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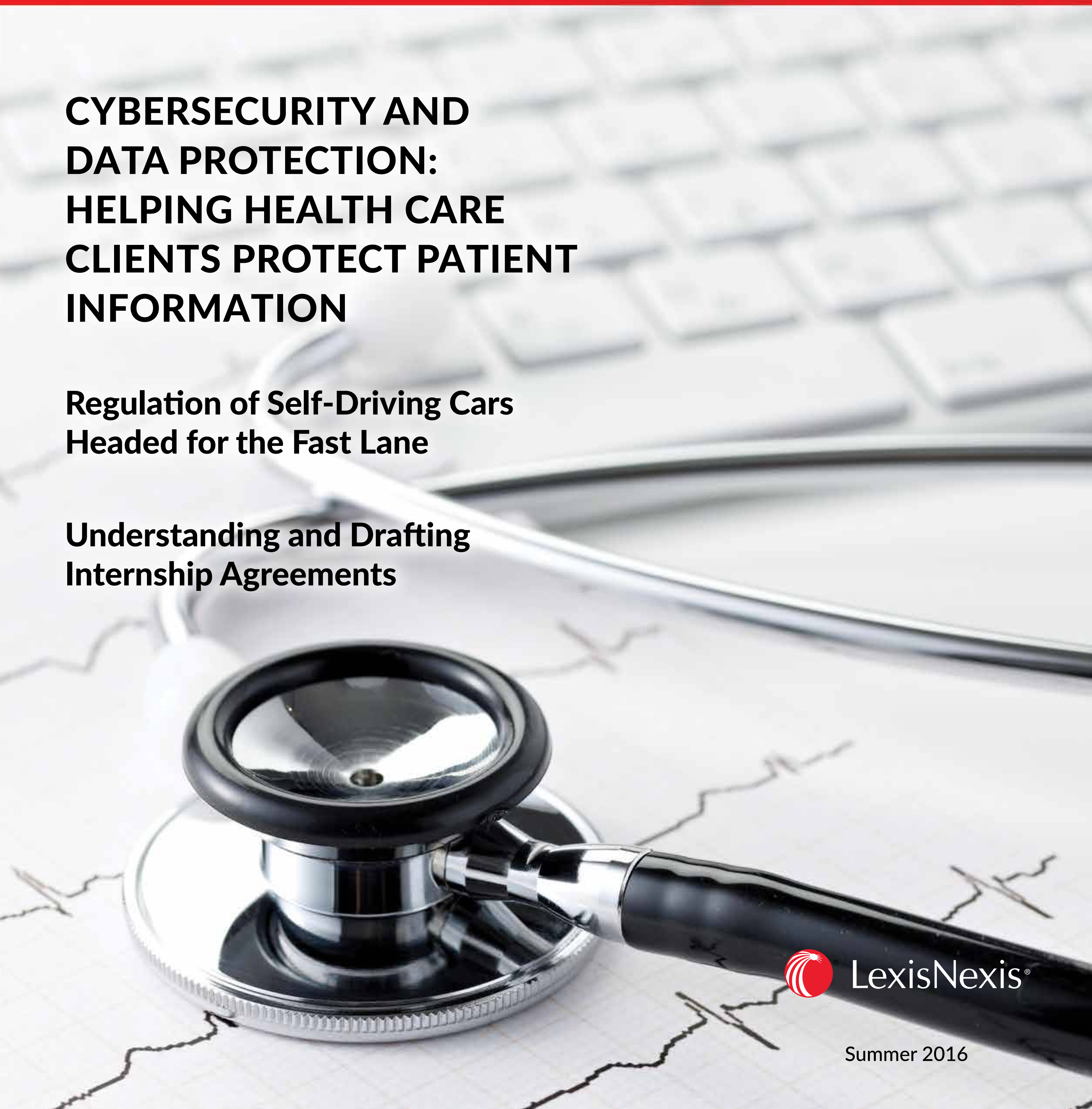

CYBERSECURITY AND DATA PROTECTION: HELPING HEALTH CARE CLIENTS PROTECT PATIENT INFORMATION

Regulation of Self-Driving Cars Headed for the Fast Lane

Understanding and Drafting Internship Agreements

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Summer 2016

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LEXIS PRACTICE ADVISOR Journal™

SUMMER 2016 (Volume 1, Issue 3)

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Eric Bourget, Editor-in-Chief

ENTERING LAW SCHOOL ALL OF US had ethical aspirations as to what the practice of law would entail. Perhaps inspired by an attorney we knew as a child, or TV shows like Perry Mason, LA Law and Law and Order, where themes of helping the underdog, carrying out justice, or righting a wrong prevailed. Whatever the initial inspiration, we chose careers as lawyers with optimistic outlooks to make the world a better place and with the intent to always abide by our ethics. Given the demands and pressures under which attorneys must operate, keeping core values each day requires grounding, reinforcement and the wise input of peers and the legal community itself, above and beyond fulfilling mandatory continuing legal education requirements.

The practice of law is filled with a myriad of ethical issues and we knew this when deciding to choose the career path of an attorney. With this in mind, this issue of the Journal includes an article that provides ethical practical guidance around day to day practice in "Avoiding Stretching Your License Beyond Legal and Ethical Limits." We will continue to create articles and practical guidance around everyday ethical considerations for the Journal and Lexis Practice Advisor to guide us through difficult situations and help us reflect upon our original motivations.

Knowing that we are also embarking upon a season where summer interns with high ideals and aspirations start working in firms and companies, we provided practice pointers on "Understanding and Drafting Internship Agreements" along with an accompanying Internship Agreement form. The Journal provides you with a broad sampling of practical guidance and insights that may be found in our online Practical Guidance workflow tool, Lexis Practice Advisor, as well as relevant articles that will bring you up to speed on current issues and trends and which will undoubtedly serve as entry points into deeper analytical research. In this issue, we have included articles addressing recent practice trends involving self-driving cars, buying and selling oil and gas assets, the developing law of LBGT protections under Title VII and the importance of cybersecurity with healthcare clients.

Our mission

The Lexis Practice Advisor Journal™ is designed to help transactional attorneys start on point and finish big. This quarterly 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 400+ seasoned attorney authors, The Lexis Practice Advisor Journal offers fresh, contemporary perspectives and compelling insights on matters impacting your transactional practice.

SEVENTEEN STATE "NEW ENERGY FUTURE" COALITION FORMED

GOVERNOR ANDREW M. CUOMO AND 16 OTHER GOVERNORS signed the Governors' Accord for a New Energy Future. The accord describes six shared goals, diversification of energy generation and expansion of clean energy sources, modernization of energy infrastructure, encouragement of clean transportation options, planning for the energy transition, working together to make transformational policy changes, and helping secure a stronger national energy future.

Environmental Law in New York, Volume 27, No. 5

FDIC ADOPTS RULE TO INCREASE DEPOSIT INSURANCE FUND

THE FEDERAL DEPOSIT INSURANCE CORPORATION approved a final rule to increase the Deposit Insurance Fund (DIF) to the statutorily required minimum level of 1.35%.

Congress in the Dodd-Frank Act increased the minimum for the DIF reserve ratio, the ratio of the amount in the fund to insured deposits, from 1.15% to 1.35% and required that the ratio reach that level by September 30, 2020. Dodd-Frank also made banks with $10 billion or more in total assets responsible for the increase from 1.15% to 1.35%.

The final rule will impose on banks with at least $10 billion in assets a surcharge of 4.5 cents per $100 of their assessment base, after making certain adjustments. The FDIC expects the reserve ratio will likely reach 1.35% after approximately two years of payments of the surcharges.

The final rule will become effective on July 1. If the reserve ratio reaches 1.15% before that date, surcharges will begin July 1. If the reserve ratio has not reached 1.15% by that date, surcharges will begin the first quarter after the reserve ratio reaches 1.15%.

"The FDIC is taking a balanced approach that maintains stable and predictable deposit insurance assessments," FDIC chairman Martin J. Gruenberg said. "At the same time assessment rates will decline for all banks, larger institutions will pay a surcharge over

a period of time. With these surcharges, the Deposit Insurance Fund is expected to reach the statutory minimum level ahead of the statutory deadline of 2020, reducing the risk that the FDIC will have to raise rates unexpectedly in the event of stress in the financial sector."

Pratt's Bank Law & Regulatory Report, Volume 50, No. 4

FLSA EXEMPTION CHANGES COULD TAKE EFFECT IN SUMMER 2016

EMPLOYERS SHOULD PREPARE TO COMPLY WITH THE NEW regulations governing the overtime exemptions for white collar administrative, executive, and professional employees under the Fair Labor Standards Act (FLSA), which are expected to dramatically increase the minimum salary for exempt employees. Signs point to a likely rollout of the new rules in the summer of 2016, with an effective date this summer or fall.

The FLSA regulation governing white collar exemptions currently provides for a minimum salary of $455 per week ($23,660 per year).[1] The Obama administration's proposal is expected to more than double the minimum salary to an estimated $970 per week ($50,440 per year) in 2016, with annual cost-of-living increases to follow.[2]

California's minimum salary for white collar exempt employees is set at twice the state minimum wage for a 40-hour work week.[3] Under the current $10 state minimum wage, California's minimum salary is $800 per week ($41,600 per year).[4] California's minimum salary for exempt employees has long been higher than the federal minimum, with the result that employees who satisfied the state minimum automatically exceeded the federal minimum. But that is expected to change when the new FLSA regulations take effect. Although the proposed regulations do not include changes to the duties test, Solicitor of Labor M. Patricia Smith reportedly said a change to the duties test should not be ruled out.[5]

Employers likely have little time to prepare for the new regulations, including the new minimum salary. At a minimum, employers should do the following:

- Identify any employees/positions currently classified as exempt with salaries lower than the expected new minimum salary of $970 per week ($50,440 per year).
- For each of these employees/positions, decide whether to comply with the new rule by increasing the salary to or above the new minimum or reclassify the employees/positions to nonexempt status.
- If employees are to be reclassified as nonexempt, ensure employees and managers are trained to comply with all requirements applicable to nonexempt employees, including shift scheduling, timekeeping, meal/rest periods, and avoiding off-the-clock work.
- Consider how overtime may affect the overall compensation provided to reclassified employees and whether and how much overtime should be prohibited or regulated to keep payroll expenses under control.
- Consider how reclassifying employees to nonexempt status could affect their right to benefits that may currently be limited to exempt employees.
- Develop a communication plan to notify employees and managers who may be affected by a reclassification, and prepare to address morale issues that could arise from any perceived demotion caused by the reclassification.

Excerpt from article by Aaron Buckley, Bender's California Labor & Employment Bulletin 137 (April 2016).

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1. 29 C.F.R. § 541.600(a)(1). 2. Robert A. Boonin, *The Proposed New Overtime Pay Exemption Rules: What's the Latest Scoop?*, Wage & Hour Defense Inst. (Feb. 18, 2016), https://wagehourdefense.wordpress.com/2016/02/18/the-proposed-new-overtime-pay-exemption-rules-whats-the-latest-scoop/. 3. *See*, e.g., Cal Code Regs., tit. 8, § 11040, sections 1(A)(1)(f), 1(A)(2)(g), 1(A)(3)(d). 4. Cal. Lab. Code § 1182.12. 5. Boonin, *supra* note 2.

PRACTICE NEWS

UNDER NEW LAW THE IRS CAN SEIZE YOUR PASSPORT

A NEW LAW ALLOWS THE INTERNAL Revenue Service (IRS) to revoke or deny passports for certain taxpayers who owe unpaid federal taxes. This change to the tax law was included in the Fixing America's Surface Transportation Act, (H.R. 22) enacted in December 2015.[1] H. R. 22 added new Internal Revenue Code (IRC) section 7345, requiring the Secretary of State, on certification by the Treasury, to deny, revoke, or limit the passport of any person who the IRS certifies as owing in excess of $50,000.[2]

IRC section 7345 provides that except in humanitarian or emergency situations, or for individuals serving in a combat zone, on receiving a certification from Treasury, the Secretary of State shall not issue a passport to any individual who has a seriously delinquent tax debt.[3] Moreover, on receipt of such certification the Secretary of State can revoke a passport previously issued to any individual.[4] The tax deficiency must be an unpaid, previously assessed legally enforceable Federal tax liability of an individual.[5]

These rules will not apply to a taxpayer (1) who is making timely payments under an agreement, such as an installment agreement, or is pursuing an offer in compromise, with the IRS,[6] (2) for which IRS collection is suspended because a Collection Due Process request has been filed,[7] or (3) for whom innocent spouse relief has been requested or is pending.[8]

The IRS is required to notify the taxpayer when it sends a certification of serious delinquency to Treasury. This means if you are on the list you will receive a heads up. Passport revocation will be allowed only after the IRS has followed its examination and collection procedures, and the taxpayer's administrative and judicial rights have been exhausted or have lapsed.

Excerpt from article by Aaron Buckley, Bender's California Labor & Employment Bulletin 137 (April 2016).

WEST VIRGINIA BECOMES THE 26TH RIGHT TO WORK STATE

FOR DECADES, RIGHT TO WORK STATES have been concentrated in the south and mountain west. More recently, however, states with a long history of powerful labor unions have enacted right to work legislation in an effort to attract business. In the past four years, Indiana, Michigan, and Wisconsin—three states with a rich history of manufacturing and workers represented by labor organizations—have passed right to work legislation.

West Virginia became the 26th right to work state when the state legislature overrode the governor's veto of a bill precluding agreements pursuant to which employees are required to provide financial support to a labor organization as a condition of employment. The veto was overturned by a simple majority vote in both chambers (18-16 in the Senate and 54-43 in the House).

Significantly, Republicans control both chambers in West Virginia for the first time in 80 years.

The new law will take effect on July 1, 2016. While it remains to be seen whether the law succeeds in attracting business to the state, the fact that right to work laws can be passed in such traditional hotbeds of labor has to be of concern to labor unions and their supporters.

Bender's Labor & Employment Bulletin VOLUME 16 • ISSUE NO. 4

1. PL 114-94, Title XXXII Offsets, Subtitle A Tax Provisions, Section 32101(a). **2.** IRC § 7345(a). **3.** IRC § 7345(e)(1)(A). **4.** IRC § 7345(e)(2)(A). **5.** IRC § 7345(b)(1). **6.** IRC § 7345 (b)(2)(A). **7.** IRC § 7345(b)(2)(B)(i). **8.** IRC § 7345 (b)(2)(B)(ii).

MORTGAGE PROGRAMS TARGETING COMMUNITY REVITALIZATION GUIDANCE ANNOUNCED

THE OFFICE OF THE COMPTROLLER OF THE CURRENCY (OCC) announced plans to issue a bulletin in the coming months to provide guidance for banks that want to set up mortgage programs so that potential homeowners may be able to secure purchase or purchase/ rehabilitation loans in excess of the supervisory loan-to-value limits.

The OCC drafted the bulletin, "Risk Management Guidance for Higher Loan-to-Value Lending in Communities Targeted for Revitalization," in response to concerns voiced by public officials, community groups, and bankers about revitalizing communities still suffering from the financial crisis. The OCC expects these programs will be focused on communities that have been officially targeted for revitalization.

Comptroller of the Currency Thomas Curry specifically mentioned barriers to financing homes and stabilizing neighborhoods in Detroit. "The limited number of home sales there can make it difficult to find comparable sales needed for valuation of a property," Curry said. "Additionally, area home values may be so low that the cost to purchase a property and make needed repairs often exceeds the post-renovation market value. These and other market conditions have combined to bring mortgage financing to a near halt in Detroit. Other cities face similar problems."

Curry pointed out that under current interagency guidelines establishing supervisory LTV expectations, banks generally "should not make single-family home mortgage loans that exceed 90 percent of the property's value, unless the loan has appropriate credit support, such as mortgage insurance, readily marketable collateral, or other acceptable collateral." He noted, however, that the interagency guidelines also establish that institutions may make exceptions to the supervisory LTV limit on a case-by-case basis. "As set out in the draft bulletin," Curry added, "we believe that engaging in higher LTV lending on a programmatic basis also can be consistent with safe and sound lending while having a positive impact in stabilizing and revitalizing communities." He encouraged bankers to reach out to local organizations to discuss issues of concern. "Periodic meetings with key local stakeholders can also help pinpoint new business opportunities, identify potential partnerships with local community organizations and public agencies, and help a bank formulate its business strategy for meeting its Community Reinvestment Act (CRA) obligations."

Curry also discussed statutory protections that safeguard the public's right to know when a bank decides to close a branch. "As more customers are served through online and mobile applications, we are seeing some banks closing branches," Curry said. "In 2015, the OCC received almost 1,200 notices of branch closures, while we received only about one-third as many applications to open new branches."

He stressed that while the OCC does not have statutory authority to prohibit a branch from closing, it does consider a bank's record of opening and closing branches—and the impact of a branch closure on the community—when it evaluates a bank's CRA performance.

Pratt's Bank Law & Regulatory Report, Volume 50, No. 3

NORTH CAROLINA'S CONTROVERSIAL SEXUAL ORIENTATION AND GENDER IDENTITY LAW

THE NORTH CAROLINA LEGISLATURE ENACTED H.B. 2, 82-16, which critics contend is among the most sweeping anti-LGBT laws in the country. It was immediately signed into law by Governor Pat McCrory. Under this law, local governments are prohibited from requiring private employers or contractors to meet wage or benefit requirements not mandated by the state. The law also bans municipalities from providing discrimination protections to classes of people not covered under state law. The law came about after the city of Charlotte passed an ordinance that added sexual orientation and gender identity to the list of existing protected groups. The part of the ordinance that caused alarm was one that permitted transgender individuals to use the restroom of their choice. The new state law overturned that ordinance.

The law's supporters claim it was aimed at providing consistent requirements for businesses throughout the state. Critics argue that if that were really the case, the state should stop municipalities from enacting any ordinances and have everything decided by the state legislature—a "big government" idea usually rejected by conservatives. Indeed, the governor said in his statement announcing he had signed the bill, "[t]he basic expectation of privacy in the most personal of settings, a restroom or locker room, for each gender was violated by government overreach and intrusion by the mayor and city council of Charlotte." He continued by saying "[w]hile local municipalities have important priorities working to oversee police, fire, water and sewer, zoning, roads, and transit, the mayor and city council took action far out of its core responsibilities."

The legislation took effect upon signing and supersedes any existing local ordinance, resolution, regulation, or policy previously adopted. Several groups have stated an intention to file lawsuits over the legislation. Moreover, since McCrory signed the bill, PayPal has abandoned plans it had announced for a global operations center in the state, Deutsche Bank stated that it would "freeze plans to create 250 jobs" near Raleigh, and the National Basketball Association is considering moving the 2017 All-Star Game from Charlotte. McCrory subsequently started a retreat, stating that he would increase discrimination protections for state employees and urged the legislature to change a part of the bill it passed. But many observers view the proposed changes as merely cosmetic.

Bender's Labor & Employment Bulletin, Volume 16, Issue 5

Julie Capell WINSTON & STRAWN LLP

UNDERSTANDING & DRAFTING **INTERNSHIP AGREEMENTS**

This article discusses how to draft effective internship agreements that comply with the U.S. Department of Labor's (DOL's) regulations concerning unpaid internships, as well as recent court decisions applying a new test concerning unpaid internships.

WHEN THE ECONOMY IS DOWN AND BUSINESSES LOOK to cut expenses, it may seem like a good idea to hire an unpaid intern. You should advise employers, however, to approach such arrangements with caution. Unpaid internship programs that do not comply with applicable federal and state laws have potentially grave consequences. Employers with misclassified unpaid interns face potential liability for unpaid wages and violations relating to failure to pay minimum wage, which could be significant for a full-time intern. In addition to the wages due to the unpaid intern, employers may face potential liability for overtime and, for employees based in California, missed meal or rest periods. Moreover, employers can incur liability for unpaid employment-related taxes owed to governmental agencies. Consequently, before advising a company to enter into an internship agreement, you must first determine that the arrangement qualifies for exemption from minimum wage and overtime obligations pursuant to the Fair Labor Standards Act (FLSA), 29 USCS § 203. If so, you should draft an agreement to support that conclusion.

Although the Supreme Court has yet to address the difference between unpaid interns and paid employees under the FLSA, the DOL published guidance in 2010 for unpaid interns working in the private sector. Recently, some courts have rejected the DOL's test in favor of a similar, but more employer-friendly, primary beneficiary test. Both tests are discussed below.

Applying the DOL's Six-Factor Test When Drafting Internship Agreements

A covered employer must pay interns minimum wage and overtime as required by the FLSA, unless the intern is not an "employee" within the meaning of the FLSA. Under the DOL's test, *all* of the following criteria must be satisfied before the company may properly classify the student as an unpaid intern:

1. The training, even though it includes actual operation of the facilities of the company, is similar to that which a vocational school would provide.
2. The training is for the benefit of the trainees or students.
3. The trainees or students do not displace regular employees but work under their close observation.
4. The company that provides the training derives no immediate advantage from the activities of the trainees or students, and on occasion its operations may actually be impeded.
5. The trainees or students are not necessarily entitled to a job at the conclusion of the training period.
6. The company and the trainees or students understand that the trainees or students are not entitled to wages for the time spent in training.

See U.S. Dep't of Labor, Wage & Hour Division, Field Operations Handbook § 10(b)(11) (1993). See also DOL, Wage and Hour Division (WHD) Fact Sheet #71: Internship Programs Under The Fair Labor Standards Act https://www.dol.gov/whd/regs/compliance/whdfs71.htm.

The DOL maintains that an employment relationship exists unless the circumstances satisfy all six factors. At least one federal court has determined that the test is based on a totality of circumstances and all six criteria need not be met in order to find that an individual is not an employee. See Reich v. Parker Fire Protection District, 992 F.2d 1023 (10th Cir. 1993). It is best practice for companies to only award unpaid internships when all six of the DOL's criteria have been satisfied. However, companies that are only subject to the jurisdiction of the Second or Eleventh Circuits can follow the less stringent primary beneficiary test discussed below, as these circuits have expressly rejected the DOL test. The following sections address drafting unpaid internship agreements in light of the six DOL factors.

Factor No. 1: Is the Internship Affiliated with a School Program?

A position will most likely qualify as an internship if the intern's school sponsors the program and the intern receives academic credit for the services he or she provides. The internship agreement should state that the on-the-job training will supplement the intern's coursework.

Factor No. 2: Who Will Primarily Benefit from the Internship?

The training program should primarily benefit the intern and not the company. A training program primarily benefits interns when they are given the opportunity to observe the practical application of classroom instruction in the workplace. The company must expose the intern to skills or learning that will enhance the intern's marketability in the vocational area. The internship agreement therefore should not state that the intern is in training to work for the company.

Factor No. 3: Will the Intern Displace Regular Employees?

The intern should not displace any of the company's regular employees by performing their regular responsibilities. But the intern may (and probably should) work under the close supervision of these employees. The internship agreement should directly state that the intern will not perform any of the company's regular employees' job duties, but the company may occasionally ask the intern to perform minor tasks.

Factor No. 4: Will the Company Benefit from the Internship?

The DOL has indicated that where the predominant benefit of the arrangement accrues to the intern, there is no employment relationship. But where interns directly perform the main work of the business, such interns step into the place of an employee and the company will likely gain an immediate (economic) advantage. If the company's regular employees are not as productive due to time spent supervising the intern and answering questions, this point may go towards the company not benefitting from the internship and may indicate that there is no employment relationship. The internship agreement should therefore state that the intern will work under the close supervision of the company's regular employees.

Factor No. 5: Is the Intern Entitled to a Job at the End of the Internship?

If the internship agreement states that the intern is entitled to a job at the end of the internship, the court or DOL will be more likely to find an employment relationship. The safest path for the employer is to explicitly state in the internship agreement that the internship is temporary and the company is under no obligation to hire the intern. Note, however, that in situations where the employer decides to formally hire the intern after the internship period ends, courts will not necessarily assume that this factor militates against the employer.

Factor No. 6: Does the Intern Know That He or She Will Not Be Paid?

The internship agreement must contain an acknowledgment by the intern that he or she does not expect compensation for the internship.

A New Test: Applying the New Seven-Factor Primary Beneficiary Test When Drafting Internship Agreements

In July 2015, the Second Circuit established a new test for determining whether an unpaid intern is properly excluded from the FLSA's minimum wage requirements. In *Glatt v. Fox Searchlight Pictures, Inc.*, the Second Circuit expressly rejected the DOL's six-factor test and offered an alternative seven-factor test that focuses on whether the employer or the intern is the primary beneficiary of the relationship. 791 F.3d 376 (2d Cir. 2015).

The primary beneficiary test focuses on the educational aspects of the internship and is less stringent than the DOL's test. In July 2015, the court in *Glatt* identified two salient features of the primary beneficiary inquiry:

- It focuses on what the intern receives in exchange for his or her work.
- It provides the court with flexibility to examine the economic reality as it exists between the intern and the employer. *Id.* at 383–84.

For example, under the primary beneficiary test, the intern does not automatically become an employee because the employer receives a benefit from the arrangement (in contrast, see DOL factor no. 4). Rather, the benefits afforded to the student must merely outweigh those afforded to the employer. See Schumann v. Collier Anesthesia P.A., 803 F.3d 1199, 1211 (11th Cir. 2015).

Also in contrast to the DOL test, "[n]o one factor is dispositive and every factor need not point in the same direction for the court to conclude that the intern is not an employee" under the primary beneficiary test. Glatt, 791 F.3d at 384. Rather, courts will look at all the circumstances of a particular arrangement, including, where appropriate, other considerations that the DOL factors do not cover.

In January 2016, the Second Circuit amended its decision in *Glatt*. In its amended decision, the court identified a third salient feature of the primary beneficiary inquiry.

> The test should acknowledge that the intern-employer relationship should not be analyzed in the same manner as the standard employer-employee relationship because the intern enters into the relationship with the expectation of receiving educational or vocational benefits that are not necessarily expected with all forms of employment.

Glatt v. Fox Searchlight Pictures, Inc., 811 F.3d 528, 536 (2d Cir. 2016). The court also added a statement confining the primary beneficiary analysis to internships and the intern's formal education, not "training programs in other contexts." 811 F.3d at 537.

Related Content

For additional discussion regarding employees covered under the FLSA, see

> WHICH EMPLOYERS MUST COMPLY WITH THE FLSA AND WHICH WORKERS ARE COVERED?

RESEARCH PATH: *Labor & Employment > Wage and Hour Compliance > FLSA Coverage and Requirements > Practice Notes > Coverage of the Fair Labor Standards Act*

For information on state laws concerning interns and volunteers, see the "Wage and Hour Requirements" column of

> CHART – STATE PRACTICE NOTES (WAGE AND HOUR COMPLIANCE)

RESEARCH PATH: *Labor & Employment > Wage and Hour Compliance > FLSA Coverage and Requirements > Practice Notes > State Wage and Hour Compliance Practice Notes*

Additionally, the Second Circuit's amended *Glatt* opinion provides that in certain cases, a court may consider evidence about an internship program as a whole rather than the individual experience of a specific intern to determine the "economic reality" of the relationship, including in cases that can proceed as a collective action.

It is best practice for companies that only operate within the jurisdiction of the Second Circuit and/or Eleventh Circuits to follow the primary beneficiary test, as both circuits have expressly rejected the DOL test in favor of this new test. Additionally, federal district courts in Illinois and California have adopted the primary beneficiary test enunciated by the Second Circuit. See Benjamin v. B&H Educ., Inc., 2015 U.S. Dist. LEXIS 144351 (N.D. Cal. Oct. 16, 2015); Hollins v. Regency Corp., 2015 U.S. Dist. LEXIS 145813 (N.D. Ill. Oct. 27, 2015). Courts have also applied the primary beneficiary test to an employee's state law claims. See Benjamin, 2015 U.S. Dist. LEXIS 144351, at *4–5 (applying the primary beneficiary test to plaintiffs' related California and Nevada claims in an FLSA action where the plaintiffs contended they were "employees" under the FLSA during a clinical training program to become licensed cosmetologists).

The following sections discuss the "non-exhaustive" considerations comprising the primary beneficiary test and provide associated tips for drafting internship agreements. Similarly, employers with formal internship programs involving numerous interns should consider whether the internship program as a whole satisfies the factors identified below.

Factor No. 1: Does the Intern Clearly Understand That There Is No Expectation of Compensation?

This factor is similar to the DOL factor no. 6, but the courts applying the primary beneficiary test have clarified that even an implied promise of compensation suggests that the intern is an employee. Thus, employers should be careful about inferring or engaging in behaviors that the intern can construe as a promise of compensation. The internship agreement should also specifically provide that the intern understands that there will be no compensation for work performed during his or her internship.

Factor No. 2: Will the Employer Provide Training That Would Be Similar to the Training an Individual Would Receive in an Educational Environment?

This factor focuses on the educational aspect of the internship and highlights the importance of ensuring training received by the intern is commensurate with training that an educational institution would provide. Therefore, it is best practice for employers to think about the educational value of tasks that they expect their interns to perform and ensure that such tasks are, in fact, educational for the intern.

Factor No. 3: Is the Internship Tied to / Related to the Intern's Formal Education Program?

This factor suggests that it is best practice to only hire interns who are already enrolled in formal education programs. It is most prudent to hire interns who can receive academic credit for the internship.

Factor No. 4: Is the Internship Friendly to the Student Status of the Intern Such as by Corresponding to the Academic Calendar?

Courts applying this factor have asked whether a legitimate reason exists for the intern to perform tasks on days when school is out of session (such as on weekends). See Schumann v. Collier Anesthesia, P.A., 803 F.3d at 1211. Similarly, a federal district court applying the primary beneficiary test has held that this factor weighs in favor of non-employee status when the internship tracks the student's academic calendar. Hollins v. Regency Corp., 2015 U.S. Dist. LEXIS 145813 at *31 (N.D. Ill. Oct. 27, 2015). Therefore, it is best practice to make sure that the student's schedule during the internship (1) corresponds with the intern's academic calendar, and (2) does not impede the student from honoring his or her academic obligations.

Factor No. 5: Does the Internship End When the Beneficial Learning for the Intern Is Complete?

An unpaid internship program should ensure that the internship's duration is limited to the period during which the internship provides beneficial learning to the intern. Therefore, it is best practice for an employer to identify the goals of the internship and determine whether the duration of the internship is necessary to accomplish them. Although this determination is not an exact science, courts applying this factor will look to whether the duration of the internship is grossly excessive in comparison to the period of beneficial learning. In other words, the duration of the internship should not exceed the period required for experiential learning so much that it appears as if the employer is taking advantage of the intern.

Factor No. 6: Does the Intern's Work Complement (Rather Than Displace) the Work of Paid Employees?

The intern's duties should not replace the work performed by paid employees, but the work also needs to provide significant educational benefits to the intern. Therefore, it is best practice to ensure that the employer does not design the intern's tasks to reduce the number of employees needed to perform certain functions. However, the employer should still task the intern with performing work that is valuable for his or her experiential learning.

Factor No. 7: Do Both the Employer and the Intern Understand That the Internship Has No Promise of Leading to a Paid Job at the Conclusion of the Internship?

Similar to the DOL factor no. 5, employers applying the primary beneficiary test should also include in the internship agreement an acknowledgement by the intern that he or she understands that there is no promise of a paid position when the internship is complete.

Drafting the Internship Agreement

Once you have conducted the above analysis and determined that the arrangement qualifies as an unpaid internship under both tests, you should document the unpaid internship arrangement in a written agreement, signed by the company and the unpaid intern, that reinforces satisfaction of all of the above legal factors.

The internship agreement should also lay out the general expectations for the internship program. For example, the company may want to specify the exact dates of the internship, the scope of work, training that will be provided, and the specific goals of the assignment. For further guidance on drafting internship agreements, an Internship Agreement form follows. L

*Julie M. Capell is a partner in the Los Angeles office of Winston & Strawn LLP. Assistance provided by **Jennifer Zhao**, an associate in the San Francisco office of Winston & Strawn LLP.*

RESEARCH PATH: *Labor & Employment > Employment Contracts > Internship Agreements> Practice Notes > Crafting Effective Internship Agreements*

Use this sample form as a starting point when drafting an Internship Agreement. The Internship Agreement should outline the general obligations of the employer and intern as well as the goals of the internship. In addition, it should serve as evidence that the relationship qualifies as a true internship that an employer may exempt from applicable wage and hour laws. For more information on Internship Agreements, see the Lexis Practice Advisor practice note entitled Understanding and Drafting Internship Agreements.

Internship Agreement

1. The purpose of this agreement is to ensure that the internship experience is productive and beneficial to both parties. This agreement outlines the obligations of the intern and the Company hosting the intern.

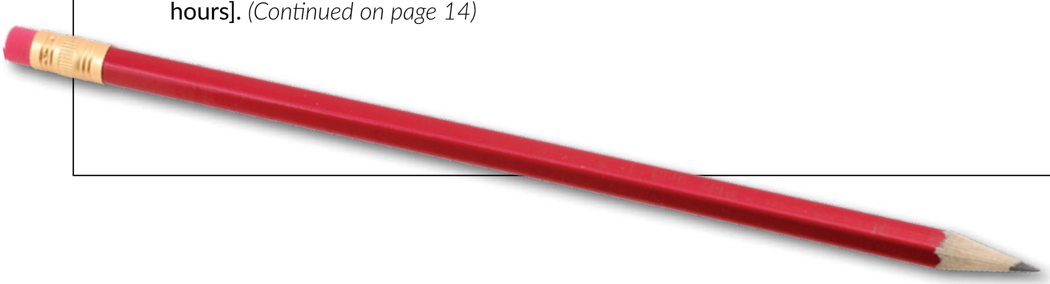
2. This internship agreement is between [insert name of intern] ("Intern"), a student of the [insert name of university or program], and the Company, which has agreed to serve as a partner with [insert name of university or program].

3. Intern will be placed at the Company for an unpaid Internship as part of the Intern's educational experience at [insert name of university or program]. This Internship will allow Intern on-the-job training to supplement his or her training and course work at [insert name of university or program].

4. The internship will begin on [insert start date] and end on [insert approximate end date]. The anticipated schedule will be [insert days of the week and hours]. *(Continued on page 14)*

1 DRAFTING NOTE: If the internship is part of a formal internship program, consider referencing the educational benefits of the internship program as a whole, in addition to the educational benefits specific to any particular intern.

4 DRAFTING NOTE: It is best practice to ensure the duration of the internship complements the intern's academic calendar and the intern's schedule does not conflict with the intern's academic obligations. Additionally, the duration of the internship should not exceed the period of time required for experiential learning such that the intern's work displaces the work of other employees and/or such that it appears as if the employer is taking advantage of the intern.



5. It is understood that the internship is temporary, and the Company is under no obligation to continue the internship or make any offer of permanent employment following the last day of the internship as set forth above.

6. It is also understood that Intern will continue to be a full-time student of [insert name of university or program] during the internship and the Company will not consider the Intern to be an employee.

7. Intern also understands that the internship is a training experience and that Intern is not entitled to, and will not, be paid any wages or other compensation for time spent training at the Company.

8. The Company will not ask Intern to perform any of its regular employees' job duties or responsibilities, but may ask Intern to perform minor tasks from time to time, such as [list tasks].

9. The Company agrees to supervise Intern and to provide an academic experience as well as a professional experience. The Company also agrees to provide learning assistance and supervision throughout the internship.

10. Upon successful completion of the internship, Intern will be awarded [insert course credits or other academic credit] for participation in the internship. [insert faculty supervisor name] is responsible for monitoring Intern's participation in the internship program.

11. Finally, this internship is conditioned upon Intern's agreement to comply with all Company policies.

Agreed to and accepted:

____

[intern name]

____

[date]

____

[company representative name]

____

[date]

5 **DRAFTING NOTE:** If the employer later decides to hire the intern, it will not necessarily mean that the intern was in fact an employee during the time of his or her internship.

6 **DRAFTING NOTE:** If the intern will receive academic credit for his or her internship, you should also include this point in the internship agreement.

7 **OPTIONAL SEVENTH PARAGRAPH:** Intern will receive academic credit for successful completion of the internship.

8 **DRAFTING NOTE:** Consider also adding a detailed work plan for the intern (i.e., a plan explaining the projects/duties that the Company will expect the intern to carry out during the internship). The projects/duties outlined should provide experiential learning to the intern and be consistent with the training the intern would receive in his or her formal education program.

9 **DRAFTING NOTE:** While the Internship Agreement should state that the intern will receive general professional training, it should not state that the intern is training to work for a specific employer.

9 **OPTIONAL NINTH PARAGRAPH:** The Company will not ask Intern to perform any of its regular employees' job duties or responsibilities, but may ask Intern to perform minor tasks from time to time, such as [list tasks]. [Insert a work plan containing a detailed explanation of each task/duty/project that the employer expects the intern to perform.]

12 **OPTIONAL TWELFTH PARAGRAPH:** The Company will require Intern to sign a Confidentiality Agreement.

*Form and Drafting Notes Provided by: **Julie M. Capell,** partner at Winston & Strawn LLP; assistance provided by **Jennifer Zhao,** associate at Winston & Strawn LLP.*

RESEARCH PATH: *Labor & Employment > Employment Contracts > Internship Agreements > Forms > Crafting Effective Internship Agreements*

Kimbely Metzger ICE MILLER

CYBERSECURITY AND DATA PROTECTION: **HELPING HEALTH CARE CLIENTS PROTECT PATIENT INFORMATION**

Medical identity theft, and incomplete patient disclosure due to cybersecurity concerns, can be dangerous—even deadly—to individuals and can compromise community wellness. Breaches of health information can have serious economic and other consequences for providers as well. This article discusses the cybersecurity landscape in health care, medical identity theft, patient disclosures, and the implementation of a security management program for health information.

BREACHES OF HEALTH INFORMATION CAN HAVE SERIOUS consequences for both providers and patients. It is easy to imagine the financial implications of cybersecurity incidents and data breaches.[1] The effort and expense associated with investigation, forensics, mitigation of damages, lost good will and reputation, billing problems, and the monitoring and untangling of consumer credit are significant and can have far-reaching effects for all parties.

While monetary losses are a large and well-known part of an incident or breach, compromised data security at health organizations can also contribute to a less recognized but perhaps more insidious problem: poorer health outcomes.

Health organizations hold a wide variety of highly confidential, personally identifying information (PII) that can wreak havoc in the wrong hands. Names, addresses, dates of birth, Social Security and driver's license numbers, and financial account information are data points with which wrongdoers traditionally seek to commit financial identity theft. Records from health organizations contain this information and more. By their very nature, health records include data of an extremely private and personal nature related to patients' overall physical condition, disease states, medical ailments, disabilities, and insurance, including Medicare, Medicaid, and Social Security (medical PII). Breach and misuse of medical PII, or even the perceived risk of breach or misuse, can cause physical as well as financial harm. As Federal Trade Commission (FTC) commissioner Terrell McSweeney remarked in March 2015:

> One of the most lucrative avenues for identity thieves has become the stealing and exploitation of medical records. Unlike other forms of identification, our medical records offer nearly complete portraits of our lives and data. These factors have made medical records, and more specifically children's medical records, the most valuable consumer information in the black market. Scammers can use the medical records of children to steal identities and commit frauds that have a good chance of remaining undetected until a child turns 18.[2]

Because health records contain information that could be particularly embarrassing if disclosed, a patient who is insecure about a provider's data practices might fear revealing sensitive, but highly relevant, medical information such as smoking status, risky sexual behavior, drug or alcohol use, and mental health concerns. If an incident or breach actually occurs, a patient's medical PII could be used to commit medical identity theft (the fraudulent use of medical credentials to receive or bill for health care), resulting in a "mixed medical record" and serious physical harm to the patient.

The Cybersecurity Landscape In Health Care

Security incidents and data breaches are prevalent in health organizations. From cyberattacks and systems failures to employee negligence and malicious insiders, the question is really no longer if, but when and how, an incident or breach will occur. Small health care providers, who believe their size and low profile immunize them from attack, may actually be at higher risk because they are less likely to take protective action (and criminals know this).

The Ponemon Institute's recently published Fifth Annual Benchmark Study on Privacy & Security of Healthcare Data paints an unsettling picture: during the last two years, 65% of represented health care organizations experienced electronic-based security incidents and 54% experienced paper-based security incidents. More than 90% had a data breach, and 40% had more than five breaches. The study estimates that the health care industry accounted for 44% of all 2013 data breaches—more than any other economic sector.

Several factors have converged to create a perfect storm on the health care landscape. First, electronic medical PII is more available than ever before. Both the American Recovery and Reinvestment Act and the Affordable Care Act incentivize—and sometimes require—health care providers to digitize patient data. Second, medical PII has high black market value. While estimates vary, one cybersecurity expert who monitored underground transactions posits that stolen health credentials can command 10–20 times the price of a U.S. credit card number.[3] Third, health organizations have lagged behind the more traditional targets (financial services and retail) in cybersecurity savvy. Because the transition to digitized health data is relatively recent, the health care sector was simply not pushed to prepare earlier. In April 2014, the Federal Bureau of Investigation (FBI) issued a private industry notification to health care providers warning "[t]he healthcare industry is not as resilient to cyber intrusions compared to the financial and retail sectors, therefore the possibility of increased cyber intrusions is likely . . . ."[4] Cybercriminals recognize that medical PII is a lucrative asset in a less secure environment.

Despite the "universal risk for data breach," the Ponemon study found that health organizations are not, overall, particularly confident in their ability to detect and respond to incidents and breaches:

- 58% report having policies and procedures in place to effectively prevent or quickly detect unauthorized access, loss, or theft of patient data
- 53% report that personnel have the technical expertise to identify and resolve data breaches
- Only 49% agree they have sufficient technologies to effectively prevent or quickly detect breaches[5]
- Only 33% report having sufficient resources to effectively prevent or quickly detect breaches

The study concludes:

> Healthcare organizations . . . face a rapidly changing threat landscape. Cyber criminals recognize two critical facts of the healthcare industry: 1) healthcare organizations manage a treasure trove of financially lucrative personal information and 2) healthcare organizations do not have the resources, processes, and technologies to prevent and detect attacks and adequately protect patient data. While the findings reveal a slow but steady increase in technologies, the pace of investments is not fast enough to keep up with the threats to achieve a stronger security posture.[6]

Medical Identity Theft

Medical identity theft occurs when a wrongdoer uses health credentials to fraudulently bill for goods or services, or to obtain health care in someone else's name. The wrongdoer may accomplish this with the true patient's consent—for example, when the true patient shares health credentials with an uninsured family member or friend—or by stealing the true patient's medical PII. Medical identity theft is underappreciated but on the rise. The Ponemon Institute estimates the number of victims increased from more than 1.5 million in 2012 to more than 1.8 million in 2013.[7]

Like its financial counterpart, medical identity theft can cause monetary loss, damaged credit, and reputational harm. Medical identity theft is unique, however, in its ability to cause physical injury via a "mixed medical record." When a person obtains medical care in another's name, the fraudulent user's medical information is integrated with the true patient's information in a single, corrupted medical record that does not accurately reflect the true patient's health condition. It is easy to imagine the potential for harm: The fraudulent user's blood type is given to the true patient, who has a different blood type. The fraudulent user's medication allergies are attributed to the true patient, who either receives a medicine to which she is allergic, or is denied a medicine to which she is not allergic. The fraudulent user's "no medications" history is attributed to the true patient, who is given a medicine that interacts with another that he is, in fact, taking.

These potential harms are more than theoretical. The 2013 Poneman survey queried 788 adults who reported they, or a close family member, were the victim of medical identity theft. Of those surveyed:

- 56% lost trust and confidence in their health care provider
- 15% reported misdiagnosis because of inaccuracies in the health record
- 14% experienced a delay in receiving medical treatment because of inaccuracies in the health record
- 13% experienced mistreatment of illness because of inaccuracies in the health record
- 11% were prescribed the wrong pharmaceutical

Medical identity theft is clearly a quality of care issue.

Patient Disclosures

Health care providers' cybersecurity practices, and patients' perceptions of those practices, may have profound effects on both patients and public health. A 2014 study by researchers at the Harvard School of Public Health showed that patients who are concerned about their health care provider's cybersecurity practices are more likely to withhold medical information.

According to this study, more than 12% of respondents had withheld information from their provider because of security concerns.[8] Federal government statistics indicate an even higher rate of withholding: compared to the overall population, individuals who strongly disagree that health care providers have reasonable protections in place for electronic health records are almost five times more likely to have withheld information from their provider (33% vs. 7%).[9]

This withholding impacts both patient care and public health:

> Patients' withholding medical information from healthcare professionals may not only impact negatively on the patient directly, but could also potentially compromise the health of others and the quality of healthcare surveillance systems. The consequences to the individual may range from relatively minor ones (such as missed opportunities for tobacco cessation counseling or treatment because of non-disclosure of smoking status) to more serious medical consequences (such as potential compromise in the timeliness, quality, and appropriateness of medical care). Patients with infectious, notifiable conditions who withhold all or part of necessary medical information… may inadvertently put the lives of others at increased risk. Furthermore, non-disclosure, underinformation or misinformation may jeopardize the data quality of healthcare surveillance systems. This is of significant public health concern, since such surveillance systems depend on accurate data to monitor existing and emerging trends in health outcomes and provide the basis for policy and population-based interventions.[10]

Most adults are, naturally, interested in their providers' health information practices. While the 2014 study has limitations, it indicates—and common sense dictates—that if a patient is concerned about the privacy and security of health records, he or she will be less likely to disclose sensitive health information. This, too, is a quality of care issue as well as a public health concern.

Healthier Data: Implementing A Security Management Program

Risk management is essential to every organization. While it is impossible to prevent every security incident and data breach, a security management program helps an organization build a culture of concern, determine potential exposure, and appropriately manage risk to an acceptable level. This, in turn, contributes to better individual and community health outcomes by building patient trust and maintaining the integrity of health records. A robust program also helps health organizations meet applicable state and federal standards, including those found in the HIPAA Privacy and Security Rules and the Medicare and Medicaid EHR Incentive (Meaningful Use) Programs.[11] Finally, a strong data management program can help businesses successfully resolve consumer complaints; limit audits, enforcement actions, and penalties by the Department of Health and Human Services Office for Civil Rights (OCR, which enforces HIPAA) or the Federal Trade Commission (which enforces the prohibition against unfair and deceptive trade practices); and reduce liability under other applicable state and federal law.

Reasonableness is the cornerstone of the OCR and FTC approaches to data security. For example, the FTC states that a business's data security measures must be "reasonable and appropriate in light of the sensitivity and volume of consumer information it holds, the size and complexity of its data operations, and the cost of available tools to improve security and reduce vulnerabilities."[12] Many aspects of a program are therefore flexible and scalable to the specific needs of an individual organization. However, successful security management programs share key components.

In its 2015 Guide to Privacy and Security of Electronic Health Information,[13] the Office of the National Coordinator for Health Information Technology (ONC) provides a sample approach for implementing a security management process in health care. While this approach does not address all the requirements of Meaningful Use or the HIPAA Security Rule, it provides a basic framework for compliance:

Sample Approach For Implementing A Security Management Process In Health Care

STEP 1: **Establish a culture of compliance, select a team, and build a knowledge base.** This will include designating a security officer, using qualified professionals to assist with a risk analysis, and promoting an organization-wide culture of protecting privacy and securing PII.

STEP 2: **Document the organization's process, findings, and actions.** These records will serve as an accurate record for the workforce and will prove essential if the organization is subject to a compliance audit.

STEP 3: **Perform a Security Risk Analysis.** The risk analysis assesses potential threats and vulnerabilities to the confidentiality, integrity, and availability of electronic PII. In general, the risk analysis will involve determining where electronic PII exists and how it is created, received, maintained, and transmitted (creation of a "data map"); identifying potential threats and vulnerabilities to the data; and evaluating risks and their associated levels—how likely it is that threats will exploit existing vulnerabilities and how this will impact the confidentiality, integrity, and availability of data. The results will inform the organization's risk management strategy.

STEP 4: **Develop an action plan.** This involves mitigating the potential risks identified by the Security Risk Analysis, focusing on high priority threats and vulnerabilities. The action plan should account for the organization's characteristics and environment—and be feasible and affordable. The action plan should include administrative, physical, and technical safeguards; organizational standards; and policies and procedures.

STEP 5: **Manage and mitigate risk.** This involves implementing the action plan, educating and training the workforce, communicating with patients, and updating vendor contracts.

STEP 6: **Monitor, audit, and update security on an ongoing basis.** This involves both monitoring the adequacy and effectiveness of the security infrastructure and making needed changes, and maintaining retrospective documentation such as an audit log of who, what, when, where, and how PII has been accessed.

The ONC also offers its *Top 10 Tips for Cybersecurity in Health Care,*[14] generally applicable to organizations of all sizes:

1 Establish a security culture.

- Build a security-minded educational culture so good habits and practices become automatic.
- Conduct information security education frequently, on an ongoing basis.
- Ensure managers and other leaders set a good example in attitude and action.
- Make taking responsibility for information security a core organizational value.

2 Protect mobile devices.

- Ensure mobile devices are equipped with strong authentication and access controls (ensure laptops have password protection, and enable password protection on mobile devices; take extra physical control precautions if password protection is not provided).
- Protect wireless transmissions from intrusion.
- Do not transmit unencrypted protected health information across public networks.
- Encrypt data when it is necessary to commit health information to a mobile device or remove a device from a secure area.
- Do not use mobile devices that cannot support encryption.
- Install and activate remote wiping and/or remote disabling.
- Disable and do not install or use file sharing applications.
- Install and enable security software, and keep it up to date.
- Research mobile applications before downloading.
- Maintain physical control (keep it with you or lock it in a secure location, lock the screen when not in use, and do not let others use it).

3 Maintain good computer habits.

- Configuration management
- Uninstall unessential software applications.
- Use caution when accepting default or standard configurations when installing software.
- Ask whether your electronic health record (EHR) developer maintains an open connection to installed software to provide updates and support—if so, ensure a secure connection at the firewall, and request that this access be disabled when not in use.
- Disable remote file sharing and remote printing within the operating system.

- Perform software maintenance.
- Automate software updates to occur regularly.
- Monitor for critical and urgent patches and updates that require immediate attention and act upon them as soon as possible.
- Perform operating system maintenance.
- Disable user accounts for former employees quickly and appropriately.
- Close access to the accounts of involuntarily terminated employees before serving notice of termination.
- Before disposal, sanitize computers and other devices that have had data stored on them. The National Institute of Standards and Technology (NIST) publishes guidelines for disposal.
- Archive old data files for storage if needed or clean them off the system if not needed, subject to applicable data retention requirements.
- Fully uninstall software that is no longer needed, including trial software and old versions of current software.
- Work with your IT team or other resources to perform malware, vulnerability, configuration, and other security audits on a regular basis.

4 Use a firewall.

- Unless the EHR is completely disconnected from the Internet, install a firewall to protect against outside intrusions and threats.
- Large practices that use a Local Area Network (LAN) should consider a hardware firewall.

5 Install and maintain anti-virus software.

- Use an anti-virus product that provides continuously updated protection against malware, viruses, and other code that attacks computers through web downloads, CDs, e-mail, and flash drives.
- Keep anti-virus software up to date.

6 Plan for the unexpected.

- Create regular and reliable data backups.
- Consider storing the backup far from the main system.
- Protect backup media with access controls.
- Test backup media regularly for ability to properly restore data.
- Have a sound recovery plan. Know what data was backed up, when backups were done, where backups are stored, and what equipment is needed to restore backups.
- Keep the recovery plan in a secure and remote location, where an identified person has responsibility to produce it in an emergency.

7 Control access to health information.

- Configure electronic records to only grant access to people with a need to know.
- Set access permissions using an access control list. Before setting permissions, identify which files should be accessible to which staff members.
- Configure role-based access as needed. In role-based access, a staff member's role within the organization (for example, physician, nurse, or billing specialist) determines what information he or she may access. Assign staff to the correct roles, and set access permissions for each role correctly, on a need-to-know basis.

8 Use strong passwords and change them regularly.

- Choose passwords that wrongdoers cannot easily guess. For example, a strong password may be of a certain length (the longer the better), combining upper and lowercase letters and special characters such as punctuation marks.
- Do not include personal information in passwords, such as birthdates, one's own name or the names of family members or pets, Social Security numbers, or information on social networking sites or other locations that others could easily discover.
- Require multifactor authentication, such as passwords plus fingerprint scans or randomly generated personal identification numbers (PINs).
- Configure systems so that passwords must be regularly changed.
- Develop a password reset process to provide quick and easy assistance for forgotten passwords. This will discourage staff from writing down passwords.

9 Limit network access.

- Prohibit installation of software without prior approval.
- Set any wireless router to operate only in encrypted mode.
- Prohibit casual network access by visitors.
- Ensure that file sharing, instant messaging, and other peer-to-peer applications have not been installed without explicit review and approval.

10 Control physical access.

- Limit the opportunity for devices to be tampered with, lost, or stolen.
- Document and enforce policies limiting physical access to devices and information.

Conclusion

The security of PII is a quality of care issue. Patient concerns can impact disclosure of important health information, and breach of medical PII can lead—among other things—to medical identity theft, a mixed medical record, and physical harm to the patient. While electronic health records offer many benefits to patient care, they also offer new and complex avenues for breach. Wrongdoers recognize both the value of health data and its ever-increasing availability. They will exploit vulnerabilities to obtain this data, regardless of the organization's size or profile.

A robust security management program will guide organizations in identifying their own security holes and threat environment and in implementing a mitigation strategy to reduce potential harm to both the entity and its patients. Successful programs share key components, which may be mandated by applicable state or federal law, such as the HIPAA Security Rule. However, programs are also flexible and scalable to the organization's size and complexity, the amount of PII it holds, and available resources.

Because patient perception may impact disclosure and thereby quality of care, organizations should proactively communicate with patients about cybersecurity. Communications should emphasize that the organization places a priority on the security and confidentiality of PII, including health information. These communications should be culturally appropriate and take into account any particular needs of the patient population.

Most importantly, the organization should back these communications with documented, ongoing efforts to achieve and maintain a culture of commitment to the privacy and security of patient data. By achieving compliance, health organizations can protect both themselves and their patients and improve the quality of individual care and community health. L

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1. A useful definition of security incident can be found in the HIPAA Security Rule: "the attempted or successful unauthorized access, use, disclosure, modification, or destruction of information or interference with system operations in an information system." 45 C.F.R. § 164.304. A breach typically refers to an actual unauthorized acquisition, access, use, or disclosure that compromises the security or privacy of unsecured data. **2.** Terrell McSweeney, Commissioner, Fed. Trade Comm'n, Remarks to the Identity Theft Resource Center, Washington, D.C., (Mar. 18, 2015). **3.** Caroline Humer and Jim Finkle, Your Medical Record is Worth More to Hackers than Your Credit Card Number, Reuters (Sept. 24, 2014), http://www.reuters.com/article/2014/09/24/us-cybersecurity-hospitals-idUSKCN0HJ21I20140924. **4.** Jim Finkle, *Exclusive: FBI Warns Healthcare Sector Vulnerable to Cyber Attacks*, Reuters (Apr. 23, 2014), http://www.reuters.com/article/2014/04/23/us-cybersecurity-healthcare-fbi-exclusiv-idUSBREA3M1Q920140423. **5.** Ponemon Institute, Fifth Annual Benchmark Study On Privacy & Security Of Healthcare Data 3 (May 2015). **6.** *Id.* at 26. **7.** Ponemon Institute, 2013 Survey On Medical Identity Theft, 5 (Sept. 11, 2013). **8.** I.T. Agaku, A.O. Adisa, O.A. Ayo-Yusuf & G.N. Connolly, *Concern about Security and Privacy, and Perceived Control Over Collection and Use of Health Information are Related to Withholding of Health Information from Healthcare Providers*, J. Am. Med. Info. Assoc. 21:375 (2014). **9.** Penelope Hughes, Vaishali Patel & Joy Pritts, *Health Care Providers' Role in Protecting EHRs: Implications for Consumer Support of EHRs, HIE and Patient-Provider Communication*, 15 ONC Data Brief (Feb. 2014). **10.** *See* Agaku et al., *supra* note 8, at 377. **11.** Health organizations may also have to comply with other privacy and security laws and requirements, including those in or promulgated by 42 C.F.R. Part 2 (confidentiality of alcohol and drug abuse records), the Family Educational Rights and Privacy Act (FERPA), Title X of the Public Health Service Act, the Genetic Information Nondiscrimination Act (GINA), private-sector contracts, state law, state boards of medicine, state associations, etc. **12.** Federal Trade Commission, Data Breach on the Rise: Protecting Personal Information From Harm. Prepared Statement before the Committee on Homeland Security and Governmental Affairs, U.S. Senate, Washington, D.C., (Apr. 2, 2014). **13.** The Office of the National Coordinator for Health Information Technology, *Guide to Privacy and Security of Electronic Health Information* (Apr. 2015), https://www.healthit.gov/sites/default/files/pdf/privacy/privacy-and-security-guide.pdf. **14.** Department of Health & Human Services, *Top 10 Tips for Cybersecurity in Health Care*, https://www.healthit.gov/sites/default/files/Top_10_Tips_for_Cybersecurity.pdf.

Ira Herman THOMPSON & KNIGHT LLP

When Supply Exceeds Demand: **Buying and Selling Oil and Gas Assets in the Current Low Price Environment**

The price of crude oil, like the price of virtually all commodities, moves up in times of high demand and down in times of excess capacity. When a mismatch exists between supply and demand, the markets are expected to self-correct. Excess supply should result in price and production cuts, while excess demand should be met with price and production increases.

DESPITE THESE TRUISMS, THE PRICE OF CRUDE OIL HAS continued its steady and protracted drop. In 2015, no fewer than 42 North American oil and gas producers filed for bankruptcy relief. The combined debt of these companies is $17.85 billion, split about 50.4% secured to 49.6% unsecured debt. History informs us that the price for a barrel of crude oil will stabilize and prices will recover. The big question is, when will this happen? Whenever it does, it may be too late for many financially distressed industry participants, especially considering the expectation, as widely reported in the press, that there will be more bankruptcy filings by oil and gas producers and more debt unloaded in 2016 compared to 2015.

Some Industry Background – Upstream, Midstream, and Downstream

The oil and gas industry is generally said to be divided into three segments: upstream, midstream, and downstream. The upstream segment includes companies that engage in the exploration for and production (E&P) of oil and gas. Businesses in the upstream sector find and produce crude oil, natural gas, and shale gas. To find and produce hydrocarbons, upstream companies require machinery, equipment, exploration services, and geophysical services. Collectively, the providers of these goods and services are known in the business as "oil field service providers."

The midstream sector processes, stores, and engages in the wholesale marketing of hydrocarbons, including crude oil and natural gas and gas liquids. Transportation companies in this sector include pipeline companies, rail car operators, barge operators, oil tanker owners, and trucking companies. Storage may include tank farms and the like.

Oil and gas operations that take place after the production phase through to the point of sale are said to be downstream. Downstream operations can include refining crude oil and distributing the by-products down to the retail level. By-products include gasoline, natural gas liquids, diesel, and a variety of other energy sources.

Relationship between Prices, Producers, and Service Companies

During a run-up in commodity prices, upstream companies increased E&P efforts, resulting in strong demand for machinery and equipment. Businesses in the machinery and equipment space include manufacturers of oil and gas field machinery and equipment such as rigs, pipes, casings, etc. Weaker commodity prices have led to a sharp downturn in energy exploration and production, hurting these companies as domestic producers reduce costs to preserve cash and protect their balance sheets.

Businesses in the oil and gas field services industry primarily provide services to oil and gas producers (upstream companies), including drilling oil and gas wells; surveying wells; running, cutting, and pulling casings; chemically treating wells; and disposing of wastewater and other production waste. Consequently, demand for such services is highly dependent on oil and gas prices. Rising oil and gas prices typically result in increased demand for oil field industry services. The number of oil and gas drilling contracts generally rise with prices because previously unprofitable sites will become profitable and, therefore, more attractive to producers. In contrast, demand for oil services falls when oil and gas prices are low.

Supply and Demand – Creating the Current Low Price Environment

The failure of the markets to self-correct and rebalance supply with demand to stabilize crude oil prices in 2015 and 2016 (so far) has been blamed on the confluence of a number of obvious and less obvious domestic and international economic and geopolitical drivers. According to Louis Besland, head of the Europe, Middle East, and Africa oil and gas practice at AlixPartners Management Consultants, the oversupply in early January 2016 was around two million barrels a day. "This imbalance has been mainly created by the North American shale oil and gas in the past four or five years. That's why Saudi Arabia believed from the beginning it's not up to them to cut back," according to Besland.[1]

Similarly, producers, in North America and globally, have maintained or increased production to generate the revenue they believe they require to continue in business. Thus, historically low prices for crude oil have resulted in more production and not less, as market participants have tried to pump their way out of trouble. Due to these factors and others, production remained at near historic highs through early 2016, despite the existing excess supply available to the markets.

On a global level, the challenges from the supply side of the ledger are reflected, by way of example, by the failure of the Organization of Petroleum Exporting Countries (OPEC) to agree on production limits at its December 2015 meeting amid Iran's plans to boost exports following the end of international

Related Content

For more information on Transnational Energy Insolvency, see

> **DIRECTOR DUTIES IN A TRANSNATIONAL ENERGY INSOLVENCY**

RESEARCH PATH: *Financial Restructuring & Bankruptcy > Identifying and Managing Bankruptcy Risk > Oil and Gas Agreements > Practice Notes > Transnational Energy Insolvency*

For more information on rights in oil and gas insolvency, see

> **EXAMINING THE STATUS OF RIGHTS IN BANKRUPTCY ARISING UNDER OIL AND GAS AGREEMENTS, SPECIFICALLY JOINT OPERATING AGREEMENTS**

RESEARCH PATH: *Financial Restructuring & Bankruptcy > Identifying and Managing Bankruptcy Risk > Oil and Gas Agreements > Practice Notes > Oil and Gas Agreements*

For more information on oil and gas leases in oil and gas insolvency, see

> **EXPLORING THE STATUS OF RIGHTS IN BANKRUPTCY ARISING UNDER OIL AND GAS AGREEMENTS, SPECIFICALLY OIL AND GAS LEASES AND THE SAFE HARBOR PROVISION FOR FARMOUT AGREEMENTS**

RESEARCH PATH: *Financial Restructuring & Bankruptcy > Identifying and Managing Bankruptcy Risk > Oil and Gas Agreements > Practice Notes > Oil and Gas Agreements*

sanctions affecting the Iranian oil industry. In mid-January, once sanctions were officially lifted, worries about Iran's return to an already oversupplied oil market drove the price of Brent crude and of West Texas Intermediate to below $30 a barrel, their lowest levels since 2003.

From the demand side, the picture is also not pretty. In its January 2016 report, the International Energy Agency (IEA) trimmed its 2016 estimates for global oil demand, as China's economic expansion appears to have continued to weaken. Consumption growth globally, according to the IEA report, will slow in 2016 to 1.2 million barrels a day, or 1.3%, from 1.7 million a day in 2015. "However," says Tom McNulty, a Director at Navigant Capital Advisors, "the supply overhang is just under 2%, and in the 1980s the supply overhang was 15%. Today, it will take very little to soak up the excess, such as a good demand number from China or a missile launched in the Middle East."

Cancellation of Oil and Gas Projects Due to the Current Price Environment

The downturn in oil prices hit projects all around the world; Wood Mackenzie, the global energy consulting company, says that 68 major projects were scrapped in 2015, which account for around 27 billion barrels of crude oil and natural gas. The *Financial Times* has estimated that some $1 trillion in planned production projects are likely to be cancelled. Already, countries like Saudi Arabia, Venezuela, and Russia, which rely heavily on state-owned producers of oil and gas for revenue, have suffered the consequences of the drop in these commodity prices.

A Capital Intensive Business

Fundamentally, E&P is a capital intensive business. The equipment needed is expensive and not all wells drilled are economically viable. As a result, E&P companies must raise large amounts of capital in order to turn a promising hydrocarbon discovery into a producing asset. One obvious way to cover the costs of exploration is to use the revenue generated by existing production. Alternatively (or in the absence of an income stream generated by production), industry participants have divided producing assets into numerous fragments, all capable of being monetized to fund E&P. Finally, an E&P company may fund its capital needs by borrowing from an institutional or other lender, often pursuant to a reserve-based revolving credit facility.

Funding E&P Costs by Transferring an Interest

Working Interests and Royalty Interests

A mineral rights owner is one who owns oil and gas deposits under the surface, including the right to explore, drill, and produce those deposits. However, many mineral interest owners are not in the business of exploration and production, as they lack the expertise and capital to explore and produce.

In order to monetize that interest, the mineral interest owner typically signs an oil and gas lease with an E&P company, giving the E&P company the right to explore and develop the subsurface in exchange for the obligation to pay the mineral rights owner a non-cost-bearing share of the income from the production, which is known as a royalty interest. As a royalty interest holder, the mineral rights owner is entitled to a stated portion of the gross production, if any, but has no right to enter the land and extract minerals, but also does not share in any of the exploration and development costs.

By virtue of the execution of the oil and gas lease, the E&P company becomes the 100% working interest owner and also obtains royalty interest in the amount conveyed by the mineral interest owner under the oil and gas lease. In contrast to a royalty interest, a working interest holder will have the right to explore and develop the minerals along with the obligation to pay the costs associated with exploration and development. A working interest in a property does not exist in perpetuity but is governed by the terms of the oil and gas lease. There may be a number of reasons for termination, including: (a) the failure to meet specified minimum production requirements, (b) the end of the productive life of a well, and (c) an agreement by the parties to terminate on a certain date.

The working interest holder may use portions of its interest to finance production, either by selling part of its working interest to third parties, using a fractional part of its net revenue as collateral for a loan, or by selling a portion of the income to be generated by production in connection with the working interest. An example of such an interest is the overriding royalty interest (ORRI). Unlike a landowner's royalty interest, ORRIs are typically carved out from a working interest. As a general proposition, there are two types of ORRIs: (a) the perpetual ORRI, which lasts for the life of the lease between the working interest holder and the mineral rights holder, and (b) the term ORRI, which is limited in duration, either until a specified volume of production is reached or a stated value of production is reached. Similar to ORRIs are net profit interests (NPIs). An NPI is carved out of a working interest, much like an ORRI; however, the NPI holder is only paid out of the profits earned from production over a contractually agreed-upon time span (in other words, ORRIs are paid as a percentage of gross revenue/production and NPIs out of net profits).

Joint Operating Agreements

Joint operating agreements (JOAs) are common in the oil and gas industry because they allow multiple coowners to cooperate in the exploration, development, and production of oil and gas in certain described property under the direction of a single

operator. A JOA typically governs the relationship among working interest coowners, who own undivided fractional oil and gas leasehold interests, and the operator, who is often simply the investor with the largest working interest. The JOA will, among other purposes, identify the interests of the parties in the leases and property, commit the parties to participate in operations on the contract area (and provide procedures for resolving disputes), provide for sharing expenses and allocate liability with respect to joint operations, and control the rights of the parties in the production from the contract area.

Farmout Agreements

Another type of agreement typical in the oil and gas industry is the farmout agreement. Farmouts are often used when a lease is expiring and the lessor does not have capital to drill. Although farmouts can take a myriad of forms, a farmout agreement typically provides for a working interest owner to assign a working interest to a party known as a farmee in exchange for certain contractually agreed-upon services. Typically, these services include drilling a well in a certain location to a certain depth within a specified timeframe. After the contractually agreed-upon services have been completed, the farmee is said to have earned an assignment, subject to the reservation of an overriding royalty interest in favor of the working interest owner.

This overriding royalty interest is usually said to be a convertible override. This means that upon payout, which is the point where the drilling costs have been recouped from production from the well, the farmee can elect to convert this override into a portion of the working interest. The decision whether to convert or not depends on whether the farmee wishes to join in production costs in exchange for the possibility of a larger return. When a farmee is comfortable with the project costs and production from the well it has drilled, the farmee will generally convert its override interest into a working interest.

Farmout agreements tend to be highly negotiated documents, although they also generally include standard terminology, as the provisions of all farmout agreements generally address several crucial issues. These issues include the duty imposed (i.e., whether the farmee has an obligation or an option to drill, etc.), the obligation that must be met in order for the farmee to earn its target interest in the property, the interest in the property to be earned, the number of wells to be committed to the farmout agreement (can be one or more), and the timing of issuance of the assignment of farmout acreage to the farmee (generally after completion of the farmee's obligations to drill, etc.).

Revolving Credit Facilities/Reserve-Based Lending

An E&P company can rely on a reserve-based revolving credit facility (an RBL facility) for its working capital needs and to fund its exploration and development programs. However, this type of financing is only available where revenue is already being generated by prior production. Loan availability under an RBL facility is permitted pursuant to a borrowing base formula set by the lender to the industry participant, primarily in consideration of the value of the participant's proved oil and gas reserves. The value of such reserves is determined by reference to a price deck set by the lender, under the terms of the RBL lending agreement.

Although RBL facilities typically require a lender to consider the value of the borrower's proved reserves in setting the borrowing base, an RBL lender is generally also permitted to consider such other information as it deems appropriate at its sole discretion. In short, the borrowing base is whatever the lender says it is.

RBL facilities typically require scheduled redeterminations of the borrowing base on a semi-annual basis, once in the spring and once in the fall. Additionally, a lender is generally provided the right to a single special redetermination between scheduled redeterminations. Finally, incurring additional long-term debt often triggers automatic reductions to the borrowing base (often a $0.25 reduction for each $1.00 of additional debt incurred), and the RBL lender is often permitted a special redetermination in connection with any termination of commodity hedging contracts. Despite the forgoing, says McNulty, "it is important to understand that

A FEW COMMON ISSUES ARISING IN OIL AND GAS BANKRUPTCY CASES INCLUDE THE TREATMENT OF JOINT OPERATING AGREEMENTS, OIL AND GAS LEASES, AND FARMOUT AGREEMENTS. THE TREATMENT OF OIL AND GAS AGREEMENTS UNDER THE BANKRUPTCY CODE DEPENDS ON THE CHARACTERIZATION OF SUCH AGREEMENTS UNDER STATE LAW.

there are many lending facilities in the market now that service their debt payments, even as the asset valuation falls below credit thresholds."

In times of steep declines in commodity prices, many E&P companies will find the availability for additional borrowings under an RBL facility reduced, in some instances, to a level below the aggregate principal amount of loans outstanding, resulting in a borrowing base deficiency. Once a borrowing base deficiency has occurred, most RBL facilities will provide the borrower the option to add additional collateral with a value equal at least to the deficiency amount or to pay down the outstanding loans in an aggregate amount equal to the deficiency in a single payment or in equal installments of three to six monthly payments.

In a typical reserves-based financing, substantially all of the collateral has already been pledged to the lender as collateral, which leaves the borrower with the sole option of paying down the debt. Choosing to repay a deficiency amount in installments gives the borrower a short window of time to raise capital, including by selling properties or securing additional credit through a junior lien or subordinated debt, in order to avoid an event of default under its RBL facility. An impending RBL default is one of many reasons an E&P company may seek bankruptcy relief. A more complete discussion of the treatment of RBL facilities in a bankruptcy case is beyond the scope of this article. The discussion that follows addresses the impact of bankruptcy on several of the types of agreements E&P companies use to raise capital, including, by way of example, oil and gas leases and joint operating agreements.

What Happens in Bankruptcy

Oil and Gas Leases

The status of rights under oil and gas agreements, including oil and gas leases and joint operating agreements, can be affected by bankruptcy law. A few of the common issues that arise in oil and gas bankruptcy cases include the treatment of joint operating agreements, oil and gas leases, and farmout agreements. The treatment of oil and gas agreements under the Bankruptcy Code is dependent on the characterization of such agreements under state law. It is therefore crucial to be aware of how the mineral law of the applicable state characterizes your rights. For example, while joint operating agreements are almost always executory contracts, an oil and gas lease may, depending on the governing non-bankruptcy law, constitute either evidence of an interest in real property that is subject to assumption or rejection under section 365 of the Bankruptcy Code or an unexpired lease that is subject to assumption or rejection under section 365.

Despite employing the noun "lease" in its description, an oil and gas lease is not necessarily an unexpired lease subject to rejection in bankruptcy and may actually instead be a real property interest. The question of whether an oil and gas lease falls within the definition of either "executory contract" or "unexpired lease," as those terms are used in section 365 of the Bankruptcy Code, is determined by referring to the applicable non-bankruptcy law.[2] The nature of the property right created by an oil and gas lease varies from state to state. In Texas and Pennsylvania, for example, oil and gas leaseholds are classified as real estate, while in Kansas, a lease is essentially a license to go upon the land in search of oil and is subject to assumption or rejection under section 365 of the Bankruptcy Code.[3]

If a lease is classified as a real property interest rather than as a lease, a debtor who is a lessor cannot reject the lease and thus deprive the lessee of its expected benefits under the lease. Although a lease that is classified as an executory contract or unexpired lease is subject to rejection, some recent case law has suggested that under section 365(h) of the Bankruptcy Code, which allows a lessee of an unexpired and already commenced lease of real property to retain its rights under the lease that are in or appurtenant to the real property for the balance of the term of the lease, "rejection would not appear to oust [lessees] from their rights to occupy the premises."[4]

Although the parties cannot control whether a lease will be characterized as an executory contract or unexpired lease, a lessee can prepare for the risk of rejection in bankruptcy by crafting and defining its rights under the lease so that they will likely be found to be "in and appurtenant to the real property" under section 365(h).[5]

Joint Operating Agreements

Joint operating agreements are uniformly held to be executory contracts and can thus be assumed or rejected under section 365 of the Bankruptcy Code.[6] Like any rights created under an executory contract, a party's rights under a joint operating agreement are at risk in the event of a bankruptcy filing. Although the risk of rejection cannot be entirely eviscerated, a party may mitigate that risk by (1) including a standard provision ensuring that the joint operating agreement is construed as an executory contract and providing for adequate assurance of performance; (2) filing a memorandum of the operating agreement of record to protect any contractual lien rights; (3) negotiating for and preserving offset and recoupment rights; and (4) drafting the operating agreement to protect certain rights as covenants running with the land, which are not subject to rejection in bankruptcy.

Bankruptcy and Distressed M&A: Current Trends

Traditional sources of capital may not be available to producers in calendar year 2016, due to the low price environment. As a result, producers will have to seek other answers to their financial problems, including by invoking the jurisdiction of the bankruptcy courts. By turning to the bankruptcy courts, producers may be able to obtain fresh credit not otherwise available to them and sell assets that may be difficult, if not impossible, to sell outside of a bankruptcy process. This is because the Bankruptcy Code provides capital providers, whether they are lenders or purchasers of distressed assets, with protections and benefits not available to them outside the bankruptcy courts. These protections and benefits, in turn, serve to enhance the ability of financially distressed businesses to dispose of assets and maximize value for existing stakeholders.

As mentioned at the outset, in calendar year 2015, no fewer than 42 North American oil and gas producers filed for bankruptcy relief. The combined debt of these companies is $17.85 billion, split about 50.4% secured to 49.6% unsecured debt. There is no reason to think, at this time, that there will be fewer filings in calendar year 2016 in the oil and gas space than there were in 2015, as bankruptcies are accelerating. Magnum Hunter Resources Corp., Swift Energy Co., and New Gulf Resources filed for Chapter 11 relief in December. In mid-January, *The Wall Street Journal* reported that "three major investment banks—Morgan Stanley, Goldman Sachs Group Inc., and Citigroup Inc.—now expect the price of oil to crash through the $30 threshold and into $20 territory in short order as a result of China's slowdown, the U.S. dollar's appreciation, and the fact that drillers from Houston to Riyadh won't quit pumping despite the oil glut. As many as a third of American oil and gas producers could tip toward bankruptcy and restructuring by mid-2017, according to Wolfe Research. Survival, for some, would be possible if oil rebounded to at least $50, according to analysts."[7]

With more assets hitting the market, bargain hunters may not be willing to pay top dollar when so many deals are available in the market place. We have already seen lenders expressing concern about the volume of assets hitting the market or likely to hit the market in the coming months. Moreover, there has been at least one instance where a lending group drove a sale process to a rapid completion for fear that competing assets would become available in the marketplace and further depress the value they could recover for the assets. "Valuation skills are essential, and they must be analytically sound. You cannot use one price curve or one flat deck for valuation purposes in a market this volatile," says McNulty.

Why Sell Assets Using the Bankruptcy Courts?

Any purchaser of distressed oil and gas assets must address certain risks endemic to distressed M&A transactions. First and foremost, such a purchaser must evaluate the fraudulent transfer risk created by the purchase of any assets at a bargain price. Fraudulent transfer risk refers to the ability of a court to look as far back as six years to find that a purchase price paid was less than "reasonably equivalent value" for the assets that were acquired, at a time when the seller was insolvent or in "financial distress" of the type listed in the applicable statutes.[8] There are two significant elements that compose the fraudulent transfer risk. First, if there is a finding that there has been a fraudulent transfer, the purchaser of an asset may be forced to pay additional sums for an asset it thought it had purchased at an agreed upon (lower) price. Second, there is the cost of defending an action alleging the existence of a fraudulent transfer. Such defense costs can be substantial, especially in more complex cases. Sales of distressed businesses or their assets tend to be made under duress, at a time when a company may be insolvent, and involve assets for which potential buyers are wary of overpaying. Thus, such sales carry a heightened risk of being made for less than "reasonably equivalent value" and of the seller being found to have been insolvent at the time of sale.

Another risk associated with distressed M&A transactions is the risk that the seller will end up in a bankruptcy case after the signing of an agreement to sell to purchaser but prior to a closing of the sale transaction. This scenario subjects the purchaser to the risk that the now-bankrupt seller will exercise its rights under section 365 of the Bankruptcy Code to reject the sale agreement or attempt to renegotiate the terms of the sale by threatening rejection.[9] Upon rejection, a seller will have no further obligations to perform under the agreement, and the purchaser will generally have an unsecured prepetition claim for the damages it incurs.

A third risk a purchaser has with respect to a distressed M&A transaction is that payments received by the purchaser post-closing but pre-filing of a bankruptcy, including true-up payments or purchase price adjustments, may be avoidable by the seller as preferential transfers under section 547 of the Bankruptcy Code, depending on timing.

In view of the considerable bankruptcy risk that exists with respect to distressed M&A transactions, purchasers have been reluctant to proceed in the ordinary course, i.e., entering into a sale agreement and closing on that agreement. Instead, purchasers have been requiring sellers of distressed assets, including oil and gas assets, to file for bankruptcy relief and obtain bankruptcy court approval of the proposed sale despite auction-related risk and the expense associated with a bankruptcy sale process. By doing so, not only does the purchaser mitigate much of the bankruptcy risk described above, but a sale pursuant to the applicable provisions of the Bankruptcy Code may afford the purchaser certain additional benefits available under the Bankruptcy Code.

There are two ways an entity can sell its business or substantially all of its assets in a bankruptcy case filed under Chapter 11 of the Bankruptcy Code. First, an entity can sell pursuant to a plan of reorganization. A plan of reorganization is essentially an agreement between a debtor entity and its stakeholders settling the claims of the stakeholders, using the value of the debtor or its assets to fund such settlement. The filing of a reorganization plan comes at the end of a case. More often than not, a Chapter 11 case can be complex, and it is not unusual for a case to last more than a year. Also, as is currently occurring with oil and gas, there is a continued risk during the pendency of a Chapter 11 case that asset values will continue to erode—the so-called melting ice cube.

The alternative to a Chapter 11 plan process is a section 363 sale. Traditionally, debtors used section 363 to sell discrete assets, specific business units, or subsidiaries. Unlike a plan of reorganization or a sale that occurs under a plan approved at the end of a case, a section 363 sale can occur at any time during the Chapter 11 process.

In 2015 and 2016, many of the Chapter 11 cases filed by E&P companies are being filed together with a motion to sell substantially all of such entities' assets, pursuant to section 363 of the Bankruptcy Code. These section 363 cases tend to move quickly, which benefits both buyers of distressed assets and stakeholders that may have an interest in such assets. The speed of such cases benefits stakeholders by reducing the costs associated with operating a distressed business entity and benefits buyers by allowing them to gain control of the assets they are buying, with the blessing of a bankruptcy court, without the delay that a longer bankruptcy process might engender. In the current low price environment and due to the benefits to buyers and stakeholders alike, there is no reason to think there will be a slowdown any time soon in the filing of oil and gas section 363 cases. L

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RESEARCH PATH: ***Financial Restructuring & Bankruptcy > Identifying and Managing Bankruptcy Risk > Oil and Gas Agreements > Practice Notes > Transnational Energy Insolvency***

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Korey Clark

REGULATION OF SELF-DRIVING CARS **HEADED FOR THE FAST LANE**

Development of autonomous, or self-driving, vehicle technologies by Google, Tesla Motors, and others has been progressing rapidly in recent years. But state efforts to regulate the testing and operation of self-driving cars on public roads have been moving at a more deliberate pace. Now the Obama administration wants to fast-track the regulatory process to get autonomous cars on the road more quickly.

GOOGLE HAS A FLEET OF SELF-DRIVING TEST VEHICLES with sensors that can "detect objects as far as two football fields away in all directions, including pedestrians, cyclists and vehicles—or even fluttering plastic shopping bags and rogue birds," and software that can process all of that information, allowing the vehicles to "safely navigate the road without getting tired or distracted," according to the website for the company's Self-Driving Car Project.[1] Those vehicles have now logged over a million miles on freeways and streets in Mountain View, California, and Austin, Texas, and the Self-Driving Car Project—launched in 2009 and currently part of the X division of Alphabet, a holding company Google formed last year to separate its core search and advertising businesses from its more speculative ventures—could soon be spun off into its own division.

Google is far from the only participant in the emerging self-driving car industry, which the Boston Consulting Group estimates will grow to $42 billion by 2025 and $77 billion by 2035. Tesla's Model S has an optional AutoPilot system that uses a "combination of cameras, radar, ultrasonic sensors and data to automatically steer down the highway, change lanes, and adjust speed in response to traffic," according to that company's website.[2] Numerous other automakers also offer or are working on semi-autonomous technologies that can intervene when, say, a driver starts to drift into another lane or gets too close to the vehicle ahead of them. And although Uber only launched its self-driving unit last year, it has tried to make up ground, according to *The Verge*, by luring engineers and executives away from Google Maps to staff its own map division, which will be critical for the success of its autonomous car system.[3]

State governments haven't demonstrated the same level of urgency with regard to self-driving cars. Only six state legislatures have passed measures relating to such vehicles, while Governor Doug Ducey, (R) Arizona addressed them via executive order, according to the National Conference of State Legislatures (NCSL).[4] NCSL and LexisNexis State Net data do indicate, however, that the number of states introducing autonomous vehicle-related bills has been ticking upward: six in 2009, nine in 2013, twelve in 2014, sixteen in 2015, and fifteen so far this year.

In 2012, California enacted SB 1298, requiring the state's Department of Motor Vehicles to adopt regulations ensuring "the safe operation of autonomous vehicles on public roads." The DMV split the development of those regulations into two phases: testing of autonomous vehicles and deployment of such vehicles to the general public. The testing regulations weren't approved until May 2014, and a draft of the deployment regulations didn't come until the end of last year.

What's more, the deployment regulations take a very cautious approach. Among other things, they mandate third-party safety certification of autonomous vehicles; require vehicle manufacturers to initially obtain a three-year provisional deployment permit, allowing them to lease but not sell their vehicles to the general public and requiring them to report accidents involving those vehicles to the DMV; impose privacy and cybersecurity requirements; and allow autonomous vehicles to be operated on public roads only if a licensed driver is at the wheel, ready to take over if necessary.

That last provision was a big disappointment to Google, which has been focusing its efforts on a completely driverless car with no gas pedal, brake pedal, or even a steering wheel. The company says its testing shows humans aren't a good backup for self-driving technology because when they get used to it, they stop paying attention to the road. The licensed driver requirement would also preclude the use of self-driving cars by those with disabilities who are dependent on others even for "simple errands," Chris Urmson, director of Google's Self Driving Car Project, wrote in a blog post after California's draft deployment regulations were released. "This maintains the same old status quo and falls short on allowing this technology to reach its full potential, while excluding those who need to get around but cannot drive," he wrote.[5] Urmson added that Google would continue working with the DMV as it seeks feedback on its proposed rules, but the agency stated in its draft regulations that it would "address the unique safety, performance and equipment requirements associated with fully autonomous vehicles without the presence of a driver in subsequent regulatory packages."

Steve Hill, director of the Governor's Office of Economic Development in Nevada, the first state to allow the testing of self-driving cars, has expressed concern that state regulation of autonomous vehicles isn't keeping pace with the industry. "The technology is really advancing faster than we had originally anticipated," he told *The New York Times.* "I wouldn't really say that Nevada, or really any place else, has really developed the policies that will be needed to facilitate the industry moving forward."[6] That assessment may be as applicable to cities as states. The Times reported that according to a study by the National League of Cities, only 6% of the nation's most populous cities have taken autonomous vehicles into account in their long-term planning.

The Obama administration wants to change that. At the North American International Auto Show in Detroit in January, U.S. Department of Transportation (DOT) Secretary Anthony Foxx announced that President Obama's 2017 budget proposal would allocate nearly $4 billion over the next decade for the testing and development of autonomous vehicle technology and that the DOT would be implementing several initiatives to speed up the adoption of that technology.

"In 2016, we are going to do everything we can to promote safe, smart and sustainable vehicles," Foxx said, according to the Associated Press. "We are bullish on automated vehicles." Spurred by the potential of self-driving cars to reduce traffic accidents—by 90%, according to a report last year from the consulting firm McKinsey & Company—cut greenhouse gas emissions, and improve Americans' mobility, Foxx said the National Highway Traffic Safety Administration (NHTSA) would work with the industry, states, and other interested parties over the next six months "to develop guidance on the safe deployment and operation of autonomous vehicles" as well as "a model state policy on automated vehicles that offers a path to consistent national policy," according to a DOT press release. Foxx also urged manufacturers of autonomous vehicles to request rule interpretations and exemptions from the NHTSA that "would ease development of new safety features," and said the DOT and NHTSA would "ensure that fully autonomous vehicles, including those designed without a human driver in mind, are deployable in large numbers when they are demonstrated to provide an equivalent or higher level of safety than is now available."

Wired reported that Foxx's announcement marked a major shift in the federal government's approach to auto regulation.[7] Traditionally, it has waited for the industry to develop new technology and then, after studying that technology, created new rules to address it. But in an interview with National Public Radio last month, Foxx said that with self-driving cars, that process might take years, so the government is instead opting to learn about the technology as it develops through rule interpretations, such as its response to a request last year from BMW to confirm that the company's self-parking system meets federal safety standards.

Wired also pointed out that Foxx's plan to work with states and industry partners to create a model state policy on self-driving vehicles seeks to avoid a patchwork of state laws that would likely inhibit their development, while acknowledging that although the federal government regulates how cars are made and states regulate how they are operated on the road, autonomous vehicles "blur that distinction—how they drive is a direct result of how they're made."[8]

Foxx's DOT and the NHTSA also appeared to be decidedly more bullish on self-driving technology—and driverless vehicles in particular—than California's DMV. But California DMV spokeswoman Jessica Gonzalez said her agency's wariness isn't because it opposes the technology. "We're definitely not against it," she told *Bloomberg Business.* "We just need to make sure that it's safe."[9] Foxx, meanwhile, told NPR that given where the technology is right now, requiring self-driving vehicles to have a licensed driver at the wheel as California's deployment regulations propose is "definitely a good principle."[10]

Evidence of that came last month when one of Google's test vehicles was involved in a low-speed collision with a municipal bus, which the test car's autonomous system had detected but predicted would yield, according to a report from the company. The incident occurred just a few months after the California DMV reported that Google vehicles were involved in eight accidents between September 2014 and September 2015, none of which were the fault of the company's self-driving software, prompting the DMV's Gonzalez to remark to *Government Technology* that "if you look at the Google accidents . . . you could come to the conclusion that it looks like the driverless cars are more cautious than the [human-driven] cars that are out there." A post on the tech blog *Backchannel* in January, however, stated that Google submitted a "voluminous report" to the California DMV citing 69 "disengagements," instances when its vehicles were switched from autonomous mode back to manual driving. The company said only thirteen of those incidents would have resulted in a collision, two with traffic cones but ten with other vehicles and one with a pedestrian crossing the street.

Ethical considerations could also give both state and federal regulators pause. At a workshop at Stanford University last year, philosophers and engineers explored ethical dilemmas that might arise with the deployment of autonomous vehicles. One such scenario involved a child running into the street and making the vehicle choose between hitting that child and swerving into the path of an oncoming vehicle. “As we see this with human eyes, one of these obstacles has a lot more value than the other,” said Stanford professor Chris Gerdes, as reported by *MIT Technology Review*. “What is the car’s responsibility?”[11]

U.S. drivers aren’t exactly clamoring for autonomous vehicles at the moment. Three out of four are “afraid” to ride in a self-driving car, while only one in five would trust one to drive itself, according to a recent survey from the American Automobile Association.[12] But it may not take too long for that to change. The AAA survey also found that drivers who owned cars with semi-autonomous features were 75% more likely to trust self-driving technology than those who didn’t, and 61% of drivers want their next car to have some form of semi-autonomous technology, such as automatic emergency braking or self-parking. L

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The Developing Law of **LGBT Protections under Title VII**

The rights of lesbian, gay, bisexual, and transgender (LGBT) individuals remain a hot topic in the American workplace. Protection under federal anti-discrimination laws has proved elusive over the years. While terms like sex, gender, sexual orientation, and gender identity are routinely used, defining these terms and addressing the ramifications of those definitions has been challenging.

TITLE VII OF THE CIVIL RIGHTS ACT OF 1964 PROHIBITS discrimination based on sex. Until about 10 years ago, it appeared to be settled law that sexual orientation and gender identity claims did not fall within the Act's reach. A seismic shift in that view has occurred over the past decade, and in the past year in particular, with the Equal Employment Opportunity Commission (EEOC) filing its first private sector lawsuits alleging sexual orientation discrimination.

This article analyzes the developing law of protection for LGBT individuals at the federal level and provides some best practices with regard to LGBT issues in the workplace.

What Is Sexual Orientation?

"Sexual orientation as a concept cannot be defined or understood without reference to sex."[1] "Sex refers to a person's biological status and is typically categorized as male, female, or intersex. There are a number of indicators of biological sex, including sex chromosomes, gonads, internal reproductive organs, and external genitalia."[2] The related concept of gender is used to "refer[] to the attitudes, feelings, and behaviors that a given culture associates with a person's biological sex. Behavior that is compatible with cultural expectations is referred to as gender-normative; behaviors that are viewed as incompatible with these expectations constitute gender non-conformity."[3] Gender, in other words, is a non-binary construct.[4]

Sexual orientation includes an individual's attraction to others and may be conventionally classified as heterosexual, gay, lesbian, or bisexual. A man is referred to as gay if he

1. Baldwin v. Dep't of Transp., Appeal No. 0120133080 (EEOC May 21, 2013), at 6 (quoting American Psychological Ass'n, Definition of Terms: Sex, Gender, Gender Identity, Sexual Orientation (Feb. 2011), http://www.apa.org/pi/lgbt/resources/sexuality-definitions.pdf [hereinafter APA Glossary]). **2.** APA Glossary, *supra* note 1. **3.** *Id.* **4.** American Psychological Ass'n, *Guidelines for Psychological Practice with Transgender and Gender Nonconforming People,* 70 Am. Psychologist 832 (Dec. 2015), http://www.apa.org/practice/guidelines/transgender.pdf.

is physically and/or emotionally attracted to other men.[5] A woman is referred to as lesbian if she is physically and/or emotionally attracted to other women.[6] Someone is referred to as heterosexual or straight if he or she is physically and/ or emotionally attracted to someone of the opposite sex.[7] An individual is referred to as bisexual if the individual is physically and/or emotionally attracted to both men and women.

What Is Gender Identity?

Gender identity is "the individual's internal sense of being male or female."[8] The related concept of gender expression is "[t]he way an individual expresses his or her gender identity . . . and may or may not conform to social stereotypes associated with a particular gender."[9]

A transgender[10] individual is one whose "gender identity . . . is different from the sex assigned to them at birth."[11] Thus, "[s]omeone who was assigned the male sex at birth but who identifies as female is a transgender woman. Likewise, a person assigned the female sex at birth but who identifies as male is a transgender man."[12] In either case, it is preferable to use the gender pronouns (he and his, she and her) associated with the individual's gender identity rather than the individual's biological or anatomical sex.[13]

Transgender individuals may express their gender identity in any variety of ways. For example, they may: (1) tell their family, friends, and coworkers about their preferred identity; (2) refer to themselves using a different name and/or with different pronouns; (3) seek legal intervention by formally changing their name and/or sex; and/or (4) seek medical intervention by undergoing counseling, hormone therapy treatments, or gender reassignment surgery.[14] There is no single marker or indicator of when a transition is "complete"; rather, it is preferable to take one's cues from the preferences expressed by the individual.[15]

Sex Discrimination and Title VII

Title VII makes it illegal for employers to "fail or refuse to hire or to discharge any individual, or otherwise to discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, because of such individual's race, color, religion, sex, or national origin."[16] The terms sexual orientation and gender identity are absent from the statute's text.[17]

What is sex? Congress did not define the term.[18] Indeed, the legislative history of Title VII reveals that sex discrimination was essentially an afterthought: "[s]ex as a basis of discrimination was added as a floor amendment one day before the House approved Title VII, without prior hearing or debate."[19]

As a result, the scope of protection against sex discrimination has been subject to judicial and regulatory interpretation for over 50 years. The interpretive evolution of sex discrimination law has progressed from the so-called traditional view of sex as biological maleness or femaleness to broader protections against gender stereotypes about how men or women should act.

The Traditional View

In the late 1970s and early 1980s, "federal courts . . . initially adopted the approach that sex is distinct from gender. As a result, the federal court held that Title VII barred discrimination based on the former but not on the latter."[20] That is, courts utilized the narrow "traditional definition [of 'sex'] based on anatomical characteristics."[21] In other words, "the phrase in Title VII prohibiting discrimination based on 'sex' means that it is unlawful to discriminate against women because they are women and against men because they are men."[22]

These courts also highlighted that "[n]o mention is made of change of sex or of sexual preference" in the text of Title VII.[23] Furthermore, given the sparse legislative history concerning sex discrimination, courts at the time concluded that "[s]ituations involving transsexuals, homosexuals or bi-sexuals were simply not considered, and from this void [courts are] not permitted to fashion [their] own judicial interdictions."[24] Thus, as the Seventh Circuit explained in *Ulane v. Eastern Airlines, Inc.*, "if the term 'sex' as it is used in Title VII is to mean more than biological male or biological female, the new definition must come from Congress."[25]

5. Baldwin, *supra* note 1, at 6 (quoting APA Glossary). **6.** *Id.* **7.** *Id.* **8.** *See* U.S. Office of Personnel Management (OPM), Guidance Regarding the Employment of Transgender Individuals in the Federal Workplace, https://www.opm.gov/policy-data-oversight/diversity-and-inclusion/reference-materials/gender-identity-guidance/ [hereinafter OPM Gender Identity Guidance]. **9.** *Id.* **10.** According to GLAAD, it is preferable to use the term transgender in lieu of the antiquated "transgendered." *See* GLAAD Media Reference Guide—Transgender Issues, http://www.glaad.org/reference/transgender (last visited Apr. 8, 2016). Conversely, individuals who identify with their birth gender may be referred to as cisgender. *Id.* **11.** OPM Gender Identity Guidance, *supra* note 8. **12.** *Id.* **13.** GLAAD Media Reference Guide, *supra* note 10. **14.** *Id.* **15.** Three illustrative examples of transgender individuals in the media are found in the television shows *Orange is the New Black* (Laverne Cox) and *Transparent* (Jeffrey Tambor) and in the 2015 film *The Danish Girl* (Eddie Redmayne). **16.** 42 U.S.C. § 2000e-2(a)(1). **17.** *See, e.g.*, Bibby v. Phila. Coca Cola Bottling Co., 260 F.3d 257, 261 (3d Cir. 2001) ("Title VII does not prohibit discrimination because of sexual orientation") (collecting cases). **18.** In General Electric Company v. Gilbert, 429 U.S. 125 (1976), the Supreme Court held that discrimination on the basis of pregnancy was not sex discrimination. In response to *Gilbert*, Congress passed the Pregnancy Discrimination Act of 1978 (PDA), which states that discrimination "because of or on the basis of pregnancy, childbirth, or related medical conditions" is sex discrimination. 42 U.S.C. § 2000e(k). **19.** Holloway v. Arthur Andersen & Co., 566 F.2d 659, 662 (9th Cir. 1977). "Ironically," as the Fifth Circuit noted, "the amendment was introduced by Representative Howard Smith of Virginia," who "was accused . . . of wishing to sabotage [the law's] passage." *See* Willingham v. Macon Tel. Pub. Co., 507 F.2d 1084, 1090 (5th Cir. 1975). **20.** Schwenk v. Hartford, 204 F.3d 1187, 1201 (9th Cir. 2000) (collecting cases). **21.** Holloway, 566 F.2d at 662. **22.** Ulane v. Eastern Airlines, Inc., 742 F.2d 1081, 1085 (7th Cir. 1984); *see also* Sommers v. Budget Mktg., Inc., 667 F.2d 748, 749–50 (8th Cir. 1982); Holloway, 566 F.2d at 662–63; Smith v. Liberty Mutual Ins. Co., 569 F.2d 325, 326–27 (5th Cir. 1978); Grossman v. Bernards Tp. Bd. of Educ., 1975 U.S. Dist. LEXIS 16261 (D.N.J. Sept. 10, 1975), *aff'd*, 538 F.2d 319 (3d Cir.), *cert. denied*, 429 U.S. 897 (1976). **23.** Voyles v. Ralph K. Davies Med. Ctr., 403 F. Supp. 456, 457 (N.D. Cal. 1975), *aff'd*, 570 F.2d 354 (9th Cir. 1978). **24.** *Id.* **25.** *Ulane*, 742 F.2d at 1086. *See also* DeSantis v. Pacific Tel. & Tel. Co., 608 F.2d 327, 329 (9th Cir. 1979).

Price Waterhouse and Sex Stereotyping

In 1989, the Supreme Court announced the landmark decision of *Price Waterhouse v. Hopkins,*[26] a case that shifted the sex discrimination landscape. Ann Hopkins sued her employer after the firm's partnership committee first tabled her candidacy for a year and then refused to propose her again.[27] A review of the written statements submitted by committee members of the partnership committee shed light on the firm's mentality.

Rather than discussing her sales performance with clients, male committee members criticized Hopkins (the only woman out of 88 candidates considered for partnership that year) as "overly aggressive" and "macho."[28] Hopkins was criticized for "using foul language" as a "lady," and, though one member thought she "ha[d] matured from a tough-talking somewhat masculine hard-nosed [manager] to an authoritative, formidable, but much more appealing lady [partner] candidate[,]" another suggested she take "a course at charm school."[29] Seeking to help her chances at partnership, a committee member recommended that Hopkins "walk more femininely, talk more femininely, dress more femininely, wear make-up, have her hair styled, and wear jewelry."[30]

The Supreme Court affirmed the lower courts' opinions, with six Justices concluding that Hopkins' "sex stereotyping" claim was covered under Title VII's ban on sex discrimination.[31] In reaching this decision, the *Price Waterhouse* Court drew on precedent recognizing that "employment decisions cannot be predicated on mere 'stereotyped' impressions about the characteristics of males or females."[32]

The Court continued:

> [W]e are beyond the day when an employer [can] evaluate employees by assuming or insisting that they match[ ] the stereotypes associated with their group, for in forbidding employers to discriminate against individuals because of their sex, Congress intended to strike at *the entire spectrum of disparate treatment of men and women resulting from sex stereotypes.*[33]

Therefore, the Court said, "gender must be irrelevant to employment decisions."[34] And "[i]n the specific context of sex stereotyping, an employer who acts on the basis of a belief that a woman cannot be aggressive, or must not be, has acted on the basis of gender."[35]

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The *Oncale* Decision

In the years since *Price Waterhouse,* two trends emerged. Some courts repeatedly rejected efforts to bootstrap sexual orientation or gender identity discrimination claims into Title VII when only sex discrimination is prohibited by the statute's text. Other courts took a broader view toward analyzing claims involving LGBT individuals as sex stereotyping based on the failure to conform to societal gender norms. In those cases, sex stereotyping, same-sex harassment, and discrimination based on the failure to conform to an employer's gender expectations are reasonably comparable to the obvious prohibitions against discrimination by one sex against the other sex.

This view, interestingly, came from the pen of the late Justice Scalia, who noted, "statutory prohibitions often go beyond the principal evil to cover *reasonably comparable evils,* and it is ultimately the provisions of our laws rather than the principal concerns of our legislators by which we are governed."[36] In *Oncale v. Sundowner Offshores Services,* [37] a male employee working on an oil platform in the Gulf of Mexico claimed that he was subject to sex harassment by several male coworkers.[38] Oncale claimed he was called sexually derogatory slurs, subjected against his will to "sex-related, humiliating actions," and graphically threatened with rape.[39]

In a unanimous opinion, the Court held that "sex discrimination consisting of same-sex sexual harassment is actionable under Title VII."[40] As the Court explained, "Title VII's prohibition of discrimination 'because of . . . sex' protects men as well as women,"[41] regardless of the motivation of the harasser.[42] Thus, "nothing in Title VII necessarily bars a claim of discrimination 'because of . . . sex' merely because the plaintiff and the defendant (or the person charged with acting on behalf of the defendant) are of the same sex."[43]

26. Price Waterhouse v. Hopkins, 490 U.S. 228 (1989) **27.** *Id.* at 231-32 **28.** *Id.* at 234-35 **29.** *Id.* at 235 **30.** *Id.* **31.** *See id.* at 250 (plurality opinion); *id.* at 260 (White, J., concurring); *id.* at 272 (O'Connor, J., concurring) **32.** See City of L.A. Dep't of Water & Power v. Manhart, 435 U.S. 702, 707 (1978) **33.** Price Waterhouse, 490 U.S. at 251 (quoting Manhart, 435 U.S. at 707 n.13 (citing Sprogis v. United Air Lines, Inc., 444 F.2d 1194, 1198 (7th Cir. 1971))) (emphasis added). **34.** *Id.* at 239. There is a very limited exception, however, whereby employers may consider gender if "gender is a 'bona fide occupational qualification [(BFOQ)] reasonably necessary to the normal operation of th[e] particular business or enterprise.'" *Id.* at 242 (quoting 42 U.S.C. § 2000e-2(e)). **35.** *Id.* **36.** Oncale v. Sundowner Offshore Servs., Inc., 523 U.S. 75, 79 (1998) (emphasis added). **37.** *Id.* **38.** *Id.* at 77. **39.** *Id.* **40.** *Id.* at 82. **41.** *Id.* at 78 (citing Newport News Shipbuilding & Dry Dock Co. v. EEOC, 462 U.S. 669, 682 (1983)). **42.** *See Oncale,* 523 U.S. at 79. **43.** *Id.*

Case Law Following *Price Waterhouse* and *Oncale*

It was on the shoulders of *Price Waterhouse* and *Oncale* that the Ninth Circuit permitted a pre-operative transgender woman to bring suit under the Violence Against Women Act (VAWA) in *Schwenk v. Hartford.*[44] The court stated:

> In *Price Waterhouse* . . . , the Supreme Court held that Title VII barred not just discrimination based on the fact that Hopkins was a woman, but also discrimination based on the fact that she failed "to act like a woman"—that is, to conform to socially-constructed gender expectations. . . . Thus, under *Price Waterhouse,* "sex" under Title VII encompasses both sex—that is, the biological differences between men and women—*and* gender. Discrimination because one fails to act in the way expected of a man or women is forbidden under Title VII . . . . Indeed, for purposes of [Title VII], the terms "sex" and "gender" have become interchangeable.[45]

Less than four months after *Schwenk,* the First Circuit decided *Rosa v. Park West Bank & Trust Co.,*[46] a case that, like the similarly named civil rights pioneer of the 1950s, broke barriers to discrimination. Lucas Rosa, a biological male crossdresser, applied for, and was denied, a bank loan while clothed in "traditionally feminine attire."[47]

In deciding the claim brought under the Equal Credit Opportunity Act, the court looked to Title VII case law and concluded that, under the reasoning of *Price Waterhouse,* Rosa could bring a claim based on a gender stereotyping theory, that is, that "the Bank [treats], for credit purposes, a woman who dresses like a man differently than a man who dresses like a woman."[48]

In *Bibby v. Coca Cola Bottling Company,* the Third Circuit recognized that same-sex harassment may constitute sex discrimination but concluded that the employee at issue did not meet his burden of proof.[49] John Bibby filed a sex discrimination lawsuit after he was allegedly physically assaulted by a coworker and was told that "everybody knows" Bibby was "gay as a three dollar bill," a "fa__ot," and a person who "take[s] it up the a__."[50]

The court rejected his appeal because Bibby only showed that he was discriminated against because of his sexual orientation—conduct that, though reprehensible, was not protected by Title VII.[51] However, the court paved the way for similar future lawsuits, noting:

> [T]here are at least three ways by which a plaintiff alleging same-sex sexual harassment might demonstrate that the harassment amounted to discrimination because of sex—the harasser was motivated by sexual desire, the harasser was expressing a general hostility to the presence of one sex in the workplace, or the harasser was acting to punish the victim's non-compliance with gender stereotypes. Based on the facts of a particular case and the creativity of the parties, other ways in which to prove that harassment occurred because of sex may be available.[52]

Two employees bringing lawsuits after *Bibby* were able to proceed on their sex discrimination claims in the Sixth Circuit. In *Smith v. City of Salem,*[53] the court permitted a sex discrimination claim brought by a transgender woman firefighter. After working for the fire department for seven years without issue, Jimmie Smith told his supervisor he was transitioning from male to female after being diagnosed with Gender Identity Disorder.[54] Shortly thereafter, Smith's coworkers commented that Smith's appearance and

44. 204 F.3d 1187 (9th Cir. 2000). **45.** *Id.* at 1201–02 (internal citations and footnotes omitted) **46.** 214 F.3d 213 (1st Cir. 2000) **47.** *Id.* at 214. **48.** *Id.* at 215–16. Confusingly, the court also stated in dicta that Rosa would not be able to bring a claim if the bank regarded him as gay. *See id.* at 216. **49.** 260 F.3d 257 (3d Cir. 2001). **50.** *Id.* at 259–60. **51.** *Id.* at 264–65. **52.** *Id.* at 264. **53.** 378 F.3d 566 (6th Cir. 2004). **54.** *Id.* at 568. **55.** *Id.* at 568–69. **56.** *Id.* at 573 (emphasis added). **57.** *Id.* at 574. **58.** 401 F.3d 729 (6th Cir. 2005). **59.** *Id.* at 737. **60.** *Id.* (citation omitted).

THOUGH THE SUPREME COURT HAS NEVER HELD THAT DISCRIMINATION AGAINST AN LGBT INDIVIDUAL CAN BE ACTIONABLE SEX DISCRIMINATION, [SEVERAL RECENT DECISIONS] ARE FAIRLY READ TO ENCOMPASS SUCH CLAIMS UNDER THE SEX STEREOTYPING UMBRELLA.

mannerisms were "not masculine enough," and Smith was suspended and then terminated.[55]

The court noted that the traditional interpretation of sex discrimination "has been *eviscerated* by *Price Waterhouse*" in that "the Supreme Court established that Title VII's reference to 'sex' encompasses both the biological differences between men and women, and gender discrimination, that is, discrimination based on a failure to conform to stereotypical gender norms."[56] Just as Ann Hopkins was discriminated against as a woman because she did not wear dresses or makeup, the court concluded, "[i]t follows that employers who discriminate against men because they *do* wear dresses and makeup, or otherwise act femininely, are also engaging in sex discrimination, because the discrimination would not occur but for the victim's sex."[57]

Approximately nine months later, in *Barnes v. City of Cincinnati,*[58] the Sixth Circuit reinforced the impact of Smith in a case involving a transgender woman police sergeant. The court explained that Philecia (born Phillip) Barnes, as a pre-operative transgender woman, was a member of a protected class as an individual who "fail[ed] to conform to sex stereotypes concerning how a man should look and behave."[59] The court also noted that it was not necessary to identify "an exact correlation with the employee receiving more favorable treatment" when claiming that similarly situated individuals were treated differently, but only that the plaintiff and comparator must be "similar in 'all of the relevant aspects'" regarding job responsibilities.[60]

In *Etsitty v. Utah Transit Authority,*[61] the Tenth Circuit illustrated the distinctions between transgender discrimination claims, on one hand, and sex stereotyping discrimination claims against a transgender individual, on the other hand. Krystal Etsitty, a pre-operative transgender woman, was fired from her bus driver position after the transit authority became concerned about which public restroom Etsitty would use.[62]

The court first concluded that "discrimination against a transsexual based on the person's *status as a transsexual* is not discrimination because of sex under Title VII."[63] Even though it concluded that transgender women were not a protected class, the court assumed, without deciding, that Etsitty could bring a claim under the *Price Waterhouse* sex stereotyping theory as an individual who "act[ed] and appear[ed] as a member of the opposite sex."[64] The court then dubiously credited the transit authority's concern that Etsitty would use a women's public restroom while still possessing male genitalia as a non-discriminatory reason, concluding that "[u]se of a restroom designated for the opposite sex does not constitute a mere failure to conform to sex stereotypes."[65]

The Eleventh Circuit extended broad protections to transgender individuals in its 2011 decision in *Glenn v. Brumby.*[66] Vandiver Elizabeth Glenn, born a biological male named Glenn Morrison, began to take steps in 2005 to transition from male to female with assistance from her health care providers, including living as a woman outside of the workplace, before being hired by the Georgia General Assembly's Office of Legislative Counsel (OLC).[67] The following year, she informed her supervisor that she was transgender and was in the process of becoming a woman.[68] When Glenn showed up at the office dressed and made up as a woman on Halloween 2006 (a day when employees were permitted to come to work wearing costumes), Sewell Brumby, the head of the OLC, objected to Glenn's attire and stated that it was "unsettling to think of someone dressed in women's clothing with male sexual organs inside that clothing" because, to Brumby, a male in women's clothing was "unnatural."[69]

By the fall of 2007, Glenn informed her supervisor that she would begin coming to work as a woman and was going to change her legal name. After Brumby learned of the development, he terminated Glenn, explaining that "Glenn's intended gender transition was inappropriate, that it would be disruptive, that some people would view it as a moral issue, and that it would make Glenn's co-workers uncomfortable."[70]

61. 502 F.3d 1215 (10th Cir. 2007). **62.** *See Id.* at 1219–20. **63.** *Id.* at 1222 (emphasis added). **64.** *Id.* at 1224. **65.** *Id.* **66.** 663 F.3d 1312 (11th Cir. 2011). **67.** *Id.* at 1313–14. **68.** *Id.* **69.** *Id.* **70.** *Id.* **71.** *Id.***72.** *Id.* at 1316. **73.** *Id.* **74.** *Id.* at 1317. **75.** *Id.* at 1321. **76.** 577 F. Supp. 2d 293 (D.D.C. 2008). **77.** *Id.* at 306 (emphasis in original). **78.** *Id.* at 305. **79.** Tronetti v. TLC Healthnet Lakeshore Hosp., 2003 U.S. Dist. LEXIS 23757, at *15 (W.D.N.Y. Sept. 26, 2003) (citing *Oncale,* 523 U.S. at 80).

Glenn contended that Brumby violated the Equal Protection Clause when he "discriminat[ed] against her because of her sex, including her female gender identity and her failure to conform to the sex stereotypes associated with the sex Defendant[] perceived her to be."[71]

Affirming summary judgment in Glenn's favor,[72] the Eleventh Circuit began by noting that the transgender label is necessarily based on "the perception that his or her behavior transgresses gender stereotypes."[73] Relying on Price Waterhouse and its descendants, the court concluded that "discrimination against a transgender individual because of her gender-nonconformity is sex discrimination."[74] The court rejected Brumby's claim that he terminated Glenn out of concern for litigation by other women who were uncomfortable with Glenn using the same restroom as unsupported by the record.[75]

Other federal courts have likewise adopted this broader view of sex. The U.S. District Court for the District of Columbia offered a particularly poignant analogy illustrating these principles in *Schroer v. Billington.*[76] In *Schroer,* the court compared sex discrimination against transgender individuals to religious discrimination against those who convert between faiths:

> Imagine that an employee is fired because she converts from Christianity to Judaism. Imagine too that her employer testifies that he harbors no bias toward either Christians or Jews but only "converts." That would be a clear case of discrimination "because of religion." No court would take seriously the notion that "converts" are not covered by the statute. Discrimination "because of religion" easily encompasses discrimination because of a change of religion.[77]

Ultimately, the court explained, it did not "matter[] for purposes of Title VII liability whether the Library withdrew its offer of employment because it perceived Schroer to be an insufficiently masculine man, an insufficiently feminine woman, or an inherently gender-nonconforming transsexual."[78]

Applying this logic to transgender employees, it would be irrational to conclude that Title VII's prohibition against discrimination on the basis of sex does not encompass discrimination because of a change of sex. Stated another way, transgender individuals "are not gender-less, they are either male or female and are thus protected under Title VII to the extent that they are discriminated against on the basis of sex."[79]

Though the Supreme Court has never held that discrimination against an LGBT individual can be actionable sex discrimination, *Price Waterhouse, Oncale,* and their progeny are fairly read to encompass such claims under the sex stereotyping umbrella.

And then there was the Court's 2013 decision in *United States v. Windsor*[80] invalidating the Defense of Marriage Act, which defined marriage exclusively as a heterosexual union, followed by its decision recognizing a fundamental right to same-sex marriage in *Obergefell v. Hodges.*[81] These cases are consistent with the emerging federal protection of LGBT rights.

Legislative Efforts at LGBT Protection

Congressional efforts to explicitly forbid discrimination on the basis of sexual orientation or gender identity have uniformly failed.[82] In recent years, the Employment Non-Discrimination Act (ENDA)[83] and Equality Act[84] have been unsuccessfully introduced. There is little in the present political climate to suggest imminent action on any bill along these lines.[85]

On the other hand, it remains established law that "transsexualism" and "gender identity disorders not resulting from physical impairments" are not considered "disabilities" under the Americans with Disabilities Act (ADA).[86] Gender dysphoria (formerly referred to as gender identity disorder) is, however, a psychological condition recognized in the fifth edition of the *Diagnostic and Statistical Manual of Mental Disorders* (DSM-5) that refers to an individual having a marked difference

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80. 133 S. Ct. 2675 (2013). In a related case decided the same day, the Court rejected a challenge by supporters of California's Proposition 8, thereby permitting same-sex marriages to go forward in the state. Hollingsworth v. Perry, 133 S. Ct. 2652 (2013). **81.** 135 S. Ct. 2584 (2015). **82.** *See, e.g., Holloway,* 566 F.2d at 662 n.6 (citing failed legislation introduced during 94th and 95th Congresses); *Ulane,* 742 F.2d at 1085–86 (citing extensive legislative history of 96th and 97th Congresses). **83.** *See, e.g.,* H.R. 1755, 113th Cong. (2013); H.R. 3017, 111th Cong. (2009); H.R. 2015, 110th Cong. (2007); H.R. 3685, 110th Cong. (2007); H.R. 3686, 110th Cong. (2007). **84.** *See* Equality Act of 2015, H.R. 3185, 114th Cong. (2015). **85.** The failure to pass such legislation does not decide the issue, however: "Congressional inaction lacks persuasive significance because several equally tenable inferences may be drawn from such inaction, including the inference that the existing legislation already incorporated the offered change." Pension Benefit Guar. Corp. v. LTV Corp., 496 U.S. 633, 650 (1990). **86.** 42 U.S.C. § 12211(b)(1). The ADA also excludes "transvestism, . . . pedophilia, exhibitionism, voyeurism, [and] other sexual behavior disorders" from coverage. *Id.* **87.** Interestingly, Utah's definition of gender identity directly tracks the meaning of the term in the DSM-5. *See* Utah Code § 34A-5-102(1)(o). **88.** These states are California, Colorado, Connecticut, Delaware, Hawaii, Illinois, Iowa, Maine, Maryland, Massachusetts, Minnesota, Nevada, New Hampshire, New Jersey, New Mexico, New York, Oregon, Rhode Island, Utah, Vermont, Washington, and Wisconsin. *See* Cal. Gov't Code § 12940; Colo. Rev. Stat. § 24-34-402; Conn. Gen. Stat. §§ 46a-60, 46a-81c; Del. Code tit. 19, § 711; Haw. Rev. Stat. § 378-2; 775 Ill. Comp. Stat. §§ 5/1-103, 5/2-102; Iowa Code § 216.6; Me. Rev. Stat. tit. 5, § 4572; Md. Code, State Gov't § 20-606; Mass. Gen. Laws ch. 151B, § 4; Minn. Stat. § 363A.08; Nev. Rev. Stat. § 613.330; N.H. Rev. Stat. Ann. § 354-A:7; N.J. Stat. Ann. § 10:5-12; N.M. Stat. § 28-1-7; N.Y. Exec. Law § 296; Or. Rev. Stat. § 659A.030; R.I. Gen. Laws § 28-5-7; Utah Code § 34A-5-106; Vt. Stat. tit. 21, § 495; Wash. Rev. Code § 49.60.180; Wis. Stat. §§ 111.32-111.322; D.C. Code § 2-1402.11. **89.** *See* Cal. Gov't Code § 12940; Colo. Rev. Stat. § 24-34-402; Conn. Gen. Stat. §§ 46a-60, 46a-81c; Del. Code tit. 19, § 711; Haw. Rev. Stat. § 378-2; 775 Ill. Comp. Stat. §§ 5/1-103, 5/2-102; Iowa Code § 216.6; Me. Rev. Stat. tit. 5, § 4572; Md. Code, State Gov't § 20-606; Mass. Gen. Laws ch. 151B, § 4; Minn. Stat. § 363A.08; Nev. Rev. Stat. § 613.330; N.J. Stat. Ann. § 10:5-12; N.M. Stat. § 28-1-7; Or. Rev. Stat. § 659A.030; R.I. Gen. Laws § 28-5-7; Utah Code § 34A-5-106; Vt. Stat. tit. 21, § 495; Wash. Rev. Code § 49.60.180; D.C. Code § 2-1402.11. **90.** *See* N.C. House Bill 2, http://www.ncleg.net/Sessions/2015E2/Bills/House/PDF/H2v4.pdf (enacted by special legislative session Mar. 23, 2016). **91.** *See* Miss. House Bill 1523, http://billstatus.ls.state.ms.us/documents/2016/pdf/HB/1500-1599/HB1523SG.pdf. **92.** *See* Ariz. Senate Bill 1062 (2014), https://legiscan.com/AZ/text/SB1062/id/912244. **93.** Georgia House Bill 757 cleared both chambers of the state legislature on March 16, 2016. Governor Deal announced his veto decision on March 28. *See* https://gov.georgia.gov/press-releases/2016-03-28/transcript-deal-hb-757-remarks-0. **94.** *See* S.D. House Bill 1008, http://legis.sd.gov/Legislative_Session/Bills/Bill.aspx?Bill=1008&Session=2016. **95.** Lawmakers in six states have also introduced bathroom restriction laws this session. For a list of all pending state legislation affecting transgender individuals, *see* The National Center for Transgender Equality's "Action Center" page at http://www.transequality.org/action-center (last visited Apr. 7, 2016). **96.** Exec. Order No. 13087, 63 Fed. Reg. 30097 (May 28, 1998), http://www.eeoc.gov/laws/executiveorders/13087.cfm. **97.** *See* Exec. Order No. 13672, 79 Fed. Reg. 42971 (July 21, 2014), https://www.gpo.gov/fdsys/pkg/FR-2014-07-23/pdf/2014-17522.pdf. **98.** U.S. Equal Employment Opportunity Commission, What You Should Know about EEOC and the Enforcement Protections for LGBT Workers: Charge Data, http://www.eeoc.gov/eeoc/newsroom/wysk/enforcement_protections_lgbt_workers.cfm. **99.** *Id.* **100.** U.S. Equal Employment Opportunity Commission, Strategic Enforcement Plan: FY 2013-2016, http://www.eeoc.gov/eeoc/plan/sep.cfm. **101.** Appeal No. 0120120821 (EEOC Apr. 20, 2012).

between his or her gender at birth and the one he or she presently identifies with.[87]

As of April 2016, 22 states and the District of Columbia have enacted their own laws prohibiting sexual orientation discrimination.[88] With the exceptions of New Hampshire, New York, and Wisconsin, employees are also protected against gender identity discrimination in these jurisdictions.[89]

By contrast, laws that permit business owners to discriminate against the LGBT community were recently enacted in North Carolina[90] and Mississippi.[91] Similar bills were passed by legislatures in Arizona,[92] Georgia,[93] and South Dakota[94] before being vetoed.[95] Litigation challenging the North Carolina law has already been filed.

The Executive Branch Approach: The EEOC Makes LGBT Issues a Priority

Recent executive enforcement efforts to curb sexual orientation and gender identity discrimination are prominent. A 1998 Executive Order signed by President Bill Clinton made it illegal to discriminate against federal public sector employees based on sexual orientation.[96] On July 21, 2014, President Obama expanded this protection to prohibit discrimination based on gender identity and to prohibit sexual orientation or gender identity discrimination by federal contractors.[97]

There are growing numbers of administrative complaints involving LGBT issues. According to the U.S. Equal Employment Opportunity Commission (EEOC), there were a total of 1,412 charges alleging sex discrimination based on an employee's sexual orientation and/or gender identity/transgender status during the 2015 fiscal year.[98] Roughly 20% of these charges involved sex discrimination based on gender identity or transgender status, with the remainder involving sexual orientation discrimination.[99]

In its 2013–16 Strategic Enforcement Plan, the EEOC announced that one of its national priorities was addressing issues of "coverage of [LGBT] individuals under Title VII's sex discrimination provisions."[100] Consistent with this Plan, the agency has taken steps to advance LGBT issues over the past few years.

In 2012, the agency concluded in *Macy v. Holder* that a transgender woman, whose job offer was revoked after informing her employer of her transition from male to female, could bring a cognizable Title VII claim based on "gender identity, change of sex, and/or transgender status."[101] Analyzing the complaint under the *Price Waterhouse* framework, the agency observed that "[w]hat matters . . . is that in the mind of the perpetrator the discrimination is related to the sex of the victim."[102]

The agency then provided an extremely broad interpretation of Title VII's sex discrimination prohibition: "Title VII prohibits discrimination based on sex whether motivated by hostility, by a desire to protect people of a certain gender, by assumptions that disadvantage men, by gender stereotypes, or by the desire to accommodate other people's prejudices or discomfort."[103] Therefore, the agency concluded, "intentional discrimination against a transgender individual because that person is transgender is, by definition, discrimination 'based on . . . sex,' and such discrimination therefore violates Title VII."[104]

In 2015, the EEOC confirmed that discrimination based on sexual orientation, like the discrimination based on transgender status in *Macy,* is sex discrimination.[105] The agency reasoned that "allegations on the basis of sexual orientation necessarily state a claim of discrimination on the basis of sex" because

> it involved treatment that would not have occurred but for the individual's sex; because it was based on the sex of the person(s) the individual associates with; and/or because it was premised on the fundamental sex stereotype, norm, or expectation that individuals should be attracted only to those of the opposite sex.[106]

102. *Id.* at 5 (citing Schwenk, 204 F.3d at 1201–02). **103.** *Id.* at 7 (citations omitted). **104.** *Id.* at 8. **105.** Baldwin v. Dep't of Transp., Appeal No. 0120133080 (EEOC May 21, 2013). **106.** *Id.* at 14.

The agency has since sought to advance the reasoning behind its administrative rulings in the judicial forum, recently filing lawsuits in *EEOC v. Scott Medical Health Center, P.C.*[107] and *EEOC v. Pallet Companies d/b/a IFCO Systems NA, Inc.*[108]

In the first of these lawsuits, the agency sued on behalf of Dale Baxley, a married gay man who claims his supervisor berated him as a ""f__king fa__ot" and "queer" three to four times a week, and also asked Baxley in relation to his sex life, "Who's the butch and who is the bitch?"[109] In *IFCO Systems,* the EEOC has sued on behalf of Yolanda Boone, a lesbian forklift operator whose supervisor, among other things, asked "Are you a girl or a man?" and told her she "would look good in a dress."[110] In each case, the agency seeks to break the implicit barrier between sex discrimination and sexual orientation discrimination.[111]

Practical Pointers

As both employer and employees look at the landscape today, here are some best practices with regard to LGBT issues in the workplace.

- **Focus on employees' abilities to perform the job.** Regardless of the extent to which there is actual protection afforded by law, remember that the concept behind anti-discrimination principles is that the focus in the workplace should be on individuals' abilities to perform the job for which they are employed. Characteristics irrelevant to job performance really have no bearing on workplace interaction. This is typically easier for some employers when addressing sexual orientation in the workplace as opposed to gender identity. Guidance regarding gender identity issues at work is readily available.
- **Ask transgender employees which pronoun to use.** Where possible, ask transgender employees which pronoun they prefer be used.[112] If such a conversation is not possible, use the pronoun consistent with the way the person presents outwardly.[113]
- **Exhibit sensitivity to transgender individuals who are transitioning.** Be sensitive to transgender individuals who are transitioning. Do not revoke a job offer based on disclosures made by the individual, as the argument that an applicant misrepresented him or herself is likely unpersuasive.[114] If a background check reveals different pronouns, ask the applicant respectfully whether he or she was previously known by a different name.[115]
- **Update personnel records.** When an employee transitions during his or her employment, be sure to update your personnel records accordingly.[116] When an employee undergoes sex reassignment surgery, be sure to maintain corresponding medical records separately from the employee's personnel file in a manner that ensures confidentiality and privacy.
- **Make certain that bathrooms are available to all employees.** Make bathrooms available to all employees regardless of their gender identity. The Occupational Safety & Health Administration (OSHA) recommends that, where feasible, employers should offer single-occupancy, unisex bathrooms (i.e., facilities that any one individual may use at a time) and/or multiple-occupancy, gender-neutral facilities with lockable stalls for each occupant.[117]
- **Update EEO policies to include sexual orientation and gender identity if covered by state or local law.** Ensure that your EEO policies are current by listing sexual orientation and gender identity as protected traits, if covered by the laws of your state or locality, or by inserting language that you do not discriminate "based on race, color, sex, religion, national origin, or any other status protected under federal, state, or local law."
- **Develop training programs.** Train employees. Sometimes the most difficult interactions are not with supervisors or managers but with coworkers. Help employees understand that the protections afforded based on sexual orientation and gender identity are just as powerful as those afforded based on race, national origin, or other protected classifications.

The best course of action is to treat employees fairly and equally, without regard to their sexual orientation or gender identity. L

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RESEARCH PATH: *Labor & Employment > EEO Counseling > Statutes, Theories, and Defenses > Articles > Title VII*

107. EEOC v. Scott Med. Health Ctr., P.C., No. 2:16-cv-00225-CB (W.D. Pa. Mar. 1, 2016). **108.** EEOC v. Pallet Co. d/b/a IFCO Sys.NA, Inc., No. 1:16-cv-00595-CCB (D. Md. Mar. 1, 2016). **109.** Complaint, Scott Med. Health Ctr., No. 2:16-cv-00225-CB at ¶¶ 11(d) –(e). **110.** Complaint, Pallet Co., No. 1:16-cv-00595-CCB at ¶ 15. **111.** *See* Complaint, Scott Med. Health Ctr., *supra* note 109 at ¶ 11(h); Complaint, Pallet Co, *supra* note 110, at ¶ 24. **112.** GLAAD Media Reference Guide, *supra* note 10, at 5; *see* Jameson v. U.S. Postal Service, Appeal No. 0120130992 (E.E.O.C. May 20, 2013) (repeated intentional misuse of transgender employee's name and pronoun rose to hostile work environment). **113.** *See* GLAAD Media Reference Guide, *supra* note 10, at 5. **114.** *See* Lopez v. River Oaks Imaging & Diagnostic Grp., Inc., 542 F. Supp. 2d 653 (S.D. Tex. 2008). **115.** OPM Gender Identity Guidance, *supra* note 8, at 3. **116.** *See* Complainant v. Dep't of Veterans Affairs, Appeal No. 0120133123 (E.E.O.C. Apr. 16, 2014) (failure to update records for over a year to reflect transgender's new name and gender amounted to sex-based harassment). **117.** OSHA, BEST PRACTICES: A GUIDE TO RESTROOM ACCESS FOR TRANSGENDER WORKERS 2, https://www.osha.gov/Publications/OSHA3795.pdf.

Trends in Securities Law and Shareholder Activism

Q&A with Keir Gumbs

PARTNER AT COVINGTON & BURLING LLP

Keir Gumbs

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As Special Counsel in the SEC's Division of Corporation Finance, what were some of your major responsibilities?

I was a special counsel in the Office of Chief Counsel within the Division of Corporation Finance. That office is like the general counsel's office for the division. We provided interpretive guidance internally to the lawyers who were reviewing registration statements, proxies, and other filings. When they had interpretive questions, they would come to our office. Similarly, folks from the outside would come to us if they had questions about an SEC rule or a no-action letter or things of that nature. It was a very good training ground for what I do now in private practice.

I had a number of areas where I was expected to develop expertise, like most special counsels in that office. One of those was shareholder proposals, which is why proxies and shareholder proposals have become such a big part of my practice. The other things that I worked on included Rule 144, general questions about the application of the Securities Act, and some of the forms of the Securities Act.

Tell us about your role at the SEC when you worked as counsel to Commissioner Roel Campos.

Substantively it was generally the same areas of law, but it was actually quite different from what I did in the Division of Corporation Finance. Working for a commissioner is an interesting experience for a couple of reasons. People who aren't familiar with the SEC assume that the commissioners know every single thing being done at the commission, every line that's been written in a no-action letter or comment letter, and every enforcement case backwards and forwards. In reality, a lot of what commissioners do is enforcement. Probably 60–70% of what I did was enforcement-related. The rest of it was rulemaking-related, with a little bit of policy discussion sprinkled in between. In the enforcement context, the way that enforcement cases are brought by the SEC, generally a staff attorney in the Division of Enforcement will prepare a recommendation to the commissioners, then the commissioners get to vote on it before they move forward with whatever the action is. As counsel to the commissioner, my job would be to act as the representative of my boss, Commissioner Campos, in discussions with the Division of Enforcement. So if he really cared about affinity-based fraud and there was a case that involved affinity-based fraud, he would want to make sure that I would express his views to the staff in how that case was being investigated, some of the theories being pursued, and things of that nature. Once they had the case and they were bringing it back before the commission, my job was to prep him so he could ask good, educated questions about the action and make sure that what the staff was doing was in line with his views as a commissioner.

On the rulemaking front, it's very similar. If a division is coming up with a rulemaking, there are many drafts—sometimes as many as 20 to 30 drafts will circulate before that draft is proposed. That drafting process is fascinating because the staff has its views that are reflected in the approach it is taking in the rulemaking, but also my boss would have his own views that he would want to make sure were reflected in the rulemaking, whether it was questions asked in the request for comments or actually relating to the structure of the rule itself. It was a great way to really get to know the rules, not just for the Division of Corporation Finance, but also for investment management, trading and markets, and some of the other offices at the SEC.

On the policy side, you would often have meetings where folks from the outside would come in to talk to the SEC about rulemaking and an experience that their company or firm was going through that might impact or influence the way the SEC thinks about a particular issue or rule. That was great preparation for being in private practice because a lot of my time was spent reading through some of the materials being circulated, helping prepare the commissioner for the meetings he was going to have, and thinking through the challenges, the issues he would care about, and the potential traps related to the subject of the meeting. This was very similar to what I do in private practice when we have clients come in and we are preparing to go before a judge or someone at the SEC or some other third party.

Were there any rulemakings that you worked on at the SEC that you now address regularly in practice? How has the application of those rules and regulations played out in your practice?

The two that stand out for me are securities offering reform and the notice and access rules that allow companies to deliver proxies over the Internet.

With respect to the securities offering reform, the Securities Act of 1933 and securities laws were enacted seven to eight decades ago. They were written at a time with a particular framework in mind. It was a time where securities were held in certificated form. There weren't that many individuals participating in the securities markets, and there was a lot of confusion. There were not as many different ways for people to participate in securities offerings because you did not have the Internet, and you did not have all of the other electronic methods of communication. All of those differences really influenced the way the Securities Act was drafted. The SEC didn't reevaluate those rules based on the Securities Act in a holistic way for decades. In 2004–2005, the SEC proposed and adopted rules relating to changes in the way that securities offerings are conducted, taking advantage of the Internet, recognizing differences among companies, between the largest and smallest companies, and things of that nature. It was a really great experience because I had an opportunity to influence the direction of how securities law was going to move for decades to come. It's fascinating thinking about how companies can best take advantage of the Internet, telephones, and fax machines, and what information is actually delivered to someone at the time of sale. When you are making wholesale changes to an area of law like that as a regulator, I think you are very concerned about whether you have gone too far, how it is going to impact the markets and impact investors. You do not want to do anything that will make it harder to raise capital, but you also do not want to do anything that is going to eliminate protections for investors. It has been quite pleasant to see how those rules have been implemented in practice because I don't think there has been a drop-off in capital raising. In fact, there has been a significant increase in the number of capital-raising transactions that have taken place and those rules made it easier. At the same time, it is fairly clear that we were able to maintain investor protections, which was very reassuring.

Similarly, with notice and access, whenever you wanted to deliver a proxy statement before 2007, the presumption was that you delivered it physically, like an actual physical proxy being put in the mail. There was guidance that allowed you to deliver it electronically with the consent of the shareholder, but that was still relatively limited. With the notice and access rules, the commission wanted to liberalize the way that companies deliver proxy materials over the Internet by allowing companies to send a notice of Internet availability that told shareholders that the proxy materials were available online and how they could access them. We were not sure how that rulemaking was going to turn out; we were not sure if a lot of companies were going to take advantage of changes or if it was going to impede the ability of shareholders to obtain proxy materials. In practice, there have been very mixed results with respect to that rulemaking. On one hand, you do see more companies using the Internet more frequently to deliver proxy materials, but on the other hand, there has been a decrease in shareholder participation with respect to companies that have relied on notice and access. This was something the SEC was told about but did not necessarily change in the rulemaking. So that rulemaking is one that has not been quite as good or consistently positive as was the case with securities offering reform, but it was still an advancement in how companies and investors could better utilize the Internet.

In your current practice with Covington & Burling, please tell us about the types of matters you regularly advise upon.

My practice roughly falls into three buckets. One bucket is related to general disclosure and compliance. In that bucket I help companies and investors comply with periodic reporting, disclosure requirements, proxy disclosure requirements, insider trading, Section 16, beneficial ownership, and a variety of securities regulations.

The second bucket of my practice is transactional in nature. I do some crowdfunding in that space, and I help companies with securities offerings and occasionally M&A or tender offer transactions.

The third bucket is corporate governance. That includes helping companies and investors understand, interact, and engage with each other with respect to corporate governance issues like shareholder proposals, proxy access, majority voting, and things of that nature.

I enjoy all three parts of my practice. I think the governance piece is where things have changed the most. It is a very dynamic practice area and one that I have really enjoyed.

Much of your practice focuses on advising boards and investors with respect to corporate governance issues including shareholder activism and proxy access:

- **How have the objectives of shareholder activists changed in recent years?**

Investor activists have become more sophisticated and professional. That is by far the biggest change. You see that especially with shareholder proposals. When I first started practice back in the late nineties, shareholder proposals were in my view a kind of untamed wild frontier. In the types of proposals that were submitted there was a very wide variety, from super-sophisticated proposals by large sophisticated institutional investors, to very unsophisticated proposals from individuals, and sometimes other institutional investors, on a variety of topics. Simpler ones included things like: "We want you to change the wrapper on the Tootsie Roll," or "We want you to give all shareholders the same discounts on cars as you give employees." But there were also serious topics, such as board independence, employment discrimination, and committee auditor independence, so it was a mishmash.

It was very interesting as a young lawyer to try to apply the very loose framework that had been created in the proxy rules for evaluating shareholder proposals to see whether a particular proposal could be excluded, should be excluded, or should not be excluded. Now things have changed. Those same retail investors who were submitting "We want you to sell a different brand of soda in your stores," are now submitting proposals such as: "We want a board report on risk and how your board oversees risk"; "We want you to tell us everything that you are doing about sustainability"; and "We want you to tell us how your political spending activities, or your lobbying activities, or your charitable giving, is consistent with the culture and values that the company purports to promote." So it has become much more sophisticated, much more professional. There are fewer shareholders involved in the process than had been the case, but the few that are involved have an outsized influence.

At one point in the late 1990s–early 2000s, one of the biggest proponents of shareholder proposals was organized labor, because labor pension funds were huge participants in the process. But that has changed dramatically. Now you don't see nearly as many labor funds involved in submitting shareholder proposals as before. On the retail side you used to see a ton of retail investors, such as Evelyn Davis or individuals like John Chevedden and others. What has happened is that there is now a much smaller number of individuals who are submitting shareholder proposals, but they have an outsized influence. Someone like John Chevedden—himself or with his affiliates—submits on average 10% to 20% of the shareholder proposals in a given year. This is pretty significant for one guy or a handful of people, and that is a big change from where things were previously.

There are two types of activists. You have what I consider to be the more governance-oriented activists, and those are the people who tend to do shareholder proposals. Then you also have what I would consider to be the more value-based activists, such as hedge funds—people who come in and say that they want you to increase the dividend, or want you to increase the share repurchase program. They sometimes use shareholder proposals. In both cases the activists have become a lot more active in the last couple of years.

- **Please discuss the influence of proxy advisory firms on shareholder activism.**

Proxy advisory firms are in some ways the fuel that makes shareholder activism work, because many firms and institutional investors subscribe to the services of proxy advisory firms. As a result, the recommendations and views of proxy advisory firms have a significant influence on corporate governance. If a proxy advisory firm says our policy is that we will always vote against boards if they do X, Y, and Z, then guess what—going forward, fewer boards are going to do X, Y, and Z because they do not want to have investors vote against their say-on-pay or against their directors. So proxy advisory firms have a very significant influence.

In some circles there is a view that it is an outsized influence, because you have one or two organizations, in the form of ISS and Glass Lewis, who together are arguably the most significant forces in corporate governance. When they come out with their policy updates every year, they dramatically influence what companies do in terms of what kind of governance features they incorporate, adopt, or amend, or how they structure their compensation program. Each of them has guidance around how they evaluate executive compensation, and that guidance really influences how companies make decisions. That has been a source of frustration for some companies who think that it may not be appropriate for one or two actors to have the level of influence held by ISS or Glass Lewis.

Some of these things are subjective, such as why it is worse for a director to sit on six boards rather than just three. But notwithstanding those objections, they provide a very important function for the proxy ecosystem, which is that you have lots of institutional investors that hold literally millions of shares in their portfolio and who even in the best of circumstances would not have very much time to dedicate to any one company's proxy. So they have to rely on someone to help them execute their voting responsibilities. That is the role of ISS and Glass Lewis. So from that perspective it is good, because otherwise those shares might not get voted, or they might be less informed in the process. That is the counterpoint for companies or for people who criticize the proxy advisory firms. But it is certainly the case that they are very influential. There was a GAO study several years ago that said on average they have anywhere from 15% to 30% of the vote at a given company. That is a pretty significant influence when you don't have full participation in proxy solicitations, because that ISS recommendation can be the difference between something passing or not passing.

- **Do you find that public companies are more willing to engage with shareholder activists these days?**

Yes, I think say-on-pay is probably one of the most significant developments with unintended consequences in corporate governance. Because of the say-on-pay vote, which was part of Dodd-Frank, companies annually have to put the compensation of their executive officers, as disclosed in the proxy, up for a vote. That process usually results in companies going out and engaging with their investors—to figure out what investors think about their compensation packages so that they are more likely to get the votes that they need. In order to do so, many companies use engagement as a method to figure out what is and is not important to their investors and what their investors think about the companies in general.

In general, proxy advisory firms have had an increased influence since say-on-pay, and that is not a bad thing. I do think that has resulted in companies doing a lot more engagement with shareholders than would have been the case before.

You are considered an expert in Sarbanes-Oxley and Dodd-Frank. What are some of the main requirements of the Acts that you work with on a regular basis in practice?

For Sarbanes-Oxley, the main requirements for most people like me who work on it regularly and do disclosure work are the internal controls and disclosure controls. Every time a company files a periodic report, they have to get certification from their CEO and CFO as to the effectiveness of their internal controls and disclosure controls. There's also an assessment of internal controls that is done by the auditor.

For Dodd Frank, it probably has to be the say-on-pay. It is not that we are spending a ton of time on say-on-pay every single day, but when looking at engagement, it really has influenced the way that companies think about engagement. That part of it impacts my work and I imagine the work of most people who practice in this area. There is a lot left to be done. Proxy access is actually another example. The SEC got authority to adopt proxy access. They did so, but the rule was invalidated. Now we are in a world where companies can submit proxy access bylaws. And even though they are not directly a result of the Dodd-Frank Act, there is a clear nexus, because when the SEC adopted its proxy access rule, it also amended the proxy rules to allow the inclusion of proxy access shareholder proposals. This was by far the number one topic last year and it looks like it may be the number one topic this year as well.

Are there any differences or new trends in the types of matters clients seek your advice and help with now as opposed to when you began in private practice?

Clients have gotten very savvy in the way they use their outside lawyers. Clients will now create the first draft in a disclosure document, which reduces their reliance on outside counsel. That is generally good for them from a budget perspective. The biggest challenge is that it is much tougher to train junior associates. When I started, it wasn't uncommon for a client to ask to have a junior associate draft a proxy. Now, following the financial crisis and economic downturn that we had in 2007–2009, clients are less likely to ask to have a junior associate draft a proxy. More often they will draft it themselves, and then ask me to review it substantively and ask to have a junior associate do a form check. This is a significant change and makes it difficult for younger lawyers to get more detailed drafting and preparing disclosure document experience.

You also have worked on corporate political spending disclosures. Can you share any recent developments in this area?

Of all the areas in my practice, this is the one that I am frequently surprised at the level of interest. First of all, I think that the influence of money in politics is horrible. I understand the level of fervor with which many of the activists in this space follow political spending. That fervor has resulted in some very positive developments in the context of disclosure. There is an index, the CPA-Zicklin Index, that is kind of like the Rosetta Stone if you want to understand how political spending is viewed from the eyes of investors. That index comes out every year, and this most recent version, which was published in the fall of 2015, was the first to include all S&P 500 companies, which is a most significant development. It now provides investors and companies with a relatively objective way to evaluate political spending disclosures, whether they are good or bad, whether they are sufficiently extensive or too extensive, and so forth.

There's a rulemaking petition that is asking the SEC to adopt a rule that would require companies to disclose political spending. Setting aside whether that is a good or bad thing, that rule has gotten more than a million—closer to two million—comments. That is illustrative of the level of interest in the topic among investors and the public at large. This petition and the CPA-Zicklin Index are significant developments. There are many more companies that provide disclosure and think about their disclosure around political spending than was the case five or six years ago. The rulemaking petition and the CPA-Zicklin Index are big parts of that.

Do you have any helpful insights from current trends you are seeing related to governance policies and procedures?

The most significant insight relates to proxy access. It's a trend. At the last count I saw, there were 200 companies that have adopted proxy access. I imagine that number is likely to double in the next year or two, and it is likely to become a very common practice, at least among larger public companies. The trend I am seeing with proxy access is that a lot of companies who have not received a shareholder proposal on the topic can read the writing on the wall, and they are taking the initiative to engage with their investors and among their board about the topic of proxy access, addressing issues such as: what kind of proxy access regime they would be willing to live with, what things they could not live with, and what kinds of issues their directors or investors have with proxy access. That by far is the trend that I am seeing the most in terms of governance policies and procedures.

What are some of your biggest career accomplishments?

I would say my biggest accomplishment is that I have developed a practice that I love. I have a great set of clients, and a wonderful team of colleagues, both partners and associates. I have been able to influence the development of the law with respect to securities while maintaining a good relationship with the SEC. There are a lot of people who don't like what they do. I love what I do. What I do is interesting. I get up every day and look forward to the challenging questions and novel issues that clients may come up with. I look forward to engaging with the SEC, to understand where the staff is coming from on issues to help my clients navigate their guidance and so forth. It's great to have found a niche for myself in this practice where I feel fulfilled, but I also feel that I am able to make a real contribution. L

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Reverse Yankee Bonds and the **New EU Market Abuse Regime**

ON JULY 3, 2016, THE EUROPEAN UNION (EU) WILL EXTEND its new market abuse regime (MAD II)[2] to the previously unregulated Global Exchange Market of the Irish Stock Exchange (GEM) and the EuroMTF of the Luxembourg Stock Exchange. MAD II will thereafter apply to U.S.-based issuers of euro-denominated bonds that are listed on the GEM and the EuroMTF. MAD II differs in significant ways from relevant U.S. law, and issuers of Listed Reverse Yankee Bonds will need to weigh the cost of complying with MAD II against the benefits of maintaining a listing of their Reverse Yankee Bonds on a European stock exchange.

This article specifies immediate actions issuers should take to comply with MAD II, describes Listed Reverse Yankee Bonds, analyzes the requirements for MAD II from the perspective of a bond issuer, and presents alternatives to the GEM and EuroMTF for Reverse Yankee Bond issuers.[2]

Immediate Actions

To comply with the requirements of MAD II, issuers of Listed Reverse Yankee Bonds should take the following actions no later than July 3, 2016:

- Create and implement a plan for managing the disclosure and delay of disclosure of inside information and for recording instances of non-disclosure.
- Identify and maintain a list of persons discharging managerial responsibilities (Managers) and persons closely associated with them and create procedures for tracking and recording transactions undertaken by such persons in the Listed Reverse Yankee Bonds.
- Create and maintain a list of persons working for the relevant issuer (including service providers) who may have access to inside information (Insiders).
- Amend existing insider trading policies to comply with MAD II (including its 30-day "blackout" close period for Managers and persons closely associated with them).
- Communicate the new requirements to employees, shareholders, advisers, and other stakeholders.

Significant uncertainty remains around how European securities regulators and other officials (including local prosecutors) will interpret and enforce MAD II. Further guidance is expected on MAD II's implementation from the European Securities and Markets Authority.

1. Regulation 596/2014 on market abuse and Directive 2014/57/EU on criminal sanctions for market abuse. The provisions of the regulation will be directly applicable in EU Member States on July 3, 2016. The provisions of the directive will be implemented by EU Member States via domestic legislation. 2. MAD II applies to any financial instruments listed or traded on multilateral trading facilities (such as the GEM and the EuroMTF) and organised trading facilities (each as defined in the EU legislative package known as "MiFID II" comprising Directive 2014/65/EU on Markets in Financial Instruments and Regulation No. 600/2014 on Markets in Financial Instruments which will replace the current Marketing in Financial Instruments Directive in January 2018), among other things. This article is not meant to be a recitation of all applicable regulations or an analysis of all considerations under MAD II.

Listing Reverse Yankee Bonds

In 2015 and 2016, U.S.-based issuers issued record volumes of euro-denominated bonds (so-called Reverse Yankee Bonds) to take advantage of low yields in Europe and the weakness of the euro, hedge their operational exposure to the euro, and raise cash for acquisitions. In 2015, the United States was the largest source of issuers in the European corporate bond markets, and, according to Dealogic, by mid-March 2016, U.S. issuers had accounted for 23% of all euro-denominated bond issues in 2016.

As with other securities issued in Europe, Reverse Yankee Bonds are typically listed on a stock exchange. Bonds are not typically listed in the United States. The reasons for listing bonds in Europe include the following:

- The "quoted Eurobond exemption," which exempts a UK or Irish company from withholding taxes on an interest payment if interest is paid on a security admitted to trading and included in the official list of a "recognized stock exchange" (recognized stock exchanges include all European Economic Area and U.S. stock exchanges, plus the Channel Islands Stock Exchange (which is in Guernsey—part of the United Kingdom, but not part of the EU) and the Cayman Islands Stock Exchange, among others)
- Investment restrictions for certain European investment funds that prohibit investments in unlisted bonds

Market practice in Europe is that all bonds are listed on a recognized exchange, whether or not there is a UK or Irish company in the issuer group. There is, however, no legal requirement to list euro-denominated bonds.

The GEM and the EuroMTF are popular listing venues for European bonds. These are multilateral trading facilities under EU law, meaning that so long as a bond issuance has a minimum denomination of at least €100,000, a listing on the GEM or EuroMTF will exempt the issuer from complying with the requirements of the EU Prospectus Directive, the EU Transparency Directive, and (prior to MAD II) the EU market abuse regime. The GEM and the EuroMTF (prior to MAD II) are regulated by the stock exchanges themselves, not by the local securities regulators (The Central Bank of Ireland (CBI) for the Irish Stock Exchange and the *Commission de Surveillance du Secteur Financier* (CSSF) for the Luxembourg Stock Exchange).

As a result, issuers listed bonds on the GEM and the EuroMTF with the understanding that the listing would be hassle- and liability-free. So long as the issuer provided the reports required under its bonds' reporting covenants and any other information affecting bondholder rights to the GEM or the EuroMTF and paid an annual listing fee, the listing would be maintained. Liability under EU securities regulations has not previously applied.

MAD II will bring the GEM and the EuroMTF and all the bonds listed on them into the same inside information and market abuse disclosure and liability regime as other listed securities in the EU. For issuers of Listed Reverse Yankee Bonds who may not be attuned to EU securities regulation, the risks of non-compliance are high, and include administrative and criminal sanctions, including fines and prison time.

Key Aspects of MAD II for Listed Reverse Yankee Bonds

MAD II defines inside information, regulates disclosure of inside information, regulates dealings by Insiders, and mandates the recordkeeping and disclosure requirements described below.

Inside Information:

MAD II defines inside information as follows:

- Information *of a precise nature,* which has not been made public, relating directly or indirectly to one or more issuers or to one or more financial instruments, and which, if it were made public, would be *likely to have a significant effect on the price* of those financial instruments or on the price of related derivative financial instruments
  - Information is of a precise nature if it indicates a set of circumstances that exists or may reasonably be expected to come into existence, or an event that has occurred or may reasonably be expected to occur, and is specific enough to enable a conclusion to be drawn as to the possible effect of that set of circumstances or event on the prices of the relevant financial instruments, including any intermediate steps
  - Information is likely to have a significant effect on the price of financial instruments if a reasonable investor would likely use it as part of the basis of its investment decision

An issuer must *inform the public as soon as possible of inside information* that directly concerns it. Inside information must be announced without delay and in a manner that allows fast access and a complete, correct, and timely assessment of the information by the public. The public may be informed either via an approved wire service or by an announcement published by the stock exchange.

In addition, all inside information that an issuer is required to disclose publicly must be published on its website and maintained there for a period of at least five years. There is no safe harbor for publishing information on another government's official website, such as the U.S. Securities and Exchange Commission's EDGAR filing service, to comply with these disclosure requirements.

Delaying Disclosure of Inside Information:

MAD II provides that an issuer may delay the publication of inside information when each of the three following conditions is met:

- The immediate disclosure of the information is likely to *prejudice the legitimate interests of the issuer.*
- Delay of disclosure is *not likely to mislead the public.*
- The issuer is able to *ensure the confidentiality* of that information.

Legitimate Interests:

While legitimate interests must be assessed on a case-by-case basis, examples include:

- Ongoing negotiations where the outcome or normal pattern of those negotiations would be likely to be affected by public disclosure (including in a distressed context).
- Competitive situations (e.g., where a contract was being negotiated but had not been finalized and disclosure would jeopardize the conclusion or threaten its loss to another party).
- Product development, patents, inventions, etc., where the issuer needs to protect its rights (though events that impact on major product developments should be disclosed as soon as possible).
- When an issuer decides to buy or sell a major holding in another entity and the deal will fail with premature disclosure.
- Impending developments that could be jeopardized by premature disclosure.

Note that a contractual requirement to selectively provide inside information (e.g., reporting of monthly management accounts to private lenders) has not specifically been noted as a legitimate interest, so there may be a requirement to disclose such information publicly at the same time it is disclosed pursuant to the contractual obligation.

Likely to Mislead the Public:

Delaying the disclosure of insider information is likely to mislead the public where, for example:

- The inside information is materially different from a previous public announcement on the matter.
- The inside information regards the fact that the issuer's financial objectives are likely not to be met, where such objectives were previously publicly announced.
- The inside information is in contrast with the market's expectations, where such expectations are based on signals that the issuer has previously set (e.g., an interview with the CEO).

Recordkeeping in Relation to Delay of Disclosure:

When publication of inside information is delayed, the issuer must maintain records of:

- The identity of all persons with responsibility for the decision to delay the publication of the inside information
- The identity of the person making the notification to the competent national authority, including their professional e-mail and telephone number
- The date and time when the inside information first existed within the issuer
- The date and time of the decision to delay the publication of the information (including the time zone)
- The reasoning in respect of each of the three conditions of the decision to delay

- The manner in which compliance with confidentiality and the conditions for delay are monitored
- Decisions relating to when public disclosure should be made

The issuer must notify the relevant competent authority of the delay in publication in writing as soon as possible after the inside information is made public and provide a written explanation of the reason for the delay and how each of the above three conditions of the decision were met.

Insider Dealing:

It is an offense under MAD II to:

- Use inside information to buy or sell financial instruments
- Disclose inside information to any other person, unless done in the normal course of business of a person's employment, profession, or duties
- Recommend or induce another person to transact on the basis of inside information

A person who deals (including the amendment or cancellation of an order) while in possession of inside information will be presumed to have used that information. Certain exemptions are available for market soundings and transactions customary in a relevant jurisdiction.

Market Manipulation:

Market manipulation or attempted market manipulation—a trade does not have to be placed or an order executed—is prohibited under MAD II, including the following activities:

- Entering a transaction, placing an order to trade, or any other behavior that
- Gives or is likely to give false or misleading signals as to the supply of, demand for, or price of, a financial instrument
- Secures or is likely to secure the price of one or several financial instruments at an abnormal or artificial level; or
- Unless the person entering into a transaction, placing an order to trade, or engaging in any other behavior, establishes that such transaction, order, or behavior has been carried out for legitimate reasons and conforms with accepted local market practices
- Activity or behavior that affects or is likely to affect the price of one or several financial instruments that employs a fictitious device or other form of deception or contrivance
- Disseminating information through the media, including the Internet, or by any other means, which gives, or is likely to give, false or misleading signals as to the supply of, demand for, or price of, a financial instrument, or secures, or is likely to secure, the price of one or several financial instruments at an abnormal or artificial level, including the dissemination of rumors, where the person who made the dissemination knew, or ought to have known, that the information was false or misleading

ALTHOUGH MOST JURISDICTIONS ALREADY HAVE LEGISLATED CRIMINAL SANCTIONS FOR MARKET ABUSE AND INSIDER TRADING, MAD II SIGNIFICANTLY EXPANDS THE SCOPE OF POTENTIAL SANCTIONS…

Manager Transactions:

MAD II requires Managers and persons closely associated with them to disclose transactions in listed shares and listed debt instruments, as well as in derivatives or financial instruments linked to such shares or debt securities.

Managers or persons closely associated with them are obligated to notify both the issuer and the competent national authority, and the issuer must notify the competent authority and the public of the relevant transaction within a timeframe of three business days of the transaction.

A Manager is defined as a person discharging managerial responsibilities, and may further be defined as a person within an issuer who is:

- A member of the administrative, management, or supervisory body of that entity
- A senior executive who is not a member of the bodies referred to in the previous bullet, but who has regular access to inside information relating directly or indirectly to that entity and power to take managerial decisions affecting the future developments and business prospects of that entity

A person closely associated to a Manager means:

- A spouse, or a partner considered to be equivalent to a spouse in accordance with national law
- A dependent child, in accordance with national law
- A relative who has shared the same household for at least one year on the date of the transaction concerned
- A legal entity controlled by or benefiting a person described above

Note that the definition of Manager applies only to the issuer itself. It is unclear whether regulatory authorities and prosecutors will read MAD II to include managers of parent companies or other control persons who are not also Managers of the issuer.

Blackout Close Periods for Insider Trading Policies:

MAD II introduces a period of 30 calendar days before the publication of an interim financial report or a year-end report in which a Manager, or a person closely associated with a Manager, must not conduct transactions for its own or a third party's account, directly or indirectly, relating to the listed securities of the relevant issuer or to derivatives or other financial instruments linked to such listed securities. Issuers of Listed Reverse Yankee Bonds should update their insider trading policies to comply with this requirement.

Insider Lists:

Issuers must maintain a list of persons working for them who may have access to inside information. These lists should be promptly updated whenever there is a change in the reason why a person is on the list, to add a new person, or whenever any person on the list no longer has access to inside information, and these lists must be maintained for a period of at least five years. Insiders include service providers, who may maintain their own lists and provide those lists to issuers (though issuers remain responsible for completeness). Separate lists for permanent and deal- or information-specific Insiders may be maintained if preferable.

The information required of each Insider (including service providers) includes:

- Name (and birth name, if different)
- Professional and personal telephone numbers
- PPS/national identification number
- Time and date of access to inside information
- The reason for including that person on the Insider list
- The date on which the Insider list was drawn up or updated

The issuer must take all reasonable steps to ensure that persons on the list acknowledge in writing the legal and regulatory duties entailed and are aware of sanctions applicable to insider trading and unlawful disclosure of such information. Insiders' lists must be provided to the applicable exchange regulator (i.e., the CBI or CSSF) upon request.

Penalties for Noncompliance

MAD II includes administrative and criminal sanctions for noncompliance. Although most jurisdictions already have legislated criminal sanctions for market abuse and insider trading, MAD II significantly expands the scope of potential sanction for Listed Reverse Yankee Bond issuers and their shareholders, employees, and service providers, especially in respect of reporting and recordkeeping requirements. It is important to note that natural persons involved as perpetrators, inciters, or accessories will potentially have the same liability as the party in noncompliance.

Alternatives

De-listing from the GEM or the EuroMTF to avoid the requirements of MAD II may be difficult. Many euro-denominated bonds (or the underwriting agreements in respect of such bonds) include covenants requiring the issuer to use commercially reasonable efforts to maintain a listing. Choosing to de-list from an exchange may also result in negative publicity or impact the trading price of listed bonds. Possible alternatives to the GEM and EuroMTF include the Channel Islands Stock Exchange and the Cayman Islands Stock Exchange, both of which benefit from the quoted Eurobond exemption but fall outside the ambit of EU regulation. Still, listing bonds on these exchanges is relatively untested, and may result in other unintended consequences. Other issuers, particularly those with no UK- or Irish-sourced income, should consider and discuss with their advisers whether to de-list bonds altogether.

Future issuers should assess whether the compliance costs of listing their euro-denominated bonds outweigh the benefits of a listing, and work closely with their advisers to determine a listing venue if listing is necessary. L

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RESEARCH PATH: *Securities and Capital Markets > Corporate Governance and Compliance Requirements for Public Companies > Corporate Governance > Practice Notes > International Market Regulation*

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Investing in U.S. Real Estate by Qualified Foreign Pension Funds

FOR OVER 30 YEARS, NON-U.S. INDIVIDUALS AND ENTITIES who invest in U.S. real estate have been subject to tax both on operating income and gains realized upon exiting the investment. There have been limited exceptions, primarily for gains earned by shareholders holding less than 5% of public real estate investment trusts (REITs) and shareholders of domestically controlled REITs that exit by selling the shares of the REIT rather than having the REIT sell the property it owns. Foreign governmental pension plans and sovereign wealth funds that are entitled to the special exemption provided to foreign governments under section 892[1] have also been able to avoid tax by taking non-controlling positions in REITs, again provided that they exit by selling shares of the REIT.

The taxation of gains occurs pursuant to section 897, often referred to as FIRPTA, an acronym for the Foreign Investment in U.S. Real Property Tax Act of 1982, which added section 897 to the Code.

Operating income is taxable either as active business income under section 871(b), for individuals, or section 882, for corporations, or as passive rental income that is subject to a 30% gross basis withholding tax under sections 871(a) or 881. Due to the fact that the 30% withholding tax applies to the gross amount of passive rents, without any deduction for operating costs or depreciation, taxpayers can elect to treat passive rents as if they were active business income subject to net basis taxation instead of the gross withholding tax.[2]

At the end of 2015, in an attempt to encourage additional foreign investment in U.S. real estate, and in particular to help provide foreign capital to fund much-needed investment in U.S. infrastructure, Congress created a new exemption in section 897(l) from FIRPTA for qualified foreign pension funds (QFPFs).

To qualify as a QFPF, a pension fund needs to meet certain requirements, including being part of a plan or arrangement established to provide tax-free or deferred pension or retirement benefits to a broad-based class of current or former employees and satisfying certain reporting rules. More guidance, likely in the form of regulations, is expected to be released in the near future clarifying how these rules apply to the great variety of forms of foreign pensions that can potentially qualify.

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1. Section references are to the U.S. Internal Revenue Code of 1986, as amended. 2. See section 871(d) for individuals and section 882(d) for corporate entities.

Related Content

For more information on the organization of REITs, see

> BASIC REIT STRUCTURES AND ENTITY TYPE

RESEARCH PATH: *Real Estate > Real Estate Investment Trusts > REIT Transactions > Practice Notes > Mergers and Acquisitions*

For more information on ownership of REITs, see

> OWNERSHIP RESTRICTIONS

RESEARCH PATH: *Real Estate > Real Estate Investment Trusts > REIT Qualification > Practice Notes > REIT Qualification*

For more information on foreign investors in REITs, see

> FOREIGN INVESTOR ISSUES

RESEARCH PATH: *Real Estate > Real Estate Investment Trusts > REIT Transactions > Practice Notes > Mergers and Acquisitions*

For more information on REIT asset limitations, see

> REIT ASSET TESTS AND QUALIFICATIONS

RESEARCH PATH: *Real Estate > Real Estate Investment Trusts > REIT Qualification > Practice Notes > REIT Qualification*

For more information on REIT income requirements, see

> REIT INCOME TESTS

RESEARCH PATH: *Real Estate > Real Estate Investment Trusts > REIT Qualification > Practice Notes > REIT Qualification*

For more information on what constitutes rent received by REITs, see

> WHAT QUALIFIES AS "RENT" IN THE REIT CONTEXT

RESEARCH PATH: *Real Estate > Real Estate Investment Trusts > REIT Qualification > Practice Notes > REIT Qualification*

A foreign pension that qualifies as a QFPF is entitled to a complete exemption from FIRPTA. While the legislation generated numerous headlines, the stories often neglected to mention that 897(l) exempts a QFPF only from the FIRPTA tax on gains from U.S. real estate. The taxation of current income from U.S. real estate, whether earned as active operating income or as passive rents, continues to be subject to tax either on a net basis or subject to the same 30% gross basis withholding tax.

Moreover, if a QFPF earns active operating income from U.S. real estate, either by owning the real estate directly or through a partnership (or a limited liability company (LLC) or other entity treated as a partnership for U.S. tax purposes), gains realized upon exit will likely be subject to tax as effectively connected income under section 882. Because 897(l) provides an exemption only from the section 897 FIRPTA tax, it will have no effect on the tax imposed by section 882.

As a result, QFPFs will continue to be reluctant to invest directly or through a pass-through entity in U.S. real estate, because they will either be subject to the prohibitively expensive 30% withholding tax on the gross amount of rental income, without any deduction for depreciation or operating costs, or be subject to the 35% corporate level tax on their net income from the property, which will also require that they file a U.S. tax return to report and pay tax on this income.

Instead, most QFPFs are likely to invest in U.S. real estate through REITs, which convert operating income into deductible dividends that do not require a QFPF to file a tax return. While the dividends are potentially subject to the same 30% withholding tax as passive rents, the amount of taxable dividends paid by a REIT are calculated after deducting the expenses, including depreciation, of owning the property. The net income that is then paid as deductible dividends will be subject to 30% withholding tax (unless reduced by treaty, as discussed below), but this produces a much better result than subjecting the rental income to 30% withholding on the gross amount, without any deduction for operating costs, or paying 35% net corporate level tax on income from a direct investment and also having to file a U.S. income tax return. Moreover, for certain QFPFs organized in a jurisdiction that has a tax treaty with the United States that includes a special article governing pension investors, such as the U.S. tax treaties with Canada, the Netherlands, and Mexico, the dividend withholding tax can be eliminated provided the pension investor is not related to the REIT. For purposes of the Netherlands treaty, relatedness is an 80% standard, while for Canada it is likely a 50% standard.

A REIT is a fairly unique entity for tax purposes, and its attractiveness will only increase with the passage of section 897(l). Although treated as a corporation under the Code, which means it therefore serves as a blocker to prevent a foreign investor such as a QFPF from having to file a U.S. tax return, it avoids corporate level tax by paying deductible dividends. Essentially, a REIT is a means of integrating the corporate income tax with respect to investments in real estate. To qualify as a REIT, however, an entity needs to meet a variety

of formal requirements as well as income and asset tests designed primarily to restrict a REIT to serving as a vehicle for investing in rental real estate.[3]

In order to satisfy the income tests, the REIT will need to earn qualifying rental income. This will require that the REIT rent the property it owns to unrelated tenants. For office properties, residential rental real estate, and retail investments, this will be rather straightforward, though a REIT that owns these types of assets will still need to carefully monitor the types of services it provides to its tenants and ensure that they comply with the various REIT rules and restrictions.

For investments in hotels and health care properties, such as congregate care and assisted living facilities, the REIT will usually lease the property to a taxable REIT subsidiary (TRS), which then hires an eligible independent contractor (EIK) to operate the hotel or health care property pursuant to a special REIT regime available only for these types of assets. The TRS is typically wholly owned by the REIT and earns a profit or spread equal to the difference between the operating income from the property and the rent it pays to the REIT. This profit is subject to corporate level tax, but the rent earned by the REIT is subject to the usual rules that allow the REIT to pay out that income as deductible dividends. The EIK is a third-party operator that is in the business of managing health care properties or hotels for a fee. Constructive ownership rules are designed to ensure that the REIT and the EIK have an arm's-length relationship and seek to prevent overlapping ownership that exceeds a 10% threshold, applying the constructive ownership rules of section 318 with certain special modifications.

Less traditional rental properties, such as those that would not typically earn rental income, can potentially be held in a REIT if the entire property can be master leased to a third-party operator, who then operates the property and pays qualifying rental income to the REIT. The lease with the operator can include a percentage component based on the gross revenue, but not profit, of the tenant. For infrastructure assets, for example, the REIT could potentially own the real estate components of the infrastructure project and lease these assets to a tenant who will operate the property and own any non-real estate assets that are necessary for its operations. For example, an investment in a power plant could potentially be structured through a REIT that owns the land, building, and other fixed assets and then leases these assets to an unrelated operator who pays qualifying rental income to the REIT and earns income from generating or distributing power or otherwise operating the plant. Similar structures can potentially be used for energy assets such as pipelines or transmission lines, with the REIT owning the real estate assets, such as the land and fixed assets like pipelines or transmission towers, and leasing those assets to an operator who earns operating income from the ultimate customers and pays qualifying rental income to the REIT.

Similar structures can be used for farmland, vineyards, and other non-traditional REIT assets. The critical elements of these structures ensure that the operator is unrelated to the REIT and that it pays arm's-length rental income to the REIT that is respected as rent for tax purposes.

To be unrelated, the REIT and the operator need to have less than 10% overlap in ownership, as determined pursuant to constructive ownership rules based on section 318, with certain unique modifications. To qualify as good REIT income, the lease will need to be on arm's-length terms and any percentage component will need to be based on gross revenue rather than the profits of the tenant. Moreover, the relationship between the operator/tenant and the REIT, including potential renegotiation of the lease terms, cannot in substance be used as a way to base the rental income on the operator's profits.

As a result of these restrictions, an investment in a REIT owning these types of assets will not be economically identical to owning these assets directly and being subject to the business risks of the underlying operations. Instead, the business will essentiality be divided into a real estate component and an operating component, and while the gross revenue percentage rental sharing formula will cause these two components to be generally aligned, there will be a risk that they will diverge, for example, if the expenses of operating the business prove to be significantly different than the parties expected, such that gross revenues differ unexpectedly from the net operating profit. As a result, a QFPF that seeks to invest in this manner will need to be comfortable with this potential divergence as a trade-off for being able to use the tax advantages of the REIT structure.

For QFPFs that are not entitled to the benefits of section 892 or a tax treaty with a special exempt pension investor article, dividends from the REIT will usually be subject to

3. Mortgage REITs can also serve as vehicles for investing in real estate mortgages, but because they convert interest income, which is often exempt by treaty or as portfolio interest, into dividends potentially subject to 30% withholding tax, mortgage REITs are not typically a tax-efficient vehicle for foreign investors. 4. While some treaties provide a lower rate of withholding for dividends, this lower rate usually doesn't apply to REITs, except in limited circumstances such as where the investor owns less than 10% of the REIT and the REIT owns a diversified portfolio of real estate assets.

30% withholding.[4] As noted, however, the amount of dividends the REIT needs to pay to avoid incurring any income tax at the REIT level will be reduced by depreciation deductions and other expenses incurred by the REIT. The REIT can potentially also be financed in part with shareholder debt in the case of a QFPF organized in a jurisdiction that has a treaty that eliminates withholding on interest income, which often applies even if that interest income is paid by a related party.[5] The interest deductions then further reduce the amount of deductible dividends the REIT needs to pay to avoid tax at the REIT level.

The principal benefit of the REIT structure for a QFPF will be that any gains on exit will generally be exempt from U.S. tax. This will be the case whether those gains are earned by selling the REIT shares or if the REIT sells the property and distributes the proceeds to the QFPF. Unlike the exemption from FIRPTA provided for domestically controlled REITs and section 892 governmental investors, a property sale and liquidation will produce the same exemption as a sale of REIT shares, greatly simplifying the proposed exit.

The ability of a QFPF to take advantage of the section 897(l) exemption from FIRPTA by having the REIT sell assets rather than having to sell REIT shares will expand the class of buyers who can acquire the asset, as some buyers are reluctant to buy REIT shares due either to their lack of familiarly with REIT structures or because certain buyers, such as individuals and certain foreign investors, are either not qualifying holders of a REIT or can't tax-efficiently buy a REIT.[6] A QFPF can therefore ensure that the REIT structure remains in place only during its ownership of the asset and allow a future buyer to hold the asset however it chooses and not have to worry about acquiring REIT shares and maintaining or liquidating the REIT.

Where the REIT earned qualifying income by renting its assets to a third party independent operator, the lease with the tenant can either be inherited by the new buyer, or the lease can include a mechanism, such as a termination fee, to be terminated or unwound when a new investor acquires the real estate assets from the REIT.

Compared to the exemption available for domestically controlled REITS, which requires that the REIT be majority owned by U.S. investors, and the section 892 exemption, which requires that the foreign governmental investor own less than 50% of and not control the REIT, the exemption from FIRPTA for QFPFs applies regardless of how much of the REIT the QFPF owns and regardless of whether the QFPF controls the REIT. While obtaining an exemption from dividends paid by the REIT under the special pension investment article of a treaty or under section 892 may still require owning 50% or less of the REIT, if the QFPF is willing to live with 30% withholding on dividends paid by the REIT, which as noted, need to be paid only with respect to the net income from the property, as reduced by depreciation deductions and deductible interest, the QFPF can own up to 100% of the REIT and have as much control rights as it wants and still be exempt on any gains when it sells interests in the REIT or the REIT sells its properties. Moreover, the exemption applies regardless of whether the exit takes place at once, via a sale of all of the REIT's property and a liquidation of the REIT, or if the REIT sells it properties over time and distributes some gains while continuing to earn rental income from other properties until they are sold. Thus, a QFPF can invest in REITs that own multiple properties and take advantage of its exemption when the REIT sells each property separately, even if those sales take place over multiple years. The REIT can therefore seek to maximize the selling price for each real estate asset by selling it to a separate buyer who is willing to pay the best price for the asset they want without having to acquire other assets owned by the REIT, which would be the case if they were required to buy all of the shares of the REIT.

As a result, while it is important to know what the new law changes and what it doesn't, through creative use of REITs, a QFPF can use the new exemption provided by section 897(l) to greatly expand its ability to invest tax-efficiently in U.S. real estate. While less traditional rental assets such as infrastructure will present interesting challenges, a creative collaboration between tax advisors and business professionals presents the opportunity to take maximum advantage of the new law's benefits. It will be fascinating to see how these structures develop over the next several years as QFPFs use section 897(l) to expand the available portfolio of potential U.S. real estate investments they consider.

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RESEARCH PATH: *Real Estate > Real Estate Investment Trusts > REIT Transactions > Articles > Qualified Foreign Pension Funds*

5. The amount of deductible interest that can be paid will be limited by rules such as the earnings stripping limitations of section 163(j), and the debt will need to have arm's-length terms to be respected as debt for U.S. tax purposes. 6. A REIT cannot be closely held, which restricts the ability of five or fewer individuals (determined after applying certain constructive ownership rules) from buying a majority interest in a REIT. Foreign investors that are not QFPFs may be reluctant to buy a REIT that has property with a value that exceeds its basis because it will be difficult for them to unwind the REIT structure without incurring the risk of being subject to tax under the special FIRPTA rule of section 897(h)(1).

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Rights Clearance

When your client plans to create new content or use existing third-party content in a new work, it must conduct a review to ensure that it is permitted to use the material. This review is known as rights clearance.

UNAUTHORIZED USE OF SUCH MATERIAL COULD SUBJECT your client to liability for violating a third party's copyright, trademark, or other intellectual property or proprietary rights. A rights clearance review should be done for all content, including films, books, songs, television shows, advertisements, or online videos.

Rights clearance is multi-faceted and occurs on several levels. Not only must you clear the work as a whole, but each individual element must be identified and separately cleared. Understanding the many rights that could be implicated in any one piece of content is important to ensure proper and complete clearance and will inform which licenses and permissions are necessary.

This article details the rights clearance process and discusses the types of works that require clearance, as well as the issues you should consider when conducting a rights clearance review and obtaining third-party consent.

How to Conduct Rights Clearance

You must take the following steps when conducting a rights clearance review:

- Identify the protectable content in the work your client intends to use.
- Determine who owns or controls the rights in the content (the client or a third party).
- Evaluate whether permission is needed to use any third-party content.
- Seek permission from the rights owner, if permission is required.

It is important to remember that you must clear the content as a whole, as well as the individual elements present within the work. For example, to use a print ad that includes a photograph of people sitting around a dining room table, you may need:

- A license from the copyright owner of the photograph as a whole
- Permission from each person appearing in the photograph (to whom the right of publicity applies)
- A license from the copyright owner for any artwork appearing on the wall behind the table in the photograph

Various content types raise different considerations for rights clearance.

Identify the Protectable Content

There are essentially three types of rights that you need to consider when identifying protectable elements and determining what rights need to be cleared:

- Copyright
- Trademark
- Right of publicity

Copyright

Copyright protects original works of authorship, including:

- Songs
- Movies
- Television shows
- Books
- Magazines
- Photographs
- Software
- Architecture

Copyright may protect the work as a whole, as well as the less obvious or underlying elements, such as the screenplay for a movie. Copyright protection covers original works, regardless of whether they were created for artistic or commercial purposes; therefore, a television commercial is entitled to copyright protection in a similar manner as a movie.

However, not all works are subject to copyright protection—namely, in those instances when:

- Copyright protection expired, and the work is in the public domain
- Copyright protection never existed (for example, because the work was created by government employees in their official capacity or the work was insufficiently original to qualify for protection)

Trademark

Trademarks identify the source of certain goods or services, and may include:

- Brand names or other words
- Business names
- Logos
- Slogans
- Product designs
- Product configurations
- Some architectural elements, such as distinctive landmark buildings

Unauthorized use of a trademark may subject your client to liability if it leads to a likelihood of confusion as to the source of the goods or services or makes it appear that the trademark holder sponsored or approved the use. As a result, clearance is

Related Content

For a more detailed discussion on copyright protection, see

> **COPYRIGHT FUNDAMENTALS**

RESEARCH PATH: *Intellectual Property & Technology > Types of IP Protection > Copyright Basics > Practice Notes > Copyright Basics*

For additional information on copyright protection, see

> **AUTHORSHIP AND OWNERSHIP OF COPYRIGHT**

RESEARCH PATH: *Intellectual Property & Technology > Copyright Ownership & Registration > Determining Copyright Ownership > Practice Notes > Determining Authors & Copyright Owners*

For a more detailed discussion on works not subject to copyright protection, see

> **USING PUBLIC DOMAIN AND ORPHAN WORKS**

RESEARCH PATH: *Intellectual Property & Technology > Copyright Ownership & Registration > Notice & Duration > Practice Notes > Copyright Term*

For a more detailed discussion on copyright duration, see

> **DURATION OF COPYRIGHT**

RESEARCH PATH: *Intellectual Property & Technology > Copyright Ownership & Registration > Notice & Duration > Practice Notes > Copyright Term*

For a more detailed discussion on trademark protection, see

> **TRADEMARK FUNDAMENTALS**

RESEARCH PATH: *Intellectual Property & Technology > Types of IP Protection > Trademark Basics > Practice Notes > Trademark Basics*

For a more detailed discussion on conducting trademark searches, see

> **PRELIMINARY & CLEARANCE TRADEMARK SEARCHES**

RESEARCH PATH: *Intellectual Property & Technology > Trademark Registration > Whether & Where to File a Trademark Application > Practice Notes > Pre-filing Considerations and Actions* required for uses or depictions of third-party marks, such as products bearing a trademark (like someone drinking from a Coca-Cola can). Trademark protection can sometimes pop up in unexpected places. For example, landmark buildings, such as the Chrysler Building, are protectable under trademark law and need to be cleared for use.

Trademark owners, particularly owners of famous trademarks, can be aggressive in policing their marks. Thus, even if a court would ultimately find that there was no violation, the trademark owner may still object to your client's use of its mark, which could result in cease and desist letters and a lawsuit. Rather than seek permission or proceed with unauthorized use of the mark, your client may want to consider removing the appearance of third-party logos or trademarks from the content, such as by blurring them or otherwise blocking them out to render them unrecognizable.

Additionally, to minimize the potential infringement of a third-party mark, many advertisers or content creators use fictitious trademarks within the proposed content. For example, films, books, and TV shows frequently refer to brands—including social media websites, restaurants, universities, or other companies—by fictitious names. However, even such fictitious uses should be cleared by conducting a preliminary and/or comprehensive trademark search to ensure that the fictitious mark is truly fictitious and doesn't already exist for the goods or services referenced.

Right of Publicity

Right of publicity laws protect unauthorized use of an individual's recognizable attributes, including that individual's:

- Name
- Voice
- Likeness
- Image
- Distinctive personal attributes (such as gestures or phrases)

Use of any of these in content for commercial purposes (such as advertising, marketing, or otherwise promoting goods, services, or brands) requires that person's consent. In some cases, even copying identifiable characteristics of a famous person—such as using a look-alike or a sound-alike or copying the person's signature phrase—without his or her permission has been found to violate the right of publicity of that person. See, e.g., Hilton v. Hallmark Cards, 599 F.3d 894 (9th Cir. 2010) (Paris Hilton had a cognizable right of publicity claim against Hallmark Cards for use of her catchphrase, "that's hot."); Midler v. Ford Motor Company, 849 F.2d 460 (9th Cir. 1988) (Bette Midler had cause of action against Ford for using a sound-alike in its commercial. "A voice is as distinctive and personal as a face.").

Rights of publicity are not limited to celebrities or public figures, and permission is needed for any person that appears recognizably in the content. As a result, when creating content that will feature other people, it is important that each of the individuals sign a release, especially if the content is to be commercialized.

Since publicity rights are derived from a patchwork of state laws and vary among jurisdictions, the best practice for drafting releases is to include a choice-of-law provision specifying the state whose laws should apply to a dispute arising from the release.

In several states, including California, Massachusetts, Indiana, Tennessee, and others (but not New York), the right of publicity also continues after a person's death. Depending on the jurisdiction, the deceased's heirs or estate may continue to control the deceased's right of publicity for a certain period of time following his or her death. The length of this post-mortem period depends on the state. In certain states, it varies depending on whether the deceased was an ordinary citizen or a celebrity.

If your client seeks to use the image, likeness, name, or other attributes of a person's identity following his or her death, you should first determine which state's law applies, and then identify who controls the estate of the deceased in order to obtain permission if needed.

Determine Who Owns or Controls the Rights

Once you have identified the protectable content, you need to properly identify the rightful owner of that material. Because intellectual property rights are transferrable through a license or assignment, the owner of the rights, or the party who can license the rights, is not always obvious. For instance:

- The author or original creator of a work may not own the copyright if the work was commissioned as a work made for hire or the copyright was assigned or licensed to another person or entity.
- The writer of a musical composition may not control the administration rights to the composition. Those rights may be controlled by a music publishing company.
- Trademarks may be owned by trademark holding companies or a parent company of the mark or brand at issue.
- Right of publicity of a deceased person can be held by the estate of a deceased person or another party who bought such right from the estate.
- As a result, it may be difficult to identify the proper rights holder of certain content. Private investigators

and professional search firms may be able to obtain this information if it is not ready accessible.

Client-Created Works

If your client created a copyrightable work, you should consider whether the work is a work made for hire. Employers rather than employees own works made for hire when the employee created the work within the scope of employment. When an employee creates a work outside of his or her work responsibilities, or creates a work as an independent contractor, the author/employee (not the employer) may own the copyright if the work was not assigned in writing.

To ensure that all employee- or independent contractor-created works are owned by the employer, it is advisable to have each party execute the proper work made for hire or assignment agreement at the outset of the engagement. In the absence of an agreement, determining whether an author is considered an independent contractor or an employee can sometimes be tricky and requires consideration of a number of factors, as discussed in *Community for Creative Non-Violence v. Reid*, 490 U.S. 730 (1989).

Third-Party Works

If your client is using third-party material, you may be able to identify the applicable rights holder through various online resources, including through:

- A copyright search on the U.S. Copyright Office's website (http://www.copyright.gov), which permits you to search copyrighted works by name
- A trademark search on the U.S. Patent and Trademark Office's website (http://www.uspto.gov), which allows you to search for trademarks and obtain owner contact information

However, note that neither copyright nor trademark protection requires registration, so unregistered works or marks will not be found on these government websites. You will need to do additional research to identify the owner of the applicable rights.

Music in particular often has many individual elements and multiple copyright owners. You may be able to determine ownership by checking the three performing rights organization (PRO) websites (ASCAP, BMI, and SESAC), searching http://www.copyright.gov, and/or reviewing album liner notes.

Evaluate Whether to Seek Permission

Even when you have identified protectable content, you may, in certain circumstances, be able to use the material without permission from the rights owner. The primary exceptions or defenses to using another's work without permission are:

- Public domain
- Fair use

However, it is generally difficult to predict what would or would not be considered a permissible use in court, and thus, using the content without permission is often speculative and risky. The owner of the content may still bring a lawsuit even when you correctly determine that permission is not required, forcing your client to defend the claim. Thus, if your client is risk averse and wants to avoid legal disputes altogether, the best practice is to obtain permission for all uses of third-party content.

Nevertheless, considering whether your client's use may be permissible without the rights owner's consent may be a useful analysis, especially when your client is willing to take calculated risks. Additionally, understanding whether an unauthorized use is defensible could bolster your client's request for permission.

Public Domain

When a work is in the public domain, the rights holder can no longer assert private rights over it. This concept arises under copyright and right of publicity.

Related Content

For a more detailed discussion on works made for hire, see

> **WORKS MADE FOR HIRE**

RESEARCH PATH: *Intellectual Property & Technology > Copyright Ownership & Registration > Determining Copyright Ownership > Practice Notes > Works Made For Hire*

For a more detailed discussion on copyright fair use, see

> **CONDUCTING A FAIR USE ANALYSIS**

RESEARCH PATH: *Intellectual Property & Technology > Copyright Ownership & Registration > Exclusive Rights & Limitations > Practice Notes > Limitations*

For a more detailed discussion on music licensing, see

> **MUSIC LAW**

RESEARCH PATH: *Intellectual Property & Technology > Music & Entertainment > Music Law > Practice Notes > Music Law*

Copyright

A copyrightable work is only protected by a copyright for a specific length of time (typically, the life of the author plus 70 years after the author's death). Once that period expires, the work enters the public domain, where it can be used freely without permission. Thus, if your client wants to use an older work, you should first determine whether the copyright is even still in effect.

Right of Publicity

Right of publicity can be limited in certain instances when an individual has no reason to expect privacy or control over his or her image. Most notably, an individual's permission is not required to use his or her name, likeness, or recognizable attributes for news reporting or commentary, or for other informational purposes that do not have a commercial tie-in. Keep in mind, however, that the use of a name and/or likeness for these purposes can give rise to other state law claims, such as defamation or false light claims. Thus, any statements should be true and accurate.

Fair Use

Fair use is a defense to both copyright and trademark claims, and it generally permits the limited use of protected material under certain circumstances.

Copyright

In determining whether a use is fair under the Copyright Act, 17 U.S.C.S. § 107, courts look at the following four factors:

- **The purpose and character of your use.** The more you alter, or transform, the original work, the more likely the use is fair. This factor also takes into consideration whether the use is for a commercial purpose: the less commercial the use, the more likely it is to be fair.
- **The nature of the copyrighted work.** If the work is fact based, like a biography, it is more likely the unauthorized use is fair because dissemination of facts has a public benefit. However, using works of art or fiction are less likely to be deemed a fair use.
- **The amount and substantiality of the portion taken.** The less you use, the more likely the use is fair. However, even use of a small portion may not be considered a fair use if the use is considered the most important element, or the heart, of the work.
- **The effect of the use upon the potential market for the original work.** If your use has a negative impact on the potential market for the original work, such that consumers are less likely to desire the original, it is more likely that the use will not be considered fair. However, if your use will benefit or have no impact upon the market for the original work, this factor will favor a fair use or have a neutral effect on the analysis.

Use of third-party copyrighted works for purposes such as criticism, comment, news reporting, teaching (including multiple copies for classroom use), scholarship, or research may be considered fair use, provided that they satisfy the four-factor test identified above. The Copyright Act also generally exempts from protection reproduction by libraries and archives and public display or performance for educational, religious, or charitable purposes.

Be particularly cautious when conducting a fair use analysis in the commercial context, as what constitutes a fair use or an exception to copyright protection is notoriously difficult to predict.

Trademark: Nominative Fair Use

The nominative fair use defense is a non-statutory doctrine that permits a third party to refer to the trademark owner's goods or services in a non-confusing manner. A use is nominative if it:

- Is necessary to refer to the product or service in question
- Is limited to only as much of the mark as is reasonably necessary to identify the product or service (e.g., using only the word mark, not the entire logo)
- Does not imply any association, sponsorship, or approval by the trademark owner

As a result, the nominative fair use defense is narrow and has limited applicability. A common nominative fair use is identifying a third party's trademark in comparative advertising.

When conducting a nominative fair use analysis, you must ultimately consider whether use of the trademark would cause a likelihood of confusion as to the source, association, sponsorship, or approval. Moreover, even if your client's use qualifies for the fair use defense, an aggressive trademark owner may still attempt to enforce its rights through cease and desist letters, or even a lawsuit.

Trademark: Parody

Use of another's trademark in a parody is protected by the First Amendment. However, the question of whether an unauthorized use is a parody can be subjective. Many of the same factors considered in a copyright fair use analysis (see Copyright above) may be considered for a trademark parody determination, such as whether the unauthorized use is for a commercial or non-commercial purpose. The biggest consideration is whether there is a likelihood of consumer confusion, so it is always relevant to determine whether a parody is an obvious joke.

It should be noted that satire—which comments upon society or a societal issue at large rather than commenting upon a specific person, work, brand, or product—is generally not considered a defense to trademark infringement. Thus, it is important to determine whether the content constitutes an actual parody or is merely satire.

Seek Permission

Once you have determined the proper owner of the protected content and that permission is necessary or preferred, you should approach that person or entity for permission to use the content. It is generally best to keep all communications in writing (including sending a confirmation letter following any oral communications) to avoid any misunderstanding or confusion.

The permission may come in any of the following forms:

- **Exclusive license.** Grants permission to your client, and only your client, to use the content in the way described by the license. Any third party using the same content would be an infringer, as there can only be one licensee.
- **Non-exclusive license.** Grants non-exclusive permission to your client to use the content in the way described by the license. Because the license is not exclusive, several competitors may use the same content without infringing as long as they are authorized licensees.
- **Release.** Typically granted by an individual, who grants permission to use his or her likeness or image.
- **Consent not to sue.** A promise by the rights owner not to sue for your client's use of its content, mark, or other proprietary right. This is often a term within a broader license but can also be framed as a simple agreement without the additional terms and conditions often contained in a more formal license.

Written permission may contain a number of terms, but the primary terms should address:

- **The scope of the use.** How does your client want to use the content? Will your client's use of the content cast any aspersions on the rights owner? How much of the content is your client using? Are there any restrictions?
- **The territory of the use.** Is the use limited to a geographic region, global in scale, or somewhere in between? Rights may be owned by or licensed to various other entities in other countries, and different countries are governed by differing intellectual property laws. Therefore, an authorized use in the United States may be infringing upon the rights of another party if used in a different country, unless all appropriate rights are cleared for each jurisdiction where the content is to be used.
- **The term of the use.** How long does your client require the permission? Is it for a single-time use (for instance, running a photograph in a single issue of a magazine), or a length of indeterminate duration (for instance, putting a photograph on a website)? Make sure to specifically negotiate whether the term of the permission has an end date or a date at which the rights owner can revoke the permission. If there is an end date (such as a one-year grant of permission), negotiate whether the agreement can be renewed for additional terms after the first term ends.
- **Payment.** Is there payment in exchange for the permission to use the content? Is the payment a flat fee or a percentage based on the revenue generated by the use? How often will payments be made?

If permission is ultimately denied, or your client cannot come to an arrangement with the rights holder, your client should walk away from the proposed use. Even if your client would ultimately have a defense to use of the material, use of the material after permission is denied will increase the risk of receiving a cease and desist letter or lawsuit.

Assess Any Public Relations Issues

In addition to the legal hurdles outlined above, your client should also consider public relations ramifications. Even if a proposed use is permissible, your client may become embroiled in a messy legal dispute, and the cost of establishing that right ultimately may be far less than the cost of repairing a tarnished public image from a public fight.

Additionally, sometimes the public response to a person's use of another's content can be negative and can result in the rights-holder rescinding the permission to use the content (unless the permission is irrevocable).

Rights Clearance by Type of Work

As is clear from the above, one piece of content may require rights clearance on multiple levels. The most common types of works requiring clearance include:

- Literary works
- Artwork
- Audiovisual content
- Existing sound recordings
- New musical cover songs
- Public performance of existing music

Below is a list of the unique rights clearance considerations for each type of work.

Literary Works

If you want to use portions of a book, magazine, article, or other literary work, you may need to clear the following:

- The copyright for the literary work itself (primary work), including quotes and excerpts
- The copyright for any third-party material within the portion of the primary work that you seek to use, such as a quote, a photograph, or artwork that is not original to the copyright owner of the literary work
- The copyright for any cover art or illustrations within the primary work if you seek to use the cover of the work or any illustrations within it
- The author's name appearing on the cover of the primary work, to the extent that you seek to use the cover of the work (to address concerns with false association or endorsement)
- The title of the primary work if you seek to use the title and if that title is protected by a trademark (this guideline is more likely to apply if the primary work is a franchise or series)
- The copyright for the work on which the primary work is based, if any (this may apply if the primary work is based on a preexisting work, such as a film or play, and may also apply to instances of "fan fiction" based on a preexisting literary work)

Image by Code2707 / Shutterstock.com

Works of Art

If you want to use portions or the entirety of a work of art (e.g., photographs, drawings, paintings, sculptures), you may need to clear the following:

- The copyright for the primary work
- The copyright for any portion of the primary work containing material that is not original to the primary work's copyright owner, such as third-party artwork, sculptures, text, or photographs included within the primary work
- The copyright for any work on which the primary work was based, if any (this may apply if the primary work is a collage of preexisting works of art, a new version of a single preexisting work of art, or some other type of derivative work)
- The copyright or trademark owner of any identifiable locations, buildings, or monuments depicted in the portion of the primary work to be used
- The trademarks of any words, names, or products (existing or fictional) depicted in the primary work
- Any recognizable person appearing in the work

This applies to traditional works of art as well as works found on the Internet, such as in a Google image search. However, certain online artwork (like clip art or stock photographs) is already cleared for use, though you may still have to pay a small fee. Typically, when artwork is included within a software program that you have already paid for—such as Microsoft

Word—or when you visit a website offering stock photographs for a small fee, these rights have already been cleared for use by third parties.

Audiovisual Content

If you want to use a portion or the entirety of audiovisual content (e.g., movies, television clips, digital videos), then you may need to clear the following:

- The copyright for the audiovisual work itself
- The copyright for the underlying works from which the audiovisual work is made (such as the script or screenplay, or the animations or artwork)
- Any person appearing in the portion of the work you intend to use if you intend to use the work for a commercial purpose and the right of publicity was not waived (for example, people attending a large, ticketed event usually waive their right of publicity when purchasing the ticket)
- Any works of art that appear within the work itself
- Any music used within the overall audiovisual work (both the sound recording and the underlying composition, which may consist of multiple owners and administrators; see Existing Sound Recordings below)
- Any trademarks depicted in the portion of the work you intend to use

Existing Sound Recordings

If you want to use existing, pre-recorded music (a sound recording only, without a visual component), you may need to clear copyright for the following:

- **The sound recording (typically, a record label).** Note that performers usually assign their rights to the record label and usually don't have any rights in the sound recording, unless the specific performance is particularly iconic.
- **The underlying composition.** The underlying composition may consist of multiple owners (different writers may have contributed to the creation of the lyrics, score, and arrangement, all of whom may have partial ownership of the composition and whose rights may be administered by different music publishers). If the sound recording is to be used in an audiovisual work, you must specifically obtain a synchronization license to synchronize the musical composition with visual images.
- **Additional songs sampled in the primary work.** If the work contains a sampled portion of another song, in addition to clearing rights for the primary work (as described above), you may also need to clear rights to the sampled piece, including clearing both the sound recording and the underlying composition of the sampled work (this may involve getting clearances from both the rights owner of the sampled sound recording, as well as the rights owner of the sample's underlying musical composition—sometimes the sample can be simply the musical composition and not the sound recording).

Making an Original Recording of Existing Music (Covers)

If you want to commission or create a new recording of music that was written by someone else (commonly referred to as a cover), you may need to clear the following:

- The copyright in the underlying composition, which may consist of multiple owners (note that under the Copyright Act, 17 U.S.C. § 115, you can get a compulsory license for the musical composition by complying with certain specified requirements and paying a pre-determined license fee mandated by statute, but this compulsory license is not available if the recording is to be used in an audiovisual work)
- All performers of the music (and, if any of the performers are signed to an exclusive recording contract with a record label, then you also need to get a label waiver)

Public Performance of Existing Music

If you engage a band to perform a song at an event, or if you wish to play sound recordings publicly at a physical location or digitally, you will generally need to obtain special licenses from the following parties:

- The applicable performing rights organization (PRO) with whom the songwriter (who may not necessarily be the performer) is affiliated. There are three PROs in the United States (ASCAP, BMI, and SESAC) and they issue public performance licenses. Many venues, event organizers, and media platforms (e.g., broadcast stations) have blanket licenses with each of these PROs that cover the public performance of nearly all recorded songs.
- If a live performance is recorded and the video recording of the performance is played publicly at a later time, you will need to obtain a synchronization license from the applicable owner(s) of the musical composition, and you may also need to obtain a label waiver to the extent the performers are signed to an exclusive recording contract with a record label. L

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RESEARCH PATH: *Intellectual Property & Technology > Advertising & Marketing > Reviewing Copy > Practice Notes > Reviewing Copy*

Rights Clearance Checklist

Conducting Rights Clearance

1. Identify all protectable content in the proposed work

Copyright. Does the content contain original works of authorship? Look for:

- ✓ Literary works (books, articles, software, etc.)
- ✓ Musical works (songs, composition, lyrics, etc.)
- ✓ Sound recordings (recording of a particular performance)
- ✓ Motion pictures or audio visual material (movies, videos, etc.)
- ✓ Works of art (pictures, sculptures, photographs, graphic designs, etc.)
- ✓ Architectural work (building and building design)

Trademark. Does the content contain source identifiers that designate particular products or services? Look for:

- ✓ Words
- ✓ Logos
- ✓ Slogans
- ✓ Names
- ✓ Product designs
- ✓ Product configurations
- ✓ Architectural elements

Right of Publicity. Are there any people or personal, identifiable attributes within the content? Look for any person's:

- ✓ Name
- ✓ Likeness (or imitations)
- ✓ Voice (or imitations)
- ✓ Image (or imitations)
- ✓ Other distinctive attribute (such as gestures or phrases)

2. Determine who owns/controls the rights

- ✓ Assess whether the client owns the material based on the work made for hire doctrine or assignment agreements at the time of employment/engagement
- ✓ Conduct owner searches and review any uploaded assignment documents on the U.S. Patent and Trademark Office and Copyright Office websites
- ✓ Conduct Internet research to identify the owner of unregistered trademark and copyright
- ✓ Determine whether an IP holding company or parent company owns the rights
- ✓ Determine whether a publishing company or record label owns the copyrighted material
- ✓ Consider whether rights of publicity are held by someone other than the individual, such as a talent manager or an estate (usually if the person is deceased)

3. Evaluate whether to seek permission

Public Domain

- ✓ **Copyright.** After the copyright duration has expired (typically the life of the author, plus 70 years after the author's death), the work is in the public domain and free to use.
- ✓ **Right of publicity.** If the use is commercial, permission is likely necessary. However, rights are limited when the individual has no reason to expect privacy or control over his or her image.

Fair Use

- ✓ **Copyright.** Fair use is a statutory defense to infringement, determined by looking at the (1) purpose and character of the use; (2) nature of the copyrighted work; (3) the amount and substantiality of the portion taken; and (iv) the effect of the use on the market for the original work.
- ✓ **Trademark.—Nominative fair use.** A non-statutory doctrine that allows a third party to refer to the trademark owner's goods or services, if (1) the use is necessary to refer to the product or service in question; (2) is limited to only as much of the mark as is reasonably necessary to identify the product or service; and (3) does not imply any association, sponsorship or approval by the trademark owner.
- ✓ **Trademark—Parody.** Use of another's trademark in a parody is protected by the First Amendment.

Obscure the Proposed Use

Where possible, fully obscuring the proposed use, such as blurring a trademark or person's face, may negate the need for permission.

4. Seek permission

- ✓ Try to put all communications with rights owner in writing
- ✓ Negotiate license, release, consent not to sue, or similar agreement
- ✓ Consider contractual terms based on needs of the proposed use including scope, territory, term, and payment

5. Consider public relations and defamation issues

Public Relations

Even if a proposed use is permissible, sometimes potential public relations backlash related to a public fight is not worth the proposed use. Additionally, sometimes the public response to use of another's content can be negative and result in the rights-holder rescinding permission to use the content.

Defamation

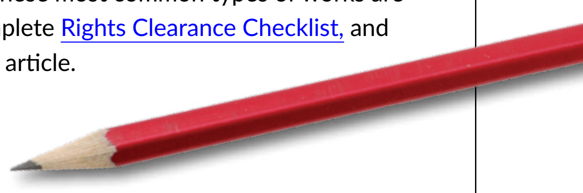
Ensure any statements related to another's name, likeness or recognizable attributes are true and accurate, to avoid state law defamation or false light claims. This is separate from permissibility under right of publicity.

Rights Clearance by Type of Work

The most common types of works requiring clearance include:

- ✓ Literary works
- ✓ Artwork
- ✓ Audiovisual content
- ✓ Existing sound recordings
- ✓ New musical "cover" songs
- ✓ Public performance of existing music

Additional detail and a listing of the unique rights clearance considerations for these most common types of works are included in the complete Rights Clearance Checklist, and also in the previous article.



Checklist Provided by: ***Po Yi,*** *a partner in Venable's Advertising and Marketing practice group.*

RESEARCH PATH: *Intellectual Property & Technology > Advertising & Marketing > Reviewing Copy > Forms > Reviewing Copy*

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Avoid Stretching Your License Beyond Its Legal and Ethical Limits

The practice of law has no universally accepted definition, but the unauthorized practice of law is well-defined in jurisdictions around the country. Most states have an assortment of rules of professional conduct, statutes, and/or court rules that establish the territorial boundaries around unauthorized practice: who can practice, where, when, and how.

THE PURPOSE UNDERLYING THE PROHIBITION AGAINST unauthorized practice is to protect the general public from the unlicensed practice of law by non-lawyer individuals and entities who are untrained and inexperienced to render legal advice or services.

Lawyers who are engaged in private practice or as in-house counsel advising their corporate employers, regardless of organizational size, structure, and practice area, need to be equally aware of the jurisdictional limits and practice restrictions that may apply to them or their organizations. Even corporate entities are not necessarily shielded from the laws on unauthorized practice. For example, New York Judiciary Law section 495(1) proscribes a corporation or voluntary association from, among other things, practicing or appearing as an attorney-at-law for any person in any court; holding itself out to the public as being entitled to practice law or to render legal services or advice; furnishing attorneys or counsel; rendering legal services of any kind in actions or proceedings of any nature or in any other way or manner; or advertising that it maintains a law office for the practice of law or for furnishing legal advice or services. See N.Y. CLS Jud. § 495.

Despite the strict ban on unauthorized practice, over the years, many states have liberalized their practice requirements to allow for multijurisdictional practice, including permitting in-house counsel who are admitted in another U.S. jurisdiction to provide legal services through an office or other systematic and continuous presence to their corporate employer or its organizational affiliates. However, such legal services are generally limited to non-litigation matters unless in-house counsel seeks admission pro hac vice. See American Bar Association (ABA) Model Rules of Professional Conduct, Rule 5.5(d), which many states have adopted either wholesale or in a modified form.

In-house counsel's ability to engage in multijurisdictional practice is recognized under a safe harbor provision of ABA Model Rule 5.5(d), which provides the following:

> A lawyer admitted in another United States jurisdiction or in a foreign jurisdiction, and not disbarred or suspended from practice in any jurisdiction or the equivalent thereof, may provide legal services through an office or other systematic or continuous presence in this jurisdiction that:
>
> (1) are provided to the lawyer's employer or its organizational affiliates; are not services for which the forum requires pro hac vice admission; and, when performed by a foreign lawyer and requires advice on the law of this or another jurisdiction or of the United States, such advice shall

be based upon the advice of a lawyer who is duly licensed and authorized by the jurisdiction to provide such advice.

In addition, Comment [16] to Model Rule 5.5 explains that Model Rule 5.5(d)(1) specifically applies, among other things, to U.S. or foreign in-house corporate lawyers who are employed by a company to provide legal services to it or its organizational affiliates, i.e., entities that control, are controlled by, or are under common control with the employer. Comment [16] provides that the lawyer's ability to represent the corporate employer outside the jurisdiction where the lawyer is licensed generally serves the interests of the corporate employer and does not create an unreasonable risk to it and others because the corporate employer is well situated to assess the lawyer's qualifications and the quality of the lawyer's work. Moreover, Comment [16] notes that to further minimize any risk to the corporate employer, when advising on the domestic law of a U.S. jurisdiction or on the law of the United States, the foreign lawyer authorized to practice under Model Rule 5.5(d)(1) needs to base that advice on the advice of a lawyer licensed and authorized by the jurisdiction to provide it.

However, in-house counsel are not shielded from potential liability involving unauthorized practice simply because they provide legal advice to their corporate employers or their organizational affiliates. Their role as corporate employees, providing both legal and business advice and wearing multiple hats within their organization, can often create complex situations that can possibly lead to unauthorized practice issues. Take for example, in-house counsel's corporate employer or its affiliate, which may have multi-state (and/or overseas) operations, businesses, or offices that give rise to the need for legal services or advice by in-house counsel in jurisdictions where they are not licensed. In-house counsel may be asked to handle transactional matters such as contracts or leases for its corporate employer (or its affiliate) in states where it conducts business with its clients or customers but where in-house counsel may not be admitted. Similarly, in-house counsel might be asked to coordinate or oversee the prosecution or defense of litigation proceedings on behalf of its corporate employer, its affiliate, a related entity, or even a third-party customer, that may be pending in one or more courts around the country (or abroad) where in-house counsel may not be licensed (or admitted pro hac vice), and to manage or direct the legal work of outside counsel who may be hired to appear in court proceedings and to handle the caseload.

It is in the context of litigation that in-house counsel and their corporate employers need to tread very cautiously to avoid the risk of unauthorized practice of law. A recent Florida Supreme Court case, *The Florida Bar re Advisory Opinion-Scharrer*

v. Fundamental Administrative Services, 176 So. 3d 1273, 1275 (Fla. 2015), illustrates how the degree of involvement or control exercised by in-house counsel and their corporate employer over pending litigation in a state where in-house counsel is not licensed can be a critical factor in determining whether their conduct constitutes unauthorized practice of law. The Florida case involved in-house counsel and counsel's corporate employer, who provided administrative support services to their client and served as a "litigation liaison" between the client and the Florida-admitted lawyers hired to represent the client in various wrongful death cases brought against the client in Florida. The client alleged that in-house counsel and counsel's corporate employer were substantially involved in the wrongful death cases by engaging in the following conduct constituting the unauthorized practice of law:

- Providing legal advice, strategy, and services to the third-party client in pending litigation where the corporate employer was not a party
- Hiring, directing, managing, controlling, and supervising Florida lawyers defending the third-party client where the corporate employer was not a party to the litigation
- Preparing pleadings, discovery responses, and other legal documents, making strategic defense strategy decisions on behalf of a third-party client, and construing and interpreting the legal effect of Florida law on behalf of the third-party client

The Florida Supreme Court dealt with the applicability of a proposed Florida Bar Advisory Opinion that analyzed whether a non-lawyer company or its in-house counsel (who is not licensed in Florida) engages in the unauthorized practice of law in Florida when the non-lawyer company and its in-house counsel control, direct, and manage litigation in Florida on behalf of the non-lawyer company's third-party customers, where such control, direction, and management is directed to a member of the Florida Bar who is representing the customer in the litigation. The Florida opinion concluded that while generally such conduct is not the unlicensed practice of law, there are circumstances where the opposite may be true, and the activity of the non-lawyer company or its in-house counsel could constitute unlicensed practice. The opinion cautioned, "the answer would be dependent on the level of involvement of the Florida lawyer versus the level of involvement of the nonlawyer." *Id.* at 1276. Ultimately, however, the Supreme Court of Florida disapproved of the Florida Bar Advisory Opinion for failure to properly address the specific conduct at issue in the case.

Practically speaking, when in-house counsel and their corporate employer become involved in litigation proceedings for the corporation, its affiliate, or on behalf of a client or customer in a jurisdiction where in-house counsel is not licensed but where outside counsel (who is admitted there) is retained, it is vitally important to consider a variety of factors: the actual roles, specific activities, and level of participation, involvement, and control that outside counsel, in-house counsel, and their corporate employer, its affiliate, or other third-parties will have in the matter in order to avoid any risk of violating the laws and rules regarding unauthorized practice of law.

Beyond that, if they venture across jurisdictional lines, they should be aware that each state may have different rules and requirements when it comes to protecting its borders from unauthorized practice by unlicensed and/or out-of-state lawyers. Moreover, most jurisdictions have a complex matrix of ethics rules, statutes, and court rules that would bar crossing state lines without a license to practice. At the same time, it should be noted that many states have adopted some combination of multijurisdictional practice rules allowing temporary practice by out-of-state lawyers, safe harbor provisions for in-house counsel to advise their organizations, and/or in-house counsel registration requirements.

Non-compliance with unauthorized practice laws and rules could potentially lead to dire consequences, not only for in-house counsel but also for the lawyer's corporate employer, its affiliates, or any third-party client or customer involved. Penalties for in-house counsel could range from professional discipline, sanctions by a court, disqualification from representation, fines, and reputational injury. For the corporate employer, ramifications could include criminal or civil penalties, court sanctions, fines, and loss of attorney-client privilege.

Aside from the dangers posed by unauthorized practice in crossing state lines in transactional and other matters, in-house counsel involved in cross-border litigation for their corporate employer or its affiliates need to be vigilant in drawing a very careful line between permitted and prohibited litigation activities in order to avoid endangering their license to practice and exposing their corporate employer to liability. L

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RESEARCH PATH: *Corporate Counsel > Ethics for In-House Counsel > Unauthorized Practice of Law and In-House Registration > Articles*


Jeffrey A. Kern and Brian Goossen AKERMAN

Selecting the Proper **Estate Planning Device**

An estate plan can be described as a process to protect and maximize a person's wealth during their lifetime, arrange for financial management and health care decision-making in the event of disability, and transfer assets to, or ensure their continued preservation for, intended beneficiaries upon death, in an orderly and cost-efficient manner.

ESTATE PLANNING INVOLVES BOTH FINANCIAL PLANNING and the implementation of legal documents (such as wills and trusts) to accomplish the above objectives. While financial planning is equally as important as the legal documents, this article will address only the legal issues. To yield the best results, the estate planning practitioner should adopt a team approach with the client's financial planner, accountant, insurance agent, and other relevant professionals to understand the client's needs and ensure a coordinated effort (e.g., asset ownership and beneficiary designations, tax returns, etc.).

The planner must consider the effect of both state and federal laws. Federal laws primarily govern federal income and transfer tax consequences whereas state laws in the areas of trusts and wills, family law, real property, contracts, and business law control the legal effect of the documents. Each state has its own rules, and state-specific tax considerations may also be warranted. This article focuses on Florida laws, although planners must be familiar with the laws of other states and countries (or consult with planners in those jurisdictions) when working with clients who have assets outside this state.

The general objectives of the estate plan may include any or all of the following:

- Maximizing wealth through prudent investing
- Protecting and managing assets in case of disability

- Protecting assets from the claims of potential creditors
- Avoiding probate
- Minimizing transfer tax, income tax, and expenses of administration
- Encouraging desired actions by beneficiaries
- Protecting beneficiaries from outside influences, including creditors, bad marriages, improvident spending, or inability to manage assets
- Caring for family members with special needs
- Maximizing a person's ability to enjoy assets while receiving governmental assistance
- Optimizing a charitable legacy
- Preserving privacy

WILLS

Legal requirements. Many planners begin the estate planning discussion with a will. While the will is only one of many documents and considerations in an estate plan, it is a logical place to start. Wills dispose of their maker's individually owned assets at death, often through a probate proceeding, and have no effect on assets or property owned in many other forms (e.g., property with a right of survivorship; retirement plans, insurance policies, or annuities; trust assets; life estates; all discussed below) which pass by operation of law or beneficiary designation. If the decedent leaves no valid will, Florida's intestacy statute mandates the order in which relatives take the decedent's estate. See Fla. Stat. §§ 732.101 *et seq.*

Valid wills require a competent testator or testatrix (i.e., the man or woman who makes the will; hereinafter referenced as testator). To be competent, the testator must be of sound mind, meaning that, when the will is made, he or she generally understands: (1) the nature and extent of his or her property; (2) the natural objects of his or her bounty; and (3) the practical effect of the will. See Fla. Stat. § 732.501; see also *In re Wilmott's Estate*, 66 So.2d 465, 467 (Fla. 1953); *Raimi v. Furlong*, 702 So.2d 1273, 1286 (Fla. Dist. Ct. App. 1994).

Wills must be executed in compliance with strict statutory formalities. See Fla. Stat. § 732.502. A will must be signed by the testator or at the testator's direction before at least two witnesses, and the witnesses must affix their signatures in the testator's presence. See *id.* Self-proving provisions, whereby an additional statutory paragraph is separately witnessed and notarized, allow the will to be probated without requiring witnesses to appear to attest to the validity of the will. See Fla. Stat. § 732.503. Because of these formalities, it is unwise to execute a will without an attorney's supervision.

A will may not be procured by fraud, duress, mistake, or undue influence. See Fla. Stat. § 732.5165. If the estate planner has any reason to suspect that the will may come under attack, additional steps may be taken to help secure evidence of the testator's capacity and freedom from influence (e.g., a videotape of the signing, a report from a psychiatrist at or near the time of execution, or a more detailed question and answer procedure at the time of signing).

Generally, a will may be used to disinherit one or more heirs. However, in the absence of a valid marital agreement waiving such right, the testator's spouse may elect against the will to receive 30% of the total estate (including assets passing outside of the will), in addition to homestead, exempt property, and allowances. See Fla. Stat. §§ 732.201 *et seq.*; see also Fla. Stat. § 732.702(1). Florida allows for creation of an elective share trust, which is funded with property that may be counted toward satisfying the elective share and is for the lifetime benefit of the surviving spouse but provides for the deceased spouse's intended beneficiaries to receive the remainder following the second spouse's death. See Fla. Stat. §§ 732.2025(2), 732.2095(2).

The only other form of forced heirship in Florida occurs when the decedent owns a residential homestead (discussed below) and is survived by a spouse or minor child(ren). See Fla. Stat. § 732.4015. In the absence of special planning, the spouse and children receive the homestead. See Fla. Stat. § 732.401.

IF THE ESTATE PLANNER SUSPECTS THAT THE WILL MAY COME UNDER ATTACK . . . STEPS MAY BE TAKEN TO HELP SECURE EVIDENCE OF THE TESTATOR'S CAPACITY AND FREEDOM FROM INFLUENCE.

Disclaimer will. A disclaimer will plan should be considered if a married couple's estate may in the future exceed the estate tax exemption amount. In the most basic scenario, each spouse provides in his or her will that assets pass outright to the surviving spouse; however, the surviving spouse has the option to disclaim some or all of his or her interest, with any disclaimed assets funding a trust that benefits the surviving spouse without causing inclusion in the surviving spouse's estate for federal estate tax purposes. While this plan provides a much desired, flexible wait and see approach, complications may arise if the surviving spouse fails to make a qualified disclaimer after the first spouse passes.

Pour over will. A decedent seldom leaves no assets in his or her individual name. Thus, a revocable trust (discussed below) should always be accompanied by a will that distributes individually owned assets to the revocable trust, where all assets may be distributed under one document. Since this will "pours" any individually owned assets into the revocable trust, it is commonly known as a pour over will.

TRUSTS

A trust is an agreement between a creator (referred to as the settlor or grantor) and a trustee, where the trustee agrees to hold legal title for (and has fiduciary responsibilities to) the beneficiaries. It is not uncommon that two or more of these roles are filled by the same person (i.e., in a revocable living trust, the settlor is often the trustee and beneficiary). In general, trusts are classified as follows:

Living vs. testamentary. A living trust, also known as an inter vivos trust, is created during the settlor's life, while a testamentary trust comes into existence after death through the maker's will or revocable trust. By their very nature, testamentary trusts are always irrevocable since the creator is no longer alive to revoke the trust. In contrast, living trusts may be revocable or irrevocable. Revocable living trusts are created during life, may be revoked or amended, and are commonly used to avoid probate and guardianship proceedings. Irrevocable living trusts cannot be revoked or amended, usually involve gift tax considerations, and are commonly used for estate tax reduction or asset protection against future creditors. In Florida, if a living trust does not provide whether it is revocable or irrevocable, the default rule is that the trust is revocable. See Fla. Stat. § 736.0602(1).

Grantor vs. non-grantor. Income is taxed to the grantor of a grantor trust and to the trust or beneficiaries of a non-grantor trust. Grantor trusts have achieved significant popularity in the last decade as income taxes paid by the grantor reduce the grantor's estate that may later be subject to transfer tax, essentially allowing a "tax-free gift" of the income taxes paid, while also allowing tax-free sales or exchanges between the grantor and the grantor trust. See Rev. Rul. 2004-64, 2004-27 I.R.B.7; Rev. Rul. 85-13, 1985-1 C.B. 184. Whereas revocable trusts are always grantor trusts, irrevocable trusts may be either grantor trusts or non-grantor trusts depending on the particular provisions contained in the trust.

Revocable vs. irrevocable. Revocable trusts may be amended, revoked, or terminated by the grantor, while irrevocable trusts lack these features.

Revocable trusts

Because the Florida probate process tends to be lengthy, costly, and time-consuming, the revocable living trust has emerged as a popular vehicle that substitutes for a will, avoids probate proceedings, and allows for a more efficient and less costly transfer of assets to the decedent's beneficiaries.

In order for the revocable trust to achieve its purpose of probate avoidance, it must be funded. In other words, the grantor's assets must be transferred to the trustee of the trust. Many (actually most) grantors of revocable trusts initially serve as sole trustee or co-trustees; in this situation, the grantor transfers assets to himself or herself as trustee. Revocable trusts require the same formalities discussed on the previous page for wills. See Fla. Stat. §§ 736.0403(2)(b), 736.0601.

While probate avoidance is usually a meritorious objective in estate planning, there are situations where court proceedings are desirable (e.g., to bar creditors' claims after a three-month statutory period instead of the longer two-year period from date of death). See Fla. Stat. §§ 733.2121, 733.710.

Revocable trusts also serve as a vehicle for disability protection in the event of the grantor's incapacity. Without the proper estate planning documents, an incapacitated person's assets must be administered in a guardianship where the assets of the incapacitated person (ward) are subject to court supervision. See Fla. Stat. § 744.101 *et seq*. Like probate, guardianship proceedings are costly and time consuming. However, guardianship can be avoided if the grantor creates a revocable trust that allows a standby trustee to take over if the grantor-trustee is determined to be incapacitated under standards set forth in the trust document. Most often, the trust will require affidavits from two examining physicians certifying that the grantor-trustee is no longer capable of managing his or her financial affairs. To avoid this potential hassle, or if the grantor needs immediate assistance managing trust assets, the grantor might instead designate a third party to serve as sole trustee or co-trustee with the grantor. As the term suggests, the trustee should be a person who is trusted implicitly.

Irrevocable trusts

Notably, revocable trusts enjoy no protection from claims by the grantor's creditors. See Fla. Stat. § 736.0501.

As previously discussed, testamentary trusts are irrevocable, while living trusts may be either revocable or irrevocable and are made irrevocable by so providing in the trust document. See Fla. Stat. § 736.0602(1).

Irrevocable trust assets pass to beneficiaries pursuant to the terms of the trust. Some trusts grant powers of appointment, allowing one or more trust beneficiaries (power holders) to direct appointive property to other beneficiaries of the power holder's choosing, usually by direction in the power holder's will. If the power holder does not exercise the power of appointment, then the appointive property passes to the takers in default under the terms of the trust.

Irrevocable trusts have multiple uses in estate planning. Most often, they are created to make lifetime gifts to third parties such as the grantor's spouse and descendants, thereby removing assets and their future appreciation from the grantor's estate. To the extent that a transfer to an irrevocable trust for the benefit of a third party exceeds the annual gift tax exclusion, it constitutes a taxable gift. While the grantor could retain certain powers to avoid gift tax consequences, doing so would cause inclusion of the assets in the grantor's estate for estate tax purposes. See Treas. Reg. § 25.2511-2(b). One negative aspect of excluding assets from the grantor's estate, however, is that the basis of those assets will not be entitled to a step-up to their fair market value at the grantor's death. See I.R.C. §§ 1014(a), 1015. Rather, gifted assets generally retain their original cost basis. See I.R.C. § 1015. Thus, if assets have appreciated during the grantor's life, it would generally be desirable to secure the stepped-up basis to reduce capital gains on a later sale by the beneficiaries. See I.R.C. § 1014(a).

Less often, for asset protection purposes, a grantor will establish an irrevocable self-settled trust for his or her own benefit with an independent trustee. Self-settled trusts are rare in Florida because it has not adopted legislation protecting these trusts from the grantor's creditors. However, a number of other jurisdictions, including Nevada, Delaware, and Alaska, have adopted legislation that allows grantors to retain discretionary benefits without being subject to future creditors. Indeed, it is likely (though not certain) that these trusts will also avoid inclusion in the grantor's estate. See I.R.S. Priv. Ltr. Rul. 200944002 (July 15, 2009) (holding that assets of a self-settled trust were not includible in the grantor's estate under I.R.C. § 2036 even though the grantor was a discretionary beneficiary of the trust). It is unsettled, though, whether a resident of a jurisdiction that has not adopted these laws may take advantage of another state's favorable legislation simply by creating a trust in that state.

It is well established, however, that irrevocable trusts created in Florida (and most other jurisdictions) for the benefit of third parties can provide maximum protection against the creditors of the grantor and the trust beneficiaries. These so-called spendthrift trusts assist beneficiaries who are poor stewards of wealth, shield beneficiaries from divorcing spouses, and allow beneficiaries with special needs to preserve their eligibility for government benefits. To help ensure asset protection, the trust should provide for an independent trustee, who can make discretionary distributions, in addition to spendthrift provisions, which prevent alienation of a beneficiary's trust interest. Spendthrift trusts are extremely flexible; for example, they may authorize accumulation (i.e., where the trustee has unlimited discretion to accumulate income or distribute it to or for the benefit of the beneficiary) or set forth staged distributions to the beneficiary at stated ages or life events selected by the grantor. If the beneficiary dies prior to full distribution, the trust may grant a power of appointment or designate alternate beneficiaries to receive the trust assets without the need for probate and, in many cases, free of transfer tax. In Florida, trusts can be dynastic, lasting up to 360 years.

Although irrevocable trusts generally cannot be changed, Florida law does provide certain instances where irrevocable trusts can be modified or reformed, usually with the consent of the trustee and beneficiaries or by court order. See Fla. Stat. §§ 736.0410, 736.04113 (authorizing modification of an irrevocable trust if its purposes "have been fulfilled or have become illegal, impossible, wasteful, or impracticable," if compliance "would defeat or substantially impair the accomplishment of a material purpose of the trust" due to "circumstances not anticipated by the settlor" or if a "material purpose of the trust no longer exists"), § 736.04115 (permitting modification without regard to the reasons provided in Fla. Stat. § 736.04113 "if compliance with the terms of a trust is not in the best interests of the beneficiaries"), and § 736.0414 (providing for modification or termination of an uneconomic trust). In certain circumstances, Florida law also allows for decanting, which involves the transfer of the existing trust assets to a new trust with similar or different terms. See Fla. Stat. § 736.04117.

Life insurance trusts. A good measure of estate planning with life insurance involves the implementation of an irrevocable life insurance trust (ILIT), which owns one or more policies insuring the grantor so that the proceeds will be excluded from his or her estate. However, as the transfer tax exemption has increased, the need for life insurance trusts to provide liquidity for the payment of estate tax has significantly diminished. Now ILITs are reserved for families in the highest bracket of wealth.

Special needs and Medicaid planning. Planning for a beneficiary with special needs involves protecting the beneficiary through management of his or her available resources, judiciously distributing assets to the beneficiary or applying them for his or her benefit, and ensuring that government benefits are not jeopardized. Because many governmental benefit programs (most notably Supplemental Security Income and Medicaid) are needs based (i.e., in order to qualify and retain eligibility, recipients must fall below certain income and/or asset levels), special needs trusts must be carefully drafted and administered so as to restrict the trustee to making only discretionary distributions that supplement, not replace, government benefits. In addition, trust distributions should be paid directly to vendors and service providers, not to the impoverished beneficiary.

A special needs trust may be established for the beneficiary with his or her own assets, often received through a lawsuit or settlement. The requirements of this so-called first party special needs trust are more stringent and generally include payback provisions (i.e., after the beneficiary dies, the government is reimbursed for benefits paid). Reimbursement will not be required from a third party special needs trust, which is typically established by one or more family members during their lives or at their deaths for the benefit of the special needs person.

ALTHOUGH IRREVOCABLE TRUSTS GENERALLY CANNOT BE CHANGED, FLORIDA LAW DOES PROVIDE CERTAIN INSTANCES WHERE IRREVOCABLE TRUSTS CAN BE MODIFIED OR REFORMED . . .

In order to qualify for Medicaid benefits based upon a minimum of countable assets, a Florida resident must make transfers at least five years in advance of filing his or her application. A person desiring to establish Medicaid eligibility, whose income exceeds the permissible limit, may establish a Miller trust to receive the excess income, and the government will be entitled to reimbursement after the Medicaid recipient dies.

When it comes to special needs trust and Medicaid planning, it is wise to consult with a specialist, as most traditional estate planners lack any significant knowledge and hands-on experience in this arena.

OTHER FORMS OF ASSET OWNERSHIP

Beyond individual ownership and trusts, there are numerous other ways in which assets may be held that affect the estate plan.

Co-ownership arrangements. Property co-owned by two or more unmarried persons with right of survivorship will pass by survivorship automatically to the surviving joint tenant(s) without the need for probate. If, on the other hand, the asset's title does not indicate a right of survivorship, then the co-owners are tenants in common, meaning that each owner has an undivided percentage share that will pass under his or her will or by intestacy. While survivorship property may offer the advantage of avoiding probate upon the first co-owner's death, the following negative considerations should be carefully weighed: (1) the deceased co-owner cannot control the disposition of his or her interest; (2) the assets are subject to attachment by creditors of the other joint tenants and may be subject to guardianship proceedings in the event of their incapacity; (3) probate will not be avoided in the event of a simultaneous death of all joint tenants; (4) taxable gifts may result from the creation of the joint tenancy if the grantor provides more consideration or owns a larger share; (5) the convenience of this arrangement may be overshadowed by other concerns, for example, where the surviving tenant is legally presumed to inherit the asset but was intended to share proceeds with other beneficiaries, or where the step-up in basis is limited to the decedent's share of the asset; and (6) the permission of other owners may be required to manage assets during the grantor's life (e.g., taking out or refinancing a mortgage on real property).

Joint property owned by married persons involves most of the same issues discussed above; however, unless the recipient spouse is a nonresident alien, the marital deduction avoids any gift tax concerns. In addition, absent evidence to the contrary, joint ownership by spouses is usually classified as tenancy by the entireties. See *First Nat'l Bank of Leesburg v. Hector Supply Co.*, 254 So. 2d 777, 779–781 (Fla. 1971); *Beal Bank v. Almand and Assoc.*, 780 So. 2d 45 (Fla. 2001). This classification, which is unique to married couples, provides asset protection for future claims against either spouse (but not both) during the marriage. See *id.* Accordingly, for clients desiring asset protection, it is best to designate accounts as tenants by the entireties, although (1) such titling will not shield against a joint debt, and (2) asset protection for the debtor spouse ends upon the parties' divorce or the death of the non-debtor spouse. Historically, one negative feature of entireties ownership between spouses has been the inability of the spouses to engage in conventional marital estate planning where a bypass trust is created on the first spouse's death in order to take advantage of each spouse's separate unified estate tax exemption. However, this concern has been largely absolved by the recent enactment of portability, which generally allows the surviving spouse to preserve the deceased spouse's unused exemption amount. See I.R.C. § 2010(c)(2)(B).

Life insurance. Life insurance proceeds pass to the insured's beneficiary under the designation on file with the insurance company and are generally not controlled by the insured's will, unless the insured designated his or her estate as beneficiary or no named beneficiary survives. In most cases, the beneficiary receives the insurance proceeds free of income tax. See I.R.C. § 101(a)(1). The proceeds will be included in the insured's estate for estate tax purposes though, unless the policy was owned by a person or trust other than the insured and the insured retained no incidents of ownership. See I.R.C. § 2042.

As noted above, estate planning with life insurance has traditionally involved the implementation of an irrevocable life insurance trust to own the life insurance policy so that the proceeds would be excluded from the insured's estate. However, with recent increases in the transfer tax exemption, only the wealthiest families will need a life insurance trust to provide liquidity for the payment of estate tax (e.g., avoiding a fire sale of real estate or business). It will be up to the client whether he or she is willing to pay the annual premiums so that assets may pass to future generations free of any transfer tax burden. Generally speaking, lower premiums may be available for married couples who purchase a second-to-die policy.

For more modest estates, life insurance offers a wealth replacement vehicle to support the family in the absence of its breadwinner.

Life insurance can be an excellent tool for those desiring asset protection because both the cash value and death proceeds are exempt from claims of the insured's creditors, unless the insured designates his or her estate as beneficiary, takes out the policy for the benefit of the creditor, or makes a valid assignment to the creditor. See Fla. Stat. §§ 222.13(1), 222.14. If the proceeds are payable to a trust, careful consideration of the trust terms and selection of trustee will protect the spendthrift beneficiary.

A common technique for couples seeking asset protection is for the couple to own their assets as tenancy by entireties, with the low-risk spouse owning a policy payable on his or her death to a spendthrift trust for the high-risk spouse so that if the low-risk spouse dies first and the entireties protection is lost, it will be replaced by a protected trust for the high-risk spouse.

Long-term care insurance. Unlike health insurance, long-term care insurance is designed to help individuals with chronic illnesses, disabilities, or other conditions involving daily suffering over an extended period of time. Long-term care insurance policies typically reimburse the policyholder up to a predetermined amount to assist with daily activities ranging from eating and dressing to providing skilled care by therapists or nurses. Many factors go into determining the best policy, including the client's age, health, and income; policy premiums; policy reimbursement maximums; and the duration over which the policy will continue to reimburse the policyholder.

Annuities. Annuities are contracts (usually with insurance companies, but in rare cases, with private individuals or trusts) to pay funds to current and future beneficiaries either on specified dates or in a lump sum. They may be deferred or payable immediately. As with life insurance, annuity proceeds pass to the beneficiary (assuming the annuity does not terminate on death) under the contract and is not controlled by the owner's will, unless the owner designates his or her estate as beneficiary or no named beneficiary survives. Commercial annuities are generally tax deferred, meaning that they accumulate income but income tax is not due until the proceeds are distributed to the owner or beneficiary. However, this tax-free buildup is not allowed if the annuity is owned by someone other than a natural person (e.g., an irrevocable non-grantor trust. See I.R.C. § 72(u)). Annuities that terminate on death are not includible in the decedent's taxable estate, as there is nothing to pass to beneficiaries.

Like life insurance, annuities enjoy creditor protection and are often purchased for this reason. See Fla. Stat. § 222.14. Private annuities (i.e., annuities paid by individuals or trusts) are also protected. See *In re Mart*, 88 B.R. 436, 438 (Bankr. S.D. Fla. 1988). For this reason, estate planners may use private annuities to solve the dual objectives of asset protection and transfer tax reduction.

Qualified plans and retirement accounts. Many clients have substantial assets in qualified accounts, including retirement plans such as 401(k)s and IRAs. These assets pass to a designated beneficiary and are not controlled by the owner's will unless the owner designates his or her estate as beneficiary or no named beneficiary survives.

Although qualified accounts are tax-deferred, meaning that they are not taxed until they are distributed to the owner or beneficiary, taxes are paid on deposits or conversions to Roth IRAs and Roth 401(k)s. Unless dealing with a Roth, special attention is required when naming beneficiaries since most individuals will prefer to stretch out payments as long as possible to allow income to grow tax-free inside the account. When qualified accounts are payable to trusts, certain rules must be followed to maintain eligibility for the stretch-out. See I.R.C. § 401(a)(9); see also Treas. Reg. 1.401(a)(9)-0 through 1.401(a)(9)-9.

For a client who is charitably inclined, designating a charity as beneficiary of a qualified account is often the best strategy, because qualifying charities are exempt from income tax and will enjoy the full account value. After a charity, from a tax perspective, the account owner's spouse is often the next best choice since a spouse may transfer the account to his or her own IRA in a tax-free rollover, delaying distributions until he or she reaches 70.5 years of age. Ultimately, required minimum distributions are based on the beneficiary's life expectancy, which all other things being equal, may lead the account owner to designate younger beneficiaries. Finally, the account owner may develop a strategy to leave taxable assets to beneficiaries in lower brackets and non-taxable assets to beneficiaries in higher brackets.

As with life insurance and annuities, qualified plans enjoy favorable creditor protection. See Natalie Choate, Life and Death Planning for Retirement Benefits, ch. 3.2.01 (2011); see also Fla. Stat. § 222.21(2)(a). Significantly, while state laws vary on this issue, the Florida legislature recently updated the statute to explicitly provide that inherited IRAs are exempt from claims of creditors of the owner, beneficiary, or participant of the inherited IRA. See *id.*; cf. *Robertson v. Deeb*, 16 So. 3d 936 (Fla. Dist. Ct. App. 2009) (holding that inherited IRAs are not entitled to exempt status or creditor protection).

Beneficiary designations. Beneficiary designations determine who will receive an account or policy benefits after the death of the owner or insured. Care must be taken in order to ensure that a client's beneficiary designation is compatible with the rest of his or her estate plan. For example, if a client wants assets to pass to a child in trust, naming the child as beneficiary will not achieve the client's goals because the asset will pass outright to the child and may require guardianship if the child is a minor.

Multiple-party accounts. A multiple-party account is an account registered at a financial institution in the name of more than one person. See Fla. Stat. § 655.82(1)(e). Typically, these include Totten trusts, pay-on-death accounts, and joint accounts. Multiple-party accounts usually avoid probate since the assets pass to the surviving account holder for Totten trusts and joint accounts or the named beneficiary for pay-on-death accounts. Nevertheless, these accounts are included in the decedent's gross estate. See I.R.C. §§ 2036(a), 2038(a)(1).

Gifts to children under the Florida Uniform Transfers to Minors Act. A custodial account is a common method to transfer assets to a minor child who cannot enter into contracts or otherwise effectively manage an inheritance. The Florida Uniform Transfers to Minors Act (FUTMA) outlines the methods of establishing and administering such an account. See Fla. Stat. § 710.101 *et seq.* A transfer made to a custodial account is irrevocable; the custodian has all the rights, powers, duties, and authority to deal with the property for the benefit of the minor in whom the property is indefeasibly vested. See Fla. Stat. § 710.113(2). The accounts are usually titled as "[custodian's name] as custodian for [minor child's name] under the Florida Uniform Transfers to Minors Act." Fla. Stat. § 710.104(1). Under the FUTMA, a minor is defined as an individual who has not attained the age of 21 years. See Fla. Stat. § 710.102(12).

Pay-on-death accounts. Pay-on-death bank and brokerage accounts enjoy similar treatment to joint accounts with right of survivorship, discussed above, since they pass outside of probate to the named beneficiary. See Fla. Stat. § 655.82(3)(a). The major difference is that the beneficiary has no rights in the account until the grantor's death, and until such time, the account is completely controlled (and revocable) by the grantor. For this reason, pay-on-death accounts are often referred to as Totten trusts or poor man's trusts. They provide an easy method of passing accounts on the grantor's death if the grantor is comfortable with the assets passing outright to the named beneficiary, if he or she survives, and is not concerned with the assets being in the grantor's probate estate should the beneficiary predecease the grantor. See Fla. Stat. § 655.82(3)(b).

Life estates. Life estates are relatively rare in estate planning. They involve ownership of an asset for life (usually the life of the beneficiary), followed by an automatic transfer to one or more remaindermen upon the death of the life tenant (or third party, in a life estate per autre vie).

If a grantor transfers an asset but retains a life interest, he or she has made a gift equal to the actuarial value of the interest transferred to the remaindermen, which is influenced by the grantor's remaining life. See Treas. Reg. §§ 25.2512-5(d)(2)(ii), 25.7520-1(c)(2).

While life estates avoid probate on the grantor's death, they are inflexible arrangements, whereby the relative rights and obligations between the life tenant and remaindermen are governed by state common law. Once a life estate is created, disposition of the asset generally requires the consent of both the life tenant and the remaindermen. However, Ladybird deeds (named after Lyndon Johnson, the former president, who reportedly implemented this arrangement for his wife, Ladybird) allow for the sale or disposition by the life tenant without joinder of the remaindermen.

The circumstances under which a life estate might appeal to a client will almost always indicate the desirability of creating a trust. A trust will satisfy the purposes of a life estate while providing greater flexibility in the use of the subject property. A trust can provide for contingencies, such as the life tenant's illness, the circumstances under which a family residence can be sold, what use can be made of the sale proceeds, and whether the proceeds can be reinvested in another residence. Even if the trust does not provide for a particular contingency, it will be easier to invoke the court's aid in fashioning an appropriate response when the property is held in trust rather than in a life estate.

Family entities. There are many reasons why families often use limited partnerships, corporations, and/or LLCs to hold and manage their assets.

First, the segregation of a business or commercial real estate in a family entity should shield the family members' personal assets from the claims of creditors who are allegedly harmed by the family asset, provided that the family complies with legal formalities and the entity is respected in its dealings with the public. This is known as firewall protection because it insulates creditor claims from spilling over to other family assets. In addition, partnerships and LLCs with more than one member limit creditors of the entity to a charging order, which protects the entity owners from foreclosure of business assets and restricts the creditor to receiving distributions as they may otherwise be made by the general partner or the manager. See Fla. Stat. §§ 620.8504, 605.0503.

Second, family entities have historically been utilized to reduce transfer taxes on the theory that ownership of the entity cannot be readily traded on an established market, nor can a minority owner control the entity; therefore, the owner is entitled to valuation discounts. See Rev. Rul. 93-12, 1993-1 C.B. 202. The IRS has challenged these discounts in the past and is now reportedly formulating rules to limit this advantage to taxpayers.

Other advantages of family entities include (1) allowing the grantor to transfer benefits to other family members while retaining control over business decisions, investments, and distributions; (2) pooling multiple family members' investments to obtain the investment advantages available to larger households; (3) involving all family members in the decision-making process for family investments; (4) safeguarding beneficiaries from improvident use of the family assets; and (5) consolidating assets into one entity for ease of transfer.

Lifetime gifts. Gifts to family members have historically served an important role in estate planning. Aside from transfer tax considerations, clients may wish to give gifts for one or more of the following reasons:

- To shift income tax to family members in lower tax brackets
- To permanently set aside funds for family members for important events, including college education, marriage, birth of a child, or starting a business
- To shield the gifted amounts from creditors
- To assist a family member in financial need
- To avoid challenges to a will or trust
- To currently satisfy charitable goals

When counseling a client about lifetime gifts, the estate planner must caution him or her that gifts of appreciated assets will be denied the step-up in basis that would otherwise be available if assets were inherited, rather than gifted.

Durable powers of attorney for property management. The Florida durable power of attorney is an alternative to the revocable trust for dealing with incapacity and avoiding guardianship. These powers, which must be immediately exercisable if executed on or after October 1, 2011, survive the incapacity of the person giving the power (the principal) and allow the named agent to deal with the assets of the principal. See Fla. Stat. § 709.2101 *et seq.* Even when a client has a revocable trust, this will not obviate the need for a power of attorney since the revocable trust applies only to assets titled in the name of the trust. Trustees have no authority over ministerial acts like signing tax returns, applying for government benefits, or representing the principal in litigation.

Since durable powers of attorney that appoint an agent other than the principal's parent, spouse, child, or grandchild are ineffective once incapacity proceedings have been commenced by a court (see Fla. Stat. § 709.2109(3)), some practitioners recommend executing a declaration of preneed guardian to guide the court in appointing a guardian. See Fla. Stat. § 744.3045(1). Unless the preneed guardian is found to be disqualified under the law, a rebuttable presumption arises that the preneed guardian is entitled to serve as guardian, and he or she will assume the duties of guardian immediately upon an adjudication of incapacity. See Fla. Stat. §§ 744.3045(4), 744.3045(5).

Living wills / designations of health care surrogate. A complete estate plan should contain a health care advanced directive, including designation of a health care surrogate who is authorized to make medical decisions if the principal loses capacity, thus avoiding the need for a guardianship of the person. See Fla. Stat. §§ 765.101(1), 765.201 *et seq.* Additionally, a living will should be prepared to express the principal's instructions concerning life-prolonging procedures. See Fla. Stat. §§ 765.101(13), 765.301 *et seq.*

Disclaimers. A disclaimer is a beneficiary's "refusal to accept an interest in or power over property." Fla. Stat. § 739.102(5). Disclaimers can provide an effective means of sidestepping an inheritance in favor of an alternate beneficiary with a greater need, a smaller estate, a lower tax bracket, or an estate that is less prone to creditor claims. To ensure that this strategy is effective, care must be taken to execute a qualified disclaimer in the manner required by federal and state law. See I.R.C. § 2518; Fla. Stat. §§ 739.101 *et seq.*

Homestead. Florida makes special provisions for homestead (i.e., the owner's principal residence). These provisions limit the right to dispose of the residence by will or lifetime transfer under certain conditions, allow certain exemptions from real estate taxes, and provide asset protection against claims. See Fla. Const. Art. X, § 4(c); Fla. Stat. §§ 196.031, 193.155, 732.226.

In general, the homestead is not subject to disposition in the owner's will if he or she is survived by a spouse or minor child(ren), absent a valid spousal waiver if there is no minor child. See Fla. Stat. § 732.4015. Rather, the principal residence passes to the spouse outright if there are no descendants; to the spouse for life, with a vested remainder in the descendants per stirpes, unless the spouse elects to take a 50% undivided interest in the residence; or to the children per stirpes if there is no spouse. See Fla. Stat. § 732.401. Notwithstanding the foregoing, this statute does not apply to property owned by the entireties or as joint tenants with right of survivorship. See Fla. Stat. § 732.401(5).

A lifetime transfer of the homestead requires the spouse's signature on the deed. See Fla. Const. Art. X, § 4(c).

Real estate tax exemptions available to the homestead include an exemption from a small portion of real estate tax and a limitation on increases in real estate taxes in any given year. See Fla. Stat. §§ 196.031(1), 193.155.

Significantly, the homestead is not subject to attachment during the lifetime of the owner or the owner's qualified heirs (based on closeness of family relationship) who inherit the homestead. See Fla. Const. Art. X, § 4(a)–(b).

Failure to understand these rules presents a trap for the unwary.

Considerations Regarding Assets in Other Jurisdictions

As a general rule, the estate planner should confine his or her practice to residents of the jurisdiction in which he or she is licensed. State laws governing the disposition of a person's assets are in large part based on residency. Accordingly, Florida laws governing wills and probate, as well as trusts and other entities, apply to Florida residents. For Florida residents who own assets in other jurisdictions, Florida laws generally apply to intangible assets (i.e., stocks, bonds, and closely held business interests), whereas the laws of those other jurisdictions will generally govern real property and tangible personal property situated therein. Similarly, in a probate proceeding, jurisdiction is based upon the decedent's residence (domiciliary probate), but the disposition of property located in other jurisdictions is granted based upon an ancillary probate that incorporates and is governed by the terms of the decedent's will or intestacy statutes. Since residency is not always clear, the estate planner should gather the necessary facts to make this determination at the beginning of the engagement.

The practitioner should be certain to review assets located in other jurisdictions and ensure that they are integrated with the client's overall estate plan. Whereas the majority of states, including Florida, have adopted a common law property regime, a significant minority of other jurisdictions are community property states where spouses share equally in all assets acquired during their marriage. Community property assets generally do not change their character simply because the clients now reside in Florida. In some cases, it may be beneficial for the property to retain its character as community property. In other cases, it may be best to transmute the community property to non-community property.

Assets owned outside of the United States also warrant consideration. As each foreign jurisdiction has different rules, it is recommended that the client consult with local counsel in the jurisdiction where the assets are located.

Conclusion

Estate planning requires a broad knowledge of wills, trusts, probate, taxes, property laws, marital laws, and laws relating to family-held businesses. No good estate plan is complete unless and until it is properly implemented. This will require careful coordination of the client's assets and solid communication with the client's team of professional advisors to ensure that the client's wishes will be carried out.

For additional coverage of Florida estate planning, please review the complete topic in the new Lexis Practice Advisor Florida Business & Commercial module, available later in June.

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RESEARCH PATH: ***Florida Business & Commercial > Estate Planning > Selecting the Proper Estate Planning Device > Practice Notes***

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United Nations Global Compact Business for the Rule of Law Framework

THE RULE OF LAW BRINGS UP significant issues for the corporate world when considering investment in other countries: political stability, independence of the judiciary, the increased risk for the company's profile, the need for greater due diligence, land rights, and worker concerns, to name a few. Where there is not a strong adherence to the rule of law, growth is weak and investment is difficult.

Last year, as part of the Business for the Rule of Law (B4ROL) initiative highlighting the foundational and mutually beneficial relationship between advancing the rule of law and sustainable development, the United Nations Global Compact launched the B4ROL Framework. This represented a pivotal moment in raising awareness of the importance of the rule of law and the role the legal profession, and General Counsel in particular, can play in advancing corporate sustainability among the global business community.

The Framework offers a guide for businesses around the world. It advocates proactive, voluntary actions to support the rule of law in everyday operations and relationships. LexisNexis was a critical source of inspiration for the B4ROL initiative, which was introduced in September 2013 by United Nations Secretary-General, Ban Ki-moon.

"Rule of law" can mean different things to people with differing histories and legal systems. However, some guiding principles include the following:

- All are equal under the law. The law applies to everyone in the same way no matter who you are.
- The law should be administered by an impartial judiciary.
- The law should be properly published and accessible; without knowing what the law is, you can't demand its protection.
- There should be provision for reasonable access to remedy; not having a remedy for your grievance means the law can be ignored.

Advancing equality and accountability under the law, transparency of laws, access to laws, including those that protect fundamental human rights, as well as many other critical aspects of the rule of law not only benefit the greater good, but are also imperative to protecting and supporting the goals of global business.

Studies show a direct connection with GDP, the economic growth of a country, and the rule of law. While lawyers can and should lead this effort, we also need to engage one of the biggest sectors of society that can make an immediate and significant difference—the business community.

Globally, too many people remain without the protection of the rule of law. They cannot progress, they cannot get fairness, they cannot achieve their potential, and they cannot get protection from abuse.

As a company whose purpose and values are rooted in the rule of law, LexisNexis is proud to partner with the United Nations Global Compact and our customers spearheading these efforts.

For more information on the B4ROL Framework, visit http://www.globalcompact.org/library/1341.

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