREET LENDING PROGRAM FACILITY TERMS

	MSNLF	MSPLF	MSELF
Ranking, Collateral, and Priority of Security	Secured/unsecured at the time of origination or at any time during the term of the loan, the loan is not contractually subordinated in terms of priority to any of the borrower's other loans or debt instruments.	Secured/unsecured at the time of origination and at all times during the life of the loan, the outstanding loan is senior to or *pari passu* with, in terms of priority and security (if any), the borrower's other loans or debt instruments (other than mortgage debt).	Secured/unsecured at the time of upsizing and at all times while the upsized tranche is outstanding, the upsized tranche is senior to or *pari passu* with, in terms of priority and security (if any), the borrower's other loans or debt instruments (other than mortgage debt).
Prepayment	Prepayment permitted without penalty.	Same as MSNLF.	Same as MSNLF.
Restrictions on Existing Lines of Credit	The borrower must commit that it will not seek to cancel or reduce any of its committed lines of credit with the lender or any other lender. Note that borrowers may still be able to (1) reduce or terminate uncommitted lines of credit, (2) allow existing lines of credit to expire in accordance with their terms, and (3) reduce availability under existing lines of credit in accordance with existing terms as a result of changes in borrowing bases or reserves in asset-based or similar structures.	Same as MSNLF.	Same as MSNLF.
Restrictions on Compensation, Stock Repurchases, and Capital Distributions	The restrictions under Section 4003(c)(3)(A)(ii) of the CARES Act will apply except with respect to distributions made by S corporations or other tax pass-through entities to the extent reasonably required to cover their owners' tax obligations in respect of such entities' earnings.	Same as MSNLF.	Same as MSNLF.

	OVERVIEW AND COMPARISON OF CERTAIN MAIN STREET LENDING PROGRAM FACILITY TERMS		
	MSNLF	MSPLF	MSELF
Restrictions on Compensation, Stock Repurchases, and Capital Distributions	The restrictions under Section 4003(c)(3)(A)(ii) of the CARES Act will apply except with respect to distributions made by S corporations or other tax pass-through entities to the extent reasonably required to cover their owners' tax obligations in respect of such entities' earnings.	Same as MSNLF.	Same as MSNLF.
Participation Amount Retained by Lender	Lender must retain 5% of the loan until the earlier of (x) the maturity date or (y) the date when the Fed sells all of its participation.	Same as MSNLF.	Lender must retain (1) 5% of the upsized tranche until the earlier of (x) the maturity date or (y) the date when the Fed sells all of its participation, along with (2) its interest in the existing term loan or revolving credit facility until the earliest of (x) the maturity of such term loan or credit facility, (y) the maturity of the upsized tranche, or (z) the date when the Fed sells all of its participation.
Transaction Fee	100 bps of the principal amount of loan paid by the borrower or the lender to the Fed.	Same as MSNLF.	Up to 75 bps of the principal amount of the upsized tranche paid by the borrower to the Fed at the time of upsizing.
Origination Fee	Up to 100 bps of the principal amount of loan paid by the borrower to the Fed e.	Same as MSNLF.	Same as MSNLF.
Annual Servicing Fee	25 bps of the principal amount of the Fed's participation paid by the Fed's SPV to the lender.	Same as MSNLF.	25 bps of the principal amount of the Fed's participation in the upsized tranche paid by the Fed's SPV to the lender.

Borrower and Lender Certifications

To qualify for the Programs, both borrowers and lenders are required to make certain covenants (some of which survive for 12 months following the date such loan is no longer outstanding) and make a number of certifications relating to the borrower being an eligible borrower under the Program as described above. Below are some of the key certifications that may have a restrictive effect on a borrower's business and operations or a lender's willingness to make a loan.

Borrower Certifications and Agreements

In order to obtain a Program loan, a borrower must certify and agree, among other things:

- **Unavailability of credit.** The borrower must confirm that it is unable to obtain adequate alternative financing from other sources. This does not mean that no alternative is available, but that if alternatives are available, that they are inadequate due to amount, price, or the terms of credit.
- **Solvency.** The borrower must certify that it is not insolvent.
- **Limit on repaying debt.** The ability of the borrower to pay the principal of, or interest on, any debt except mandatory amounts when due (or refinancing debt that is maturing no later than 90 days from the date of such refinancing) and regular payments on revolving lines of credit is limited.
- **Maintain payroll.** The borrower must make commercially reasonable efforts to maintain payroll and retain employees during the term of the loan.
- **Limits on compensation.** Strict requirements limit the increase of or additional bonuses to salaries between $425,000 and $3 million, subject to exceptions for those employees subject to a collective bargaining agreement.
- **Limits on repurchases of equity securities.** The borrower is restricted from repurchasing its own shares and the shares of its parent company, subject to exceptions for contractual obligations to repurchase or purchase shares that were in effect prior to March 27, 2020.
- **Limits on distributions.** The borrower must agree not to pay dividends or make other capital distributions on common stock, subject to exceptions for S corporations and other pass-through entities to make tax distributions.

In general, the lender is required to collect the required certifications and covenants from the borrower at the time of originating the loan. Lenders are not required to independently verify the borrower's certifications or actively monitor ongoing compliance with covenants, but if such lender becomes aware of a breach or of a material misstatement during the term of the loan, the lender is required to notify the Fed.

Lender Certifications and Agreements

In connection with each Program loan, the lender must certify and agree, among other things:

- **EBITDA requirement for borrower.** The lender must certify that the borrower (and/or its affiliates) meets the relevant financial covenant set out under the relevant Program terms and that the method of calculation of EBITDA is in accordance with methods previously used by such lender for that borrower or is typically used by the lender for similarly situated borrowers.
- **Lien certification.** If a loan under the MSPLF is secured, the lender must certify that the collateral coverage ratio is at least 200% or else not less than the collateral coverage ratio for the borrower's secured debt (other than mortgage debt). If the loan is under the MSELF, the lender must certify that any collateral securing the underlying credit facility at the time of the loan secures both the underlying facility and the new loan.
- **Eligible loan not subordinated.** The lender must certify at the time of origination that the eligible loan is not and will not become through the action, consent, or facilitation of the lender, contractually subordinated in terms of priority to any of the borrower's other loans or debt instruments.
- **Existing debt.** The lender must certify that it will not cancel or reduce any existing committed lines of credit to the borrower except in the case of events of default or require payments of principal of, or interest on, any such existing debt unless such payments are mandatory and due or in the case of default and acceleration.
- **Material breach of certain borrower certifications and covenants.** The lender must certify that the eligible loan documentation contains a provision triggering a mandatory prepayment upon the lender's receipt of notice that the borrower has materially breached its certifications or covenants.
- **Cross-acceleration provisions.** The lender must certify that the eligible loan documentation contains a provision triggering an event of default or acceleration if the borrower has defaulted on any other loans made by the lender (or its affiliates).
- **Financial reporting covenant.** The lender must certify that the eligible loan documentation contains a financial reporting covenant requiring the borrower to deliver the required financial information and calculations in accordance with the relevant Program requirements.

Restrictions and Limitations of Existing Credit Agreements

Any borrower seeking to take advantage of the facilities under the Program will need to perform an analysis to assess how any loan under the Program Facilities will integrate with existing debt structures. Contractual issues related to everything from restrictions on additional debt and liens to prohibitions on distributions should be assessed carefully to determine the appropriateness of a credit solution under the Program. The below non-exhaustive list is intended to provide a quick review of key items that should be considered prior to any borrowing under the Program Facilities.

General Restrictions on Debt and Lien Incurrence; Sizing Considerations

Although most covenants only restrict the ability of a borrower to incur more debt, the general covenant structure of a borrower's debt agreements should be assessed in totality to determine interactions with any loan incurred under one of the Program Facilities. For example, at the outset, restrictions on the incurrence of debt and liens (if applicable) that are contained in existing debt agreements will have to be assessed to determine potential requirements for waivers or lender consents if there is not sufficient capacity under the existing covenants to incur debt under one of the Program Facilities. Similarly, borrowers will have to perform calculations and analysis as to whether the additional debt will cause any issues with respect to compliance with any existing financial covenants. Borrowers should also make a strategic assessment to determine if consumption of capacity under existing debt and lien incurrence baskets will cause financing challenges in the future by restricting future incurrence capacity under the current debt facilities.

Further, as described above, the Program Facilities provide for specified limitations on the loan sizing. It is important to note that EBITDA determinations for purposes of sizing the loans under the Program Facilities will not be tied to any contractual agreements or EBITDA definitions that may exist among the relevant borrowers and lenders, but rather to each lender's internal underwriting criteria. This may have the effect that certain borrowers that are used to being able to add back substantial amounts to their EBITDA pursuant to bespoke EBITDA credit agreement provisions may find themselves limited to smaller loans than they would otherwise expect. It is also noteworthy that existing undrawn lines of credit (subject to certain exceptions (e.g., for commercial paper backstops or receivables financing)) will have to be included in the leverage calculation for purposes of loan sizing, which again may result in unexpected reductions to available loan amounts under the Program Facilities.

Related Content

For an overview of key provisions of credit agreements that need to be reviewed to determine a borrower's ability to meet its ongoing obligations, see

> MARKET TRENDS 2020: COVID-19 RAMIFICATIONS IN LOAN DOCUMENTS

RESEARCH PATH: *Finance > Trends & Insights > Market Trends > Practice Notes*

For a resource kit that provides a selection of amendments, consents, and other modifications for loan documents, along with an index of related content, see

> AMENDMENTS, CONSENTS, AND WAIVERS RESOURCE KIT

RESEARCH PATH: *Finance > The Credit Agreement > Credit Agreement Guide > Practice Notes*

For a description of negative covenants and related definitions, see

> NEGATIVE COVENANTS IN CREDIT AGREEMENTS

RESEARCH PATH: *Finance > The Credit Agreement > Credit Agreement Guide > Practice Notes*

For detailed advice on the use of financial covenants in credit agreements that require the borrower to comply with negotiated financial performance benchmarks, see

> FINANCIAL COVENANTS AND EBITDA CALCULATIONS IN CREDIT AGREEMENTS

RESEARCH PATH: *Finance > The Credit Agreement > Credit Agreement Guide > Practice Notes*

Repayment of Existing Indebtedness

Borrowers should also be aware that the Fed has provided for certain restrictions relating to the repayment and termination of any debt other than loans incurred under the Program Facilities, except for loans under the MSPLF, which, as mentioned above, are permitted to be used by the borrower to refinance existing debt owed to a lender that is not the eligible lender at the time the MSPLF loan is made.

Generally, borrowers will be restricted from making payments of principal and interest on other debt unless such payments are mandatory and due; provided that a borrower will be permitted to refinance debt that is maturing no later than 90 days from the date of such refinancing. While this should allow servicing of other debt in the ordinary course, borrowers should keep in mind that as a practical matter, loans under

the Program Facilities will need to be repaid first during any deleveraging efforts, which in certain circumstances may increase the borrowers' overall borrowing costs (e.g., if any other debt has a higher rate of interest than the Program Facilities).

Further, the Program Facilities do not permit the borrower to cancel or reduce any of its committed lines of credit with any lender. However, the Fed has advised that this covenant does not prohibit the reduction or termination of uncommitted lines of credit in the normal course of business, the expiration of existing lines of credit in accordance with their terms, or the reduction of availability under existing lines of credit in accordance with their terms due to changes in borrowing bases or reserves in asset-based or similar structures. The intent behind this prohibition is most likely ensuring that borrowers maintain as many liquidity sources as possible while the Program Facilities loans are outstanding; this could result in borrowers being required to maintain in place (and pay associated fees) lines of credit they do not have any plans to utilize.

Incremental Incurrence

For a borrower seeking to make use of the MSELF, one of the more likely paths such borrower would elect to follow to expand any specific loan would be through the incremental facility provisions of the relevant credit agreement. The specific terms of the MSELF should be reviewed in light of existing constraints related to incremental facilities.

Borrowers should consider the effect of an expansion facility on key contractual constraints related to maturity/amortization or even, potentially, most favored nation (MFN) provisions. For example, many credit agreements will not permit incremental facilities that mature earlier, or have a shorter weighted average life to maturity, than the existing facilities. Given the relatively short maturity and substantial required amortization of the MSELF, this could prevent borrowers from incurring loans under the MSELF under their existing credit agreements absent existing lenders' consent or applicable exceptions contained in the existing credit documents.

In addition, borrowers should review MFN provisions in their existing debt instruments to confirm that no MFN provisions are triggered (which could result in an increase of the rate of interest on the underlying loans in certain prescribed circumstances). Further, mechanics related to the implementation of the upsized loan should be reviewed to ensure that any consent rights or requirements for documentation (e.g., amendments) are satisfied prior to making use of any loan under the MSELF.

Capital Distributions

The capital distribution restrictions that apply to any loan under the Program Facilities are relatively stringent and may set tighter constraints than existing provisions in the borrower's debt documents.

Except for tax distributions, loans under the Program Facilities would prohibit the payment of dividends or making of capital distributions with respect to any of the eligible borrower's common stock while the loan is outstanding and for 12 months thereafter. A borrower would also be prohibited from the repurchase of any of its equity securities (or those of its parent company) while the loan is outstanding and for 12 months thereafter, except as required by existing contractual obligations.

The Fed has not expanded these restrictions or provided further guidance on any other potential distribution exemptions that may be part of the normal course of business. While the exception for tax distributions is certainly helpful, there may be other ordinary course distributions that may be relevant depending on the particular borrower's structure (e.g., making distributions for overhead expenses and the like to any parent company) that would not be permitted under the existing guidelines.

Security Interests

New loans under the MSNLF will have some flexibility as to priority, as the only requirement is that such loans not be contractually subordinated in terms of priority to other existing debt. While the Fed guidelines do not specify with absolute certainty what contractually subordinated means in this context, it appears that this refers to payment priority and will not restrict lien subordination (e.g., incurring loans under the MSELF as second lien debt behind existing first lien debt) and incurring unsecured loans under the MSELF if the borrower has existing secured debt. On the other hand, loans and upsizes under the MSPLF and MSELF, respectively, are required to be senior to or equal with, in terms of payment priority and security, the borrower's other loans or debt instruments (other than mortgage debt). Notably, all loans may be senior or unsecured; however, the MSELF loans must be secured by the same collateral package, if any, as the underlying loan.

The requirement that both the MSPLF and MSELF loans be *pari passu* with any existing secured debt will trigger the need to ascertain any limitations on the incurrence of *pari passu* debt and liens and related procedural requirements. The easiest approach here would be, in the case of the MSELF, structuring the new loans as a new incremental tranche under the existing credit agreement. However, in the case of the MSPLF and loans under the MSELF structured as sidecar facilities, a *pari passu* intercreditor agreement will most likely be required.

Some credit agreements include the basic framework for incurrence of additional *pari passu* secured debt, including mechanics for *pari passu* intercreditor agreements, but the requirement to enter into an intercreditor agreement with the existing lenders could significantly delay the borrower's ability to access the new financing, as well as significantly increase the expense to the borrower to obtain such financing. In scenarios where credit agreements do not include specific mechanics for additional *pari passu* debt, amendments and/or consents from the existing lenders may be required, which could further increase the delay caused by putting a *pari passu* intercreditor agreement in place.

Related Content

For information on standard representations and warranties in a credit agreement, along with negotiation points for both lender's and borrower's counsel, see

> REPRESENTATIONS AND WARRANTIES IN CREDIT AGREEMENTS

RESEARCH PATH: *Finance > The Credit Agreement > Credit Agreement Guide > Practice Notes*

For an explanation of assignments and participations and the significant differences between these related concepts, see

> ASSIGNMENTS VS. PARTICIPATIONS IN CREDIT AGREEMENTS

RESEARCH PATH: *Finance > The Credit Agreement > Credit Agreement Guide > Practice Notes*

For a discussion on trends in incremental loan provisions and incremental equivalent debt facilities that are commonly included in loan agreements in large cap and upper middle market deals, see

> RECENT TRENDS IN INCREMENTAL LOAN FACILITIES

RESEARCH PATH: *Finance > Trends & Insights > First Analysis > Practice Notes*

For a step-by-step guide to determine whether a borrower has access to an incremental facility or an accordion and how it may be exercised, see

> THE CLIENT ASKS: HOW DO WE EXERCISE AN INCREMENTAL FACILITY?

RESEARCH PATH: *Finance > The Credit Agreement > Credit Agreement Guide > Practice Notes*

Certifications and Covenants

Eligible borrowers should make a detailed assessment of where in the debt document to include the required certifications and covenants. The required certifications and covenants are somewhat general, and there has been little detailed guidance to assist in narrowing the potentially wide interpretations that could apply to such certifications and covenants. As such, borrowers may want to spend some time determining the optimal location for these requirements to avoid the risk of inadvertently breaching a covenant or certification and causing a cascade of events and/or accelerations throughout the debt instruments.

MSELF participants should be especially vigilant in assessing eligibility of syndicate participants in any upsize. Inadvertent inclusion of an existing syndicate member that happens to be an ineligible lender could trigger an event of default (as the MSELF upsize will be in direct violation of the program requirements), making the loan ineligible for purchase by the SPV and causing cross actions throughout the debt facilities. L

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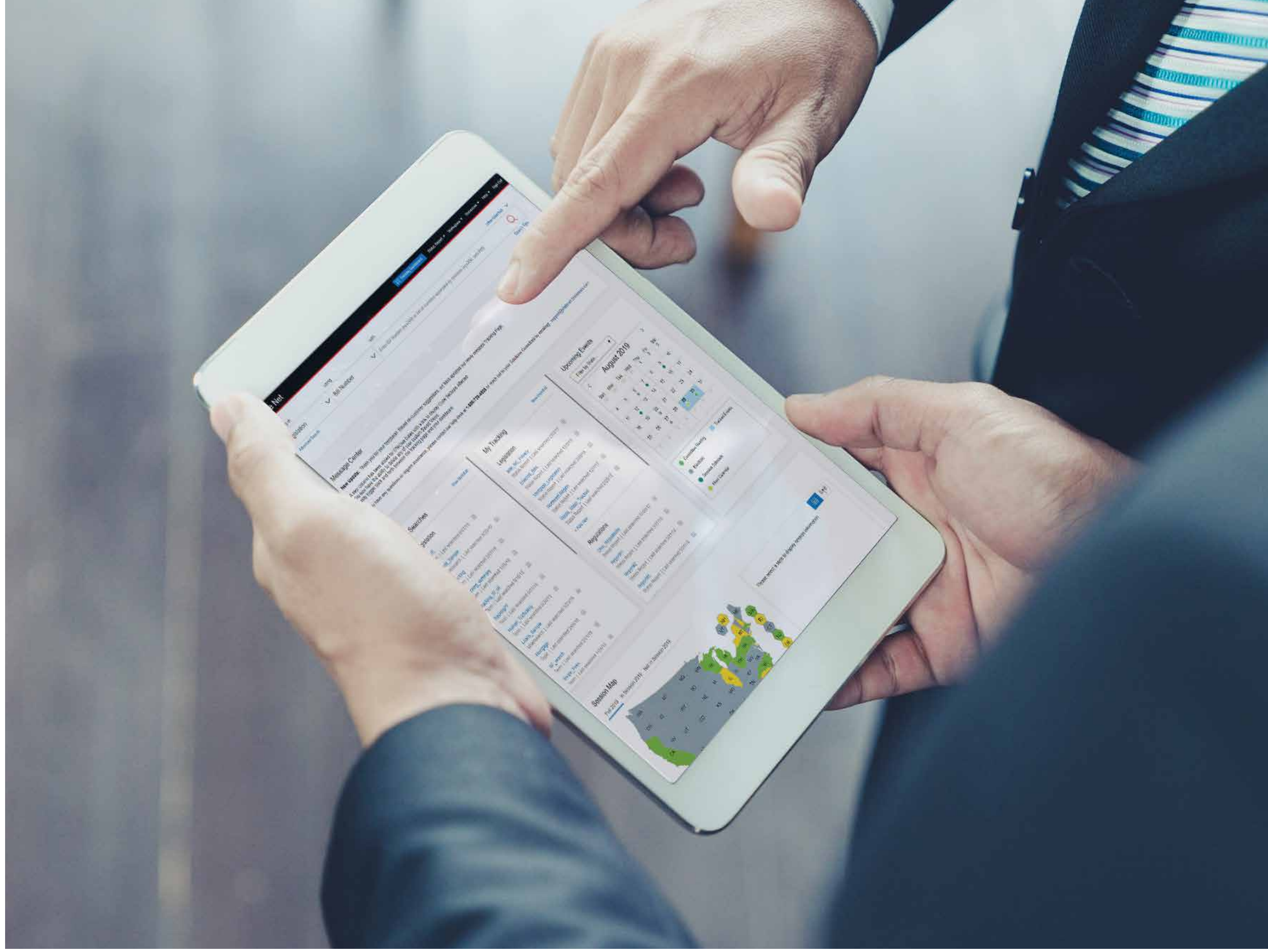



Mollie Duckworth, Jonathan Gordon, John Kaercher, Carina Antweil, and Michael Portillo BAKER BOTTS LLP

A Surge of SPACs in a Turbulent Economic Climate

Special purpose acquisition companies (SPACs), so called blank-check companies, are experiencing a resurgence in the current turbulent economic climate. SPACs are entities formed to raise capital through an initial public offering (IPO) for the purpose of taking an existing (but yet to be identified) private company public via an acquisition.

ONCE DERIDED FOR THEIR EARLY UTILIZATION IN fraudulent schemes, in recent years SPACs have attracted experienced management teams, reputable underwriters, and high-profile sponsors. On July 22, 2020, Pershing Square Capital Management's Bill Ackman priced the largest-ever SPAC IPO, which raised $4 billion and was underwritten by a group led by Citigroup, Jeffries, and UBS. The increased reputation of the players in the SPAC market, the high-profile targets acquired, and the unfavorable market conditions for traditional IPOs have thrust this once-overlooked investment vehicle into the mainstream. According to data from Barron's, SPAC IPOs accounted for one in four U.S. IPOs that priced in 2019, raising a total of $13.6 billion. And despite the ongoing COVID-19 pandemic, 2020 has seen a continued uptick in SPAC activity. To date, according to data from SPACInsider, SPAC IPOs have already raised a record $19 billion in 50 IPOs.

SPAC Basics

As noted above, SPACs have no immediate business purpose of their own. Though the SPAC must go through the standard IPO process of filing a registration statement with the U.S. Securities and Exchange Commission (SEC), the simplified balance sheet and boilerplate disclosure language often result in the process being considerably quicker than it would be for an established business. SPACs are largely marketed to investors based on the reputations of their sponsors and management teams and do not identify an acquisition target prior to the IPO.

Investors in the SPAC are typically sold units, comprising one share of common stock and a fraction of a warrant to purchase a share of common stock in the future at a price above the IPO valuation. The warrants serve as an inducement for the investor to participate in the potential upside of the investment. Following the IPO, the proceeds of the IPO are deposited in a trust account reserved for the acquisition and the public may trade the units, common stock, or warrants separately. The warrants are typically detachable, meaning that following registration they can be traded separately from the common stock, creating the potential for arbitrage opportunities. The consummation of the IPO also starts the clock for the SPAC to identify and complete an acquisition within a set timeframe, usually 24 months, or it must return the trust account balance, net of liquidation costs, to the shareholders (referred to as redeeming the stock). Once a target is identified and the acquisition is approved by the SPAC, the deal is typically put to a vote of the shareholders, who retain the right to request that their shares be redeemed in the event that they do not like the transaction. The guarantee of a return of the trust account balance in the event either an acquisition isn't consummated within the set timeframe or the investor dislikes the proposed deal provides attractive downside protection for potential SPAC investors.

SPAC Developments

There have been two key developments in the structure of SPACs that have led to their recent resurgence. First, in early SPACs, the shareholders were required to vote against the acquisition in order to redeem their shares. Now, it is typical for shareholders who vote in favor of the acquisition to retain the right to seek redemption of their shares (while retaining the warrants and the resulting upside in the event that the acquisition is successful), so there is little risk to the shareholders in approving the transaction. This has resulted in greater certainty for targets that the deal will be approved, increasing the attractiveness of SPACs as a vehicle for going public.

Second, as mentioned above, SPACs have enjoyed increased credibility and publicity from signing up higher profile sponsors, underwriters, and management teams. This has allowed SPACs to raise greater pools of money, unlocking the ability to pursue transactions with high-profile technology and life sciences targets previously believed to be unavailable to SPACs. Indeed, in the past year, several well-known startups such as sports-betting operator DraftKings Inc., Richard Branson's private space company Virgin Galactic Holdings Inc., and electric-truck maker Nikola Corp. have utilized combinations with SPACs as a vehicle to take their company public. Additionally, on July 12, 2020, healthcare services firm MultiPlan Inc. announced an $11 billion deal to merge with a SPAC, which, if consummated, will represent the largest-ever SPAC transaction.

In addition to the developments leading to the resurgence of SPACs, SPAC sponsors are also getting more creative in structuring SPACs to increase the likelihood that investors vote in favor of the identified business combination. For example, in Pershing Square's SPAC, only a portion of the warrants are detachable, with the balance of the warrants remaining attached to the common stock and only being issued to those investors who do not redeem their shares in connection with the business combination. Furthermore, the attached warrants that would have otherwise been issued to investors who redeemed their shares are divvied up among the investors who did not redeem their shares. These features led to the term tontine being used to describe Pershing Square's SPAC,

> Another key factor in the recent SPAC boom is the turbulence in the traditional IPO market. A SPAC transaction provides a target company with a measure of certainty that a traditional IPO cannot.

a reference to an old investment structure in which a group of investors pay money into an investment vehicle in exchange for future periodic payouts, but when an investor dies their payout is split among the living investors.

Furthermore, the traditional SPAC provides the SPAC sponsor with the opportunity to acquire 20% of the shares in the SPAC for nominal consideration, effectively compensating the sponsor regardless of the combination's ultimate performance. The Pershing Square SPAC did not contain this provision, better aligning the sponsor with its investors in the success of the SPAC. This, combined with the tontine component, better incentivizes the sponsor to identify a good deal and the investors to then vote in favor of that deal.

Uncertainty in Traditional IPO Market

Another key factor in the recent SPAC boom is the turbulence in the traditional IPO market. A SPAC transaction provides a target company with a measure of certainty that a traditional IPO cannot. The target negotiates a fixed price per share with only one party—the SPAC—and though the amount to be raised is not guaranteed due to potential shareholder redemptions, the valuation is locked in. In the traditional IPO setting, the price per share is not fixed and may fluctuate wildly until the IPO is priced. While this was previously an exciting prospect for technology unicorns, recent disappointing IPO results, including the well-publicized failure of WeWork's proposed IPO, caused a contraction in the traditional IPO market. The COVID-19 pandemic has only compounded these issues as it injected a level of volatility into the capital markets that left companies uncertain as to the prospects of their IPOs.

Risks to Consider

SPAC transactions are not without their risks. Given that SPACs are essentially just pools of money held in trust for public shareholders, the transactions lack many of the protections common in public mergers, such as breakup fees if the transaction falls through. This has become especially important given the recent market disruptions associated with COVID-19. For example, after agreeing to a merger with Global Blue in January of 2020, the board of directors of Far Point, a SPAC sponsored by Dan Loeb and Thomas Farley, is now recommending that investors reject the merger due to the adverse impact COVID-19 has had on Global Blue's business. In a traditional public M&A transaction, Far Point would be required to pay a termination fee as a result of the board's change of heart, but that is not typically the case for SPAC transactions.

Related Content

For an overview of the impact of COVID-19 in a number of practice areas, including Corporate and M&A, see

> CORONAVIRUS (COVID-19) RESOURCE KIT

RESEARCH PATH: *Corporate and M&A > Trends & Insights > First Analysis > Practice Notes*

For a discussion of insurance coverage as a risk allocation tool in M&A transactions during the coronavirus pandemic, see

> CORONAVIRUS (COVID-19): IMPLICATIONS FOR REPRESENTATIONS AND WARRANTIES INSURANCE

RESEARCH PATH: *Corporate and M&A > M&A Provisions > Articles*

For an introduction to acquisition financing, see

> ACQUISITION FINANCING FUNDAMENTALS

RESEARCH PATH: *Corporate and M&A > Acquisition Finance > Sources of Acquisition Financing > Practice Notes*

For a look at the role played by financial advisors in M&A transactions, see

> FINANCIAL ADVISORS IN M&A TRANSACTIONS

RESEARCH PATH: *Corporate and M&A > Structuring and Planning a Deal > M&A Financial Advisors > Practice Notes*

Additionally, the total cost to the target, factoring in the percentage ownership the SPAC sponsor receives for taking on the downside risk of funding working capital and other expenses that are not recovered in the event that a target is not acquired, can be much higher than a traditional IPO. As the frequency and size of SPACs continue to grow relative to the pool of viable targets available for acquisitions, sponsors may be incentivized to initiate less favorable transactions in order to avoid reaching the end of the SPAC's lifecycle without a deal. It is also important for a target to consider that, once the combination with the SPAC is complete, the newly public operating company is not able to take advantage of many of the typical grace periods afforded by the SEC to companies in a traditional IPO. If a target does not have the systems in place to comply with SEC requirements on day one, this can result in regulatory difficulties, bad press, and lower market valuation. Notwithstanding these risks, in light of the ongoing uncertainty in the capital markets and the ever-expanding pool of capital available through SPACs, we expect the utilization of SPACs to continue to be a viable alternative to a traditional IPO in this challenging environment.

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Special Purpose Acquisition Companies

This article discusses recent market trends regarding special purpose acquisition companies (SPACs), covering notable transactions, deal structure and process, and other key market trends, and provides an outlook for the rest of the year.

THIS ARTICLE DISCUSSES RECENT MARKET TRENDS regarding special purpose acquisition companies (SPACs), covering notable transactions, deal structure and process, and other key market trends, and provides an outlook for the rest of the year.

The market for initial public offerings (IPOs) of SPACs experienced significant growth in 2019, a trend that has only continued through the first half of 2020. According to our proprietary database, 2019 featured 57 SPAC IPOs raising over $12 billion in the U.S. markets, an increase from 43 deals raising $9.6 billion in 2018. In addition, the first half of 2020 has shown that a steady market continues for SPAC IPOs, featuring 32 transactions raising over $9.3 billion. A few years ago, the SPAC market was considered a niche corner of the capital markets landscape, but this market has boomed, continuing to see larger and more well-established sponsors creating larger and more complex structures backed by the largest investment banks (so-called bulge-bracket banks) as their underwriters. This trend has continued virtually unabated through the COVID-19 pandemic.

SPACs raise funds through an IPO and, in turn, use the capital they raise to seek to acquire one or more businesses in the future. A SPAC is typically marketed to focus on potential acquisitions in a particular industry or geography, although at the time of the IPO a SPAC will not have identified a particular target. A SPAC normally offers units composed of shares of common stock and warrants, or fractions of warrants, to purchase common stock with a strike price higher than the

offering price of the unit. 52 days following the pricing of the IPO, holders can usually separate the units into the underlying common stock and warrants, allowing the warrants and common stock to trade separately. The funds raised by the SPAC in the IPO are placed in an interest-bearing trust account which generally cannot be disbursed other than (1) for the closing of an acquisition or (2) to redeem shares that investors have elected to have redeemed upon an acquisition or extension of the life of the SPAC. In some SPACs, a portion of the interest earned on the trust account can be used to fund the working capital of the SPAC. A SPAC typically has between 18 months and two years from the IPO pricing date to consummate an initial business combination before its formation documents require the SPAC to liquidate and return the funds in the trust account to investors or seek approval from shareholders for an extension.

Notable Transactions

The SPAC market had several notable transactions in the last year, including ever-increasing transaction sizes highlighted by Pershing Square Tontine Holdings Ltd., sponsored by Bill Ackman's Pershing Square funds, which raised $4.0 billion in its IPO in July. In addition, the business combination market provided some interesting companies to the public markets, including Richard Branson's space exploration venture, Virgin Galactic.

Virgin Galactic

Our last update highlighted the Social Capital Hedosophia SPAC, led by Chamath Palihapitiya, a former Facebook executive, as a notable IPO raising gross proceeds of $690 million. Social Capital closed its initial business combination in 2019 by merging with Richard Branson's Virgin Galactic, providing the commercial space exploration company with additional capital and access to the public markets. Mr. Palihapitiya will remain involved in the company as chairman and Virgin Galactic will continue to be led by its pre-transaction management team.

In connection with the transaction, Social Capital domesticated from the Cayman Islands to Delaware and valued the merged company at an enterprise valuation of $1.5 billion. The transaction is an example of SPAC transactions increasingly becoming the focus of private companies looking to enter the public markets without using a traditional IPO structure.

Pershing Square Tontine Holdings

Continuing a trend of sponsor-backed transactions and highlighting the ever-increasing deal size at the top of the market, Bill Ackman came to market with a SPAC, Pershing Square Tontine Holdings, Ltd., featuring a unique unit structure and massive deal size. Pershing Square Tontine raised $4 billion in its IPO and includes an additional $1 billion in forward purchase commitments from Pershing Square funds, giving it a $5 billion equity war chest to seek out an initial business combination aimed at mature unicorns. In addition, Pershing Square Tontine Holdings structured its unit in two unique ways: first, the economics are based on a $20.00 per unit IPO price, double the typical SPAC deal and, second, a portion of the warrants are subject to forfeiture to the extent the related shares are redeemed in connection with an initial business combination.

The registration statement for a SPAC follows the same form requirements as any other IPO. However, since the SPAC has no operations to describe, the disclosure is relatively simple.

First, fundamentally the higher share price is largely just a feature of the larger transaction because all of the other economic terms (other than the fractional warrants discussed below) are also effectively doubled from the usual $10.00 per unit terms in a typical SPAC. Second, and more interestingly, the warrants issued as part of the unit are uniquely structured to incentivize shareholders not to redeem in connection with an initial business combination. At the IPO, the units included one share of common stock; one-ninth (1/9) of a warrant to purchase common stock; and the right to receive a pro rata portion of warrants (the Tontine Warrants) representing, in the aggregate, two-ninths (2/9) of a warrant to purchase common stock per unit issued in the IPO. Effectively, this means that in the IPO each unit consists of one share and one-third of one warrant but the tontine structure of the warrants incentivizes shareholders not to redeem in the initial business combination because any shares that are redeemed lose their participation in the Tontine Warrants.

Deal Structure and Process

Initial Public Offering

A sponsor typically forms the SPAC entity prior to making an initial filing of a registration statement—usually on Form S-1. A SPAC is most often sponsored by either (1) well-known professionals in the specific industry or geography of focus for the SPAC or (2) private equity funds seeking acquisitions outside the focus of their general funds.

The registration statement for a SPAC follows the same form requirements as any other IPO. However, since the SPAC has no operations to describe, the disclosure is relatively simple. The registration statement includes current financial information of the SPAC, including audited financial statements, and a detailed description of the SPAC structure. In addition, although the SPAC will not have identified a target, the registration statement will (1) describe the expertise of the sponsor and the executive team and (2) generally include a description of the investment opportunity in the industry or geography on which the SPAC will focus.

Upon consummation of an IPO, the typical capitalization of a SPAC is as follows:

- Twenty pecent of the outstanding shares are issued for a nominal amount to the sponsor(s) in what is referred to as the sponsor promote or the founders shares.
- Eighty pecent of the outstanding shares are issued to the public in the IPO as part of a unit that also contains a warrant or a fraction thereof. The proceeds of the IPO, after paying part of the underwriting discount and other expenses, are placed in a trust account. The remaining part of the underwriting discount is only paid upon the consummation of an initial business combination.
- The sponsor also purchases warrants to fund the difference between the offering price to the public and the commissions and expenses paid by the SPAC such that there are enough funds in the trust to repurchase shares at the offering price of a unit upon redemption. The proceeds received by the SPAC from the privately placed warrants are referred to as the sponsor's at risk capital because upon a liquidation, these amounts are paid out to the public shareholders and the warrants purchased would not have any value and would not receive any distributions.
- In addition, many SPACs include forward purchase arrangements or other equity commitments with their sponsor, its affiliates, and other investors at the time of the IPO to provide additional equity financing in connection with the initial business combination, providing the SPAC with greater certainty that any equity funding necessary to complete the transaction will be available.

Business Combination

Upon consummation of the IPO, the SPAC is typically listed on either Nasdaq or the New York Stock Exchange (NYSE) and management of the SPAC turns its attention to seeking an existing business or assets to acquire in the SPAC's initial business combination. Management of the SPAC is typically a group of people affiliated with or on loan from the sponsor who dedicate part of their time to seeking an initial business combination. Pursuant to Stock Exchange rules, the initial business combination must occur with one or more target businesses that together have an aggregate fair market value of at least 80% of the assets held in the trust account (excluding the deferred underwriting commissions and other items) at the time of the definitive transaction agreement.

After signing a definitive agreement for the initial business combination, the SPAC must either (1) seek stockholder approval of the initial business combination—in connection with which stockholders may seek to have their shares redeemed (regardless of whether they vote for or against the initial business combination)—or (2) provide stockholders with the opportunity to sell their public shares to the SPAC by means of a tender offer. Whether through redemption or a tender offer, the price the SPAC must pay for the shares is an amount in cash equal to the holder's pro rata share of the aggregate amount then on deposit in the trust account, including interest but less amounts permitted to be withdrawn for taxes and for working capital purposes. Many SPACs restrict holders (together with others they are acting in concert with) from redeeming more than a certain percentage—generally 10% to 20%—of the outstanding public shares in order to discourage holders from accumulating large blocks of shares. This is often referred to as the Bulldog provision (named after an activist investment fund that in 2008 accumulated a large stake in TM Entertainment and Media, a SPAC, and attempted to replace the board of directors and force an early liquidation of the SPAC).

The choice to seek stockholder approval of the initial business combination or to conduct a tender offer for its shares is in the discretion of the SPAC, generally in consultation with the counterparties to the business combination. The decision is based on a variety of factors, including whether the completion of the business combination otherwise requires approval of the SPAC's stockholders (such as authorization to amend the formation documents or to issue 20% or more of the outstanding shares) and the timing of the transaction. In addition, a business combination is often structured to supplement the trust account (or to backstop any redemptions) through issuance of new equity in the combined company at closing through previously arranged equity instruments or through a private investment in public equity (PIPE) investment. The PIPE, the terms of which may vary widely, may be committed at signing or marketed to potential PIPE investors between the signing and closing of the business combination. The transactions also often include committed debt financing, either to refinance existing debt of the target company subject to acceleration upon the completion of the transaction or as consideration to purchase the target company. The process from signing to closing typically takes two to five months, depending on the stockholder and regulatory approvals necessary to complete the transaction.

Proxy

If the SPAC submits the combination to a shareholder vote, it will typically prepare and file a proxy statement with the Securities and Exchange Commission (SEC) on Schedule 14A to be mailed to shareholders. The SPAC proxy contains all the information that is typical for a large merger, including the target's current and historical audited and interim financial statements as well as other detailed disclosure about the target company or companies. Often targets in initial business combinations are not regularly preparing financial statements that meet SEC filing requirements or being audited under the standards of the Public Company Accounting Oversight Board. In that case, preparing the information can be a significant impediment to timely filing the proxy statement, which affects the timing of closing the transaction. The proxy will also contain a complete description of the post-transaction company and its management, directors, governance structure, and material contracts (including debt financing agreements related to the de-SPACing transaction). If the transaction structure contemplates an entity other than the SPAC as the surviving public company, the proxy could be combined with a prospectus and filed as a registration statement on Form S-4 to register new shares in the surviving company. The proxy is also used to offer the shareholders their redemption rights pursuant to the SPAC's charter documents.

If the business combination contemplates a tender offer in lieu of a proxy/redemption, the SPAC will prepare a Schedule TO which includes a similar level of disclosure about the target company or companies and the terms of the transaction as the proxy statement.

Liquidation

Pursuant to its formation documents, if a SPAC is unable to complete the initial business combination within a set time period (usually 18 months to two years from the IPO, subject to extension), the SPAC will (1) cease all operations except for the purpose of winding up; (2) redeem the then-outstanding public shares for cash at a per-share price equal to the aggregate amount then on deposit in the trust account,

Related Content

For additional information on SPACs, see

> SPECIAL PURPOSE ACQUISITION COMPANIES

RESEARCH PATH: *Capital Markets & Corporate Governance > IPOs > Conducting an IPO > Practice Notes*

For an overview of initial public offerings (IPOs), including the legal requirements under securities laws, see

> INITIAL PUBLIC OFFERING PROCESS

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For an explanation on how to prepare, file, and review a company's registration statement for an IPO, see

> REGISTRATION STATEMENT AND PRELIMINARY PROSPECTUS PREPARATIONS FOR AN IPO

RESEARCH PATH: *Capital Markets & Corporate Governance > IPOs > Drafting the Registration Statement > Practice Notes*

For the ten crucial tips for launching a successful IPO, see

> TOP 10 PRACTICE TIPS: INITIAL PUBLIC OFFERINGS

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Related Content

For a resource kit that provides practical guidance on IPOs for equity securities, see

> INITIAL PUBLIC OFFERINGS RESOURCE KIT

RESEARCH PATH: *Capital Markets & Corporate Governance > IPOs > Conducting an IPO > Practice Notes*

For a summary of the financial and liquidity requirements for an initial listing of primary equity securities on the Nasdaq, see

> NASDAQ INITIAL LISTING REQUIREMENTS TABLE

RESEARCH PATH: *Capital Markets & Corporate Governance > IPOs > Conducting an IPO > Checklists*

For a listing of the continued financial and liquidity listing requirements for equity securities on the Nasdaq, see

> NASDAQ CONTINUED LISTING REQUIREMENTS TABLE

RESEARCH PATH: *Capital Markets & Corporate Governance > IPOs > Conducting an IPO > Checklists*

For a discussion of the shareholder approval rules for companies listed on the New York Stock Exchange (NYSE) and the Nasdaq, see

> 20% RULE AND OTHER NYSE AND NASDAQ SHAREHOLDER APPROVAL REQUIREMENTS

RESEARCH PATH: *Capital Markets & Corporate Governance > Corporate Governance and Compliance Requirements for Public Companies > Corporate Governance > Practice Notes*

including any earned interest, divided by the number of then outstanding public shares; and (3) as promptly as reasonably possible following such redemption, dissolve and liquidate, subject in each case to the SPAC's obligations under applicable law, including to provide for claims of creditors. A SPAC can also seek to have the initial time period to seek a business combination extended, so long as it concurrently offers holders of the outstanding public shares the redemption rights they would have upon liquidation. The SPAC's officers and directors waive their rights to liquidating distributions from the trust account with respect to any shares held by them prior to the IPO, but not with respect to any public shares they acquire in or following the IPO.

Other Key Market Trends

As the SPAC IPO market has expanded in the last couple of years, we have continued to see the size of SPAC IPOs grow. While Pershing Square Tontine Holdings is the largest SPAC IPO to date, our data shows in the first half of 2020, 34% of SPAC IPOs raised more than $300 million, compared to 10% in 2019. As larger and more sophisticated sponsors continue to enter the SPAC market, backed by larger and more diverse investment banks as their underwriters, we see this trend continuing even as the number of smaller SPACs continues to grow. In addition, over the past few years we have seen more SPACs list on the NYSE than in the past, likely due to a reduction in the NYSE listing fees applicable to SPACs. In addition, SPACs can experience challenges complying with the exchanges' round lot and public holder requirements prior to the consummation of an initial business combination because their shares often trade among a relatively limited number of investors. Both the NYSE and Nasdaq have been working to adjust to their listing rules to mitigate obstacles faced by SPACs in listing their shares and keeping their shares listed, though many of the changes have not survived SEC review. The exchanges are expected to continue to work with the SEC and the SPAC community to avoid outcomes where SPAC companies are subject to delisting proceedings.

Market Outlook

SPACs continue to be an attractive vehicle for raising capital and an efficient pathway for privately held businesses to become publicly traded on an expedited timeline compared to a traditional IPO, diverting less of management's time to the transaction process and allowing management to focus on running the business. Market interest remains strong, both in new SPAC IPOs and in de-SPACing transactions. 2019 was a strong year for SPAC IPOs, and there are numerous SPACs that are well on their way to a successful de-SPACing transaction. The active market in 2020 should ensure a robust de-SPACing pipeline on the heels of a few strong years of SPAC IPO activity.

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RESEARCH PATH: *Capital Markets & Corporate Governance > Trends & Insights > Market Trends > Practice Notes*


Alex May and William Erlain JENNER & BLOCK LLP

Public Company Reporting and Corporate Governance

This article provides an overview of the notable market trends in corporate governance and public company reporting in 2019 and early 2020 and the outlook for the remainder of 2020.

IN 2019, THE SECURITIES AND EXCHANGE COMMISSION (the SEC) continued its activities to simplify and reduce the amount of disclosure public companies must provide and improve the usability of such disclosure by implementing changes to Regulation S-K. Corporate governance considerations related to increasing board diversity and environmental, social, and governance compliance and disclosure dominated discussions in and outside of board rooms. In addition, through the Delaware Supreme Court's decision in *Marchand v. Barnhill*[1] and related cases, Delaware courts have considered to what extent Delaware corporations' boards of directors must monitor certain risks or face potential exposure for breaches of fiduciary duty.

Of course, 2020 has been, and will continue to be, dominated by issues related to COVID-19 disclosures and related governance issues arising from the pandemic.

SEC Final Rules—FAST Act Updates to Regulation S-K

The SEC revised a wide range of disclosure requirements in its final rule titled "FAST Act Modernization and Simplification of Regulation S-K,"[2] published in March 2019. The revisions were made pursuant to legislative mandates to reduce the costs and burdens on registrants, to improve the readability and navigability of disclosures, and to discourage repetition and disclosure of immaterial information. The SEC originally proposed the revisions in October 2017. The updates largely were effective in the second quarter and did not impact all registrants in 2019 due to the timing of the adoption. However, most registrants have been or will be impacted in 2020 and into 2021.

Management Discussion and Analysis

Traditionally, the management discussion and analysis (MD&A) section in registrants' annual reports was required to cover three years of the registrant's performance. However, in many cases, the earliest comparison was contained in the registrant's previous annual report and did not provide new information. The SEC amended Item 303 of Regulation S-K[3] to permit registrants to identify a prior filing where the MD&A covering the earliest comparison can be found, instead of including such information in the current year's annual report. While the amendment is straightforward on its face, the SEC has issued compliance and disclosure interpretations to assist registrants in implementing the change. For example, if information about the earliest year is "necessary to an understanding of its financial condition, changes in financial condition and results of operations," then a registrant must either include such information in the current disclosure or expressly incorporate by reference the prior disclosure.

Confidential Information

Prior to the SEC's revisions in 2019, registrants were required to submit confidential treatment requests to the SEC for contracts or arrangements that contained competitively sensitive information. A typical confidential treatment request, or CT request, involved a written analysis of the applicable contract or arrangement that was submitted to the SEC staff with the unredacted exhibit. Registrants would file the redacted exhibit and await response from the SEC staff on whether the CT request would be granted. Item 601(b) of Regulation S-K[4] now permits registrants to file redacted material contracts and certain other exhibits without applying for confidential treatment, provided the redacted information (1) is not material and (2) would likely cause competitive harm to the registrant if publicly disclosed. The registrant must still analyze such redactions under the same standards as under the previous CT request regime. The SEC may review a registrant's use of redactions to ensure all material information was disclosed, but the SEC will make such requests separate from any requests for supplemental information in order to minimize the risk of inadvertent public disclosure of competitive information.

Similarly, the SEC also revised Item 601(a) of Regulation S-K to permit registrants to omit attachments (such as schedules and other ancillary agreements) to material contracts if no material information is contained within such attachments. Registrants must otherwise identify the contents of an omitted attachment unless the material contract adequately conveys such information. This revised approach has the benefit of decreasing disclosure of voluminous schedules to credit agreements and financing documents which were largely form documents. While some registrants have elected to make reference to Item 601(a)(5) in the exhibit index to Forms 10-K, 10-Q, and 8-K, some registrants have elected to omit the attachments/materials without reference to Item 601(a)(5) of Regulation S-K.

In addition, Item 601(b) of Regulation S-K now applies the two-year lookback period for the disclosure of material contracts only to newly reporting registrants. All other registrants must

1. 212 A.3d 805 (Del. 2019). 2. https://www.sec.gov/rules/final/2019/33-10618.pdf. 3. 17 C.F.R. § 229.303. 4. 17 C.F.R. § 229.601.

disclose material contracts that are to be performed in whole or in part at or after the filing date.

Description of Property

Item 102 of Regulation S-K[5] covers properties of the registrant and, with the exception of registrants in certain industries, generally required the disclosure of materially important properties. However, as companies transitioned from requiring specific properties or plants in their businesses, this disclosure requirement was considered antiquated in some respects. As a result, the SEC amended Item 102 of Regulation S-K to require disclosure of only those properties that are material to the registrant. Many registrants have elected to disclose fewer properties, or none at all in response to revised Item 102 of Regulation S-K.

SEC Proposed Rules—Description of Business, Legal Proceedings, and Risk Factors

In connection with its modernization and simplification efforts for Regulation S-K, the SEC proposed revisions to certain Regulation S-K disclosure requirements titled "Modernization of Regulation S-K Items 101,103, and 105,"[6] published in August 2019.

5. 17 C.F.R. § 229.102. 6. https://www.sec.gov/rules/proposed/2019/33-10668.pdf.

General Development of Business

The SEC proposed to replace the prescribed five-year time frame for describing the general development of the registrant's business in Item 101(a) of Regulation S-K[7] with a materiality threshold. Registrants could elect to report a shorter time period or a longer time period if material to an understanding of the registrant's business. Similarly, the SEC proposed to replace the prescribed three-year time frame for smaller reporting companies in Item 101(h) with the same materiality threshold.

In connection with potentially removing the time frame contained in Item 101(a) of Regulation S-K, the SEC also considered to what extent the development of the business should be required in filings other than initial registration statements. The SEC proposed to revise Item 101(a) to allow registrants to describe only material updates to their description of the general development of the business contained in their initial registration statement. Registrants would incorporate by reference the most recently filed disclosure that, taken together, would present a full discussion of the general development of its business, including whether the registrant's business strategy has changed. The SEC believes that this should allow investors to focus more on the material developments than a recitation of the history of the registrant.

Lastly, the SEC proposed revising Item 101(a)(1) of Regulation S-K to require only the disclosure of information material to the understanding of the general development of the registrant's business. The SEC noted its intention to emphasize a principles-based disclosure approach to the business section.

7. 17 C.F.R. § 229.101.

Related Content

For additional information and practical guidance on Brexit, see

> MARKET TRENDS 2019/2020: BREXIT DISCLOSURE

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For an overview of practical guidance on COVID-19 in various practice areas, including capital markets, see

> CORONAVIRUS (COVID-19) RESOURCE KIT

RESEARCH PATH: *Capital Markets & Corporate Governance > Trends & Insights > Practice Notes*

For a full discussion of Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A), see

> MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

RESEARCH PATH: *Capital Markets & Corporate Governance > Public Company Reporting > Periodic Reports > Practice Notes*

For an analysis of Securities and Exchange Commission (SEC) guidance on using performance metrics in MD&A, see

> SEC PROPOSES TO AMEND FINANCIAL DISCLOSURE REQUIREMENTS AND PROVIDES GUIDANCE ON USING KEY PERFORMANCE METRICS IN MD&A: CLIENT ALERT DIGEST

RESEARCH PATH: *Capital Markets & Corporate Governance > Public Company Reporting > Periodic Reports > Articles*

Notably, the proposed rules include material changes in the registrant's business strategy in addition to other currently prescribed topics.

Description of Business

Item 101(c) of Regulation S-K requires a general description of the registrant's business with a list of disclosure topics. The SEC considered the various disclosure topics and, based on input from commenters, proposed to remove certain disclosure topics from Item 101(c) and to add a disclosure topic requiring disclosure of human capital resources. The SEC reasoned that companies were trending away from being natural resource and fixed-asset intensive to being human resource intensive. The SEC also proposed to add language that clarifies registrants only need to discuss disclosure topics which are material to their business.

Legal Proceedings

For Item 103 of Regulation S-K[8] related to disclosure of legal proceedings, the SEC proposed allowing hyperlinks or cross-references to overlapping disclosures located elsewhere in a filing. For example, if there is disclosure meeting the requirements in the contingencies footnote in the financial statements, a registrant could cross-reference that disclosure (or parts of disclosure) to prevent double disclosure. In addition, the SEC also proposed adjusting the threshold for environmental proceeding disclosures from $100,000 in Item 103, which was adopted in 1982, to $300,000 to reflect inflation.

Risk Factors

The SEC proposed three amendments to Item 105 of Regulation S-K[9] relating to the disclosure of risk factors. First, the SEC proposed requiring registrants to insert a summary risk factor disclosure if their risk factor disclosure exceeds 15 pages. The summary would contain short, concise, listed statements summarizing the risk of the registrant's business. Second, the SEC proposed requiring the disclosure of only material risks and not simply the most significant risks. And third, the SEC proposed codifying the requirement to organize risk factor disclosures under relevant headings, as many registrants already do. To the extent a registrant discloses general risk factors and omits an explanation for why such risks are specific to its business or securities, such risk factors would be grouped under a "General Risk Factors" caption.

SEC Proposed Rules—Proposed Rules regarding MD&A

As part of its mission to review and update Regulation S-K (as discussed above), the SEC proposed further revisions[10] to MD&A on January 30, 2020. Pursuant to mandates codified in the JOBS Act and FAST Act, the proposed revisions intend to address overlapping or unnecessary disclosure requirements (particularly as a result of advances in technology and the availability of information), to help reduce burdens on registrants and improving readability for investors.

Elimination of Certain Financial Disclosure Requirements

With fairly straightforward reasoning, the SEC proposed to eliminate Item 301 of Regulation S-K (requirement to provide five years of selected financial data)[11] and Item 302 of Regulation S-K (requirement to provide two years of selected quarterly financial data),[12] because such information is readily available in prior public filings or otherwise covered by separate disclosure requirements in Item 303 of Regulation S-K.

8. 17 C.F.R. § 229.103. 9. 17 C.F.R. § 229.105. 10. https://www.sec.gov/rules/proposed/2020/33-10750.pdf. 11. 17 C.F.R. § 229.301. 12. 17 C.F.R. § 229.302.

> The SEC proposed to require disclosure of trends or uncertainties that are reasonably likely to cause (rather than will cause) a change in the relationship between costs and revenues.

Revisions to Item 303 of Regulation S-K

The SEC proposed to add to or revise certain requirements in Item 303 of Regulation S-K to better reflect the purposes of MD&A. The proposed revisions seek to reorganize current standards, eliminate redundant or outdated provisions, and emphasize other portions.

- **Redefine purposes of MD&A and make conforming changes**. The SEC proposed to add/recaption new Item 303(a) of Regulation S-K to clarify the principal objectives of the MD&A section. This has the impact of changing current Item 303(a) to Item 303(b) and current Item 303(b) to Item 303(c).
- **Clarification of changes required to be discussed in MD&A**. Revised Item 303(a) would clarify that MD&A requires narrative discussion of the underlying reasons for material changes from period-to-period in one or more line items in quantitative and qualitative terms, rather than only the "cause" for material changes. Also noteworthy is the SEC's proposal to require disclosure of material changes within a line item even when the line items offset each other.
- **Addition of material cash requirements**. The SEC proposed to revise the capital resources disclosure requirement to require registrants to disclose their material cash commitments, which includes, but is not limited to, capital expenditures. Revised Item 303(a)(2) would also require disclosure of the anticipated source of funds needed to satisfy such cash requirements, and the general purpose of such requirements. At the current time, the SEC does not intend to define capital resources, instead leaving that determination up to the registrant.
- **Reasonably likely standard for trends and uncertainties related to costs and revenues**. The SEC proposed to require disclosure of trends or uncertainties that are reasonably likely to cause (rather than will cause) a change in the relationship between costs and revenues. This generally aligns with current MD&A language.
- **Material changes in revenues and volumes**. In accordance with existing standards, the SEC is proposing to revise Item 303(a)(3)(iii) to require disclosure of material changes in net sales or revenues, rather than just increases.
- **Off-balance sheet disclosures**. The SEC, in considering changes to Item 303(a)(4) of Regulation S-K, considered the history of the disclosure, the purposes, and similar disclosure required by U.S. GAAP. The SEC sought to preserve the requirement to disclose material off-balance sheet arrangements but avoid repetitive disclosure. In doing so, the SEC proposed to require registrants to discuss commitments or obligations, including contingent obligations, arising from arrangements with unconsolidated entities or persons that have, or are reasonably likely to have, a material current or future effect on a registrant's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, cash requirements, or capital resources.
- **Critical accounting estimates**. The SEC also proposed to require disclosure of critical accounting estimates and why each critical accounting estimate is subject to uncertainty, how much each estimate has changed during the applicable reporting period, and the sensitivity of the reported amount to various conditions.
- **Options in presenting interim information**. Currently, interim financial information is required to be presented on a year-to-date comparison basis and then on a quarterly comparison basis. With respect to the quarterly comparison basis, the quarter comparison is measured from the previous year's quarter. The SEC is proposing to allow registrants the flexibility to provide a quarterly comparison that is for the previously completed quarter rather than the previous year's quarter. However, if the registrant elects to change the presentation during an interim period, the SEC proposed to require disclosure of both the previous year's quarter and the previous quarter and the reasons for the change, potentially blunting the attractiveness of such disclosure.

The SEC also proposed to eliminate the following requirements: (1) Item 303(a)(3)(iv) (discussion of inflation and changing prices), (2) Item 303(a)(5) (tabular disclosure of contractual obligations), (3) Item 303(c) (statutory safe harbor for forward-looking information in off-balance sheet arrangements and contractual obligations disclosures), and (4) Item 303(d) (certain accommodations for smaller reporting companies).

SEC Proposed Rules—Earnings Releases and Quarterly Reports

At the end of 2018, the SEC published a request for comment on how it can modernize and simplify periodic disclosures, specifically in regard to the nature and timing of disclosures made on Form 10-Q. One option proposed by the SEC is to allow the voluntary release of earnings on Form 8-K to satisfy the core disclosure requirements of Form 10-Q. To that end, the SEC requested feedback on why companies separately file earnings, whether investors rely more on earnings releases or Form 10-Qs, and whether the filing of both disclosures creates confusion, among other issues. Additionally, the SEC requested feedback on whether the timing for filing Form 10-Q can be adjusted to reduce the burden on registrants, including the option of reducing the number of periodic filings made per year.

SEC Areas of Focus—LIBOR Transition Factors

The London Interbank Offer Rate (LIBOR) is a reference interest rate which determines lending rates for various types of contracts and debt throughout the world. Many market participants expect that LIBOR will cease to exist in its current form after 2021. In response, market participants and regulators alike are working to determine how existing agreements contemplate the termination of LIBOR and what alternatives exist for a new reference rate.

Alternative Reference Rates

In the United States, the Alternative Reference Rates Committee (ARRC) continued to advocate for the use of the Secured Overnight Financing Rate (SOFR) as the main replacement for LIBOR. Throughout 2019, the ARRC published a number of guidance releases on fallback language to include in new contracts, including contracts for floating rate notes, syndicated loans, bilateral business loans, and securitizations. And in early 2020, the ARRC published consultations on fallback language for new variable-rate private student loan agreements and on swaptions impacted by the central counterparty clearing houses transition to SOFR.

The International Swaps and Derivatives Association (ISDA) released a number of consultations in 2019 on recommended adjustments to SOFR to address differences in tenor and the reflection of certain risk factors, as compared to LIBOR. The ARRC later released its own consultation in early 2020 for recommended adjustments for cash products.

Beginning on March 2, 2020, the ARRC now publishes 30-day average SOFR, 90-day average SOFR, and 180-day average SOFR rates, in addition to a daily index which can be used to calculate compounded average rates for customer time periods.

SEC Guidance

The SEC released a statement in July 2019 outlining its guidance on how market participants should address the transition away from LIBOR. For existing contracts, the SEC urged for comprehensive contingency planning to begin as soon as possible; and for new contracts, the SEC cited the ongoing efforts of the ARRC, ISDA, and other groups to develop new reference rates and fallback options. The SEC has yet to endorse a particular alternative reference rate and may never specifically endorse an alternative rate.

The July 2019 statement also contained division-specific guidance highlighting the unique risks and considerations for each registrant. For example, the Division of Corporation Finance advised registrants to be specific when disclosing risks, to avoid boilerplate disclosures, and to explain how the board administers its oversight of the company's risk.

SEC Areas of Focus—Brexit

Over the past several years, registrants have had to grapple with the uncertainty of whether a withdrawal agreement, if any, between the United Kingdom and the European Union would be approved, the timetable of the withdrawal, and the ultimate terms of such withdrawal. And more recently, there has been significant uncertainty about the impact of the January 2020 withdrawal agreement between the parties. As detailed below, the SEC provided guidance in 2019 on how companies should approach Brexit-related disclosures. Particularly with the outbreak of the COVID-19 pandemic, Brexit-related disclosures have decreased in prominence but still remain an important consideration based on the business and international risk profile of the registrant.

SEC Guidance

In a March 2019 speech, the Director of the Division of Corporation Finance critiqued generic disclosures about Brexit that do little to help investors understand the specific risks posed to each registrant. Instead, the Director advised registrants to consider whether their disclosures would "satisfy the curiosity of a thoughtful, deliberative board member considering the potential impact of Brexit on the company's business, operations and strategic plans[.]" Types of risk the SEC will expect to see discussed, to the extent they bear on a particular registrant's business, include but are not limited to: (1) regulatory risks, (2) the impact on supply chains, (3) risk of losing customers, (4) exposure to currency devaluation or foreign currency exchange rate risk, (5) contractual risk, and (6) the impact on financial statement recognition, measurement, or disclosure. Often these disclosures have been located in registrants' risk factors section, but certain registrants have elected to provide additional disclosure in other sections of their periodic filings.

SEC Areas of Focus—International IP and Technology Risks

On December 19, 2019, the SEC's Division of Corporation Finance published guidance[13] on disclosing intellectual property and technology risks when registrants conduct business outside the United States, particularly in jurisdictions without comparable levels of protection. The SEC noted that a registrant's valuable information may be stolen through direct intrusion by private and state actors and through more indirect means, such as reverse engineering or other disclosures to third parties. Moreover, a registrant may be required to compromise its technology and intellectual property protections in order to conduct business in a certain jurisdiction.

To those ends, registrants have been instructed to disclose material risks of theft or compromise that are tailored to the registrant's business. This includes consideration of the types of technology and intellectual property used in the business, the jurisdictions in which the registrant operates, and any concessions the registrant makes to its privacy and security standards. The SEC also noted that hypothetical disclosures may not be sufficient when the registrant has previously experienced or is currently experiencing an adverse event.

SEC Areas of Focus—Key Performance Indicators

Effective February 25, 2020, the SEC published new guidance[14] on the discussion of key performance indicators (or KPIs) and metrics in MD&A, pursuant to Item 303(a) of Regulation S-K. The SEC reaffirmed that Item 303(a) requires the disclosure of information necessary for investors to understand the registrant's financial condition and results. Additionally, to the extent a registrant decides to disclose certain key performance indicators and metrics, the SEC confirmed such information should follow any applicable requirements, such as Item 10 of Regulation S-K (such as those non-GAAP measures), and "should not deviate materially from metrics used to manage operations or make strategic decisions."

Item 303(a) of Regulation S-K further requires that the disclosure of metrics must be accompanied by all information necessary to ensure that the disclosure is not misleading. Determining what or how much information must be disclosed depends on the specific facts and circumstances, but the SEC generally expects to see (1) a clear definition of the metric and how it is calculated, (2) a statement indicating the reasons why the metric provides useful information to investors, and (3) a statement indicating how management uses the metric in managing or monitoring the performance of the business. If the registrant changes how a metric is calculated or presented from one reporting period to another, the SEC encourages a discussion of how and why the metric changed, to the extent it is material. Furthermore, the SEC announced an enforcement action with respect to a company's KPIs in early 2020, so the SEC's attention to KPIs is more than just a theoretical guidance matter.

13. https://www.sec.gov/corpfin/risks-technology-intellectual-property-international-business-operations. 14. https://www.sec.gov/rules/interp/2020/33-10751.pdf.

SEC Areas of Focus—COVID-19 Disclosures

Throughout 2020, registrants in virtually every industry have focused on disclosures resulting from the novel coronavirus or the COVID-19 pandemic. While some registrants with calendar-year end reporting added risk factors and related disclosures in their Form 10-Ks filed in February and early March, for many registrants the impact of the COVID-19 pandemic was not fully realized until March, April, and May of 2020.

In response to registrant and investor concern regarding appropriate disclosures, on March 25, 2020, the SEC's Division of Corporation Finance released guidance on disclosures concerning the COVID-19 pandemic.[15] The guidance reaffirmed the same principles that govern disclosures generally and probed registrants to consider the varied ways they may be materially impacted by the COVID-19 pandemic. For example, registrants should assess whether the pandemic will (1) impact financial condition or results, (2) impact capital or financial resources, (3) cause material impairments, (4) impact demand for products and services, or (5) cause material disruption through travel restrictions and border closures. The Division also suggested registrants avail themselves of the safe harbors in Section 27A of the Securities Act and Section 21E of the Exchange Act for forward-looking information, as the pandemic and its effects continue to develop.

Additionally, the Division urged registrants to begin considering how the pandemic will impact their financial reporting as soon as possible, as more time may be needed to account for issues like impairment adjustments. However, to the extent a GAAP financial measure is not available at the time of an earnings release because more time is needed to make COVID-19 adjustments, the Division is open to companies "reconciling a non-GAAP financial measure to preliminary GAAP results that either include provisional amount(s) based on a reasonable estimate, or a range of reasonably estimable GAAP results."

The SEC has allowed for relief from filing deadlines provided the registrant files a Form 8-K (or Form 6-K) describing, among other things, the reasons why the registrant could not file the applicable report, the estimated date for the filing of the report, and any COVID-19 related risk factors. The report must be filed within 45 days of the original report.

Since March 2020, registrants have responded to the SEC's guidance as well as the realities of the COVID-19 impact on their businesses. Many registrants have elected to provide robust risk factors regarding the varied effects of COVID-19 on their business, elected to carefully consider their liquidity disclosures (including disclosures as a result of, or related to, their election to draw on credit agreements or access the capital markets), and tailor their MD&A to provide COVID-19-specific impacts (such as disclosure of supply chain issues).

Another side-effect of the financial dislocations caused by COVID-19 is an increase in accounting-related disclosures, often with negative effects. For example, goodwill impairments (due to cash flow measurements or revenue recognition issues), going concern disclosure (due to lack of revenue or other issues related to the registrant's debt covenants), revenue recognition, and write-offs for bad accounts have been and will continue to be problematic for many registrants.

In addition, the SEC had previously issued (and such letters have now become public) a number of comment letters to registrants related to the impact of COVID-19 and reviewing the registrant's COVID-19 disclosures generally. While a number of the comment letters have been issued to registrants with significant operations in China, it would be expected that registrants with sizable domestic operations will receive and respond to similar letters from the SEC regarding the COVID-19 disclosures.

Related Content

For a review of current reporting obligations, see

> PERIODIC AND CURRENT REPORTING RESOURCE KIT

RESEARCH PATH: *Capital Markets & Corporate Governance > Public Company Reporting > Periodic Reports > Practice Notes*

For an update on disclosure guidance related to COVID-19, see

> COVID-19 UPDATE: SEC STAFF ISSUES ADDITIONAL DISCLOSURE GUIDANCE

RESEARCH PATH: *Capital Markets & Corporate Governance > Trends & Insights > First Analysis > Articles*

For an explanation of the impact of COVID-19 on capital markets and securities law, see

> MARKET TRENDS 2019/20: COVID-19 FROM A SECURITIES LAW PERSPECTIVE

RESEARCH PATH: *Capital Markets & Corporate Governance > Trends & Insights > Market Trends > Practice Notes*

15. https://www.sec.gov/corpfin/coronavirus-covid-19.

www.lexisnexis.com/PracticalGuidance-Product 71

Governance Trends—Environmental, Social, and Governance Initiatives

Focus on environmental, social, and governance (ESG) initiatives and compliance remained high in 2019 and early 2020. According to various estimates, sustainable or ESG-based investing assets (whose definition continues to evolve) now account for a significant minority of professionally managed assets in the United States, and it is estimated that sustainable or ESG-based assets will account for half or more in the next 5 to 10 years. Institutional investors continued to bolster their ranks to better scrutinize proxies and encourage change by discussions with company management to consider ESG activities as part of their business and operating plans. Furthermore, shareholders persisted in adding ESG issues onto company proxies in 2019 and into 2020. While there has been some lessened concern around ESG initiatives as a result of the COVID-19 pandemic, ESG initiatives are expected to continue to grow and be a focus of investors in the coming years.

Industry Calls to Action

The Business Roundtable released its "Statement on the Purpose of the Corporation" on August 19, 2019, in which it underscored that companies must consider the interests of all stakeholders and not simply shareholders. The organization's list of commitments includes "protect[ing] the environment by embracing sustainable practices," "[d]ealing fairly and ethically with suppliers," and "[i]nvesting in . . . employees," among others. While the statement gained a significant amount of attention for statements apparently reducing the primacy of shareholders, the message to participants was that ESG was being considered very seriously by some of the United States' largest companies.

On the institutional investor front, on January 14, 2020, the Chairman and CEO of BlackRock signed letters to CEOs and the company's clients in an appeal to take climate change more seriously. He warned of a forthcoming "significant reallocation of capital" based on the profound risk that climate change poses and advocated that "sustainability should be our new standard for investing." A few weeks later, the CEO of State Street Global Advisors characterized addressing material ESG issues as "essential to a company's long-term financial performance" and noted that a company's performance on ESG issues "will soon effectively be as important as its credit rating."

Disclosure and Standards

While institutional investors and prominent business organizations generally agree on the importance of ESG, the standards of responsible practices and disclosure requirements are, at best, a patchwork of frameworks, policies, and standards. Furthermore, what responsible ESG practices are in one industry might be different than in another industry, providing for a lack of clarity for participants and registrants. Well-known standards and frameworks include those set by the Sustainability Accounting Standards Board, the Global Reporting Initiative, and Climate Disclosure Standards Board and Task Force on Climate-related Financial Disclosures (with respect to climate change and environmental topics).

And other entities have continued to provide alternative standards and frameworks. For example, The World Economic Forum published in early 2020 a list of proposed core metrics and disclosures on topics ranging from climate risk, ethical governance, diversity and inclusion, and community investment. The organization's hope is to close the gap between the well-established standards for disclosing financial information and the lacking framework for ESG matters.

In the United States, the SEC currently does not have specific requirements to disclose specific ESG matters. However, SEC Commissioner Allison Herren Lee remarked at an investment adviser conference in March 2020 that there is "overwhelming investor demand for consistent, reliable, and comparable disclosure," and noting that a lack of such disclosure "undermines efficient capital allocation." The Commissioner pledged her continued advocacy for climate risk disclosures through rulemakings and guidance. While any finalized SEC ESG disclosure standards are not expected to be issued in 2020, it is expected to be a topic of investor input in 2020 as the SEC considers the overall changes to Regulation S-K.

Governance Trends—Board Composition

Board composition and refreshment continues to be a focus of many investors and governmental entities. While strict tenure requirements remain somewhat rare, many boards realize that refreshment is important and long tenures are being scrutinized. For example, ISS found that, as of May 2019, just under 25% of directors on profiled Russell 3000 boards had less than three years of tenure, the highest mark in at least the last 12 years. This rate is driven in part by the recent emphasis on board diversity as measured in terms of skills, experiences, and viewpoints—factors which are discussed in more detail below. While many observers are encouraged by the movement toward shorter tenures and more frequent turnover, other parties have observed that the overall rate of refreshment is still low.

Gender Diversity

Boards continue to have an increasing number of female directors. For example, the 2019 U.S. Spencer Stuart Board Index found that over 90% of S&P 500 boards now contain two or more female directors, a significant increase over the 53% mark a decade ago. Moreover, 46% of new independent directors are women.

Racial and Ethnic Diversity

Boards also are adding an increasing number of minorities. The 2019 U.S. Spencer Stuart Board Index found that 23% of new S&P 500 directors are minorities, defined as African-American/Black, Asian, or Hispanic/Latino. According Spencer Stuart, 93% of the top 200 S&P 500 companies (by revenue) have minority directors, which is up from 85% a decade ago.

Age Diversity

The percentage of relatively young directors on Russell 3000 boards is trending down, and the average age of an S&P 500 independent director has remained largely the same since 2009. Many companies impose age limits, though these are often set high—for example, only 15% of independent directors on S&P 500 boards with age limits are within three years of mandatory retirement according to Spencer Stuart.

Governance Trends—Legislation Related to Diversity

In addition to institutional investors and proxy advisors, 2019 and 2020 saw federal and local governments proposing or enacting legislation requiring female and/or diverse directors on publicly traded companies headquartered or incorporated in the state.

Federal Level

In November 2019, the U.S. House of Representatives passed a bill that would require certain corporations to disclose in Exchange Act filings the gender, race, ethnicity, and veteran status of their board of directors, nominees, and executive officers. While an increasing number of companies elect to provide this information on an individual or aggregate basis in their proxy statements, it is not specifically required by current rules under the Securities Act or Exchange Act. While it is unlikely that the U.S. Senate will take up this legislation in 2020, it remains a subject of federal interest.

California

Publicly held domestic and foreign public corporations with their principal executive offices in California were required to have at least one female (self-identified) board director by the end of 2019. The next benchmark will be the end of 2021, at which point boards with six or more directors will need to have at least three female directors, and boards with five directors will need to have at least two female directors.

Illinois

Starting no later than January 1, 2021, domestic and foreign public corporations with a principal executive office in Illinois will need to annually report the number of women and certain categories of minorities on their board. Such corporations will also need to disclose whether and how they consider demographic diversity when selecting new directors and executive officers.

Maryland

Starting October 1, 2019, domestic stock corporations with total sales exceeding $5 million and tax-exempt domestic nonstock corporations with operating budgets exceeding $5 million are required to report the total number of directors and female directors on their board in their annual filings.

New York

Starting June 27, 2020, domestic corporations and foreign corporations doing business in the state are required to report the number of total directors on their board and which directors are female. Such reports will be made in their routine filing statement, and the state will aggregate the information.

Washington

No later than January 1, 2022, public companies incorporated in Washington must either have a gender diverse board (consisting of 25% or more persons who self-identify as female) or deliver or disclose to its stockholders a board diversity discussion and analysis. The board diversity discussion and analysis should contain information about the corporations' activities toward developing and maintaining diversity on its board.

Governance Trends—Delaware Fiduciary Duty Litigation

In June 2019, the Delaware Supreme Court issued its decision in *Marchand v. Barnhill*,[16] increasing the exposure for boards of directors of Delaware corporations to fiduciary liability for *Caremark*[17] claims. In *Marchand*, a Delaware corporation failed to maintain proper food safety protocols and the unsafe food caused the death of several consumers. Stockholders sued the directors and officers on a derivative basis for, among other things, breach of fiduciary duty for failing to oversee a compliant food safety program.

The Delaware Supreme Court focused on whether the stockholders had adequately stated a *Caremark* claim for the failure to oversee the corporation's food safety function. While the Delaware Court of Chancery found that the plaintiffs had failed to state a claim against the defendant directors and officers, the Delaware Supreme Court reversed and found that the plaintiffs stated a case for breach of fiduciary duty against the defendant directors' failure to oversee the mission critical regulatory risks of food safety. While the Delaware Supreme Court noted that prevailing on a *Caremark* claim remained a difficult proposition, the impact of both reversing the Delaware Court of Chancery and moving past the motion to dismiss stage was significant as it potentially expanded the number of event-driven breach of fiduciary duty claims.

In October 2019, the Delaware Court of Chancery later interpreted and adopted *Marchand* in a related decision. *In re Clovis Oncology, Inc. Derivative Litig.*[18] involved a Delaware corporation which developed lung cancer treatments and failed to maintain proper controls for the reporting of the efficacy of an important drug in development. When the company publicly reported the problems in determining the efficacy of the drug and the company's stock declined significantly, plaintiff stockholders sued the Clovis board derivatively for breach of fiduciary duty. Applying and interpreting *Marchand*, the Delaware Court of Chancery found that Clovis' directors failed to oversee the mission critical regulatory risk of monitoring the safety/efficacy of its products. Thus, the plaintiffs stated a claim under *Caremark* and the suit was allowed to proceed.

The impact of *Marchand* and *Clovis* was significant, as its focused attention on director oversight duties, particularly for regulated industries and single-product companies (or companies with a handful or products). While *Marchand* and *Clovis* do not stand for the requirement that directors set up shadow monitoring programs which circumvent management's role for reporting to the board, the cases do stand for increased director oversight of pure compliance risks. Directors should familiarize themselves with regulatory risks impacting the company's products or services and how each risk is being considered, particularly those mission critical risks. Occasional oversight or failure to act on so-called red flags will receive less leniency from Delaware courts.

Governance Trends—D&O Insurance Market

In 2019 and early 2020, the market for D&O insurance experienced significant increases in premiums, and the trend is expected to continue through the remainder of 2020. Many companies, even those with relatively rare claims experience, are seeing their premiums increase significantly—even doubling in industries such as life sciences, biotechnology, cryptocurrency, and cannabis. Rates are also rising for excess coverage, where coverage in lower excess layers may cost nearly as much as an insured's primary coverage. For the remainder of 2020, additional litigation around COVID-19 events and a low interest rate environment has and will continue to mean premium increases.

One driver of this increased pressure is the historically high frequency of securities class action litigation, and more generally, event-based litigation is becoming more common, where plaintiffs allege wrongdoing in relation to data breaches, cybersecurity events, product liability, or failure to address governance reforms. L

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16. 212 A.3d 805. 17. In re Caremark Int'l, 698 A.2d 959 (Del. Ch. 1996). 18. 2019 Del. Ch. LEXIS 1293 (Oct. 1, 2019).



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Pandemic Preparation: 72-Hour Response Plan to Government Inquiry

THIS ARTICLE PROVIDES GUIDANCE COVERING KEY questions that your organization may face as a result of a regulatory and enforcement inquiry during COVID-19, including a checklist to aid your response. Considering and approving these best practices is good; mastering and implementing them so that you may reflexively employ them is ideal. And a critical component of this is identifying outside counsel that you trust, that knows you and your business, and that can respond quickly to assist you in this high-stakes and fast-moving context.

As the financial industry continues to adjust to the effects of COVID-19, market participants should remain vigilant and prepared from a regulatory and enforcement perspective. If history is any indication, the extreme market volatility over the past several months will lead to a flurry of enforcement activity. The current volatility lends itself to the potential for regulatory and enforcement inquiries on a variety of topics, including participation in government-sponsored programs and the receipt of government funds, business continuity plans, redemption procedures, and valuation processes, not to mention the increased possibility of inquiries into potential fraud (including insider trading and accounting and disclosure failures). Now, more than ever, all market participants—be they public companies, private funds, financial institutions, or other regulated entities—need to be prepared to respond appropriately and effectively if confronted by an enforcement authority. Two weeks from now, it may be you sitting at your desk (wherever that may be these days) when an email attaching a subpoena or information request from the U.S. Securities & Exchange Commission (SEC) or Department of Justice (DOJ) hits your inbox, or worse, the Federal Bureau of Investigation (FBI) acting on behalf of the DOJ shows up with a search warrant. The first 72 hours are critical to putting your organization on a path to success.

Action Items

Determining the Source and the Nature of the Inquiry

Multiple authorities have investigative powers and a request could come from any of them. In addition to the DOJ and the Enforcement Division of the SEC, the state attorneys general and local prosecutors retain broad authority to police the securities and financial services industry. Other regulators can also conduct investigations or examinations, including the Commodity Futures Trading Commission, the Financial Industry Regulatory Authority (FINRA), and the SEC's Office of Compliance Inspections and Examinations (OCIE), which more and more frequently works in close tandem with the SEC's Enforcement Division. Although the information in this article is generally applicable to requests from any regulator, we will focus on investigations that originate with the SEC or DOJ.

In the early stages of an investigation, the SEC and DOJ typically have the same goal: they both want to gather documentary and testimonial evidence to determine whether a violation has been committed and whether there is sufficient evidence to pursue formal charges against an entity or associated individuals. At this stage, the SEC and DOJ often work together to conduct parallel investigations into the same underlying conduct. After the evidence has been gathered, each agency will determine independently whether the underlying conduct merits criminal charges, which only the DOJ has jurisdiction to bring, or civil charges, which the SEC can bring, or both. Importantly, receiving an initial request from the SEC does not preclude the possibility that the DOJ is lurking in the background to see how the evidence unfolds.

Evaluating the Request and Early Considerations

After taking a deep breath, you should read and evaluate the request. Consider the following things:

- **What information can be gleaned about the inquiry and your firm's role in it?**
  - ✓ The nature of the investigation and your firm's role in it are best learned from the language of the requests themselves. The requests will be directed at the issues or circumstances that are of greatest concern to the policing authority, and you should carefully scrutinize the requests for an indication of the conduct that the government believes is potentially problematic and any legal theory that it is possibly pursuing.
  - ✓ Neither the SEC nor the DOJ are required to describe the nature of their investigations to entities or individuals being asked to provide documents or related information. But there are a couple ways to learn more information to inform your immediate response.
    - o If the SEC's Enforcement Division has issued a subpoena for documents, then it did so pursuant to a Formal Order of Investigation issued by the Commission itself, which describes in very general terms the basis for the investigation and the statutory provisions that the SEC suspects may have been violated. You are entitled to see the Formal Order upon request.
    - o In the case of a grand jury subpoena, the prosecutor may be asked whether the DOJ classifies the company (or any individual employees who may have been subpoenaed) as a witness, a subject, or a target. A witness is someone who is not suspected of wrongdoing and merely is believed to possess relevant evidence. A subject is someone "whose conduct is within the scope of the grand jury's investigation" and therefore could face charges. A target is someone against whom there is already "substantial evidence" of criminality and is a "putative defendant" (a rarely used designation at the outset of an investigation). The DOJ often uses the subject classification liberally, not wanting to show its hand or commit to a classification on either end of the spectrum. The SEC, on the other hand, does not use these designations, and until charges are filed, considers everyone a witness.
    - o On occasion, some U.S. Attorney's offices will include in the grand jury subpoena the provisions of the U.S. Code of which the conduct being investigated may be in violation. As with the SEC's Formal Order, the information provided is not binding on the government, but often is a good indication of what conduct is being investigated.
    - o The speed at which the government is demanding you produce the requested documents also can be an important indication of your role in the investigation. The greater the urgency of the government's demand, the more likely it is they view you as playing an active and possibly ongoing role in the potentially suspect conduct. Both the SEC and DOJ are known to issue forthwith subpoenas that require the production of documents or information immediately. Such a demand both accelerates the timing of your response and heightens the importance of getting it right consistent with your strategic interests.
    - o You need to think beyond the most obvious sources of documents and information and identify the right subject matter experts within your organization who can possibly shed light on the nature of the government's concerns and who will need to be involved to insure a complete and accurate response. This, of course, requires balancing the need for information from others within your organization against the desire to limit disclosure of the investigation's existence.

- **Should you retain outside counsel?**
  - ✓ Outside counsel plays a critical role in protecting your interests in this context. You must be prepared to respond quickly in a manner that is consistent with your longer-term strategic goals. And identifying the right counsel in advance, and talking through these issues now, will equip you with the necessary tools for a prompt, careful, and informed response. Involving outside counsel from the start can have significant advantages in terms of information gathering, document preservation, document collection, and narrowing the scope of the government's request.
  - ✓ Often, the best resource for understanding the nature of the government's inquiry is experienced counsel that has the expertise to have a meaningful conversation with the investigating entity and learn as much as they can about the nature of the investigation.
  - ✓ As will be discussed further below, experienced counsel also serves as a buffer between your organization and the investigating entity and avoids putting you in the position of having to answer tough questions that may be avoided initially by experienced counsel.
- **Is disclosure required?**
  - ✓ Early and often, you need to consider—and then reassess over time—whether any disclosure obligations are triggered, either by the initial request, or by subsequent developments.
  - ✓ The decision to disclose the existence of an investigation must be balanced against what can be said given the early stage of the investigation. Until you know more, it can be difficult to assess accurately when to say something and what to say. Premature disclosure can make things worse, thus the need to constantly assess at various stages whether an obligation to disclose is triggered.
  - ✓ As a separate matter, the government also may request, or even order, you not to disclose the existence of the investigation or information request. Assuming that it is in your interests to comply with such a request—and it is hard to imagine it would not be at this early stage—you will need to balance this request against any competing disclosure obligations.
  - ✓ If materiality is the standard by which disclosure must be measured, it has to be assessed in light of all circumstances, including existing legal obligations, governing documents, client and investor relationships, and other considerations. You must also review any agreements or side letters that you may have with clients, suppliers, or investors. Such side agreements may contain broader disclosure obligations and may also contain most-favored-nation clauses that require the application of broader disclosure provisions to other investors.
  - ✓ Once a decision has been made that disclosure of an investigation is necessary, always consider retaining a public relations adviser. Such an adviser can be a vital resource in terms of delivering the best message possible. Working through outside counsel is often the best route for retaining and directing a public relations adviser.

- **Notify your insurance carrier.**
  - ✓ Early in the process, consider whether to notify your insurance carrier of the inquiry. Responding to requests for information or subpoenas is often not covered, but depending on the inquiry, your company's status in the inquiry, and your insurance policy, any legal fees you incur may be covered.

Document Preservation

A very early consideration must be what steps need to be taken to preserve documents that are potentially responsive to the request. The goal is to take reasonable steps to preserve any and all potentially responsive documents. Being investigated is bad enough; you don't want to make things worse by accidently destroying documents that you are now under an obligation to maintain—regardless of whether you ever have to produce them. Your response at this very early stage of the investigation will be subject to scrutiny in hindsight as the investigation progresses.

Related Content

For a comprehensive list of practical guidance on COVID-19 covering various practice areas, including securities, see

> CORONAVIRUS (COVID-19) RESOURCE KIT

RESEARCH PATH: *Capital Markets & Corporate Insights > Trends & Insights > Practice Notes*

For a discussion of capital markets and securities law in the time of COVID-19, see

> MARKET TRENDS 2019/20: COVID-19 FROM A SECURITIES LAW PERSPECTIVE

RESEARCH PATH: *Capital Markets & Corporate Insights > Trends & Insights > Market Trends > Practice Notes*

For a summary of the most recent guidance and accommodations by the SEC and national stock exchanges in response to COVID-19, see

> COVID-19 UPDATE: SEC AND NASDAQ RESPONSE AND UPDATED SEC C&DIS

RESEARCH PATH: *Capital Markets & Corporate Governance > Trends & Insights > First Analysis > Articles*

- **Issue a legal hold notice.**
  - ✓ Draft and circulate a legal hold notice to any employees who might have responsive documents in their possession. It is a good idea for outside counsel to at least review, if not draft, your legal hold notice.
  - ✓ The obligation to issue a legal hold notice may impact your decision as to how broadly you disclose the existence of the investigation inside or outside of your organization. There are advantages and disadvantages to referencing the inquiry in the legal hold notice versus asking employees to retain documents without reference to the specific inquiry. For example, stating that your company has received a subpoena may increase the seriousness with which employees take the legal hold notice, but it also increases the circle of people who know about the investigation.
  - ✓ Even if the subpoena or request for information seems overbroad, the legal hold should cover all documents potentially responsive to the request. Work with counsel to make a good faith assessment of what may potentially be responsive.
  - ✓ Make clear that employees in possession of responsive, or potentially responsive, documents should not destroy any of those documents, from deleting emails or electronic documents to throwing away hard copy documents or notes.
  - ✓ At this stage, you just need to maintain and preserve—not identify and collect.

- **Ensure that the hold notice is sufficiently broad in scope.**
  - ✓ Hold notices should cover any potentially responsive business-related communications, regardless of the location or format in which these communications are maintained. This includes business-related communications to and from personal email addresses, text messages to and from personal mobile devices, and alternative communications platforms such as WhatsApp, Slack, and Telegram. As a regular practice, employees should be told to conduct business on appropriate communication platforms and should be forewarned that personal devices and channels may need to be searched to satisfy your company's obligation to produce business-related communications.
  - ✓ The government has become very savvy in demanding production of business communications located on personal devices and platforms, and you must ensure that the company's hold order puts employees on notice that these items must be maintained. Moreover, courts have become increasingly aggressive in requiring organizations to maintain, review, and produce such items.
- **Override any automatic document destruction protocols.**
  - ✓ Even if your general policy is to dispose of documents on a regular schedule (often true with emails), the requirement to maintain documents that are potentially responsive to the government request takes precedence over your normal document destruction policy.
  - ✓ Auto-delete functionality must also be turned off for individuals' personal devices if they contain potentially responsive or relevant business-related communications. Auto-delete functionality does not preempt your organization's obligation to maintain potentially responsive communications, and failure to affirmatively disable such functionality upon receiving a subpoena or other document request will be subject to close scrutiny.
  - ✓ Remember: Document hold orders may stay in place for a long time and will have to withstand employee attrition, office relocation, and any offsite work arrangements.
  - ✓ Regulators consider destruction of documents incredibly problematic regardless of the intent. Ensuring that potentially relevant documents aren't destroyed is of the utmost importance.

Contacting the Government

Once you have a handle on the request and have taken the necessary steps to preserve any potentially responsive documents, it is time to contact the requesting entity. Your initial relationship with the government should be one of collaboration and cooperation, even if this changes as the investigation progresses. Keep in mind that at this stage the government holds all the cards, and you need to establish credibility with the government that they can rely on you—and your counsel—to act appropriately under the circumstances. There are several considerations when contacting the government.

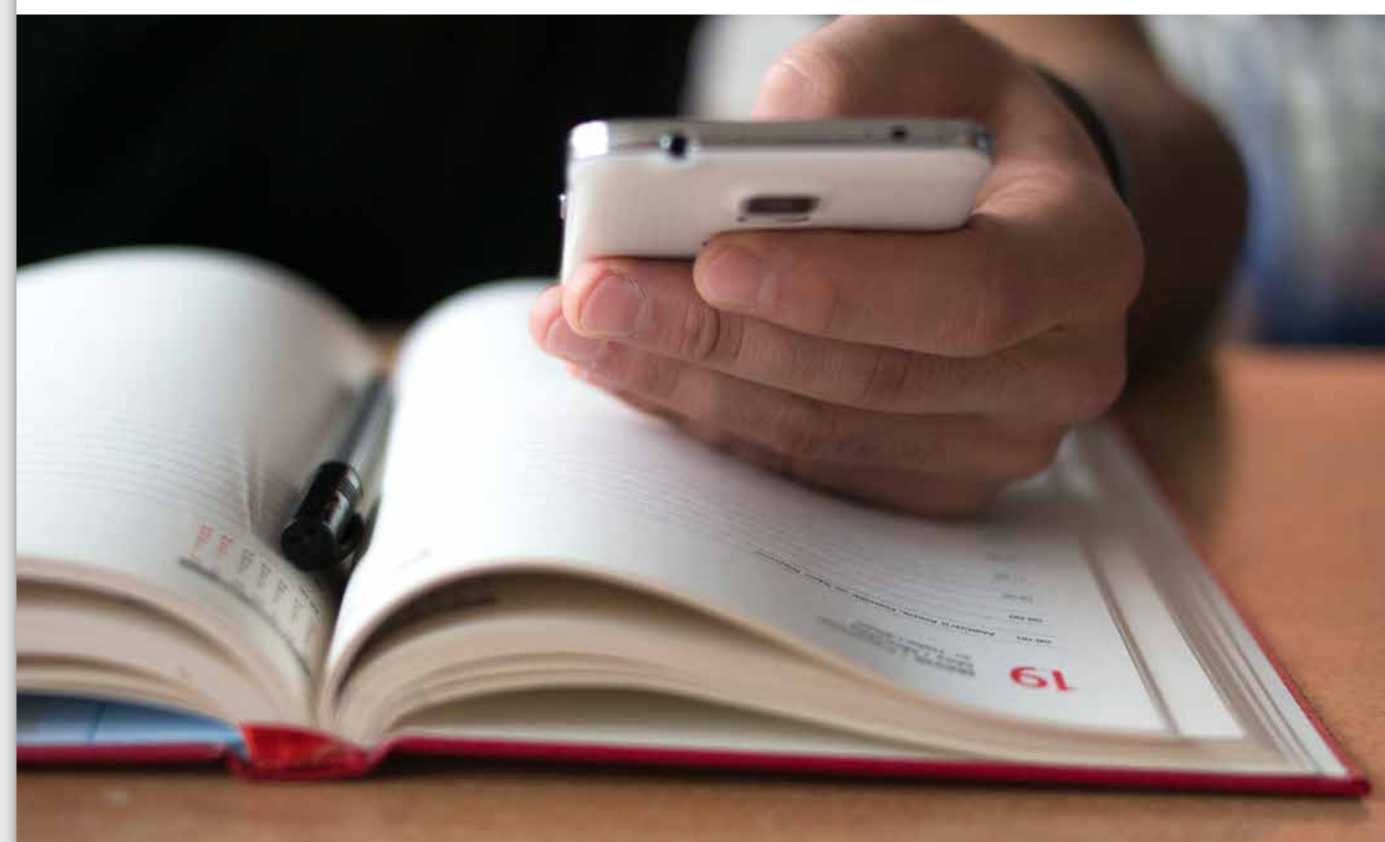
- **Decide whether outside counsel should contact the government on your behalf.**
  - ✓ Outside counsel offers the greatest degree of protection, a valuable layer of insulation, and can draw on experiences at or with the relevant investigative bodies.
  - ✓ Outside counsel can help convey the sense that the request is being treated with the utmost importance.
  - ✓ In limited circumstances, for example in an examination by OCIE, it may be best for in-house counsel or the chief compliance officer to contact the government, even if outside counsel is operating in the background. Such an outreach can set a more relaxed tone, whereas the appearance of outside counsel may unnecessarily raise the temperature at the start of what may be a routine inquiry.

- **Make a good first impression.**
  - ✓ Strike the appropriate tone. Be polite and respectful. Establish that the company is responsible and committed to compliance, taking the request seriously, and cooperating with the requesting entity.
  - ✓ In very rare circumstances, particularly at this very initial stage of an inquiry, it may be in your strategic best interests not to cooperate, and there may be steps that you can take to quash a request for information or documents. This is a very significant decision that will have significant impact on your relationship with the government throughout the investigation and should be taken only after careful consideration with experienced counsel to ensure that it is consistent with your overall response and long-term interests. Moreover, taking steps to challenge a request may result in public court filings that disclose the existence of the investigation and your involvement in it. It is hard to imagine a circumstance in which such early-stage disclosure would be consistent with your interests.
  - ✓ As discussed below, there are a number of interim steps that can be taken at this stage that are well short of an outright refusal to cooperate, and you should take advantage of these incremental steps to shape the investigation and learn more about what role you—and your employees—play in the investigation and any potential exposure you might have.
  - ✓ Remember: You are being judged in every interaction with the government, particularly at the beginning. Each communication should be well thought out and calibrated to be consistent with your strategic approach. Don't underestimate the importance of establishing a good working relationship with the government—it can make all the difference.

- **Narrow the request and talk about timing.**

  Requests are frequently overbroad and drafted on tight deadlines, so government agencies are often receptive to reasonable efforts to narrow. Consider the following approaches:

  - ✓ Limit or prioritize particular subject matter, and within this subject matter, prioritize the rolling production of information responsive to certain requests. This also will help you understand the nature of the investigation and the initial focus of the government's interest. The more you can learn about what the government is concerned about, the better you can assess your potential exposure and how you want to respond to the inquiry.
  - ✓ Establish reasonable and achievable timeframes or deadlines for providing responsive documents or information. Requests often come with a two-week deadline for production, but typically the government is amenable to extending the time for production. Of course, at this initial stage, you may not be able to accurately predict the time or effort necessary to fully respond. But having this conversation will help you assess the urgency of the investigation and will avoid misunderstandings later if you and the government are operating on different schedules.
  - ✓ Consider offering responsive information that can be easily gathered and presented effectively in lieu of providing the requested documents. Often providing such information in a list, chart, or table can avoid the production of voluminous documents that may be hard to decipher and may reflect information that goes beyond what is sought.
  - ✓ In limited circumstances, consider whether providing a narrative answer can substitute for production of requested documents. This requires a level of confidence that you understand fully the underlying circumstances and is often best reserved for later in the investigation when you have a better handle on the facts.
  - ✓ Remember: Stay focused on overall strategy. Your approach may depend on whether you are the subject of an investigation, a victim of the fraud, or a neutral third party. Regardless, a well-calculated initial provision of information may cut off the need for a broader inquiry.



- **Tell the truth under all circumstances and implore employees to do the same.**
  - ✓ Not telling the truth is the quickest and most direct path to an adverse outcome. There are criminal sanctions for not telling the truth to government officials, and if the government feels you are not being forthright, it will pursue the investigation even more aggressively. Therefore, it is often best to defer or qualify any response to government questions until such time as the underlying facts are fully established.
  - ✓ When speaking to government officials, telling the truth is paramount regardless of whether you or your employees are under oath. Emphasize to your employees the importance of always telling the truth to the government, regardless of the setting. As is often noted, one provable lie—even as to a non-material fact—can turn a mediocre investigation into a case worth pursuing aggressively. And a provable lie as to a material fact can lead to criminal prosecution.
  - ✓ Exception: When an individual invokes the constitutional right against self-incrimination, he or she opts not to speak with the government at all. Indeed, the inability to tell the truth without incriminating oneself is often a critical factor in the decision as to whether your employees should speak to the government. This is an important and complicated decision with broad-ranging consequences that should only be made by the potentially invoking witness after consulting with counsel.
  - ✓ The government can, and may, contact employees for an interview or testimony prior to contacting the company. The government may also reach out to former employees, and you should be mindful about whether and how to alert current and former employees that they may be contacted by the government. Encouraging unrepresented witnesses not to speak to the government could be seen as obstructing the government's investigation. While the government is not permitted to directly contact individuals it knows are represented by counsel, the SEC and the DOJ may not operate under the assumption that current or former employees are represented by company counsel.

Fact Gathering

In the early stages, it is also important to conduct sufficient investigation into the underlying circumstances to satisfy your good faith obligation to maintain potentially responsive documents and to begin to formulate an approach to responding to the investigation. In addition to identifying responsive material as discussed above, you will likely want to speak with at least some of the involved employees. You may also want, or need, to conduct more formal interviews, and, if so, you should begin to formulate a plan for those interviews. In preparing for and conducting employee interviews as part of an investigation, keep the following things in mind:

- **Employees have an obligation to cooperate with the company and can be terminated for refusing to do so.**
  - ✓ Cooperation is typically the best option for the company and the employee so companies should strive to warn employees about the potential consequences, including termination, and encourage cooperation with the company's investigation.
- **Employee interviews should be conducted by counsel (either outside or in-house) in order to create and maintain the attorney-client privilege.**
  - ✓ At some point, the company may decide to disclose the information gathered in such initial interviews. But at this initial stage, you should take appropriate steps to preserve the confidentiality of information gathered in such interviews.
- **Counsel needs to provide the employee with notice that any information provided will be used by the entity in its best interest.**
  - ✓ As highlighted by the U.S. Supreme Court in *Upjohn Co. v. United States*, employees should be warned that the interviewer is an attorney for the company—not his or her individual counsel—and that any attorney-client privilege associated with the interview belongs to the company.
  - ✓ The *Upjohn* warning cuts off any later claim by an employee that he or she believed company counsel was acting as his or her counsel and that the witness (rather than the company) controls the decision as to whether information gathered or statements made in the interview can be disclosed to the government.
- **Encourage the employee to keep the interview and its substance confidential with one significant exception.**
  - ✓ Employees should not discuss the investigation among themselves. Doing so can lead to employees influencing (either intentionally or unintentionally) each other's recollections and statements regarding the underlying facts. Such water-cooler talk can create a confused record of what happened and could lead to premature disclosure.
  - ✓ Exception: Employees should not feel like their cooperation with the company or its counsel prevents them from speaking to the government about the same underlying facts. However, if the government already knows that the company is represented by counsel, it should not reach out to employees directly and employees should be encouraged to contact company counsel immediately and refer the inquiring agent or attorney to company counsel.
- **Identify any additional potentially responsive documents, including documents existing on company-issued devices and even home or personal devices.**
  - ✓ Employees have no right to privacy or grounds to object due to personal information existing on company-issued devices, including company cell phones that also are used for personal purposes.
  - ✓ The company may be obligated to search employees' personal devices if they potentially contain responsive business communications or documents. The company also must inform employees that those documents must be maintained.

Voluntary Versus Compelled Production

The SEC and the DOJ both have means by which they can require production of documents and testimony by force of law, just as they can seek such information on a voluntary basis.

- It would be very rare for anyone, at such an early stage, to refuse outright to cooperate with a government request for information until they had a better understanding of the request and the nature of the underlying circumstances.
- Refusal to comply with a voluntary request will be the first fact cited to explain why a subpoena requiring production should be issued. At this stage, it is most important to learn what you can about the investigation and, if possible, establish a productive relationship with the investigating authority in order to influence the ultimate outcome.
- While there may well come a point when you decide to challenge an overbroad or overly burdensome request for information—either through a motion to quash or otherwise—the immediate aftermath of having received such a request is not such a time, except in the most extraordinary of circumstances and only with the advice of experienced counsel.

FBI/Search Warrant

The information above is generally applicable, but if, instead of receiving a voluntary request or a subpoena for documents, the FBI shows up with a search warrant, you must be prepared to take specific steps to appropriately protect you and the company. In that situation, the government has already established probable cause of a crime with a judge. If faced with a warrant, you should immediately call counsel and should not do anything that could be viewed as interfering with the search. Interfering with a properly executed search warrant is prohibited and comes at the risk of criminal prosecution. Prior to the arrival of counsel, you should cooperate fully with any requests for documents or information, while at the same time monitoring the search to keep track of what is being taken and protecting the confidentiality of documents that may be covered by the attorney-client privilege. Once counsel arrives, counsel can examine the search warrant, take over responsibility for monitoring the search and protecting the privilege, and otherwise assist in responding appropriately to the search warrant.

Looking Ahead

The initial response to a request for information sets the tone for the whole process—good or bad. Being fully prepared to respond appropriately at the outset is vital. Preserving and collecting documents efficiently and effectively minimizes the burden on the company and prevents future production issues. Establishing a respectful, professional, and cooperative relationship and rapport with the government can lead to a quick and favorable outcome and reduce the potential for and the severity of an adverse outcome. Conducting a thorough fact-gathering investigation at the beginning creates an immediate knowledge advantage and limits surprises down the road. Given the recent COVID-19-induced market volatility, participants in the financial industry should prepare to respond to regulators and enforcement authorities because the likelihood of such interactions is only increasing. L

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Timothy Murray MURRAY HOGUE AND LANNIS

Ten Things Every Attorney Should Know About Contracts (But May Not)

ONE TIME I FOUND MYSELF IN A BREACH OF CONTRACT TRIAL before a grizzled jurist who seemed to have as much familiarity with contract law as I have with high fashion (none). I would like to say that he compensated for this deficiency with street smarts and a courteous judicial temperament, except it wouldn't be true.

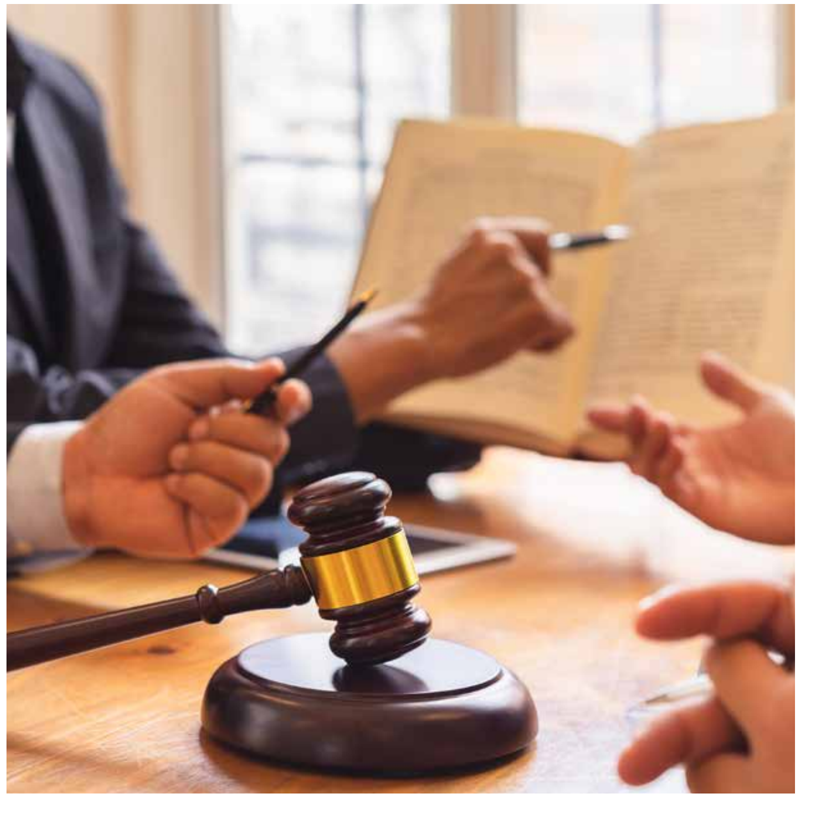
The attorneys were arguing some point of law, and I'm not sure what prompted it, but the judge suddenly emitted a full-throated roar that I would have mistaken for thunder if I hadn't seen his lips moving.

"Judges don't bother with the rules of contract law!"

I could not have been more astounded if the judge had started doing a puppet show from the bench. He proceeded to sermonize that judges resolve contract law questions by relying on instinct, which "usually" matches the textbooks.

I was only glad that Professor Corbin wasn't there. This might have killed him all over again.

The case settled shortly after that, and it's anyone's guess whether that judge's rulings would have matched the textbooks. The judge was simply wrong, to put it charitably—the vast majority of judges do bother with the rule of law (though most aren't as comfortable with contract law as the practicing bar assumes). But his other-worldly musings did contain a sobering kernel of truth: the demands on the time of the judiciary and the practicing bar too often force us to rely on instinct more than we'd prefer. Of course, few of us brazenly celebrate that reality as this judge did.



In many years of practicing commercial law, and of updating and revising the *Corbin on Contracts* treatise, I have found that there are certain concepts in modern contract law that every attorney should know but that many do not. The following are some of the most important.

1. Timp v. Gibbs, 2020 Minn. App. LEXIS 229 (Aug. 10, 2020).

1 There Is a Critical Difference Between a Breach and a Material Breach

The failure to appreciate this difference can be disastrous for our clients. Every breach, big and small, entitles the aggrieved party to sue and to potentially recover damages, but only a material breach—one that goes to the essence of a contract[1]—"discharges the non-breaching party from its duties under the contract."[2]

Until a court declares that the breach was material, an aggrieved party will not know for certain whether that party may be discharged from its obligations under the contract. A judicial determination of that question could take months and even years.[3] If the aggrieved party stops performing its obligations without a judicial declaration of material breach, and if it later turns out that there was no material breach, then the aggrieved party itself has committed a material breach.[4]

But determining whether a breach was material is often as clear as a fog off the coast of Maine. "[T]he 'materiality' of any alleged breach is a question of fact,"[5] and only where the facts are undisputed should the court decide the matter on its own.[6] To determine whether a breach was material, many courts hold that the fact finder should apply the factually intense, five-prong test of Section 241 of the Restatement (Second) of Contracts.[7] One of those factors even requires the fact finder to consider the breaching party's good faith—a rare departure from the principle that "[c]ontract liability is strict liability," and a party is responsible for a breach even if that party was without fault.[8]

A client aggrieved by a breach may not appreciate its attorney's caution that the client should not blithely treat the contract as cancelled.[9] Careful contract drafting can avoid some of the uncertainty by spelling out events that warrant cancellation of the contract and that allow the aggrieved party to be discharged from further contractual obligations.[10] This requires a conversation with the client to decide which breaches will make continuation of the contract intolerable. The client might need to be prodded on this issue since clients generally are more concerned about dickered terms—that's what the UCC's principal drafter Karl Llewellyn called the commercial terms that the parties actually bargain—and less about the boilerplate, which generally is riddled with legalese and deals with what happens if something goes wrong (clients generally are more optimistic than lawyers). Drafting should spell out those intolerable events with clarity—no court has ever complained that a contract is too clear. The provision should include a catch-all spelling out that dissimilar events otherwise constituting material breaches also warrant cancellation and discharge.

2 The Covenant of Good Faith and Fair Dealing Is Overused and Rarely Successful

Generally, "[e]very contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement." Few concepts in our jurisprudence are invoked as frequently as the implied covenant of good faith and fair dealing,[11] yet it "is rarely successfully invoked."[12] It is little wonder that it is raised so frequently—"courts' descriptions of it often are larded with nebulous legal platitudes and fluff that can be contorted to mean whatever a litigant wants them to mean."[13] For example, judicial opinions suggest that "evasion of the spirit of the bargain" constitutes a breach of the covenant, but that description is far too broad to be helpful—it "affords triers of fact *carte blanche* to concoct a contract from whole cloth based not on the parties' *actual* bargain but on the '*spirit*' of their bargain, whatever that means."[14] When it comes to actual rulings, however, courts usually apply the covenant sparingly. To use it where it is not appropriate weakens the force of legitimate claims.[15]

When is it appropriately invoked? The covenant usually is applied only where there is an express "contractual provision [that] allows a party *discretion* in the manner of its performance . . . ."[16] The discretion must be exercised in good faith. In addition, "[t]he duty of good faith includes a duty to cooperate whenever cooperation is necessary for performance of the contract."[17]

2. Travelers Cas. & Sur. Co. of Am. v. Harlingen Consol. Indep. Sch. Dist., 2018 U.S. Dist. LEXIS 221032, *14 (S.D. Tex. Nov. 2, 2018). *See* Gas Sensing Tech. Corp. v. New Horizon Ventures PTY LTD, 2020 WY 114 (2020). 3. *See, e.g.*, http://uscourts.gov/Statistics/FederalCourtManagementStatistics.aspx. 4. *See* Coleman v. DeSteph, 2015 N.H. LEXIS 218, *1-2 (Oct. 14, 2015) ("The refusal of a party to perform under a contract in response to a breach that is not material is itself a material breach of the contract."); Ryko Mfg. Co. v. Eden Servs., 823 F.2d 1215, 1239 (8th Cir. 1987) ("[A] jury reasonably could conclude that Eden's conduct did not constitute a material breach of the distributorship contract and that Ryko's termination of Eden therefore was itself a material breach of the contract."). 5. Ozone Int'l, LLC v. Wheatsheaf Grp. Ltd., 2020 U.S. Dist. LEXIS 80008, *9 (W.D. Wash. May 6, 2020). *See* ShermansTravel Media, LLC v. Gen3Ventures, LLC, 2020 Ind. App. LEXIS 314 (July 27, 2020). 6. Dalrymple v. Winthrop, 97 Mass. App. Ct. 547 (2020). 7. Steven W. Feldman, Rescission, Restitution, and the Principle of Fair Redress: A Response to Professors Brooks and Stremitzer, 47 Val. U.L. Rev. 399, 425 (2013) ("Many courts cite with approval section 241's five factors . . . ."); Int'l Diamond Imps., Ltd. v. Singularity Clark, L.P., 2012 PA Super. 71 (2012) ("The trial court abused its discretion . . . in omitting to evaluate the materiality of Appellants' alleged breach according to the factors prescribed by Restatement (Second) of Contracts § 241."). The Restatement (Second) of Contracts § 241 provides that these five factors are significant: (a) the extent to which the injured party will be deprived of the benefit which he reasonably expected; (b) the extent to which the injured party can be adequately compensated for the part of that benefit of which he will be deprived; (c) the extent to which the party failing to perform or to offer to perform will suffer forfeiture; (d) the likelihood that the party failing to perform or to offer to perform will cure his failure, taking account of all the circumstances including any reasonable assurances; (e) the extent to which the behavior of the party failing to perform or to offer to perform comports with standards of good faith and fair dealing. 8. Restatement (Second) of Contracts, Ch. 11 Introductory Note. 9. The Uniform Commercial Code (UCC) calls this cancellation, not termination: "'Cancellation' occurs when either party puts an end to the contract for breach by the other," UCC § 2-106(4), while "'[t]ermination' occurs when either party pursuant to a power created by agreement or law puts an end to the contract otherwise than for its breach." UCC § 2-106(3). 10. Cmty. Alts. Va. v. Jones, 2018 Va. App. LEXIS 215, *6 (Aug. 7, 2018) ("[T]he default rule of material breach can be displaced by the parties' agreement."). Even otherwise nonmaterial breach can be included as events warranting discharge. 11. "'Good faith and fair dealing' is one of the most commonly used phrases in the legal lexicon, yet the conceptual framework behind it is incredibly abstract and has yet to be precisely defined." Monica E. White, "Package Deal": The Curious Relationship Between Fiduciary Duties and the Implied Covenant of Good Faith and Fair Dealing in Delaware Limited Liability Companies, 21 U. Miami Bus. L. Rev. 111, 127 (2013). 12. vMedex, Inc. v. TDS Operating, Inc., 2020 U.S. Dist. LEXIS 152059, *23 (D. Del. Aug. 21, 2020). 13. John E. Murray, Jr. & Timothy Murray, Corbin on Contracts Desk Edition, § 26.02 (2019). 14. *Id.* 15. *See* Bayer Chems. Corp. v. Albermarle Corp., 171 F. App'x 392, 398, n. 10 (3d Cir. 2006). 16. John E. Murray, Jr. & Timothy Murray, Corbin on Contracts Desk Edition, § 26.02 (2019). 17. *Id.*

The "covenant is not untethered from the parties' express contract,"[18] and it "does not exist 'in the air'"[19] as "a 'free-floating duty' separate from a contract."[20] "When a party does what the contract expressly allows it to do, there can be no breach of the implied covenant of good faith because the covenant does not override express contract terms."[21]

There are also contracts where a party's performance is measured by the other's satisfaction. These come in two varieties: where satisfaction is dependent on a party's personal taste or feelings and where satisfaction is dependent on criteria that can be objectively measured. For the former, the party to be satisfied must only act honestly; for the latter, that party must act honestly and reasonably.[22]

3 *Contra Proferentem* (Construing the Document Against the Drafter) Is Overused

This is another case of overuse.[23] This canon "applies 'only as a last resort' when the meaning of a provision remains ambiguous after exhausting the ordinary methods of interpretation."[24] Where there is an ambiguity, a court is supposed to consider extrinsic evidence to discern the parties' intentions before resorting to this canon.[25]

When is it appropriately used? "[T]he 'contra proferentem' canon is meant primarily for cases 'where the written contract is standardized and between parties of unequal bargaining power.'"[26] Where an agreement is not a nonnegotiable contract of adhesion, and the parties are sophisticated commercial entities represented by counsel throughout the negotiations, it is most unlikely that a court will apply *contra proferentem*.

4 A Letter of Intent Might Be More Than an Aspirational Statement of Intent—It Might Be a Binding Contract

A preliminary agreement—such as a letter of intent—is one where parties agree on some matters under negotiation but intend to execute another, more formal writing that will contain additional terms. These documents generally do not result in a binding contract, but that is not always the case. "Documents that typically are not intended to reach the parties' ultimate contractual objective—including letters of intent and proposals—can, in fact, be legally operative contracts that do just that."[27]

One time, an attorney asked me to explain the difference between a letter of intent and a memorandum of understanding. I advised that he should forget attributing much significance to the labels employed—letters of intent, memoranda of understanding, term sheets are not terms of art and do not have universally accepted meanings.[28] A document could call itself a ham sandwich and still be a binding contract depending on the substance (though I'd hesitate to enter into a deal with someone who would call a contract a ham sandwich).

A preliminary agreement is a binding agreement on the ultimate contractual objective if the parties agree on all essential terms and if neither party understands that the other intends to delay contract formation until something else happens (the something else can be a more formal written memorial of the deal, obtaining approval from someone higher up in the company, or anything else).[29] Even if the parties to a preliminary agreement understand that they will have a more formal written document, that intention will not prevent or delay contract formation where the parties have agreed on all essential terms—unless one party conditions contract formation on having a more formal document.[30]

18. *Id*. 19. Johnson Enters. of Jacksonville v. FPL Grp., 162 F.3d 1290, 1314 (11th Cir. 1998). 20. Blaustein v. Lord Balt. Capital Corp., 2012 Del. Ch. LEXIS 126, at *9 (May 31, 2012). 21. John E. Murray, Jr. & Timothy Murray, Corbin on Contracts Desk Edition, § 26.02 (2019). 22. John E. Murray, Jr. & Timothy Murray, Corbin on Contracts Desk Edition, § 31.03 (2019). 23. Michelle E. Boardman, Boilerplate Versus Contract: *Contra Proferentem*: The Allure of Ambiguous Boilerplate, 104 Mich. L. Rev. 1105, 1127 (2006) ("[C]ompulsive application of contra proferentem to clauses that are not ambiguous, but rather simply disputed, can also belittle the role of language . . . ."). 24. Lamps Plus, Inc. v. Varela, 139 S. Ct. 1407, 1417, 203 L. Ed. 2d 636, 647 (2019) (citing Corbin on Contracts). *See also* Candella v. Liberty Mut. Ins. Co., 2020 Mich. App. LEXIS 5243, *6 (August 13, 2020). 25. Sahrapour v. Lesron, LLC, 119 A.3d 704 (D.C. App. 2015). 26. Advance Wire Forming, Inc. v. Stein, 2020 U.S. Dist. LEXIS 153940, *31, n. 11 (N.D. Ohio Aug. 25, 2020), citing Yellowbook Inc. v. Brandeberry, 708 F.3d 837, 847 (6th Cir. 2013). 27. John E. Murray, Jr. & Timothy Murray, Corbin on Contracts Desk Edition, § 2.06 (2019). 28. Patrick's Rest., LLC v. Singh, 2019 U.S. Dist. LEXIS 111073 (D. Minn. July 3, 2019) (label not determinative); Samet v. Bayview Loan Servicing, LLC, 2019 U.S. Dist. LEXIS 216591 (D. Nev. Dec. 17, 2019) (court enforced a document the parties called a "tentative agreement"). 29. Timothy Murray, Corbin on Contracts § 2.9 (Rev. ed. 2018). 30. *Id.*

5 Freedom of Contract Is Sometimes a Myth

Parties generally can enter into the contract of their choosing. This maxim is so firmly embedded in the DNA of our jurisprudence, it is easy to overlook the prominent exceptions. Here are a half-dozen examples:

- Liquidated damages that do not bear a reasonable relationship to anticipated (or actual, in some states) damages caused by the breach are not enforceable.[31] Clients sometimes want to include such penalty provisions in their contract to motivate the other party to perform its end of the bargain. Clients need to be educated that such provisions are not enforced if challenged.
- Restrictive employment covenants with overly broad temporal or geographic restrictions will not be enforced. Some courts will not partially enforce the restriction by modifying it, and the employer may lose the restrictive covenant altogether—just because the employer tried to get too much.[32]
- An agreement to prevent a party "from voluntarily disclosing information about crimes to law enforcement authorities . . . is unenforceable as against public policy."[33] Yet, some settlement agreements contain such provisions indeed, an agreement not to report the crime is sometimes the primary impetus for the deal.
- An agreement to shorten the statute of limitations is unenforceable if it does not allow a reasonable time to investigate and file suit.[34] Including a provision forcing a party to sue within a matter of months after the cause of action accrues may not allow enough time, depending on the claim. The UCC says that the limitations period cannot be shortened to less than one year, and it cannot be extended beyond the time the legislature has ordained.[35]
- Parties generally do not have unlimited freedom to specify a choice of law. Usually, the choice of law must have a substantial relationship to the parties or transaction.[36]
- Courts generally do not enforce agreements to exempt parties from their own gross negligence, recklessness, or intentional conduct.[37] Courts usually do not enforce exculpatory agreements in general if the party seeking the waiver renders a public service (such as common carriers, public utilities,[38] hospitals,[39] innkeepers,[40] and "places of public accommodation such as retail stores, restaurants, and businesses who have a duty to serve all comers"[41]) and the exculpatory agreement relates to that public service.[42] In contrast, waivers regarding recreational activities usually are enforced.[43]

31. Dobson Bay Club II DD, LLC v. La Sonrisa de Siena, LLC, 393 P.3d 449 (Ariz. 2017). 32. *E.g.*, Gaver v. Schneider's O.K. Tire Co., 856 N.W.2d 121 (Neb. 2014). 33. Cosby v. Am. Media, Inc., 197 F. Supp. 3d 735, 742 (E.D. Pa. 2016). 34. E.g., Murphy v. Magna Seating of Am., Inc., 2020 U.S. Dist. LEXIS 64443, *12-13 (E.D. Mich. April 13, 2020). 35. U.C.C. § 2-725. 36. E.g., Bell v. Kokosing Indus., 2020 U.S. Dist. LEXIS 129400 (E.D. Ky. July 22, 2020). Delaware and New York are notable exceptions: certain contracts are exempt from this rule. *See* Timothy Murray, 15 Corbin on Contracts § 89.9 (Rev. 2d 2020) (publication pending). 37. *In re* Facebook, Inc., 402 F. Supp. 3d 767, 799-800 (N.D. Cal. 2019). 38. Restatement (Second) of Contracts, § 195, cmt. a (1991). 39. Courbat v. Dahana Ranch, Inc., 141 P.3d 427, 438 (Haw. 2006). 40. *See* Yang v. Voyagaire Houseboats, Inc., 701 N.W.2d 783 (Minn. 2005). 41. Dominguez v. United States, 2018 U.S. Dist. LEXIS 30060, *29 (D. N.M. Feb. 26, 2018). 42. E.g., Restatement (Second) of Contracts, § 195, cmt. a (1991); Copeland v. HealthSouth/Methodist Rehab. Hosp., 565 S.W.3d 260, 270-271 (Tenn. 2018). 43. Courbat, 141 P.3d 427 (citing Corbin on Contracts).

6 The Duty to Read Is the Glue That Holds Modern Contract Law Together

The duty to read means that parties are bound by contracts to which they have given their assent even if they did not bother to read them.[44] It is a foundational concept in contract law—so well-accepted that judicial decisions rarely mention it except in passing. But it has never been more important than in the 21st century.

Our lives are an endless stream of contracts of adhesion. "Most contracts are contracts of adhesion"[45]— non-negotiable (take-it-or-leave-it) and standardized.[46] When consumers take out a loan, sign up for a credit card, buy or rent a car, check into a hotel, sign a waiver to go skiing, or do any number of other things, they are presented with a contract of adhesion, and there is no haggling over its terms—the buyer either agrees to it or there is no deal. Most people do not bother to read adhesion contracts since they cannot bargain over them anyway. But the law does not care—if you sign it, generally you are bound by all its terms, because you had a duty to read it. Despite a pervasive wariness about adhesion contracts, they "are generally enforced."[47] Judge Frank H. Easterbrook of the U.S. Court of Appeals for the Seventh Circuit went so far as to ask rhetorically, "But what's wrong with a contract of adhesion anyway?"[48] The duty to read makes adhesion contracts possible.

But things got complicated with internet contracts. Website owners who want users to be bound by their contractual provisions (including arbitration provisions) typically do not put the terms on the webpage that the user must access to use the site. The terms can be accessed by a hyperlink that takes the user to another webpage. This is a classic example of a contractual term found in a non-contractual place: a website does not look, feel, or smell like a contract—and, importantly, there is no duty to read a non-contractual document.[49] The website owner wishing to bind the other party to its terms must create a duty to read. In many cases, website owners fail to do that.

Courts have held that the user is not bound by the website owner's contractual terms because (1) the user did not actually see them and was not on inquiry notice of them (often the hyperlink is below the order button and the user would have no reason to scroll down to it,[50] or the hyperlink is inconspicuous because of clutter—it gets lost in a sea of other information on the webpage[51]) or (2) the website did not clearly indicate that the user's continued use of the site constitutes the user's assent to the hyperlinked terms.[52] These deficiencies are remedied by ensuring that the design and content of the website creates a duty to read the terms—by putting the user on inquiry notice of the hyperlinked terms and by making clear that continued use of the site will bind the user to the critical, hyperlinked legal terms.

7 A Common Provision Excluding Consequential Damages May Not Work as Anticipated

The most common exclusion of damages is a provision excluding consequential damages. "Consequential damages are defined as '[s]uch damage, loss or injury as does not flow directly and immediately from the act of the party, but only from some of the consequences or results of such act.'"[53] Sellers generally try to exclude consequential damages because they can be far more substantial than direct damages. But merely including a provision excluding consequential damages may not exclude the damages that the drafter anticipates.

First, there is no universal agreement as to what constitutes consequential damages. "The term 'consequential damages' is subject to multiple interpretations, and 'no two courts or treatises define consequential damages the same way.'"[54] It is not always clear whether a category of damages falls in the direct or consequential damages bucket, and "when courts seek to discern whether damages are direct or consequential, they often grope for bright lines where there are none."[55] Where possible, it is best to actually spell out categories of damages to be excluded.

Second, lost profits are sometimes called "the 'quintessential example of consequential damages.'"[56] But, in fact, some lost profits are direct damages.[57] Merely excluding consequential damages will not exclude these damages.

Third, in a sale of goods setting, when an exclusive remedy set forth in a contract fails of its essential purpose (e.g., when the seller does not cure or correct the deficiencies of an exclusive remedy), the law makes available to the buyer the entire panoply of remedies under Article 2 of the UCC.[58] In that scenario, if the contract contains an exclusion of consequential damages, some courts say that even the exclusion is disregarded.[59]

Fourth, in rare instances, courts hold that direct damages alone do not allow an aggrieved buyer a fair quantum of remedy, so courts will disregard an exclusion of consequential damages.[60]

Related Content

For more information on the implied covenant of good faith and fair dealing, see

> IMPLIED COVENANT OF GOOD FAITH AND FAIR DEALING

RESEARCH PATH: *Commercial Transactions > General Commercial and Contract Boilerplate > Contract Boilerplate and Clauses > Practice Notes*

For an examination of the issues that arise when buyers and sellers of goods exchange offer and acceptance documents with disparate terms, see

> BATTLE OF THE FORMS

RESEARCH PATH: *Commercial Transactions > Supply of Goods and Services > Contract Formation, Breach, and Remedies under the UCC > Practice Notes*

For a review of the drafting of merger, survival, and notice clauses in commercial contracts, see

> MERGER, SURVIVAL, AND NOTICE CLAUSES

RESEARCH PATH: *Commercial Transactions > General Commercial and Contract Boilerplate > Contract Boilerplate and Clauses > Practice Notes*

For guidance on how to avoid common pitfalls that may arise when drafting and negotiating a sale of goods agreement, see

> SALE OF GOODS AGREEMENTS: AVOIDING COMMON PITFALLS

RESEARCH PATH: *Commercial Transactions > Supply of Goods and Services > Contract Formation, Breach, and Remedies under the UCC > Practice Notes*

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44. *E.g.*, CSX Transp., Inc. v. ABX&D Recycling, Inc., 2013 U.S. Dist. LEXIS 84063 (D. Mass. June 14, 2013). 45. Tess Wilkinson-Ryan, Intuitive Formalism in Contract, 163 U. Pa. L. Rev. 2109, 2115 (2015). 46. Tims v. LGE Cmty. Credit Union, 935 F.3d 1228 (11th Cir. 2019). 47. Baltazar v. Forever 21, Inc., 367 P.3d 6, 11 (Cal. 2016). *See* Siler v. Chase Bank, USA, N.A., 2009 U.S. Dist. LEXIS 144870, *6 (N.D. W.Va. Jan. 29, 2009) ("[A]lthough most contracts are adhesion contracts that are on a 'take it or leave it basis,' these are generally enforceable."). 48. United States v. Hare, 269 F.3d 859, 862 (7th Cir. 2001). 49. *E.g.*, Nguyen v. Barnes & Noble Inc., 763 F.3d 1171, 1178-1179 (9th Cir. 2014); Motley v. ContextLogic, Inc., 2018 U.S. Dist. LEXIS 192447 (N.D. Cal. Nov. 9, 2018).

50. Starke v. Squaretrade, Inc., 913 F.3d 279 (2d Cir. 2019); Wilson v Huuuge, Inc., 944 F.3d 1212 (9th Cir. 2019). 51. Nicosia v. Amazon.com, Inc., 834 F.3d 220 (2d Cir. 2016); Cullinane v. Uber Techs., Inc., 893 F.3d 53 (1st Cir. 2018). 52. *Starke*, 913 F.3d 279. 53. Greenway Equip., Inc. v. Johnson, 602 S.W.3d 142, 150 (Ark. App. 2020) (citation omitted). 54. Team Contrs., L.L.C. v. Waypoint NOLA, L.L.C., 2017 U.S. Dist. LEXIS 160763, at *10 (E.D. La. Sept. 29, 2017). 55. John E. Murray, Jr. & Timothy Murray, Corbin on Contracts Desk Edition, § 56.02 (2019). An example: Jay Jala, LLC v. DDG Constr., Inc., 2016 U.S. Dist. LEXIS 150969 (E.D. Pa. Nov. 1, 2016). 56. NuVasive, Inc. v. Miles, 2020 Del. Ch. LEXIS 279, *42 (Aug. 31, 2020) (citation omitted). 57. In Elorac, Inc. v. Sanofi-Aventis Can., Inc., 343 F. Supp. 3d 789 (N.D. Ill. 2018), damages from a product manufacturer's breach of contract with one of its distributors, preventing the distributor from making resales of the product, were held to be direct damages, even though the resales were transactions separate from the breached contract. The lost profits flowed directly from, and were a natural and probable result of, the breach. 58. U.C.C. § 2-719(2). 59. *See, e.g.*, Steer Am., Inc. v. Niche Polymer, LLC, 2018 U.S. Dist. LEXIS 141799 (N.D. Ohio Aug. 21, 2018). This is a minority position. 60. This situation arises when, for example, "a product with a latent defect [is] incorporated into something else that cost much more to fix than merely the purchase price of the defective item." Luckey v. Alside, Inc., 245 F. Supp. 3d 1080, 1091, n. 18 (D. Minn. 2017).

8 Certain Invisible Terms Are Part of Every Contract

Certain invisible terms actually become part of the parties' contract: trade usage,[61] course of dealing,[62] and course of performance.[63] "'Agreement' . . . means the bargain of the parties in fact, as found in their language or inferred from other circumstances, including course of performance, course of dealing, or usage of trade . . . ."[64] This evidence may explain—and even supplement—the contract.[65]

What does that mean? It means that evidence of these matters is admissible regardless of whether anything in the contract is said about them, and regardless of whether the contract has a merger clause that excludes evidence of prior or contemporaneous agreements that are not included in the contract. Trade usage and course of dealing may be admitted despite the parol evidence rule, even for completely integrated agreements.[66] Course of performance is not subject to the parol evidence rule at all since it involves post-formation conduct.[67]

The UCC allows parties to "carefully negate" trade usage and course of dealing.[68] This requires words in addition to the usual merger clause.[69] Course of performance technically cannot be negated since it involves conduct that occurs post-contract formation.[70]

9 People Often Confuse Interpretation and Integration

Integration and interpretation serve two different purposes. Integration is the process to determine which terms are part of the contract; interpretation is the process used to determine what those terms mean.[71] When the parties have entered into a written agreement but one of the parties wants to introduce evidence of a prior written or oral agreement, the court has to decide whether that prior agreement is admissible. It does this by deciding whether the subsequent written agreement is completely or partially integrated.

If the prior agreement contradicts the later one, the parol evidence rule mandates that the prior agreement is excluded. Those are the easy cases. "The difficult cases—the ones that are more likely to erupt into litigation—are those where there is no contradiction between the prior agreement and the subsequent written contract. Determining whether the prior agreement is admissible hinges on whether the subsequent written contract is completely or partially integrated."[72]

A partially integrated agreement is intended by the parties as a final expression of some but not all terms of their agreement. It discharges the parts of prior or contemporaneous agreements that contradict the subsequent writing, but not the parts that contain consistent additional terms. A completely integrated agreement is intended by the parties as a complete and exclusive statement of the terms of the agreement. Not only does it discharge the contradictory parts of prior or contemporaneous agreements, it discharges any prior or contemporaneous agreements that are within the scope of the agreement.[73]

Courts use different tests to determine whether an agreement is completely integrated. Many courts employ the natural omission test: would reasonable parties in this situation naturally and normally include the terms of the prior agreement in the subsequent written document? If so, the subsequent writing is completely integrated, and the prior agreement is inadmissible. If not, the subsequent written agreement is only partially integrated, and the prior agreement is admissible.[74] Courts also employ the separate consideration test—if the prior agreement was agreed to for separate consideration, the subsequent written agreement is only partially integrated and the prior agreement is admissible.[75] Some courts follow the appearance test where the court decides just by looking at the agreement whether it is a complete expression of the whole agreement.[76]

Sound confusing? It is confusing. Much of the confusion can be alleviated by including a merger or integration clause in the contract to manifest the parties' intent to be bound only by the terms of their final writing. "A merger clause can act as a sort of silver bullet that automatically transforms a partially integrated agreement into a completely integrated agreement."[77] Not all jurisdictions regard merger clauses as conclusive.[78]

A garden variety merger clause generally does not preclude evidence of fraud, but some courts hold that if the contract contains an anti-reliance clause stating that the parties did not rely upon extra-contractual representations, claims of fraud in the inducement may be barred.[79] Some courts hold that the non-reliance disclaimer must specifically track the alleged misrepresentation in order to exclude evidence of the fraud.[80]

Only after the parties figure out the terms of the agreement by determining these integration questions should the court interpret the agreement. That is an entire article unto itself.

Related Content

For a discussion on the legal effect of preliminary agreements, such as proposals, applications, and letters of intent, see

> PRELIMINARY AGREEMENTS

RESEARCH PATH: *Commercial Transactions > General Commercial and Contract Boilerplate > Contract Boilerplate and Clauses > Practice Notes*

For guidance on drafting or interpreting clauses that exclude consequential damages, see

> DRAFTING EXCLUSION OF CONSEQUENTIAL DAMAGES CLAUSES

RESEARCH PATH: *Commercial Transactions > Trends & Insights > First Analysis > Articles*

For a checklist that outlines what counsel should consider when drafting or reviewing a commercial contract, see

> COMMERCIAL CONTRACT DRAFTING AND REVIEW CHECKLIST

RESEARCH PATH: *Commercial Transactions > General Commercial and Contract Boilerplate > Contract Boilerplate and Clauses > Checklists*

For assistance in drafting term clauses, recitals, and definitions in commercial contracts, see

> TERM, RECITALS, AND DEFINITIONS

RESEARCH PATH: *Commercial Transactions > General Commercial and Contract Boilerplate > Contract Boilerplate and Clauses > Practice Notes*

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61. A practice "having such regularity of observance in a place, vocation, or trade as to justify an expectation that it will be observed with respect to the transaction in question." U.C.C. §1-303(c). *See* Restatement (Second) of Contracts §222 (1981). 62. A sequence of previous conduct between the parties that is fairly regarded as establishing a common basis of understanding for interpreting their expressions and other conduct. U.C.C. §1-303(b); Restatement (Second) of Contracts §223 (1981). 63. A sequence of conduct with respect to the contract at issue that involves repeated occasions for performance by a party, and the other party, with knowledge and opportunity to object, acquiesces in that performance. U.C.C. §1-303(a); Restatement (Second) of Contracts §202(4) (1981). 64. U.C.C. § 1-201. 65. U.C.C. § 2-202. 66. U.C.C. §§ 1-201(b)(3), 1-303; Restatement (Second) of Contracts § 209, cmt (a) (1981); Restatement (Second) of Contracts §§ 221-224 (1981). 67. Bayer Chems. Corp., 171 Fed. Appx. 392. 68. U.C.C. § 2-202, comment 2. 69. Precision Fitness Equip., Inc. v. Nautilus, Inc., 2011 U.S. Dist. LEXIS 13576 (D. Colo. Feb. 2, 2011). 70. U.C.C. § 2-202, official comment 2; K. Rowley, Contract Construction and Interpretation: From the "Four Corners" to Parol Evidence (and Everything in between), 69 Miss. L.J. 73, 331 (1999) (course of performance cannot be "carefully negated"); 1 William D. Hawkland, Uniform Commercial Code Series § 2-208:3, at 2-306 (1998) (no provision in UCC to negate course of performance). 71. John E. Murray, Jr. & Timothy Murray, Corbin on Contracts Desk Edition, § 25.03 (2019). 72. *Id.*

73. *See, e.g.*, Restatement (Second) of Contracts §§ 210, 213, 215, and 216 (1981). 74. John E. Murray, Jr. & Timothy Murray, Corbin on Contracts Desk Edition, § 25.06 (2019). 75. Restatement (Second) of Contracts § 216 (2)(a). 76. Armstrong Paint & Varnish Works v. Cont'l Can Co., 133 N.E. 711, 713 (Ill. 1921). Regardless of the test employed, evidence that the subsequent written agreement is void due to fraud, mistake, or duress generally is admissible. Blackledge v. Allison, 431 U.S. 63, 75, n. 6 (1977) (citing Corbin on Contracts). There are, of course, variations, depending on the jurisdiction. In Pennsylvania, for example, only fraud in the execution—not fraud in the inducement—overcomes the parol evidence rule. 77. John E. Murray, Jr. & Timothy Murray, Corbin on Contracts Desk Edition, § 25.05 (2019). The Restatement (Second) of Contracts states that including a merger clause in the contract is "likely to conclude the issue whether the agreement is completely integrated." Restatement (Second) of Contracts §216 cmt. e (1981). 78. John E. Murray, Jr. & Timothy Murray, Corbin on Contracts Desk Edition, § 25.05 (2019). 79. Billington v. Ginn-LA Pine Island, Ltd., LLLP, 192 So. 3d 77, 80 (Fla. App. 2016). 80. FIH, LLC v. Foundation Capital Partners LLC, 920 F.3d 134 (2d Cir. 2019).

10 Parties Who Buy and Sell Goods or Services by Exchanging Terms Without Signing Off on the Same Document Do So at Their Peril

A staggering number of transactions for the sale of goods occur without having a document signed by both parties. A common scenario: the parties agree on essential business terms (description of the goods, quantity, price, and delivery terms). The buyer makes an offer to buy by sending seller its purchase order form with the essential business terms on the front and small print boilerplate terms and conditions on the back. The seller sends its acceptance via an acknowledgement form that mirrors the essential business terms on the buyer's form but includes its own—very different—boilerplate "terms and conditions" on the back (e.g., the seller's form almost always disclaims implied warranties and excludes consequential damages). Then the seller ships the goods, and the buyer accepts them.

In the vast majority of these transactions, there is no problem, and if there is, the parties work it out amicably. But sometimes a dispute arises that leads to a legal action. Whose terms prevail in that scenario? This is the mind-boggling part: it's not possible for both sets of terms to be the contract. Do the lawyers who draft these terms and conditions ever explain that to the client? I've had this discussion with in-house counsel—one general counsel of a large company looked at me as if I had just told him that I saw Elvis at the grocery store. I guess it was too astonishing to believe.

For the scenario noted above, prior to the UCC, there was no contract based on the exchange of the forms because the boilerplate terms did not match. The contract was formed when the seller shipped and the buyer accepted the goods, and the terms were those of the party who sent the last set of terms (usually the seller). The UCC changed all that with § 2-207. Now, the law recognizes a contract at the time the non-matching forms are exchanged. But § 2-207 does a terrible job explaining which set of terms apply—§ 2-207 was "a miserable, bungled, patched-up job"[81] that "has cut a jaw-dropping swath of confusion that has confounded the commercial bar for decades."[82]

Under the scenario discussed above, if the essential terms match, there is a contract.[83] But what are the terms? Here is the explanation—kindly do not blame me if you think that it makes no sense: the seller's additional terms become part of the contract unless the buyer's form "expressly limits acceptance to the terms of the offer"[84] or the buyer otherwise provides notice of objection to the terms.[85] If the buyer fails to do either of those things, the seller's additional terms become part of the contract unless they materially alter the buyer's terms.[86] What about the seller's terms that are different and not additional? The UCC forgot to tell us what to do about those, and this has generated mass confusion with a lot of states adopting the so-called knockout rule—expressly different terms are knocked out.[87] The seller can still make a counter-offer if it tracks the language of § 2-207 and "acceptance is expressly made conditional on assent to the additional or different terms."[88] If that happens, and the parties proceed to perform anyway (they almost always do), the terms are those on which the writings agree, "together with any supplementary terms incorporated under any other provisions of this Act"[89]—which means that the pro-buyer remedies and implied warranties provisions of the UCC become part of the contract. The bottom line: if the buyer is the offeror (and good luck controlling which party is the offeror in a given case), and if the buyer drafts its boilerplate terms correctly, in most jurisdictions, it can usually win the battle of the forms (at least for important things such as ensuring that the contract has no exclusion of consequential damages and disclaimer of implied warranties).

This is the most complex area in all of contract law, and even a comprehensive explanation is confusing beyond all reckoning. This area has spawned an astonishing amount of litigation—and courts routinely botch the resolution of questions concerning it. Will it ever change? Not until the legislatures do something about it or until in-house counsel better appreciate that when their clients do business this way, it is anyone's guess whether their contractual terms will govern. That is a very risky way to do business. L

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RESEARCH PATH: *Commercial Transactions > Trends & Insights > First Analysis > Articles*

81. Letter from Grant Gilmore, Professor, Vt. Law Sch., to Robert S. Summers, Professor, Cornell Univ. Law Sch. (Sept. 10, 1980), as reprinted in James J. White, Contracting Under Amended 2-207, 2004 Wis. L. Rev. 723, 724 (2004). **82.** Timothy Murray, Corbin on Contracts § 3.37 (Rev. ed. 2018). **83.** U.C.C. § 2-207(1). **84.** U.C.C. § 2-207(2)(a). **85.** U.C.C. § 2-207(2)(c). **86.** U.C.C. § 2-207(2)(b). **87.** Timothy Murray, Corbin on Contracts § 3.37 (Rev. ed. 2018). **88.** U.C.C. § 2-207(3). **89.** *Id.*

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Leave and Vacation Sharing and Donation Policies: Key Drafting Tips and Legal Issues

This article provides key drafting tips and best practices for employers when drafting leave and vacation sharing and donation policies. A leave-sharing and donation policy allows employees to donate or share paid time off (PTO), including vacation and sick days, for use by other employees for medical emergencies, including those related to pandemics such as the coronavirus (COVID-19).

IN PARTICULAR, THIS ARTICLE DISCUSSES:

- Leave and vacation sharing and donation policies
  - Tax considerations
  - ERISA applicability and compliance
  - Privacy and anti-discrimination laws
  - State and local paid sick leave and other paid time off (PTO) laws
  - National Labor Relations Act (NLRA) compliance

Leave and Vacation Sharing and Donation Policies

This section addresses the key aspects of leave and vacation sharing and donation policies and COVID-19 implications.

What Is Leave and Vacation Sharing?

In conjunction with their PTO policies, some private employers implement leave-sharing and donation policies to allow employees to donate a portion or all of their accrued, unused PTO to a leave-sharing bank maintained by the employer. Employees who have exhausted all available accrued PTO

can request leave donations to assist them due to a medical emergency or major disaster.

Leave-Sharing Programs and COVID-19

In view of the widespread disruption COVID-19 has caused, some employers are utilizing leave-sharing programs to alleviate the burden on employees who would otherwise have to take an unpaid absence from work. An employee who has either received a positive diagnosis or who is experiencing symptoms of COVID-19 and has been told by a doctor to quarantine would qualify for donated leave for a medical emergency exception if the diagnosis or symptoms cause a prolonged absence and other requirements set forth below are met. Likewise, an employee who must take care of a family member in the same situation would qualify.

Families First Coronavirus Response Act (FFCRA)

The Families First Coronavirus Response Act (FFCRA)[1] provides up to two weeks or 80 hours (for full-time employees) of emergency paid leave to employees who are:

- Subject to a federal, state, or local quarantine or isolation order related to COVID-19
- Experiencing COVID-19 symptoms and seeking a medical diagnosis
- Advised by a healthcare provider to self-quarantine related to COVID-19
- Caring for an individual subject to an isolation order or advised by a healthcare provider to self-quarantine

The FFCRA applies to all public employers and to private employers with fewer than 500 employees. This employee threshold for private employers leaves many U.S. employees who work for large private employers without paid leave for COVID-19-related absences. In addition, the FFCRA allows employers to exercise discretion to exclude healthcare providers and emergency responders from FFCRA coverage to ensure employers maintain sufficient workers to combat the COVID-19 pandemic.

Tax Considerations

This section addresses key tax considerations to consider when developing leave-sharing and donation policies.

Negative Effect of the Assignment of Income Rule on Leave Donations

As a general rule, an employee who donates accrued and unused PTO bears tax liability on the leave income paid to the other employee. This follows from the assignment-of-income doctrine, under which a taxpayer's assignment to another person of his or her right to receive compensation for personal services does not relieve the taxpayer of the tax liability on the assigned income.[2] Due to the assignment-of-income doctrine, the amount representing the leave transferred to another employee is generally included in the donor-employee's income and is generally subject to income tax withholding, as well as employment tax withholding including Federal Insurance Contributions Act and Federal Unemployment Tax Act withholding.

Two Exceptions to the Assignment-of-Income Rule: Medical Emergencies and Major Disasters

The IRS has recognized two exceptions to the general assignment of income rule, permitting tax liability for leave donations to be borne by the employee-recipient instead of the employee-donor. The IRS has issued guidance, which we address below, for favorable tax treatment of leave donations for two purposes:

- Medical emergencies
- Major disasters

Medical Emergencies

Donations are eligible for favorable tax treatment if they are made under leave-sharing and donation programs for medical emergencies that meet the following requirements:

- **Employer's PTO donation or leave-sharing program.** The donor donates accrued but unused PTO through the employer's PTO donation or leave-sharing program.
- **Medical emergency.** Eligible employees must use the donated PTO for leave relating to a medical emergency.
  - **Definition.** The IRS defines medical emergency as "a medical condition of the employee or a family member of the employee that will require the prolonged absence of the employee from duty and will result in a substantial loss of income to the employee because the employee will have exhausted all paid leave available apart from the leave-sharing plan."[3]
    - Keep in mind, without further IRS guidance, it is doubtful that a person who is merely self-quarantined without symptoms of COVID-19 or another illness or without a doctor's instruction to isolate will qualify for the medical emergency exception, even if the employer has told him or her not to come to work.
- **Written application.** The recipient must submit a written application for donated PTO, including a description of the medical emergency.

- **Exhausted other available PTO before using donated leave.** The recipient must have exhausted all other available PTO, including vacation, sick days, workers' compensation, and any other available PTO, before using donated PTO under the leave-sharing program.
- **Limit on donated PTO.** The program must restrict how much PTO a donor-employee may donate.
- **Rules for awarding of donated PTO.** The program must set forth rules for how donated PTO is awarded to eligible employees.
- **Normal rate of compensation.** The recipient must receive donated PTO at the recipient's normal rate of compensation, not the donor's rate of compensation.
  - **Example**. If a donor-employee who earns $20 per hour donates eight hours of vacation time (the equivalent of $160), a recipient-employee who earns $10 per hour using all of that donated PTO would receive 16 hours of PTO at a rate of $10 per hour (the equivalent of $160).
- **The recipient-employee cannot return donated PTO to the donor-employee.** Surrendered PTO hours cannot be returned to the donor-employee and must remain available for use by the recipient-employee.[4]

Leave-Sharing Requirements

Leave-sharing programs may also satisfy the required criteria in the following circumstances:

- **Death of parent, spouse, or child.** In lieu of a medical emergency, the recipient-employee may use the donated PTO for absences relating to the death of a parent, spouse, or child.
- **Intermittent absence.** The prolonged absence caused by the medical emergency may be intermittent.
- **Designation of individual employee.** The employee-donor may designate an individual employee who may use the donated PTO.
  - Employers should tread carefully and consult with counsel before permitting employee-donors to designate a specific leave recipient. This arrangement involves administrative challenges, workforce morale concerns, as well as potential discrimination claims.[5]

If all the required criteria above for medical emergencies are satisfied, the IRS will not treat the donated PTO as wages to the employee-donor as long as the donated time off is treated as wages to the employee-recipient for federal income tax purposes. Because the donated PTO is not treated as wages to the employee-donor, the employee-donor may not claim an expense, charitable contribution, or loss deduction for the donation.[6]

1. Pub. L. No. 116-127, 134 Stat. 178 (Mar. 18, 2020). 2. *See* Lucas v. Earl, 281 U.S. 111 (1930); Helvering v. Eubank, 311 U.S. 122 (1940). 3. *See* Rev. Rul. 90-29, 1990 IRB LEXIS 132 (Jan. 1990).

4. *Id. See also* IRS Priv. Ltr. Rul. 9051005, 1990 PLR LEXIS 2642 (Sept. 6, 1990); IRS Priv. Ltr. Rul. 200720017, 2007 PLR LEXIS 258 (Feb. 9, 2007). 5. *See* IRS Priv. Ltr. Rul. 9051005, 1990 PLR LEXIS 2642; IRS Priv. Ltr. Rul. 200720017, 2007 PLR LEXIS 258. 6. *See* Rev. Rul. 90-29, 1990 IRB LEXIS 132.

Major Disasters

In contrast to medical emergency leave-sharing plans, an IRS-approved leave-sharing program for major disasters allows employees to donate unused, accrued PTO to an employer-sponsored leave bank for use by employees adversely affected by a specific major disaster.

Definition of Major Disaster

A major disaster means either of the following:

- A major disaster as declared by the President under Section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act that warrants individual assistance or individual and public assistance from the federal government under that Act[7]
- A major disaster or emergency as declared by the President pursuant to 5 U.S.C. § 6391[8]

IRS-Approved Major Disaster Leave-Sharing Plans

IRS-approved major disaster leave-sharing plans meet the following criteria:

- **Employee must be adversely affected by the major disaster.** To be adversely affected by the major disaster, the disaster must cause severe hardship to the employee or a family member that requires the employee to miss work.
- **Specific leave recipient.** The plan does not allow employees to deposit leave for a specific leave recipient.
- **Amount of leave donated.** The amount of leave that an employee may donate any year generally may not exceed the maximum amount of leave that the employee normally accrues in a year.
  - Under this requirement, employees likely cannot donate emergency sick leave provided under the FFCRA.
- **Normal rate of compensation.** The recipient must receive the donated leave at his or her normal rate of compensation from leave deposited in the leave bank.
- **Reasonable limit.** The plan must adopt a reasonable limit, based on the severity of the disaster, on the period after the disaster occurs during which employees may deposit leave in the leave bank. A leave recipient must use leave from the leave bank.
- **Cannot convert to cash.** A leave recipient may not convert leave from the leave bank into cash in lieu of leave but may use such leave to eliminate a negative leave balance incurred due to an advance of leave resulting from the disaster. The leave recipient may also substitute leave received under the plan for unpaid leave used because of the disaster.
- **Reasonable determination.** The employer must make a reasonable determination, based on need, on the amount of leave an approved recipient may receive under the plan.
- **Used for major disaster.** The leave must be used for purposes related to the major disaster (e.g., COVID-19) that gave rise to the creation of the leave-sharing plan.
- **Unused leave.** Any unused leave in the leave bank after the reasonable time for using such leave has passed (as determined by the employer) must be returned within a reasonable time to the donors (or the donors who are still employed by the employer, at the employer's option).
- **Amount returned.** The amount returned to each donor must be in the same proportion as the amount donated bears to the total amount donated on account of the major disaster.[9]

7. *See* 42 U.S.C.S. § 5170, providingthat the president may declare an event a major disaster. *See also* IRS Priv. Ltr. Rul. 200720017, 2007 PLR LEXIS 258 (declining favorable tax treatment to an employer plan designed to assist employees affected by "catastrophic casualty loss" as overbroad and not "designed to be limited specifically to aid the victims of a 'major disaster' as declared by the President . . . ").
8. *See* 5 U.S.C.S. § 6391, providing that, in the event the President declares a major disaster or emergency, that results in severe adverse effects for a substantial number of federal employees, the President may direct the Office of Personnel Management to establish a leave-sharing plan for federal employees who are adversely affected by the disaster or emergency.
9. *See* IRS Notice 2006-59, 2006 IRB LEXIS 330 (July 10, 2006).

> Employers adopting a PTO donation policy to assist Section 170 organizations should be careful to set an expiration date for the policy.

Employer Cash Donations to Section 170(c) Organizations to Aid COVID-19 Pandemic Victims from Employees' Forgone Leave

As an alternative to leave-donation policies to assist coworkers affected by medical emergencies or major disasters, the IRS approved a special leave donation program to assist COVID-19 pandemic victims outside one's workplace.[10]

To begin, an employee (or the employer) selects a charity to receive the cash equivalent of all or a portion of the employee's unused PTO. The chosen charity must provide relief for COVID-19 victims and the donation must be paid before January 1, 2021. If these conditions are met, the forgone PTO is not included in the employee's taxable gross income or wages.[11]

The employee is not entitled to a Section 170 charitable deduction for the value of his or her forgone leave. But the employer can take either a Section 170 charitable deduction or a Section 162 business deduction.[12]

Employers adopting a PTO donation policy to assist Section 170 organizations should be careful to set an expiration date for the policy. If the policy extends past the relief provided by the program as detailed in IRS Notice 2020-46 (evidently, December 31, 2020), the employee is treated as receiving taxable wages but may be able to take a Section 170 deduction on his or her tax return. Instead of a Section 170 charitable deduction, the employer is entitled to a Section 162 deduction for compensation.[13]

ERISA Applicability and Compliance

Employers must consider whether their leave-sharing/donation plan may implicate the Employee Retirement Income Security Act of 1974 (ERISA). If the program is an ERISA-governed plan, in addition to invoking ERISA fiduciary responsibilities for program administration, the employer will need to comply with applicable provisions of the statute, including plan document, reporting, and disclosure requirements.

The principal inquiry is whether the leave-sharing program constitutes an employee welfare benefit plan as defined under ERISA and, if so, whether an exception is available.

ERISA Employee Welfare Benefit Plans and the Payroll Practices Exception

In general, an ERISA employee welfare benefit plan is one established or maintained by an employer that is intended to provide a broad spectrum of specifically listed benefits to participants or beneficiaries, including benefits for vacation or in the event of sickness, accident, or disability, through the purchase of insurance or other means.[14] Thus, at first glance, a leave-sharing program would fall squarely within the general definition.

Under implementing regulations, however, a leave-sharing program may fall within the payroll practices exception to an employee welfare benefit plan. Payroll practices include payments of an employee's "normal compensation, out of the employer's general assets" when the employee is "physically or mentally unable to perform his duties; or otherwise absent for medical reasons" or when the employee is on vacation or absent on a holiday.[15]

A leave-sharing program should generally qualify for the payroll practices exception if it meets all of the following conditions:

- The employer pays program benefits out of its general assets (rather than establishing a trust in which to set aside amounts to fund the program).
- The leave benefits paid to an individual can never exceed the amount the individual would receive for working during the applicable period at their regular pay rate (to comply with the normal compensation limitation).
- The program limits eligibility to current employees who, but for their medical absence, are expected to perform services for the employer.

Program communications and disclosures should also explicitly state that the program does not constitute an employee welfare benefit plan for purposes of ERISA.

10. *See* IRS Notice 2020-46, 2020 IRB LEXIS 254.The program allows employees to forgo unused PTO, the value of which is not counted as taxable income to the employee, and which value one's employer converts into a tax-favored cash donation to a Section 170(c) charitable organization that assists pandemic victims. *See also* 26 U.S.C.S. § 170(c). 11. *See* IRS Notice 2020-46. 12. *Id*. *See also* 26 U.S.C.S. § 170; 26 U.S.C.S. § 162. 13. *See* IRS Notice 2020-46. 14. *See* 29 U.S.C.S. § 1002(2). 15. *See* 29 C.F.R. § 2510.3-1(b); *see also* Foster v. Sedgwick Claims Mgmt. Servs., Inc., 842 F.3d 721 (D.C. Cir. 2016) (holding an employer's short-term disability plan was exempt from ERISA because it fell within a regulatory exception for payroll practices).

Related Content

For guidance on a range of COVID-19-related legal issues, see

> CORONAVIRUS (COVID-19) RESOURCE KIT

RESEARCH PATH: *Labor & Employment > Workplace Safety and Health > Policies and Procedures > Practice Notes*

For up-to-date information on federal, state, and local employment laws addressing the COVID-19 pandemic, see

> CORONAVIRUS (COVID-19) FEDERAL AND STATE EMPLOYMENT LAW TRACKER

RESEARCH PATH: *Labor & Employment > Workplace Safety and Health > Policies and Procedures > Practice Notes*

For practical guidance for employers for responding to pandemic diseases, see

> PANDEMIC FLU/INFLUENZA/CORONAVIRUS (COVID-19): KEY EMPLOYMENT LAW ISSUES, PREVENTION, AND RESPONSE

RESEARCH PATH: *Labor & Employment > Attendance, Leaves, and Disabilities > Attendance and Time Off > Practice Notes*

For a template for a leave-sharing and donation policy, see

> LEAVE SHARING AND DONATION POLICY FOR MEDICAL EMERGENCIES

RESEARCH PATH: *Labor & Employment > Attendance, Leaves, and Disabilities > Attendance and Time Off > Forms*

Employer Obligations If a Leave-Sharing and Donation Plan Is Deemed an Employee Welfare Plan

If a leave-sharing and donation plan is deemed an employee welfare benefit plan, the employer must satisfy many additional ERISA compliance obligations including the following:

- **Form 5500.** Form 5500 annual reporting to the federal government and the related summary annual report disclosure obligation for plan participants and certain beneficiaries
- **Disclosure requirements.** Disclosure requirements for participants and beneficiaries, for example, summary plan descriptions
- **Fiduciary obligations.** Adherence to strict fiduciary obligations applicable to ERISA plan sponsors and plan administrators
- **Other plan administration requirements.** Other plan administration requirements, for example, detailed claims procedures implemented by the U.S. Department of Labor (DOL)[16]

Privacy and Anti-discrimination Laws

This section addresses how employers should address sensitive medical information in connection with leave donation plans.

Review Applicable Federal and State Laws

Employers must consider the applicability and requirements of applicable federal and corresponding state laws governing employee privacy, including:

- Americans with Disabilities Act (ADA)
- Family and Medical Leave Act (FMLA)
- Genetic Information Nondiscrimination Act (GINA)

16. 29 C.F.R. § 2560.503-1.

ADA

The ADA, which applies to employers of at least 15 employees, limits the medical inquiries that employers may make of employees. It also obligates employers to use separate forms to collect any information regarding the medical condition or history of employees and requires employers to keep any such information separate from other personnel files.

Furthermore, the ADA requires employers to keep such information confidential, subject to certain narrow exceptions. An employer may disclose such information only to:

- Supervisors and managers if it relates to "necessary restrictions on the work or duties of the employee and necessary accommodations"[17]
- First aid and safety personnel "when appropriate, if the disability might require emergency treatment"[18]
- Government officials investigating compliance with the ADA, upon request[19]

FMLA

Under the FMLA, employers can require an employee taking FMLA leave because of his or her own serious health condition or the serious health condition of a covered relative to provide medical certification from the healthcare provider. Under regulations issued by the DOL, however, an employer cannot require the diagnosis of the employee or covered relative.[20]

Furthermore, once medical certification is provided, the employer may not request additional information from the healthcare provider. While an employer may contact the employee's healthcare provider for purposes of clarifying or authenticating the medical certification, the contact must be made by a healthcare provider representing the employer, and only with the employee's permission.[21]

GINA

GINA prohibits covered employers from using genetic information in employment-related decisions but includes an exception where an employer inadvertently requests or requires information about an employee or an employee's family member.

EEOC implementing regulations provide for a safe harbor under which an employer's receipt of genetic information in connection with a lawful request for medical information is deemed inadvertent as long as the request includes model language:

- Instructing the employee not to provide genetic information in responding to the medical information request
- Describing the scope of genetic information under GINA[22]

State and Local Paid Sick Leave and Other PTO Laws

Before implementing a leave-sharing/donation program, employers must consider any applicable state or local paid sick leave or other PTO laws that may limit an employee's ability to donate a particular type of leave.

Consult State and Local Paid Leave Laws

An increasing number of states, counties, and cities now provide statutory paid leave benefits.

Employers with employees in jurisdictions with paid leave requirements should ensure that employees have sufficient accrued paid leave to comply with the applicable laws before allowing them to donate leave under the programs. Carefully examine these state and local laws and implementing regulations. Focus particularly on rules concerning forfeiture of leave and whether the applicable paid leave law specifically addresses leave donation.

Use It or Lose It Policies

Some states have prohibitions against use it or lose it policies regarding vacation time. Bans on use it or lose it policies can impact the amount of leave employees can donate.

California. In California, for instance, earned PTO (including vacation, PTO that combines vacation and sick leave, and personal days) is considered wages and is earned as the work is performed. As it is earned, PTO is vested, and it cannot be forfeited.

Colorado. Similarly, in Colorado, pursuant to recent amendments to implementing regulations under Colorado's Wage Protection Act, employees cannot forfeit earned (accrued) vacation pay.[23]

Forfeiture

While there may be nothing in these state laws that prohibits employees from voluntarily donating accrued PTO to co-workers in need, employers must be careful that a donation is not deemed a forfeiture. If not properly drafted, a leave-sharing and donation policy could create the impression that donations are not purely voluntary, running afoul of a prohibition on forfeitures. On the other hand, without a written leave-sharing policy, while there would be nothing prohibiting an employer to allow a donation to occur, the employee-donor would lose favorable tax treatment accorded to IRS-approved leave-sharing plans.

17. 29 C.F.R. § 1630.14(b)(1)(i). 18. 29 C.F.R. § 1630.14(b)(1)(ii). 19. 29 C.F.R. § 1630.14(b)(1)(iii). 20. 29 C.F.R. § 825.306. 21. 29 C.F.R. § 825.307. 22. *See* 42 U.S.C.S. § 2000ff et seq. 23. *See* 7 Colo. Code Regs. § 1103-7, Rule 2.17.

National Labor Relations Act (NLRA) Compliance

Unionized and nonunionized employers must ensure that their employment policies do not infringe on employees' rights under the NLRA. Employers must also ensure they do not enforce otherwise lawful policies that restrict employees' rights under the NLRA.

In addition, unionized employers must bargain collectively with the union concerning terms and conditions of employment and ensure their policies do not contradict the terms of collective bargaining agreements they have with their employees' union. L

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RESEARCH PATH: *Labor & Employment > Employment Policies > Terms of Employment > Practice Notes*

Related Content

For an analysis of the Family and Medical Leave Act, see

> FMLA LEAVE: GUIDANCE FOR EMPLOYERS AND EMPLOYEES

RESEARCH PATH: *Labor & Employment > Attendance, Leaves, and Disabilities > Family and Medical Leave > Practice Notes*

For an overview of what employers need to know about the Genetic Information Nondiscrimination Act, see

> GENETIC INFORMATION NONDISCRIMINATION ACT (GINA) EMPLOYMENT DISCRIMINATION PROHIBITIONS

RESEARCH PATH: *Labor & Employment > Privacy, Technology, and Social Media > Protecting Employee Data > Practice Notes*

For a sample policy on paid time off, see

> PAID TIME OFF (PTO) AND SICK DAYS POLICY

RESEARCH PATH: *Labor & Employment > Employment Policies > Terms of Employment > Forms*

Theodore K. Cheng, Esq., ADR OFFICE OF THEO CHENG

Can and Should Arbitrators Compel Parties to Participate in **Remote Arbitration Hearings?**

This article discusses the complex issue of whether and how an arbitrator can compel parties to participate in remote arbitration hearings amid the novel coronavirus (COVID-19) pandemic.

ONE IMPACT OF THE PANDEMIC HAS BEEN TO CREATE DELAYS in the scheduling of in-person arbitration evidentiary hearings due to ongoing governmental regulations, travel restrictions, and concerns over personal health and safety. This delay undoubtedly compromises the promise of arbitration as an expeditious and cost-effective dispute resolution process. By agreement, some parties have arranged to proceed remotely using any one of the many available video teleconferencing (VTC) platforms, such as Zoom, WebEx, or Microsoft Teams. Even if the arbitration agreement expressly prohibits holding a remote hearing, the parties could nonetheless agree otherwise and proceed remotely.

But what if there is a dispute between the parties as to whether to proceed remotely? When the parties' arbitration agreement specifically forbids remote hearings, it is a relatively easy matter for the arbitrator to:

- Refrain from proposing a remote hearing
- Deny applications to proceed remotely
- Sustain objections when one party wishes to proceed remotely while the other does not[1]

1. *See* Code of Ethics for Arbitrators in Commercial Disputes (2004), Canon I.E. ("When an arbitrator's authority is derived from the agreement of the parties, an arbitrator should neither exceed that authority nor do less than is required to exercise that authority completely.").

But rarely do today's agreements explicitly address this issue.

Because the arbitrator is the decision-maker charged with resolving the parties' disputes, there are several things for parties and counsel to consider before deciding either to make an application to convert an in-person hearing to one conducted remotely or, conversely, to seek to postpone an in-person hearing until a future date when it is safe to do so. By its very nature, arbitration is a creature of contract. When there is a fundamental disagreement about how the proceeding should be conducted—particularly, the main event—the default arguably ought to be what the parties had originally intended when they entered into the agreement, namely, the normal in-person hearing.

But these are not normal times. It is difficult to imagine holding safe, let alone fulsome, in-person hearings when even vigorous disinfection, wearing masks, and social distancing do not necessarily guarantee personal health and safety. Moreover, the practicality of having witnesses testify during an in-person hearing raises potentially problematic issues because mask-wearing can obfuscate a witness's appearance, demeanor, and reactions. With the realistic likelihood of scheduling in-person hearings being indefinitely postponed, parties, counsel, and arbitrators are all mindful of the adage that justice delayed is justice denied. Indeed, in many circumstances, a delay in the proceeding invariably advantages one party at the expense of another.

When the prospect of an in-person hearing seems indefinitely delayed, an arbitrator operates under certain ethical duties that suggest an obligation to affirmatively propose that the parties undertake a remote hearing. Under the Code of Ethics for Arbitrators in Commercial Disputes (Code), arbitrators:

- Have a responsibility to the arbitration process itself and must observe high standards of conduct so that the integrity and fairness of the process are preserved[2]
- Should conduct themselves in a way that is fair to all the parties and should not be swayed by outside pressure, public clamor, fear of criticism, or self-interest[3]
- Should conduct the proceeding to advance the fair and efficient resolution of the matters submitted for decision[4]
- Should afford all parties the right to be heard, allowing each party a fair opportunity to present its evidence and arguments[5]

Accordingly, there is a sound basis under the Code for the notion that arbitrators have an ethical obligation to affirmatively propose that the parties undertake a remote hearing, especially when the prospect of an in-person hearing seems indefinitely delayed.

These underlying ethical principles underscore the importance of maintaining the integrity and fairness of the process; advancing the fair and efficient resolution of the dispute; and affording parties a fair (but, notably, not necessarily perfect) opportunity to present evidence and arguments. They also operate as constraints on an arbitrator's authority and exercise of discretion in resolving a dispute over proceeding with a remote hearing.

Many arbitration agreements typically incorporate the use of a particular provider's arbitration rules, default to the Federal Arbitration Act (FAA) or applicable state arbitration statute, or leave the conduct of the arbitration proceeding to the sound discretion of the arbitrator. In each case, the arbitrator is generally afforded broad discretion to conduct the proceeding in a manner that advances the expeditious and cost-effective resolution of the dispute, while being consistent with its underlying premise of fairness and due process.[6]

But exercising that discretion requires care on the part of the arbitrator to ensure that the party objecting to proceeding remotely and seeking a postponement to a day when an in-person hearing can be held has made an appropriate showing. Some factors for arbitrators, parties, and counsel to consider include:

- Timing considerations in the arbitration clause or case management orders
- The age of the proceeding
- The stage of the proceeding when the party makes the request or objection
- Whether it is premature to determine if the arbitrator should move the hearing online
- Whether the arbitrator previously held any in-person hearings
- The location and nature of a possible in-person hearing
- Whether the arbitrator can resolve a portion of the case through documentary submissions or a remote proceeding
- Whether the requesting party's reasons for postponement are reasonable and well-founded
- Whether the objecting party will suffer any undue prejudice by shifting to a remote hearing
- Whether there exist any continuing liability or time-sensitive matters, such as emergency health or safety issues
- The state of government regulations and associated travel restrictions, along with the family and health considerations of counsel, parties, and witnesses
- Whether there are legitimate concerns over the use of the VTC platform, such as:
    - Competency of the arbitrator, counsel, parties, or witnesses
    - Availability of appropriate equipment
    - Difficulty preparing or marshaling witnesses
    - Efficient handling of exhibits
    - Improper witness coaching
    - Preservation of confidentiality
    - Platform security
- The technical support available to address real-time issues that may arise
- Whether the arbitrator will be able to:
    - Understand the testimony and exhibits
    - Assess witnesses
    - Decide the dispute fairly[7]

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2. *See* Code of Ethics for Arbitrators in Commercial Disputes (2004), Canon I.A. **3.** *See* Code of Ethics for Arbitrators in Commercial Disputes (2004), Canon I.D. **4.** *See* Code of Ethics for Arbitrators in Commercial Disputes (2004), Canon I.F. **5.** *See* Code of Ethics for Arbitrators in Commercial Disputes (2004), Canon IV.B. **6.** *See, e.g.,* AAA Commercial Arbitration Rule 32(c) (2013) ("When deemed appropriate, the arbitrator may also allow for the presentation of evidence by alternative means including video conferencing, internet communication, telephonic conferences and means other than an in-person presentation. Such alternative means must still afford a full opportunity for all parties to present any evidence that the arbitrator deems material and relevant to the resolution of the dispute and, when involving witnesses, provide an opportunity for cross-examination."); AAA Construction Industry Arbitration Rule 33(c) (2015) (same); CPR Non-Administered Arbitration Rule 12.1 (2018) ("The Tribunal shall determine the manner in which the parties shall present their cases.") JAMS Comprehensive Arbitration Rule 22(g) (2014) ("The Hearing, or any portion thereof, may be conducted telephonically or videographically with the agreement of the Parties or at the discretion of the Arbitrator."). **7.** *See* Nat'l Academy of Arbitrators, Formal Adv. Op. No. 26 (Apr. 1, 2020) (Adv. Op. 26); Neil Eiseman, Can a Commercial Arbitrator Demand a Virtual Hearing?, N.Y.L.J. (May 20, 2020); American Arbitration Association, "Considerations for Rescheduling Adjourned Cases" (2020).

> Presently, there is little authority concerning the propriety of an arbitrator ordering parties to conduct a remote hearing.

In these extraordinary times, examples of reasons that likely would not establish sufficient good cause to prevent conversion to a remote hearing— absent extenuating circumstances—include:

- A mere desire or preference on the part of any participant to proceed in-person
- A lack of training on VTC platforms, particularly given numerous training opportunities offered for low or no cost
- An unfamiliarity, discomfort, disdain, or fear of technology
- The inability for any group of participants (e.g., counsel, parties, and/or witnesses) to be in the same physical location, either before or during the hearing

By contrast, some obvious examples that would likely qualify as establishing sufficient good cause include situations where a hearing participant:

- Tests positive for COVID-19
- Lives in the same household as someone who has tested positive for COVID-19
- Has been exposed to someone who has tested positive for COVID-19
- Must care for a family member who has tested positive for COVID-19
- Has closed the business due to governmental regulations
- Is unable to access the office where relevant case files are located
- Is in a location with unstable or unreliable telephone or internet service that the participant cannot otherwise remediate

Presently, there is little authority concerning the propriety of an arbitrator ordering parties to conduct a remote hearing. One notable exception is Formal Advisory Opinion No. 26 (April 1, 2020) issued by the National Academy of Arbitrators (the Academy), the organization of labor and employment arbitrators in the United States and Canada.[8] Based on the

8. *See* Adv. Op. 26.

Code of Professional Responsibility for Arbitrators of Labor-Management Disputes, the Academy concluded that, in the absence of a collective bargaining agreement or an ad hoc agreement prohibiting video hearings, an arbitrator may—in exceptional circumstances—order a remote hearing, in whole or in part, without mutual consent and over the objection of a party.[9] The substance of this opinion, including the Academy's guidance on factors that arbitrators, parties, and counsel should consider in terms of remote proceedings, is highly instructive for all participants regardless of whether the dispute arises in the labor-management context.

However, in its opinion, the Academy urged arbitrators to first obtain the parties' agreement to proceed remotely before determining that a video hearing is necessary to provide a fair and effective proceeding. Indeed, nothing in the opinion "imposes an affirmative obligation to order a video hearing absent the agreement of the parties."

Keep in mind that, under the FAA, parties may move to vacate an arbitration award "where the arbitrators were guilty of misconduct in refusing to postpone the hearing, upon sufficient cause shown."[10] State arbitration statutes often have similar provisions or afford vacatur under the general catch-all of arbitrator misconduct.[11] Thus, to guard against vacatur of the final award, all arbitration participants should strive to create a complete record of all views on the matter before the arbitrator rules on an application or objection to converting an in-person hearing to a remote hearing. L

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Related Content

For practical guidance on the impact of the coronavirus in a number of practice areas, see

> CORONAVIRUS (COVID-19) RESOURCE KIT

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For an overview of arbitration rules, see

> AAA ARBITRATION RESOURCE KIT

RESEARCH PATH: *Civil Litigation > Arbitration and Other ADR > Arbitration Fundamentals > Practice Notes*

For a discussion of procedures to be followed in commercial arbitrations before the American Arbitration Association (AAA), see

> AAA COMMERCIAL ARBITRATION PROCEDURE

RESEARCH PATH: *Civil Litigation > Arbitration and Other ADR > Arbitration Fundamentals > Practice Notes*

For information on the stages of arbitration under the AAA rules, see

> AAA COMMERCIAL ARBITRATION FLOWCHART

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For first-person accounts from attorneys on practicing during the coronavirus, see

> LITIGATION DURING THE CORONAVIRUS; ATTORNEYS TELL HOW THEY'RE NAVIGATING THE CHALLENGES

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For an overview of the Federal Arbitration Act's provisions, see

> FEDERAL ARBITRATION ACT FUNDAMENTALS

RESEARCH PATH: *Civil Litigation > Arbitration and Other ADR > Arbitration Fundamentals > Practice Notes*

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9. *See* Code of Professional Responsibility for Arbitrators of Labor-Management Disputes (2007). 10. *See* 9 U.S.C. S. § 10(a)(3). 11. *See*, *e.g.*, N.Y. C.P.L.R. § 7511 ("The award shall be vacated on the application of a party who either participated in the arbitration or was served with a notice of intention to arbitrate if the court finds that the rights of that party were prejudiced by . . . (i) corruption, fraud or misconduct in procuring the award; or . . . (iii) an arbitrator, or agency or person making the award exceeded his power . . . ").

Advancing the Rule of Law

How LexisNexis Legal & Professional Will Work To Advance Racial Justice

In an effort to advance racial justice and equality, LexisNexis is undertaking a series of actions to ensure greater diversity within the company and drive change in the communities it serves.

Practical Guidance has launched the Protestors' Rights Resource Kit, a compilation of publicly available resources to inform protest participants and members of the press covering protests of their legal rights. The kit includes information from the websites of organizations that promote civil rights, equal rights and access to justice in addition to LexisNexis resources that provide background and context on constitutional rights and police civil liability.

LexisNexis Legal & Professional CEO Mike Walsh announced three areas of concentration aimed at advancing the rule of law and the company's inclusion and diversity strategy:

- **Eliminate systemic racism in our legal systems.** The company will make cash and in-kind donations over the next five years to organizations working to advance the rule of law and improve racial and social justice. The LexisNexis Rule of Law Foundation will work with legal organizations, nongovernmental organizations, and other partners to raise awareness of inequities and hidden biases in legal systems and bring about change.
- **Be an advocate for Black lives.** LexisNexis has signed the Business in the Community Race at Work Charter and has committed to its five calls to action to ensure that ethnic minorities are represented at all levels of the organization. Jamie Buckley, Chief Product Officer, was named the executive sponsor in support of the Charter.
- **Ensuring a culture and practice of inclusion and diversity.** In the newly created Inclusion and Diversity Officer role, Ronda Moore is charged with developing and implementing a strategic inclusion and diversity agenda for LexisNexis Legal & Professional.

"LexisNexis people around the globe express their solidarity toward eliminating racism," Walsh said. "They have submitted hundreds of ideas, large and small, on how we can help address racial injustice. The proof of our commitment will be in the actions we proudly push forward to fight systemic racism. We believe we can make a lasting and positive change in the fight against injustice for our employees and for our customers, while strengthening the rule of law."