The LEXIS PRACTICE ADVISOR Journal™
FALL 2019
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The LEXIS PRACTICE ADVISOR Journal™

Practical guidance backed by leading attorneys from Lexis Practice Advisor®

MINIMIZING YOUR COMPANY'S EXPOSURE TO A RANSOMWARE ATTACK

Proving Fame For Trademark Dilution Claims

Drafting Enforceable Arbitration Agreements

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Fall 2019

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The
LEXIS PRACTICE ADVISOR Journal™

FALL 2019 (Volume 4, Issue 3)

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Eric Bourget, Editor-in-Chief

A RANSOMWARE ATTACK CAN SHUT down your client's business, leaving a company stranded without the use of its vital IT systems. Attacks are occurring in hospitals, retail businesses, and other large companies, causing services to come to a halt. The decision whether to pay ransom is a loaded question because there are no guarantees it will work and paying certain entities could be a violation of anti-terrorism laws. In this edition of the Lexis Practice Advisor Journal, we bring you guidance on how to help your clients prepare for and react to this escalating threat.

Arbitration agreements are receiving a great deal of attention lately, particularly in the area of class arbitration. These agreements—designed to keep disputes out of court— are becoming one of the most frequently litigated contract issues. This drafting guidance highlights some of the most contentious areas related to these provisions—including forced arbitration—which are inspiring proposed consumer and worker protection legislation.

This edition of the Lexis Practice Advisor Journal looks at permissible discovery requests for attorneys on either side of employment litigation. Two companion articles provide guidance on the scope of discovery that defendant-employers and plaintiff-employees may obtain in employment discrimination lawsuits under federal employment discrimination statutes such as Title VII of the Civil Rights Act of 1964, the Americans with Disabilities Act, and the Age Discrimination in Employment Act. Key discovery issues addressed include, among others, discovery requests, responses, and objections; resolving discovery disputes; and strategies for obtaining discovery effectively.

Foreign investors have historically viewed U.S. real estate as an attractive and stable investment. Because so much U.S. real estate is bought and sold by foreign investors, many attorneys eventually find themselves representing either a foreign buyer or seller of U.S. real estate or a domestic client buying U.S. real estate from a foreign person. These transactions can raise a number of issues, including differing customs and expectations, reporting requirements, and the potential for adverse tax consequences. This article walks attorneys through the complexities they may encounter when working with foreign parties in U.S. real estate transactions.

Also in this edition, we delve into what it takes to prove "fame." To assert a dilution claim in federal court or in a Trademark Trial and Appeal Board (TTAB) proceeding, the plaintiff's trademark must be famous. This threshold requirement is often the hardest element to prove in a dilution case. Thus, it is crucial to understand the legal standard for fame, the statutory fame factors, and the types of evidence that can bolster a plaintiff's case.

Our mission

The Lexis Practice Advisor Journal™ is designed to help attorneys start on point. This supplement to our online practical guidance resource, Lexis Practice Advisor®, 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 Lexis Practice Advisor Journal offers fresh, contemporary perspectives and compelling insights on matters impacting your practice.

NINTH CIRCUIT REINSTATES EMPLOYEES' SUITS OVER PAYMENT FOR POST-SHIFT INSPECTION PERIODS

EMPLOYEES OF NIKE AND CONVERSE MAY PROCEED with class action suits alleging that the athletic wear companies violated California law by refusing to pay them for time spent during mandatory post-shift security checks, the U.S. Court of Appeals for the Ninth Circuit has ruled. Rodriguez v. Nike Retail Services, 2019 U.S. App. LEXIS 19475 (9th Cir. June 28, 2019); Chavez v. Converse Inc., 2019 U.S. App. LEXIS 19494 (9th Cir. June 28, 2019).

The appeals court reversed two rulings by the U.S. District Court for the Northern District of California entering summary judgment for Nike and Converse in class actions brought by Isaac Rodriguez and Eric Chavez on behalf of employees of retail stores operated by the two companies in California. The suits allege that employees were required to submit to inspections of their belongings after punching out for the day and were not paid for their time in violation of the California Labor Code.

In two separate rulings, the district court held that the employees' claims are barred by the federal de minimis doctrine, which precludes recovery under the Fair Labor Standards Act (FLSA) for otherwise compensable amounts of time that are small, irregular or difficult to record administratively.

Rodriguez and Chaves appealed. The Ninth Circuit stayed proceedings pending the California Supreme Court's ruling in Troester v. Starbucks Corp., 5 Cal. 5th 829 (Calif. Sup. 2018). In that case, a Starbucks shift supervisor alleged that the company's failure to pay for closing tasks performed after he clocked out violated state law. Starbucks contended that the time spent was de minimis. The state high court held that the de minimis doctrine does not apply to wage and hour cases brought under state law.

Citing *Troester*, the Ninth Circuit vacated the entry of summary judgment in both cases and remanded for reconsideration by the district court, rejecting the argument by Nike and Converse that the exit inspections are de minimis even under the *Troester* holding.

"To the extent Nike urges us to interpret *Troester* as replacing the federal de minimis doctrine's 10-minute daily threshold with a state-law 60-second analogue, we decline to do so," the court said. "Not only would this interpretation read far too much into *Troester's* passing mention of 'minutes,' but it would also clash with *Troester's* reasoning, which emphasized the requirement under California labor laws that 'employee[s] must be paid for all hours worked or any work beyond eight hours a day.' We doubt that *Troester* would have been decided differently if the closing tasks at issue had taken only 59 seconds per day."

RESEARCH PATH: *Labor & Employment > Wage and Hour > Compensation > Articles*

SUPREME COURT TAKES ON QUESTION OF HEALTH INSURER REIMBURSEMENT UNDER ACA

THE U.S. SUPREME COURT WILL HEAR THREE CASES next term that raise the issue of whether health insurers are entitled to reimbursement for $12 billion in losses incurred under the Affordable Care Act (ACA). (Moda Health Plan Inc. v. United States, 2019 U.S. LEXIS 4338 (June 24, 2019); Maine Community Health Options v. United States, No. 18-1023; Land of Lincoln Mutual Health Insurance Co. v. United States, 2019 U.S. LEXIS 4281 (June 24, 2019).

At issue is the so-called risk corridors, a three-year stabilization program set forth in Section 1342 of the ACA intended to encourage insurers to participate in the ACA by capping financial losses. The program required the Secretary of Health and Human Services (HHS) to administer a payment adjustment system for qualified health plans based on the ratio of the allowable costs of the health plan to its aggregate premiums. However, Congress specifically excluded payments under Section 1342 from the HHS budget in fiscal years 2015, 2016, and 2017.

Three insurers—Moda Health Plan Inc., Maine Community Health Options, and Land of Lincoln Mutual Health Insurance Co.—filed separate suits in the U.S. Court of Federal Claims, seeking recovery of money due under the program. The insurers argued that removal of the funding for the risk-corridors program did not negate the government's responsibility to make the payments since the statute was not amended or repealed.

The Claims Court ruled for Moda but found for the government in the suits filed by Land of Lincoln and Maine Community Health, finding that the removal of funding negated the HHS' responsibility under the statute. On appeal, the U.S. Court of Appeals for the Federal Circuit reversed with respect to Moda and affirmed on the other two cases, effectively ruling for the government in all three cases.

The insurers filed separate petitions for writ of certiorari; all three were granted on June 24. The cases were consolidated for oral argument, expected to take place in the Supreme Court's next term, which begins on Oct. 7.

RESEARCH PATH: *Employee Benefits & Executive Compensation > Health and Welfare Plans > Health Plans and Affordable Care Act > Articles*

BAN ON "IMMORAL," "SCANDALOUS" TRADEMARKS VIOLATES CONSTITUTION, SUPREME COURT RULES

A FEDERAL BAN ON THE REGISTRATION OF "IMMORAL" OR "scandalous" trademarks violates the First Amendment to the U.S. Constitution, the U.S. Supreme Court ruled June 24 in Iancu v. Brunetti, 2019 U.S. LEXIS 4201 (2019). The court's ruling means that the owner of a clothing line can register the trademark FUCT to identify his products and that other trademarks previously barred from registration on the same grounds may now be registrable.

Citing its June 2017 decision in Matal v. Tam, 137 S.Ct. 1744 (2017), which invalidated the Lanham Act's ban on registering disparaging marks as discriminatory "on the basis of viewpoint," the court said, "Today we consider a First Amendment challenge to a neighboring provision of the Act, prohibiting the registration of 'immoral[]' or 'scandalous' trademarks. We hold that this provision infringes the First Amendment for the same reason: It too disfavors certain ideas."

The court, in a 6-3 decision written by Justice Elena Kagan, upheld a ruling by the U.S. Court of Appeals for the Federal Circuit reversing a holding by the Trademark Trial and Appeal Board that the proposed trademark was unregistrable under Section 2(a) of the Lanham Act¸15 U.S.C.S. § 1052, which lists "immoral" or "scandalous" material among the content that is not registrable.

"[E]ven assuming the Government's reading would eliminate First Amendment problems, we may adopt it only if we can see it in the statutory language. And we cannot," the court said. "The statute as written does not draw the line at lewd, sexually explicit, or profane marks. Nor does it refer only to marks whose 'mode of expression,' independent of viewpoint, is particularly offensive. It covers the universe of immoral or scandalous—or (to use some PTO synonyms) offensive or disreputable—material. Whether or not lewd or profane. Whether the scandal and immorality comes from mode or instead of viewpoint. To cut the statute off where the Government urges is not to interpret the statute Congress enacted, but to fashion a new one."

Dissenting, Chief Justice John G. Roberts Jr. said that while the "immoral" portion of the statute violates the First Amendment, the "scandalous" portion is susceptible of a narrowing construction. Justice Stephen G. Breyer also wrote in favor of bifurcating the "immoral" language from the "scandalous" portion, noting that a ban on registration of vulgar or obscene marks would not prohibit unregistered use of those marks.

Justice Sonia Sotomayor also agreed with the majority's reasoning on the "immoral" portion of the statute, but she said that striking down the "scandalous" portion will mean that "the Government will have no statutory basis to refuse (and thus no choice but to begin) registering marks containing the most vulgar, profane, or obscene words and images imaginable." Justice Breyer joined in Justice Sotomayor's dissent.

Following the Supreme Court's ruling, trademark owners are free to register trademarks that consist of or comprise immoral or scandalous matter (if such marks are otherwise registrable). The eagerness of brand owners to do so remains to be seen.

RESEARCH PATH: *Intellectual Property & Technology > Trademarks > Trademark Registration > Articles*

THIRD CIRCUIT UPHOLDS NATIONWIDE INJUNCTION AGAINST ACA CONTRACEPTION REGULATIONS

THE U.S. COURT OF APPEALS FOR THE THIRD CIRCUIT HAS upheld a preliminary nationwide injunction against enforcement of proposed regulations that would expand the category of employers who can refuse to offer contraceptive coverage to employees on religious or moral grounds (Commonwealth of Pennsylvania v. President United States of America, 2019 U.S. App. LEXIS 20778 (3rd Cir. 2019).

A three-judge panel affirmed an order by U.S. Judge Wendy Beetlestone of the Eastern District of Pennsylvania blocking enforcement of two regulations that would have taken effect on Jan. 14, 2019. Religious Exemptions and Accommodations for Coverage of Certain Preventive Services Under the Affordable Care Act, 83 Fed. Reg. 57,536 (Nov. 15, 2018) and Moral Exemptions and Accommodations for Coverage of Certain Preventive Services Under the Affordable Care Act, 83 Fed. Reg. 57,592 (Nov. 15, 2018). While religious organizations were already exempted from the obligation to provide coverage, the new regulations would apply to non-religious employers, including publicly traded companies.

The regulations, issued by the U.S. Departments of Health and Human Services (HHS), Labor and the Treasury, and finalized in November 2018, stem from an executive order issued in May 2017 by President Donald J. Trump directing federal agencies to consider issuing amended regulations to address "conscience-based objections" to a provision in the Patient Protection and Affordable Care Act (ACA) (Pub. L. No. 111-148, 124 Stat. 119 (Mar. 23, 2010)) requiring employers to provide no-cost birth control coverage to employees. "Promoting Free Speech and Religious Liberty," Exec. Order No. 13798, 82 Fed. Reg. 21,675 (May 4, 2017).

The Commonwealth of Pennsylvania and the State of New Jersey challenged the rules and moved for preliminary injunctive relief.

Granting the motion, Judge Beetlestone said that the regulations exceed the scope of the authority granted to the three agencies under the ACA and are not authorized by the Religious Freedom Restoration Act (RFRA) (42 U.S.C.S. § 2000bb). Further, she said, Pennsylvania and New Jersey have demonstrated the sufficient requisite likelihood of irreparable harm in the absence of injunctive relief to justify issuance of an injunction.

Affirming, the Third Circuit panel held that the two states are likely to succeed in proving that the agencies did not follow the Administrative Procedure Act's notice and comment requirements in promulgating the regulations. Further, the panel said, the regulations are not authorized by the ACA or the RFRA.

Finally, the appeals court said, the states have shown that a nationwide injunction, rather than an order limited to the states within the Third Circuit, is necessary to provide relief.

In a similar proceeding, the U.S. Court of Appeals for the Ninth Circuit heard arguments on June 6 in an appeal from a January 2019 ruling by a federal judge in Oakland, California, enjoining enforcement of the same regulations in 13 plaintiff states (California, Connecticut, Delaware, Hawaii, Illinois, Maryland, Minnesota, New York, North Carolina, Rhode Island, Vermont, Virginia, and Washington) and the District of Columbia. Prior to the hearing, the appeals court ordered supplemental briefing by the parties on the impact of the Pennsylvania court's ruling. California v. United States HHS, 2019 U.S. App. LEXIS 12917 (9th Cir. April 29, 2019).

Both cases are likely to be appealed to the U.S. Supreme Court, regardless of the outcome in the Ninth Circuit.

RESEARCH PATH: *Labor & Employment > Employment Policies > Safety and Health > Articles*

Current Awareness

State Legislatures Moving to Expand Consumers' Control over Personal Information

FOLLOWING THE EXAMPLE SET BY THE CALIFORNIA legislature, which enacted a sweeping data privacy statute in June 2018, state legislatures have begun to enact, or at least propose, similar laws to give consumers greater control over their personal information. As states continue to put privacy statutes on the books, the result is likely to be a patchwork of standards for businesses and other entities to follow.

Background

The California Consumer Privacy Act (CCPA) was signed into law a week after its introduction and just hours after its unanimous approval by the State Assembly and Senate. The wide-ranging law gives consumers greater control over how businesses can use their personal information. Under the new law, which takes effect on January 1, 2020, consumers will have the right to request that businesses disclose how their personal information is used and to ask that personal information be deleted under some circumstances.

Approximately a dozen amendments are making their way through the legislature in advance of the statute's January 1 effectiveness date.

Nevada

In neighboring Nevada, the legislature has passed a bill amending the state's existing online privacy law to require entities that operate websites to establish a designated address for consumers to submit requests to opt out of the sale of personal information. The Nevada statute is narrower than the California law, limiting the definition of "sale" to the "exchange of covered information for monetary consideration by the operator to a person for the person to license and sell the covered information to additional persons." The term "operator" is defined as a person who "(a) Owns or operates an Internet website or online service for commercial purposes; (b) Collects and maintains covered information from consumers who reside in this State and use or visit the Internet website or online service; and (c) Purposefully directs its activities toward this State, consummates some transaction with this State or a resident thereof or purposely avails itself of the privilege of conducting activities in this State, or otherwise engages in any activity that constitutes sufficient nexus with this State to satisfy the requirements of the United States Constitution."

The statute, SB 220, was signed into law by Governor Stephen F. Sisolak on May 29 and takes effect on October 1. It does not create a private cause of action; its enforcement lies with the state Attorney General.

New York

In New York, a bill proposed by State Senator Kevin Thomas would amend the general business law to add a new article entitled New York Privacy Act. The bill contains many of the same provisions as the California law, but also imposes on companies the role of "data fiduciary," providing as follows: "Personal data of consumers shall not be used, processed or transferred to a third party, unless the consumer provides express and documented consent. Every legal entity, or any affiliate of such entity, and every controller and data broker, which collects, sells or licenses personal information of consumers, shall exercise the duty of care, loyalty and confidentiality expected of a fiduciary with respect to securing the personal data of a consumer against a privacy risk; and shall act in the best interests of the consumer, without regard to the interests of the entity, controller or data broker, in a manner expected by a reasonable consumer under the circumstances."

The New York bill provides a private right of action for injunctive relief and monetary damages by "any person who has been injured by reason of a violation of this article."

The bill, S5642, has been referred to committee.

Task Force Creation in Texas, Connecticut

In Texas, the Texas Consumer Privacy Act, HB 4518, which contained many of the provisions in the CCPA, failed to pass the state House of Representatives before the end of the legislative session. However, a second bill, HB 4390, which amends the Texas Identity Theft Enforcement and Provision Act by strengthening notification requirements in the event of a data privacy breach, creates the 15-member Texas Privacy Protection Advisory Council to propose data privacy legislation by September 2020. The bill was signed by Governor Gregory Abbott on June 14.

Similarly, in Connecticut, SB 1108, a bill modeled on the CCPA, was referred to committee, then amended to create a consumer privacy task force. The bill was signed by Governor Ned Lamont on July 9, 2019.

Legislators in a number of other states have introduced data privacy bills similar to the CCPA, many of them currently pending before relevant committees. Among the states with pending bills are Pennsylvania (HB 1049); Massachusetts (SB 120); Rhode Island (HB 5930); and Maryland (SB 613). Other states are expected to follow suit as consumers continue to demand greater control over their personal data, especially in the absence of federal legislation addressing the issue.

Ohio Incentivizes Protection Practices

The Ohio Data Protection Act (ODPA) provides legal safe harbor against data breach claims and incentivizes the adoption of strong cybersecurity practices rather than punishing entities for failure to adhere to specific regulations. This safe harbor is provided to entities that create, maintain and comply with a cybersecurity program conforming to an industry-recognized cybersecurity framework recognized by the ODPA. Ohio Rev. Code Ann. § 1354.02.

Initial Guidance

As more states enact laws that significantly expand consumer privacy rights, counsel should be aware of the potential impact on companies located or doing business in any of these states, including:

- The disproportionate burden and cost of compliance for small and midsized companies
- The technical challenges of reconfiguring a company's system to process consumer requests for disclosure, delivery, and deletion of their personal information
- Incurring significantly higher litigation costs in states that allow for a private right of action by consumers
- Statutory requirements on companies to implement new workplace policies and provide internal training to employees -and-
- Anti-discrimination protections for consumers who exercise their rights under these laws

These laws are subject to further legislative amendments, agency regulations, and court challenges as both consumer and industry groups seek clarification of and consider further changes. As a result, companies need to anticipate making material revisions to their relevant compliance programs to adjust as these laws evolve.

RESEARCH PATH: *Data Security & Privacy > Privacy Policies > Articles*

Related Content

> **CALIFORNIA CONSUMER PRIVACY ACT (CCPA) RESOURCE KIT**

RESEARCH PATH: *Data Security & Privacy > State Law Surveys and Guidance > California Consumer Privacy Act (CCPA) > Practice Notes*

> **CALIFORNIA CONSUMER PRIVACY ACT (CCPA) OVERVIEW**

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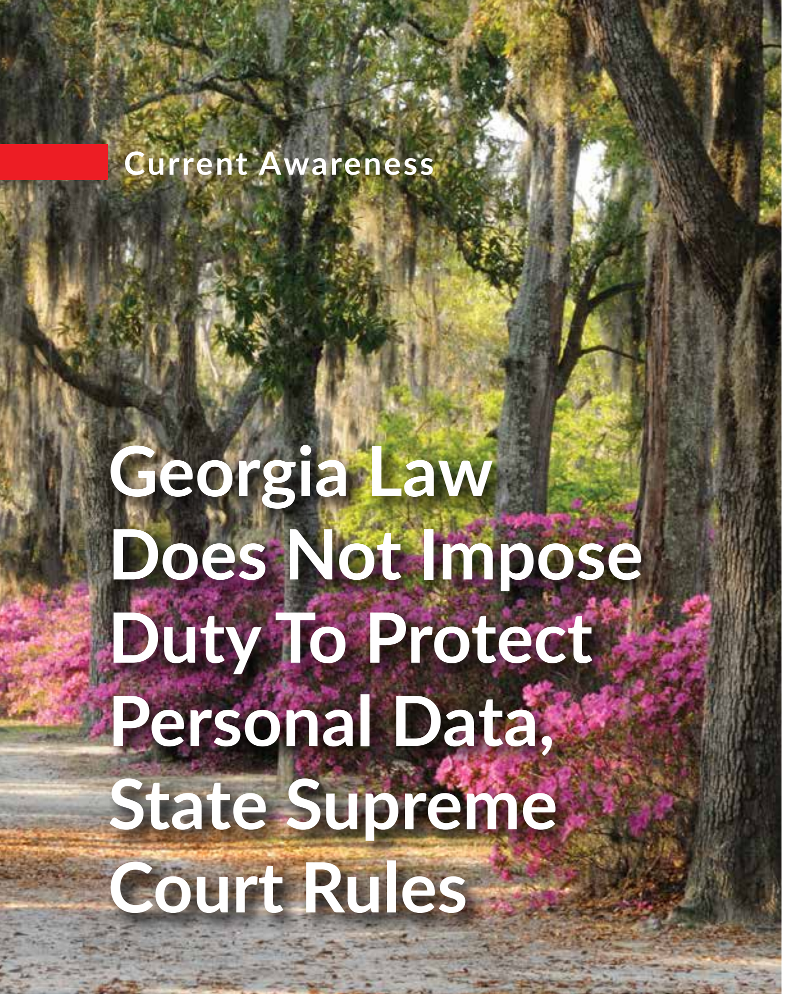
> **CCPA COMPLIANCE: COMPARING KEY PROVISIONS OF THE GDPR AND CCPA**

RESEARCH PATH: *Data Security & Privacy > State Law Surveys and Guidance > California Consumer Privacy Act (CCPA) > Practice Notes*

> **OHIO DATA PROTECTION ACT (ODPA) COMPLIANCE**

RESEARCH PATH: *Data Security & Privacy > Data Breaches > Planning > Practice Notes*



Georgia Law Does Not Impose Duty To Protect Personal Data, State Supreme Court Rules

GEORGIA LAW DOES NOT IMPOSE AN AFFIRMATIVE DUTY on the state government and its employees to safeguard the personal information of residents, the Supreme Court of Georgia has ruled. Dep't of Labor v. McConnell, 2019 Ga. LEXIS 336 (Ga. Sup. May 20, 2019).

The court affirmed the dismissal of negligence claims asserted against the Georgia Department of Labor by Thomas McConnell, a Georgia resident whose personal information was made public, along with that of 4,757 other applicants for government services, when a Labor Department employee inadvertently forwarded a spreadsheet containing the information to approximately 1,000 recipients.

McConnell filed suit on his own behalf and that of a proposed class of individuals whose information—name, Social Security number, home telephone number, and email address—was included on the spreadsheet, asserting causes of action for negligence, breach of fiduciary duty, and invasion of privacy. The plaintiffs alleged that, as a result of the disclosure, they were required to freeze accounts, alert credit reporting agencies, and monitor their credit reports and accounts, causing them to incur expenses. In addition, they alleged that the disclosure caused them to experience emotional distress.

The state moved for dismissal; the trial court granted the motion, finding the suit barred by sovereign immunity and holding that the complaint failed to state a viable claim.

The Court of Appeals of Georgia affirmed, finding that the complaint failed to state a claim, but not addressing the sovereign immunity issue. McConnell successfully petitioned for review by the Supreme Court, which found that the appeals court erred in failing to consider the sovereign immunity issue and remanded to the appeals court.

On appeal, the Court of Appeals reversed the trial court on the sovereign immunity issue, but again affirmed on the failure to state a claim issue. The parties successfully filed cross-petitions for review.

Affirming, the Supreme Court found first that McConnell's suit is not barred by sovereign immunity, citing broad language in the Georgia Torts Claims Act, O.C.G.A. § 50-21-20 et seq., waiving immunity in all tort actions except for those specifically enumerated and including within the definition of loss "any other element of actual damages recoverable in actions for negligence."

However, the Supreme Court said, the statute imposes no duty on the state to protect the personal information of applicants and, therefore, McConnell cannot maintain causes of action for negligence, breach of fiduciary duty, or invasion of privacy.

"The complaint alleged only a negligent disclosure, not an intentional one," the court said. Even assuming that the Georgia Personal Identity Protect Act, O.C.G.A. § 10-1-393.8(a)(1), creates a duty enforceable in tort to refrain from intentionally disclosing social security numbers, the court said, "McConnell has not shown that the Department owed him or the other proposed class members a duty to protect their information against negligent disclosure."

Nor has McConnell shown that the Trustee Clause of the Georgia Constitution imposes a fiduciary duty on public employees to protect citizens' private information, the court said, finding that the Trustee Clause is triggered only when a public officer benefits financially as a result of discharging his duties.

Finally, the court said, McConnell has failed to show that the disclosure caused him and the proposed class members embarrassment as required by Georgia law. "The complaint alleged that the matter disclosed only the name, social security number, home telephone number, email address and age of individuals who had sought services or benefits from the Department," the court said. "This kind of information does not normally affect a person's reputation, which is the interest the tort of public disclosure of embarrassing private facts was meant to remedy."

RESEARCH PATH: *Data Security & Privacy > Industry Compliance > Public Sector > Articles*

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Minimizing Your Company's Exposure to a **Ransomware Attack**

This article provides companies with key issues to consider before, during, and after a ransomware attack. Recently, there have been a number of ransomware attacks against our clients. Ransomware typically encrypts one or more IT systems, causing them to become inoperable unless a company pays a ransom (usually in Bitcoin or another cryptocurrency). In many instances, ransomware effectively shuts down all or a substantial portion of a company's business. Because of the potential harm, companies should prepare for this type of attack as they would for any other potential disaster.

THIS ARTICLE IS DESIGNED TO PROVIDE COMPANIES (and their financial sponsors, if applicable) with key issues to consider before, during, and after a ransomware attack.

Before a Ransomware Attack

Insurance

Companies should consider obtaining cyber liability insurance, which can cover the cost of responding to a ransomware attack (e.g., counsel, forensic IT firms) and remediating the IT environment, as well as fees or liability from lawsuits or claims resulting from an attack. Companies should also consider whether existing insurance policies (e.g., property or business interruption policies) cover cybersecurity incidents.

Incident Response Policy

Ransomware attacks often create a significant crisis for a company, which can face pressure from customers, business partners, investors, and employees to resume business operations as soon as possible. Establishing an incident response policy ahead of time can help companies respond to such attacks in a more expeditious and orderly manner, which can help minimize potential business disruption and damages from a ransomware attack. An incident response policy should consider:

- **The minimal IT infrastructure required to run the business.** For example, a company might be able to take orders on paper but might not be able to function without certain systems.
- **How company personnel can communicate if email is unavailable.** Consider establishing an emergency phone tree or other alternative forms of communication.
- **The role and selection of potential external "first responders."** Consider including legal counsel, a forensic IT specialist, a crisis communications firm, a company's insurance carrier, and a consultant that can acquire cryptocurrency and arrange to make a ransom payment if necessary.

Backups

Companies should consider making regular backups of their IT systems, key assets, and critical configurations. Once backups are made, they should be stored in a location that is not accessible from the company's operating or production environment. Taking these actions might enable a company to avoid or minimize potential damage from a ransomware attack.

Emotet and Trickbot

Malware is constantly evolving, but two types that have been used in a number of recent ransomware attacks are called Emotet and Trickbot. The attacks often begin one to three weeks before systems become encrypted, so corporate IT teams should consider periodically checking for indications of whether these types of malware are operating on a company's systems. If such activity is detected, even if quarantined by anti-virus or anti-malware software, then a potential ransomware attack could be forthcoming. Contact your legal counsel and a forensic IT specialist for more information about addressing these types of malware.

During a Ransomware Attack

Whether to Pay the Ransom

Several factors should be considered in determining whether to pay the ransom demand. Although law enforcement discourages victim companies from paying a ransom, some companies have paid the ransom when the affected systems are not backed up or cannot be restored from backups, or when a company cannot afford the disruption from restoring or rebuilding its IT environment. Some studies indicate that in 50 to 70 percent of ransomware cases, companies pay the ransom. Even then, the decryption key is not guaranteed to work.

Before making a payment, companies need to consider whether doing so would violate U.S. law prohibiting payments to individuals or entities that are subject to U.S. economic sanctions or that are designated as terrorist organizations. While the odds of conclusively determining an attacker's identity are low, companies and their counsel should nevertheless seek to conduct due diligence on the attacker's identity (usually based on the attacker's Bitcoin wallet) to determine whether such a payment would violate U.S. law.

Forensic IT Specialist

A forensic IT specialist can assist with investigating the ransomware attack, including determining the root cause and advising on potential remediation options. Determining the root cause is important to properly eradicate the ransomware and prevent reinfection. To facilitate a rapid response, companies should consider establishing a relationship with a forensic IT specialist in advance of a cybersecurity incident.

> Many forms of ransomware embed themselves deep in a company's systems in order to launch future attacks. Even after paying a ransom and applying a decryption key, or after restoring the systems from backups, companies should consider monitoring their systems and network for potential reinfection attempts...

Counsel

In addition to the issues described above, counsel can advise on potential legal issues arising from a ransomware attack, including whether public disclosures or notifications to investors, individuals, customers, business partners, lenders, and regulators are required. Securities and Exchange Commission guidance requires disclosure of material cybersecurity risks and incidents, and while the monetary impact is certainly not the only factor in determining materiality, it can be an important factor in disclosures related to ransomware attacks. In 2017 alone, Merck, FedEx, and Maersk disclosed estimated losses from ransomware attacks totaling $310 million, $300 million, and $200 million to $300 million, respectively.

Crisis Communications

If public disclosure is required per the above guidance, or to the extent that the issue is otherwise leaked, it can be helpful to engage crisis communications experts that can assist in mitigating any potential reputational effects as well as enhance the company's legal strategy.

Insurance

Companies that are victims of a ransomware attack should notify their cyber liability carriers, which can provide options for legal counsel, forensic IT specialists, and other consultants that can assist in responding to a data breach. Failure to follow procedures in the policy can preclude coverage for certain expenses, such as fees for legal counsel or forensic IT specialists.

After a Ransomware Attack

Monitoring

Many forms of ransomware embed themselves deep in a company's systems in order to launch future attacks. Even after paying a ransom and applying a decryption key, or after restoring the systems from backups, companies should consider monitoring their systems and network for potential reinfection attempts by the ransomware.

Review IT Security

To help prevent future attacks, companies should consider reviewing their IT security environment for other potential active threats, while also reviewing their security controls for potential enhancements. Many consultants can assist companies with performing an IT security assessment, which can include threat hunting and benchmarking a company's security practices against those of its peers.

Notifications

Legal counsel can advise on whether companies are required to notify employees, customers, investors, regulators, or others of the ransomware attack. Even if such notification is not legally required, companies should consider whether notification is nevertheless appropriate as a business matter.

Related Content

For an explanation of the steps to take to minimize the risk of and reduce the harm from a ransomware attack, see

> RANSOMWARE PLANNING AND RESPONSE BEST PRACTICES

RESEARCH PATH: *Data Security & Privacy > Data Breaches > Response > Practice Notes*

For guidance on what should be included in plans for avoidance of and responding to a data breach, see

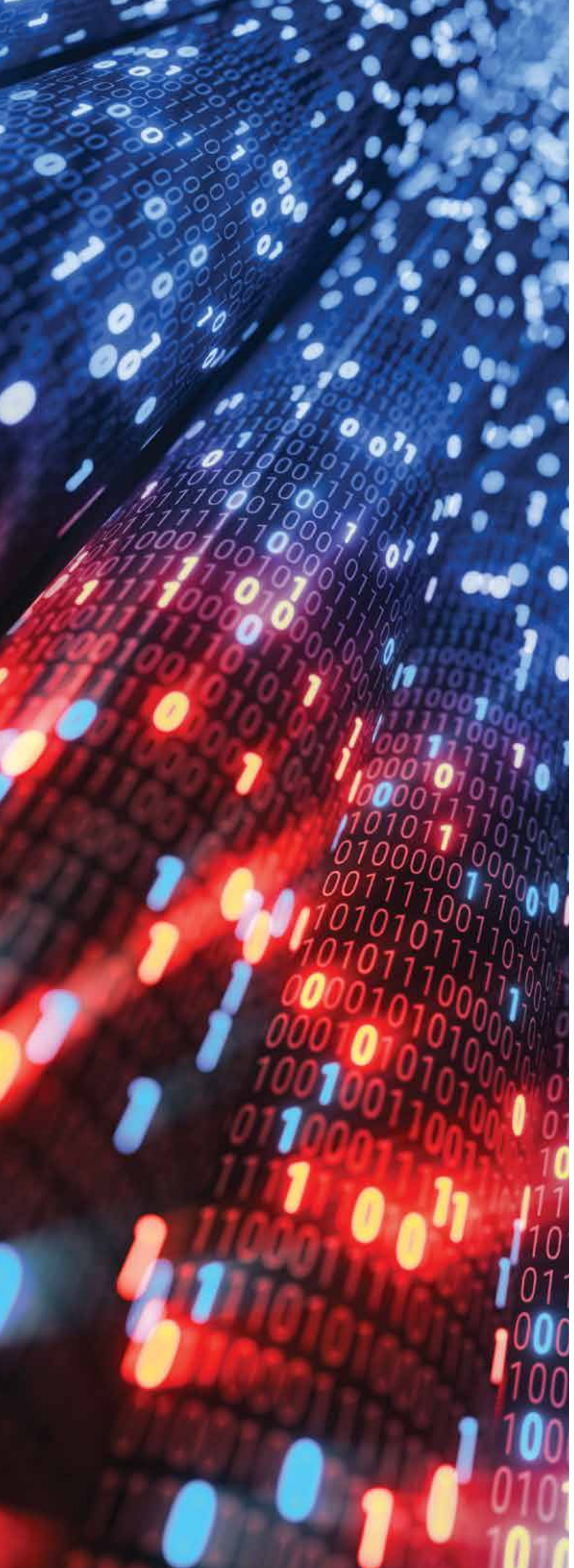
> DATA BREACH AVOIDANCE AND RESPONSE PLAN CHECKLIST

RESEARCH PATH: *Data Security & Privacy > Data Breaches > Response > Checklists*

For more information on how organizations should both plan for and manage a data breach, including best practices, see

> DATA BREACH PLANNING AND MANAGEMENT

RESEARCH PATH: *Data Security & Privacy > Data Breaches > Response > Practice Notes*



Litigation and Enforcement

Companies that are victims of ransomware attacks typically have not been the subject of follow-on civil litigation or government enforcement actions. However, in 2018, a class action complaint was filed against Allscripts following a ransomware attack that crippled its operations for about a week. While that case is still pending, it is likely that, with ransomware attacks becoming more common, shareholders and other stakeholders will demand greater protection from companies if and when an incident occurs. As such, we anticipate that litigation and enforcement actions related to ransomware are likely to rise in the coming months and years. L

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RESEARCH PATH: Data Security & Privacy > Data Breaches > Response > Articles

Timothy Murray MURRAY HOGUE AND LANNIS

Drafting Enforceable Arbitration Agreements: **Hottest Issue in Contract Law**

Arbitration agreements are supposed to ensure that disputes are resolved outside of court, and that's why it's an irony of almost cosmic proportions that "the enforceability of arbitration agreements is likely 'the single most litigated contractual issue' today . . . ."[1]

WHAT EXACTLY ARE WE DOING WRONG WHEN WE DRAFT clauses that are supposed to keep disputes out of court—but that don't keep disputes out of court? It happens with alarming frequency.

The enforceability of arbitration agreements is a white-hot topic in a milieu that is notoriously staid (dull may be a more accurate description) and where change usually comes at a glacial pace. Court battles over whether arbitration provisions are enforceable are so prevalent that, not long ago, we did something we do neither lightly nor often: we added a new—and hefty—chapter to the iconic *Corbin on Contracts* treatise. It's called, "Agreements to Arbitrate Challenged Due to the Absence of Mutual Assent."[2]

Commercial practitioners need to be aware of the seismic activity in this area of the law—it's important to advising clients, drafting, and litigating. This short article will highlight some of the most contentious issues that affect the enforceability of arbitration provisions.[3]

Lamps Plus v. Varela

A barometer of the turbulence in this area of the law is the U.S. Supreme Court's decision in *Lamps Plus v. Varela*,[4] where the court sharply divided over the construction of an arbitration provision. *Lamps Plus* was a battle over class arbitration, which seems to be ground zero for much of the opposition to arbitration.[5]

Frank Varela filed a putative class action against his employer, Lamps Plus, after a fraudulent federal income tax return was filed in his name—a hacker impersonating a Lamps Plus official had tricked another Lamps Plus employee into disclosing Varela's and other employees' tax information. Lamps Plus moved to compel arbitration on an individual, as opposed to a classwide, basis pursuant to an arbitration agreement that Varela signed at the time he started working for Lamps Plus. That agreement provided that "arbitration shall be in lieu of any and all lawsuits or other civil legal proceedings relating to my employment." The district court granted the motion to compel arbitration, but it authorized arbitration on a classwide basis. The U.S. Court of Appeals for the Ninth Circuit affirmed, holding that the arbitration agreement was ambiguous on the question of individualized versus class arbitration, so it applied the canon of construction *contra proferentem* and construed it against the drafter, Lamps Plus, to allow class arbitration. *Contra proferentem* provides that where two reasonable meanings are possible, "the court will often adopt the meaning that is less favorable in its legal effect to the party who chose the words."[6]

The Supreme Court reversed. Chief Justice John Roberts, writing for the majority, held that under the Federal Arbitration Act (FAA), arbitration is a matter of consent, and an arbitration agreement that is ambiguous as to whether it allows class arbitration does not provide the necessary "contractual basis" to compel class arbitration. Justice Roberts explained that class arbitration is markedly different from the traditional, individualized arbitration contemplated by the FAA and that class arbitration undermines the most important benefits of individual arbitration. In short, a court will not allow class arbitration unless the parties expressly agree to it.

Critical to the Supreme Court's holding was its refusal to apply *contra proferentem* to construe the ambiguous agreement against Lamps Plus. Chief Justice Roberts cited *Corbin on Contracts* to explain that *contra proferentem* is only triggered when a court cannot discern the parties' intentions. Since the FAA requires that arbitration be premised on the parties' consent, a court will not *infer* consent by applying *contra proferentem*—a canon that has nothing to do with consent—to an ambiguous provision.

The majority opinion was met with vociferous opposition. In her colorful dissent, Justice Ruth Bader Ginsburg wrote: "Piling Pelion on Ossa, the Court has hobbled the capacity of employees and consumers to band together in a judicial or arbitral forum." Justice Sonia Sotomayor's dissent took issue with the majority's insistence that class-action arbitration was not envisioned by the FAA. Justice Elena Kagan wrote that *contra proferentem* should be applied in any contractual setting where it might apply as a matter of pure contract law, including this one. She wrote: "Nothing in the FAA shields a contracting party, operating against the backdrop of impartial state law, from the consequences of its own drafting decisions."

At the oral argument of the case, Justice Ginsburg pointed out that the entire dispute could have been avoided if the contract had clearly stated that class action arbitration was prohibited: "So, here, . . . the concern is lawyers that are less than the best and didn't put in a class action waiver . . . ."[7]

1. Richard Frankel, *The Arbitration Clause as Super Contract*, 91 Wash. U. L. Rev. 531, 551 (2014). 2. 15 Corbin on Contracts § 83.5A. 3. Proposed bills of one kind or other have been floating around Congress for years designed to ensure that disputes involving employees and consumers are resolved in courts instead of arbitration. *E.g.*, the Forced Arbitration Injustice Repeal Act, 116 S. 610, introduced February 28, 2019, and the Restoring Justice for Workers Act, 116 S. 1491, introduced May 15, 2019. Given the current political divide in Washington, D.C., it is unlikely that any such bill will become law in the near future. 4. 139 S. Ct. 1407, 203 L. Ed. 2d 636 (2019). 5. "Perhaps the true motivation for resisting arbitration lies [in] the arbitration clause's accompanying class action waiver." Nicosia v. Amazon.com, Inc., 2019 U.S. Dist. LEXIS 100162, *21 (E.D.N.Y. June 14, 2019). 6. Margaret Kniffin, 5 Corbin on Contracts § 24.27. 7. U.S. Supreme Court Tr. of Oral Arg. 34 (Oct. 29, 2018).

Justice Ginsburg was exaggerating, of course—"the best lawyers" don't always get it right, and, as it turned out, the absence of an explicit waiver of class arbitration did not prove fatal to Lamps Plus here. But Justice Ginsburg was right that an explicit waiver likely would have avoided the entire dispute. For that matter, an express provision allowing class arbitration would have avoided it, too. The best way to win a lawsuit over contract interpretation is to avoid it altogether by drafting with clarity. No judge has ever complained that a contract is too clear for him or her.

The lesson of *Lamps Plus* is that class arbitration will not be ordered without an express contractual provision allowing it. But since arbitration agreements are invariably drafted by the employer or the business selling a product or service, such a provision is unlikely.

Arbitration Agreements In-The-Box

Sellers of services and mass-produced products often want to bind consumers to an arbitration provision that the consumer either does not receive or does not see until after the sales transaction is completed. A common example of this phenomenon is when the buyer purchases a smart phone or other electronic device and the manufacturer has inserted an arbitration provision in the documentation found in-the-box that the phone comes in—which the consumer doesn't see, if at all, until after he or she gets home.

In these money now, terms later scenarios, the U.S. Court of Appeals for the Seventh Circuit's solution is the prevailing one—though it has generated controversy because it jumbles the traditional chronology of contract formation: previously undisclosed terms that the consumer receives or sees only after the sales transaction are enforceable against the buyer if the buyer is afforded the opportunity to reject the terms and return the product for a refund within the time set forth in the terms.[8] The Seventh Circuit's pro-business rule ratifies the way business actually is conducted.

But lately, some courts are saying that the Seventh Circuit's rule doesn't do enough to provide consumers notice of important contract terms that will be binding on them—such as arbitration provisions. Without sufficient notice, there is no mutual assent, and the arbitration provision is unenforceable. The underlying rationale for these decisions is that neither the box for the smart phone nor the documentation inside-the-box *look* like contracts, so there is no duty to read them, and that's why, for arbitration and other contract terms found in-the-box, the terms are enforceable only if the consumer is on inquiry notice of the contract terms.[9] The leading case is *Norcia v. Samsung Telcoms. Am., LLC.*[10] I wrote the following in *Corbin on Contracts*:

> Inquiry notice is the sine qua non of assent under *Norcia* and its progeny. In order to bind a party to an arbitration provision, it is not necessary for the party to see the entirety of the terms at the time of contract formation so long as (1) he or she knows at the time of contract formation that important terms imposing obligations on him or her will apply, (2) the terms are subsequently made available to the party, and (3) he or she has the ability to opt out after a reasonable opportunity to review the terms.[11]

Thus, the exterior of the box containing the product needs to conspicuously alert the buyer that there are important legal terms contained in-the-box that will be binding on the buyer (and it can't just indicate that warranty provisions are contained in the box since warranty provisions generally confer rights on the buyer and don't impose obligations). The document inside the box containing the arbitration and other important contract terms must conspicuously notify the consumer that important terms are contained inside.[12]

For transactions where a buyer does not sign off on a document that looks like a contract, the seller must make sure—by providing conspicuous notice—that the buyer knows that he or she will be bound by contract terms. The trend in the law is to place a greater emphasis on the necessity of inquiry notice of arbitration and other provisions.

Internet Arbitration Agreements: The Hottest of the Hot Contract Law Issues

Website owners often want contract terms to govern the use of their sites. These terms are typically set forth on a separate webpage and are accessed by the user via a hyperlink. Almost all of the disputes in this area are over hyperlinked arbitration provisions. A common scenario is for a consumer who purchased goods or services online to file a putative class action for some claim or other, and the website owner then moves to compel arbitration

8. Hill v. Gateway 2000, 105 F.3d 1147 (7th Cir. 1997). 9. Norcia v. Samsung Telcoms. Am., LLC., 845 F.3d 1279 (9th Cir. 2017). 10. *Id.*. 11. John E. Murray & Timothy Murray, Corbin on Contracts §83.5A (Supp. 2018). 12. Aside from *Norcia*, *supra*, *see* Noble v. Samsung Elecs. Am., Inc., 682 Fed. Appx. 113 (3d Cir. 2017); Robinson v. OnStar, LLC, 721 Fed. Appx. 704 (9th Cir. 2018).

Since there is no duty to read a website, the website owner can create a duty to read hyperlinked contract terms if the design and content of the site puts the user on inquiry notice of the terms.

based on the hyperlinked arbitration provision. There is a staggering amount of litigation over the enforceability of arbitration provisions contained in contract terms that are hyperlinked on websites.

But off on the horizon, a storm is brewing about whether traditional contract law should be fundamentally overhauled to deal with these sorts of contractual terms, and commercial practitioners need to be aware of it. But first, it's necessary to briefly review the legal landscape of internet contracts.

Internet Contracts in a Nutshell

There is a duty to read things that look like contracts—one can't sign or accept the benefits of a document that looks like a contract and later claim that its terms aren't binding because he or she didn't read it.[13] But a "web page does not look like a contract,"[14] so there is no inherent duty to read it—and that includes the terms hyperlinked to it. A party "is not bound by inconspicuous contractual provisions of which he was unaware, contained in a document whose contractual nature is not obvious."[15] The duty to read rule is critical here—if there were a duty to read a website, we would not be talking about any of this.

Since there is no duty to read a website, the website owner can create a duty to read hyperlinked contract terms if the design and content of the site puts the user on inquiry notice of the terms.[16] This is done by (1) making the hyperlink so conspicuous (in terms of size, color, and proximity) that a reasonable person would have seen it,[17] and (2) including conspicuous language making clear to a reasonable internet user that the hyperlinked terms will contractually bind the user if he or she proceeds to use the website to order the goods or services.[18]

The Gathering Storm: Contract Law Traditionalists Versus Reformers

Against that backdrop, there is the brouhaha that's been forming just over the horizon for years—about whether contract law in this area needs to be fundamentally overhauled. It pits contract law traditionalists versus reformers.

The Traditionalists. The traditionalists insist that internet contracts do not change the fundamental rules of contract law, which means that there must be mutual assent to make arbitration provisions enforceable. If there is no duty to read, the website owner must put users on inquiry notice of the terms as discussed above. This is the prevailing view in the United States, grounded in long-settled contract law and expressed in case after case—rarely with as much zeal in as Judge Ronald B. Leighton's opinion in *Wilson v. Huuuge, Inc.*[19] In *Huuuge*, plaintiffs filed a class action to recover money lost playing defendant's electronic gambling games available via a mobile app. Defendant moved to compel arbitration pursuant to the arbitration provision hyperlinked to the app page in the defendant's "Terms of Use." The court held that the hyperlink was inconspicuous and did not put a user on inquiry notice.

Judge Leighton rejected the defendant's argument that the court "apply a blanket presumption that users these days just assume that every app they download is riddled with binding terms and provisions, many of which remove or limit important rights, and it is their duty to ferret out these terms wherever they may be." In the opinion's *coup de grace*, Judge Leighton wrote:

> While online users today are savvier than in the past, this does not mean that the rules of contract law no longer apply. If an app developer wishes to bind a user to their copious terms, the onus is on the developer to at least provide reasonable notice and easy access. This is not a difficult thing to do when designing an app…. The fact is, [defendant] chose to make its Terms non-invasive so that users could charge ahead to play their game. Now, they must live with the consequences of that decision.

The Reformers. Pitted against the traditionalists are the reformers, who reject the notion that long-settled rules of contract law still work when it comes to internet contracts—they advocate a fundamental overhaul of contract law. This view has been expressed in various ways in the law reviews for a long time, but judges have almost uniformly ignored it. In *Nicosia v. Amazon.com, Inc.*,[20] however, a senior federal judge named I. Leo Glasser has written a bombshell

13. Murray v. Cunard S.S. Co., 139 N.E. 226, 228 (N.Y. 1923). 14. John E. Murray & Timothy Murray, Corbin on Contracts § 83.5A (Supp. 2018). 15. Windsor Mills, Inc. v. Collins & Aikman Corp., 25 Cal. App. 3d 987, 993 (1972). *See also* Starke v. Squaretrade, Inc., 913 F.3d 279 (2d Cir. 2019). 16. John E. Murray & Timothy Murray, Corbin on Contracts § 83.5A (Supp. 2018). 17. The caselaw is replete with disputes over whether the terms were sufficiently conspicuous. "If a hyperlink is contained in inconspicuous font and is relegated to a portion of the webpage that the user would not reasonably look to, courts will find the hyperlinked terms unenforceable." *Id. See, e.g.*, Rushing v. Viacom Inc., 2018 U.S. Dist. LEXIS 176988 (N.D. Cal. Oct. 15, 2018); Benson v. Double Down Interactive, LLC, 2018 U.S. Dist. LEXIS 193492 (W.D. Wash. Nov. 13, 2018); Vitacost.com, Inc. v. Mccants, 210 So. 3d 761 (Fla. Dist. Ct. App. 4th Dist. 2017); Herman v. SeaWorld Parks & Entm't, Inc., 2016 U.S. Dist. LEXIS 181173 (M.D. Fla. Aug. 26, 2016). Other cases hold that hyperlinks contained on pages filled with all sorts of information may be inconspicuous because of clutter. *See, e.g.*, Cullinane v. Uber Techs, 893 F.3d 53, 64 (1st Cir. 2018) ("If everything on the screen is written with conspicuous features, then nothing is conspicuous."); Nicosia v. Amazon.com, Inc., 834 F.3d 220 (2d Cir. 2016). 18. Nguyen v. Barnes & Noble Inc., 763 F.3d 1171 (9th Cir. 2014); Motley v. ContextLogic, Inc., 2018 U.S. Dist. LEXIS 192447 (N.D. Cal. Nov. 9, 2018). 19. 351 F. Supp. 3d 1308 (W.D. Wash. 2018). As of the date this article was written, this case was on appeal to the Ninth Circuit. It is cited here because Judge Leighton's language is emblematic of the traditionalist view. 20. 2019 U.S. Dist. LEXIS 100162 (E.D.N.Y. June 14, 2019).

of a judicial opinion that ranks as the most progressive to date on internet contracts.

Judge Glasser was obligated to adhere to the traditionalist, prevailing view in deciding the actual dispute before him, but then he devotes a significant portion of his opinion to advocating a sea of change in the law of contracts. Judge Glasser suggests that the focus on ensuring that internet users have inquiry notice is misguided. Users are already aware that websites have terms and conditions—"it would be difficult to exist in our technological society without some generalized awareness of the fact." But "most consumers will not read the terms and conditions, no matter how prominently the notice is displayed, and those that do will usually not understand them." Further, "[a]mong those that both read and understand the terms of use, most will proceed with the transaction anyway, because the terms are presented on a take-it-or-leave-it basis. The 'reasonably conspicuous' notice rule is therefore one which is unlikely to have much effect, if any, on overall consumer welfare."

What all this means, Judge Glasser says, is that "unscrupulous merchants are able to insert any contractual term they wish into the" agreement, and that concern should be our focus—the substance and fairness of the terms, not mutual assent. What does Judge Glasser suggest? He says that the late Professor Karl Llewellyn, the chief architect of Article 2 of the Uniform Commercial Code, had the answer: "[T]he consumer offers his 'blanket assent to whatever terms the merchant deems appropriate, provided they are not 'unreasonable or indecent.'" Judge Glasser suggests that courts ought to scour internet terms and aggressively ferret out unconscionability to ensure that the terms are fair.

What Does the Future Hold? Given the foothold that the traditionalist view has on our jurisprudence, the law is unlikely to change in a significant way any time soon. But floods can start as a trickle, and Judge Glasser has sounded an alarm bell that can't be unrung. On the one hand, Judge Glasser's opinion gives voice to fears that have been percolating for years in the dim, dark recesses of the law reviews. His concerns ought to be confronted head-on in the discourse over hyperlinked arbitration provisions.

But on the other hand, Judge Glasser's opinion is troubling because it is terribly dismissive of the idea that internet users should be given notice (whether actual or inquiry) of the terms that will bind them—as if notice is scarcely worth the bother. But the absence of notice is anathema to the very notion of contract.

Beyond that, isn't the fear that "unscrupulous merchants are able to insert any contractual term they wish into the" internet agreement a tad overblown? Which terms, exactly, is Judge Glasser concerned about? And how is the doctrine of unconscionability not being employed properly to police them? The disputes in this area are rarely about weird or draconian clauses that unscrupulous merchants sneak into the boilerplate of hyperlinked terms. The disputes are almost always about arbitration provisions—and newsflash: courts love arbitration. One wise jurist wrote: "It is well-established that federal public policy strongly favors arbitration."[21] That jurist was I. Leo Glasser.

Further, courts already police clauses to ensure at least a measure of fairness. When a website describes a product being sold, that description is an express warranty, and courts will not enforce a disclaimer of that warranty hidden away in the legal underbrush of hyperlinked boilerplate.[22] Moreover, courts insist that buyers have a fair quantum of remedy for breaches,[23] and they do not enforce penalty provisions disguised as liquidated damages.[24]

Perhaps most fundamentally, aside from these protections that the law insists on, why should a website owner not have the right to insist on contract terms of its choosing? And shouldn't website users have the choice not to read the site's terms of use but to plow ahead and use the site anyway? Aren't these choices the price of freedom of contract, and isn't freedom of contract indispensable to a free society? We routinely bind people to all manner of non-internet contracts even though they choose not to read the terms—does this mean that all of contract law must be knocked over and rebuilt? I leave the answers to these questions to you—it's all beyond my pay grade.

Miscellaneous

There are many other issues related to the enforceability of arbitration provisions that can't be covered here due to limited space, but here are quick takes on three other important issues.

Scope: Broad Versus Narrow. When a party brings a claim related to a contract, he or she often tacks on extra-contractual claims along with a claim for breach of contract. But when parties to a contract agree to arbitration, generally they don't want some claims to be subject to arbitration and others to be resolved in court—that largely defeats the whole purpose of the arbitration provision. To help ensure that this doesn't happen, the arbitration agreement has to be broadly worded. Here's one of many, many examples. In *Garcia v. Kendall Lakes Auto., LLC*,[25] plaintiff purchased a vehicle from defendant, and the contract contained a provision providing for arbitration of claims "arising out of or relating to this [sales] Order or the parties['] relationship . . . whether statutory or otherwise . . . ." Plaintiff subsequently filed an action against the defendant alleging that the defendant violated the Telephone Consumer Protection Act (TCPA) because, he claimed, he did not consent to an unsolicited telephone message. Defendant moved to compel arbitration.

21. Bakon v. Rushmore Serv. Ctr., LLC, 2017 U.S. Dist. LEXIS 85038, *3 (E.D.N.Y. June 2, 2017). 22. *E.g.*, Dakota Style Foods, Inc. v. SunOpta Grains & Foods, Inc., 329 F. Supp. 3d 794 (D.S.D. 2018). 23. U.C.C. § 2-719 cmt. 1. *See also* In re: Yahoo! Inc. Customer Data Sec. Breach Litig., 313 F. Supp. 3d 1113 (N.D. Cal. 2018) (customers of web services provider pled an actionable claim that the provider's exclusion of consequential damages for data breaches was substantively unconscionable). 24. *E.g.*, Dobson Bay Club II DD, LLC v. La Sonrisa de Siena, LLC, 242 Ariz. 108 (2017). 25. 2019 U.S. Dist. LEXIS 50317 (S.D. Fla. Mar. 26, 2019).

Related Content

For practice tips to assist in drafting an arbitration clause, see

> ARBITRATION CLAUSE DRAFTING

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

For an overview of the laws applicable to arbitration in the United States, see

> ARBITRATION LAWS OVERVIEW

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

For a discussion on the advantages and disadvantages of arbitrating versus litigating disputes, see

> ARBITRATION ADVANTAGES AND DISADVANTAGES

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

For information on the issues to consider when deciding whether to litigate or arbitrate a dispute in the United States, see

> ARBITRATION VS. LITIGATION IN THE UNITED STATES (FEDERAL)

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

For an outline of the common issues and potential problems to consider when drafting a general arbitration clause for a commercial contract, see

> COMMON PROBLEMS WITH ARBITRATION CLAUSES CHECKLIST

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

The court granted the motion to compel and rejected plaintiff's argument that the arbitration provision did not encompass the TCPA claim. The provision contained the words "relating to," which are broad in scope and apply to claims having a significant relationship to the contract at issue. In contrast, the words "arising from" or "arising out of" are narrow and require a direct relationship to a contract's terms and provisions. Here, the language of the arbitration provision encompassed the consent issue of the statutory claim.

Delegation Provisions. The parties can delegate issues regarding the validity of arbitration (e.g., unconscionability, fraudulent inducement) to the arbitrator, but not the threshold question of whether an agreement exists in the first place.[26] An example is a clause that gave the "Arbitrator . . . exclusive authority to resolve any dispute relating to the [Agreement's] enforceability . . . including . . . any claim that all or any part of this Agreement is void or voidable."[27] Delegation provisions are useful to give arbitration agreements more teeth, but even with a delegation provision, the disputes discussed above about in-the-box and internet contracts would need to be resolved by a court.

Provisions Making Arbitration the Exclusive Dispute Resolution Method. It is critical that the agreement's language about submitting disputes to arbitration should be couched in mandatory, not permissive, terms. The agreement needs to make clear that there is no choice about whether to submit disputes to arbitration.[28]

Note that "when the parties have designated an organization to administer their arbitration, and have indicated that this is the exclusive or only 'forum' in which they wish their arbitration to take place, if that organization is unable to administer the arbitration, the arbitration agreement is considered void and unenforceable."[29] L

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

26. In re Uber Text Messaging, 2019 U.S. Dist. LEXIS 102007, *18 (N.D. Cal. June 18, 2019); King v. AxleHire, Inc., 2019 U.S. Dist. LEXIS 72861 (N.D. Cal. Apr. 30, 2019); Doctor's Assocs. v. Kirksey, 2018 U.S. Dist. LEXIS 197515 (D. Conn. Nov. 19, 2018); McFadden v. Van Chevrolet-Cadillac, LLC, 2018 U.S. Dist. LEXIS 130554 (W.D. Mo. Aug. 3, 2018). 27. Rent-A-Center, W., Inc. v. Jackson, 561 U.S. 63, 65, 130 S. Ct. 2772, 2774, 177 L. Ed. 2d 403, 408 (2010). 28. Tex. Health Res. v. Kruse, 2014 Tex. App. LEXIS 7567 (July 11, 2014). 29. Ridge Nat. Res., L.L.C. v. Double Eagle Royalty, L.P., 564 S.W.3d 105, 147 (Tex. App. 2018).

S.H. Spencer Compton FIRST AMERICAN TITLE INSURANCE COMPANY
and Diane Schottenstein SCHOTTENSTEIN LAW

Representing Foreign Buyers and Sellers in United States Real Estate Transactions

Today, many parts of the world are unsettled due to a variety of economic, political, and/or environmental issues. Such unrest can lead to rapid inflation, which can devalue local currencies. Some nations restrict the amount of local currency a citizen may take out of their country. Where does international money consistently find a safe home? Foreign investors have historically viewed U.S. real estate as an attractive and stable investment.

ACCORDING TO THE NATIONAL ASSOCIATION OF REALTORS (NAR), between April 2016 and March 2017 foreign buyers and recent immigrants purchased $153 billion in U.S. residential property. This represented about 284,455 homes, an increase from 214,885 homes in the previous 12-month period, or 5% of all existing residential home sales in that 12-month period.[1] Furthermore, international investors have purchased over $365 billion in U.S. commercial real estate since 2010, with the majority of capital flowing to the largest metropolitan regions. Manhattan alone represented nearly a fifth of all foreign investment in commercial real estate.[2] In fact, NAR reported that 18% of its surveyed commercial real estate brokers closed transactions with international clients.[3] Because so much U.S. real estate is bought and sold by foreign investors, it is ever more likely that you, as an attorney, will represent either a foreign purchaser or seller of U.S. real estate or a domestic client buying U.S. real estate from a foreign person. This article discusses issues you may encounter in such circumstances.

At the outset, you need to understand your client's expectations as to immigration and U.S. citizenship. Property ownership is not sufficient to entitle a person to reside in the United

1. *See* 2017 Profile of International Activity In U.S. Residential Real Estate, National Association of Realtors (July 2017). 2. *See* Evan Gentry, *Why Foreign Investors Love U.S. Commercial Real Estate and Why More Will Follow*, Forbes Real Estate Council (May 30, 2018). 3. *See* Commercial Real Estate International Business Trends 2018, National Association of Realtors (June 2018).

States and does not create a pathway to citizenship except pursuant to a specific program such as the EB-5 program. Once you understand your foreign client's proposed transaction, you should walk the client through the steps necessary to consummate it, explain what the expectations of the parties to the transaction will be, and listen to the client's expectations.

Customs and Expectations

In the United States, local real estate laws and customs vary, sometimes greatly, from state to state. For example, some states levy a tax on mortgage recording, while others tax real property transfers but not transfers of the entity that owns the real property. In the United States, title insurance is commonplace, but in most foreign countries, it is rarely used.

Certain customs and practices can make for unpleasant surprises (which are devoutly to be avoided). For example, a foreign buyer (or any buyer) of a New York City condominium should be advised that there is a 1% mansion tax that a buyer must pay on residential conveyances over $1,000,000. Similarly, when the purchase is based on a floorplan in a glossy brochure that is marketing a building yet to be constructed, the buyer should expect to pay the seller's New York State and New York City transfer taxes, as is customary in contracts for new construction in New York City. Because the buyer is now paying the seller's tax obligation, that cost is deemed additional consideration and is added to the purchase price to reach the grossed-up purchase price upon which the buyer will pay the computed transfer taxes.

A buyer's expectation for the availability of services and amenities on the move-in date should also be tempered. Contracts often provide for a closing as soon as a temporary certificate of occupancy is obtained (so that occupancy is legal), but despite the developer's good faith efforts, certain construction may be ongoing, and full services, such as a health club or screening room, might not be available until a later date (which can be much later).

Added Complexities

Certain complexities that might not arise with a U.S. party may slow down or complicate a transaction for a foreign party. If a transaction will be financed, for example, a foreign party may have more hoops to jump through in getting a mortgage than a domestic buyer might. There could be additional documentation requirements to prove creditworthiness and confirm international assets. Currency conversion issues can impact transaction timing due requirements of the U.S. banking system or the home country (or both). An international wire transfer will likely not move as quickly or smoothly as a domestic one.

Documents executed in a foreign country with a notarial attestation that are to be recorded in a U.S. jurisdiction must be authenticated. Many countries, including the United States, have joined a treaty called the "Hague Convention of 5 October 1961 Abolishing the Requirement of Legalisation for Foreign Public Documents." This treaty reduces the authentication process to the issuance of a certificate called an apostille by an authority designated by the country where the document was issued. If your client plans to execute a document in a foreign country where attestation is required in the United States, the client must obtain an apostille, generally from a U.S. consulate or embassy. This process should be initiated well in advance of closing.

Note that it is generally more difficult to serve and sue a foreign person than a domestic one. For this reason, sellers sometimes require a larger down payment, rather than relying solely on their ability to take a foreign person to court. Likewise, any judgment obtained against a foreign person might be difficult to enforce if all or most of their assets are located abroad.

Nonetheless, many successful transactions today involve foreign persons and these complexities need not deter or derail a mutually satisfactory closing.

Cooperative and Condominium Ownership

Although there are many cooperative apartments available in locales like New York City, a foreign purchaser should consider carefully before seeking to purchase one. It is generally accepted that a cooperative's board of directors has the right to accept or reject a purchaser for any reason, or no reason, as long as it does not violate anti-discrimination laws. Cooperative boards can and do ask for detailed financial and social information that a foreign buyer may not want to produce. Compared to ownership of a condominium, cooperative ownership is more restrictive: limited or no subleasing permitted, occupancy and use requirements, etc. Although there is a board approval process for a condominium purchase, it is generally less rigorous than for a cooperative, and condominium boards rarely prohibit corporate or other types of ownerships often favored by foreign investors. Rather than a buyer approval right, a condominium board has merely a right of first refusal to purchase the unit. Where a board does not wish the transaction to go through, it can refuse to waive its first refusal right. The resulting cloud on title can (and often will) discourage a commercial lender from granting a mortgage. Such refusals to waive are rare, but not unheard of. Where a foreign buyer is determined to purchase a cooperative (and not a condominium), he or she might consider buying a sponsor cooperative unit, where board approval is not required.

Foreign Investors' Tax and Structural Considerations

This article is not intended to give tax advice, and readers should encourage foreign buyers or sellers in real estate transactions to consult tax advisors. That said, a foreign person buying or selling U.S. property should be aware of several potential tax issues: there are income tax, gains tax, and state and local transfer tax, as well as estate tax issues to be concerned with. In addition to federal, state, and local tax considerations, deciding how to structure the transaction can be a multilayered and fact-specific process. Considerations include:

- The nature of the property
- The intended holding period
- The buyer/seller's situation and the totality of their U.S. connections
- Tax treaties between the foreign investor's home jurisdiction and the United States
- The treatment of income repatriated to the foreign investor's home jurisdiction
- The organizational structure of the foreign investor

The size of the investment and whether it is for personal use or part of a business can also play roles in determining the best approach.

Should an individual or a U.S. or a foreign entity purchase the property? And, if an entity, what kind of entity? A common structure for holding U.S. property is a limited liability company, a pass-through tax entity that offers certain privacy and other benefits. However, as of 2017, Internal Revenue Service (IRS) regulations mandate that a single-member foreign-owned limited liability company comply with specific complex requirements established under Section 6038A of the Internal Revenue Code. These requirements can include designating a responsible party, complying with reporting requirements, and retaining permanent records regarding related-party transactions. Will this be acceptable to your client? There can be large penalties for noncompliance.

Income Tax Issues

Income tax consequences vary depending on the use of the property. If a property is for personal benefit, such as a vacation home that will not generate income, this analysis may not apply. However, where rental income will be generated, the IRS has two divergent approaches to taxing income of foreign persons. Under the first approach, when income can be effectively connected with the conduct of a U.S. trade or business, foreign persons are taxed on the amount of effectively connected income net of deductions allocable to such income, which may consist of such items as mortgage costs, taxes, insurance, and brokerage fees. The net is then taxed using the regular rate that applies to U.S. persons. Alternatively, income can be characterized as Fixed, Determinable, Annual, or Periodic (FDAP). Generally, income from U.S. sources that constitutes interest, dividends, rents, or royalties is FDAP income and is taxed at a flat rate of 30% of the gross income with no deductions. That said, where there is rental income, even if it is not considered effectively connected, the investor may be able to make a special election to have it taxed on a net basis. To further complicate the analysis, under certain circumstances where a foreign person is present in the United States over a specified period of time, that person might be deemed a U.S. resident for U.S. income

Related Content

For a discussion of the tax considerations applicable to foreign investment in U.S. property, see

> **FOREIGN INVESTMENT IN REAL PROPERTY TAX ACT FUNDAMENTALS**

RESEARCH PATH: *Real Estate > Commercial Purchase and Sales > Tax Considerations > Practice Notes*

For information on the use of real estate trusts by foreign investors, see

> **FOREIGN INVESTOR ISSUES**

RESEARCH PATH: *Corporate and M&A > Real Estate Investment Trusts > REIT Transactions > Practice Notes*

For guidance on using a real estate investment trust to purchase property, see

> **REAL ESTATE INVESTMENT TRUSTS RESOURCE KIT**

RESEARCH PATH: *Corporate and M&A > Real Estate Investment Trusts > REIT Transactions > Practice Notes*

tax purpose and consequently required to file a U.S. income tax return and pay taxes on their worldwide income. Your client should consult with an experienced tax advisor to identify and work through any such issues.

Taxes on Disposition

The question here is: what taxes will be due on the disposition of the property? When the estate of a deceased foreign person sells property that he or she owned as an individual, U.S. estate tax (if triggered) will apply to the fair market value of the property on the date of death, without adjustment for inflation and with limited credits. Additionally, there will be U.S. capital gains taxes on the gain.

FIRPTA Liability for U.S. Purchasers

The Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) creates a procedure for the payment of U.S. capital gains tax by a foreign seller.[4] With some exceptions, 15% of the purchase price must be remitted to the IRS. Note that a buyer of real property from a foreign seller must be concerned with FIRPTA compliance because the buyer will be liable for the applicable gains taxes if the foreign seller fails to pay them.

At a typical closing, the buyer receives a seller's affidavit certifying that the seller is not a foreign person, in which event there are no issues, unless the buyer has reason to doubt the certification. However, where the seller is a foreign person and cannot legitimately deliver a FIRPTA affidavit, the FIRPTA statute imposes secondary liability for the foreign seller's unpaid capital gains taxes on the buyer. In this way, the law makes the buyer a party to a seller's noncompliance, and the buyer must assure that there is proper compliance or will be left with an unwanted liability. Since the seller's gains tax liability can be a large amount, the seller will often file for a determination that a lesser amount is due. Under this scenario, the seller files for a Notice of Determination and the 15% tax, rather than being paid to the IRS at the time of the closing, is held in escrow. Once the IRS determination letter is received, the escrow agent will remit the indicated tax amount to the IRS and refund any balance to the foreign seller. The buyer may want evidence that a Notice of Determination has been applied for as a condition to closing and withholding. Further, the buyer may want to know the foreign seller's basis in the property in order to calculate the estimated liability amount. For example, if the foreign seller sold at a loss, the capital gains tax due will be less than the 15%, so the buyer's transferee liability will be accordingly reduced.

Restrictions and Reporting Requirements

There is no blanket prohibition on foreigners owning real estate in the United States. However, there are a number of U.S. reporting requirements and restrictions that may apply in certain circumstances.

BEA Reporting Requirements

In 1976, Congress passed the International Investment and Trade in Services Survey Act (Survey Act), requiring the Bureau of Economic Analysis (BEA) to regularly collect data on international capital flows and investments in the United States.[5] However, in 2009, the BEA's filing requirement for the acquisition of a direct or indirect interest in U.S. real estate by a foreign investor was discontinued for budgetary reasons. It wasn't until 2014 that the BEA reinstated such mandatory reporting requirements. The BEA rules apply to a U.S. business investing in U.S. real estate if any foreign person has a 10% or more direct or indirect interest in that business. There are many rules and exceptions relating to the BEA reporting requirements, as well as a form to file for exemption from reporting.[6]

4. *See* 26 U.S.C.S. § 1445; 26 U.S.C.S. § 897; 26 U.S.C.S. § 6039C. 5. *See* 22 U.S.C.S. §§ 3101–3108. 6. *See* the Bureau of Economic Analysis website at https://www.bea.gov, and *A Guide to BEA's Direct Investment Surveys*, Bureau of Economic Analysis (2018), https://www.bea.gov/system/files/2018-04/a-guide-to-bea-direct-investment-surveys.pdf.

Agricultural Foreign Investment Disclosure Act of 1978

This Act mandates filing requirements in connection with the acquisition or transfer of any agricultural land to a foreign person.[7] Hefty fines will be levied for a failure to report. The statute's goal is to prevent purchaser anonymity for acquisitions of agricultural land in the United States.[8]

Foreign Asset Control Rules

The U.S. federal government imposes economic sanctions against, and prohibits certain transactions with, specified countries, entities, individuals, and organizations. The Office of Foreign Asset Control (OFAC) at the U.S. Department of Treasury oversees and enforces these sanctions. All U.S. persons as defined by OFAC must comply with these restrictions. According to applicable rules, the term "United States person" or "U.S. person" means "any United States citizen, permanent resident alien, entity organized under the laws of the United States or any jurisdiction within the United States (including foreign branches), or any person in the United States."[9]

Patriot Act Compliance

The Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (commonly known as the Patriot Act) was passed after September 11, 2001, primarily to deter and punish terrorist acts in the United States, and around the world, as well as to enhance law enforcement's investigatory tools.[10] No U.S. citizen or company may do business with any Specially Designated Global Terrorist, which is a designation authorized under U.S. Executive Order 13224 (among other executive orders), and C.F.R. Title 31, pts. 595, 596, and 597 (among other U.S. laws and regulations). People or entities are designated as Specially Designated Global Terrorists (SDGTs) under Executive Order 13224 by the U.S. Department of State or the U.S. Department of the Treasury.

The penalties for failure to comply with the Patriot Act are up to $500,000 for companies or up to $250,000 and/or 10 years' imprisonment for individuals. Most purchase and sale agreements for real estate today contain representations to establish the parties' compliance with the Patriot Act. Accordingly, it is critical to know the background of each counterparty all the way down to its individual constituents. Patriot Act issues can have a significant impact on a transaction and its ability to close, and Patriot Act representations should be thoroughly evaluated. Section 352 of the Patriot Act imposes requirements on every financial institution and all persons involved in real estate settlements and closings.[11]

Additional Considerations

The specifics of a transaction may trigger additional considerations that might not come into play in a real estate transaction without a foreign party.

Other Governmental Requirements

Other federal requirements may apply to specialized situations (such as antidumping, antitrust, traffic in arms, etc.) that probably would not apply to an everyday real estate transaction. There also may be local and/or state filing requirements that must be complied with.

Absentee Ownership

If a foreign purchaser intends to own but not occupy their property, maintenance and management processes should be put in place.

Diplomatic Immunity

From a foreigner's perspective, diplomatic immunity is a good thing but, from a counterparty's perspective, it is troubling. Many will hesitate to enter into a contract with someone who is not subject to the same rules as they are. There are a number of potential ways to address this concern: a deep-pocketed domestic guarantor, a designated U.S. agent for service of process, and/or a larger contract deposit than usual to be held in escrow in the event the foreign purchaser decides to default.

Conclusion

This article is intended to illuminate issues that may arise in real estate transactions involving foreign persons. Although each situation is unique and nuanced, an attorney who is sensitive to potential concerns can guide his or her client to a positive outcome. L

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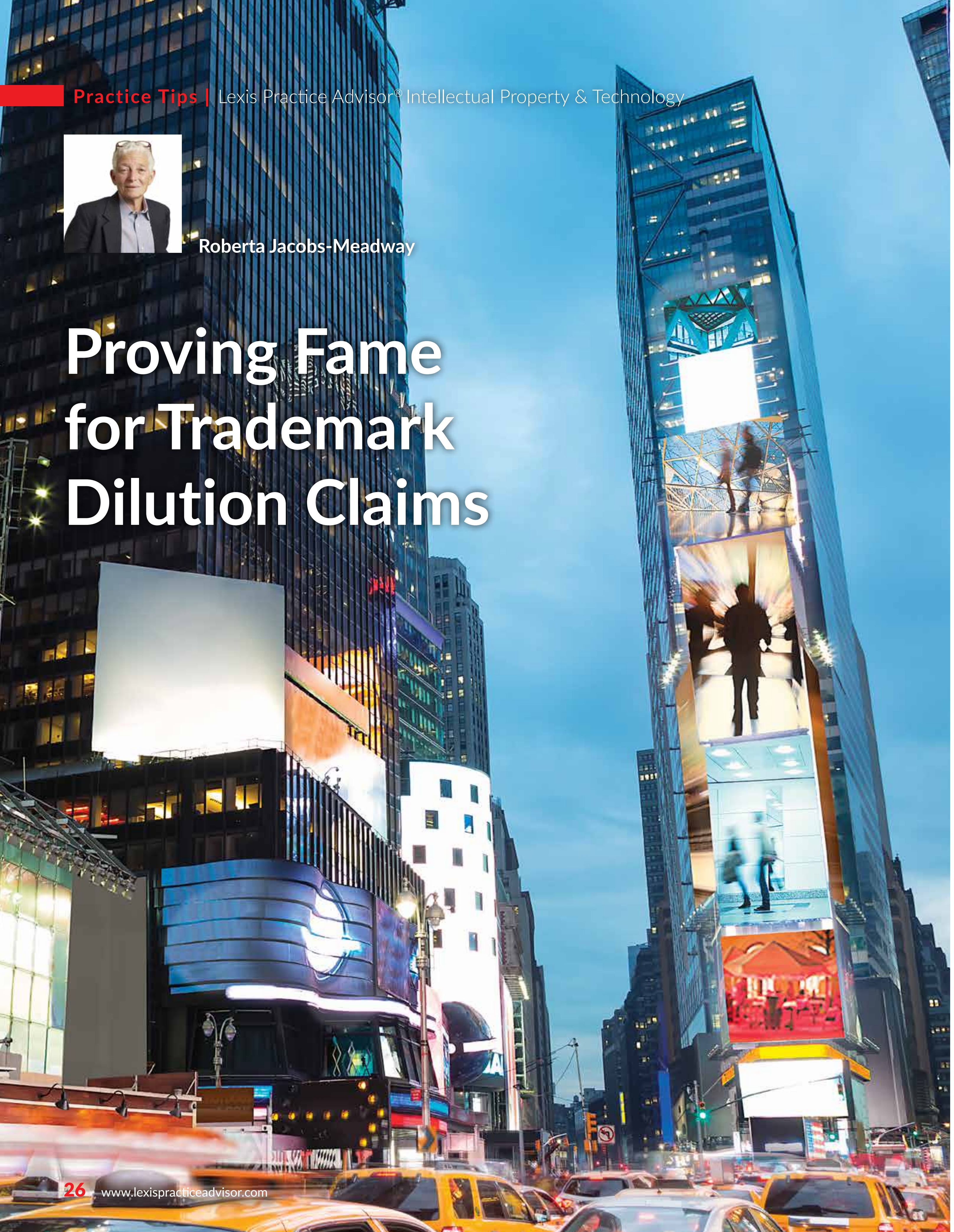
RESEARCH PATH: *Real Estate > Commercial Purchase and Sales > Miscellaneous Ownership Issues > Articles*

7. *See* 7 U.S.C.S. §§ 3501–3508. 8. *See* 7 C.F.R. § 781.1. 9. *See* 31 C.F.R. § 560.314. 10. *See* Pub. L. No. 107-56, 115 Stat. 272 (Oct. 26, 2001). 11. *See* 31 U.S.C.S. § 5318.



Roberta Jacobs-Meadway

Proving Fame for Trademark Dilution Claims

This article addresses how to prove a trademark is famous when asserting a dilution claim in federal court or in a Trademark Trial and Appeal Board (TTAB) proceeding pursuant to the Trademark Dilution Revision Act of 2006 (TDRA).[1] Topics discussed include the legal standard for fame, the statutory fame factors, and the types of evidence that may be submitted.

Legal Standard for Fame

To assert a dilution claim under the TDRA, the plaintiff's mark must be famous. The statute defines a famous mark as "widely recognized by the general consuming public of the United States as a designation of source of the goods or services of the mark's owner."[2] It also lists four non-exclusive factors that courts may consider when assessing fame. Statutory fame factors are discussed later in this article.

Fame is a high standard that is hard to meet. Plaintiffs must show that "when the general public encounters the mark in almost any context, it associates the term, at least initially, with the mark's owner."[3]

Relatively few marks qualify as famous under the TDRA, aside from those that are truly "household names" or "part of the collective national consciousness."[4]

Examples of famous marks include:

- Budweiser
- Camel
- Kodak
- Barbie
- Nissan
- Nike
- Rolex
- Pepsi[5]

Statutory Fame Factors

The statutory factors for determining whether a mark is famous for dilution purposes are:

- The duration, extent, and geographic reach of advertising and publicity of the mark, by either plaintiff or third parties
- The amount, volume, and geographic extent of sales of goods or services offered under the mark
- The extent of actual recognition of the mark
- Whether the mark is registered on the Principal Register or under earlier federal trademark acts

These factors are non-exclusive and, as such, courts may consider any other relevant evidence in assessing fame.[6] Other types of evidence that may be considered are discussed later in this article.

Note that a plaintiff's mark must have become famous prior to the defendant's allegedly diluting use.[7] It is therefore crucial to submit evidence of fame for the relevant time period (i.e., up to the date that the defendant first used its mark in commerce). Bear this in mind when evaluating and gathering evidence of fame.

Factor One: Advertising and Publicity of Mark

The first statutory fame factor is the duration, extent, and geographic reach of advertising and publicity of the mark (by either plaintiff or third parties).[8] Generally, the longer a mark has been used and advertised and the more widespread the advertising and publicity, both geographically and across different types of media, the more likely the mark will be found famous. However, there are no hard and fast rules as to what will be deemed sufficient in a given case. You must gather and weigh all relevant evidence.

Length of Use

While length of use is one factor to consider, it is typically not the most significant factor. For instance, marks have been found famous when used for nearly 100 years (or longer) in some cases, but not others.[9]

Other examples include:

- **Marks found famous.** Prozac (11 years' use); Animal Planet (5 years' use).
- **Marks found not famous.** Bongo (15 years' use); trade dress (50 years' use).[10]

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1. 15 U.S.C.S. § 1125(c). 2. 15 U.S.C.S. § 1125(c)(2)(A). 3. Coach Servs., Inc. v. Triumph Learning LLC, 668 F.3d 1356, 1373 (Fed. Cir. 2012) (quotations and citations omitted). 4. Thane Int'l, Inc. v. Trek Bicycle Corp., 305 F.3d 894, 911 (9th Cir. 2002); *see also* Nissan Motor Co. v. Nissan Computer Corp., 378 F.3d 1002, 1011 (9th Cir. 2004) (dilution is a cause of action "reserved for a select class of marks—those marks with such powerful consumer associations that even non-competing uses can impinge on their value"). 5. *See* Bd. of Regents, Univ. of Tex. Sys. *ex. rel.* Univ. of Tex. at Austin v. KST Elec., Ltd., 550 F. Supp. 2d 657 (W.D. Tex. 2008) (listing examples of famous marks from the TDRA's legislative history and previous cases); Maker's Mark Distillery, Inc. v. Diageo N. Am., Inc., 703 F. Supp. 2d 671, 698 (W.D. Ky. 2010) (listing examples of marks found famous under the TDRA). 6. 15 U.S.C.S. § 1125(c)(2)(A). 7. 15 U.S.C.S. § 1125(c)(1). 8. 15 U.S.C.S. § 1125(c)(2)(A)(i). 9. *Cf.*, *e.g.*, Rolex Watch U.S.A. Inc. v. AFP Imaging Corp., 101 U.S.P.Q.2d (BNA) 1188, 1191–92 (TTAB 2011), *vacated on other grounds*, 2013 TTAB LEXIS 46 (TTAB 2013) (Rolex famous where used continuously and exclusively since 1915, and there was no evidence of any third-party usage or registration of similar marks), with Theta Chi Fraternity, Inc. v. Leland Stanford Junior Univ., 212 F. Supp. 3d 816, 827 (N.D. Cal. 2016) (Theta Chi marks not famous, even though marks had been used for 160 years, where there were only 175,000 members over that period of time). 10. *See* Eli Lilly & Co. v. Natural Answers, Inc., 86 F. Supp. 2d 834, 849 (S.D. Ind. 2000) ("massive publicity" made Prozac famous "despite its relatively short life"); Discovery Commc'ns, Inc. v. Animal Planet, Inc., 172 F. Supp. 2d 1282, 1291 (C.D. Cal. 2001) (Animal Planet famous due to "extensive use with a variety of products and services since 1996"); Michael Caruso & Co. v. Estefan Enters., Inc., 994 F. Supp. 1454, 1463 (S.D. Fla. 1998) (Bongo not famous where publicity and advertising only targeted junior women's apparel market and mark was only used for 15 years); Hershey Foods Corp. v. Mars, Inc., 998 F. Supp. 500 (M.D. Pa. 1998) (Reese's trade dress not famous, despite its use for half a century and other positive evidence, where it was unregistered and similar to other third-party marks in the food industry).

Advertising Expenditures

Large amounts of money spent on advertising a mark can bolster a fame argument but, standing alone, will generally not be sufficient to establish fame.[11]

Examples of advertising expenditures that aided (or did not aid) a finding of fame include:

- **Marks found famous.** Just Do It ($6 billion spent over 20-plus years); Tempur-Pedic (over $250 million spent over three-year period).
- **Marks found not famous.** Navajo ($3.8 million spent annually); Clue (millions of dollars spent on advertising).[12]

Be sure to provide context for all advertising figures. Determine the amount plaintiff spent on advertising products sold under the mark (over a significant period of time) vis-à-vis the amounts spent by major competitors. This will give you an idea of the significance of the number in the marketplace and whether a court is likely to find the amount compelling.

Extent and Geographic Reach of Advertising

Clearly, to establish nationwide fame, it is best for a plaintiff to point to many instances of nationwide advertising. Plaintiff should cite all national, regional, and local advertising campaigns that have prominently featured the mark at issue, such as advertisements appearing on or in:

- Magazines
- Newspapers
- Television
- Radio
- Podcasts
- Billboards
- Subways and bus stops
- The internet
- Social media

The longer and more extensive the advertising efforts, the more likely the mark will be deemed famous.[13]

Be sure to include any advertising by third parties, such as retailers or other mark owners engaging in cross-promotional or co-branded activities. Advertising by both the plaintiff and third parties is relevant to the first fame factor.[14]

While you should highlight any online advertising efforts, be aware that courts may discount the value of such evidence given the ubiquity of the internet. Also, as a practical matter, viewers of the ads may come from one or many states, making it difficult to measure the true geographic reach of the advertising.[15]

Publicity of Mark

Publicity of the mark, by either the plaintiff or third parties, is also relevant. Aside from traditional advertising, a plaintiff may publicize its mark in various ways, such as through:

- Press releases
- Trade shows or conferences
- Event sponsorship and promotion

Third-party publicity bears not only on factor one, but also on factor three.[16]

Factor Two: Sales of Goods or Services Offered under Mark

The second statutory fame factor is the amount, volume, and geographic extent of sales of goods or services offered under the mark.[17] Generally, the more widespread the plaintiff's sales and the higher the sales figures, the more likely the mark will be deemed famous. As with the first fame factor, however, there are no bright-line rules; what is sufficient for a finding of fame will vary from case to case.

Amount and Volume of Sales

As one district court has explained, "courts generally have limited famous marks to those that receive multimillion-dollar advertising budgets, generate hundreds of millions of dollars in sales annually, and are almost universally recognized by the general public."[18]

Examples of sales figures that aided a finding of fame include:

- Hot Wheels (three billion units sold in all 50 states and throughout the world over a 37-year period)
- Jack Daniel's (best-selling whiskey in the United States since 1997, exceeding 75 million cases and $10 billion in sales)
- PODS (nationwide network of PODS locations and franchises and cumulative sales of more than $3 billion)
- Rolex (annual U.S. sales in the "hundreds of millions of dollars")[19]

11. *See, e.g.*, Schutte Bagclosures Inc. v. Kwik Lok Corp., 48 F. Supp. 3d 675, 702 (S.D.N.Y. 2014). 12. *See* Nike Inc. v. Maher, 100 U.S.P.Q.2d (BNA) 1018, 1026 (TTAB 2011); Dan-Foam A/S v. Brand Name Beds, LLC, 500 F. Supp. 2d 296, 323 n.209 (S.D.N.Y. 2007); Navajo Nation v. Urban Outfitters, Inc., 2016 U.S. Dist. LEXIS 63599, at *10–11 (D.N.M. May 13, 2016); Hasbro, Inc. v. Clue Computing, Inc., 66 F. Supp. 2d 117, 131 (D. Mass. 1999). 13. *See, e.g.*, Toys "R" Us, Inc. v. Akkaoui, 1996 U.S. Dist. LEXIS 17090 (N.D. Cal. Oct. 29, 1996) (finding fame where plaintiffs advertised their products "through a variety of channels both locally and nationally"). 14. *See, e.g.*, Chanel, Inc. v. Camacho & Camacho, LLP, 2018 TTAB LEXIS 13, at *25 (TTAB Jan. 12, 2018) (not precedential) (third-party retailers such as Bergdorf Goodman, Saks Fifth Avenue, and Bloomingdales advertised and promoted opposer's products bearing the mark at issue through print advertising, catalogs, and other means). 15. *See, e.g.*, Avery Dennison Corp. v. Sumpton, 189 F.3d 868, 879 (9th Cir. 1999) (noting that "worldwide use of a non-famous mark," such as by marketing products on the internet, "does not establish fame"); Global Brand Holdings, LLC v. Church & Dwight Co., 2017 U.S. Dist. LEXIS 208759, at *12–13 (S.D.N.Y. Dec. 19, 2017) (allegations that plaintiff used its XOXO marks widely in internet advertisements not sufficient to state a plausible claim that marks are famous). 16. *See, e.g.*, TiVo Brands LLC v. Tivoli, LLC, 129 U.S.P.Q.2d (BNA) 1097, 1104 (TTAB 2018). 17. 15 U.S.C.S. § 1125(c)(2)(A)(ii). 18. Schutte Bagclosures Inc. v. Kwik Lok Corp., 48 F. Supp. 3d 675, 702 (S.D.N.Y. 2014). 19. *See* Jada Toys, Inc. v. Mattel, Inc., 518 F.3d 628, 635 (9th Cir. 2008); VIP Prods., LLC v. Jack Daniel's Props., Inc., 291 F. Supp. 3d 891, 900 (D. Ariz. 2018); PODS Enters., LLC v. U-Haul Int'l, Inc., 126 F. Supp. 3d 1263, 1277 (M.D. Fla. 2015); Rolex Watch U.S.A. Inc. v. AFP Imaging Corp., 101 U.S.P.Q.2d (BNA) 1188, 1192 (TTAB 2011), *vacated on other grounds*, 2013 TTAB LEXIS 46 (TTAB 2013) .

Bear in mind, however, that large sales figures per se are not enough to establish fame. They may certainly bolster a fame argument, but if your other evidence of fame is weak, a judge is unlikely to rule in your favor. For instance, the following marks were found not famous despite fairly significant sales evidence:

- The Children's Place (sales of $280 million in 1998 through 228 retail stores, having grown from $100 million through 87 stores in 1994)
- XOXO (sales of hundreds of millions of dollars of goods sold nationwide through brick-and-mortar stores and online)
- Yellow and black trade dress for power tools (trade dress not famous, despite over $20 billion in sales nationwide since 1992, where plaintiffs failed to show fame among the general consuming public, as opposed to the niche market of DIYs and professional tradesmen)
- Red dripping wax seal used on bottles of bourbon (annual U.S. sales of 800,00 cases, with each bottle retailing at about $24)[20]

To strengthen your sales evidence, be sure to provide context for all sales figures. Determine the number of units sold annually and the dollar amounts of such sales (over a significant number of years) and compare these figures to those of plaintiff's major competitors. This will give you an idea of plaintiff's standing in the marketplace and whether a court is likely to find the numbers compelling. For instance, being a top seller in a category of goods by a 3:1 margin over the next largest competitor would be more persuasive than having high revenues but only a 10% market share.

Note that where goods are inexpensive, high volume may be more telling than gross revenues, and similarly, volume may be less significant where the goods are expensive.[21]

Volume also must be viewed in context. For instance, for nontraditional sales such as downloads of an app or visitors to a website, volume would need to be especially high to be persuasive, as evidenced by the following cases:

- **Marks found famous.** Yelp (website averaged 102 million monthly unique visitors between January and March 2013).
- **Marks found not famous.** Pinterest, Pin, and Pin It (website had 25 million monthly active users by October 2012, about 8% of the U.S. population); Perfect365 (20 million U.S. downloads of selfie app).[22]

Finally, be sure to cite the specific retail outlets and websites through which plaintiff's goods are sold. For instance, in the *E.A. Sween* case, plaintiff's food products were sold "through a variety of retail outlets throughout the country, including convenience stores, delis, drug stores, gas stations, truck stops, resorts, and vending machines," which supported a finding of fame.[23]

Geographic Extent of Sales

To establish nationwide fame, plaintiff must show that its goods are sold (or services rendered) across the United States. It is best to point to sales in multiple locations in many states. For example, the Red Lobster mark would more likely be deemed famous, based on approximately 700 locations in 44 states, than the mark of a restaurant chain in a tristate region with only 60 locations.[24]

In some instances, however, the goods or services associated with a mark will be sold or rendered in a single location. This fact will not preclude a finding of fame if the mark is otherwise widely recognized by the general consuming public. For instance, the following marks were found famous despite being associated with only one location (New York City):

- Empire State Building
- The House that Ruth Built[25]

20. *See* TCPIP Holding Co. v. Haar Commc'ns Inc., 244 F.3d 88, 100 (2d Cir. 2001); Global Brand Holdings, LLC v. Church & Dwight Co., 2017 U.S. Dist. LEXIS 208759, at *13 (S.D.N.Y. Dec. 19, 2017); Black & Decker Corp. v. Positec USA Inc., 2015 U.S. Dist. LEXIS 42968, at *106 (N.D. Ill. Mar. 31, 2015); Maker's Mark Distillery, Inc. v. Diageo N. Am., Inc., 703 F. Supp. 2d 671, 698 (W.D. Ky. 2010). 21. *See, e.g.*, E.A. Sween Co. v. Deli Express of Tenafly, LLC, 19 F. Supp. 3d 560, 573 (D.N.J. 2014) (Deli Express mark found famous where more than one million sandwiches were sold across the country per week). 22. *See* Yelp Inc. v. Catron, 70 F. Supp. 3d 1082, 1096 (N.D. Cal. 2014); Pinterest, Inc. v. Pintrips, Inc., 140 F. Supp. 3d 997, 1034 (N.D. Cal. 2015); ArcSoft, Inc. v. CyberLink Corp., 153 F. Supp. 3d 1057, 1066–67 (N.D. Cal. 2015). 23. E.A. Sween Co. v. Deli Express of Tenafly, LLC, 19 F. Supp. 3d 560, 573 (D.N.J. 2014). 24. *See, e.g.*, McDonald's Corp. v. McSweet, LLC, 112 U.S.P.Q.2d (BNA) 1268, 1287 (TTAB 2014) ("MC" family of marks famous due, in part, to opposer operating over 14,000 restaurants across the United States that collectively serve an average of 26 million people per day). 25. *See* ESRT Empire State Bldg., L.L.C. v. Liang, 2016 TTAB LEXIS 270, at *22 (TTAB June 17, 2016) (not precedential) (noting that visitors from around the world visit opposer's observation deck daily and are exposed to multiple uses of the mark on everything from tickets to uniforms to gift items to the building itself); N.Y. Yankees P'ship v. IET Prods. & Servs., Inc., 114 U.S.P.Q.2d (BNA) 1497, 1505 (TTAB 2015) (over 63 million people had attended Yankees home games since 1990).

> Consumer surveys are often submitted as evidence of fame . . . while surveys are not technically required, they can provide strong evidence of fame (assuming they are properly structured and conducted). Conversely, the absence of a survey can negatively impact your case, especially if the other evidence of fame is not strong.

Factor Three: Extent of Actual Recognition of Mark

The third statutory fame factor is the extent of actual recognition of the mark.[26] When analyzing this factor, courts consider whether the mark is widely recognized by the general consuming public of the United States. Local or niche fame is insufficient.

To show that a mark is widely recognized by the general public, plaintiffs generally submit two types of evidence:

- Third-party publicity
- Consumer surveys

Third-Party Publicity

Unsolicited and extensive media attention can be a powerful indication of fame. For instance, in TiVo Brands LLC v. Tivoli, LLC, 129 U.S.P.Q.2d (BNA) 1097 (TTAB 2018), third-party recognition of opposer's TIVO mark tipped the balance in favor of finding the mark famous for dilution purposes (as of 2010). This evidence included:

- Clips from television shows referencing TIVO digital video recorders (DVRs)
- A 2008 Los Angeles Times article referring to TIVO as having "near household-name recognition"
- News articles from 2010 describing the TIVO DVR as an "iconic brand," "revolutionary," and a "pioneer" product (some also repeated text from a May 25, 2010 press release)
- A media analysis and reporting report generated through Cision, a third-party analytics vendor, detailing over 30,000 mentions of TIVO in news outlets from January 2000 to April 2009[27]

Other examples of third-party publicity include:

- Associations of the mark with celebrities (e.g., photographs of celebrities carrying Chanel-branded handbags or wearing Chanel fashions that are published in tabloid magazines)
- Brand rankings (e.g., BusinessWeek's annual "Best Global Brands" article that lists the top 100 brands in the world)
- Industry-specific awards
- The mark's appearance in movies, television shows, books, museums, etc.[28]

Brand owners should thus collect and maintain, in the ordinary course of business, an archive of unsolicited media mentions, rankings, awards, etc., noting the level of exposure or "hits." Recorded interviews with key individuals (e.g., vendors, customers, social media influencers) made at appropriate points in the relationship—such as at inception, termination, or on reaching some significant milestone—may also be useful. Gathering such materials throughout the life of a brand will make proving fame easier if a dilution lawsuit is later filed (or conversely, a paucity of evidence will indicate the potential weakness of a dilution claim).

Consumer Surveys

Consumer surveys are often submitted as evidence of fame under the third fame factor. While surveys are not technically required, they can provide strong evidence of fame (assuming they are properly structured and conducted). Conversely, the absence of a survey can negatively impact your case, especially if the other evidence of fame is not strong.[29]

If, on the other hand, you have extensive evidence of fame but no survey (or unfavorable survey results), a court may overlook the lack of survey evidence and find the mark famous, depending on the facts of the case.[30]

There are three major issues to note with fame surveys:

- Survey universe (who constitutes the general consuming public?)
- Level of recognition (what percentage of recognition is necessary for a mark to be widely recognized?)
- Timing of survey (during what time period must fame be measured?)

26. 15 U.S.C.S. § 1125(c)(2)(A)(iii). 27. *See, e.g.*, Thane Int'l, Inc. v. Trek Bicycle Corp., 305 F.3d 894, 912 (9th Cir. 2002) (press accounts about the popularity of a brand or pop-culture references can provide evidence of fame). 28. *See, e.g.*, Chanel, Inc. v. Makarczyk, 110 U.S.P.Q.2d (BNA) 2013, 2021 (TTAB 2014). 29. *See, e.g.*, Lingo v. Lingo, 785 F. Supp. 2d 443, 455 (D. Del. 2011) (LINGO'S MARKET not famous where plaintiffs provided no evidence of consumer surveys or advertisements outside of the Rehoboth Beach community); Network Automation, Inc. v. Hewlett-Packard Co., 2009 U.S. Dist. LEXIS 125835, at *33 (C.D. Cal. Sept. 14, 2009) (plaintiff's failure to present any survey or expert opinion regarding the extent of actual recognition of the Network Automation mark weighed heavily in favor of finding the mark not famous). 30. *See, e.g.*, H-D U.S.A., LLC v. SunFrog, LLC, 311 F. Supp. 3d 1000, 1043 (E.D. Wis. 2018) (disregarding lack of survey given "overwhelming" evidence of fame of Harley Davidson marks); UMG Recordings Inc. v. Mattel Inc., 100 U.S.P.Q.2d (BNA) 1868, 1887 (TTAB 2011) (finding Motown mark famous, despite lack of survey evidence, where the evidence of public exposure was so strong that the Board could infer "significant actual recognition among the general public"); Adidas Am., Inc. v. Payless Shoesource, Inc., 546 F. Supp. 2d 1029, 1063 n.12 (D. Or. 2008) ("Given the extensive evidence adidas submitted as to each of the statutory 'fame' factors, its failure to conduct a fame survey is not dispositive.").

Factor Four: Federal Registration of Mark

The fourth statutory fame factor is whether the mark is federally registered on the Principal Register or under earlier federal trademark acts.[31]

While federal registration is not required to bring a dilution claim under the TDRA, the lack of a Principal Register registration weighs against a finding of fame (and, as a practical matter, courts are very unlikely to find an unregistered mark famous absent strong evidence of fame under the other factors).[32]

Rare examples of courts finding unregistered marks (or trade dress) famous include:

- Gucci's Diamond Motif Trade Dress (the Repeating GG Pattern with a pair of inverted Gs in each corner rendered in a brown/beige color combination)
- The Dallas Cowboys' America's Team mark[33]

While it is strongly advised that a dilution plaintiff own a federal registration, note that simply owning a registration is not, by itself, sufficient to show fame. This is merely one factor to consider in the analysis (and in most cases, the least important of the factors).[34]

When submitting a federal registration as evidence of fame, be sure to highlight:

- That the mark is registered on the Principal Register (not the Supplemental Register)
- How long the mark has been registered
- Whether the registration is incontestable
- Whether the mark is registered for a wide range of goods/services (if so, it may be easier to prove that dilution is likely)
- Related registrations (e.g., if plaintiff alleges dilution of a family of marks or owns other registrations for the same or closely similar marks for different goods or services)

Incontestability is conclusive evidence of validity (i.e., distinctiveness). To bring a dilution claim under the TDRA, a mark must be both famous and distinctive. While fame is usually the contested issue, having an incontestable registration would obviate the need to separately establish distinctiveness.

31. 15 U.S.C.S. § 1125(c)(2)(A)(iv). 32. *See, e.g.*, Hershey Foods Corp. v. Mars, Inc., 998 F. Supp. 500, 517 (M.D. Pa. 1998) (noting that "failure to register counts against a finding of fame" as a person "would be expected to register a famous mark;" Reese's unregistered trade dress found not famous); Juice & Java, Inc. v. Juice & Java Boca, LLC, 2017 U.S. Dist. LEXIS 6913, at *16 (S.D. Fla. Jan. 17, 2017) (noting that "one could logically infer lack of fame from a lack of registration"). 33. *See* Gucci Am., Inc. v. Guess?, Inc., 868 F. Supp. 2d 207, 219 (S.D.N.Y. 2012); Dallas Cowboys Football Club, Ltd. v. Am.'s Team Props., Inc., 616 F. Supp. 2d 622, 643 (N.D. Tex. 2009). 34. *See, e.g.*, Coach Servs., Inc. v. Triumph Learning LLC, 668 F.3d 1356, 1374 (Fed. Cir. 2012).

Other Evidence of Fame

Because the statutory fame factors are nonexclusive, courts are free to consider other evidence when assessing fame for dilution purposes.[35] Thus, do not limit yourself to the statutory factors. Carefully evaluate whether any other types of evidence may support a finding of fame in your client's case. Also research the case law in your jurisdiction to see what types of additional evidence (if any) judges have found persuasive.

Relevant evidence might include:

- An absence of commercially significant third-party uses
- Admissions of fame by defendant
- Prior judicial determinations of fame

Absence of Commercially Significant Third-Party Uses

Under the Federal Trademark Dilution Act of 1995 (which preceded the current dilution statute), one of the fame factors was "the nature and extent of use of the same or similar marks by third parties." Essentially, if a plaintiff's mark was a common word used by numerous third parties, such a fact would weigh against a finding of fame.[36]

Stated another way, extensive, commercially significant third-party uses of the same or similar marks (especially for unrelated goods/services) would weigh against fame because the mark would be associated with multiple entities and not just plaintiff. Thus, showing an absence of commercially significant third-party uses could point towards a mark being famous.

Under the current statute (the TDRA), this principle does not appear as an express, enumerated fame factor. Rather, the TDRA lists six nonexclusive factors that courts may consider in determining whether a mark is likely to cause dilution by blurring. One of those factors is "the extent to which the owner of the famous mark is engaging in substantially exclusive use of the mark."[37]

However, courts may still consider this issue in a fame analysis when appropriate evidence is made of record.[38]

Admissions of Fame by Defendant

A defendant may sometimes admit that plaintiff's mark is famous (e.g., in the answer to the complaint, discovery responses, proposed findings of fact, etc.). Such admissions of fame will likely be accepted so long as they are clear and directed towards dilution fame, rather than likelihood of confusion fame.

For instance, courts (or the TTAB) credited admissions of fame as to the following marks:

- Superman, Superwoman, and the appearance of Superman in his blue bodysuit with the letter "S" inside a five-sided shield on the chest and a red cape (based on applicant's admissions in the answer in an opposition proceeding)
- Top hat logo design of the New York Yankees (based on applicant's response to a request for admission and the record evidence in an opposition proceeding)
- Just Do It (based on applicants' "compelling" responses to an interrogatory and a document production request in an opposition proceeding)

35. 15 U.S.C.S. § 1125(c)(2)(A). **36.** *See, e.g.*, Avery Dennison Corp. v. Sumpton, 189 F.3d 868, 878 (9th Cir. 1999) (AVERY DENNISON not famous); Hasbro, Inc. v. Clue Computing, Inc., 66 F. Supp. 2d 117, 132 (D. Mass. 1999) (CLUE not famous). **37.** 15 U.S.C.S. § 1125(c)(2)(B)(iii). **38.** *See, e.g.*, Juice & Java, Inc. v. Juice & Java Boca, LLC, 2017 U.S. Dist. LEXIS 6913, at *16 (S.D. Fla. Jan. 17, 2017) (stating in fame analysis that "[t]hird-party use of the same or similar marks undermines any claim of distinctiveness for purposes of a dilution claim"); Rolex Watch U.S.A. Inc. v. AFP Imaging Corp., 101 U.S.P.Q.2d (BNA) 1188, 1192 (TTAB 2011), *vacated on other grounds*, 2013 TTAB LEXIS 46 (TTAB 2013) (noting in fame analysis that ROLEX "is a coined and fanciful term with no other meaning other than its significance as a trademark" and that the record "is devoid of any third-party usage or registration of similar marks").

Related Content

For an overview of defense strategies in trademark dilution actions, see

> **TRADEMARK DILUTION CLAIMS, REMEDIES, AND DEFENSES**

RESEARCH PATH: *Intellectual Property & Technology > Trademarks > Trademark Litigation > Practice Notes*

For more information on registration and incontestability, see

> **TRADEMARK REGISTRATIONS: MAINTENANCE AND RENEWAL**

RESEARCH PATH: *Intellectual Property & Technology > Trademarks > Trademark Registration > Practice Notes*

To learn about the TTAB's approach to cases alleging trademark dilution, see

> **TTAB DECISION TRACKER: DILUTION**

RESEARCH PATH: *Intellectual Property & Technology > Trademarks >TTAB Proceedings > TTAB Decision Tracker > Practice Notes*

For an overview of the factors considered by the U.S. Court of Appeals for the Federal Circuit and the TTAB in likelihood of confusion cases, see

> **LIKELIHOOD OF CONFUSION FACTORS: KEY LEGAL PRINCIPLES AND REPRESENTATIVE CASES (FED. CIR. AND TTAB)**

RESEARCH PATH: *Intellectual Property & Technology > Trademarks > Trademark Registration > Practice Notes*

For a list of evidence that may be submitted to prove fame, see

> **FAME EVIDENCE IN A TRADEMARK DILUTION CASE CHECKLIST**

RESEARCH PATH: *Intellectual Property & Technology > Trademarks > Trademark Litigation > Checklists*

For an overview of dilution litigation, see

> **SUBSTANTIVE ISSUES IN INTER PARTES PROCEEDINGS, 3 GILSON ON TRADEMARKS §9.03[2][F]**

RESEARCH PATH: *Intellectual Property & Technology > Trademarks > TTAB Proceedings > Secondary Materials*

- Fendi (based on defendants' admission in the answer)
- Planet Hollywood word mark and design marks (based on defendants' admission in their proposed findings of fact and other substantial evidence offered during the proceeding)[39]

Prior Judicial Determinations of Fame

Submitting evidence of past judicial decisions finding your client's mark famous, or referencing the fame of the mark, can bolster your client's arguments of fame in the instant case. Bear in mind, however, that each case must be decided on its own facts. Courts (or the TTAB) are not bound to follow the decision by another court against a different entity based upon a different record.[40]

Evidence of prior judicial determinations of fame may be more persuasive if:

- Dilution fame was found (not likelihood of confusion fame)
- The same mark was at issue
- The same general timeframe was at issue (i.e., the date by which plaintiff's mark must have been famous)
- Identical or very similar facts were presented
- The case was decided by the same court hearing the present case (or a court in the same jurisdiction, such as another district court within the Second Circuit).[41] L

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39. *See* DC Comics v. Rivetti, 2017 TTAB LEXIS 318, at *15 (TTAB Aug. 17, 2017) (not precedential); N.Y. Yankees P'ship v. IET Prods. & Servs., Inc., 114 U.S.P.Q.2d (BNA) 1497, 1503 (TTAB 2015); Nike Inc. v. Maher, 100 U.S.P.Q.2d (BNA) 1018, 1024 (TTAB 2011); Fendi Adele S.r.l. v. Filene's Basement, Inc., 696 F. Supp. 2d 368, 390 (S.D.N.Y. 2010); Planet Hollywood (Region IV), Inc. v. Hollywood Casino Corp., 80 F. Supp. 2d 815, 834, 896 (N.D. Ill. 1999). **40.** *See, e.g.*, Citigroup Inc. v. Capital City Bank Grp., Inc., 94 U.S.P.Q.2d (BNA) 1645, 1665 (TTAB 2010). **41.** *See, e.g.*, Coach Servs., Inc. v. Triumph Learning LLC, 668 F.3d 1356, 1375–76 (Fed. Cir. 2012); Mattel, Inc. v. S.W. Fantasies, Inc., 2012 TTAB LEXIS 392, at *20 (TTAB Sept. 26, 2012) (not precedential); Adidas Am., Inc. v. Payless Shoesource, Inc., 546 F. Supp. 2d 1029, 1063 (D. Or. 2008).

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Discovery in Employment Discrimination Litigation: What Defendants Can Request and Obtain from Plaintiffs

This article provides guidance on the scope of permissible discovery employers may obtain from plaintiffs in employment discrimination lawsuits under statutes including Title VII of the Civil Rights Act of 1964 (Title VII), the Americans with Disabilities Act (ADA), and the Age Discrimination in Employment Act (ADEA). Additionally, this article discusses a list of commonly disputed discovery issues stemming from employer discovery requests and effective responses to common objections.

Amendments to Rule 26 of the Federal Rules of Civil Procedure

The 2015 amendments to the Federal Rules of Civil Procedure changed the scope of discovery available in employment discrimination cases. The amendments to Rule 26 deleted the former provision for the discovery of relevant but inadmissible information because some used the phrase "reasonably calculated to lead to the discovery of admissible evidence" incorrectly, to define the scope of discovery.

Under the revised rule, information is discoverable if it is relevant to any party's claim or defense and is proportional to the needs of the case.[1] The amendments are described as a restoration of the proportionality calculation. Thus, courts are now narrowing the scope of what once was very

broad discovery. Attorneys should be familiar with Rule 26 when drafting, responding to, or seeking court intervention concerning discovery requests.

1. Fed. R. Civ. P. 26(b)(1).

Rule 26(b)(1) defines the scope of discovery as follows:

> Parties may obtain discovery regarding any nonprivileged matter that is relevant to any party's claim or defense and proportional to the needs of the case, considering the importance of the issues at stake in the action, the amount in controversy, the parties' relative access to relevant information, the parties' resources, the importance of the discovery in resolving the issues, and whether the burden or expense of the proposed discovery outweighs its likely benefit.

Information within this defined scope does not need to be admissible in evidence to be discoverable. In applying the proportionality factors of Rule 26(b)(1), the courts have, in some cases, found the majority of documents sought to be of minimal importance in resolving the issues in the action and the documents to be accessible through public information sources available to the employee.

Limitations to the Scope of Discovery

As a result of the amendments, courts are handling discovery in employment discrimination cases differently than before. Rule 26 encourages courts to be more "aggressive in identifying and discouraging discovery overuse" by emphasizing the need to analyze proportionality before ordering the production of relevant information. Thus, courts are limiting the scope of discovery to information that is relevant to the specific claims and defenses of the parties (e.g., what happened to the plaintiff in the specific situation at issue) and proportional to the case's needs.

Courts can limit the extent of discovery if:

1. The discovery sought is unreasonably cumulative or duplicative or can be obtained from another source that is more convenient, less burdensome, or less expensive
2. The party seeking discovery has had many opportunities to obtain the information by discovery –or–
3. The proposed discovery is outside the permitted scope under Rule 26(b)(1)[2]

Rule 26 also places limitations on the production of electronically stored information (ESI), such as social media content, emails, text messages, and other electronic information. Parties may specify the form in which ESI is produced. Parties may object to providing ESI if doing so would impose an undue burden or cost on the producing party because the information is not reasonably accessible. However, a court may still order a party that makes this objection to produce the information sought if the requesting party shows good cause, considering the limits of Rule 26(b)(2)(C).

Discovery Employers Seek from Plaintiffs

The prior broad scope of discovery in employment discrimination cases allowed for wide-ranging requests concerning information like similar misconduct and complaints by other employees, and performance issues and personnel files from prior employers. Each discovery request is now subject to examination under the amended Rule 26(b)(1) and its proportionality factors, which generally result in a narrower scope of discovery than before.

2. Fed. R. Civ. P. 26(b)(2)(C).

Related Content

For more information on collecting the right material, see

> **DOCUMENT IDENTIFICATION AND PRESERVATION IN WORKPLACE INVESTIGATIONS**

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

For more information on preserving attorney-client privilege and work product protection during internal investigations, see

> **ATTORNEY-CLIENT PRIVILEGE AND WORK PRODUCT PROTECTION IN WORKPLACE INVESTIGATIONS**

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

For an annotated template of a document request letter that you can follow when drafting your requests to the plaintiffs in a multi-plaintiff action, see

> **DOCUMENT REQUESTS (DEFENDANT TO PLAINTIFF) (EMPLOYMENT DISCRIMINATION CLASS OR COLLECTIVE ACTION)**

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

For an annotated template of a document request letter for use in a single-plaintiff action, see

> **DOCUMENT REQUESTS (DEFENDANT TO PLAINTIFF) (SINGLE-PLAINTIFF DISCRIMINATION ACTION)**

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

You should draft discovery requests with the aim of uncovering information about the employee's case, including potential witnesses, individuals with knowledge, background, documents, and other evidence that supports the employee's claims and possible damages. Traditional discovery requests to employees include prior and subsequent employee records of the employee, tax returns, diaries, logs, medical records, and communications between the employee and current or former employees of the employer where the underlying circumstances of the case are discussed. The new limitation of Rule 26(b)(1) should not hinder you from continuing to request this kind of information, but you should be prepared to make a heightened showing that you need it (e.g., the information is relevant to the subject matter of the case, it is not readily available elsewhere, it concerns the conduct complained of, etc.).When drafting and serving interrogatories, document production requests, admissions, authorizations, and FOIA requests, focus on:

- Justifying the burden for any discovery that goes beyond the direct circumstances of the alleged wrongful conduct
- The damages claimed by the employee –and–
- Any defenses

Make sure to include the following types of information in your requests unless they are not relevant to your particular case.

Employment Records and History

A plaintiff's employment records from previous employers allow an employer to obtain similar complaints the employee has made or filed against other employers, dates of employment and income for calculation of damages, and a pattern of the employee's poor performance or misconduct.

Tax Records

An employee's income is relevant for the purposes of damages and mitigation. An employee's claims for back pay or front pay may be limited by later employment, other sources of income, or failure to obtain new employment. Tax records are the most accurate and complete sources of an individual's income; however, a plaintiff may be reluctant to produce this information because it contains personal information they find irrelevant to the case and their claim for damages.

Diaries and Journals

An employer's request for personal diaries and journals is to obtain evidence (or the lack thereof) of emotional distress and/or physical damages and any reference to or description of the allegations in the complaint. Diaries and journals can exist in hard-copy books, electronic formats (on computers, tablets, smartphones, etc.), or audio/video recordings.

Medical Records

Employers seek a plaintiff's medical records for claims of emotional distress, physical damages, or disability. This type of information (e.g., healthcare records or medical information about the employee) may require a release of information signed by the employee to accompany the document request. This is particularly true when the plaintiff does not have a copy of his or her medical records; in such a case, the only source of the records would be an institution such as a hospital, which is not otherwise authorized to release patient records to third parties.

> Employers often request records from an employee's social media accounts . . . because social media is a relatively new area of discovery for employment discrimination cases, courts are still determining the scope of content employers can obtain from employees.

Plaintiffs must sign a medical release form that authorizes an institution to release protected information. Note that a medical release is the only kind of release an employer may compel a plaintiff to sign. However, not all courts will order a plaintiff to sign a release. If the plaintiff does sign a release, you may use it to request the information directly from the institution or third party, rather than requesting it from the plaintiff or their counsel.

Emails, Texts, and Other Electronic Communications

Employers often seek electronic communications between the employee and other individuals regarding the allegations in the complaint and/or between the employee and any individual he or she claims subjected the employee to discrimination or harassment.

Prepare for objections from the plaintiff alleging the requests are overbroad or that all relevant communications have been provided, for example. Additionally, prepare for disputes concerning the format and manner in which the electronic communications should be produced. To aid in preventing and responding to objections from the plaintiff, consider limiting the request in time and scope. For example, request the production of emails or text messages only if they are:

- Between plaintiff and a current and/or former employee of defendant
- Written during the pertinent time period –and–
- In relation to the plaintiff's alleged emotional or mental state

Social Media Accounts

Employers often request records from an employee's social media accounts, such as Twitter, Facebook, Google+, Snapchat, YouTube, etc. These requests are for reasons similar to why employers seek diaries and journals. The purpose is to obtain information about the employee's emotional and psychological state (for claims of emotional distress damages), physical state (for claims of physical damages or disability), any reference to or description of the allegations in the complaint, and mitigation of damages.

Because social media is a relatively new area of discovery for employment discrimination cases, courts are still determining the scope of content employers can obtain from employees.

The social media information that employers seek can include profile information, photographs, postings, messages, tweets, videos, etc. Remember to use the proportionality factors of Rule 26 to determine if the plaintiff's social media information is discoverable.

As previously stated, parties may specify the form in which the opposing party should produce ESI, including social media information. However, this is often a point of dispute between the parties. Examples of methods of production include requesting the employee's username and password, a download of social media data, or authorizations for the release of records from the social media accounts to subpoena the social media platform organizations.

Other Litigation

Other legal proceedings can yield information concerning the employee's mental and/or physical state or employability, show that the employee has a history of filing lawsuits or filed similar lawsuits alleging the same facts or claims against a different employer, reveal statements the employee made about his or her employment with the employer, or confirm wages earned.

Best Practice Tips and Considerations for Successful Discovery Requests

Start with What Your Client Has

When defending employers, obtain as much factual information as early in the dispute as possible from your own client. Engaging in this process early on can pay off, particularly if the court limits the scope of discovery later in the case.

Gather Documents

Obtain from your client the employee's personnel file and other documents related to employee performance, attendance, and disciplinary action; the company handbook; and information and documents about similarly-situated employees. This material will help you identify evidence of legitimate, non-pretextual reasons for adverse employment actions.

Engage in an Informal Discovery Process

Conduct informal witness interviews. The notes you take during the interviews are work product and generally not discoverable.

Conduct Background Checks

Search civil and criminal records to determine if the employee or members of his or her family have been involved with other litigation or issues that affect the employee's claims.

Conduct Internet Searches

You can obtain information about the plaintiff and witnesses at no or minimal cost through internet searches using search engines, social media platforms, and other similar websites. Additionally, LexisNexis can be a useful tool in obtaining information quickly and efficiently.

Formal Discovery

Scope of Discovery

Remember the requirements for permissible discovery:

- The matter must not be privileged
- The matter must be relevant to any party's claim or defense
- Information need not be admissible in evidence to be discoverable
- The matter must be proportional to the needs of the case

For the last requirement—proportionality—consider the proportionality factors:

- How important are the issues at stake in the action?
- How much is the amount in controversy?
- What is the parties' relative access to relevant information?
- What are the parties' resources?
- How important is discovery in resolving the issues?
- What is the burden/expense of the proposed discovery, and does this outweigh its likely benefit?

If the considerations and answers to the questions align in favor of the discovery, the request is more likely to be granted, even if objected to. If they don't, apply these requirements to tailor the request to the issues of the case.

Privileged Information

If the plaintiff objects that information you request is privileged, examine whether you can use either of these two approaches to overcome the objection:

- **Waived privilege.** If the plaintiff has already produced the documents in the current action or another case, or has produced the documents to the government, you can argue that the plaintiff has waived any privilege or protection and thus compel discovery.
- **Showing need.** Rule 26(b)(3)(A)(ii) permits discovery of even privileged information if a party can show a "substantial need for the materials to prepare its case and cannot, without undue hardship, obtain their substantial equivalent by other means."

Document Requests

You can ask the plaintiff to provide documents to you. The process for requesting production is governed by Rule 34.

Scope of Document Requests

Keep the following in mind when deciding on the breadth of each document request.

- Describe each document or type of document that you seek with "reasonable particularity" (i.e., strike a balance between being too specific so that many relevant documents fall outside of the scope of the request, and being so broad that the other party could raise an objection).[3]
- Identify the time period from which you seek the documents (it often begins three years before the alleged discrimination). Ensure the time range is not so narrow that it fails to cover relevant documents. On the other hand, don't make the requested time frame too long because it can be subject to objection.
- When you plan to inspect the other party's documents, specify a reasonable meeting place and time for opposing counsel and/or the plaintiff to meet with you. Note that the opposing party may choose to produce copies of the information instead of allowing you to inspect the originals at an agreed-upon meeting.
- Remember, just because a document is discoverable does not make it admissible as evidence in a trial.

Spoliation and ESI

If you believe the plaintiff has destroyed or altered discoverable ESI or other information (i.e., has committed spoliation), move for sanctions. Courts can sanction plaintiffs by fining them, holding them in contempt, striking or dismissing pleadings or claims, or prohibiting the introduction of certain evidence.

3. *See* Fed. R. Civ. P. 34(b)(1)(A).

Objections

Below are examples of the objections employers can expect to receive on various types of material, and methods to avoid them. Strive to make your discovery requests proof against these objections or grounds for denial of your motions to compel information.

Objections to Employment Records or History

Plaintiffs commonly make the following objections to requests for records and other documents related to their employment history:

- The requested information is not relevant and/or is unduly burdensome.
- The plaintiff has already supplied the information or equivalent material. The new request would in effect impose a cost on the plaintiff to produce unnecessary duplicates.
- The request is too broad. (Stay away from overly broad terms in the request, such as all, every, or each.)
  - Subpoenas seeking "any and all employment records" without limitation, or a plaintiff's entire personnel file from a previous or later employer, are deemed overbroad and will be quashed.[4]
- The information requested improperly infringes on plaintiff's privacy.
  - Courts recognize an individual's legitimate privacy interest with respect to subsequent employment.[5]
- The request is too vague. This is similar to the "too broad" objection, and also requires that you be more specific in your definition of the item or document that you want.

Employers can limit or specify their requests for employment records or history to the following to avoid objections from plaintiffs:

- Employment records, such as payroll documents, showing dates, positions, and/or rates of pay to demonstrate the extent to which the plaintiff mitigated damages
- Grievances, complaints, charges, lawsuits, etc., that the plaintiff filed during prior employment to show patterns, habits, and credibility –and–
- Documents constituting or showing performance reviews, discipline, job responsibilities, time and attendance, and/or reasons for termination to demonstrate qualifications and job performance

Objections to Requests for Social Media Activity

Plaintiffs commonly make the following objections to requests related to their social media activity:

- The requested information is not relevant and/or unduly burdensome.
- The request is too vague. This is similar to the "too broad" objection, and also requires that you be more specific in your definition of the item or document that you want.
- The information requested improperly infringes on plaintiff's privacy.
- The purpose of the request is to harass, embarrass, harm, impede, or needlessly impose a cost or burden on the plaintiff.

4. *See* Pacheco v. Borden Dairy Co. of Fla., LLC, 2014 U.S. Dist. LEXIS 66293, at *2–3 (M.D. Fla. May 2, 2014) (agreeing with the plaintiff's argument that the subpoenas "served on Plaintiff's prior employers seeking…[a]ll records pertaining to employment and job placement of [Plaintiff] including applications, work history, personnel file, discipline records, employment contracts/agreements, documents relating to absences/leaves, attendance, [and] performance" were "overly broad [and] not reasonably calculated to lead to the discovery of admissible evidence"); *see also* Singletary v. Sterling Transport Co., Inc., 289 F.R.D. 237, 242–44 (E.D. Va. 2012) (quashing subpoenas to plaintiff's prior employers and finding subpoenas "overbroad on their face" in seeking "the complete personnel file of plaintiff") and EEOC v. Evening Entertainment Group, LLC, 2012 U.S. Dist. LEXIS 85310, at *1 (D. Ariz. June 20, 2012) ("Defendant's blanket requests for all personnel records from three former employers are overbroad on their face and amount to a fishing expedition."). 5. *See* EEOC v. Princeton Healthcare Sys., 2012 U.S. Dist. LEXIS 65115, at *1 (D.N.J. May 9, 2012); *see also* Tinio v. St. Joseph's Reg'l Med. Ctr., 2014 U.S. Dist. LEXIS 92565, at *4 (D.N.J. July 7, 2014) ("Courts . . . have precluded production of current employment records because 'individuals have a legitimate privacy interest in information regarding [their] subsequent employment'").

Plaintiff's social media activity can be relevant to the factual allegations in the complaint, claims of damages, emotional distress, and disability; you just need to limit requests to that scope. For example, limit requests to the social media activity relevant to the factual allegations in the complaint by seeking production of activity that relates to the plaintiff's work performance (to the extent social media was used during work hours), words or conduct the plaintiff finds unacceptable or offensive, and/or communications between the plaintiff and the coworker or supervisor who committed the alleged harassment and/or discrimination.

Emails, Texts, and Other Electronic Communications

Plaintiffs commonly make the following objections to requests for their electronic communications:

- The plaintiff has already supplied the information or equivalent material. The new request would in effect impose a cost on the plaintiff to produce unnecessary duplicates.
- The request is too broad. (Stay away from overly broad terms in the request, such as all, every, or each.)
- The parties cannot agree on the manner and/or method of production.

Employers can prevent, or at least undermine, these objections from plaintiffs by limiting requests for electronic communications in time and scope. Limiting requests to communications that took place during relevant time periods, that were between current and former employees, and that relate to allegations in the complaint (such as mental states the employer's wrongdoing caused), can result in an order for production.[6]

Medical Records

Plaintiffs' objections to requests for medical records tend to include the following:

- The requested information is not relevant and/or unduly burdensome.
- The information requested improperly infringes on plaintiff's privacy.
- The purpose of the request is to harass, embarrass, harm, impede, or needlessly impose a cost or burden on the plaintiff.

To avoid or prevail over objections, limit your requests for medical records to those related to the factual allegations in the complaint and to damages. Courts routinely require production of medical records that are limited in time and in scope to plaintiff's alleged disability or mental state.

Tax Records

Plaintiffs facing requests for their tax records often make the following objections:

- The requested information is not relevant.
- The information requested improperly infringes on the plaintiff's privacy.
- The employer has readily available other means to obtain documents or information without resorting to discovery.

As indicated above, tax records are relevant to the plaintiff's damages and mitigation of damages. Depending upon the jurisdiction, employers may need to show that the requested tax records are relevant to the litigation and contain information that is not readily available by other means of discovery. In the U.S. Court of Appeals for the Eighth Circuit, for example, courts use a two-prong test to determine the discoverability of tax returns. The court first considers whether the tax return is relevant to the subject matter of the action. If it is, the court then considers whether a compelling need for the tax records exists since the information the employer seeks is not readily available from other sources. The party requesting the tax returns has the burden of establishing relevance and the resisting party has the burden to identify the other source of the information sought.[7] In the U.S. Court of Appeals for the Sixth Circuit, however, tax returns "enjoy no special privilege from disclosure."[8]

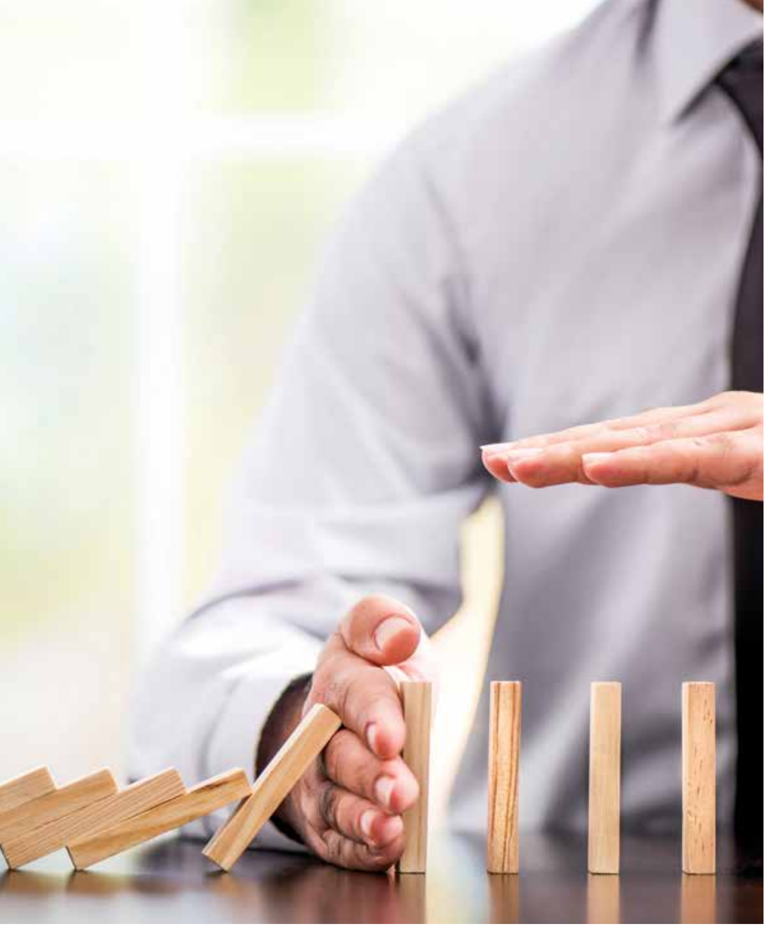
Diaries and Journals

Plaintiffs tend to object vigorously to requests for their personal diaries and journals, usually on the following grounds:

- The purpose of the request is to harass, embarrass, or harm the plaintiff.
- The employer has readily available other means to obtain documents or information without resorting to discovery.

Plaintiffs are reluctant to produce journals and diaries because they may contain private and embarrassing material. While this may be true, courts still find diaries discoverable when they contain relevant information concerning a plaintiff's mental state, the conduct complained of, or the plaintiff's relationship with the alleged harasser or discriminator. Employers seeking a plaintiff's diaries or journals should err on the side of caution by making specific and limited requests.

6. *See* Robinson v. Jones Lang LaSalle Ams., Inc., 2012 U.S. Dist. LEXIS 123883 (D. Or. Aug. 29, 2012). 7. *See* Johnson v. MERS-Goodwill, 2014 U.S. Dist. LEXIS 173847, at *2–3 (E.D. Mo. Dec. 17, 2014.) 8. EEOC v. SCI Tenn. Funeral Servs., 2006 U.S. Dist. LEXIS 97441, at *8 (W.D. Tenn. June 30, 2006).



Object to Objections

Beware of plaintiffs who refuse production and object only that the request is overly broad or unduly burdensome. This is one example of vague objections, which are a sign that the objecting attorney is just trying to cover his or her bases and does not have a well-founded objection.

Vagueness also runs into problems under Rule 34, which now requires parties to make objections with specificity. Thus, an objection that a request is "unduly burdensome" or "vague and ambiguous" without more may not be acceptable. In certain circumstances, it may be necessary to identify the specific part of the request that is "vague and ambiguous" or "unduly burdensome."

Do not let a vague objection pass unremarked—require opposing counsel to be specific. For example:

- Objection: already supplied
- Response: have the plaintiff identify where the information has already been supplied
- Objection: too broad
- Response: the plaintiff has failed to identify specifically what about the request is too broad
- Objection: too vague
- Response: the plaintiff has failed to identify specifically what about the request is too vague. L

Related Content

For a discussion of deposing plaintiffs in a discrimination action, see

> DEPOSING PLAINTIFFS IN EMPLOYMENT LITIGATION

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

For a checklist to use in preparing defense witnesses, see

> DEPOSITION PREPARATION OF DEFENSE WITNESSES CHECKLIST (EMPLOYMENT CASES)

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

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

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Discovery in Employment Discrimination Litigation: What Plaintiffs Can Request and Obtain from Defendants

This article discusses the scope of discovery that plaintiffs can obtain from defendants in employment discrimination cases, including limitations on discovery that defendants often attempt to assert, such as privilege, lack of relevance, lack of proportionality, and privacy interests. The article addresses how to use the different mechanisms for obtaining discovery effectively. It then discusses specific types of discrimination cases and discovery disputes that often occur in such cases.

Scope of Discovery Generally

The outer limit of permissible discovery in any federal case is set by Federal Rule of Civil Procedure 26(b), which permits parties to "obtain discovery regarding any nonprivileged matter that is relevant to any party's claim or defense and proportional to the needs of the case." The rule contemplates three limits on the scope of discovery: privilege, relevance, and proportionality. Two other important limits are the privacy interests of other employees and the bases for obtaining a protective order against discovery under Rule 26(c).

The Privilege Limitation

In addition to the familiar role of attorney-client privilege and attorney work product that are common to litigation in general, several specific issues arise in the context of employment discrimination. Following are tactics to challenge assertions of privilege in this context.

First, the employer may have conducted its own investigation of the alleged discrimination, either internally or with the assistance of outside counsel, and may assert that the investigation is privileged. If the investigation was conducted by human resources personnel, or was not conducted

because of litigation but merely as part of a human resources investigation, a court may hold that it is not privileged at all.[1]

Second, even if responsive documents are privileged, the defendant likely will have waived the privilege if it is asserting a *Faragher/Ellerth* affirmative defense. This defense, which applies in certain harassment cases, excuses the employer from liability if the alleged harasser is a co-worker (as opposed to a supervisor), and if the employer can prove (1) that the employer exercised reasonable care to prevent and correct any harassing behavior and (2) that the plaintiff unreasonably failed to take advantage of the preventive or corrective opportunities that the employer provided.[2] By asserting this defense, an employer puts its response to the challenged behavior at issue in the case, likely waiving its privilege concerning its own investigation of the complaints of harassment, as well as the nature of its policies for responding to and investigating complaints of harassment.[3] This can also waive the privilege for communications with outside counsel, if the content of the communications is relevant to the *Faragher/Ellerth* defense.[4]

Even outside the context of harassment cases, look carefully at the defendant's affirmative defenses in the answer. If they offer the defendant's investigation of or response to the challenged conduct as part of a defense, that may result in a waiver as to any information concerning the defendant's investigation or response.[5]

To be able to evaluate a defendant's assertions of privilege, you should demand a privilege log that complies with Rule 26(b)(5). Make this demand in your discovery requests, and if the defendant does not provide a satisfactory log with its discovery responses, renew the demand through meet-and-confer discussions right away. If the defendant is not willing to provide a privilege log, you may have to initiate a motion to compel.

Relevance

Any information that would tend to prove or disprove any element of any claim or defense is relevant. Note that some practitioners mistakenly argue that any information that is "reasonably calculated to lead to admissible evidence" is discoverable. Rule 26(b) was amended in 2015 to eliminate this phrase.

Lack of relevance will rarely be a hurdle that prevents you from obtaining discovery you need—as long as you can articulate a reason why the requested information could tend to prove or disprove an element of your claim, the information is relevant. Once you demonstrate relevance, the burden will be on the defendant to argue that some other limitation allows the defendant to withhold relevant information.

Proportionality

The factors Rule 26 lists for determining whether a discovery request is proportional to the case are "the importance of the issues at stake in the action, the amount in controversy, the parties' relative access to relevant information, the parties' resources, the importance of the discovery in resolving the issues, and whether the burden or expense of the proposed discovery outweighs its likely benefit."[6] The proportionality limit on discovery is likely to come into play when the plaintiff makes requests that place a burden on the defendant, such as a request for voluminous documents, or a request that would require the defendant to engage in a time-consuming search.

One common example is requests for production of emails, given the large quantity of emails that employees tend to generate. Courts often apply the proportionality limit by striking a compromise between the two parties' positions. For example, in Duhigg v. Goodwill Industries[7], the plaintiff asked the defendant to search the email accounts of three managers who allegedly harassed her for any emails mentioning her first or last name for the four years preceding her termination. The defendant reported that the search generated about 14,000 emails, which the defendant refused to review or produce. The defendant also conducted a search using its own chosen search terms during a shorter time period, which resulted in no hits. The court held that requiring the defendant to produce all emails with either the plaintiff's first or last name was too broad, but the court faulted the defendant for unilaterally choosing search terms and for applying them to a shortened time period. The court approved the plaintiff's time period, but ordered the parties to meet and confer regarding which search terms to use.

1. *See, e.g.*, Koumoulis v. Indep. Financial Marketing Grp., Inc., 295 F.R.D. 28, 46–47 (E.D.N.Y. 2013). **2.** *See* Vance v. Ball State Univ., 570 U.S. 421, 423 (2013). **3.** *See, e.g., Koumoulis*, 295 F.R.D. at 47–48. **4.** *See* id. **5.** *See, e.g.*, Walker v. Cnty. of Contra Costa, 227 F.R.D. 529, 535 (N.D. Cal. 2005) (in failure-to-promote case, defendant waived privilege by identifying investigation as affirmative defense, causing court to order disclosure of nearly all of an investigatory report prepared by an attorney retained by defendant). **6.** Fed. R. Civ. P. Rule 26(b)(1). **7.** 2016 U.S. Dist. LEXIS 126791, at *2 (D. Neb. Sept. 16, 2016).

The privacy interest of other employees is a common objection to the plaintiff's discovery requests in discrimination cases. State and federal privacy protections differ, so the discovery you can obtain may depend on whether you are in state or federal court.

A defendant will likely raise proportionality as an objection to requests for evidence of other similar allegations of discrimination or harassment made by employees of the defendant other than the plaintiff. Again, courts often strike a balance to achieve proportionality. For example, in Marsh v. Bloomberg Inc.[8], the plaintiff sought "all complaints regarding gender discrimination, fair pay, or harassment" at all Bloomberg offices and in any settlement agreements resolving such claims. Based on proportionality concerns, the court limited production to all sexual harassment or gender discrimination complaints filed about any person working in the same office as the plaintiff, and any settlement agreements related to that office that did not contain confidentiality provisions, with the names of the complainants to be redacted.[9]

The proportionality analysis in a class case will allow the plaintiff to discover a much broader range of information. For example, in a class action gender discrimination case, you may be able to obtain information pertaining to all the class members.[10] In drafting discovery requests and in meeting and conferring over them, keep in mind that the broader the time period and geographic scope that your request covers, the more likely that a court will impose limitations due to proportionality concerns.

Privacy Limits on Discovery

The privacy interest of other employees is a common objection to the plaintiff's discovery requests in discrimination cases. State and federal privacy protections differ, so the discovery you can obtain may depend on whether you are in state or federal court. If you are in federal court, state privacy law may apply if state law supplies the rule of decision (for example, in a diversity jurisdiction case).[11] Some courts recognize a privacy interest arising from the U.S. Constitution.[12] Others rely on Rule 26(c)'s protection against "annoyance" and "embarrassment" (discussed below under The Factors That Justify a Protective Order Limiting Discovery under Rule 26(c)). As a general rule, federal courts balance the plaintiff's need for the discovery against the strength of the privacy interest of other individuals. If your case is likely to involve the records of other employees, or records of your own client that are sensitive and should be kept confidential, propose to the defendant early on that you enter into a stipulated protective order that requires the parties to maintain the confidentiality of private information produced in discovery. The existence of such a stipulated protective order gives a measure of protection to sensitive documents produced in discovery, and therefore may cause courts to reject a defendant's refusal to produce information based on privacy grounds.[13] Some district courts or judges have a standard protective order that you may use. Entering into such an agreement early on can prevent delays in production of the information. If you plan to submit to the court information that has been designated confidential, you will need to follow the appropriate procedure in that court for filing documents under seal, which may require some advance planning. For example, depending on the court, you may need to file a motion for leave to file documents under seal.

The Factors That Justify a Protective Order Limiting Discovery under Rule 26(c)

Defendants resisting discovery may file a motion for a protective order under Rule 26(c), which allows courts to enter an order to "protect a party or person from annoyance, embarrassment, oppression, or undue burden or expense." The rule acts both as a source of limitations on available discovery, as well as a mechanism for defendants to invoke any of the previously discussed limits on discovery (privilege, privacy, etc.).[14] The undue burden and oppression factors call for the same type of analysis as the proportionality requirement.

8. 2017 U.S. Dist. LEXIS 77648, at *3 (N.D. Cal. May 22, 2017). **9.** *Marsh*, at *6–7. *See also* Wagner v. Gallup, Inc., 788 F.3d 877, 888 n.4 (8th Cir. 2015) (affirming lower court's decision to limit discovery into age discrimination case by location and job title). **10.** *See* Chen-Oster v. Goldman, Sachs & Co., 293 F.R.D. 557 (S.D.N.Y. 2013). **11.** *See, e.g.*, Madrigal v. Allstate Indem. Co., 2015 U.S. Dist. LEXIS 191875, at *17–19 (C.D. Cal. 2015) (applying California's constitutional privacy protection to discovery dispute when sitting in diversity). **12.** *See, e.g.*, Roettgen v. Foston, 2016 U.S. Dist. LEXIS 122476, at *3 (S.D. Cal. Sept. 9, 2016). **13.** *See, e.g.*, Chen-Oster v. Goldman, Sachs & Co., 293 F.R.D. 557, 566 (S.D.N.Y. 2013). **14.** *See, e.g.*, Jauhari v. Sacred Heart Univ., Inc., 2017 U.S. Dist. LEXIS 29441, at *5 (D. Conn. Mar. 2, 2017) (to professor claiming discrimination in denial of tenure, court granted discovery into comparator evidence for professors seeking tenure in the same year, but otherwise denied discovery based on likelihood of "annoyance [or] embarrassment" under Rule 26(c)).

If the defendant refuses to produce some of the written discovery you requested, you should initiate a meet-and-confer process. It is often helpful to use a combination of telephone calls and letters to conduct this process.

Mechanisms for Obtaining Discovery

Your goal in discovery is to obtain the proof that will allow the plaintiff to survive a summary judgment motion and then prevail at trial. At the outset of discovery, you should perform legal research to understand each element of your client's claim(s) and each element of the defendant's likely defenses. Then, you should draft a discovery plan that maps out the evidence you need to prevail on each of the elements of the claims and defenses. By doing this up front, you will avoid realizing long into the case that you have failed to request discovery on a topic that is important to your case. As the case proceeds and you gather evidence, update your discovery plan to see what you have obtained, what you are still missing, and whether you have learned of new topics of discovery that you had not been able to foresee at the outset of the case.

All discovery requests must be signed under Federal Rule of Civil Procedure 26(g). By signing a request, you are certifying that the request is not unreasonable or unduly burdensome. If the court finds that this rule has been violated without substantial justification, it is required to impose a sanction under Rule 26(g).

Requests for Production of Documents

Serve document requests early in the case—you will need the evidence to depose witnesses, to prepare your witness to be deposed, and to determine what additional discovery to request. Indeed, the Federal Rules now permit a plaintiff to serve discovery requests 21 days after service of the complaint. Although such requests will be deemed to have been served on the day of the Rule 26(f) conference (which was formerly the earliest possible date of service), delivering the requests to the defendant early will give the defendant time to make a full, timely response, and will undermine any later argument by the defendant that it needs more time to respond. There is no limit on the number of document requests you can propound under the Federal Rules, so be specific and comprehensive, but do not be unnecessarily duplicative. If you propound 100 requests, you will not only have to write them, but you will have to review 100 responses and meet and confer about any disputes. When drafting, beware that the defendant will probably interpret them as narrowly as possible. Thus, even though an objective reader might assume that you had intended to include certain documents in your request, if there is any way to interpret the wording of your requests narrowly, such that they arguably do not require the production of certain documents, a defendant may withhold the types of documents you are seeking based on such an interpretation.

You should generally use document requests to obtain documents concerning:

- **The plaintiff.** Seek any formal or informal complaints that he or she made, his or her personnel file (or application file, if the case involves a failure to hire), performance reviews, payment information, relevant communications, and any other documents that might bear on the claims or defenses. Talk with your client about the requests as you prepare them to make sure you cover all documents the client can think of that might be relevant. Speaking with your client will also help you determine whether to request production of the plaintiff's own emails, which you should do if, for example, the emails might contain examples of discriminatory or harassing messages, reflect complaints by your client, or show how your client was performing relative to co-workers whom the employer treated differently.
- **The alleged harasser or perpetrator of discrimination.** You likely should request documents pertaining to any other allegations of discrimination or harassment by that individual because such incidents will tend to prove that he or she was more likely to engage in the same behavior toward your client.
- **The alleged incidents of discrimination or harassment.** Seek any documents in the defendant's possession pertaining to the alleged incidents of discrimination or harassment. Word the request broadly to cover any document the employer might possess, including the company's knowledge of and responses to any reports or complaints, as well as all documents pertaining to any investigation by anyone into the incident.
- **Comparable employees and examples of other complaints.** Depending on the nature of the case, seek documents about similarly situated employees (or documents that will help you identify who the similarly situated employees are). Determine which documents will help you prove that the employer treated your client less favorably than those comparable employees. Seek documents about any other employees who complained of similar conduct, which may either tend to prove that the plaintiff's allegations are truthful, or be probative of how the company responds to such allegations.
- **Documents pertaining to the company's anti-discrimination policies and procedures.** These are particularly important if the employer is going to rely on its response to your client's complaint(s) or on his or her alleged failure to formally complain as a defense.
- **Any other documents that will help complete your proof plan.** As discussed above, at the outset of the case, map out the elements of the claims and the elements of any likely defenses. Then look at each element and consider whether the defendant may have documents that would help you prevail on that element.
- **Documents about the defendant entity.** If there is any uncertainty about which entity is the relevant defendant, or whether multiple entities might be liable (e.g., due to a joint employer relationship), request information about the defendant entities that will allow you to establish liability.

Interrogatories

Unlike document requests, interrogatories in federal court are limited to 25 per party unless the court grants leave to propound more. Be careful not to waste them. In a case with multiple plaintiffs, one strategy is to have a single plaintiff propound interrogatories, such that if that plaintiff reaches the limit of 25 interrogatories, another plaintiff can propound additional interrogatories if necessary. As with document requests, word the interrogatories extremely carefully to make sure that the defendant cannot interpret them more narrowly than you intend. Note that responses to interrogatories (unlike responses to document requests and requests for admission) must be verified—signed under oath by the responding party. If you receive unverified responses, you should insist upon verification.

Interrogatories are useful, particularly early in the case, for identifying witnesses to depose or interview. For example, in a termination case, you should seek the names and contact information of each person involved in the decision to terminate your client's employment. In a harassment case, you should seek the identity of everyone with knowledge about the incidents of alleged harassment. You should also seek the identity of others who complained about the harasser's conduct or about similar conduct at the plaintiff's workplace, although you will likely have to overcome a privacy objection. To that end, you can agree that the interrogatory responses will be covered by a stipulated protective order.

You can use interrogatories to pin down the defendant to a specific story, which you can then probe and attempt to rebut in depositions and follow-up discovery. For example, in a termination case that may involve a mixed motive, ask the defendant to state all the reasons why it terminated the plaintiff's employment. The answer will give you a target to attack, both in depositions and in further written discovery, in attempting to rebut the defendant's claim that it would have terminated the plaintiff even absent any unlawful motive.[15] Likewise, if you suspect that the defendant may assert that it would have fired the plaintiff anyway based upon facts it learned *after* the termination,[16] ask the defendant to state any facts that would support the employee's termination that it discovered after the termination.

You can also use interrogatories to identify any documents that were responsive to your discovery requests but were destroyed.

For additional helpful interrogatories to consider asking, California provides so-called "form" interrogatories specific to employment cases, and although the form itself can be used only in California state courts, it may provide helpful ideas for interrogatories in federal cases.[17]

Requests for Admission

You can use requests for admission to nail down certain uncontroversial facts so that you do not have to expend time and effort attempting to demonstrate them in discovery. For example, if you would like a clean piece of evidence stating that your client applied for a particular position but that another individual was hired for it, you could request the defendant to admit those facts. The request for admission will have to be quite straightforward and incontrovertible for the defendant to admit it; if there is any room for disagreement, it will likely deny the request, or admit it only in part.

Another excellent use of requests for admission, particularly as the case moves closer to trial, is to establish the authenticity of documents that you wish to submit into evidence. If a defendant fails to make an admission when requested, and the plaintiff later proves that the admission was true or the document genuine, the court may award sanctions.[18]

Meet-and-Confer on Written Discovery

If the defendant refuses to produce some of the written discovery you requested, you should initiate a meet-and-confer process. It is often helpful to use a combination of telephone calls and letters to conduct this process. Phone calls allow you to get a sense of the real basis of the defendant's objections and where the defendant (and you) may be willing to compromise. Letters allow you to keep track of what has been discussed or agreed in the phone calls, and provide a record that you can use

15. *See* 42 U.S.C.S. § 2000e-5(g)(2)(B). 16. *See* McKennon v. Nashville Banner Pub. Co., 513 U.S. 352, 362 (1995). 17. *See* Form Interrogatories – Employment Law https://www.courts.ca.gov/documents/disc002.pdf. 18. *See* Fed. R. Civ. P. 37(c)(2).

if you need to file a motion to compel the defendant to produce additional information. Organize your letters by request number, and be comprehensive—if you do not include certain requests as raising discovery disputes, you will be in a weaker position to show the court that you met and conferred on those requests, but were unable to obtain adequate responses from the defendant. Keep the process moving quickly, and be sure to track and document whether the defendant is living up to its commitments to produce certain documents by certain dates. If the meet-and-confer process is taking too long, it can be helpful to specify a reasonable date on which you will initiate the motion-to-compel process. If you do not engage in a meaningful meet-and-confer process before filing a motion to compel, the court may require further meeting and conferring before issuing a decision.

Related Content

For more information on plaintiff-side discovery in employment discrimination cases, see

> DEPOSING EMPLOYER WITNESSES: HOW TO PREPARE IN EMPLOYMENT DISCRIMINATION CASES (PRO-EMPLOYEE)

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

For a discussion of deposition strategies in employment cases, see

> RULE 30(B)(6) DEPOSITION STRATEGIES FOR EMPLOYEE-PLAINTIFFS IN EMPLOYMENT CASES

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

For a sample document request form for use by plaintiffs' counsel, see

> DOCUMENT REQUESTS (PLAINTIFF TO DEFENDANT) (SINGLE-PLAINTIFF DISCRIMINATION ACTION)

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

For a checklist to use in preparing a plaintiff for his or her deposition, see

> DEPOSITIONS IN EMPLOYMENT LITIGATION: PREPARING THE PLAINTIFF CHECKLIST (EMPLOYEE)

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

For a model discovery plan, see

> DISCOVERY PLAN (TITLE VIII DISCRIMINATION CASES (PRO-EMPLOYEE)

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

Moving to Compel Further Responses to Written Discovery

If your meet-and-confer process does not provide you with the information you need, do not be afraid to file a motion to compel. Certain defendants will simply withhold responsive information unless you show that you are willing to hold them accountable with the court. If you win a motion to compel, the defendant will be less likely to wrongfully withhold information in the future, as the judge will not look kindly upon repeated unjustified refusals to produce information.

Individual courts and judges often have specific procedures for motions to compel. Some judges begin the process with short, informal submissions of the parties' respective positions, after which the judge will provide the parties with an indication of how he or she would likely rule if a full-blown motion were filed. Other courts have elaborate local rules that govern the submission of joint briefing, providing a specified order and length of time for each party to provide its portion of the submission to the other party.[19] Be sure to review the court's local rules and the judge's rules or standing order well in advance, so that if, for example, you want to have the motion decided before a deposition, or you need to resolve a dispute before a discovery cut-off date, you do not wait too long to initiate the process.

Depositions

Depositions are typically more useful after you have obtained written discovery. The written discovery will give you ideas for lines of deposition questioning, and will give you ways to hold the deponent accountable by introducing documents that contradict the deponent if he or she is not truthful. If you depose a witness before you obtain certain documents that are relevant to that witness, it may not be possible to depose the witness a second time.

For each deposition, prepare a detailed outline. Use your discovery plan to make sure you obtain testimony that will fill in the plan

19. *See, e.g.*, C.D. Cal. Loc. R. 37-1, 37-2.

wherever possible, and also to generate lines of questioning that will help you locate additional evidence you need.

One key deposition will be of the defendant's corporate designee under Federal Rule 30(b)(6). Your deposition notice must include a list of the topics about which you wish to question the witness. The company then has an obligation to prepare the witness to speak about those topics. The witness's testimony, if it is within the noticed topics, will be binding on the company. Draft the topics so that they are broad enough to cover the lines of questioning that you will want to ask, but specific and concrete enough that the defendant has a fair opportunity to prepare the witness on the topics. If the defendant objects to the scope of the topics in such a way that you will not be able to obtain important testimony, you can either seek a ruling on the objection before the deposition or hold the deposition open pending a ruling on the objection. Note: you will generally be free to question the witness about topics outside of the notice, although the defendant has the right to object and state that the answers to such questions are given in the witness's personal capacity only, and not on behalf of the company.

Disputes That Often Arise in Specific Types of Discrimination Cases

Disputes That Arise in Title VII Cases

In individual discrimination cases under Title VII of the Civil Rights Act of 1964,[20] such as those involving a termination, failure to promote, or failure to hire based on membership in a protected category, the plaintiff typically must seek information about how the employer treated other similarly situated employees or applicants. This often generates disputes about employee privacy. The information is often essential to the plaintiff's case—summary judgment may be granted against an employee who fails to demonstrate the existence of similarly situated employees who were treated more favorably, if no other evidence of discrimination is present. Therefore, courts are likely to compel disclosure of such information over privacy objections, although they will take steps to limit the invasion of privacy if possible.[21]

Defendants often challenge requests concerning other incidents or complaints of similar discrimination or harassment on either relevance or privacy grounds. You nevertheless have a good chance of obtaining such information, because many courts have held that evidence of systemic discrimination in a workplace is probative of an individual's claim of discrimination, even if the plaintiff is not claiming that the employer engaged in a pattern or practice of this kind of unlawful conduct.[22]

In class discrimination cases, you will be able to obtain broader information than in an individual case.[23] In addition, if you have a need to contact the individuals who made complaints in order to investigate the claims, you should seek unredacted versions of the complaints.[24] If you are asserting a company-wide claim, you may obtain company-wide discovery if you are able to plead in the complaint, or gather facts to demonstrate, that the practice you are challenging did, in fact, apply company-wide, regardless of different business units, regional management teams, and the like.[25] Still, courts will balance the plaintiff's need for the discovery with the burden on the defendant.[26]

In Title VII disparate-impact class actions, which allege that a facially neutral policy had a disparate impact on a protected category of employees, you will likely be entitled to information about the impact that the allegedly discriminatory policy had on the class. Statistical proof is typically central to disparate impact claims, so plaintiffs have a strong claim for access to the data that will allow analysis of the impact of the policy at issue.

You may consider noticing the deposition of the defendant's CEO or other high-level managers. If the CEO has personal knowledge of facts relevant to the case, you should be able to take the deposition. If not, you will face an uphill battle. Courts tend to protect upper-level management from speculative depositions.[27]

20. 42 U.S.C.S. § 2000e et seq. 21. *See, e.g.*, Harris v. Harley-Davidson Motor Co. Operations, Inc., 2010 U.S. Dist. LEXIS 119311, at *7 (M.D. Pa. Nov. 10, 2010) (requiring defendant to answer interrogatories identifying similarly situated employees who also complained of harassment, and to produce the portions of those employees' personnel files relating to the complaint and defendant's response, while redacting confidential and private information); Metcalf v. Yale Univ., 2017 U.S. Dist. LEXIS 21032, at *2 (D. Conn. Feb. 15, 2017) (similar). 22. *See, e.g.*, Digan v. Euro-Am. Brands, LLC, 2012 U.S. Dist. LEXIS 26045, at *11 (N.D. Ill. Feb. 29, 2012). 23. *See, e.g.*, Chen-Oster v. Goldman, Sachs & Co., 293 F.R.D. 557, 564 (S.D.N.Y. 2013) (in gender discrimination class action, requiring defendant to produce "any internal complaints regarding compensation, promotion, or performance review where a female employee who is a member of the putative class drew a comparison between herself or another putative class member and one or more of her male colleagues"). 24. *Chen-Oster*, at 565. 25. *See, e.g.*, Bell v. Lockheed Martin Corp., 270 F.R.D. 186, 189–92 (D.N.J. 2010) (granting company-wide discovery because complaint sufficiently alleged that gender discrimination practices applied across business units). 26. *See, e.g.*, Welch v. Eli Lilly & Co., 2008 U.S. Dist. LEXIS 32812, at *4 (S.D. Ind. Apr. 16, 2008) (where defendant produced information pertaining to 5,000 potential comparators, court was unwilling to order production pertaining to defendant's 21,000-person national workforce, but suggested that such a step might be justified if the plaintiffs came forward with evidence from the initial production that supported their claim of a discriminatory pattern or practice). 27. *See, e.g.*, Lewelling v. Farmers Ins. of Columbus, 879 F.2d 212, 218 (6th Cir. 1989); *but see* Conti v. American Axle and Manufacturing, 326 Fed. Appx. 900, 907–908 (6th Cir. 2009) ("It is very unusual for a court to prohibit the taking of a deposition altogether and absent extraordinary circumstances, such an order would likely be in error.") (internal citation omitted).

Related Content

For a Rule 30(b)(6) notice form, see

> **NOTICE OF DEPOSITION (FRCP RULE 30(B)(6)) (PLAINTIFF TO DEFENDANT)**

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For a guidance on complying with the ADEA, see

> **AGE DISCRIMINATION IN EMPLOYMENT ACT (ADEA): KEY CONSIDERATIONS**

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

For more information on the ADA, see

> **AMERICANS WITH DISABILITIES ACT: EMPLOYER REQUIREMENTS AND REASONABLE ACCOMMODATIONS**

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

For more information on Title VII, see

> **TITLE VII COMPLIANCE ISSUES**

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

For an analysis of potential joint employer relationship, see

> **JOINT EMPLOYMENT RELATIONSHIPS: BEST PRACTICES AND RISKS**

RESEARCH PATH: *Labor & Employment > Screening and Hiring > Recruiting and Screening > Practice Notes*

For information on joint employers, see

> **9 LARSON ON EMPLOYMENT DISCRIMINATION § 152.08**

RESEARCH PATH: *Corporate Counsel > Labor and Employment Law > Employment Discrimination > Secondary Materials*

Disputes That Arise in ADA Cases

In discrimination cases under the Americans with Disabilities Act (ADA) in which plaintiffs challenge the failure to provide a reasonable accommodation, plaintiffs must prove that with a reasonable accommodation, they could have performed the essential functions of the job in question, and that the employer refused to make such accommodations. Evidence concerning other employees may prove that other employees with similar disabilities were performing the functions of the job with the help of accommodations. Based on privacy grounds, courts will be wary of disclosing information about the reasonable accommodation requests of other employees, but such information may be obtainable, potentially on an anonymized basis.[28]

Disputes That Arise in ADEA Cases

Discrimination cases under the Age Discrimination in Employment Act (ADEA) raise many of the same issues as Title VII cases. As a general matter, an employee over the age of 40 who has suffered an adverse employment action can prove discrimination, among other ways, by showing that he or she was replaced by a younger employee, or that similarly situated younger employees were not subject to the same adverse action. Thus, as in a Title VII case, discovery necessarily involves inquiring about the circumstances of other employees.

One wrinkle in ADEA cases is that the ADEA does not authorize mixed-motive discrimination claims (unlike Title VII claims, as discussed above). Keep this distinction in mind when creating your discovery plan. L

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28. *See, e.g.*, Frederick v. California Department of Corrections and Rehabilitation, 2011 U.S. Dist. LEXIS 53269, at *7 (N.D. Cal. May 18, 2011).

Mark Haut LEXIS PRACTICE ADVISOR

Representing Parties in Interest in a Chapter 11 Bankruptcy

This article provides general guidance for counsel retained to represent a party in interest in a bankruptcy proceeding. Bankruptcy cases involve myriad issues so coverage in this article is limited to certain general actions that should usually be taken when representing a party in interest. Counsel should refer to the specific topics in Lexis Practice Advisor to find practical advice concerning specific bankruptcy issues.

Overview of Representing Parties in Interest in Bankruptcy

In addition to debtor representation, attorneys are retained in bankruptcy proceedings to handle a wide variety of matters both big and small. Numerous parties have stakes in the outcome of a bankruptcy case, particularly a large case. Some attorneys represent parties involved in every aspect of the case, such as creditors' committees and Debtor in Possession (DIP) lenders (among others), while other attorneys are retained to handle discrete matters, such as filing a proof of claim, defending a client in an adversary proceeding, and/or responding to a motion. Counsel may also be retained prior to the bankruptcy to assist with prebankruptcy planning and workout discussions with the debtor.[1]

Counsel representing Chapter 11 debtors and creditors' committees have numerous responsibilities that are outside the scope of this article.[2] When filing bankruptcy, certain non-debtor clients will immediately retain counsel to represent them in all matters that may arise in the bankruptcy proceeding. These clients may be existing clients that frequently utilize the same counsel's services for bankruptcy

matters (usually large institutional clients, such as banks, national landlords, or telecommunications companies), existing clients of other departments in the bankruptcy counsel's firm, or new clients.

1. For information on workouts, *see* Business Workouts. 2. For information on certain of these responsibilities, *see* Creditors' Committees' Roles in Chapter 11, Creditors' Committee Objections, and Fiduciary Duties and Statutory Obligations of Professionals to the Debtor-in-Possession.

Counsel Retained Immediately after the Bankruptcy Filing

Counsel retained upon the Chapter 11 filing (or prior) should immediately review the bankruptcy petition and first day motions to determine if any of the relief sought is objectionable. After a Chapter 11 filing, the debtor typically files several motions at the same time as the petition (known as first day motions). First day motions involve matters requiring immediate consideration and are heard on or soon after the bankruptcy filing date. The first day motions often include requests for interim postpetition financing and/or the use of cash collateral, as well as requests for authority to pay certain prepetition claims (such as certain employee and critical vendor claims, for example) ahead of others during bankruptcy. The requests for interim relief are made to ensure that the debtor's business operations continue uninterrupted.[3] In certain jurisdictions, the debtor is also required to file an affidavit or declaration with the first day motions (a so-called first day affidavit). The affidavit typically includes general and specific information about the debtor and is used to meet the applicable local rule requirement and provide evidentiary support for the first day motions. For this latter reason, debtors in jurisdictions that do not require a first day affidavit will sometimes still file one with the first day filings. A review of the first day affidavit will assist counsel in understanding the debtor's business, the events leading to the bankruptcy filings, and potentially the debtor's intentions for the bankruptcy proceeding. Counsel will be able to quickly access all of these documents through Case Management/Electronic Case Files (CM/ECF), and, when dealing with large debtors, the claims agent's website. Claims agents typically maintain a website to provide the public with free access to all filings on the bankruptcy docket as well as the claims filed in the case.

Counsel should consider how the first day motion affects the client's interests. For instance, counsel to significant and essential trade creditors should consider contacting the debtor to negotiate obtaining critical vendor status. Counsel should discuss with the client whether counsel should attend the first day hearing regarding the first day motions to object to entry of orders that may adversely affect their interests or otherwise be present to protect their rights. Time permitting, counsel might file a quick objection to one or more of the first day motions. However, in most cases, counsel will not have time to draft an objection and will need to make an oral objection at the first day hearing. When there is an objection to interim relief, counsel usually negotiates the terms of the proposed order with debtor's counsel at the courthouse.

> To effectively represent a non-debtor client in a bankruptcy proceeding, counsel will need to understand the client's relationship with the debtor and the reason for the retention.

Outside of the first day motions, counsel may also need to take certain actions in the early stages of the bankruptcy case to protect its client's interests. For instance, some creditors will need to timely file a reclamation claim to preserve its reclamation rights.[4] Prepetition secured creditors may object to the final DIP financing and/or cash collateral motion if the client's prepetition lender is not convinced that its liens are adequately protected. Depending on the client and the size of its claims, counsel may also want to discuss whether the client wants to serve on the creditors' committee. Serving on the committee allows a creditor to influence the outcome of the case in a meaningful way. On the other hand, serving on the committee comes with significant responsibilities.[5] In sum, counsel should be prepared to file objections and otherwise protect its client's interests during the flurry of activity that takes place at the beginning of a Chapter 11 case.

Necessary Actions during the Bankruptcy Case

Regardless of when counsel is retained, counsel should typically take the following additional steps after being retained:

- **File a notice of appearance**. In most cases, counsel should file a notice of appearance requesting service of all pleadings. The notice should include the client's name, the law firm's name and contact information (office address, telephone number, and fax), and the specific lawyers at the firm and their email addresses.[6] Counsel representing a client that also wants to receive service of all pleadings should include the name of the individual who should receive pleadings (often in-house counsel) and that person's contact information. Note that in certain cases, filing a notice of appearance could potentially waive jurisdictional objections.[7] Counsel should inform the client that the notice of appearance is a publicly filed document prior to the filing. In certain instances, the client may want to silently monitor the case and, for business reasons, may not want certain parties or the general public to be aware of its interest in the bankruptcy. For instance, the client may be interested in the potential sale of the debtor's assets to a competitor and would consider bidding for such assets if the competitor is also bidding or becomes a stalking horse bidder. However, until that point, the client may want to be informed of these and other developments in the case while considering various strategies.
- **If applicable, file a *pro hac vice* application and retain local counsel**. If not authorized to practice in the debtor's jurisdiction, counsel should submit a request to be admitted *pro hac vice*. Counsel should check the local rules for the *pro hac vice* requirements and use the applicable local form. In some jurisdictions, counsel can be admitted *pro hac vice* and practice before the court without local counsel and, in other jurisdictions, counsel must have local counsel to be admitted (and submit objections, other pleadings, and appear before the court).[8] Counsel should check with the client to determine if the client has a preference for local counsel (or uses the same firm for local counsel). If the client has no preference, counsel should then ask members of the firm or other attorneys for local counsel recommendations.
- **If applicable, file a Fed. R. Bankr. P. 2019 statement**. Fed. R. Bankr. P. 2019 is a disclosure rule that generally requires committees, creditor groups working in concert, and the attorneys who represent them to file a verified statement that lists each committee or group member's name, address, and nature and amount of each disclosable economic interest. Counsel representing multiple creditors typically file the statement at the outset of the case (and supplement the statement as needed). Attorneys providing general advice to multiple creditors that are following a bankruptcy case do not have to file a statement unless or until the attorney takes a position in the case, such as filing pleadings, objections, or appearing in court (or soliciting votes). Counsel that files a proof of claim on the client's behalf or advises the client on voting on a plan but takes no positions in court (through pleading, appearances, etc.) does not have to file a statement. Despite these rules, counsel should usually file the statement at the beginning of the multiple representations and not risk inadvertently failing to comply with the rule by taking positions before filing the statement (or entirely neglecting to file the statement) as the bankruptcy case becomes active. Counsel should also check the local rules for rules addressing the timing or other local requirements for Fed. R. Bankr. P. 2019 statements.[9]
- **Review schedules**. The debtor is required to file a schedule of assets and liabilities with (or within 14 days of filing) the bankruptcy petition. However, in large complex cases, it is often not possible to file schedules and statements of financial affairs within 14 days. Fed. R. Bankr. P. 1007(c) permits the bankruptcy court, for cause, to extend the time for filing the schedules and statements. When the schedules are filed, counsel should identify its client's claims and confirm whether the debtor listed them accurately. In doing so, counsel should ascertain if the debtor listed the claims as contingent, disputed, or unliquidated claims. When representing a large corporation with many affiliates, counsel should check the schedules to see if any affiliates, subsidiaries, or d/b/as are listed. Counsel may already have the relevant names as part of its review of client contracts with the debtor or other due diligence. Even if counsel believes it has all such information, counsel should still check with the client. Some large corporations acquire smaller businesses and, consequently, have many distinct business units that may have limited communication with

Related Content

For an overview of the Bankruptcy Code, see

> **BANKRUPTCY 101 FOR COMMERCIAL LITIGATORS**

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For a detailed summary of the Chapter 11 process, see

> **CHAPTER 11 CASES OVERVIEW**

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For a discussion on the roles of the major participants in a Chapter 11 case, see

> **CHAPTER 11 KEY PLAYERS**

RESEARCH PATH: *Bankruptcy > Commencing a Bankruptcy Proceeding > Current Bankruptcy Scheme and Reforms > Practice Notes*

3. For more information on first day motions, *see* First Day Filings. 4. For more information on reclamation, *see* Reclamation. 5. For more information, *see* Creditors' Committee Formation. 6. *See* Fed. R. Bankr. P. 9010(b). 7. *In re* LandAmerica Fin. Grp., Inc., 2013 Bankr. LEXIS 1756, at *3 n.4 (Bankr. E.D. Va. Apr. 30, 2013) ("[b]y filing a proof of claim and a notice of appearance, Experian consented to personal jurisdiction in this Court"); *see also In re* Deak & Co., 63 B.R. 422, 432 (Bankr. S.D.N.Y. 1986) ("[b]y filing his notice of appearance, DAMA has indicated and, in essence, declared himself to be not only interested in these proceedings but to have acknowledged that his interests are affected . . . [and] [i]n this context, DAMA has voluntarily interjected himself into these proceedings and by his presence has indicated his consent to jurisdiction over matters involving him").

8. *Compare* S.D.N.Y. U.S.B.C. L.B.R. 2090-1 (allowing *pro hac vice* admission without local counsel) with Del. Bankr. L.R. 9010-1 (requiring local counsel). 9. For more information, *see* Disclosure Obligations under Bankruptcy Rule 2019.

each other. In such cases, the client's affiliate may be involved in the bankruptcy without the client's knowledge (e.g., filing a proof of claim on behalf of the affiliated business unit). This can be detrimental to the client if the client is not getting a complete picture of the business issues that need protecting (and is potentially losing leverage to negotiate a global resolution of issues between the parties). Locating this information on the schedules can greatly assist the client in such circumstances.[10]

- **Monitor docket**. Monitoring the docket is a good general practice for an attorney representing a creditor or other party in interest in a bankruptcy proceeding. Numerous events can occur during the course of a bankruptcy that will affect a party in interest's rights. Counsel can monitor the docket him- or herself, assign a junior associate or a paralegal to conduct such monitoring, and/or sign up for CM/ECF alerts. Counsel should be mindful of the costs associated with such monitoring and discuss the activity to be monitored with the client. In large (or mega) bankruptcy cases, monitoring the docket (and reviewing various pleadings) can result in significant billings. Counsel can avoid surprising the client with these billings and a resulting fee dispute by discussing the matter prior to incurring such costs and billing the client.
- **Keep track of deadlines**. Counsel should also keep track of the various deadlines that may affect the client's interest in a bankruptcy case. The most important of these deadlines is the deadline by which creditors are required to file their proofs of claim (referred to as the bar date). The court will often set a bar date for filing administrative expense claims and a separate bar date for filing general unsecured claims. These deadlines are generally firm and the failure to timely submit a client's proof of claim by the applicable bar date is likely to result in the claim being dismissed. Counsel should therefore calendar bar dates established by the bankruptcy court. Note that in certain limited instances, counsel may advise against filing a proof of claim because of the risk to the creditor (even though any creditor has the right to file a claim) that, among other things, the filing will give the bankruptcy court jurisdiction over pending litigation with the debtor.[11]
- **Review relevant pleadings and, if necessary, object**. Certain motions filed in a bankruptcy will directly impact the client, such as an objection to the client's claim and a motion to assume and assign the client's contracts with the debtor. Other motions may impact recoveries or other issues important to the client. For example, a creditor may want to file its own plan of reorganization/liquidation[12] and, therefore, may oppose a debtor's request to extend the debtor's exclusive period for filing a plan and obtaining acceptances.[13] Counsel will need to discuss whether to object to a motion or attempt to resolve outstanding issues through settlement discussions. If preparing an objection, be sure to provide the client with sufficient time to review the objection prior to the objection deadline. To have sufficient time, counsel may need to start the objection while the parties are negotiating a resolution.
- **Review the terms of the disclosure statement and plan**. A disclosure statement is a document that describes the terms of the plan and is transmitted by a plan proponent to allow the plan proponent to solicit votes regarding the plan from a holder of a claim or interest.[14] The basic function of a plan is to provide for the treatment that is to be afforded to the debtor's creditors and equity security holders with respect to their various claims and interests. Counsel should describe the relevant terms of these documents to (1) explain how the client's claims will be treated or interests otherwise affected, (2) assist the client with its determination on whether to vote for or against the plan, and (3) detail any objectionable provisions in the plan.[15]

The above list of recommended actions is not meant to be all-inclusive but instead represents certain universal general practices when representing a party in interest in a Chapter 11 bankruptcy proceeding. There are numerous other actions that counsel may need to take during the bankruptcy case. Note that counsel representing a party to an adversary proceeding will need to take other steps as part of the representation but should keep apprised of the bankruptcy proceeding and possibly take the actions described above.[16]

10. For more information on the debtor's schedules, *see* Schedules and Statements of Financial Affairs. **11.** For more information, *see* Proofs of Claim in Bankruptcy and Proofs of Claim Categories and Calculations. **12.** *See* 11 U.S.C.S. § 1121(d)(1). **13.** For information on exclusivity, *see* Parties That May File Plans. **14.** For more information, *see* Disclosure Statements. **15.** For more information, *see* Acceptance Process and Chapter 11 Plan Confirmation Resource Kit. **16.** For more information, *see* Adversary Proceedings.

Related Content

For an outline of the initial steps that legal counsel should take when a client is near default or insolvency, see

> **REPRESENTING DEBTORS**

RESEARCH PATH: *Bankruptcy > Commencing a Bankruptcy Proceeding > Current Bankruptcy Scheme and Reforms > Practice Notes*

For general information on representing creditors leading up to the bankruptcy, see

> **REPRESENTING SECURED AND UNSECURED CREDITORS**

RESEARCH PATH: *Bankruptcy > Commencing a Bankruptcy Proceeding > Current Bankruptcy Scheme and Reforms > Practice Notes*

For an outline of steps to assist a trade creditor client that suspects a customer or supplier may file for bankruptcy protection, see

> **TRADE CREDITORS' PREPETITION CHECKLIST (DEALING WITH FINANCIALLY DISTRESSED ENTITIES)**

RESEARCH PATH: *Bankruptcy > Commencing a Bankruptcy Proceeding > Chapter 11 Petitions and First Day Motions > Checklists*

For a checklist to help a trade creditor client navigate the bankruptcy process and react to a customer's bankruptcy filing, see

> **TRADE CREDITORS' POSTPETITION CHECKLIST**

RESEARCH PATH: *Bankruptcy > Commencing a Bankruptcy Proceeding > Chapter 11 Petitions and First Day Motions > Checklists*

Understanding the Client's Interests

To effectively represent a non-debtor client in a bankruptcy proceeding, counsel will need to understand the client's relationship with the debtor and the reason for the retention. Counsel should usually obtain copies of agreements and other documentation between the debtor and the client and ascertain the amounts at stake and the client's business interests. For some clients, counsel will need to educate the client on Chapter 11 bankruptcies and the bankruptcy process. For example, if applicable, counsel should inform a secured creditor of its right to adequate protection and a trade creditor of the significance of being a critical vendor.

If possible, all of the above-referenced discussions and due diligence will occur prior to taking positions in the bankruptcy proceeding. Counsel that fully comprehends the client's interests in the bankruptcy case, including the monetary amounts at stake, will be able to advise the client whether a particular pleading should be filed or position taken and perform the associated cost-benefit analysis with the client. For example, in some cases, the legal fees that would be incurred in objecting to a motion are higher than the monetary amounts at issue or the expected distribution on the client's claim. However, a simple dollar and cents calculation does not end the analysis of whether a client should object to a particular motion. A motion can also impact the client's business, its rights under a contract with the debtor or a purchaser of the debtor's business, and potential exposure to the debtor's estate. The client may also have an objective beyond the simple collection of its debt, which is to preserve a profitable business relationship with the debtor. Thus, counsel and the client party in interest should develop a game plan for how it wants to deal with the debtor.

As part of developing a game plan, counsel should also analyze whether the client has any preference, fraudulent conveyance, or other legal exposure. This may prove relevant to settlement discussions as the elimination of significant preference or other exposure can be extremely valuable. With respect to preference exposure, creditors should gather records (invoices, correspondence, checks, receipts, shipment confirmations, etc.) of their business with the debtor during the 12–18 months prior to the debtor's bankruptcy filing, and counsel should perform a preference analysis.[17] L

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17. For more information, *see* Preferences and Fraudulent Conveyances versus Preference Actions.

John Popeo LEXIS PRACTICE ADVISOR

Industrial Loan Companies

Industrial loan companies (ILCs) and industrial banks are state-chartered entities originally formed to lend to industrial workers who were unable to obtain credit from traditional depository institutions.

ILCS AND INDUSTRIAL BANKS HAVE MANY OF THE SAME powers of traditional banks. However, unlike traditional institutions, ILCs and industrial banks can be owned by commercial firms that are not subject to the Bank Holding Company Act of 1956, as amended (BHC Act).[1] This distinct ownership structure enables ILCs and their parent commercial firms to avoid regulatory restrictions applicable to most depository institutions, and it has prompted several nonbank firms, including Fintechs and investment companies, to apply for ILC charters. This article provides an overview of ILCs and their regulatory framework.

What Is an ILC?

The Utah Department of Financial Institutions defines an ILC as a state-chartered depository institution that is:

- Eligible for federal deposit insurance by the Federal Deposit Insurance Corporation (FDIC)
- Exempted from the technical definition of a bank for the purposes of the BHC Act
- Otherwise generally subject to banking laws and regulations applicable to other bank charter types

ILCs have limited nationwide banking powers, but generally maintain powers and privileges similar to a traditional commercial bank. Unlike traditional banks, however, ILCs can be owned by nonfinancial commercial firms that are not regulated as bank holding companies (BHCs) by the Board of Governors of the Federal Reserve (Federal Reserve). This is important because the existing BHC Act regulatory framework generally does not allow nonbanking, commercial firms to own most types of banks unless the consolidated entities engage only in banking and certain related services or incidental financial activities.

To avoid qualifying as a bank under the BHC Act[2], an ILC must:

- Not accept demand deposits that the depositor may withdraw by check or by similar means for payment to third parties –or–
- Have total assets of less than $100,000,000

1. 12 U.S.C.S. § 1841 et seq. 2. *See* 12 U.S.C.S. § 1841(c)(2)(H).

ILCs can be depository institutions (holding FDIC-insured deposits) or non-depository (not offering deposit accounts to customers). While most ILCs offer FDIC-insured deposit accounts to their customers, by law, non-depository ILCs can exist that do not offer deposit accounts to their customers.

Establishing or acquiring an institution that is not a bank under the BHC Act is the only way that a commercial firm can own an FDIC-insured depository institution. ILCs can be commercially owned (i.e., owned by a parent firm that engages in activities other than banking, insurance, and securities) or financially owned (owned or controlled by a company that engages only in banking or financial activities, similar to a BHC or financial holding company). Financially owned ILCs are subject to banking activity restrictions and consequently may only engage in the same activities as FDIC-insured banks or depository institutions (unlike commercially owned ILCs).

As discussed below, most ILCs that are commercially owned are not subject to supervision under the BHC Act, but remain subject to the same federal regulatory requirements that apply to commercial banks and savings associations, including federal restrictions governing affiliate transactions (Sections 23A and 23B of the Federal Reserve Act and implementing Regulation W),[3] insider-lending restrictions,[4] the Bank Secrecy Act (BSA), and money-laundering restrictions.

Moratorium

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) imposed a three-year moratorium on approving FDIC deposit insurance for new Competitive Equality Banking Act (CEBA) banks that would be directly or indirectly owned or controlled by a commercial firm (nonfinancial company, such as a retailer or manufacturer) and on the transfer of ownership of an ILC to a commercial firm (except for limited circumstances). This moratorium expired on July 21, 2013.

Since the moratorium was lifted in 2013, several Fintech companies have applied for ILC charters. Fintech applicants include firms such as Nelnet, Social Finance (SoFi), and Square Financial Services, Inc. At the time of this writing, the FDIC has not approved an ILC charter since 2008, principally due to controversy surrounding the ILC charter and criticism from community bankers that the ILC charter obscures the division between commerce and banking and affords ILCs an unfair competitive advantage over banks.

The Dodd-Frank Act also required the Government Accountability Office (GAO) to evaluate the role and regulation of ILCs. The GAO released this report in January 2012[5] and did not recommend repealing federal rules that provide for ILC ownership by commercial entities.

Background and History

ILCs have existed for over a century. These institutions first emerged in the early 1900s as niche lenders sought to provide credit to low-to-moderate income consumers. The description, "industrial loan company" or "industrial bank" aligns with their original mission to lend to industrial workers who had difficulty accessing credit via traditional institutions.

The very first ILCs were small, did not offer deposits, and, as a result, were not viewed as a competitive threat to commercial banks and thrifts (or savings and loan institutions). As the financial marketplace evolved, however, ILCs emerged as a popular alternative to banks and today provide a broader array of financial services to a more diverse customer base. During the 1990s, ILCs experienced significant asset growth as they evolved into larger, more complex institutions.

Wal-Mart

Since their inception, ILCs were either stand-alone entities or their parent companies were financial firms. In 1988, General Motors acquired an ILC charter. This led several other automotive and manufacturing firms to follow suit and form ILCs in Utah and Nevada. In 2005, the retail store Wal-Mart filed applications with the Utah Department of Financial Institutions and the FDIC to form a new ILC. Wal-Mart's applications triggered a wave of protests from commercial banks and financial regulators. Opponents of Wal-Mart's applications cited that Wal-Mart should not be permitted to engage in the business of banking and would be a broader threat to both the banking system and to the FDIC Deposit Insurance Fund (DIF).[6]

In response to Wal-Mart's application, the FDIC held two public hearings and placed a temporary moratorium on ILC applications in 2006. At the state level, legislatures also passed laws to block any prospective ILC from opening branches in different jurisdictions. At this same time policy and lawmakers in Washington, D.C. explored new legislation to prohibit newly formed ILCs owned by commercial companies. This sequence of events caused Wal-Mart to withdraw its applications in 2007 prior to the FDIC issuing any decision in connection with its deposit insurance application.

Competitive Equality Banking Act (CEBA)

In practical terms, any entity controlling a bank qualifies as a BHC. In 1987, the Competitive Equality Banking Act[7] amended the BHC Act to close a loophole in the definition of bank under the BHC Act. In this connection, Congress excluded certain charter types, such as ILCs, from the definition of bank under the BHC Act. As a result, an entity that owns or controls an ILC is not a BHC within the meaning of the BHC Act, and is therefore not subject to restrictions applicable to BHCs, including activities restrictions that forbid BHCs from engaging in nonfinancial activities. This exclusion makes ILCs attractive to nonfinancial companies, such as automobile manufacturers, energy companies, retailers, and similar commercial firms that would not otherwise be permitted to own banks.

The Competitive Equality Banking Act also created an exemption from the definition of bank under the BHC Act for ILCs chartered in states with statutes requiring ILCs to be FDIC-insured as of March 5, 1987 (the date of the Act's passage into law). As a result, only ILCs chartered in those grandfathered jurisdictions, as determined by the Federal Reserve, are eligible for the ILC exemption.

Less Stringent Supervision

ILCs, as state-chartered institutions, are subject to safety and soundness supervision, regulation, and examination by their chartering authority (state banking regulator) and the FDIC as their primary federal regulator.

The FDIC is also empowered to examine the affairs of any ILC affiliate.[8] The term affiliate includes a parent commercial company and any of its subsidiaries.[9] This authority also enables the FDIC to evaluate relationships between an ILC and its affiliates and to assess the effect of such relationships on the ILC's operations. State regulatory authorities in California, Nevada, and Utah have similar authority to conduct examinations of ILC affiliates.

The FDIC's supervisory authority over ILC affiliates, however, is significantly more limited than the authority that consolidated BHC supervisors have over BHCs and commercial-bank affiliates. For example, the FDIC's authority to examine an insured depository institution affiliate is limited to examinations necessary to disclose fully the relationship between the ILC and an affiliate and the effect of such relationship on the ILC. Relationships include arrangements requiring interaction, interdependence, or mutual reliance between an ILC and its affiliate (e.g., contracts, transactions, or shared operations). When such relationships do not exist, any reputation or similar risk that could impact the institution may go undetected. As a result, FDIC's authority is not equivalent to consolidated supervision of a BHC by the Federal Reserve.

The FDIC does, however, have full authority to advance enforcement actions against an ILC's institution-affiliated parties (IAPs), which includes any affiliate that may qualify as an IAP (in certain circumstances an affiliate may qualify as an IAP). An IAP includes "any director, officer, employee, or controlling stockholder" (other than a BHC) of, or agent for, a depository institution, and can also include "any independent contractor (including any attorney, appraiser, or accountant) who knowingly or recklessly" engages in misconduct.[10]

The following chart provides a brief comparison of supervisory authorities of the prudential federal banking regulators (the FDIC, the Federal Reserve, and the Office of the Comptroller of the Currency (OCC)):

3. 12 C.F.R. pt. 223. **4.** 12 C.F.R. pt. 215. **5.** https://www.gao.gov/assets/590/587830.pdf. **6.** *See* GAO-05-621, Sept. 15, 2005, *Industrial Loan Corporations-Recent Asset Growth and Commercial Interest Highlight Differences in Regulatory Authority*. **7.** Pub L. No. 100-86, 101 Stat. 552 (Aug. 10, 1987).

8. As defined in 12 U.S.C.S § 1841(k). **9.** 12 U.S.C.S. § 1820(b)(4). **10.** 12 U.S.C.S. § 1813(u).

COMPARISON OF SUPERVISORY AUTHORITIES OF FEDERAL BANK REGULATORY AGENCIES

Description of Supervisory Authority	FDIC	Federal Reserve	OCC
Examine relationships, including specific transactions, if any, between the insured institution and its parent or affiliates.	Express statutory and regulatory authority	Express statutory and regulatory authority	Express statutory and regulatory authority
Examine beyond specific transactions when necessary to disclose the nature and effect of the relationship between the insured institution and the parent or affiliate.	Express statutory and regulatory authority	Express statutory and regulatory authority	Express statutory and regulatory authority
Examine the parent or any affiliate of an insured institution, including a parent or affiliate that does not have any relationships with the insured institution or concerning matters that go beyond the scope of any such relationships and their effect on the depository institution.	Limited authority	Express statutory and regulatory authority	Express statutory and regulatory authority
Take enforcement actions against the parent of an insured institution.	Limited authority	Express statutory and regulatory authority	Express statutory and regulatory authority
Take enforcement actions against affiliates of the insured institution that participates in the conduct of affairs of, or acts as agent for, the insured institution.	Limited authority	Express statutory and regulatory authority	Express statutory and regulatory authority
Take enforcement action against any affiliate of the insured institution, even if the affiliate does not act as agent for, or participate in the conduct of, the affairs of the insured institution.	Limited authority	Express statutory and regulatory authority	Express statutory and regulatory authority
Compel the parent and affiliates to provide various reports such as reports of operations, financial condition, and systems for monitoring risk.	Limited authority	Express statutory and regulatory authority	Express statutory and regulatory authority
Impose consolidated or parent-only capital requirements on the parent and require that it serve as a source of strength to the insured depository institution.	Limited authority	Express statutory and regulatory authority	Express statutory and regulatory authority
Compel the parent to divest of an affiliate posing a serious risk to the safety and soundness of the insured institution.	Limited authority	Express statutory and regulatory authority	Express statutory and regulatory authority

FDIC examiners can review an ILC's current written business plan and evaluate any changes. Examiners may also review any arrangements involving shared management or employees. In the latter case, referred to as dual employees, agreements should be in place that define compensation arrangements, specify how to avoid conflicts of interest, establish clear reporting lines, and assign authority for managing any dual-employee relationship.

Further, 12 U.S.C.S. § 1820(c) empowers the FDIC, in the course of its supervisory activities, to issue subpoenas and to take and preserve testimony under oath, so long as the documentation or information sought relates to the affairs or ownership of the insured institution. Accordingly, individuals, corporations, partnerships, or other entities that in any way affect the ILC's affairs or ownership may be subpoenaed and required to produce documents. Each state regulatory agency, including the Utah Department of Financial Institutions, is similarly empowered (and has direct authority under state law) to conduct examinations of parents and affiliates.

States Offering ILCs

ILCs are offered in the following states: California,[11] Indiana,[12] Minnesota,[13] Nevada (note that Nevada does not directly charter industrial banks but relies on the Nevada Thrift Companies Act),[14] and Utah.[15]

ILCs or industrial banks were formerly offered in Colorado and Hawaii as well; however, laws allowing organizers to apply for ILC charters have since been repealed in these jurisdictions, and existing ILCs have either failed or converted their charter type.

The majority of ILCs principally operate in California, Nevada, and Utah, with Utah being the most popular state for ILCs, and Nevada being the second. Several ILCs based in Utah have evolved into larger, more complex financial institutions with extensive access to capital markets. Banking laws in California, Nevada, and Utah have undergone changes that generally place ILCs on par with traditional banks. According to Utah officials, ILCs expanded in Utah because of business-friendly state laws and the fact that Utah offers a financial service-oriented workforce. Consequently, in working on any ILC application, you should be prepared to interface with the Utah Department of Financial Institutions, the FDIC Bank Activities Group, and the FDIC Risk Management and Applications team.

Supervision and Regulatory Treatment

ILCs, as state-chartered institutions, have always been regulated by their state's primary chartering authority. However, at the federal level, ILCs with FDIC deposit insurance are also subject to FDIC supervision and regulation.

Federal banking law permits FDIC-insured ILCs to engage in the same activities as other depository institutions. ILCs can offer a full range of loans such as consumer, commercial and residential real estate, and small business loans. In addition, FDIC-insured ILCs are subject to Sections 23A and 23B of the Federal Reserve Act, which, among other things, establishes restrictions for bank transactions with affiliates. ILCs can also export their home state's interest rates to customers residing elsewhere (effectively allowing ILCs offering credit cards to charge their state's maximum allowable interest rates in other states) and can generally branch across multiple states.

Examples of other regulatory safeguards that ILCs must comply with are articulated under the following Federal Reserve regulations:

- Regulation D, which sets reserves a depository institution must hold against deposits[16]
- Regulation F, which requires that institutions to establish policies and procedures to prevent excessive exposure to any individual correspondent bank[17]
- Regulation O, which governs extensions of credit by a depository institution to an executive officer, director, or principal shareholder of such institution[18]

In addition to these safeguards, ILCs must also comply with BSA anti-money laundering laws and regulations and Community Reinvestment Act (CRA) requirements. Moreover, as with other depository institutions, ILCs are subject to consumer protection laws and must comply with federal consumer protection laws and regulations, including the following regulations enforced by the Consumer Financial Protection Bureau:

- Regulation B, which implements the Equal Credit Opportunity Act's antidiscrimination provisions[19]
- Regulation Z, which implements the Truth in Lending Act requirements relating to disclosures and other consumer protections[20]
- Regulation CC, which implements the Expedited Funds Availability Act, including the Act's requirements regarding the limits on the length of time that a hold may be placed on funds deposited into an account[21]

The following chart provides an overview of ILC powers and highlights key differences between ILCs and other traditional banks:

11. Cal. Fin. Code § 18000, et seq. 12. Ind. Code Ann. § 28-5-1-1, et seq. 13. Minn. Stat. Ann. § 345.31, et seq. 14. Nev. Rev. Stat. Ann. § 677.010, et seq. 15. Utah Code Ann. § 7-8-21, et seq. 16. 12 C.F.R. 204.1, et seq. 17. 12 C.F.R. 206.1, et seq. 18. 12 C.F.R. pt. 215. 19. 12 C.F.R. pt. 1002. 20. 12 C.F.R. pt. 1026. 21. 12 C.F.R. pt. 229.

COMPARISON OF KEY DIFFERENCES BETWEEN ILCS AND TRADITIONAL BANKS		
Powers	**State-Chartered Commercial Bank (Subject to the BHC Act)**	**ILC or Industrial Bank (Not Subject to BHC Act)**
Ability to accept demand deposits	Yes	Varies by state. Where authorized by the state, demand deposits can be offered if either (1) ILC's assets are less than $100 million or (2) the ILC has not been acquired after August 10, 1987. A primary difference between ILCs and other FDIC-insured depository institutions is that, to remain exempt from the BHC Act, ILCs must be chartered in the grandfathered states and generally do not accept demand deposits if their total assets are $100 million or more.
Ability to export interest rates	Yes	Yes
Ability to branch interstate	Yes	Yes
Ability to offer full range of deposits and loans	Yes	Yes, but see row one above concerning demand deposit accounts
Authorized by every state	Yes	No ILCs currently are chartered only in seven states.
Examination, supervision, and regulation by federal bank regulatory agency	Yes	Yes
FDIC may conduct limited scope examination of affiliates	Yes	Yes
Golden Parachute restrictions apply	Yes	Yes, to the ILC; no, to the parent commercial firm
Cross-Guarantee liability applies	Yes	No
Section 23A & 23B, Regulation O,[22] CRA apply[23]	Yes	Yes

22. 12 C.F.R. pt. 215. 23. 112 U.S.C.S. § 2901, et seq.

COMPARISON OF KEY DIFFERENCES BETWEEN ILCS AND TRADITIONAL BANKS		
Powers	**State-Chartered Commercial Bank (Subject to the BHC Act)**	**ILC or Industrial Bank (Not Subject to BHC Act)**
Parent commercial firm subject to umbrella federal oversight	Yes	No
Parent commercial firm activities generally limited to banking and financial activities	Yes	No
Parent could be prohibited from commencing new activities if a subsidiary depository institution has a CRA rating that falls below satisfactory	Yes	No
Parent could be ordered by a federal banking agency to divest of a depository institution subsidiary if the subsidiary becomes less than well-capitalized under prompt corrective action (PCA) standards under 12 U.S.C.S. § 1831o	Yes	A parent commercial firm is not subject to the same restrictions as BHC, savings and loan holding company (SLHC), or financial holding company (FHC).
Range of enforcement actions can be applied to the subsidiary depository institutions if parent fails to maintain adequate capitalization under PCA standards	Yes	No
Control owners who have caused a loss to a failed institution may become subject to personal liability	Yes	Yes

As shown in the above chart, there are few, if any, banking activities unique to ILCs relative to other traditional depository institutions.

Under the Federal Deposit Insurance Act, all FDIC-insured institutions, including ILCs, are permitted to engage only in activities as principal that are permissible for a national bank chartered by the OCC, although the FDIC may approve of an additional activity if it determines that the activity would pose no significant risk to the FDIC's DIF and the institution complies with capital requirements under federal laws and regulations.

Management Assessment

Senior executives, directors, and officers are accountable for ensuring the operational safety and soundness of the institutions they oversee. This same principle that similarly applies to all ILCs. As a result, the FDIC and the Utah Department of Financial Institutions (assuming an ILC application is submitted in Utah) will consider, among other things, the following factors in connection with any ILC application:

- Character, reputation, and financial standing
- Resources (including capital) to support operations
- Board of directors, the majority of whom must be outside, unaffiliated individuals (including some of whom must be Utah residents)
- Autonomous decision-making authority and responsibilities reside with the board and management such that they are in control of the ILC's activities and direction
- Experience in banking, including a sufficient track record and demonstrable knowledge, expertise, and experience in operating a depository institution in a regulated environment
- Independence from parent holding company and affiliates (note, however, the goals and policies of the parent may be effected if defined in the ILC's strategic business plan)
- A bona fide strategic business plan that, among other things, justifies the purpose of the ILC's existence, how it will serve the convenience and needs of the community where it is situated, and three years' *pro forma* financial projections (including required additional detail)
- Policies regarding lending activities, Regulation W compliance, Regulation O compliance, and other relevant procedures and program requirements

The FDIC has further outlined conditions that it may impose on any applicant in connection with an application for federal deposit insurance for any institution that will be owned by, or

significantly involved with transactions related to, a parent commercial or financial holding company. Among other things, these nonstandard conditions include:

- Requirements that the organizers appoint a board of directors, the majority of whom will be independent of the bank's parent company and its affiliated entities
- Appointment and retention of a knowledgeable, experienced, and independent team of executive officers
- Development and maintenance of a current, written business plan that is adopted by the ILC's board of directors and is appropriate to the nature and complexity of the activities conducted by the ILC and separate from any business plan of an affiliate company
- A written policy statement that, to the extent management, staff, or other personnel or resources are employed by both the ILC and the parent company or any affiliate, the ILC's board of directors will ensure that such arrangements are governed by written contracts giving the ILC authority, and control necessary to direct and administer the ILC's affairs

Public Policy Concerns

An understanding of public policy concerns related to ILCs generally is essential in preparing any ILC application to a state or federal regulator.

While there are several regulatory concerns related to ILCs generally, two public policy concerns often drive debate among market participants, policymakers, and regulators:

- **Separation of banking and commercial activities.** The policy separating banking and commercial activities was a reaction to the perception that banks, particularly those in larger conglomerate organizations, had a disproportionate amount of economic power leading up to the Great Depression of the 1930s. The BHC Act sought to address concerns regarding the historical separation of banking from commerce by restricting banks and their BHCs to banking-related activities. This policy concern was often echoed by legislators and regulators during the global financial recession in 2008.
- **Deposit insurance and reliance on the federal safety net.** In the United States, the federal safety net refers to deposit insurance provided by the FDIC to depository institutions it insures. This same privilege is not afforded to nonbank entities that do not hold deposits (as such term is defined in 12 U.S.C.S. § 1813(l)), such as BHCs or bank affiliates. Each of the federal bank regulatory agencies, including the FDIC, has a vested interest in preventing the federal safety net from supporting risks outside of insured banking activities. This principle has been the most widely debated in, and the most frequently cited reason for, the current BHC supervisory and regulatory structure.

Each of the above policy concerns are addressed in greater detail below.

Separation of Banking and Commerce

The separation of banking and commerce is rooted in the Banking Act of 1933, which refers to the Glass-Steagall Act. Glass-Steagall erected the wall between banking and commerce and was enacted to restrain the disproportionate economic power amassed by banks during the 1930s. The Glass-Stegall Act was calibrated to prohibit banks from owning corporate stock and sought to limit affiliations between banks and securities firms (and commercial entities).

In 1956, Congress and federal banking supervisors reaffirmed the long-standing policy of separating banking and commerce by passing the BHC Act. The BHC Act, among other things, prohibited BHCs from owning controlling entities that were not banks unless the Board determined that the entity's activities were "so closely related to the business of banking . . . as to be a proper incident thereto . . . ." In 1970, the BHC Act was amended to broaden the Federal Reserve's authority under Regulation Y[24] to determine when an activity is sufficiently related to banking.

In 1999, the Gramm-Leach-Bliley Act (GLBA)[25] eroded the wall separating banking and commerce. The GLBA, among other

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For more information on de novo bank application process, see

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For an analysis of the regulations for transactions between a member bank and its affiliates, see

> RESTRICTIONS ON BANK AFFILIATE TRANSACTIONS: SECTIONS 23A AND 23B OF THE FEDERAL RESERVE ACT AND REGULATION W

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For a discussion of insider lending restrictions, see

> INSIDER-LENDING LAWS AND COMPLIANCE CONSIDERATIONS FOR FINANCIAL INSTITUTIONS

RESEARCH PATH: *Financial Services Regulation > Bank Activities and Regulatory Enforcement Actions > Corporate Governance and Insider Lending > Practice Notes*

things, amended the BHC Act to relax the separation between banking and commerce and permit a new category of certain qualified BHCs (known as FHCs under Section 4(m) of the BHC Act) to engage in a more expansive range of financial activities. These activities included, among other things, insurance underwriting and securities brokerage.[26]

The GLBA effectively reaffirmed aspects regarding separation of banking and nonfinancial, commercial industries. However, the mixing of banking and commerce can come about in several

24. 12 C.F.R. pt. 225. 25. 15 U.S.C.S. § 6801, et seq. 26. *See* 12 U.S.C.S. § 1843(k).

forms. For example, a bank may wish to engage in nonfinancial activities, and commercial firms may similarly seek to enter banking. A bank may also wish to take an equity stake in a commercial firm, or a commercial firm may want to make an ownership investment in a bank.

With respect to ILCs, mixing banking and commerce has primarily been in the form of commercial, nonfinancial firms owning and operating insured banks. The policy objective that belies the separation of banking and commerce is driven primarily by seeking to curtail risks to the U.S. banking and financial system, the FDIC DIF, and U.S. taxpayers. As discussed in the section that follows, the potential risks that may result from mixing banking and commerce include, among other things:

- Expansion of the federal safety net for banks to their commercial entities
- Increased conflicts of interest within a mixed banking and commercial holding company structure –and–
- Dominating economic power exercised by larger financial conglomerates

Deposit Insurance and Federal Safety Net

Washington, D.C. regulators and policymakers are concerned that the ILC structure capitalizes on federal deposit insurance and abuses the federal safety net. A supervisory objective of insulating an FDIC-insured depository institution from risks taken by a bank affiliate is fundamentally different from the supervisory goal of integrating a bank with its affiliates. A concern voiced by ILC opponents is that a supervisory regime that supports the notion that certain institutions can engage in nonbanking, commercial activities through affiliates and holding companies effectively expands the federal safety net to nondepository institutions, which contradicts and undermines a fundamental precept of federal banking regulation.

Opponents have also cited that ILCs' holding companies and their affiliates may be able to mix banking and commerce more than other depository institutions because the holding companies and affiliates of ILCs are not subject to business activity limitations that generally apply to BHCs. Opponents have further cited that while the FDIC has supervisory authority over an insured ILC, it does not have the same authority to supervise ILC holding companies and affiliates as a consolidated supervisor. As a result, these parties claim that the FDIC and other regulators are concerned that ILCs pose a unique risk to the DIF as some ILC commercial activities are not adequately supervised and regulated by regulatory authorities.

Related Content

For a detailed explanation of anti-money laundering laws and regulations see

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Healthcare Financing

Anti-assignment Limitations

This article describes how to structure financing transactions for healthcare providers to overcome anti-assignment and collection limitations on Medicare and Medicaid receivables.

THE UNIFORM COMMERCIAL CODE (U.C.C.) GENERALLY prohibits restrictions on assignment, making it possible for secured lenders to obtain a perfected security interest in these assets. However, other regulations make it difficult for lenders to collect on these receivables. Lawyers, therefore, use a double lockbox mechanism to work around these federal regulations. You should be familiar with this structure and its legal status as defined in recent case law.

Introduction

Receivables, or "accounts" as defined under the U.C.C., are a valuable and common asset type to pledge to lenders in secured financings. They are simple to perfect, requiring only a general grant of the asset type in a security agreement along with the filing of a U.C.C. financing statement. However, many contracts that give rise to the underlying receivables also contain restrictions that on their face would prevent their assignment to lenders. These contractual anti-assignment clauses would be broad enough to greatly diminish the value of receivables as a form of collateral.

The U.C.C. solves this by rendering most contractual anti-assignment clauses ineffective. Under U.C.C. § 9-406, a term in an agreement between an account debtor (i.e., the party that owes payment to the borrower under the receivable) and the assignor or borrower that "prohibits, restricts, or requires the consent of the account debtor or person obligated on the promissory note to the assignment or transfer of, or the creation, attachment, perfection, or enforcement of a security interest in, the account" is generally ineffective. A term that would result in a default of a contract if the underlying account is pledged is similarly rendered ineffective. This has allowed for borrowers to freely assign these assets and has made Asset-Based Loan financings more accessible to borrowers with large amounts of receivables.

However, a key aspect to an assignment from a lender's perspective would be its right to receive payments from the account debtor. The U.C.C. has some lender-friendly provisions here but contains some restrictions relevant to the assignment of Medicare and Medicaid receivables. The anti-assignment override provided by the U.C.C. would not be of use to a lender that is unable to collect on those receivables from an account debtor (i.e., the government) during, say, an exercise of remedies. Fortunately for lenders, U.C.C. § 9-406(a) would require an account debtor to make a payment to an assignee (i.e., a lender) if adequate notice is provided to the account debtor. However, U.C.C. § 9-406(b) limits this right of payment if it is otherwise restricted "under law other than this article."

In fact, the Medicare and Medicaid anti-assignment provisions, with limited exceptions, prohibit anyone, except the healthcare provider, from receiving payments from federal government healthcare programs. In order to comply with the anti-assignment provisions, a provider cannot assign its right to be paid to any other entity, including its lenders. However, as described below, there are cash-management techniques, which if properly structured, will enable the parties to arrange compliant financing transactions.

Anti-assignment Provisions – The Regulatory Framework

Pursuant to 42 C.F.R. § 424.73, except with respect to certain limited exceptions, "Medicare does not pay amounts that are due a provider to any other person under assignment, or power of attorney, or any other direct payment arrangement." There are several exceptions to this anti-assignment provision, which apply only under limited circumstances but are generally described as payment to a government agency or entity, payment under assignment established by or in accordance with a court order, and payment to an agent who furnishes billing and collection services to the provider, all subject to certain conditions being met.

There are also specific anti-assignment provisions pertaining to each of Medicare Parts A and B. Part A covers hospital insurance benefits for the aged and disabled, while Part B includes supplementary medical insurance benefits for the aged and disabled. For Part A, 42 U.S.C.S. § 1395g(c) states in relevant part that "No payment which may be made to a provider of services under this title [42 U.S.C.S. § 1395 et seq.] for any service furnished to an individual shall be made to any other person under an assignment or power of attorney . . . " with certain specified exceptions, such as with respect to an assignment to a government agency. For Part B, 42 U.S.C.S. § 1395u(b)(6) states in relevant part that, with certain listed exceptions, "No payment under this part [42 U.S.C.S. § 1395j et seq.] for a service provided to any individual shall . . . be made to anyone other than such individual or (pursuant to an assignment described in subparagraph (B)(ii) of Paragraph (3)) the physician or other person who provided the service . . . ."

In addition, 42 C.F.R. § 447.10, as outlined in Subsection (a), implements Section 1902(a)(32) of the Social Security Act "which prohibits State payments for Medicaid services to anyone other than a provider or beneficiary, except in specified circumstances." Pursuant to Subsection (d), "Payment may be made only (1) To the provider; or (2) To the beneficiary if he is a noncash beneficiary eligible to receive the payment under § 447.25," or as otherwise outlined in other sections of 42 C.F.R. § 447.10 (covering, for example, reassignments and payments to a billing agent, such as a billing service or an accounting firm in specified circumstances).

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> RESEARCH PATH: *Finance > Security > Perfection & Priority > Practice Notes*

The Double Lockbox Mechanism

It is crucial for both borrowers and lenders, and their counsel, to understand and comply with all aspects of the anti-assignment provisions. The Medicare Claims Processing Manual (Manual), Chapter 1, Section 30.2.5, provides useful guidance to lenders in dealing with Medicare and Medicaid receivables. Specifically, the Manual states that payments due a provider may be sent to a bank for deposit in such provider's account if certain conditions are met, including that the account be "in the provider/supplier's name only and only the provider/supplier may issue any instructions on that account. The bank shall be bound by only the provider/supplier's instructions. No other agreement that the provider/supplier has with a third party shall have any influence on the account. In other words, if a bank is under a standing order from the provider/supplier to transfer funds from the provider/supplier's account to the account of a financing entity in the same or another bank and the provider/supplier rescinds that order, the bank honors this rescission notwithstanding the fact that it is a breach of the provider/supplier's agreement with the financing entity."

Further, the Manual states that the bank "may provide financing to the provider/supplier, as long as the bank states in writing, in the loan agreement, that it waives its right of offset. Therefore, the bank may have a lending relationship with the provider/supplier and may also be the depository for Medicare receivables." In accordance with the Manual, despite what a provider and lender may agree to in writing, the lender cannot purchase the provider's Medicare receivables.

Accordingly, in light of the above manual provisions, a common and well-accepted mechanism for providers and lenders to structure payments is to have the provider open multiple deposit accounts, with one in the name of provider that receives only Medicare and Medicaid payments. The provider then enters into a compliant arrangement with the bank that generally vests sole control of the account with the provider while having standing (yet revocable) instructions to sweep the monies from the account into another provider bank account that the lender can access and possibly control. This concept is often referred to as the "double lockbox." Parties regularly elect to have the sweep occur daily in order to ensure funds are not accumulating in the government payments account.

In setting up a double lockbox, there are various details involved and both providers and lenders need to carefully address those to avoid running afoul of any applicable federal or state restrictions. An example of typical language in loan documents that utilize this double lockbox mechanism is as follows:

> If any of the Account Debtors is a Governmental Authority, including, without limitation, Medicare and Medicaid (each a "Governmental Account Debtor"), Borrower shall ensure that all collections of such Accounts shall be paid directly to Accounts # XXXXXX, XXXXXX, XXXXXX, at Lender for Borrower (collectively, the "Governmental Accounts"). All funds deposited into the Governmental Accounts shall be transferred into the Borrower's Operating Accounts by the close of each business day pursuant to that certain Sweep Account Agreement dated as of the date hereof (as amended, restated, replaced, extended, supplemented or otherwise modified from time to time, the "Sweep Agreement") by and between Borrower and Lender.

While there has not been a significant amount of litigation concerning the validity of these arrangements, they have typically passed judicial muster. For example, in *DFS Secured Healthcare Receivables Tr. v. Caregivers Great Lakes, Inc.*, when referring to 42 U.S.C. S. § 1395g(c), the court stated that "On its face, this statute stands only for the proposition that Medicare funds cannot be paid directly by the government to someone other than the provider, but it does not prohibit a third party from receiving Medicare funds if they first flow through the provider."[1]

Further, in *Lock Realty Corp. IX v. U.S. Health, LP*, the court favorably cited *DFS Secured Healthcare Receivables Trust* and other cases that support the right to assign Medicare and Medicaid receivables and of third parties to collect on those amounts if they first flow through the provider.[2] These other cases include:

- *In re Missionary Baptist Foundation of America, Inc.* (affirming the decision of the district court and holding that the bank took a valid security interest in the debtor's accounts receivable due from medical care payments)[3]
- *Credit Recovery Systems, LLC v. Hieke* ("[T]he Court notes that neither the Medicare nor Medicaid statutes expressly proscribe a provider's assignment of the general right to receive Medicare or Medicaid receivables to a non-provider.")[4]
- *In re E. Boston Neighborhood Health Ctr. Corp.* ("Nothing in these statutes prohibits the Debtor, as provider, from granting a security interest in its receivables under these programs or invalidates such security interests. By prohibiting the governmental insurer from making payment on the receivables to anyone other than the Debtor, the statutes may impair the Defendants' ability to seek payment on the receivables from the governmental insurer without the provider's cooperation, but that cooperation may well be available, and the statutes do not impair the Defendants' ability to enforce their security interests once payment has been issued.")[5]
- *In re American Care Corp.*(denying junior creditor's motion to terminate adequate protection payment to senior creditor who was entitled such protection pursuant to its valid security interest in Medicare receivables)[6]

The court in *Lock Realty Corp. IX*, concludes, "The financing arrangements in this are case are valid and in accord with the federal anti-assignment statute, so Lock Realty cannot enforce its judgment to the extent satisfaction would infringe on a superior interest in the receivables." The court in *Lock Realty*

1. 384 F.3d 338, 350 (7th Cir. 2004). 2. 2007 U.S. Dist. LEXIS 14578, at *6–8 (N.D. Ind. Feb. 27, 2007). 3. 796 F.2d 752, 759 (5th Cir. 1986). 4. 158 F. Supp. 2d 689, 693 (E.D. Va. 2001). 5. 242 B.R. 562, 573 (Bankr. D. Mass. 1999). 6. 69 B.R. 66, 67 (N.D. Ill. 1986).

Corp. IX also provided further insight on proper structuring by stating:

> In other words, the intervenors' rights in the funds flow through Americare since neither party can receive Medicare funds pursuant to their arraignment without subsequent judicial enforcement of the security agreement. Because the financing arrangements don't provide a non-provider with the opportunity to submit a false claim, the concerns addressed by the anti-assignment statute aren't implicated.[7] A court-ordered assignment pursuant to 42 C.F.R. § 424.90, directing payment from AdminiStar to Health Care Services or National City Bank doesn't violate federal law.

Conclusion

As the above illuminates, it is both possible and commonplace for lenders to offer financing to healthcare providers using Medicare and Medicaid receivables as collateral despite the existence of the anti-assignment provisions by using well documented, commercially acceptable, and compliant financing and collateral agreements. However, given the continued evolution in the way healthcare services are provided and financed, counsel for both providers and lenders must continue to stay abreast of all applicable laws, rules, regulations, and other interpretive guidance to ensure continuing compliance with all laws applicable to healthcare financings. L

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

Related Content

For a description of assets commonly omitted from a collateral package, see

> ASSETS COMMONLY EXCLUDED FROM THE SECURITY PACKAGE

RESEARCH PATH: *Finance > Security > The Security Package > Practice Notes*

For a discussion of cash management agreements, see

> CASH MANAGEMENT ARRANGEMENTS

RESEARCH PATH: *Finance > Real Estate Acquisition Financing > Closing Documents and Other Ancillary Documents > Practice Notes*

For information on the eligibility criteria applicable to accounts receivable, see

> ACCOUNTS RECEIVABLE ELIGIBILITY CRITERIA

RESEARCH PATH: *Finance > Asset-Based Lending > The Borrowing Base > Practice Notes*

For an overview of the use of affirmative covenants, see

> AFFIRMATIVE COVENANTS IN CREDIT AGREEMENTS

RESEARCH PATH: *Finance > The Credit Agreement > Representations, Warranties and Covenants > Practice Notes*

For a lockbox agreement form, see

> LOCKBOX AGREEMENT

RESEARCH PATH: *Finance > Security > Perfection & Priority > Forms*

7. *See, e.g.*, Bank of Kansas v. Hutchinson Health Services, Inc., 12 Kan. App. 2d 87, 735 P.2d 256, 259 (Kan. Ct. App. 1987).

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Reverse Mergers

This article examines market trends in reverse mergers by addressing recent notable transactions, deal structure and process, deal terms, disclosure trends, and legal and regulatory trends, and provides a market outlook for 2019.

OVER THE LAST DECADE, A SIGNIFICANT NUMBER OF PRIVATELY held companies have transitioned to public company status via a reverse merger with an existing public company with no or nominal operations and assets (a shell company) as an alternative to an initial public offering (IPO). Although the existing public company is typically the surviving legal entity, the privately held company's shareholders gain control of the resulting entity, which is referred to as a surviving reverse merger company. For purposes of this discussion, a reverse merger means a combination (whether through merger or share exchange) of a privately held company and an existing reporting shell company, but does not include a transaction involving a special-purpose acquisition company.

Reverse merger activity in 2018 continued to decline from a high point in transaction volume in 2010. The strong IPO market in 2018 did not spark a revival of the reverse merger market, but it did slow the rate of decline. Reverse merger transactions decreased 6% in 2018 compared to 2017, compared to a 16% decrease in 2017 versus 2016.

Notable Transactions

Deal Activity

The analysis discussed in this article is based on a review of 217 reverse mergers completed between January 2015 and December 2018 (the Reviewed Transactions) for which a Super 8-K (as defined below) was filed, as identified by *Private Raise*, a service that monitors and researches reverse merger activity. While the reverse merger market is not known for high-profile and large dollar value deals, included in this group of Reviewed Transactions are 59 surviving reverse merger companies that had a post-closing market capitalization of at least $75 million (Notable Transactions).

Reverse merger market transaction volume declined to 46 transactions in 2018 from a high of 256 transactions in 2010, the year prior to enforcement actions by the Securities and Exchange Commission (SEC) against several Chinese companies due to poor accounting practices (as discussed in further detail below). The following table summarizes the total number of reverse mergers by country based on where the business of the surviving reverse merger company was located for the years indicated.

Year	United States	China	Other	Total
Avg. 2012 to 2014	97	9	24	130
2015	59	8	12	79
2016	38	9	11	58
2017	31	9	9	49
2018	28	7	11	46

Source: Private Raise

Industry Insights

Reverse mergers are completed across industries, with at least 40 sectors represented between January 2015 and December 2018. Based on an analysis of the Reviewed Transactions, the most active sectors were:

Industry	Percentage
Healthcare/biotech	23%
Tobacco, cannabis, and related	7%
Financial services	7%
Software	6%
Internet-related	6%

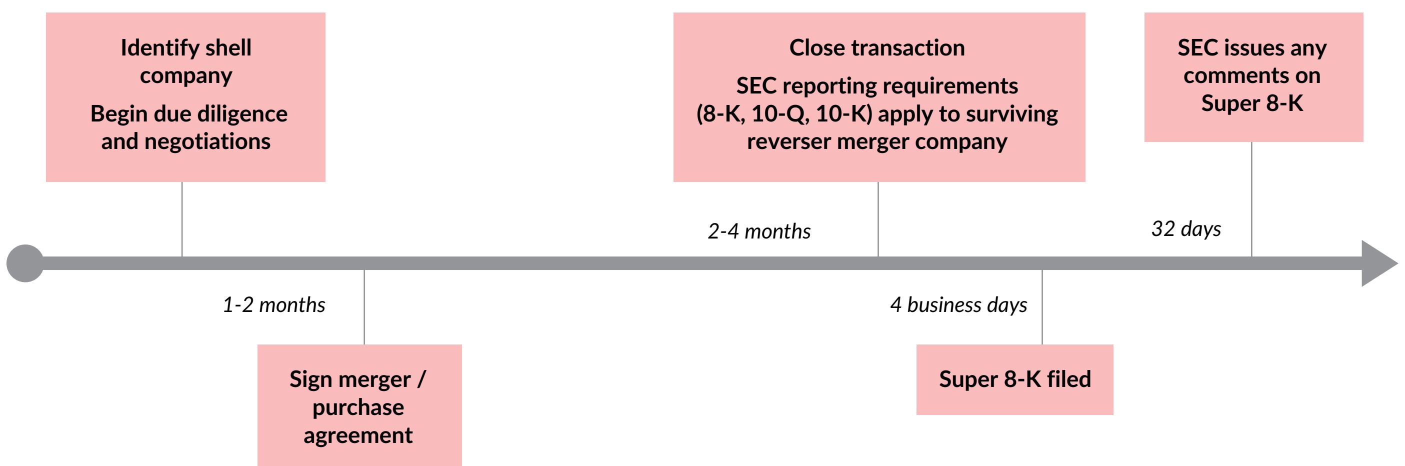
Among Notable Transactions, the health-care/biotech industry represented 46% of these larger deals.

Industry sector trends among the Reviewed Transactions were largely consistent with the industries represented by companies undertaking IPOs for the same period (minus tobacco, cannabis, and related), although a larger percentage of IPOs was represented by companies in the technology industry.

Deal Structure and Process

The timeline for a reverse merger can vary considerably from transaction to transaction; however, there are key events and requirements that generally apply to all reverse mergers.

Similarly, while the market capitalization and industries of surviving reverse merger companies vary, there are a number of common structural and legal deal terms, as discussed below.



Note: The timing above as it relates to signing a merger agreement and closing is illustrative only and depends on a number of factors, including the history and shareholder base of the shell company and deal structure.

Identifying a Shell Company

The definition of a shell company is provided in Rule 405[1] under the Securities Act of 1933, as amended (the Securities Act), and Rule 12b-2[2] under the Securities Exchange Act of 1934, as amended (the Exchange Act). Shell companies generally fall into one of three categories:

- **Blank check.** Shell companies formed for the specific purpose of effecting a reverse merger are known as blank check shell companies. Despite the advantages of this entity type, only 5% of the Reviewed Transactions involved blank check shell companies.
- **Development stage.** Shell companies that have previously filed a registration statement under the Securities Act and may have a business plan but only have nominal operations are known as development stage companies. Approximately 66% of the Reviewed Transactions involved development stage shell companies.
- **Natural.** Shell companies that previously conducted operations that were either disposed of or otherwise terminated are known as natural shell companies. Approximately 29% of the Reviewed Transactions involved natural shell companies.

1. 17 C.F.R. § 230.405. 2. 17 C.F.R. § 240.12b-2.

Related Content

For further information on reverse mergers and other going private transactions, see

> **GOING PRIVATE TRANSACTIONS: STRUCTURING AND PLANNING**

RESEARCH PATH: *Capital Markets & Corporate Governance > Beneficial Ownership: Reporting, Compliance and Tax Matters > Going Private Transactions - Rule 13e-3 > Practice Notes*

For a further discussion of smaller reporting companies, see

> **EMERGING GROWTH COMPANY VERSUS SMALLER REPORTING COMPANY COMPARISON CHART**

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

For a form of merger agreement in another context, see

> **AGREEMENT AND PLAN OF MERGER (TWO STEP CASH TENDER OFFER) (PRO-BUYER) (DE)**

RESEARCH PATH: *Capital Markets & Corporate Governance > Tender Offers > The Two-Step Acquisition Process > Forms*

For information on risk factors in other contexts, see

> **RISK FACTOR DRAFTING FOR A REGISTRATION STATEMENT**

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

A central concern for privately held companies when identifying the shell company with which to execute a reverse merger is whether the shell company is free of liabilities. Upon consummation of the merger, the surviving reverse merger company will bear all liabilities of the shell company and, as discussed below, post-closing indemnification for these liabilities from shell company pre-closing shareholders is unlikely to be available. Therefore, comprehensive due diligence is essential, especially in the case of development stage and natural shell companies, with particular attention to be paid to securities law compliance, accounting controls, and legacy tax, employee, environmental, and tail liabilities that may arise from prior transactions by the shell company.

Smaller Reporting Companies

A smaller reporting company is currently defined under Rule 405 of the Securities Act as an issuer with public float of less than $250 million. Companies with public float of less than $700 million also qualify as a smaller reporting company if they have annual revenues of less than $100 million. The large majority of surviving reverse merger companies meet the definition of a smaller reporting company and make use of the significant flexibility afforded to smaller reporting companies. A summary of accommodations available to smaller reporting companies is provided as Annex A. Most notable are:

- Flexibility with respect to required financial statements, including no requirement to provide selected or supplementary financial information
- Exemptions from required compensation disclosure, including the compensation discussion and analysis
- Simplified and scaled disclosure with respect to management's discussion and analysis of financial information and description of business

Transaction Structure

The majority of Reviewed Transactions were structured as share exchanges, where a shell company acquires a privately held company in exchange for shares of the shell company. Less common are reverse triangular mergers, whereby an acquiring shell company forms a wholly owned subsidiary to merge into the privately held company, which then survives as a wholly owned subsidiary of the acquirer. Bespoke structures (e.g., asset purchases) are also used in certain circumstances. Regardless of structure, upon consummation of the reverse merger, owners of the privately held company receive equity, most often representing a control position, of the post-closing public company.

Deal Terms

Merger/Share Exchange Agreement

The applicable merger or share exchange agreement will generally resemble a typical mergers and acquisition (M&A) agreement. Below is a brief summary of key provisions based on a review of the merger and share exchange agreements of the Notable Transactions.

Representations and Warranties; Indemnification

Key representations and warranties include:

- Authority to enter into the transaction and perform the obligations set forth in the agreement
- Capitalization (including sufficiency of authorized shares)
- Preparation of financial statements in accordance with generally accepted accounting principles and accuracy of books and records
- Compliance with applicable SEC reporting requirements
- Absence of undisclosed liabilities

In addition, such agreements may contain certain additional representations and warranties customary for M&A transactions, such as with respect to compliance with applicable laws, the absence of litigation, material contracts, and tax and employee matters. The scope and detail of the representations and warranties will depend on the circumstances of the deal; the nature and history of the shell company; the desire on the part of the privately held company to obtain additional formal disclosure with respect to the shell company; and the negotiated remedies in the event of breaches of, or inaccuracies in, the representations and warranties.

Remedies

Monetary remedies in the event of breaches of, or inaccuracies in, representations and warranties or failure to perform covenants may be difficult to obtain from shell company shareholders unless a portion of the purchase price is payable in cash and can be held back or deposited into escrow at closing. Some parties choose to include alternative remedies, including specific performance, termination rights, and closing conditions relating to the accuracy of representations and warranties and performance of covenants.

No-Shops and Break-up Fees

State corporate law may impose a fiduciary duty on the board of a shell company to change its recommendation in favor of the reverse merger transaction under certain circumstances (e.g., a bona fide superior proposal). To that end, parties to merger and share exchange agreements may bargain for no-shop provisions. Example provisions that may be included in such a covenant include an obligation to:

- Cease negotiations with third parties at signing
- Not actively solicit alternative transactions
- Provide the privately held company with matching rights in response to an unsolicited superior proposal
- Submit the transaction to shareholders regardless of a change in the board's recommendation

Additionally, the privately held company may attempt to bargain for a termination fee in the event that the agreement is terminated in certain circumstances. If the shell company resists such a termination fee in a customary amount given a scarcity of available funds, the parties may negotiate alternatives, such as a smaller fee or a reimbursement of the privately held company's transaction expenses.

Related Content

For a summary of the instructions and other guidance regarding Item 2 of Form 8-K, see

> **FORM 8-K PREPARATION FOR AN ITEM 2 EVENT**

RESEARCH PATH: *Capital Markets & Corporate Governance > Public Company Reporting > Current Reports on Form 8-K > Practice Notes*

For guidance on preparing the long form registration statement on Form 10, see

> **FORM 10 DRAFTING**

RESEARCH PATH: *Capital Markets & Corporate Governance > Registration under the Exchange Act > Section 12 Registration > Practice Notes*

For an explanation on how to draft an Item 5 Corporate Governance and Management disclosure for Form 8-K, see

> **FORM 8-K PREPARATION FOR AN ITEM 5 EVENT**

RESEARCH PATH: *Capital Markets & Corporate Governance > Public Company Reporting > Current Reports on Form 8-K > Practice Notes*

For further information on OTC Markets, see

> **REQUIREMENTS FOR JOINING OTCQX, OTCQB, AND OTC PINK FOR U.S. ISSUERS CHECKLIST**

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

PIPEs

As a primary purpose of a reverse merger is to enhance a privately held company's access to capital, many transactions are accompanied by a private investment in public equity, or PIPE, transaction. These PIPEs typically involve a shell company issuing common stock to accredited investors prior to, or concurrent with, the closing of the reverse merger. Based on an analysis of the Reviewed Transactions, approximately 26% include a PIPE, with a higher percentage for Notable Transactions. The average total PIPE amount for Notable Transactions is $8.9 million, which is approximately $3.1 million more on average than the entire group of Reviewed Transactions.

The surviving reverse merger company ordinarily provides these accredited investors in a PIPE with anti-dilution rights as well as registration rights requiring the surviving reverse merger company or any successor to register the shares for public resale. Registration rights are important, as under Rule 144(i)[3] of the Securities Act, if a company has ever reported being a shell company, investors in the entity cannot sell unregistered shares under Rule 144 unless the issuer has been current in its SEC reporting obligations for the preceding 12 months.

Accounting Treatment

In a business combination effected primarily by exchanging equity interests, the acquirer usually is the entity that issues its equity interests. However, in some business combinations, the issuing entity is instead the acquiree and the non-issuing entity is the acquirer for accounting purposes.[4] The SEC staff generally considers the type of reverse merger referred to in this discussion to be a capital transaction for accounting purposes. As a result, the privately held company's financial statements are used and reported at historical cost basis.

In reverse mergers where the shell company is deemed to be the accounting acquirer, however, purchase accounting methodology, which requires a determination of assets at fair market value, must be applied. This valuation exercise involves additional time and expense. Some factors to consider when determining which party is the accounting acquirer according to ASC paragraphs 805-10-55-12 and -13 are:

- **Relative voting rights in the combined entity after the business combination.** The acquirer usually is the combining entity whose owners as a group retain or receive the largest portion of the voting rights in the combined entity. In determining which group of owners retains or receives the largest portion of the voting rights, an entity shall consider the existence of any unusual or special voting arrangements and options, warrants, or convertible securities.
- **Existence of a large minority voting interest in the combined entity if no other owner or organized group of owners has a significant voting interest.** The acquirer usually is the combining entity whose single owner or organized group of owners holds the largest minority voting interest in the combined entity.
- **Composition of the governing body of the combined entity.** The acquirer usually is the combining entity whose owners have the ability to elect, appoint, or remove a majority of the members of the governing body of the combined entity.
- **Composition of the senior management of the combined entity.** The acquirer usually is the combining entity whose former management dominates the management of the combined entity.
- **Terms of the exchange of equity interests.** The acquirer usually is the combining entity that pays a premium over the pre-combination fair value of the equity interests of the other combining entity or entities.
- **Size of the combining entity.** The acquirer usually is the combining entity whose relative size (measured in, for example, assets, revenues, or earnings) is significantly larger than that of the other combining entity.

Disclosure Trends

Risk Factors

Item 105 (formerly Item 503) of Regulation S-K[5] requires a discussion of the most significant factors that make an offering speculative or risky. Surviving reverse merger companies commonly disclose in their risk factors:

- Management's lack of experience in operating a public company or the potential for failure to maintain adequate internal controls as required by the SEC for public companies, as management of surviving reverse merger companies typically come from the former privately held company and may have limited public company experience
- Potential inability to attract the attention of securities analysts, given that the New York Stock Exchange (NYSE) and the Nasdaq Stock Market (Nasdaq) will not list surviving reverse merger companies for a minimum of one year post-transaction
- Lack of history of compliance with U.S. laws and accounting principles, as many privately held companies seeking to go public are organized and/or operate outside of the United States

3. 17 C.F.R. § 230.144. 4. *See* Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) paragraph 805-10-55-12. 5. 17 C.F.R. § 229.503.

Based on SEC comments to disclosures related to the Reviewed Transactions, including in the Form 8-K filed upon the completion of a reverse merger, risk factors should reflect the following:

- Risks of investing in a surviving reverse merger company
- Risks specific to the business of the surviving reverse merger company
- Risk factor addressing an independent auditor going concern opinion, if applicable
- Subcaptions that are clear statements of the risks presented and avoid repetitive risk factors

Form 8-K

Item 2.01(f)

A surviving reverse merger that involves a shell company triggers the filing of a Form 8-K within four days of the closing of the reverse merger.[6] The Form 8-K must contain all the information required by Form 10 under the Exchange Act. Form 10 disclosure includes, among other items:

- Description of the business
- Risk factors
- Financial information required by Items 301[7], 303[8], and 305[9] of Regulation S-K
- Information on directors and officers
- Executive compensation

Form 8-K inclusive of the Form 10 disclosure is sometimes referred to as a Super 8-K. The most frequent SEC comment to Form 8-K disclosure for the Reviewed Transactions was to include the required Form 10 disclosure in the closing Form 8-K. Other SEC comments to Form 8-K disclosures for the Reviewed Transactions include requests to provide:

- Clear disclosure that the transaction is a reverse merger transaction
- Disclosure of the identities of the parties to the transaction and any relationships
- Summary of the key terms of the transaction, including the number of shares issued as consideration
- Disclosure of the material terms of material contracts to which the surviving reverse merger company or its directors or officers are parties
- Proper asset, liability, and goodwill recognition
- Appropriate pro forma financial statements
- Description of applicable government regulations

> **SEC comment.** "It appears from your disclosure that you were a shell company as that term is defined in Rule 12b-2 under the Exchange Act prior to the acquisition, as you had no or nominal operations and no or nominal noncash assets. Please tell us whether the transaction reported on this Form 8-K resulted in a change in your status as a shell company. If so, pursuant to Item 2.01(f) of Form 8-K, please amend your Form 8-K to provide the information that would be required if you were filing a general form for registration of securities on Form 10 under the Exchange Act. If you believe your status as a shell company has not changed as a result of the current transaction, please confirm that going forward, you will appropriately mark your Exchange Act filings to identify yourself as a shell company."

Item 5.06

The SEC also comments in cases where it believes there has been an unreported change in shell company status.

> **SEC comment.** "We note disclosure in Item 5.06 and elsewhere in your report that you believe you exited shell company status as a result of the merger agreement described under Item 1.01. A shell company, as defined under Rule 12b-2 of the Securities Exchange Act of 1934, as amended, is a company that has no or nominal operations and either: (i) no or nominal assets; (ii) assets consisting solely of cash and cash equivalents; or (iii) assets consisting of any amount of cash and cash equivalents and nominal other assets. We note that you are a developmental stage company with an aspirational business plan and you have not yet begun any operations or generated any revenues as of March 31, 2015. Accordingly, please provide us with a detailed analysis whereby you determined that you are no longer a shell company as defined under Rule 12b-2. For guidance, refer to SEC Release No. 34-52038."

Item 9.01(c)

Item 9.01(c) of Form 8-K requires financial statements and financial information to be filed in a Super 8-K. If such financial statements and information are not included, the SEC will often issue a comment requesting an explanation as to why a company believes it was not a shell company at the time of the reverse merger transaction.

> **SEC comment.** "Please provide us with your detailed analysis as to why you believe you were not a shell company at the time of the acquisition, requiring that the financials be filed with the initial report. Please refer to Item 9.01(c) of Form 8-K."

6. *See* Item 2.01(f) of Form 8-K, which is available at https://www.sec.gov/forms. 7. 17 C.F.R. § 229.301. 8. 17 C.F.R. § 229.303. 9. 17 C.F.R. § 229.305.

Legal and Regulatory Trends

SEC Enforcement

It is important for the surviving reverse merger company to be prepared to provide adequate disclosure and make timely filings immediately following the completion of a reverse merger.

In 2011, the SEC took enforcement action in several reverse mergers, which led to the SEC suspending trading in several surviving reverse merger companies and even revoking the Exchange Act and Securities Act registration of surviving reverse merger companies for failing to make the requisite periodic filings. The actions cited:

- Questions regarding the accuracy and completeness of information in public filings
- The failure to disclose certain material events and information
- Questions regarding the potential existence of two separate sets of corporate books and accounts

The SEC continues to monitor reverse mergers and take enforcement action.

Stock Exchange Listing Standards

Surviving reverse merger companies are subject to heightened listing requirements. Both the NYSE and Nasdaq enacted rules in 2011 requiring surviving reverse merger companies to complete the following prior to listing on the exchange:

- A one-year trial period of trading on the U.S. over-the-counter (OTC) markets or another regulated U.S. exchange
- The filing of all required Exchange Act reports with the SEC prior to listing
- Maintenance of a minimum stock price of $4 per share for a specified period of time prior to listing

In light of these requirements, surviving reverse merger companies typically list on an OTC market during their trial period prior to listing on the NYSE or Nasdaq. Two of the most common OTC markets for such a listing are the Pink Sheets and the OTC Bulletin Board (operated by the Financial Industry Regulatory Authority), which have fewer listing and reporting requirements.

Market Outlook

On June 28, 2018, the SEC increased the financial thresholds for smaller reporting company status as set forth below:

	Previous	Current
Public float	Less than $75 million	Less than $250 million
Revenues	Less than $50 million	Less than $100 million

In a change from the proposed rules, companies will also qualify as a smaller reporting company if they have a public float of less than $700 million and annual revenues of less than $100 million.[10] The changes expand the number of companies eligible to qualify as a smaller reporting company, thereby potentially increasing the appeal of the reverse merger transaction structure.

10. *See* SEC Release No. 33-10513, 34-83550 (June 28, 2018) available at https://www.sec.gov/rules/final/2018/33-10513.pdf.

Annex A

Regulation S-K	
Item	**Scaled Disclosure Accommodation for Smaller Reporting Companies**
101 – Description of Business	May satisfy disclosure obligations by describing the development of its business during the last three years rather than five years. Business development description requirements are less detailed than disclosure requirements for non-smaller reporting companies.
201 – Market Price of and Dividends on the Registrant's Common Equity and Related Stockholder Matters	Stock performance graph not required.
301 – Selected Financial Data	Not required.
302 – Supplementary Financial Information	Not required.
303 – Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A)	Two-year MD&A comparison rather than three-year comparison. Two-year discussion of impact of inflation and changes in prices rather than three years. Tabular disclosure of contractual obligations not required.
305 – Quantitative and Qualitative Disclosures about Market Risk	Not required.
402 – Executive Compensation	Three named executive officers rather than five. Two years of summary compensation table information rather than three. Not required to provide compensation discussion and analysis, grants of plan-based awards table, option exercises and stock vested table, pension benefits table, nonqualified deferred compensation table, disclosure of compensation policies and practices related to risk management, and pay ratio disclosure.

Regulation S-K	
Item	**Scaled Disclosure Accommodation for Smaller Reporting Companies**
105 (formerly Item 503) – Prospectus Summary and Risk Factors	No risk factors required in Exchange Act filings.
404 – Transactions with Related Persons, Promoters, and Certain Control Persons	Description of policies/procedures for the review, approval, or ratification of related party transactions not required. Item 404 also contains the following expanded disclosure requirements applicable to smaller reporting companies: (1) rather than a flat $120,000 disclosure threshold, the threshold is the lesser of $120,000 or 1% of total assets; (2) disclosures are required about parents of the reporting company and underwriting discounts and commissions where a related person is a principal underwriter or a controlling person or member of a firm that was or is going to be a principal underwriter; and (3) an additional year of Item 404 disclosure is required in filings other than registration statements on Form S-4.
407 – Corporate Governance	Audit committee financial expert disclosure not required in first year. Compensation committee interlocks and insider participation disclosure not required. Compensation committee report not required.

Regulation S-X	
Rule	**Scaled Disclosure**
8-02 – Annual Financial Statements	Two years of income statements rather than three years. Two years of cash flow statements rather than three years. Two years of changes in stockholders' equity statements rather than three years.
8-03 – Interim Financial Statements	Permits certain historical financial data in lieu of separate historical financial statements of equity investees.
8-04 – Financial Statements of Businesses Acquired or to Be Acquired	Maximum of two years of acquiree financial statements rather than three years.
8-05 – Pro Forma Financial Information	Fewer circumstances under which pro forma financial statements are required.
8-06 – Real Estate Operations Acquired or to Be Acquired	Maximum of two years of financial statements for acquisition of properties from related parties rather than three years.
8-08 – Age of Financial Statements	Less stringent age of financial statements requirements.
402 – Executive Compensation	Three named executive officers rather than five. Two years of summary compensation table information rather than three. Not required to provide compensation discussion and analysis, grants of plan-based awards table, option exercises and stock vested table, pension benefits table, nonqualified deferred compensation table, disclosure of compensation policies and practices related to risk management, and pay ratio disclosure.

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LexisNexis Canada Fundraiser Benefits South African Anti-Human Trafficking Group

LEXISNEXIS EMPLOYEES IN CANADA JOINED FORCES recently to organize and staff a pancake breakfast to raise funds for a South African organization that provides care and counseling to clients facing a wide range of societal and health issues, including commercial sex workers and victims of human trafficking.

The breakfast, organized by the LexisNexis Rule of Law Committee, raised $800 for the Umgeni Community Empowerment Centre (UCEC) in Durban, home of LexisNexis South Africa.

Pancakes were served by 10 LexisNexis Canada employees, including members of the Senior Leadership Team, to approximately 50 participants. Donations were matched dollar-for-dollar by LexisNexis.

The UCEC, founded in 2003, describes its mission as “To play a vital role in the implementation of programs aimed at empowering both individuals and communities to become self sustainable and contributory citizens.” In addition to human-trafficking victims and commercial sex workers, the organization serves abused children, victims of rape and domestic violence, those living with HIV/AIDS, and other marginalized communities.

The group operates a soup kitchen and distributes food parcels to the elderly and needy in addition to operating crisis centers for those recovering from substance abuse and a day care center for poverty-stricken children. In addition, an annual 10/K Stop Human Trafficking Walk is in its sixth year.

The pancake breakfast followed a visit by LexisNexis employees to UCEC, where they cooked and served lunch and handed out bags of groceries to homeless people. Jay Brecher, Director of Subscription Content for LN Canada, who was among the visitors, said, “I have volunteered at soup kitchens for nearly 20 years, but I had never seen so many homeless people, especially children, at one meal. It was heartbreaking, but it affirmed the importance of UCEC’s work.”

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