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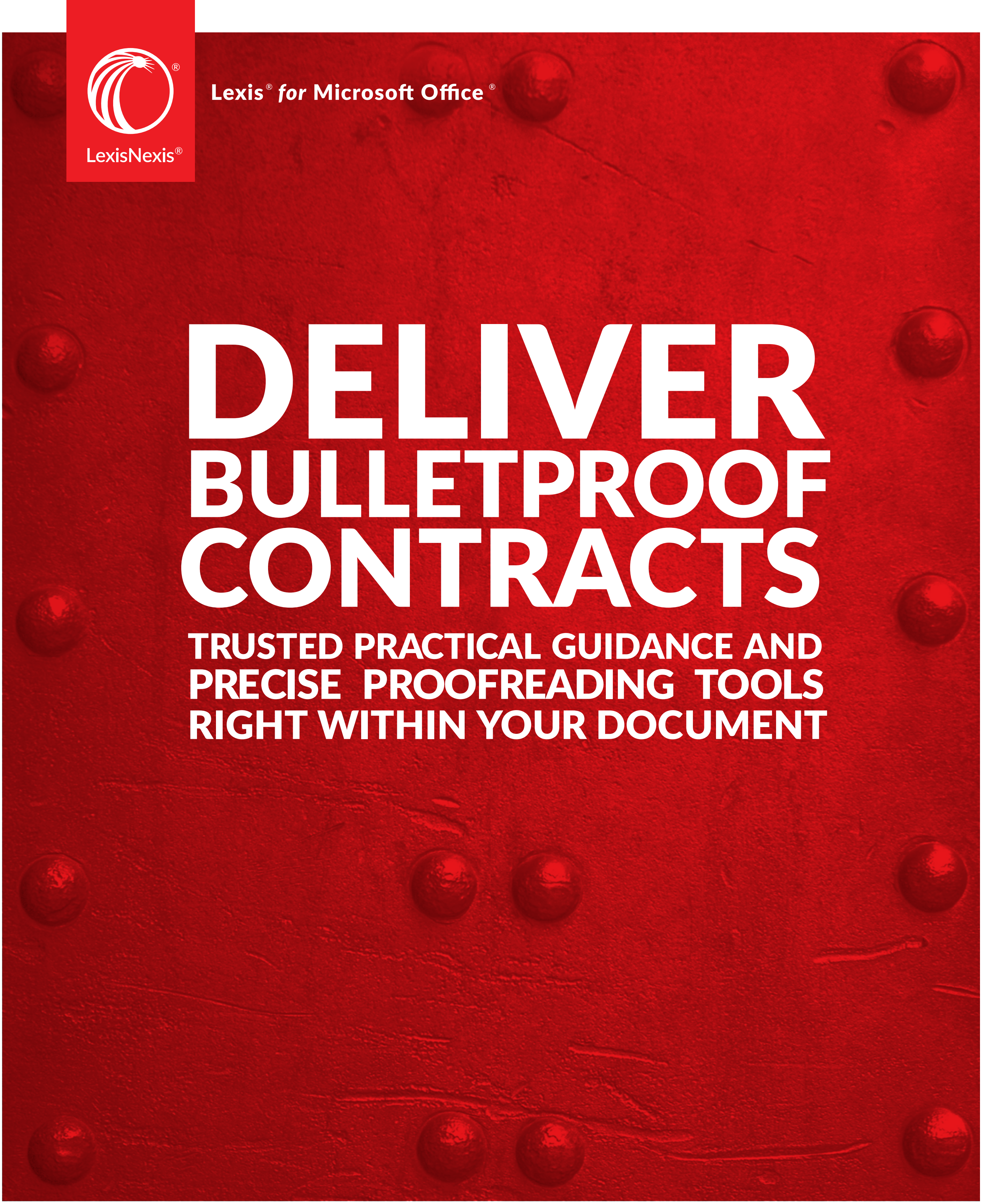

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Eric Bourget, Editor-in-Chief

WHEN WE LAUNCHED THE LEXIS Practice Advisor Journal™ this past December we set out to release a publication that supplements Lexis Practice Advisor®, our online practical guidance offering. All of the various articles, practice notes, practice trends, practice pointers, practice projections, model forms, checklists, and flow charts you see within the Journal can also be found within Lexis® Practice Advisor.

Not only does the Lexis Practice Advisor Journal supplement our online product but it interacts with it as well. Your digital copy of the Lexis Practice Advisor Journal is interactive in that research paths with URLs are provided at the end of each article, which pull you directly to the content as it appears within our online product. In addition, URLs that lead you to related practical guidance, forms, and checklists within Lexis Practice Advisor® are included within articles. Using the digital version of this Journal should optimize your experience using Lexis Practice Advisor®; however, the print version is also ideal for taking with you on the go. If you have only received a print version and would like a digital copy, or if you would like a print version and currently subscribe to Lexis Practice Advisor®, please visit our website here (www.lexisnexis.com/practice-advisor-journal-form) and request the same.

Our cover story in this issue examines the U.S. Equal Employment Opportunity Commission's Final Rules, which provide guidance on how wellness programs should be fashioned to comply with the requirements of both the Americans with Disabilities Act (ADA) and the Genetic Information Nondiscrimination Act (GINA) and still be consistent with the provisions governing wellness programs in the Health Insurance Portability and Accountability Act of 1996 (HIPAA), as amended by the Affordable Care Act (ACA). This comes at a time when many employers provide new plan offerings and employees are required to make a decision about health and wellness plans for the following year. In addition, we provide practice trends on the newly enacted Defend Trade Secrets Act, designed to help companies protect trade secrets. Further, we provide guidance on avoiding contract drafting landmines in your practice as well as practice pointers on Cloud-Based Outsourcing with an outsourcing checklist. As always, we provide relevant articles that will bring you up to speed on current issues and trends and that will undoubtedly serve as entry points into deeper analytical research.

Our mission

The Lexis Practice Advisor Journal™ is designed to help attorneys always start on point. This supplement to our online practical guidance resource, Lexis Practice Advisor®, brings you a sophisticated collection of practice insights, trends, and forward-thinking articles. Grounded in the real-world experience of our 400+ seasoned attorney authors, the Lexis Practice Advisor Journal offers fresh, contemporary perspectives and compelling insights on matters impacting your practice.

STUDY ON INJECTION WELL INDUCED EARTHQUAKES

THE U.S. GEOLOGICAL SURVEY (USGS) RECENTLY released its short-term forecast for seismic activity. For the first time, it includes a discussion of "Induced Earthquakes." The study, which comes after a significant hike in the incidence of earthquakes in the United States, reports that the states facing the highest risk from human-induced earthquakes are, in order, Oklahoma, Kansas, Texas, Colorado, New Mexico, and Arkansas, with the largest populations at risk located in Oklahoma and Texas. The USGS concluded that wells with higher rates of injection are more likely to be associated with induced seismic activity. The full report is available at http://pubs.usgs.gov/of/2016/1035/ofr20161035ver1_1.pdf.

Pratt's Energy Law Report, Volume 16, Number 6.

COMMUNITY REINVESTMENT ACT GUIDANCE

THE FEDERAL BANK REGULATORY AGENCIES PUBLISHED final revisions to their "Interagency Questions and Answers Regarding Community Reinvestment."

The new and revised guidance addresses questions raised by bankers, community organizations, and others regarding the agencies' Community Reinvestment Act (CRA) regulations in the following areas:

- Availability and effectiveness of retail banking services
- Innovative or flexible lending practices
- Community development-related issues, including (i) economic development, (ii) community development loans and activities that revitalize or stabilize underserved nonmetropolitan middle-income geographies, and (iii) community development services
- Responsiveness and innovativeness of an institution's loans, qualified investments, and community development services

Complete details are available at https://www.ffiec.gov/cra/qnadoc.htm.

The agencies last published the Q&As in full on March 11, 2010. In 2013, the agencies adopted revised guidance on community development topics that amended and superseded five Q&As and added two new Q&As. The new 2016 Q&As, which are based on a 2014 proposal, clarify nine of the ten proposed Q&As, revise four existing Q&As for consistency, and adopt two new Q&As.

Pratt's Bank Law & Regulatory Report, Volume 50, No. 8.

RECAP OF CHANGES TO THE FAIR LABOR STANDARDS ACT WHITE COLLAR EXEMPTION REGULATIONS

HERE ARE THE KEY CHANGES TO THE federal exemption rules scheduled to take effect on December 1, 2016:[1]

- **Salary threshold.** The salary threshold (minimum salary) will increase from its current level of $455 per week ($23,660 per year) to $913 per week ($47,476 per year).[2]
- **Bonuses and commissions.** Employers can count bonuses and commissions to satisfy up to 10% of the salary threshold, provided they are paid at least quarterly.[3]
- **Automatic updates to salary threshold.** The salary threshold will be adjusted every three years to maintain it at the 40th percentile of full-time salaried workers in the lowest income Census region of the country.[4]
- **Highly compensated employee threshold.** This annual salary threshold will increase from $100,000 to $134,004.[5]

Tips for Employers When Reclassifying Employees to Nonexempt (Hourly) Status

- **Identify affected employees.** Any exempt employee who currently earns a salary less than the new threshold of $47,476 per year must either have a salary increase to the new threshold or be reclassified to nonexempt status. Any employer who is currently considering using commissions and/or bonuses to partially satisfy the new salary threshold should carefully think through how it would work. Keep in mind that commissions/bonuses used to satisfy the salary threshold must be paid at least quarterly or the exemption will be invalid, which will require the employer to go back and pay the employee any overtime the employee worked during the period the salary threshold was not satisfied. This, of course, will require the employer to track the employee's work time. For these reasons, use of commissions and bonuses to satisfy the salary threshold may be impractical.
- **Choose an effective date.** The new regulations take effect December 1, 2016, which falls on a Thursday. But most pay periods run Sunday through Saturday, Monday through Sunday, or the like. As a result, implementing a reclassification on December 1 may be impractical for most employers. An effective date earlier than December 1 may be necessary.
- **Set hourly rates (do the math).** Many payroll systems can automatically convert an annual salary to an hourly pay rate by dividing the salary by 2080, based on the following formula: 40 hrs/wk x 52 wks/yr = 2080 hrs/yr. But this formula assumes no overtime. Before setting hourly pay rates, employers should carefully estimate the amount of overtime they expect employees to work and plan accordingly (do the math).
- **Anticipate morale / status issues.** Many employees who are reclassified to hourly/nonexempt status will consider it a demotion. A communication/messaging plan is therefore important. In addition, some employers make certain benefits available only to salaried, but not hourly, employees. A review of benefit plans may therefore be necessary. Some employers have addressed this issue by creating a class of employees with names such as "Nonexempt Professionals" or "Overtime Eligible Professionals." Employees with these classifications are nonexempt but nevertheless receive the same benefits as exempt employees.

- **Training.** Many exempt employees have never punched a clock or otherwise recorded their work time. Many managers have never supervised nonexempt employees. They will need to be trained on timekeeping procedures and other policies and practices that apply to nonexempt employees, including meal periods and rest breaks.

Excerpt from article by Aaron Buckley, Bender's California Labor & Employment Bulletin, Volume 16, Issue 8.

1. Defining and Delimiting the Exemptions for Executive, Administrative, Professional, Outside Sales and Computer Employees, 81 Fed. Reg. 32,391, 32,399. 2. *Id.* at 32,405. 3. *Id.* at 32,425. 4. *Id.* at 32,430. 5. *Id.* at 32,429.

PRACTICE NEWS

IRS PROVIDES GUIDANCE ON AWARDS OF ADMINISTRATIVE COSTS AND ATTORNEY'S FEES

THE IRS HAS PROVIDED GUIDANCE ON THE RECOVERY of administrative and litigation costs in connection with the determination, collection, or refund of any tax, interest, or penalty by individuals and organizations that provide pro bono representation to taxpayers. The revenue procedure supplements concurrently issued final regulations, T.D. 9756. Specifically, Revenue Procedure 2016-17 provides detailed information and processes regarding pro bono representation.

To recover fees in a pro bono case, the representative must maintain contemporaneous activity records of all time spent on the case for which fees are being claimed. The IRS's denial of an award of fees, in whole or in part, may be challenged in the Tax Court under I.R.C. § 7430(f). The hourly rate used to calculate an attorney fee award for pro bono representatives who charge hourly rates in their ordinary course of business will generally be limited to the lesser of the statutory hourly rate set forth in I.R.C. § 7430(c)(1)(B)(iii) or their hourly billing rate, unless they can establish that a special factor, as set forth in I.R.C. § 7430(c)(1)(B)(iii), applies.

A fixed rate is given for individuals who provide pro bono representation but do not charge an hourly rate for representing taxpayers equal to the statutory hourly rate under I.R.C. § 7430(c)(1)(B)(iii). If an award based on a higher hourly rate is sought, the burden will be on the requester to establish that a higher hourly rate is appropriate. Reasonable fees may be recovered for work performed by students who have been authorized to practice before the IRS or Tax Court under the supervision of a practitioner through the clinical, student practice, and calendar call program, and by paralegals or other persons qualified to perform paralegal work who are assisting pro bono representatives. Fees for time claimed for other volunteers (such as students or professionals who have not been authorized to practice before the IRS or Tax Court or paralegal students) working at a pro bono clinic or organization may be recoverable case by case.

To be eligible for an award of attorney's fees, taxpayers represented by a pro bono representative must meet all applicable requirements of I.R.C. § 7430. A fee awarded under I.R.C. § 7430(c)(3)(B) will generally be paid to the pro bono representative unless the IRS is specifically instructed by the representative in writing to pay the fee to the representative's employer, such as a law firm.

Lexis Federal Tax Journal Quarterly, June 2016.

CONSUMER FINANCIAL PROTECTION BUREAU STUDENT LOAN "PAYBACK PLAYBOOK" TO PROVIDE PERSONALIZED INFO

THE CONSUMER FINANCIAL Protection Bureau (CFPB) recently unveiled its student loan Payback Playbook. The set of prototype disclosures provides borrowers with personalized information about their repayment options from loan servicers so they can secure a monthly payment they can afford.

"Millions of consumers needlessly fall behind on their student loan debt, despite their right under federal law to a payment they can afford," said CFPB Director Richard Cordray. "The Payback Playbook . . . is designed to help ensure student loan servicers provide personalized information, tailored to the borrower's individual situation. This will help these borrowers take action, stay on track, and steer clear of financial distress."

According to the CFPB, about 43 million Americans owe student loan debt, with outstanding debt estimated at $1.3 trillion. One out of four student loan borrowers is currently in default or scrambling to stay current on student loans, despite the availability of income-driven repayment options for the vast majority of borrowers. Also, 70% of federal Direct Loan borrowers in default earned incomes low enough to qualify for reduced monthly payment under an income-driven repayment plan.

The Payback Playbook would require servicers to provide personalized information tailored to borrowers' specific circumstances that show what their payments will be under different repayment plans. This information would include the number of payments over the life of the loan, monthly payment amounts, and whether payments will change over time.

The Payback Playbook would also provide borrowers with updated information when their plans or circumstances change so they can keep on top of their payments. This information would include how much longer they need to make payments until their loan is paid off or forgiven.

In a related action, the Bureau also released a new action guide to help military borrowers navigate their student loan repayment options and take advantage of special consumer protections designed to help men and women in uniform manage their debt while serving our country.

Pratt's Bank Law & Regulatory Report, Volume 50, No. 6.

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Timothy Murray MURRAY, HOGUE & LANNIS

CONTRACT DRAFTING **LANDMINES**

There are innumerable articles, books, and seminars that offer guidance on contract drafting style. Among many other things, they typically counsel drafters to avoid legalese, redundancy, inconsistency, and ambiguity—all important suggestions.

CLARITY, FOR EXAMPLE, IS PARAMOUNT. I CAN'T EVER recall hearing a judge complain that a contract was "too clear" for him or her. And no attorney wants a court to say about his or her contract what the Second Circuit recently said about a contractual provision central to a dispute: "[W]e have no idea what it meant."[1]

But there's another kind of problem associated with drafting that can't be cured by a style manual and that is largely ignored in the discourse about writing better contracts: we can't write effective contracts without a healthy respect for the daunting complexities of contract law.

Judicial decisions are replete with holdings that the contract at issue wasn't worded correctly to achieve its intended effect. Like it or not, there are rules of substantive contract law that govern the way certain contractual provisions have to be written—rules that vary from jurisdiction to jurisdiction, that often aren't as well known as they should be, and that sometimes violate the style mavens' sacred tenets. The sheer number of reported decisions where contracts weren't worded correctly suggests an unacceptable indifference to the substantive law of contracts among too much of the practicing bar.

Taking the time to consult the case law as we draft is a prudent investment for the client—most lawsuits involving contracts can be won, or better yet, averted, in the drafting stage.

The following are some of the drafting landmines associated with common contractual provisions that every lawyer who deals with contracts ought to know about. Many of these vary from jurisdiction to jurisdiction, of course, and this guide is only intended as a start.

Naming the Parties

Sometimes contracts define an entity by tacking on words to this effect: ". . . including its subsidiaries, divisions, parent, and affiliates." Broadly defining a business entity party can be problematic. It is well known that a division has no legal identity separate from the corporation in which it is integrated and that subsidiaries and parents are separate legal entities—purporting to contract on behalf of another legal entity poses a host of well-known problems.

A common problem that may not be as well known is the use of the word "affiliates." This word pops up routinely in contracts, but there is no universally accepted definition for it. Absent a definition for it in the contract, the word has been held to be ambiguous.[2]

DRAFTING TIP:
Either don't use the word "affiliates," or define it in the contract.

Recitals

Contracts frequently include recitals, sometimes called preambles or whereas clauses. Recitals can be useful to spell out the contract's purpose or to provide context or tell the back story for the transaction. They can be particularly helpful to explain how the contract fits with other transactions between the parties—for example, whether the latest contract is a substitute agreement or a modification of an earlier one.

Courts generally afford recitals less contractual significance than the so-called operative terms of the contract, and this sometimes poses significant problems. Many courts hold that the operative provisions trump the recitals in the event of a conflict. Some courts go so far as to say that recitals are not even part of the contract.[3] The case law counsels against including matters of substance in recitals.

DRAFTING TIP:
To avoid disputes about recitals, incorporate them into the operative terms of the contact with a specific provision.[4] For example: "The above recitals are made a part of this Agreement."

Effective Date

A written contract is typically formed at the time it is executed (that is, when all the parties have adopted it—usually, but not always, by signing). Often, in the contract's introductory paragraph, a specific effective date is stated. If that date is not tied to the date the last party signed the contract, and if there is a discrepancy between the effective date written in the introductory paragraph of the contract and the date of actual execution (that is, the date of the last signature to the agreement), courts are permitted to ignore the effective date written in the introductory clause to discover the real date of execution.[5]

When would a court need to do this? When one party seeks to introduce evidence of a purported oral agreement that would vary the written contract. The parol evidence rule bars the admission of pre-execution, but not post-execution, communications that contradict or add to the terms of the agreement. If, for example, an alleged oral agreement was made after the effective date written in the introductory paragraph of the contract but before the date of actual execution (usually signing) of the contract, such oral agreement would be a preformation understanding barred by the parol evidence rule. As one court stated: "Massachusetts case law consistently refers to the execution of a written agreement, and not to its effective date, as the event that triggers application of the parol evidence rule."[6]

DRAFTING TIP:
Have the parties date their signatures at the end of the contract. Define the effective date in the introductory paragraph by stating: "The contract will be effective as of the date the last party signs it."

Time is of the Essence

Clients often don't understand that even when the contract spells out specific dates for performance, a late performance typically (though not always) is an immaterial breach that will not discharge the non-breaching party's obligations nor entitle it to more than nominal damages.[7]

Can the parties turn late performance into material breaches?

Including the words "time is of the essence" in connection with a date for performance is often regarded as an effective means to signal that if a performance is late, it is a material breach.[8] Even without using those magic words, sometimes the facts compel the conclusion that time is of the essence.

A drafting landmine arises when "time is of the essence" is either overused or misused. A generalized time is of the essence clause that purports to make every contractual obligation of the essence, especially if such clause appears in a standardized, preprinted form, may be ignored by the courts. Further, some jurisdictions do not give conclusive effect to time is of the essence provisions. In one case, Kodak was late delivering machinery to DuPont, and DuPont relied on the contract's time is of the essence clause to terminate the contract. The court held that such termination was, itself, a breach because in Illinois, time is of the essence clauses are not determinative of materiality, and a jury ultimately determined that DuPont had no right to terminate the contract.[9]

DRAFTING TIP:
Use "time is of the essence" sparingly—only when time really is of the essence, and spell out the reasons why timely performance is critical. Don't use generalized time is of the essence clauses intended to apply to every obligation in the contract. Put the magic words in the same paragraph as the specific obligation it references. Finally, before treating your client's duties under the contract as discharged because the other party was late and the contract had a time is of the essence clause, consult the law of the pertinent jurisdiction to ascertain if it treats such clauses as determinative of materiality.

Negating the Invisible Terms Implied in Every Contract

Certain invisible terms are implied in every contract to cover areas not expressly addressed by the contract's terms: trade usage, course of dealing, and course of performance. "'Agreement' . . . means the bargain of the parties in fact, as found in their language or inferred from other circumstances, including course of performance, course of dealing, or usage of trade . . ." U.C.C. § 1-201. These terms are frequently misused, even by courts. Course of performance refers to repeated conduct by a party after contract formation that the other party acquiesces to without objection. Course of dealing is a sequence of conduct between the parties in prior transactions that establishes a basis for interpreting their expressions and conduct. And trade usage is any practice or method of dealing so common in the trade as to justify an expectation that it will be observed in the present contract. The *Restatement (Second) of Contracts* makes clear that these concepts are not limited to contracts for the sales of goods but are applicable to contracts in general. (See § 202(4): course of performance; § 222: usage of trade; and § 223: course of dealing.) These invisible terms are not only used to interpret the contract in question, they may actually supplement or qualify it. U.C.C. § 1-303. Evidence of trade usage, course of dealing, and course of performance are admissible even when the words of the agreement are clear and unambiguous. Such evidence has nothing to do with the parol evidence rule.

It is often the case that clients would prefer not to be governed by invisible terms. They, and their counsel, may consider it preferable to have the terms of the contract limited to the written memorial of their agreement. U.C.C. § 2-202 cmt.2, provides that trade usage and course of dealing can be "carefully negated." This requires words in addition to the standard integration or merger clause.

Can course of performance be negated? Technically, no. See U.C.C. § 2-202 cmt. 2; K. Rowley, *Contract Construction and Interpretation: From the "Four Corners" to Parol Evidence (and Everything in between)*, 69 Miss. L.J. 73, 331 (1999). See also, 1 William D. Hawkland, *Uniform Commercial Code Series* § 2-208:3, at 2-306 (1998). Why not? Course of performance constitutes a post-contract formation modification.

DRAFTING TIP:
Draft the merger clause to include a negation of course of dealing and trade usage:

The parties intend this Agreement to constitute the complete, exclusive, and fully integrated statement of their agreement. As such, it is the sole repository of their agreement and they are not bound by any other agreements, promises, representations, or writings of whatsoever kind or nature. The parties also intend that this complete, exclusive, and fully integrated statement of their agreement may not be supplemented or explained (interpreted) by any evidence of trade usage or course of dealing.

No Oral Modification and Anti-Waiver Clauses

While the law of the particular jurisdiction needs to be consulted, clauses purporting to forbid oral modifications generally can't be relied upon to preclude oral modifications. Contracts can keep most preformation understandings from having contractual significance (there are some important exceptions, such as understandings induced by fraud), but post-formation understandings are much more difficult to control in the document. "Even where the contract specifically states that no non-written modification will be recognized, the parties may yet alter their agreement. . . . The pen may be more precise in permanently recording what is to be done, but it may not still the tongues which bespeak an improvement in or modification of what has been written."[13]

Anti-waiver provisions are subject to the same sorts of considerations. One court explained: "[A]n 'anti-waiver' clause, like any other term in the contract, is itself subject to waiver or modification by course of performance."[14]

Contracts predominantly for the sale of goods pose their own issues. Many courts hold that pursuant to U.C.C. § 2-209(3), the statute of frauds requires any modification to be in writing, even those that did not need to be in writing at the time of contract formation. Many legal scholars criticize this construction of the UCC.

It is also important to remember that there can be post-formation warranties:

> The precise time when words of description or affirmation are made or samples are shown is not material. The sole question is whether the language or samples or models are fairly to be regarded as part of the contract. If language is used after the closing of the deal (as when the buyer when taking delivery asks and receives an additional assurance), the warranty becomes a modification, and need not be supported by consideration if it is otherwise reasonable and in order. (Section 2-209).

U.C.C. § 2-313 cmt. 7.

DRAFTING TIP:
While there is no sure-fire way to preclude oral modifications or waivers, if the contract's no oral modification clause states that certain specified agents shall have no power to vary the contract or to waive the performance of conditions, this will make it much more difficult for oral modifications to be legally operative. Such a provision "is notice that these agents have no such power when the contract is made. Therefore, a party who wishes to rely upon a subsequent waiver by the specified agent must show that in some way he acquired such a power after the contract was made."[15]

Related Content

For more information on specifying the parties in a contract, including affiliates, and granting rights to non-parties, see

> **IDENTIFYING THE CONTRACTING ENTITY**

RESEARCH PATH: *Corporate Counsel > Contract Boilerplate and Clauses > The Contracting Entity >Practice Notes > The Contracting Entity*

For assistance in drafting and interpreting recitals in contracts, see

> **DRAFTING RECITALS**

RESEARCH PATH: *Corporate Counsel > Contract Boilerplate and Clauses > Recitals > Practice Notes > Recitals*

For additional guidance on setting forth the date that a contract goes into effect, see

> **DETERMINING THE EFFECTIVE DATE**

RESEARCH PATH: *Corporate Counsel > Contract Boilerplate and Clauses > Effective Date > Practice Notes > Effective Date*

For a detailed discussion on limiting or excluding damages in the event of a breach of a contract, see

> **DEFINING AND LIMITING REMEDIES**

RESEARCH PATH: *Corporate Counsel > Contract Boilerplate and Clauses > Remedies and Limitation of Remedies > Practice Notes > Remedies and Limitation of Remedies*

For an overview of force majeure clauses, see

> **DRAFTING A FORCE MAJEURE CLAUSE**

RESEARCH PATH: *Corporate Counsel > Contract Boilerplate and Clauses > Force Majeure > Practice Notes > Force Majeure*

For an explanation of indemnification and hold harmless clauses in contracts, see

> **ESTABLISHING INDEMNITY**

RESEARCH PATH: *Corporate Counsel > Contract Boilerplate and Clauses > Indemnity > Practice Notes > Indemnity*

Landmines Associated with Damages Limitations

The Presumption of Cumulative Remedies

The default contractual remedies provided under the Uniform Commercial Code and the common law generally favor buyers. Sellers routinely seek to limit or exclude remedies in the parties' contract, but this must be accomplished carefully in order to be effective.

There is "a presumption that clauses prescribing remedies are cumulative rather than exclusive. If the parties intend the term to describe the sole remedy under the contract, this must be clearly expressed." U.C.C. § 2-719 cmt.2. "[R]esort to a remedy as provided is optional unless the remedy is expressly agreed to be exclusive, in which case it is the sole remedy." U.C.C. § 2-719(1)(b). (Courts also have applied this principle to contracts governed by common law principles.)[16]

A drafter should not assume that merely listing specific remedies will be sufficient to prevent the non-breaching party from obtaining other remedies. If the drafters desire for the remedies listed to be the exclusive remedies, the contract should spell out that the remedies listed are the sole and exclusive remedies available for breach.

For example, where a contract provided that in the event of non-delivery of coal, the seller "shall" pay the buyer the difference between the total base price under the contract and the price at which the buyer purchases substitute coal, a court held that the contract did not clearly express an intent that this was to be the exclusive remedy. It did not overcome the "presumption that clauses prescribing remedies are cumulative rather than exclusive." Consolidation Coal Co. v. Marion Docks, Inc., 2010 U.S. Dist. LEXIS 31365 (W.D. Pa. Mar. 31, 2010). There are many similar examples.

DRAFTING TIP:
To insure that a specified remedy is exclusive, the contract needs to say it. Example:

Sole and Exclusive Remedy.

The parties agree that the seller will repair or replace, at the seller's option, any defective part in the product for a period of 90 days from the date of delivery. This remedy is intended to be the sole and exclusive remedy of the buyer for any breach of this contract.

Drafting a Damages Limitation Too Well May Result in No Limitation at All

Sometimes, parties draft clauses that limit damages too well, and the result is that a court might not honor any limitation at all. "[I]t is of the very essence of a sales contract that at least minimum adequate remedies be available." U.C.C. § 2-719 cmt. 1.

Consider the following case. Plaintiff, a window and door manufacturer, incorporated defendant's aluminum lineals in the windows and doors it sold. Customers who installed these products started to complain that the lineals were losing their paint adhesion. Plaintiff sued defendant, and defendant countered by citing the terms of the contract between plaintiff and defendant that limited plaintiff's recovery to the purchase price of the lineals. The court held that the remedy must be greater than the one set forth in the contract. The use of the lineals in finished doors and windows made the total cost to remove, repair, and replace them dramatically higher than the purchase price of the lineals, so limiting the remedy to the purchase price would not provide a minimum adequate remedy under the law.[17] A money back guarantee or similar remedy does not always place the aggrieved party in the position it would have occupied had the contract been performed—the essential purpose of contract law.

DRAFTING TIP:
Don't exclude all damages just because the other party will agree to it. Give the other party a remedy that will provide at least a minimal adequate remedy in the event of a breach, or a court might strike the limitation altogether.

If a Remedy Fails of Its Essential Purpose, It Might Eliminate the Exclusion of Consequential Damages

Sellers' contracts often include clauses providing a limited repair or replacement remedy in lieu of all other buyer remedies. If that sole remedy "fails of its essential purpose"—that is, if the seller does not perform the remedy in a timely fashion or fails in an effort to provide the remedy—the default remedies allowed by the UCC are restored. The UCC provides: "Where circumstances cause an exclusive or limited remedy to fail of its essential purpose, remedy may be had as provided in this Act." § 2-719(2). (This concept has been extended to contracts not involving the sale of goods.)[18] In effect, the law allows the aggrieved party to pursue the remedies that were surrendered in exchange for the failed substituted remedy.

But what happens when a contract's substituted remedy—for example, an exclusive repair remedy—fails of its essential purpose and that contract also contains an exclusion of consequential damages? Since failure of essential purpose opens the door to the default remedies as provided by law, should the buyer also be entitled to consequential damages despite the provision excluding consequential damages? The jurisdictions are split.

If the exclusion of consequential damages is viewed as dependent on the validity of the substituted remedy, the failure of that remedy would also remove the exclusion of consequential damages. If, however, the exclusion of consequential damages is viewed as an independent exclusion apart from the substituted remedy, exclusion of consequential damages would be honored. Currently, the independent view is the prevailing view throughout the country, but it would be prudent to draft the contract in a way to negate the minority, dependent view.

DRAFTING TIP:
To retain the exclusion of consequential damages even when a remedy fails of its essential purpose, the contract needs to spell this out:

Sole and Exclusive Remedy.

The parties agree that the seller will repair or replace, at the seller's option, any defective part in the product for a period of 90 days from the date of delivery. This remedy is intended to be the sole and exclusive remedy of the buyer under this contract. Should this sole and exclusive remedy fail of its essential purpose, however, the seller will return the purchase price to the buyer minus the reasonable value of the buyer's use of the product. The parties also agree that, regardless of the failure of the sole and exclusive remedy, seller will not be liable for any consequential damages of whatsoever kind or nature. The parties intend the exclusion of consequential damages as an independent agreement apart from the sole and exclusive remedy herein.

Force Majeure

With respect to a contract for the sale of goods, without a force majeure clause, performance is excused where it "has been made impracticable by the occurrence of a contingency the non-occurrence of which was a basic assumption on which the contract was made." (U.C.C. § 2-615(a)). Force majeure provisions have been held to displace the default defenses automatically given by law: impossibility, frustration of purpose, and impracticability.[19]

The danger in drafting a list of force majeure events is in missing something since no one can list every possible event that might occur—but the canon of interpretation/construction *expressio unius est exclusio alterius* would exclude any item not specifically listed.

The solution: add a catch-all at the end of the list—but this catch-all needs to deal with another canon of interpretation/construction, *ejusdem generis*, by referencing dissimilar events or circumstances.

DRAFTING TIP:
Draft a clause that deals with *expressio unius est exclusio alterius* and *ejusdem generis:* "The parties expressly condition the performance of their duties under this Agreement on the nonoccurrence of [*list events*], in addition to any and all events, regardless of their dissimilarity to the foregoing, deemed to be impracticable or impossible under the law."

Material Breach

A breach of contract may be material or immaterial. When a party to a contract materially breaches the contract, the other party is—if it so chooses—discharged and freed of any obligation to perform and may, at that point, sue for damages. When a breach is immaterial, the non-breaching party is not excused from future performance but may sue for the damages caused by the breach.

To determine if a breach is material, courts often look to the factors set forth in *Restatement (Second) Contracts, § 241.* This is generally an issue of fact, though sometimes it can be so clear that no reasonable trier of fact could disagree about the outcome. The problem is, without a court order, parties can't know for certain if the breach was material or if the non-breaching party has the right to be discharged from his or her contractual obligations.

The contract can avoid the uncertainty as to what constitutes a material breach by spelling out the events that warrant termination of the contract and discharge from further contractual obligations. "As with other default contract rules, parties to a contract 'may agree to displace' the principle of material breach." *Morrison Comprehensive Learning Ctr., LLC v. Va. Dep't of Med. Assistance Servs.*, 2016 Va. App. LEXIS 122, at *6 (Va. Ct. App. Apr. 12, 2016). Even otherwise non-material events can be included as events warranting termination and discharge (*e.g.*, "any violation of an employee handbook that is not cured within 10 days following notice").

Drafting these provisions raises the same sorts of issues that affect force majeure clauses. The canon of construction/interpretation *expressio unius est exclusio alterius* would exclude any item not specifically listed, and those unlisted items might be deemed breaches that don't warrant termination or discharge. The problem is that no one can list every situation that might result in material breach. The solution: add a catch-all—but, as is the case with force majeure clauses, the catch-all needs to deal with the canon of construction/interpretation *ejusdem generis* by referencing dissimilar events or circumstances.

DRAFTING TIP:
Draft a clause that deals with *expressio unius est exclusio alterius* and *ejusdem generis* and the presumption of cumulative remedies:

The following warrant immediate termination of this Agreement: any violation of this Agreement or the employee handbook that is not cured within 10 days of written notice, [*list other events*], in addition to any and all other reasons, regardless of their dissimilarity to the foregoing, deemed to constitute material breaches under the law. A termination in accordance with this paragraph shall not be the Employer's sole and exclusive remedy for any breach of this Agreement.

Indemnity

Indemnity provisions raise a host of potential problems, but one of the more insidious is that if the indemnity provision is drafted broadly, it may be applied to cover any claim at all—not just claims asserted by third parties, but even breach of contract claims between the parties to the contract. While it may seem peculiar—

and wrong—to allow an indemnity clause to be used to support a claim for breach of contract, courts in some jurisdictions hold that if the indemnification clause is not expressly limited to claims brought by third parties, claims between the parties themselves are also covered by the indemnity language.

This is important primarily because an indemnity provision is typically the one place in the contract where a party (in this case, the party to be indemnified) is permitted to recover attorney's fees. Accordingly, if the indemnity clause is used to support a garden variety claim for breach of contract, the winner may recover attorney's fees.

DRAFTING TIP:
If you want your indemnity provision to be limited to third-party claims—define the events triggering indemnity as claims asserted by third parties.

Warranty

As with most of the other provisions referenced here, drafting express warranties and disclaimers of implied warranties raises a host of issues deserving of their own article. One of the most misunderstood aspects of warranty law concerns the time to bring an action for breach.

Generally, warranties warrant that the goods will do certain things or be a certain way at the time of delivery. Warranties do not extend to future performance unless the contract explicitly says so. Thus, generally, "[a] breach of warranty occurs when tender of delivery is made." U.C.C. § 2-725(2). The statute of limitations starts to run from the date of delivery, not from the time a problem with the product manifests itself.

But U.C.C. § 2-725(2) provides an exception that allows the warranty to extend to "future performance of the goods" where "discovery of the breach must await the time of such performance." In that case, "the cause of action accrues when the breach is or should have been discovered."

So what, you say? The lawyer drafting a warranty can extend the warranty to future performance, which would have the effect of delaying a finding of breach, the accrual of a cause of action, and the running of the statute of limitations to a future time when the buyer discovers or reasonably should discover that the product does not meet warranty.

This is a very powerful tool for purchasers. With just a few words in the express warranty, the drafter can, in effect, extend the statute of limitations out many, many years beyond the norm. *Hoctor v Polchinski Mems., Inc.*, 50 Misc. 3d 65 (N.Y. App. Term 2015) involved a tombstone purchased and installed in 2003. The tombstone seller's literature stated the tombstones were guaranteed to "last forever" and were "backed by a perpetual warranty." A problem with the tombstone purportedly was discovered in 2013. The court held: "The foregoing provisions in defendant's literature constituted an explicit warranty of future performance." *Id.* at 67.

DRAFTING TIP:
If the warranty mentions a specific time period or that the product will "last forever" or comes with a "perpetual warranty," the statute of limitations will not even start to run until a problem is, or reasonably should be, discovered within such time period. For purchasers, such a warranty extending to future performance can be a very valuable provision, even if the contract otherwise limits the time to sue after the cause of action accrues.

Landmines Associated with Choice of Law

Clients often assume that the choice of law clause determines the place where lawsuits must be litigated, and they need to be disabused of that assumption.

There are significant differences with respect to the substantive law from one jurisdiction to the next, of course. In negotiating a contract, if you are going to insist on the law of one state or another, it is important to know why. Sometimes, counsel for the other party to the contract will tell me that his or her client will only accept the law of a certain state, but when I inquire why, they usually can't provide a rational basis. (It is sometimes surprising how little attorneys know about the law of contracts in their own state—for example, ask the lawyer who insists that the law of his or her state apply to the contract whether, under the law of that state, a well-drafted merger clause is conclusive on the question of whether the contract is fully integrated.)

Aside from selecting the state based on the law, as opposed to an arbitrary guess, there are various drafting landmines associated with choice of law. Here are three of the most important:

Scope: If Too Narrow, It May Not Encompass All Claims

When a choice of law provision is included in the contract, generally, the parties want the law they select to govern all claims in the event of a dispute. Commercial litigation often involves claims not only for breach of contract but for extra-contractual claims (e.g., torts or statutory violations) as well. But if the clause is drafted too narrowly, it might be construed to govern only the construction and interpretation of the contract, not extra-contractual claims.

To assure the application of the chosen law to all claims, a broad choice of law clause is needed. See, e.g., *Jiffy Lube Int'l, Inc. v. Jiffy Lube of Pa., Inc.*, 848 F. Supp. 569 (E.D. Pa. 1994) (explaining that "This Agreement shall be construed, interpreted and enforced in accordance with the laws of the State of Maryland" is narrow, not encompassing extra-contractual claims); *Lipman Bros. v. Apprise Software, Inc.*, 2015 U.S. Dist. LEXIS 95301 (E.D. Pa. July 21, 2015) (explaining that "any suit brought to enforce this Agreement or based on this Agreement or the business relationship between the parties" is broad language covering tort claims).

If a choice of law provision is narrow, and if there are extra-contractual claims, the court is forced to look beyond the choice of law clause and apply the forum state's conflicts-of-laws analysis to decide which state's laws govern the extra-contractual claims. Thus, with narrow language, it is quite possible that a court will hold that one state's laws govern the contract claims while another state's laws govern the extra-contractual claims. (The same analysis regarding scope is also applicable to choice of forum and arbitration clauses.)

DRAFTING TIP:
Draft a broad choice of law provision. To do this, the law of the applicable jurisdiction needs to be consulted to insure the language selected will be construed as broad language. Here's a generic broad clause:

Any and all matters of dispute between the parties to this Agreement, whether arising from the Agreement itself or from alleged extra-contractual dealings, interactions, or facts prior to or subsequent to the formation of the Agreement, including, without limitation, fraud, misrepresentation, negligence, or any other alleged tort or violation of the contract, shall be governed by, construed, and enforced in accordance with the laws of the Commonwealth of Pennsylvania, regardless of the legal theory upon which such matter is asserted.

Opting Out of CISG

The United States and more than 80 other nations have ratified the United Nations Convention on Contracts for the International Sale of Goods (CISG), a treaty that governs transactions for the sale of goods (roughly equivalent to the UCC, but with important differences). The CISG is the law in virtually every leading trading nation in the world.

Unless the parties have clearly agreed to opt out of the CISG, any contract for the sale of goods between parties that have their principal places of business in different CISG countries are bound by the articles of the CISG rather than the domestic law of the parties' countries.

When parties subject to CISG decide to opt out of CISG, it does not occur merely by agreeing on the law of a particular state in the choice of law provision. The Supremacy Clause makes the CISG part of each state's substantive law. What that means is that for contracts under CISG, generally, if the choice of law provision states, for example, "Pennsylvania law shall apply," that means that CISG shall apply.

To opt out of CISG, the parties need to expressly state they are opting out of CISG.[20] Whether the parties should opt out of CISG is a different question. There are, indeed, significant differences between the contract law of the UCC and the CISG that need to be considered to answer that question—including the fact that CISG has no parol evidence rule.

Related Content

For tips on drafting representations, warranties, and disclaimers in contracts, see

> **DRAFTING REPRESENTATIONS AND WARRANTIES**

RESEARCH PATH: *Corporate Counsel > Contract Boilerplate and Clauses > Representations and Warranties > Practice Notes > Representations and Warranties*

For additional information on contractual choice of law provisions, see

> **DRAFTING A CHOICE OF LAW CLAUSE**

RESEARCH PATH: *Corporate Counsel > Contract Boilerplate and Clauses > Choice of Law > Practice Notes > Choice of Law*

For an overview of the assignment of contractual rights, the delegation of contractual duties, and the construction of anti-assignment clauses, see

> **UNDERSTANDING ASSIGNMENT AND DELEGATION OF DUTIES**

RESEARCH PATH: *Corporate Counsel > Contract Boilerplate and Clauses > Assignment and Delegation of Duties > Practice Notes > Assignment and Delegation of Duties*

For more information on payment provisions in contracts, including the differences between pay-when-paid versus pay-if-paid clauses, see

> **DEALING WITH PAYMENT, COLLECTION, AND AUDIT**

RESEARCH PATH: *Corporate Counsel > Contract Boilerplate and Clauses > Payment, Collection, and Audit > Practice Notes > Payment, Collection, and Audit*

DRAFTING TIP:
If the parties do not want any disputes decided under the CISG, add language indicating that the parties are opting out at the end of the choice of law provision:

The parties hereby agree that the United Nations Convention on Contracts for the International Sale of Goods will not apply to this Agreement.

Determining Whether the Contract Is Governed by Common Law or the UCC

A question that can be of paramount importance is whether the contract will be governed by the UCC or common law. This question is generally not dealt with in the text of the contract, though it should be.

Generally, if the predominant purpose of the contract is for the sale of goods, the UCC applies. Courts consider a variety of factors to determine the predominant purpose of a contract. One court listed several: (1) the contract's language; (2) the terms of payment—that is, whether the price is primarily calculated based on the costs of the goods or services; (3) the mobility of the goods; (4) the value of both the goods and services; and (5) the business of the seller.[21]

Generally, a drafter can't dictate whether the UCC should apply if the nature of the contract clearly suggests it shouldn't. However, if the issue is close, it can be helpful if the words of the contract characterize it. One court explained: "Though the label that contracting parties affix to an agreement is not necessarily determinative of the agreement's predominant purpose, it can constitute potent evidence of that purpose." *Ross-Simons of Warwick, Inc. v. Baccarat, Inc.*, 102 F.3d 12, 17 (1st Cir. 1996). If a party has expressly agreed the contract is predominantly for the sale of goods, a court will likely look askance at that party's argument that the contract is actually predominantly for services, not goods.

DRAFTING TIP:
Spell out in the contract whether it is for the sale of goods or otherwise. For example: "The parties expressly agree that this Agreement is predominantly for the sale of goods."

Anti-Assignment Clauses Require Magic Words to Prevent Assignments

Contracts routinely include clauses forbidding the assignment of the contract without the approval of the other party. Many courts hold that in order to be effective—that is, in order to remove not just the right but the power to assign—such clauses need to contain magic words, such as the following: "Any attempted assignment in breach of this agreement shall be null, void, and invalid," or "the non-assigning party shall not recognize any such assignment." *Erection Co. v. Archer W. Contrs., LLC*, 2015 U.S. Dist. LEXIS 27294, at 25 (D. Nev. Mar. 4, 2015).

Where such language is not included in the anti-assignment clause, according to courts that follow this rule, any provision limiting or prohibiting assignments will merely remove the *right*, not the *power*, to assign. Thus, the assignment will be allowed, and the non-assigning party can sue for damages (but damages would likely be at least difficult, perhaps impossible, to prove in that circumstance).[22]

DRAFTING TIP:
Add language to this effect:

Anti-Assignment: The rights and duties under this contract may neither be assigned nor delegated. The parties further agree to surrender any power to assign their rights or delegate their duties as of the moment of formation of this contract. Any attempt by either party to assign any right or delegate any duty under this contract shall be null and void.

General Clauses Disclaiming Third-Party Beneficiary Are Not Always Effective

It is common to include in contracts a general clause stating that no third-party beneficiaries have rights under the contract. But where it is clear that a purpose of a contract was to benefit certain non-parties (and not merely as an incidental result of the contract), many courts would regard those non-parties as third-party beneficiaries with the right to enforce the contract.

"If the intent of the contract was to directly benefit a third-party, he should not be denied that benefit because of a general disclaimer of intent to benefit third-parties when that benefit is the very object of the agreement." *Doyle v. Jewell*, 2015 U.S. Dist. LEXIS 47766, at *15 (D. Utah Apr. 9, 2015).

DRAFTING TIP:
If a purpose of the contract is to benefit certain persons, and if the parties to the contract really don't want to give those persons the right to enforce the contract, the drafters should include a specific clause explaining that those specific persons have no rights to enforce the contract—make it clear the contract is referring to them. Don't rely on a generalized "no third-party beneficiary" clause.

Pay-when-paid versus Pay-if-paid

In the construction industry, if the owner doesn't pay the general contractor, the general contractor is still obligated to pay the subcontractor. Subcontract provisions that shift the risk of the owner's non-payment to the subcontractor, often referred to as pay-if-paid provisions, are common in that industry. Most, but by no means all, courts enforce them.[23] These sorts of provisions may also be employed in contexts other than the construction industry.

Sometimes parties think they are drafting pay-if-paid clauses when they are really drafting pay-when-paid clauses—there's a big difference. Courts do not like pay-if-paid provisions, so they require such clauses to explicitly state that the subcontractor won't be paid unless the contractor is paid. If a clause merely states that "the subcontractor will be paid within seven days of contractor's receipt of payment from the owner," the requisite explicitness to shift the risk of non-payment is not present, and courts construe such a clause to be a pay-when-paid provision, which does not transfer the risk of non-payment to the subcontractor. *BMD Contrs., Inc v. Fid. & Deposit Co. of Md., 679 F.3d 643 (7th Cir. 2012).* Such a clause "address[es] the timing of payment, not the obligation to pay." Id. With a pay-when-paid clause, if the owner doesn't pay, the contractor is not excused from paying the subcontractor—it must pay within a reasonable time.

DRAFTING TIP:

To draft an enforceable pay-if-paid provision, make clear that the subcontractor will not be paid unless and until the owner pays. It might state that "the owner's payment to the contractor is a condition precedent to contractor's obligation to pay subcontractor." *Sloan & Co. v. Liberty Mut. Ins. Co., 653 F.3d 175 (3d Cir. 2011).* "A pay-if-paid condition generally requires words such as 'condition,' 'if and only if,' or 'unless and until' that convey the parties' intention that a payment to a subcontractor is contingent on the contractor's receipt of those funds." *LBL Skysystems (USA), Inc. v. APG-America, Inc.*, 2005 U.S. Dist. LEXIS 19065 (E.D. Pa. Aug. 31, 2005).

Modifying Limitations Periods

Sometimes drafters become too aggressive in their attempts to limit the time to bring a legal action for breach. Generally, parties may contractually shorten the limitations period to not less than one year for contracts predominantly for the sale of goods (U.C.C. § 2-725), and not shorter than a reasonable time for contracts governed by common law. (Some states have statutes governing this.)

Generally, parties are not permitted to enlarge the limitations period beyond the period allowed by law. Tolling agreements are generally not governed by this rule because such agreements are made after the cause of action accrues. After a cause of action accrues, the parties may agree to extend the limitations period beyond the time allowed by statute since the defendant is on notice of the claim and is able to preserve evidence and avoid being prejudiced by an enlarged limitations period.[24]

DRAFTING TIP:

If you desire to shorten the statute of limitations, consult the applicable law of the governing jurisdiction because if you are too aggressive and try to limit it to less time than allowed by law, the provision might be deemed invalid, and your client will be stuck with the period mandated by the applicable statute of limitations.

Headings

Headings, of course, don't capture everything in the paragraphs that follow. They are often tacked onto agreements with little thought or care. That's one reason drafters add clauses making clear the heading has no effect. Without such a clause, in the case of ambiguity, courts may use headings as guidance to discern the paragraph's purpose.[25]

DRAFTING TIP:

Add a clause to this effect: "Any headings preceding any of the sections of this Agreement are inserted solely for convenience of reference, shall not constitute a part of the Agreement, and shall not otherwise affect the meanings."

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RESEARCH PATH: ***Corporate Counsel > Contract Boilerplate and Clauses > The Contracting Entity > Practice Notes > General Contract Drafting and Boilerplate***

1. Orlander v. Staples, Inc., 802 F.3d 289 (2d Cir. 2015). 2. Omnicom Group, Inc. v. 880 West Long Lake Assocs., 504 Fed. Appx. 487 (6th Cir. 2012). 3. *See, e.g.*, Koch v. Boxicon, LLC, 2016 Tex. App. LEXIS 3274 (Tex. App. Mar. 30, 2016); West v. Liberty Mut. Ins. Co., 1994 U.S. App. LEXIS 20169 (4th Cir. Aug. 3, 1994). 4. *See* PGA Mech. Contrs., Inc. v GPNZ Realty Co., LLC, 37 Misc. 3d 1210(A) (N.Y. Sup. Ct. 2012). 5. Galvin v. Excel Switching Corp., 2006 Mass. Super. LEXIS 295, at *22-23, (Mass. Super. Ct. 2006). 6. *Id.* at *24. 7. *See* Linder v. Swepi, LP, 549 Fed. Appx. 104, 107-08 (3d Cir. 2013). 8. *See* Linan-Faye Constr. Co. v. Housing Auth., 995 F. Supp. 520, 524 (D. N.J. 1998). 9. Kodak Graphic Communs. Can. Co. v. E. I. du Pont de Nemours & Co., 2016 U.S. App. LEXIS 1764 (2d Cir. Feb. 3, 2016). 10. *See, e.g.*, Bayer Chems. Corp. v. Albermarle Corp., 171 Fed. Appx. 392 (3d Cir. 2006) (course of performance invoked to supplement express terms of contract). 11. *Id.* 12. Precision Fitness Equip., Inc. v. Nautilus, Inc., 2011 U.S. Dist. LEXIS 13576 (D. Colo. Feb. 2, 2011). 13. Wagner v. Graziano Constr. Co., 390 Pa. 445, 448(1957). 14. Westinghouse Credit Corp. v. Shelton, 645 F.2d 869 (10th Cir. 1981). 15. Corbin on Contracts § 40.13. 16. M.G.A., Inc. v. Amelia Station, Ltd., 2002-Ohio-5091 (Ohio Ct. App.2002); Creighton Univ. v. GE, 2009 U.S. Dist. LEXIS 22166 (D. Neb. Mar. 18, 2009). 17. Marvin Lumber & Cedar Co. v. Sapa Extrusions, Inc., 964 F. Supp. 2d 993 (D. Minn. 2013). 18. Barrack v. Kolea, 651 A.2d 149 (Pa.Super. 1994). 19. Aquila, Inc. v. C. W. Mining, 2007 U.S. Dist. LEXIS 80276 (D. Utah Oct. 30, 2007). 20. 6-25 Corbin on Contracts § 25.6; It's Intoxicating, Inc. v. Maritim Hotelgesellschaft mbH, 2013 U.S. Dist. LEXIS 107149 (M.D. Pa. July 31, 2013); BP Oil Int'l, Ltd. v. Empresa Estatal Petroleos de Ecuador (PetroEcuador), 332 F.3d 333 (5th Cir. Tex. 2003). 21. Boardman Steel Fabricators, Ltd. v. Andritz, Inc., 2015 U.S. Dist. LEXIS 119562 (E.D. Ky. 2015). 22. *See* 9-49 Corbin on Contracts § 49.9 (2015). 23. In re Makwa Builders, LLC, 545 B.R. 311 (Bankr. D.N.M. 2016). 24. Byron Cmty. Unit Sch. Dist. No. 226 v. Dunham-Bush, Inc., 215 Ill. App. 3d 343, 351 (1991). 25. *See, e.g.*, Lipman Bros. v. Apprise Software, Inc., 2015 U.S. Dist. LEXIS 95301 (E.D. Pa. July 21, 2015).

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Cloud-Based Outsourcing

Cloud computing is a subscription-based service that offers on-demand network access to a shared pool of configurable computer resources (e.g., networks, applications, servers, storage, etc.) that is usually hosted by the supplier and provided over the Internet. Such services can be rapidly provisioned and released with minimal transition services and management effort. Cloud services are outsourcing without a single dedicated data center. There are varying service models and deployment methods in cloud computing that provide a customer with different levels of control, flexibility, and management.

Cloud Computing Service Models

There are four primary service models in cloud-based outsourcing:

- **Software as a Service (SaaS)** provides software applications that are hosted by a supplier and made available to customers over the Internet.
- **Platform as a Service (PaaS)** provides an outsourced platform that is hosted by a supplier and allows customers to develop, test, and manage web applications.
- **Infrastructure as a Service (IaaS)** provides virtualized computer resources (e.g., servers, storage, and networking) on a pay-per-usage basis over the Internet.
- **Desktop as a Service (DaaS)** provides virtual desktops that are hosted by a supplier and accessible from anywhere via the Internet.

Cloud-based outsourcing is compelling for information services because it offers greater flexibility and economy. However, such solutions raise unique legal considerations including data privacy, security, and e-discovery issues. Suppliers are able to offer low cost, flexible solutions because they standardize their offerings for multiple customers. Consequently, suppliers are less likely than traditional outsourcing providers to adapt their solutions to the customer's needs or negotiate contract terms to meet customer requirements.

Cloud Computing Deployment Models

Cloud deployment models represent a specific type of cloud environment distinguished primarily by ownership, size, and access. Each deployment model has varying degrees of data security, risk, and investment.

- **Private cloud or on-premises cloud.** The private cloud infrastructure provides a dedicated network and equipment that are operated solely for the customer's business and are managed internally or externally. In a private cloud arrangement, the customer maintains all components of the associated technology, which includes any servers or software required to deploy cloud resources. Private clouds give customers a greater degree of flexibility and control over data security and storage but are also more expensive given the physical space, hardware, and environmental controls required.

- **Public cloud.** The public cloud is made available to the general public by a supplier who owns, operates, and hosts the cloud infrastructure and offers access to users over the Internet. Because users share the public cloud, this model offers the greatest flexibility (on demand scalability) and cost savings (pay as you go model). However, the public cloud has increased security risks as customers have no visibility or control over where the infrastructure is located, and it offers limited configuration and availability variance.
- **Community cloud.** The community cloud infrastructure is a multi-tenant cloud service model that is shared among several organizations and is governed, managed, and secured commonly by all the participating organizations or a third-party managed service supplier. Community clouds are a hybrid form of private clouds built and operated specifically for a group that shares common goals. With the community cloud, the costs of deployment and access are spread over fewer users than the public cloud, but there are more users than the private cloud.
- **Hybrid cloud.** The hybrid cloud is composed of two or more clouds (private, public, and/or community clouds) that remain separate but are bound together, offering the advantages of multiple deployment models. A hybrid cloud increases the flexibility of cloud computing as customers can leverage suppliers in either a full or partial manner. There are, however, increased potential risks with accessing multiple cloud platforms.

Selection Considerations

Because each cloud model offers varying degrees of flexibility, efficiency, data security, and cost savings, the customer must select the appropriate model to meet its needs and manage the associated risks. Key considerations include whether the outsourced service is business critical and the sensitivity of the outsourced data. For example, public clouds work better where the outsourced service is not critical to the customer's business and the outsourced data is not sensitive. Customers should carefully evaluate each of the following in selecting the right cloud computing service, deployment model, and supplier:

- The supplier's security standards
- The availability and reliability of the service
- Price (i.e., whether the service will provide cost savings and whether it provides flexible, usage-based pricing)
- Data privacy (For example, does the outsourced data include personal data or competitively-sensitive data such as trade secrets)
- Service level agreement performance objectives/guarantees
- Scalability (i.e., whether the service allows the customer to easily increase or decrease usage and resources to accommodate changing business needs)
- Continuity of the service (For example, can the supplier suspend the services for non-compliance? What is the supplier's business interruption/disaster recovery procedure?)
- Loss of control
- Supplier's reputation and long term viability (For example, if the supplier is a start-up, the customer should evaluate whether it is well-funded, whether it has a strong vertical industry position, and whether it is innovative/proactive in updating the technology and exploring new services)
- Data location/storage concerns
- Regulatory issues (For example, is the service compatible with legal requirements imposed by the Gramm-Leach-Bliley Act, 15 U.S.C. § 6801 et seq., Health Insurance Portability and Accountability Act, 42 U.S.C. § 1320det seq., or other applicable laws, and/or with industry requirements such as the Payment Card Industry Data Security Standard (https://www.pcisecuritystandards.org/documents/PCI_SSC_Getting_Started_with_PCI_DSS.pdf)?)
- The supplier's technology lock-in position (This is where the supplier implements a proprietary solution for the customer, making the customer dependent on the supplier's technology; which, by definition, is not available from another or successor supplier, and is problematic with PaaS solutions and occurs where the platform has limited compatibility with other software, equipment, solutions and/or where the supplier restricts or limits migration (i.e., does not provide termination assistance services and/or does not provide or allow data to be extracted and migrated for continued use).)
- The ability to easily transition upon expiration/termination of the service

Due diligence is essential in the selection process. See Initial Considerations in Cloud Computing Agreements (Due Diligence of the Cloud Provider.)

Key Legal Issues

There are a number of legal challenges and issues that arise in cloud-based outsourcing agreements that need to be carefully considered and managed in order to mitigate the risks inherent in such transactions.

Ownership/Use of Data

While the customer may assume it owns the data that the cloud service / supplier collects, uses, and processes on its behalf, the contract should detail ownership and data usage rights. Company data should be broadly defined to include all data or information provided by, or accessed or collected from or through, the company and its systems, and all data resulting from the processing, generation, or aggregation of such data or the performance of the services. The contract should also expressly limit the supplier's right to use such data. For example, it should prohibit the supplier from using company data in aggregated, de-identified form for purposes outside of the contract and from disclosing or selling company data, even in aggregated form, to any third parties.

Data Security

The security and protection of data is critical in cloud-based outsourcing agreements. The contractual requirements will vary based upon the nature and sensitivity of the data outsourced to the cloud solution. The customer should consider including the following: confidentiality obligations that encompass company data even if such data is not confidential; data encryption requirements, applicable both in transit and in storage; a right to audit security procedures and data centers; immediate notification obligations for any incidents that may compromise data and security breaches; and audit rights to assess controls and procedures for storing, handling, and transmitting data. For more information, see Privacy and Data Security in Outsourcing.

Data Storage

Data storage considerations impact privacy and security issues. For example, if data is accessible from, processed, or stored outside the United States, the location of such services (e.g., China, India, Russia, etc.) may increase the risk of a security breach. Moreover, the location of the data also impacts compliance with data privacy and security laws such as the Gramm-Leach-Bliley Act, 15 U.S.C. § 6801 et seq., Health Insurance Portability and Accountability Act, 42 U.S.C. § 1320d et seq., and the EU Data Protection Directive, http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2016.119.01.0089.01.ENG&toc=OJ:L:2016:119:TOC. Thus, consider specifying limitations on the locations where data can be accessed and stored. For example, data shall not be accessible from, transferred to, processed, or stored in any location outside the U.S.

Related Content

For comprehensive outsourcing guidance, see

> OUTSOURCING CONSIDERATIONS AND PLANNING

RESEARCH PATH: *Corporate Counsel > Outsourcing > Planning and Procurement in Outsourcing > Practice Notes > Planning and Procurement in Outsourcing*

For a discussion of cloud computing agreements and due diligence, see

> INITIAL CONSIDERATIONS IN CLOUD COMPUTING AGREEMENTS (DUE DILIGENCE OF THE CLOUD PROVIDER)

RESEARCH PATH: *Corporate Counsel > Software and Information Technology > Cloud Computing > Practice Notes > Cloud Computing*

For more information on Cloud Computing see

> DRAFTING AND NEGOTIATING EFFECTIVE CLOUD COMPUTING AGREEMENTS

RESEARCH PATH: *Corporate Counsel > Software and Information Technology > Cloud Computing > Practice Notes > Cloud Computing*

Data Access and Portability

Data access and portability, both during the contract term and upon the expiration or termination of the contract, are problematic in cloud computing agreements. An example would be a technology lock-in position where the supplier stores the customer's data in a proprietary format not available to, or offered by, other vendors, and then either refuses or charges a high rate to convert that data into a format that would be usable by a successor supplier. Thus, the customer should include obligations for the supplier to provide data in a specified format (to ensure it is usable) upon request at any time during the contract, regardless of whether a party is in default or breach under the agreement, and within a specified period of time upon the expiration or termination of the agreement for any reason. This will protect against customer data being held hostage by the supplier in exchange for an additional fee for access. The contract should also address how the supplier will handle customer data in the event of a government subpoena or other legal action.

Service Level Agreements (SLAs)

Most suppliers will contractually limit and restrict SLAs by referring to them as performance goals or objectives rather

than contractual requirements. The customer should consider making the SLA a representation and warranty. It should also consider including specific remedies for service interruptions and outages. Such remedies should include credits, the right to conduct a yearly comprehensive review, the right to have a sit down meeting by the parties' executives for repeated failures, and termination rights for cause if interruptions/outages are chronic or excessive. This last right should expressly excuse payment of any early termination fee and/or entitle the customer to a refund of any prepaid, unused fees. The customer should also ensure that credits are not specified as the sole and exclusive remedy for an outage, which would conflict with any SLA representations and warranties, as well as termination rights for cause. Finally, the customer should ensure that any exceptions to or carve-outs from the SLA are limited, as overbroad exclusions gut the SLA.

Service Interruptions / Business Continuity / Disaster Recovery

The contractual definition of a service interruption should be carefully reviewed, as well as the supplier's obligations upon an interruption. For example, does a service interruption include a cyberattack or data breach? Does the agreement include a detailed business continuity and/or disaster recovery plan with specified backup procedures and data recovery mechanisms?

It is important to understand the parties' obligations and responsibilities, including liability, in the event that the customer cannot gain access to its data due to an interruption. The contract should include the parties' rights and obligations regarding notice of an interruption, mitigation efforts, suspension of payment provisions and/or interruption credits—with reference to SLAs as discussed above—and termination rights if the interruption cannot be cured after a specified period of time.

Warranties

Most suppliers will try to limit warranties, but the customer should carefully consider including warranties regarding conformity to service descriptions and specifications; performance/SLA; compliance with laws; compliance with security requirements and obligations; and the non-use of disabling codes, viruses, and cookies or other tracking technologies.

Wind-Down / Termination Assistance

The contract should include a provision permitting a wind-down period upon termination that allows the customer to continue using the service for a specified period of time, in order for the customer to transition to another provider. Alternatively, it could require the supplier to assist in such a transition to maintain business continuity. These types of provisions usually require the supplier to maintain a specified level of service for a predefined period of time. Such a provision may also require the supplier to assist with data migration. At the end of any wind-down or termination assistance period, the contract should detail the supplier's obligations to destroy or erase, as applicable, all data from the service and its systems.

Force Majeure Events

Force majeure events should be defined as both beyond the reasonable control of the supplier, as well as unforeseeable and unavoidable. This is an important distinction because while some events might be beyond the supplier's control, they are not unforeseeable or entirely unavoidable. One example of this is a cyberattack. The provision should also specify that any force majeure events do not excuse the supplier's business continuity / disaster recovery obligations. This is crucial to avoid a potential conflict of terms, because performance is generally excused for force majeure events, but there are continuing obligations under business continuity and disaster recovery plans. It should also be specified that payment obligations are excused during a force majeure event, or for prepaid services, include the right to receive service credits for each day of service interruption. Finally, the supplier should have a duty to mitigate damages, and the customer should have a right to terminate without liability if the force majeure event continues after a specified period of time. For example, the customer should be excused from the obligation to pay any early termination fee and/or should have the right to a refund for any prepaid, unused fees. For more information, see Business Continuity and Contingency Planning in Outsourcing.

Limitation of Liability

Limitations on liability should be carefully considered and should exclude damages arising from certain obligations such as those arising from the supplier's negligence, breach of its confidentiality / data security obligations, or failure to comply with applicable privacy and data security laws and regulations. The contract should also expressly carve out the supplier's indemnification obligations from any specified limitations on direct damages and exclude indirect damages.

Indemnification

The indemnification provision should expressly include the supplier's obligation to indemnify, defend, and hold the customer harmless, as some jurisdictions do not include the duty to defend as inherent to the indemnification obligation. The supplier's indemnification obligations should cover breach of the supplier's obligations to protect and secure company data, failure to comply with laws, and third-party claims alleging that access to or use of the cloud service infringes any third-party rights. It should also be specified that the contractual limitations of liability do not apply to the supplier's indemnification obligations.

Export Control

The parties' responsibility to comply with export control regulations should be addressed in the contract as moving data to the cloud is deemed an export if such data is accessible from another jurisdiction.

Additional Terms and Conditions / Supplier's Right to Change Terms

Depending on the cloud service and deployment model, the contract may incorporate by reference other supplier terms and conditions—specific policies, for example. Any applicable terms, conditions, and policies should be carefully reviewed so as to ensure that they do not conflict with negotiated provisions, such as remedies for SLA failures. This review should be done even if the agreement contains a provision stating that in the event of a conflict, the agreement's terms will apply, since some courts have not effectively enforced such provisions. Furthermore, the supplier may have the flexibility to change its terms and conditions without the customer's approval. Some suppliers will agree to a compromise in this area, such as a requirement that any changes do not degrade the service or weaken the security requirements, or that the supplier will notify the customer in writing of any changes and give the customer the right to terminate if any of the changes adversely affect the customer or the service. L

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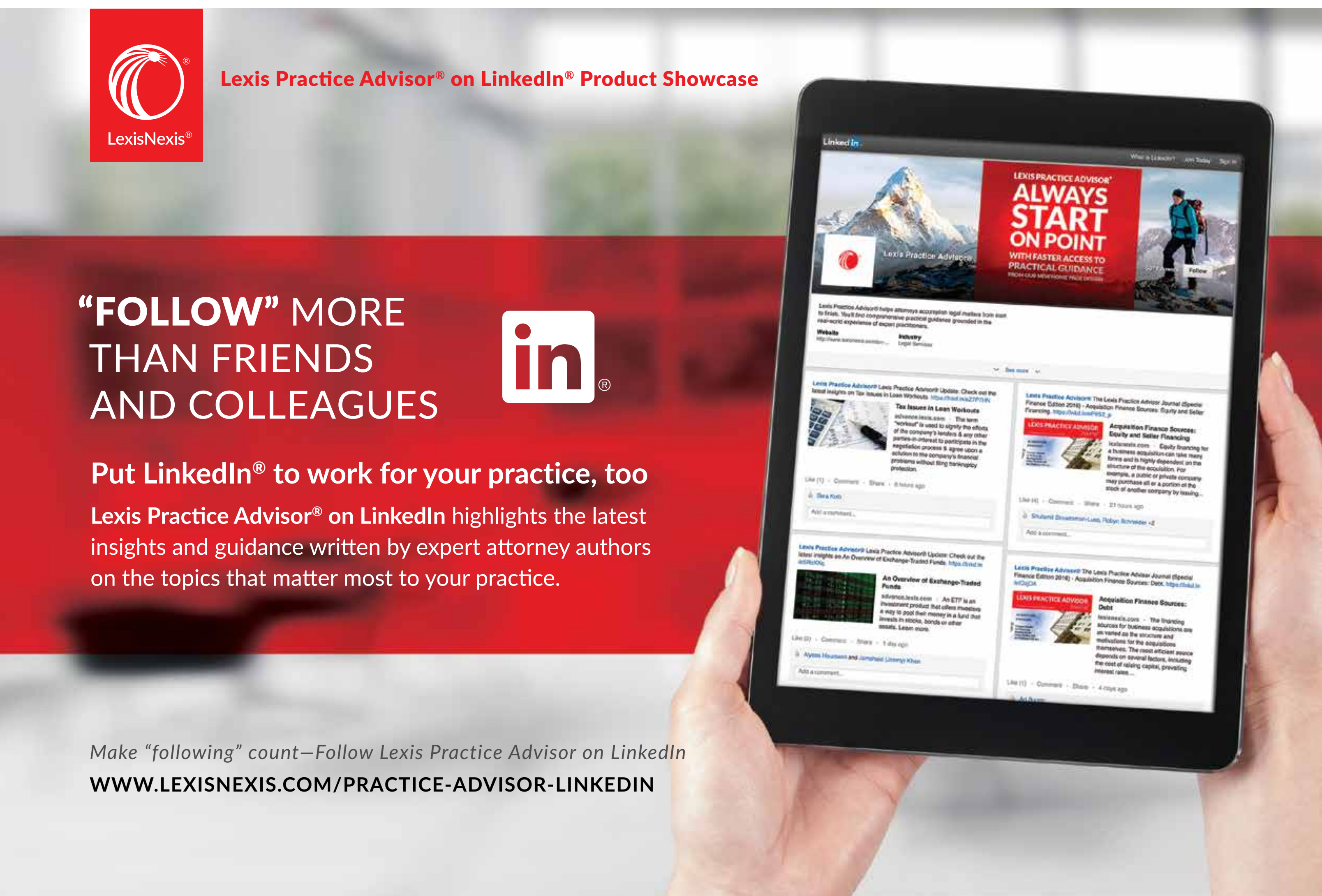
RESEARCH PATH: *Corporate Counsel > Outsourcing > Special Issues in Outsourcing > Practice Notes > Special Issues in Outsourcing*



Outsourcing Checklist

James E. Meadows CULHANE MEADOWS PLLC

The following checklist summarizes major issues that may arise during negotiations and in fulfilling an outsourcing agreement. This is an excerpt from the complete checklist available in Lexis Practice Advisor. The matters and interests to be negotiated in an outsourcing deal and the volume of documents required to capture the parties' agreements are complex. Those parties who organize their efforts from the outset and perform an appropriate level of analysis and diligence are the ones most likely to succeed in achieving their objectives.

1. Structure of the Agreement

✓ How will the agreement be structured?
- A single services agreement
- A master agreement with site-specific, country specific, or entity-specific statements of work
- Separate agreements for reengineering, development, and ongoing management
- Separate agreements documenting the terms applicable to a joint venture/ strategic alliance relationship and the terms applicable to ongoing services

✓ What is the inter-relationship between these agreements if separate, e.g., cross-termination, payment?

2. Contracting Party

✓ Who will sign the agreement on behalf of customer? On behalf of supplier?

✓ If there is a master agreement with separate statements of work, will the same party that signs the master agreement sign the statements of work?

3. Entities Receiving Services from Supplier

✓ Determine who will receive services from supplier.

✓ Entities may include:
- Customer affiliates
- Joint ventures/alliances
- Contractors
- Suppliers
- Clients of customer

✓ Will customer have the option of adding/deleting entities over the term?

✓ How will mergers/acquisitions/divestitures be handled? What will customer's and supplier's ongoing obligations be?

✓ Which entity(ies) will have payment obligations? Are recipients of services third-party beneficiaries?

4. Entities Providing Services to Customer

✓ Determine which entity (or entities) will provide the services to customer.

✓ Will there be any subcontracting/teaming relationships?

✓ For international deals, how will supplier provide resources/services in each country? Will supplier use affiliated entities or subcontractors?

✓ What are customer's rights to approve/remove subcontractors?

✓ Which entity(ies) will have performance/indemnification obligations?

5. Term

✓ What is the commencement date of services? Will there be one commencement date for all sites? Will there be one commencement date for all services?

✓ How long is the term of the agreement? If the transaction includes multiple agreements, are all of the agreements co-terminus? If there is a master agreement with separate site/statements of work, are all of the agreements co-terminus?

✓ Will there be a pilot period?

✓ What are each party's renewal rights? What type of notice is required for renewal?

6. Scope of Services

✓ Determine the general scope of services to be provided by supplier. *(Continued on page 24)*

- ✓ Determine those services which will be provided in-house by customer or to customer by a third party.
- ✓ Describe in detail the services (typically by service category) to be provided by supplier.
- ✓ Define customer's responsibilities with respect to the services to be provided by supplier (i.e., definition of requirements, strategic direction, approvals).
- ✓ Define existing and future requirements (e.g., capacity requirements, volume changes, business changes).
- ✓ Allocate managerial and financial responsibility.

7. Transition Plan

- ✓ How will the transition of services to supplier be handled?
- ✓ Will there be any redundant/parallel environments?
- ✓ Determine the performance standards during transition.
- ✓ How long will the transition period be?

8. Methodologies

- ✓ Assess methodologies to be used by supplier. Are the methodologies proprietary to supplier or licensed from a third party? If licensed from a third party, are there any use restrictions? What are customer's rights to use during the term and after expiration/termination?
- ✓ Will any of customer's methodologies continue to be used during the term of the transaction? What are supplier's use rights (e.g., use in connection with services to customer only; use in connection with other customers)?
- ✓ How will supplier transition customer to supplier's methodologies (if applicable)?
- ✓ How will the methodologies introduced by supplier be integrated with customer's existing and future methodologies (with respect to the applicable business function as well as other business areas, e.g., information systems)?
- ✓ Will supplier be developing/providing any new methodologies? If so, how will ownership/use rights be allocated? How will new methodologies be rolled out (e.g., define time period, consequences for failure to meet deadlines, each party's responsibilities)?

9. Technology

- ✓ Assess technology to be used by supplier. Is the technology proprietary to supplier or licensed from a third party? If licensed from a third party, are there any use restrictions? What are customer's rights to use during the term and after expiration/termination?
- ✓ Will any of customer's technology continue to be used during the term of the transaction? What are supplier's use rights (e.g., use in connection with services to customer only; use in connection with other customers)?
- ✓ Will the environment be dedicated/shared?
- ✓ How will supplier transition customer to supplier's technology (if applicable)?
- ✓ How will the technology introduced by supplier be integrated with customer's existing or future technology, e.g., is supplier technology compatible with technology used by customer's information system group?
- ✓ Will supplier be developing/providing any new technology? If so, how will ownership/use rights be allocated? How will new technology be rolled out (e.g., define time period, consequences for failure to meet deadlines, each party's responsibilities)?

10. Assets

- ✓ Will supplier be purchasing any of customer's assets (e.g., equipment, real estate)? If so, when will purchase be made (e.g., on date of signing)?
- ✓ How will assets be valued (e.g., book value, fair market value)?
- ✓ Is the transfer of assets necessary in conjunction with the transfer of employees in order to constitute an "automatic transfer" under the particular country's employment/redundancy laws?

11. Projects

- ✓ Identify any projects that supplier will be responsible for implementing/managing as part of the transaction.
- ✓ Will supplier be responsible for any new implementations? If so, what are each party's responsibilities? What are the consequences if the reengineering is not successful or performed by deadlines specified?

A more detailed listing of issues to consider in outsourcing transactions is included in the complete outsourcing checklist in the Corporate Counsel module of Lexis Practice Advisor.

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RESEARCH PATH: ***Corporate Counsel > Outsourcing > Negotiating and Drafting the Oursourcing Agreement > Forms > Outsourcing Agreements***

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EEOC'S FINAL RULES ON **WELLNESS PROGRAMS**

Given concerns over rising health care costs and missed workdays by employees suffering from various illnesses, many employers have implemented employee wellness programs and activities to promote healthier lifestyles or to prevent disease with the expectation that such programs will reduce healthcare costs.[1] However, these programs must be appropriately designed so as not to run afoul of existing anti-discrimination laws, including laws prohibiting discrimination based on disability or genetic information, among others.

ON MAY 16, 2016, THE U.S. EQUAL EMPLOYMENT Opportunity Commission (EEOC) took a big step forward by providing guidance on how wellness programs should be fashioned to comply with the requirements of the Americans with Disabilities Act (ADA) and the Genetic Information Nondiscrimination Act (GINA) by issuing Final Rules on the application of both laws to employer wellness programs.[2]

ADA Final Rule

The ADA contains a number of exceptions to its general rule prohibiting employers from making disability-related inquiries or requiring medical examinations. One of the exceptions applies to certain voluntary wellness programs.[3] The ADA Final Rule makes it clear that medical inquiries or medical examinations as part of an employee health or wellness program are allowed under the ADA as long as the inquiries and examinations are conducted in connection with an "employee health program" (as defined below) and are truly voluntary, and the information obtained is used only for purposes of the program and satisfies confidentiality requirements.[4] While employees may not be required to participate in an employer's wellness program, the ADA Final Rule allows a company to offer incentives to encourage employees to participate. However, the incentives must be consistent with the nondiscrimination provisions of the Health Insurance Portability and Accountability Act of 1996 (HIPAA), as amended by the Affordable Care Act (ACA),[5] which generally limits incentives to 30% of the total cost of employee-only coverage.[6]

The ADA Final Rule specifically revises Section 1630.14 of its regulations[7] in the following manner to address when and how medical examinations and inquiries are permitted in the context of an employee health or wellness program.

Definition of Employee Health Program

The EEOC, for the first time, defines what constitutes an employee health program that may rely on the wellness program exception to the ADA's prohibition on requiring medical examinations and making health-related inquiries: it is a program "reasonably designed to promote health or prevent disease." Under the regulations, a program will satisfy this standard if the program (1) has a reasonable chance of improving the health of, or preventing disease in, participating employees; (2) is not overly burdensome nor a subterfuge for violating the law; and (3) is not highly suspect in the method chosen to promote health or prevent disease.[8]

According to the EEOC, this definition is satisfied if an employer institutes a program to conduct a health risk assessment or biometric screening of employees for the purpose of alerting them to health risks of which they may not be aware. An employer's use of aggregate information from employees' health risk assessments to design and offer health programs aimed at specific conditions that are prevalent in the workforce will also pass regulatory muster. On the other hand, the EEOC explains that if an employer collects medical information on a health questionnaire without providing employees any follow-up programs, information, or advice, this activity will not satisfy the definition of an employee health program and will not be eligible for the wellness program exception to the ADA rules.[9]

Also excluded from the definition are programs designed mainly to shift costs from the employer to targeted employees based on their health and programs where an employer imposes overly

1. See Kristin Madison, *Reconciling Policy Objectives*, 51 Willamette L. Rev. 407, 412–13 (2015). An annual survey conducted by the Kaiser Family Foundation Health Research and Educational Trust indicated that 55% of large firms that offered wellness programs said that most of their wellness benefits were provided by a group health plan. *See* Karen Pollitz & Matthew Rae, Kaiser Family Foundation, *Workplace Wellness Programs Characteristics and Requirements* 5 (2016), http://kff.org/private-insurance/issue-brief/workplace-wellness-programs-characteristics-and-requirements/. **2.** EEOC, Final Rule, "Regulations Under the Americans with Disabilities Act," 81 Fed. Reg. 31126 (May 17, 2016); EEOC, Final Rule, "Genetic Information Nondiscrimination Act," 81 Fed. Reg. 31143 (May 17, 2016). The ADA Final Rule and GINA Final Rule apply regardless of whether the wellness program is related to a group health plan. 81 Fed. Reg. at 31132; 81 Fed. Reg. at 31152. **3.** The ADA Final Rule does not pertain to wellness programs that do not request or require medical information from employees, such as programs that merely provide employees with information about health matters and healthy lifestyles. The rule also does not pertain to similar types of wellness plans that may be offered by entities other than those subject to Title I of the ADA, such as social service agencies covered under Title II of the statute, 42 U.S.C. § 12131, *et seq.*, or public accommodations subject to Title III, 42 U.S.C. § 12181, *et seq.*, which may provide similar programs to individuals who are considered volunteers. **4.** 29 C.F.R. § 1630.14(d). **5.** See Titles I and IV of the Health Insurance Portability and Accounting Act of 1996, Pub. L. 104-191, adding Section 9802 of the Internal Revenue Code and Section 2702 the Employee Retirement Income Security Act, and Section 2705 of the Public Health Service Act (PHS Act). The nondiscrimination provisions originally enacted in HIPAA set forth eight health status related factors, which the HIPAA final regulations refer to as "health factors." 71 FR 75014 (Dec. 13, 2006). Under HIPAA and the final regulations, as well as under PHS Act Section 2705 (as added by the Affordable Care Act), the eight health factors are: health status, medical condition (including both physical and mental illnesses), claims experience, receipt of health care, medical history, genetic information, evidence of insurability (including conditions arising out of acts of domestic violence), and disability. **6.** Final Rule, "Incentives for Nondiscriminatory Wellness Programs in Group Health Plans," 78 Fed. Reg. 33158 (June 3, 2013). **7.** 29 C.F.R. § 1630.14. **8.** 29 C.F.R. § 1630.14(d)(1). This standard is similar to the standard under the regulations jointly issued by the Departments of Labor, Treasury, and HHS in implementing the Affordable Care Act amendments to HIPAA. See 26 CFR 54.9802-1(f)(3)(iii); 29 CFR 2590.702(f)(3)(iii); 45 CFR 146.121(f)(3)(iii). **9.** 29 C.F.R. § 1630.14(d)(1).

burdensome amounts of time for participants to achieve a reward, requires unreasonably intrusive procedures, or places on the employee significant costs related to medical examinations.[10]

When an Employee Health Program Is Voluntary

Under the ADA, medical inquiries or required medical examinations in connection with a wellness program must be voluntary. The ADA Final Rule sets forth four factors that must be met for employee medical inquiries or medical examinations to be voluntary. These factors are as follows:

- The employer does not require employees to participate in the program.
- The employer does not deny coverage under any of its health insurance or benefit plans for employees who do not participate.
- The employer does not take any adverse action or retaliate against any employee for not participating (or for participating).
- The employer provides employees with a written notice, which is reasonably likely to be understood, that describes (1) what medical information will be obtained as part of the wellness program; (2) who will receive the information; (3) how the medical information will be used; and (4) the restrictions on its disclosure.[11]

To ensure that participation in an employee wellness program is truly voluntary, the Final Rule makes clear that it would be unlawful for an employer that offers both a traditional preferred provider health plan and a high deductible plan to limit the traditional plan coverage only to those employees who participate in a wellness plan that includes a health risk assessment. It would also be unlawful for an employer to condition participation in the employer's group health plan on an employee completing a health risk assessment.[12]

Incentives Offered for Employee Health Programs

Read in isolation, the requirement that participation in a wellness program must be voluntary might be construed as preventing employers from offering rewards to their employees for their participation or imposing penalties for non-participation in wellness programs (at least to the extent they are not de minimis). However, as the EEOC explained in discussing its Final Rule, the ADA, as interpreted in light of the HIPAA non-discrimination rules, as amended by the ACA, "does not prohibit the use of incentives to encourage participation in employee health plans," although the ADA "does place limits on them."[13]

Accordingly, the ADA Final Rule clarifies that the use of incentives in an employee health program, either in the form of a reward or penalty, does not render the program involuntary.[14] In doing so, the EEOC concluded that regulatory limits on incentives to participate in wellness programs "cannot be so substantial as to be coercive."[15] In general conformity with HIPAA's regulations, the ADA Final Rule, therefore, allows an employer to offer incentives of up to 30% of the total cost of employee-only coverage under the employer's group health plan (or, in the absence of an employer plan, an ACA Exchange plan), whether in the form of a reward or penalty, to promote an employee's participation in a wellness plan that includes disability-related inquiries or medical examinations.[16]

The incentive rule applies to all employee health programs whether they are offered only to employees enrolled in an employer sponsored group health plan, offered to all employees whether or not they are enrolled in such a plan, or offered as a benefit of employment where an employer does not sponsor a group health plan or group health insurance coverage. The 30% limit is in reference to the cost of employee-only coverage (including both the employee's and the employer's contribution) under, as applicable: (1) the wellness program offered if it is a stand-alone group health plan; (2) the group health plan in connection with which the wellness program is offered; (3) the employer's lowest-cost group health plan if the wellness program is not offered in connection with a particular plan and the employer has more than one plan; or (4) if the employer does not offer health insurance, the second-lowest-cost Silver Plan on the ACA Exchange for the jurisdiction of the employer's principal place of business (applicable to a 40-year-old non-smoker).[17]

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10. *Id.* **11.** 29 C.F.R. § 1630.14(d)(1). The EEOC has published a sample notice form that employers may use to comply with their written notice obligations under the Final Rule. The sample notice is available at https://www1.eeoc.gov//laws/regulations/ada-wellness-notice.cfm. **12.** *Id.* **13.** 29 C.F.R. 1630 Appendix § 1630.14(d)(3). **14.** *Id.* **15.** *Id.* **16.** 29 C.F.R. § 1630.14(d)(3)(iv). For the limitations under HIPAA, see 26 CFR 54.9802-1(f)(3)(ii) and (4)(i); 29 CFR 2590.702(f)(3)(ii) and (4)(ii); 45 CFR 146.121(f)(3)(ii) and (f)(4)(ii). A special rule under HIPAA permits an incentive of up to 50% for participation in tobacco cessation programs as part of a wellness plan. See 26 CFR 54.9802-1(f)(5); 29 CFR 2590.702(f)(5); 45 CFR 146.121(f)(5). **17.** *Id.*

Significantly, the ADA Final Rule goes beyond the existing HIPAA requirements, which impose a 30% limit on incentives for health contingent wellness programs (i.e., programs where the incentive is contingent in part on an activity or outcome related to a health factor). The ADA Final Rule's incentive limit applies to both health contingent and participatory wellness programs that include a health risk assessment (in a participatory program, the reward or penalty is based only on participation). The HIPAA rule places no limits on incentives for participatory wellness programs.

Confidentiality of Employee Health Program Information

The EEOC's proposed ADA wellness program regulations already required that medical records developed in the course of providing voluntary health services to employees, including wellness programs, be maintained in a confidential manner, be kept separately from other records, and not be used for any purpose violative of the statute.[18] The ADA Final Rule includes added confidentiality protections by limiting the information received by an employer as part of an employee health program only to aggregated data in a format that does not disclose, nor is reasonably likely to disclose, the identity of specific individuals, except to the extent necessary to administer the plan.[19] Additionally, medical information collected from employees as part of a wellness program that is part of a group health plan also comes within the confidentiality protections of HIPAA as protected health information.[20] Thus, in the Interpretive Guidance to the ADA Final Rule, the EEOC opines that a wellness program governed by HIPAA "likely will be able to comply with its [confidentiality] obligations under [the ADA] by complying with the HIPAA privacy rule."[21]

The Interpretive Guidance also sets forth various steps the Commission believes an employer should take in order to protect the confidentiality of employee medical information:

- Properly train individuals who handle medical information about the confidentiality requirements of applicable laws, including HIPAA and the ADA.
- Promulgate clear privacy policies and procedures related to the collection, storage, and disclosure of medical information.
- Ensure that online systems and other technology have safeguards against unauthorized access, such as encryption.[22]

Importantly, the EEOC suggests that, as a best practice, those individuals who are privy to medical information disclosed as part of an employee health program be separate from those persons responsible for making decisions relating to a worker's employment, such as hiring, termination, or discipline. The EEOC opines that the use of a third party vendor to administer a wellness program may reduce the risk for employers that medical information may be disclosed improperly to individuals who make employment decisions.[23]

Reasonable Accommodation Obligations

Although not specifically referenced in the text of the ADA Final Rule, the EEOC's Interpretive Guidance makes it clear that even if a wellness program is deemed voluntary and provides incentives of no more than 30% of the total cost of employee-only coverage, this does not end an employer's obligations under the ADA. That is because, in addition to prohibiting discrimination on the basis of disability and the collection of disability-related information, the ADA requires employers to provide reasonable accommodations to employees with disabilities. This statutory obligation includes assisting disabled employees in participating in wellness programs as well as achieving any health-related goals and incentives that the plan may incorporate. As the EEOC's Interpretive Guidance states, an employer must provide "reasonable accommodations . . . , absent undue hardship, to enable employees with disabilities to earn whatever financial incentive an employer or other covered entity offers."[24]

For example, the EEOC advises that in a situation where an employer may offer employees a financial incentive to attend a nutrition class, the employer will need to provide a sign language interpreter for an employee who is deaf and needs an interpreter to understand the information communicated in the class. The only exception is if providing the interpreter would create an undue hardship for the employer. If a wellness program distributes written materials, an employer will also need to provide the materials in an alternative format, such as enlarged print or on a computer disk, to an employee with a vision impairment. Additionally, the EEOC's Interpretive Guidance opines that if an employee has a disability that makes drawing blood dangerous, the employer must exempt that employee from any biometric screening that includes a blood draw or provide an alternative test that the employee can safely undergo.[25]

Smoking Cessation Programs

As with reasonable accommodation, the ADA Final Rule does not specifically address smoking cessation programs. In its Interpretive Guidance, however, the EEOC explains that because these rules apply only to employee health programs that include disability related inquiries or medical examinations, a smoking cessation program that merely asks employees whether or not they use tobacco is not a program that implicates the ADA's limitations on disability-related inquiries or medical examinations. Thus, the EEOC takes the position that the ADA Final Rule does not apply to

18. 29 C.F.R. § 1630.14(d)(4) (formerly § 1630.14(d)(1) and (2)). **19.** 29 C.F.R. § 1630.14(d)(4)(ii) The disclosure exceptions under the proposed rules for relaying information about necessary restrictions on work duties and necessary accommodations, appropriate disclosure to first aid and safety personnel, and agency compliance audits also apply to this enhanced provision. *Id.* **20.** See 45 C.F.R. Parts 160 and 164 (HIPAA Privacy, Security, and Breach Notification Rules). **21.** 29 C.F.R. 1630 Appendix § 1630.14(d)(4). **22.** *Id.* **23.** *Id.* **24.** 29 C.F.R. 1630 Appendix § 1630.14(d)(3). **25.** *Id.*

incentives that an employer may offer in connection with a smoking cessation program. Accordingly, the EEOC opines that an employer can offer incentives as high as 50% of the cost of employee coverage under such a program, pursuant to the HIPAA regulations, without implicating or running afoul of the disability-related inquiries or medical examinations provision of the ADA.[26]

EEOC's Final GINA Regulations

Like its ADA Final Rule, the EEOC's GINA Final Rule clarifies the limited circumstances in which an employer can offer incentives under a wellness program. In particular, the regulations permit an inducement for an employee's spouse who participates in the program to voluntarily provide medical information.[27] The GINA Final Rule does not allow an employer to ask for the spouse's genetic information, nor to seek either the genetic information or the current or past health status of the employee's children.[28] Instead, the GINA Final Rule limits the type of information that may be sought in a health risk assessment solely to the spouse's manifestation of disease or disorder.[29]

More specifically, the GINA Final Rule provides that an employer's wellness plan may offer a limited incentive (either in the form of a reward or penalty) for an employee's spouse to provide information about the spouse's manifestation of disease or disorder as part of a health risk assessment if (1) the health or genetic services offered under the program to the employee's spouse are "reasonably designed" to promote health or prevent disease,[30] and (2) the spouse gives prior, knowing, voluntary, written authorization to collect the information.[31] Additionally, the Final Rule adds a provision stating that employers may not require employees (or employees' spouses or dependents covered by the employer's health plan) to agree to the sale or waive the confidentiality of their genetic information as a condition for receiving an incentive or participating in a wellness program.[32] The Final Rule also includes a provision, not specifically contained in the proposed regulations, stating that it is a violation of Title II of GINA for an employer to deny access to health insurance or health benefits, or to retaliate against an employee, because the employee's spouse declined to provide information as to the spouse's manifestation of disease or disorder.[33]

The GINA Final Rule provides that where an employer provides an incentive for an employee's spouse to participate in an employer sponsored wellness program with a health risk assessment, the inducement for the spouse to complete the assessment may not exceed over 30% of the total employee-only cost of the employer's relevant group health plan (where the relevant plan is determined under similar rules as for the ADA Final Rule limitation discussed above).[34] As with the ADA Final Rule, where the employer provides no group health plan, the 30% limit is in reference to the cost of insuring a 40-year-old non-smoker on the ACA Exchange's second-least-costly Silver Plan.[35]

Note that the GINA limitation is applied separately from the ADA limitation, so that the total incentive value can be up to 60% of the employee-only coverage if both apply. Thus, if an employer offers a health plan at a total cost of $14,000 (including both employer and employee contributions) for family coverage, and the plan costs

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26. *Id.* In its comments on its Final Rule, the EEOC cautions that if an employer's smoking cessation program includes biometric screening or other medical tests for the presence of nicotine or tobacco, then the ADA's financial incentive rules will apply, and in that instance, the ADA's 30% rule will trump the 50% HIPAA provision. *Id.* **27.** 81 Fed. Reg. 31143 (May 17, 2016). **28.** 29 C.F.R. § 1635.8(b)(2)(iii). According to the EEOC, prohibiting incentives to obtain the genetic or health information of children is important to preventing discrimination against the employee. The Commission believes that the possibility of discrimination is greater where the employer has access to information about the health status of the employee's children as opposed to the person's spouse, due to the fact that information about an employee's genetic make-up or predisposition to disease may be gleaned from information about the current or past health status of the employee's children. 81 Fed. Reg. at 31147. **29.** A spouse's health risk assessment may include a questionnaire or a medical examination, such as a blood pressure test or blood test, to detect high cholesterol or high glucose levels. 29 CFR 1635.8(b)(2)(iii). **30.** 29 CFR 1635.8(b)(2)(i)(A). According to the EEOC, this means that the service has a reasonable chance of improving the health of, or preventing disease in, participating persons. Thus, collecting information on a health questionnaire without providing follow-up information or advice is not allowed unless the information collected is actually used to design a program that addresses at least a subset of the conditions identified. Additionally, a program is not reasonably designed to promote health or prevent disease if it imposes, as a condition for obtaining a reward, an overly burdensome amount of time for participation, requires unreasonably intrusive procedures, or places significant costs related to medical examinations on employees. Nor is a program reasonably designed when it exists just to shift costs from the employer to particular employees based on their health. Importantly, GINA's existing prohibition on use of genetic information for employment-based decisions is maintained. Thus, it is unlawful for an employer to use health information provided by a spouse to make an employment decision related to the employee. 81 Fed. Reg. at 31152. **31.** 29 CFR 1635.8(b)(2)(i)(A). **32.** 29 CFR 1635.8(b)(2)(iv). **33.** 29 C.F.R. 1635.8(b)(2)(v). **34.** 29 C.F.R. 1635.8(b)(2)(iii). **35.** *Id.*

ONE OF THE MAJOR BENEFITS THAT SHOULD FLOW FROM IMPLEMENTATION OF THE EEOC'S FINAL RULES WILL BE ITS ASSISTANCE TO PRACTITIONERS IN DRAFTING EFFECTIVE WELLNESS PLANS THAT INCLUDE HEALTH RISK ASSESSMENTS FOR BOTH EMPLOYERS AND SPOUSES, YET STILL PASS EEOC SCRUTINY.

$6,000 for self-only coverage, the inducement to the employee to participate and to the employee's spouse to provide information about a manifested disease or disorder in a wellness program may not exceed $1,800 to the employee and $1,800 to the spouse.[36] The value of any inducement is taken into account for this purpose whether it is in the form of financial or in-kind rewards, such as paid time off for the employee, prizes, or other items of value, or penalties, such as increased medical plan premiums.

The GINA Final Rule 30% inducement limit generally parallels the limitations set forth in HIPAA, as amended by the Affordable Care Act, for health contingent wellness program inducements. The limit is also in line with the ADA Final Rule, which authorizes employers to provide incentives for employees to participate in a wellness program that collects information about the current or past health status of the employee. In promulgating that rule, the EEOC determined that allowing "incentives in excess of 30% of the cost of self-only coverage . . . would be coercive."[37] As the EEOC explained, it could "see no reason for adopting a different threshold where the employee's spouse is the individual whose health information is being sought."[38]

Effective Date of Final ADA and GINA Rules

The EEOC considers many of the changes in the ADA and GINA Final Rules to be mere clarifications of the existing rules, and these have immediate effect. However, the new rules specifically concerning (1) the notice that must be provided to employees under the ADA Final Rule regarding the information being sought through medical inquiries or medical examinations and (2) the level of incentives permissible under GINA to induce an employee's spouse to provide information about the spouse's manifestation of disease or disorder apply only prospectively to employer wellness programs. The applicability date is the first day of the first plan year of the group health plan used to calculate the level of incentives that begins on or after January 1, 2017.[39] Thus, if the plan year for the health plan used to calculate the permissible incentive limit begins on January 1, 2017, that is the date on which those provisions of the Final Rules apply to the wellness program.

Related Content

For more information on designing and operating an employer wellness program, see

> IMPLEMENTING COMPLIANT WELLNESS PROGRAMS

RESEARCH PATH: *Labor & Employment > Employee Benefits > Health and Welfare Plans > Practice Note > Other Welfare Benefit Issues*

For additional discussion about how employers can collect and use certain genetic and medical information, see

> FULFILLING THE REQUIREMENTS OF TITLE II OF THE GENETIC INFORMATION NON-DISCRIMINATION ACT (GINA)

RESEARCH PATH: *Labor & Employment > Employee Benefits > Health and Welfare Plans > Practice Note > Other Welfare Benefit Issues*

For guidelines designed to assist you in implementing a compliant wellness plan, see

> DESIGNING AND IMPLEMENTING COMPLIANT WELLNESS PROGRAMS—CHECKLIST

RESEARCH PATH: *Labor & Employment > Employee Benefits > Health and Welfare Plans > Forms > Fringe Benefit & Wellness Programs*

To see a sample notice form containing model clauses, see

> HIPAA NONDISCRIMINATION NOTICE FOR WELLNESS PROGRAMS

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Importance of the EEOC's Final Rules

The EEOC's rules recognize that wellness plans can have an important role to play in health care, both in terms of promoting employee health as well as in controlling healthcare costs. Additionally, by allowing incentives in line with those allowed under HIPAA, the Commission's regulations are particularly good news for employers.

36. *Id.* at 31154. **37.** 81 Fed. Reg. at 31154. **38.** *Id.* **39.** 81 Fed. Reg. at 31129 (ADA); *Id.* at 31147 (GINA). When an ACA Exchange Plan is used as a reference for the limitation, the plan year is the calendar year. *Id.*

The ADA Final Rule provides some necessary clarity as to how the EEOC views wellness programs and how the programs should be structured to be consistent with the ADA.

The GINA Final Rule also represents a significant step in eliminating past uncertainty as to whether offering an inducement to obtain health information from an employee's spouse violates the requirements of the statute. The Final Rule clarifies that an employer will avoid GINA liability if it limits inducements to those permitted under the rule, which like the ADA Final Rule are in line with the HIPAA requirements. As the EEOC has said, "allowing inducements in return for a spouse providing information about his or her manifestations of disease and disorder, while limiting inducements to prevent economic coercion, is the best way to effectuate the purposes of the wellness provisions of GINA and HIPAA."[40]

Thus, one of the major benefits that should flow from implementation of the EEOC's Final Rules will be its assistance to practitioners in drafting effective wellness plans that include health risk assessments for both employees and spouses, yet still pass EEOC scrutiny. Accordingly, all practitioners who advise employers on health and benefit plan matters should carefully review the ADA and GINA Final Rules and take appropriate steps to ensure that wellness plans are drafted in a manner that conforms to the regulatory requirements.

In this regard, practitioners should consider the following guidance for their clients implementing wellness programs:

- Do not require employees to participate in the wellness program.
- Do not deny health insurance to employees who do not participate in the program.
- Do not take any adverse action or retaliate against employees who do not participate in the wellness program or who fail to achieve certain health outcomes.
- Provide reasonable accommodations to allow disabled employees to participate in the wellness program and to obtain any incentives offered for certain health outcomes.
- If the program seeks medical information or requires medical examinations, provide employees with a notice that:
    - Is written in a way the employee is likely to understand
    - Describes the type of medical information that will be obtained and the purposes for which the information will be used
    - Describes the restrictions on the disclosure of medical information, the parties with whom it will be shared, and the methods the employer will use to ensure confidentiality

- If the program uses inducements, either in the form of a reward or penalty, to encourage employees to participate in the program or to encourage employee spouse's to provide information regarding a manifested disease or disorder, limit the value of the inducement to a maximum of 30% of the total cost of self-only coverage under the employer's group health plan (including both the employee's and the employer's contribution).

By following this guidance, practitioners can help ensure that the wellness plans they draft will not only lead to a healthier workforce, but also not become subject to a successful legal charge under the ADA or GINA.[41] L

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RESEARCH PATH: ***Labor & Employment > Employee Benefits > Health and Welfare Plans > Articles > Fringe Benefit and Wellness Programs***

40. 81 Fed. Reg. at 31146. 41. For additional information on the EEOC's ADA and GINA rules see J. Mook, "EEOC Issues Proposed Rule on Wellness Programs," 15 Bender's Lab. & Empl. Bull. 213 (July, 2015); J. Mook, "EEOC Proposes Amending GINA Regs for Wellness Plans." 16 Bender's Lab. & Empl. Bull. 1 (Jan., 2016); J. Mook, "EEOC Issues Final ADA and GINA Rules on Wellness Programs," 16 Bender's Lab. & Empl. Bull. 203 (July, 2016). This EIA is adapted from the article, "EEOC Issues Final ADA and GINA Rules," 16 Bender's Lab. & Empl. Bull. 203 (July, 2016).

Eric E. Bensen

DEFENDING TRADE SECRETS UNDER **THE ECONOMIC ESPIONAGE ACT**

The Defend Trade Secrets Act (DTSA)[1] creates for the first time a federal private cause of action for trade secret misappropriation.[2] Prior to the DTSA's enactment, private causes of action for trade secret misappropriation were solely a matter of state law, which in a vast majority of states was based on the Uniform Trade Secret Act (UTSA). The DTSA, although not preempting state law, borrows heavily from the UTSA, so much so that the burden that a trade secret claimant must meet to establish the existence of a trade secret and act of misappropriation is under both acts identical.

THE ENACTMENT OF DTSA USHERS IN THREE NOTABLE changes to trade secret law. First, where its interstate commerce requirement is met, the DTSA confers original jurisdiction on federal courts to hear trade secret misappropriation claims.[3] Second, unlike the UTSA, the DTSA provides for ex parte seizures of property when necessary to prevent the dissemination of a misappropriated trade secret.[4] Third, the DTSA immunizes individuals from liability under federal and state law for certain confidential disclosures of trade secret information.[5]

The DTSA was enacted as amendments to what is commonly known as the Economic Espionage Act (EEA), which provides criminal penalties for trade secret misappropriation and a civil cause of action for trade secret misappropriation that can be brought by the federal government.[6] Although enacted as part of the EEA, no doubt the DTSA and EEA will, as a practical matter, typically be thought of as separate statutes.

Discussion

Definitional Aspects of the DTSA

The key definitions of the DTSA are taken from the UTSA. Thus, like the UTSA, the DTSA places no definitional limit on the type of information that can at least potentially be protected as a trade secret.[7] To qualify for trade secret protection, any purported trade secret must: (1) in fact be secret,[8] (2) derive actual or potential independent economic value from not being generally known to or readily ascertainable through proper means by another person who could obtain economic value from the disclosure or use of the information,[9] and (3) have been consistently subject to efforts reasonable under the circumstances to protect its secrecy.

Misappropriation includes the wrongful acquisition of a trade secret—that is, the acquisition of a trade secret by a person who knows or has reason to know that the acquisition was made by improper means[11] —and the wrongful use or disclosure of a trade secret—that is, the use or disclosure by one who (1) used improper means to acquire the secret or (2) knew or had reason to know that the secret was: (a) derived from a person who used improper means to acquire it, (b) acquired it under circumstances giving rise to a duty to maintain its secrecy, or (c) derived from or through a person who owed a duty to the owner to maintain its secrecy.[12]

"Improper means" includes "theft, bribery, misrepresentation, breach or inducement of a breach of a duty to maintain secrecy, or espionage through electronic or other means."[13] However, in a departure from the UTSA that is nonetheless consistent with general trade secret practice, the DTSA expressly provides that reverse engineering, independent derivation, and any other lawful means of acquisition are excluded from the definition of "improper means."[14]

The DTSA speaks in terms of the "owner" of a trade secret,[15] but the term "owner" is defined to include not only the legal owner (i.e., the party with legal title to the trade secret), but also an equitable title holder and a licensee of the trade secret.[16]

Interstate Commerce Requirement

The DTSA provides standing to pursue a trade secret claim only where the trade secret is "related to a product or service used in,

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1. Defend Trade Secrets Act § 2(e). Enacted on and effective as of May 11, 2016. **2.** 18 U.S.C. § 1833(b)(1). **3.** 18 U.S.C. § 1836(c) ("JURISDICTION.—The district courts of the United States shall have original jurisdiction of civil actions brought under this section."). **4.** 18 U.S.C. § 1836(b)(2). **5.** 18 U.S.C. § 1833(b). **6.** 18 U.S.C. § 1831-1839. The DTSA left the EEA's substantive provisions respecting criminal trade secret actions unchanged other than to adjust the maximum penalty levied against organizations for trade secret misappropriation from $5,000,000 to the greater of $5,000,000 or three times the value of the stolen trade secret. 18 U.S.C. § 1832(b). The DTSA also amended the RICO statute to include criminal violations of the EEA as a predicate act. 18 U.S.C. § 1961(1). **7.** 18 U.S.C. § 1839(3) ("[T] he term 'trade secret' means all forms and types of financial, business, scientific, technical, economic, or engineering information, including patterns, plans, compilations, program devices, formulas, designs, prototypes, methods, techniques, processes, procedures, programs, or codes, whether tangible or intangible, and whether or how stored, compiled, or memorialized physically, electronically, graphically, photographically, or in writing if ...."); *cf.* UTSA § 1(4). For numerous examples of subject matter that has been granted or denied trade secret protection, see Roger M. Milgrim & Eric Bensen, 1 Milgrim on Trade Secrets § 1.09 (Matthew Bender) (hereinafter Milgrim on Trade Secrets). **8.** The DTSA does not expressly require secrecy in the sense of stating that, "A trade secret must be secret . . .," but it is axiomatic that publicly available information cannot be claimed as a trade secret. For a discussion of the secrecy requirement for trade secret protection, see *supra* note 7, Milgrim on Trade Secrets § 1.03. **9.** 18 U.S.C. § 1839(3)(B); *cf.* UTSA § 1(4)(i) (a trade secret must "derive[] independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable by proper means by, other persons who can obtain economic value from its disclosure or use . . ."). For a discussion of the UTSA's "independent economic value" requirement, see *supra* note 7, Milgrim on Trade Secrets § 1.01[2][c][iii][C]. **10.** 18 U.S.C. § 1839(3)(A); *cf.* UTSA § 1(4)(ii). For a discussion of the "reasonable efforts" or "reasonable precautions" requirement for trade secret protection, see *supra* note 7, Milgrim on Trade Secrets § 1.04. **11.** 18 U.S.C. § 1839(5)(A); *cf.* UTSA § 1(2)(i). For a discussion of misappropriation through wrongful acquisition, see *supra* note 7 Milgrim on Trade Secrets § 15.01[d]. **12.** 18 U.S.C. § 1839(5)(B); *cf.* UTSA § 1(2)(ii). For a discussion of misappropriation through wrongful use or disclosure, see *supra* note 7, Milgrim on Trade Secrets § 15.01[d]. **13.** 18 U.S.C. § 1839(6)(A); *cf.* UTSA § 1(1). **14.** 18 U.S.C. § 1839(6)(B). For a discussion of independent development, see *supra* note 7, Milgrim on Trade Secrets § 7.01[1][a]. For a discussion of reverse engineering, see id. § 15.01[1][d][iv]. **15.** 18 U.S.C. § 1836(b)(1) ("IN GENERAL.—An owner of a trade secret that is misappropriated may bring a civil action under this subsection if the trade secret is related to a product or service used in, or intended for use in, interstate or foreign commerce."). **16.** 18 U.S.C. § 1839(4). For a discussion of standing to sue for trade secret misappropriation and, in particular, whether a non-owner has such standing, see *supra* note 7, Milgrim on Trade Secrets § 15.01[1].

or intended for use in, interstate or foreign commerce."[17] No doubt that is a low threshold, but it can still be expected to be a substantial obstacle to DTSA standing for many trade secret claimants. This is so because many, perhaps even most, trade secret cases involve the misappropriation of confidential customer related information. Where the trade secret claimant is a local service business (e.g., a realtor, general contractor, local delivery service, etc.), the claimant's customer information would be unlikely to be viewed as related to or used in interstate commerce under a reasonable interpretation of Congress's interstate commerce power. Perhaps the same logic would apply to customer information belonging to a local distributor of product sourced from another state because the transaction between the distributor and its customers would be solely an intrastate matter. However, given the often expansive construction that courts have given to Congress's constitutional authority to regulate interstate commerce, courts might not have trouble concluding that customer information in those cases relates to interstate commerce.

Civil Seizure Provisions

Unlike the UTSA, the DTSA provides for ex parte seizures of property when necessary to prevent the dissemination of a misappropriated trade secret. It appears that the seizure remedy was a driving force behind the adoption of the DTSA. However, while Congress was considering the bill, an amendment was added to ensure that ex parte seizures were available only in "extraordinary circumstances,"[18] that is, where a defendant[19] is expected to attempt to flee the country or planning to immediately disclose the trade secret to a third party, or where a defendant is otherwise not amenable to the enforcement of the court's orders.[20]

The ex parte provision[21] includes numerous limitations,[22] although those limitations are not intended to curb equitable relief that is otherwise available under federal law.[23] Before a court can issue a seizure order, it must find the following based on "specific" facts:[24]

- **Ineffectiveness of other injunctive relief.** Defendant would evade, avoid, or otherwise not comply with an order under Federal Rule of Civil Procedure 65 or other form of equitable relief. [25]
- **Irreparable injury.** The applicant would suffer an immediate and irreparable injury if the seizure order was not issued.[26]
- **Balance of equities.** The harm to the applicant that would result from a denial of the order would outweigh the harm to the legitimate interests of defendant and substantially outweigh the harm to any third parties that would result were the order issued.[27]
- **Likelihood of success.** The applicant is likely to succeed on the merits of its claim (i.e., it is likely to succeed in showing that the information is a trade secret and that defendant misappropriated the trade secret or conspired to misappropriate the trade secret).[28]
- **Actual possession.** Defendant has actual possession of the trade secret and any property to be seized.[29]
- **Reasonable particularity.** To the extent reasonable under circumstances, the applicant has described the matter to be seized and the location of the matter to be seized with reasonable particularity.[30]
- **Threat of destruction/inaccessibility.** Defendant would destroy, move, hide, or otherwise make the matter to be seized inaccessible to the court were the applicant to proceed on notice to the applicant.[31]
- **No publication.** The applicant has not publicized the requested seizure.[32]

The DTSA also sets forth numerous requirements for the seizure order itself. Most are fairly routine.[33] The order must: (1) set forth the court's findings of fact and conclusions of law,[34] (2) provide for the narrowest seizure of the property necessary to achieve the purpose of the order and to do so with minimal interruption

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17. 18 U.S.C. § 1836(b)(1). **18.** 18 U.S.C. § 1836(b)(2)(A)(i) ("Based on an affidavit or verified complaint satisfying the requirements of this paragraph, the court may, upon ex parte application *but only in extraordinary circumstances*, issue an order providing for the seizure of property necessary to prevent the propagation or dissemination of the trade secret that is the subject of the action.") (emphasis added); S. Rep. No. 114-220, at 5 (2016). **19.** The DTSA uses "the party to which the order would be issued," 18 U.S.C. § 1836(b)(2)(A)(ii), but here, "defendant" is used for simplicity. **20.** S. Rep. No. 114-220, at 6 (2016). **21.** 18 U.S.C. § 1836(b)(2). **22.** S. Rep. No. 114-220, at 6 (2016). **23.** S. Rep. No. 114-220, at 6 (2016). **24.** 18 U.S.C. § 1836(b)(2)(A)(ii). **25.** 18 U.S.C. § 1836(b)(2)(A)(ii)(I). **26.** 18 U.S.C. § 1836(b)(2)(A)(ii)(II). **27.** 18 U.S.C. § 1836(b)(2)(A)(ii)(III). **28.** 18 U.S.C. § 1836(b)(2)(A)(ii)(IV). In connection with one option available to an applicant, the statute actually states that the applicant must be likely to succeed in showing that defendant "misappropriated the trade secret of the applicant by improper means . . . " There are, of course, no proper means to misappropriate a trade secret: "misappropriation" is defined to mean the acquisition of a trade secret by improper means. E.g., 18 U.S.C. § 1839(5)(A) ("[T]he term 'misappropriation' means . . . acquisition of a trade secret of another by a person who knows or has reason to know that the trade secret was acquired by improper means . . . "). However, it appears the "improper means" language was included to protect third parties such as members of the press who may possess a misappropriated trade secret, but did not use or conspire to use improper means to acquire the secret. S. Rep. No. 114-220, at 6-7 (2016). **29.** 18 U.S.C. § 1836(b)(2)(A)(ii)(V). This requirement was added to protect third parties, such as an Internet service provider, from seizure. S. Rep. No. 114-220, at 6 (2016). **30.** 18 U.S.C. § 1836(b)(2)(A)(ii)(VI). For a discussion the requirement that a trade secret claimant describe its trade secret with particularity, see *supra* note 7, Milgrim on Trade Secrets § 15.01[d][i]. **31.** 18 U.S.C. § 1836(b)(2)(A)(ii)(VII). It is not clear what this requirement adds to the requirement that the court make a finding that defendant will evade, avoid or otherwise not comply with other forms of injunctive relief. It is a safe bet that a defendant that would evade, avoid or otherwise ignore an injunction would act no more cooperatively in response to a notice from plaintiff. **32.** 18 U.S.C. § 1836(b)(2)(A)(ii)(VIII). It appears that this provision is intended to protect a defendant from the publicity that may arise from a seizure order. *Cf.* 18 U.S.C. § 1836(b)(2)(C) ("PROTECTION FROM PUBLICITY.—The court shall take appropriate action to protect the person against whom an order under this paragraph is directed from publicity, by or at the behest of the person obtaining the order, about such order and any seizure under such order."). **33.** What follows is a high-level summary of the required elements of a seizure order and related requirements. The DTSA itself should be consulted for the details of those requirements. **34.** 18 U.S.C. § 1836(b)(2)(B)(i).

of the business operations of third parties and the legitimate business interest of the defendant,[35] (3) provide guidance to the law enforcement officials that will execute the order,[36] (4) set a date for hearing at the earliest possible time,[37] and (5) require the applicant to provide security for the payment of damages in the event that the seizure or attempt to seize was wrongful or excessive.[38]

Less routine are the steps the court must take respecting confidentiality. The seizure order itself must be accompanied by an order prohibiting access to the seized materials by either the applicant or defendant and prohibiting any copy of the seized material.[39] Moreover, the court must take "appropriate action" to protect defendant from publicity about the order or any seizure by or at the behest of the applicant.[40] With respect to seized materials, the court shall take such materials into its possession and take appropriate measures to protect their confidentiality, including taking steps to ensure that any electronic materials are stored in a manner that does not permit Internet access.[41] Although a seizure order is to be executed by law enforcement officials, the court may allow a technical expert who is unaffiliated with the applicant and is bound by a court-approved non-disclosure agreement to participate in the seizure if the participation of the expert would aid in the execution of the order and minimize the burden of the seizure.[42] Any party that claims to have an interest in the subject matter seized may make a motion to have electronic materials included in the seized material encrypted.[43]

Remedies

The injunctive relief provisions of the DTSA are based on those in the UTSA.[44] Thus, as under the UTSA, a court may under the DTSA grant an injunction to prevent any "actual or threatened" misappropriation,[45] require affirmative actions to be taken to protect the trade secret,[46] and in "exceptional circumstances that render an injunction inequitable," grant what is elsewhere referred to as a "royalty injunction" (i.e., it may condition future use of the trade secret on payment of a reasonable royalty for a period of time no longer than the period of time for which use of the trade secret could be enjoined).[47]

However, recognizing that laws respecting restraints on employee mobility vary from state to state and seeking to avoid conflict with those laws,[48] Congress included two provisions in the DTSA that limit injunctive relief in the employee context. First, an injunction that would prevent an individual from entering into an

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employment relationship must be based on evidence of threatened misappropriation and cannot be based merely on the information that the person possesses.[49] That is, the DTSA rejected the "inevitable disclosure" doctrine—which had also been rejected in many states—under which a trade secret owner could be entitled to injunctive relief upon a showing that: (1) a former employee was going to work for a direct actual or potential competitor, (2) the employee's new position or activity would be essentially the same as his prior position or activity such that the employee would "inevitably" use the owner's trade secret in the new position, and (3) the trade secret at issue was advanced and potentially highly valuable to the second employer.[50] Second, and more broadly, the DTSA bars injunctive relief that would otherwise conflict with state law prohibiting restraints on the practice of a lawful profession, trade, or business.[51]

Like the UTSA,[52] the DTSA permits a successful claimant to recover damages for its actual loss caused by the misappropriation,[53]

35. 18 U.S.C. § 1836(b)(2)(B)(ii). **36.** 18 U.S.C. § 1836(b)(2)(B)(iv). **37.** 18 U.S.C. § 1836(b)(2)(B)(v). **38.** 18 U.S.C. § 1836(b)(2)(B)(vi). Damages for wrongful seizure are provided for in 18 U.S.C. § 1836(b)(2)(G). **39.** 18 U.S.C. § 1836(b)(2)(B)(iii). **40.** 18 U.S.C. § 1836(b)(2)(C). **41.** 18 U.S.C. § 1836(b)(2)(D). The court may appoint a special master to isolate the misappropriated trade secret information to facilitate the return of unrelated property and data to the person from whom the property was seized. 18 U.S.C. § 1836(b)(2)(D)(iv). **42.** 18 U.S.C. § 1836(b)(2)(E). **43.** 18 U.S.C. § 1836(b)(2)(H). **44.** *Cf.* UTSA § 2. **45.** 18 U.S.C. § 1836(b)(3)(A)(i). Preliminary injunctive relief for trade secret misappropriation is discussed in *supra* note 7, Milgrim on Trade Secrets § 14.01. Permanent injunctive relief for trade secret misappropriation is discussed in *supra* note 7, Milgrim on Trade Secrets § 15.02[1]. **46.** 18 U.S.C. § 1836(b)(3)(A)(ii). Steps that can be taken in litigation to preserve the secrecy of a trade secret are discussed in *supra* note 7, Milgrim on Trade Secrets § 14.02. **47.** 18 U.S.C. § 1836(b)(3)(A)(iii). Royalty injunctions are discussed in *supra* note 7, Milgrim on Trade Secrets § 15.02[q] **48.** S. Rep. No. 114-220, at 8 (2016). State laws respecting the restraints that an employer is permitted to place on an employee's post-employment activities are discussed in *supra* note 7, Milgrim on Trade Secrets ch. 4. **49.** 18 U.S.C. § 1836(b)(3)(A)(i)(I). **50.** Note that as the DTSA does not preempt state law (other than with respect to certain protections for immunized disclosures discussed *infra)*, 18 U.S.C. § 1838, a state that had adopted the inevitable disclosure doctrine could still allow injunctive relief under that doctrine in connection with a misappropriation claim brought under state law. For a discussion of the inevitable disclosure theory, including a critique of its use in ordinary circumstances, see *supra* note 7, Milgrim on Trade Secrets § 5.02[3][d]. **51.** 18 U.S.C. § 1836(b)(3)(A)(i)(II). **52.** *Cf.* UTSA § 3(a). **53.** 18 U.S.C. § 1836(b)(3)(B)(i)(I). Damages for trade secret misappropriation are discussed in *supra* note 7, Milgrim on Trade Secrets § 15.02[3].

ONE OF THE RISKS INHERENT IN ANY TRADE SECRET LITIGATION IS THE POSSIBILITY THAT THE TRADE SECRET WILL BE DISCLOSED IN RECORDS OF THE PROCEEDING, WHICH ARE GENERALLY OPEN TO THE PUBLIC.

damages for unjust enrichment from the misappropriation to the extent that unjust enrichment damages are not taken into account inthe computation of damages for actual loss,[54] and in lieu of damages measured by other means, a reasonable royalty for defendant's unauthorized disclosure or use of the trade secret.[55]

Also like the UTSA,[56] the DTSA permits an award of exemplary damages up to two times the amount awarded as compensatory damages in the case of willful and malicious misappropriation.[57] The DTSA also permits, as does the UTSA,[58] an award of attorney's fees where a misappropriation claim is made in bad faith, a motion to terminate an injunction is made or opposed in bad faith, or the misappropriation was shown to have been willful and malicious.[59] However, as discussed below, exemplary damages and attorney's fees may be denied where an employer has failed to comply with the DTSA's immunized disclosure provisions.

Statute of Limitations

The statute of limitations for a claim under the DTSA is three years from the date on which the misappropriation was, or by the exercise of reasonable diligence should have been, discovered.[60] The DTSA provides that a continuing misappropriation constitutes a single claim of misappropriation[61] which is to say that the statute of limitations runs once from the time that the misappropriation was or should have been discovered, not again from each unauthorized use or disclosure of the secret.[62]

Preservation of Confidentiality and Immunized Disclosures

One of the risks inherent in any trade secret litigation is the possibility that the trade secret at issue will be disclosed in the records of the proceeding, which, as is the case with any federal litigation, are generally open to the public. Generally applicable federal (and state) laws include provisions that a trade secret claimant may avail itself of to guard against such disclosure.[63]

The DTSA includes several provisions specific to the Act to protect the confidentiality of trade secrets that are the subject of a DTSA proceeding. For example, the DTSA prohibits a court from authorizing the disclosure of any information that the owner asserts is a trade secret unless the court first gives the party the opportunity to file a submission under seal supporting the information's trade secret status.[64] The DTSA further provides that information provided under seal cannot be used for any purpose other than for the action in which it was submitted (unless required by law).[65] Lastly, the DTSA provides that the disclosure of information relating to a trade secret in a DTSA action shall not by itself constitute a waiver of trade secret protection for the information.[66]

The DTSA also immunizes individuals from liability under federal and state law for certain confidential disclosures of trade secret information.[67] Three types of disclosure are protected:

- A disclosure made in confidence to a federal, state, or local government official, either directly or indirectly, or to an attorney solely for the purpose of reporting or investigating the suspected violation of law[68]
- A disclosure made in a complaint or other document filed under seal in a lawsuit or other proceeding[69]
- A disclosure to an attorney or in a court proceeding by an individual who files a lawsuit for retaliation by an employer for the individual's reporting of a suspected violation of law as long as any court filings are made under seal and the individual does not otherwise disclose a trade secret except pursuant to a court order[70]

The DTSA's Notice Requirements

Interestingly, the DTSA requires that an employer shall provide notice of the DTSA's immunities from disclosure in any contract or agreement with an "employee," including traditional employees, independent contractors, and consultants,[71] that concerns the use of a trade secret or other confidential information.[72] Alternatively, the employer can provide in a nondisclosure agreement a cross-reference to a policy document provided to employees in which the employer sets forth the employer's reporting policy for suspected violations of law.[73] This intrusion into what was otherwise solely a matter of state law (non-disclosure agreements are governed by state, rather than federal, law) is bound to be a trap for the unwary. However, the notice requirement applies only to contracts and agreements entered into after May 11, 2016,[74] the effective date of

54. 18 U.S.C. § 1836(b)(3)(B)(i)(II). Unjust enrichment for trade secret misappropriation is discussed in *supra* note 7, Milgrim on Trade Secrets § 15.02[3][c]. **55.** 18 U.S.C. § 1836(b)(3)(B)(i)(III). Reasonable royalties for trade secret misappropriation are discussed in *supra* note 7, Milgrim on Trade Secrets § 15.02[3][e]. **56.** *Cf.* UTSA § 3(b). **57.** 18 U.S.C. § 1836(b)(3)(C). Exemplary damages for trade secret misappropriation are discussed in *supra* note 7, Milgrim on Trade Secrets § 15.02[3][i]. **58.** *Cf.* UTSA § 4. **59.** 18 U.S.C. § 1836(b)(3)(D). Attorney's fees for trade secret misappropriation are discussed in *supra* note 7, Milgrim on Trade Secrets § 15.02[3][k]. **60.** 18 U.S.C. § 1836(d). **61.** 18 U.S.C. § 1836(d). **62.** For a discussion of the discovery rule, under which a claim for trade secret misappropriation arises only once for statute of limitations purposes, and the continuing tort approach, under which each unauthorized use or disclosure gives rise to a new claim for statute of limitations purposes, see *supra* note 7, Milgrim on Trade Secrets § 13.04[2]. **63.** For a discussion of such provisions and additional techniques that a trade secret claimant may utilize to protect its trade secret, see *supra* note 7, Milgrim on Trade Secrets § 14.02. **64.** 18 U.S.C. § 1835(b). **65.** 18 U.S.C. § 1835(b). **66.** 18 U.S.C. § 1835(b). **67.** 18 U.S.C. § 1833(b). **68.** 18 U.S.C. § 1833(b)(1)(A). **69.** 18 U.S.C. § 1833(b)(1)(B). **70.** 18 U.S.C. § 1833(b)(2). **71.** 18 U.S.C. § 1833(b)(4). **72.** 18 U.S.C. § 1833(b)(3)(A). **73.** 18 U.S.C. § 1833(b)(3)(B). Seemingly, Congress had in mind whistleblower policies that are common in employee policy manuals. It is not clear, however, whether a cross-reference to a standard whistleblower policy would suffice to meet this requirement if that policy does not specify the specific immunizations provided for by the DTSA. **74.** 18 U.S.C. § 1833(b)(3)(D). **75.** 18 U.S.C. § 1833(b)(3)(C). **76.** *See supra* note 7, Milgrim on Trade Secrets §§ 15.02[3][i], [k].

the DTSA. Also, a failure to comply does not bar a claim under the DTSA: its bars only the recovery of exemplary damages or attorney's fees against an employee who had not received the required notice.[75] Even then, attorney's fees and exemplary damages would remain available under state law.[76]

Comments

It will be interesting to see whether the actual impact of the DTSA matches the fanfare with which it was an acted. No doubt a seizure order under the DTSA is in theory a powerful, new protection for trade secret owners. However, given the relatively strict requirements that have to be met to obtain a seizure order and the fact that a trade secret owner would have to discover the misappropriation fairly quickly for a seizure order to do any good, it may not be a frequently utilized protection.

Providing courts with original jurisdiction over trade secret claims will no doubt benefit some trade secret claimants by allowing them to sidestep potential disputes about the existence of diversity or pendent jurisdiction. However, many if not a majority of trade secret claims are already heard in federal court. Also, rather than being matters of interstate commerce, many trade secret disputes are local in nature. Accordingly, while the number of trade secret claims brought in federal court will no doubt increase, that increase may be somewhat marginal.

Is not clear that the DTSA can even meet its stated goals. One goal of the DTSA was to bring the rights of trade secrets owners "into alignment with those long enjoyed by owners of other forms of intellectual property, including copyrights, patents, and trademarks."[77] It does not. Unlike the Patent Act and Copyright Act, which preempt state laws that provide similar rights with respect to inventions and works of authorship respectively, and the Lanham Act, which essentially creates a federal scheme for trademark protection that parallels protections available under state law, the DTSA neither generally preempts state law protection for trade secrets[78] nor creates any new substantive rights in commercially sensitive information.[79] Rather, the net impact of the DTSA is to create subject matter jurisdiction for trade secret claims in federal court (where the DTSA's interstate commerce requirement is met) and to create a new—albeit carefully circumscribed—right for a trade secret owner to have the government seize trade-secret-related property from a defendant. Thus, although enacted as substantive law, the net effect of the DTSA is largely procedural.

The other goal of the DTSA was to "provide a single, national standard for trade secret misappropriation with clear rules and predictability for everyone involved."[80] However, prior to the DTSA, trade secret law was already largely uniform.[81] As the Senate report for the DTSA itself recognized, the differences among state trade secret laws prior to the adoption of the DTSA were "relatively minor."[82] Moreover, the more notable differences in state trade secret law, in particular, differences as to the extent to which the UTSA preempts common law claims concerning trade secret misappropriation,[83] and the length of the statutes of limitation for

77. S. Rep. No. 114-220, at 3 (2016). **78.** 18 U.S.C. § 1838. **79.** The DTSA further provides that it shall not be construed to "be a law pertaining to intellectual property for purposes of any other Act of Congress." Defend Trade Secrets Act § 2(g). **80.** S. Rep. No. 114-220, at 14 (2016). **81.** At the time of the enactment of the DTSA, 47 states had adopted the UTSA. While state enactments of the UTSA were not strictly speaking uniform, the requirements that a trade secret claimant had to meet to establish the existence of a trade secret and an act of misappropriation did not vary significantly. Massachusetts and North Carolina had trade secret statutes that were not based on the UTSA, Mass. Gen. Laws ch. 93, § 42; N.C. Gen. Stat. §§ 66–152, but, in practice, trade secret law in those states did not differ significantly from the UTSA. *See supra* note 7, Milgrim on Trade Secrets § 1.01[3]. New York, which still followed the *Restatement of Torts* (1937) for trade secret misappropriation, was arguably the outlier. However, while there were differences between the *Restatement* and the UTSA (*e.g.*, unlike the *Restatement*, the UTSA did not require that a trade secret be in continuous use in the owner's business to qualify for protection), the significance of those distinctions were diminishing over time. E.g., Zylon Corp. v. Medtronic, Inc., 2015 N.Y. Misc. LEXIS 1276, 18-19, 2015 NY Slip Op 30610(U) (Sup. Ct. N.Y. County Apr. 17, 2015) (plaintiffs claimed as their trade secret their process for manufacturing zero-fold balloons for angioplasty catheters; the fact that plaintiff, which sought to license the technology to defendant in exchange for royalty payments, did not actually manufacture catheter balloons was not fatal to its claim because the claimed trade secret could be put to continuous use by a catheter balloon manufacturer). **82.** S. Rep. No. 114-220, at 2 (2016). **83.** For a discussion of the different constructions that courts have given to the UTSA's preemption provision, see *supra* note 7, Milgrim on Trade Secrets § 1.01[3][a].

WHERE A TRADE SECRET CLAIMANT BRINGS AN ACTION FOR MISAPPROPRIATION IN FEDERAL COURT, THE CLAIMANT WOULD BE WELL-ADVISED TO PURSUE BOTH THE DTSA CLAIM AND A PARALLEL STATE LAW CLAIM.

trade secret claims,[84] did not impact the burden that an owner had to meet to prevail on a misappropriation claim.

More importantly, because the DTSA incorporates the UTSA's definitions of "trade secret," "misappropriation," and "improper means," a federal district court construing the DTSA will, given the lack of other guidance, almost certainly rely on the decisional trade secret law of the state in which it sits to construe the DTSA. By doing so, those courts will likely impart whatever differences exist among state trade secret laws to the DTSA itself. For example, assume State A requires that a trade secret not be known or ascertainable by proper means to satisfy the independent economic value requirement for trade secret protection, while State B requires only that the trade secret not be generally known or readily ascertainable by proper means.[85] In that event, it could be predicted with some confidence that a federal court sitting in State A would conclude that a trade secret must not be known or ascertainable by proper means to satisfy the DTSA's definition of trade secret, while a federal court in State B would conclude that a trade secret must not be generally known or readily ascertainable to meet that definition. True, the Supreme Court may eventually resolve differences of great importance (and/or federal courts of appeal may take steps to encourage uniformity). However, any uniformity that may result will only create conflicts between federal and state trade secret law. For example, in the above hypothetical, were the Supreme Court to conclude that the DTSA requires only that a trade secret not be generally known or readily ascertainable by proper means to satisfy the DTSA's definition of a trade secret, state and federal trade secret law in State A would conflict. Accordingly, notwithstanding the passage of the DTSA, a significant advance in the uniformity of trade secret law is not likely on the horizon.

That said, where a trade secret claimant brings an action for misappropriation in federal court, the claimant would be well-advised to pursue both the DTSA claim and a parallel state law claim: the DTSA claim would resolve any issues about subject matter jurisdiction and at least keep open the possibility of obtaining a seizure order, while the state law claim would keep open the opportunity to obtain attorney's fees and exemplary damages in the event the owner has not satisfied DTSA's notice requirements. L

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84. E.g., Cal. Civ. Code § 3426.6 (three-year statute of limitations), Ohio Rev. Code Ann. § 1333.66 (four-year statute of limitations), 765 Ill. Comp. Stat. 1065/7 (five-year statute of limitations).
85. The former, stricter rule was, as of 2016, the rule in Kansas while the latter, more lenient rule was followed in other UTSA states. See *supra* note 7, Milgrim on Trade Secrets § 1.01[2][c][viii].

Trade Secrets License Agreement

This is a sample license agreement for the exclusive or non-exclusive license of a trade secret. This basic form of agreement provides for payment of an ongoing royalty through the term of the agreement.

Trade Secrets License Agreement

This agreement is made and entered into by and between [name of licensor] with its principal office at [address] (hereinafter collectively known as Licensor) and [name of licensee] with its principal office at [address] (hereinafter referred to as Licensee).

Witnesseth

WHEREAS, Licensor has developed and possesses valuable and proprietary trade secret information pertaining to [description of trade secret that is subject of the agreement] (hereinafter referred to as "Trade Secrets"); and

WHEREAS, Licensee is desirous of acquiring from Licensor, and Licensor is desirous of providing to Licensee, a license to use Trade Secrets.

NOW, THEREFORE, in consideration of these mutual promises and covenants hereinafter set forth and other good and valuable consideration, the parties intending to be legally bound thereby, have covenanted and agreed, and hereby do covenant and agree, as follows:

1. Licensor hereby grants to Licensee the [exclusive/nonexclusive] license to use Licensor's trade secrets.

2. Licensor promises to disclose to Licensee the aforesaid trade secrets.

3. In consideration of the aforementioned grants and promise, Licensee shall pay to Licensor the sum of [amount] in lawful money of the United States upon execution of this Agreement. In addition, Licensee shall pay to Licensor a royalty commencing [date].

4. The Licensee's duty to pay running royalty shall terminate when the licensed trade secret no longer has trade secret status.

5. Licensee agrees to maintain the confidentiality of all know-how and confidential information already imparted or to be imparted by Licensor relating to the trade secrets and not to disclose same to others without the express written permission of Licensor. This obligation shall not apply to information now in the public domain nor (after the date such information enters the public domain) to information entering the public domain not in violation of this Agreement.

6. This agreement shall last for a period of [term of agreement] unless sooner terminated by the mutual agreement of the parties hereto. Upon termination, the Licensee agrees not to use nor disclose in any manner the licensed trade secrets.

7. [Length of time] prior to termination, the parties hereto shall enter into good faith negotiations for the renewal of the licenses granted hereunder for an additional [length of time] period.

8. In the event any part or provision of this Agreement should be held invalid or unenforceable, the validity of the remaining provisions and parts of this Agreement shall not be affected by such holding.

9. This Agreement embodies the entire understanding between the parties and may not be varied except in writing signed by the parties hereto.

10. This Agreement shall be interpreted and construed and the legal relationship created herein shall be determined in accordance with the laws of the State of [state].

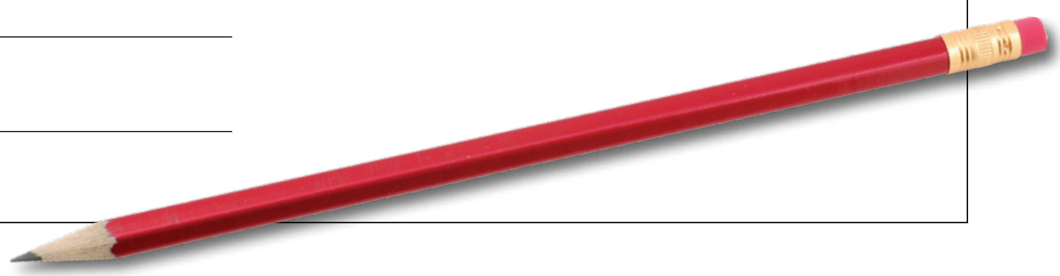
11. Neither this Agreement nor any interest herein may be assigned, in whole or in part, by either party without the prior written consent, either party may assign this Agreement to a successor of all or substantially all of its business, provided, further, that the assignor shall remain liable and responsible to the non-assigning party hereto for the performance and observance of all such duties and obligations.

12. Licensor and Licensee agree to execute, acknowledge and deliver all such further instruments, and to do all such other acts as may be necessary or appropriate in order to carry out the intent and purposes of this Agreement.

IN WITNESS WHEREOF, the parties have caused this Agreement to be signed by their duly authorized officers this [____________________] day of [____________________], 20[______].

BY:____

BY:____



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Examining the Duty to Provide **Religious Accommodations**

Title VII of the Civil Rights Act of 1964 (Title VII) prohibits discrimination based on an individual's religion, and also requires employers to furnish reasonable accommodations for an individual's religious practices or beliefs unless the accommodation imposes an undue hardship on the employer's business operations.

THIS ARTICLE ANALYZES THE OBLIGATIONS IMPOSED on both the individual and the employer when an employee or an applicant requests an accommodation for his or her religious beliefs, specifically addressing the following religious accommodation issues:

- Title VII's Broad Definition of Religion
- Notice Requirement
- Duty to Engage in Interactive Process
- Definition of Reasonable Accommodation
- Undue Hardship

Title VII's Broad Definition of Religion

Title VII adopts a very broad definition of religion and specifically requires employers to accommodate employees' religious beliefs:

> The term "religion" includes all aspects of religious observance and practice, as well as belief, unless an employer demonstrates that he is unable to reasonably accommodate to an employee's or prospective employee's religious observance or practice without undue hardship on the conduct of the employer's business.
>
> 42 U.S.C. § 2000e(j).

According to the Equal Employment Opportunity Commission (EEOC), Title VII's definition of religion extends not only to traditional, organized religions, such as Christianity, Judaism, Islam, Hinduism, and Buddhism, but also encompasses sincerely held religious beliefs that are "new, uncommon, not part of a formal church or sect, only subscribed to by a small number of people, or that seem illogical or unreasonable to others." See EEOC Compliance Manual § 12-I(A)(1).

Title VII's Test for Whether a Set of Beliefs Is a Religion

An individual's set of beliefs will meet Title VII's definition of a religion if they are sincere, meaningful, and occupy a place in the life of an individual similar to that filled by organized religions' belief in a supreme being. Adeyeye v. Heartland

Sweeteners, LLC, 721 F.3d 444 (7th Cir. 2013) (quoting U.S. v. Seeger, 380 U.S. 163, 165–66 (1965)). A belief in some form of deity is not required for Title VII protection, as reflected by the courts' recognition that atheism is a religion. Section 12 of the EEOC Compliance Manual states that religion under Title VII includes both theistic beliefs and practices and non-theistic moral and ethical beliefs. See EEOC Compliance Manual § 12-I(A)(1).

Most courts apply a two-factor test to determine whether a set of beliefs is a religion in the context of Title VII's accommodation requirement:

- The belief necessitating the accommodation must actually be religious in the individual's own scheme of things.
- The belief must be sincerely held by the individual.

See, e.g., Van Koten v. Family Health Management, 955 F. Supp. 898, 902 (N.D. Ill. 1997) (citing Redmond v. GAF Corp., 574 F.2d 897, 900 n.12 (7th Cir. 1978)).

Whether the Beliefs Are Religious

The EEOC's test—which is similar but not identical to the above-outlined test applied by most courts—sheds some light on what beliefs are religious for purposes of Title VII. The EEOC defines religious beliefs to include "moral or ethical beliefs as to what is right and wrong which are sincerely held with the strength of traditional religious views." EEOC Compliance Manual § 12-I(A)(1). See 29 C.F.R. § 1605.1.

Title VII's broad definition of religion leads many courts to resolve disputes in favor of coverage. As a result, the grounds on which an employer can challenge an individual's religious beliefs are typically very narrow.

Religious beliefs typically involve concerns about life, purpose, and death, and not social, political, or economic philosophies. The following are a few examples of how courts have addressed whether particular beliefs meet the definition of religion:

- **Church of Wicca is a religion.** In Van Koten v. Family Health Management, 955 F. Supp. 898 (N.D. Ill. 1997), the court found that an employee's adherence to the Wicca religion—whose religious beliefs included the beliefs that Halloween was a holy day, that astrology, psychic abilities, and reincarnation are valid, and respect for all life forms—meets Title VII's definition of religion. Id. at 902.
- **Universal Belief System is a religion.** In Lorenz v. Wal-Mart Stores, Inc., 2006 U.S. Dist. LEXIS 36145 (W.D. Tex. May 24, 2006), the court held that Title VII covered an employee's practice of "Universal Belief System"—which stresses tolerance and acceptance of other people's religious beliefs—even though the employee did not know anyone other than his mother and himself that followed this belief system. 2006 U.S. Dist. LEXIS 36145 at *29.
- **Klu Klux Klan is not a religion.** Courts have found that "the proclaimed racist and anti-semitic ideology" of the Klu Klux Klan takes on "a narrow, temporal and political character inconsistent with the meaning of 'religion' as used in [Title VII]." Bellamy v. Mason's Stores, Inc., 368 F. Supp. 1025, 1026 (E.D. Va. 1973); see also Slater v. King Soopers, 809 F. Supp. 809, 810 (D. Colo. 1992).
- **Creativity is a religion.** While courts have found the Klu Klux Klan is not a religion, one court has found that "Creativity"—which has white supremacy as a central tenet—is a religion for Title VII purposes. Peterson v. Wilmur Communs., Inc., 205 F. Supp. 2d 1014, 1021–24 (E.D. Wis. 2002).
- **Veganism may be a religion.** One district court held in denying a motion to dismiss Title VII religious discrimination claims that plaintiff had plausibly alleged that veganism is a religion, rejecting the employer's argument that it is a mere dietary preference or social philosophy. Chenzira v. Cincinnati Children's Hosp. Med. Ctr., 2012 U.S. Dist. LEXIS 182139, at *11 (S.D. Ohio Dec. 27, 2012). Note, however, that in McDavid v. County of Sacramento, 2006 U.S. Dist. LEXIS 43711, at *15 (E.D. Cal. June 26, 2006), the court held that veganism is not a religion for purposes of the Free Exercise Clause of the First Amendment.

Whether an individual's beliefs meet Title VII's definition of religion is a fact-specific inquiry that employers must address on a case-by-case basis.

Whether the Beliefs Are Sincerely Held

Determining whether an individual's beliefs are sincerely held requires a delicate balance between questioning the sincerity of an individual's beliefs and ensuring that the individual's beliefs meet the requirements of a religion under Title VII. This question of sincerity is fundamental because, if the individual cannot show that the beliefs are sincerely held, the employer is not required to provide an accommodation. Courts have repeatedly held that Title VII does not require an employer to accommodate a request that is based on personal preference and not a sincerely held religious belief. Thus, it is acceptable for an employer to question the validity or sincerity of the individual's religious beliefs by showing the individual has acted in a manner contrary to his or her religious beliefs in the past.

Of course, that an individual has not always sincerely held a particular religious belief or followed certain observances does not mean that he or she cannot do so in the future, especially

where the individual can show that the change is due to a conversion or deepening in his or her faith.

Accommodation Requirement Does Not Extend to Personal Preferences

The following are examples of courts finding that the employer did not violate Title VII when it denied the individual's requested accommodation because the request was based on personal preferences and not sincerely held religious beliefs:

- **Exceptions to grooming policies.** Title VII does not require an employer to make exceptions to its work rules because the individual objects on less than credible religious grounds. In Hussein v. Waldorf Astoria, 134 F. Supp. 2d 591 (S.D.N.Y. 2001), the court rejected the employee's objection to the employer's grooming policy requiring employees to be clean shaven because the employee never wore a beard in the prior 14 years of employment, never explained why his religion prevented him from shaving, and shaved his beard within three months. Id. at 596–97.
- **Objection to union membership.** An employee objected to the requirement that he join a labor union when his faith (Seventh-Day Adventist) prohibited union membership. The appellate court held that the employer did not have a duty to accommodate because the employee acted in a manner contrary to his professed religious beliefs based on the following evidence as to the sincerity of the claimed religious beliefs: (1) the employee lied on his employment application, (2) he did not object to union membership until after he rejected the union's accommodation of his specific objections, (3) he was divorced, (4) he took an oath before a notary upon becoming a public employee, and (5) he worked five days a week (instead of the six required by his faith). EEOC v. Union Independiente De La Autoridad De Acueductos Y Alcantarillados De P.R., 279 F.3d 49, 56–57 (1st Cir. 2002).
- **Time, place, and manner of the accommodation.** An employer may generally deny an employee the right to take leave (either paid or unpaid) or to prepare for religious observances unless the individual's religion requires that a particular observance take place at a particular time, location, or manner. Tiano v. Dillard Dep't Stores, 139 F.3d 679, 682–83 (9th Cir. 1998). In *Tiano*, the Ninth Circuit ruled that Title VII does not protect an employee who felt compelled to leave her job to make a religious pilgrimage during an employee vacation blackout period. The court found that there was no conflict between the religious belief and the employment duties because it was the employee's decision—not compelled by the practices of her religion—to make the pilgrimage at that particular time rather than waiting until after the employer's blackout period. Id. See also Dachman v. Shalala, 9 F. App'x 186, 192 (4th Cir. 2001); Wessling v. Kroger Co., 554 F. Supp. 548, 552–53 (E.D. Mich. 1982).

Notice Requirement

Notice is a critical element of an employer's obligation to provide a religious accommodation, as the obligation does not arise until the employer has notice of the individual's need for the accommodation. The burden is generally on the employee or applicant to inform the employer of the religious nature of a conflict with a work rule and of the need for an accommodation. Thomas v. National Association of Letter Carriers, 225 F.3d 1149, 1155–56 (10th Cir. 2000). Knowledge that an individual has strong religious beliefs is generally not enough to put an employer on notice of the individual's need for an accommodation. Chalmers v. Tulon Co., 101 F.3d 1012, 1020 (4th Cir. 1996).

There is an exception to the general rule that mere knowledge of the beliefs does not trigger the duty to accommodate where the employer has particularized, actual knowledge of the need to accommodate the individual's religious beliefs. Heller v. EBB Auto Co., 8 F.3d 1433, 1439 (9th Cir. 1993). For example, one district court found that the employer had sufficient notice where, when considering an applicant for a pharmacist position, the district manager spoke to a job reference that advised the manager that the applicant had previously refused to sell condoms because of his religious beliefs. Hellinger v. Eckerd Corp., 67 F. Supp. 2d 1359, 1363 (S.D. Fla. 1999).

Generally, to give the employer notice, an individual only needs to provide enough information about his or her religious beliefs to permit the employer to understand the nature of the conflict between the individual's religious practices and the employer's job requirements. Heller, 8 F.3d at 1439.

However, with respect to a job applicant's disparate treatment claim, the U.S. Supreme Court has held that an employer that acts with the motive to avoid the obligation to provide an accommodation may violate Title VII even if the employer has no more than an "unsubstantiated suspicion" that the individual requires an accommodation. [Equal Employment Opportunity Commission v. Abercrombie & Fitch Stores, Inc., No. 14-86, 575 U.S. ____, 2015 U.S. LEXIS 3718, at *8, 135 S.Ct. 2028 (June 1, 2015).]

The Supreme Court made clear that a job applicant will prevail on a disparate treatment claim if his or her need for an accommodation was a motivating factor in the employer's refusal to hire the applicant, regardless of whether the employer had actual knowledge of the employee's need for an accommodation. Id. at *8-9.

Duty to Engage in the Interactive Process

Once an individual provides an employer with notice of the need to accommodate a particular religious practice or belief, both the employer and the individual have an obligation to engage in an interactive process to determine whether an accommodation is possible. Ansonia Bd. of Educ. v. Philbrook, 479 U.S. 60, 69 (1986). The individual has an obligation to identify those employment practices or rules that interfere with his or her religious belief so that the employer can assess whether an accommodation is available. The employer then has the obligation to consider—in good faith—whether an accommodation is possible and whether such accommodation poses an undue hardship to its business operations.

An employer is not required to offer an individual his or her preferred accommodation. All an employer needs to do is offer a reasonable accommodation; once the employer does so, the employer has satisfied its obligations under Title VII. An employer is not required to show that the offered accommodation is the best accommodation or that an alternative would be worse or more of a hardship.

Definition of Reasonable Accommodation

A reasonable accommodation is an accommodation that eliminates the conflict between the employment requirements and the individual's religious beliefs. Title VII does not require the employer to satisfy all of the individual's requests; it only needs to eliminate the conflict with the individual's religious beliefs. In Ansonia Board of Education v. Philbrook, 479 U.S. 60 (1986), the U.S. Supreme Court held that Title VII does not require an employer to grant the employee the particular accommodation he or she requests, because any reasonable accommodation by the employer is sufficient to meet its accommodation obligation. In other words, the employee may not be entitled to "the most beneficial accommodation." The Court stated:

> By its very terms the statute directs that any reasonable accommodation by the employer is sufficient to meet its accommodation obligation. The employer violates the statute unless it "demonstrates that [it] is unable to reasonably accommodate . . . an employee's . . . religious observance or practice without undue hardship on the conduct of the employer's business." 42 U.S.C. § 2000e(j).

Id. at 68. Of course, the accommodation offered must be reasonable. Lewis v. New York City Transit Auth., 12 F.Supp.3d 418, 442-45 (E.D.N.Y. 2014).

A proposed accommodation is not reasonable if it only eliminates part of the conflict and a full accommodation would not pose an undue hardship. For example, where an individual's religious beliefs prohibit the individual from working from sundown Friday through sundown Saturday, the employer will not satisfy Title VII if it only offers to avoid scheduling the individual for Saturday (but not Friday night) shifts. An accommodation is also unreasonable if it requires an individual to accept a reduction in pay or loss of benefits if there is an alternative accommodation that does not require the individual to do so. Baker v. The Home Depot, 445 F.3d 541, 546 (2d Cir. 2006) ("an offer of accommodation may be unreasonable 'if it cause[s] [an employee] to suffer an inexplicable diminution in his employee status or benefits'").

Ultimately, whether a proposed accommodation is reasonable is a fact-specific question and employers should approach each request for accommodation on a case-by-case basis. Employers that refuse as a matter of firm policy to consider certain types of accommodations or adopt policies that do not provide for flexibility only invite potential failure to accommodate claims.

Related Content

For an annotated religious accommodation policy, see

> RELIGIOUS ACCOMMODATION POLICY

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

For an annotated dress code policy, see

> DRESS CODE AND GROOMING POLICY

RESEARCH PATH: *Labor & Employment > Employment Policies > Standards of Conduct > Forms > Dress Code Policies*

Examples of Reasonable Accommodations

Examples of reasonable accommodations include:

- **Flexible scheduling.** Reasonable accommodations often involve flexible arrival or departure times, unpaid leave, flexible break times during the work day, use of lunch period as work time in exchange for early departure, staggered work hours, or allowing the employee the make up lost time due to religious observances.
- **Voluntary substitutes or shift changes.** Allowing employees to swap schedules, exchange shifts, or find a substitute to fill their scheduled work time often meet the reasonable accommodation requirement.
- **Lateral transfer or change of job assignments.** Employers should consider whether they can transfer the employee to another comparable position or limit the job duties so that they do not conflict with the employee's religious beliefs or practices, provided that this accommodation would not cause an undue hardship.
- **Payment of union dues to charitable organization.** Where the individual's religious beliefs prohibit membership in a labor union, most employers and unions permit the individual to choose a charitable organization to which it can donate an amount equivalent to the union dues.
- **Providing space to pray.** Where the individual's religious beliefs require prayer during the work day, employers satisfy the reasonable accommodation requirement by providing a place to pray, either during work or break time.
- **Exceptions to uniform requirements or dress codes.** Unless doing so poses an undue hardship, employers should make exceptions to dress codes or uniform requirements that conflict with an individual's religious beliefs. For more detail on this issue, please see the sections below on Dress Codes and Uniform Policies; and Grooming and Personal Appearance Policies.

Offering Use of Vacation Time for Sabbath Observance as a Reasonable Accommodation

One issue on which courts have reached conflicting results is employers' practices of offering to accommodate the individual's requirement for Sabbath observance by offering to allow the use of vacation time. Compare Kilpatrick v. Hyundai Motor Manufacturing Alabama, LLC, 911 F. Supp. 2d 1211, 1217–18 (M.D. Ala. 2012) (summary judgment denied because court could not conclude that allowing the plaintiff to use his vacation and personal days was a reasonable accommodation as a matter of law); and Jacobs v. Scotland Manufacturing, Inc., 2012 U.S. Dist. LEXIS 85826 (M.D.N.C. 2012) (denying employer's summary judgment motion) with Guy v. MTA New York City Transit, 2012 U.S. Dist. LEXIS 138526 (E.D.N.Y. 2012), report adopted, 2012 U.S. Dist. LEXIS 138523 (E.D.N.Y. 2012) (holding that allowing the plaintiff to use paid vacation and unpaid personal days to miss work on his Sabbath was a reasonable accommodation as a matter of law). This appears to be an evolving issue which will likely be the subject of further litigation, which may result in the determination of guidelines for employers navigating this mine field.

Undue Hardship

Title VII does not require an employer to accommodate an individual's religious beliefs where the accommodation would impose an undue hardship on the employer's business operations. According to the U.S. Supreme Court, the employer must show that the accommodation would impose "more than a de minimis cost" or burden. Trans World Airlines v. Hardison, 432 U.S. 63, 84 (1977). There, the Court held that requiring an employer to deviate from a seniority system in its collective-bargaining agreement to allow an employee to have Saturdays off to observe the Sabbath would constitute an undue hardship.

While the concept of undue hardship is a bit nebulous, both the EEOC and courts are clear that an accommodation imposes an undue hardship where it requires "more than a de minimis cost." 29 C.F.R. § 1605.2(e). Whether a cost is de minimis depends on the overall size and operating cost of the employer and includes both economic costs (such as payment of overtime compensation to a substitute) and non-economic costs (such as compromising the safety of the workplace). Generally, the EEOC does not consider administrative costs or the infrequent payment of premium wages (such as overtime compensation) to a substitute employee to impose an undue hardship.

Note that it is more difficult for an employer to show an undue hardship under the Americans with Disabilities Act (ADA) than for a proposed religious accommodation under Title VII. Under the ADA, undue hardship occurs when the proposed accommodation imposes a significant expense or difficulty (as opposed to a de minimis cost under Title VII) when factors such as an employer's size, financial resources, and the nature and structure of its operation are considered. The Title VII test allows the employer greater leeway.

Effect on Coworkers

Seniority Systems and Collective Bargaining Arrangements

The cost of an accommodation to an employer is often less of a consideration than the impact an accommodation would have on an individual's coworkers. The U.S. Supreme Court has made clear that an accommodation that deprives another employee of a job preference or benefit imposes an undue hardship. TWA v. Hardison, 432 U.S. 63, 84 (1977) (holding that an accommodation that would have required the employer to carve out an exception to a seniority system imposed an undue hardship). Employers are not required to make exceptions to seniority systems or collectively bargained arrangements to accommodate an individual's religious beliefs.

Disruption to Coworkers

A proposed religious accommodation may also pose an undue hardship where it causes a disruption for an employee's coworkers. Wilson v. U.S. W. Commc'ns, 58 F.3d 1337 (8th Cir. 1995). In Wilson, the court found that an employer did not have to accommodate an employee whose religious beliefs required her to wear a graphic anti-abortion pin that made her coworkers upset and caused coworkers' productivity to decline. Id. at 1342, n.3. Similarly, an accommodation that would require coworkers to cover an employee's shifts can cause an undue hardship where it disrupts work routines and the perceived favorable treatment negatively affects morale. Brener v. Diagnostic Ctr. Hosp., 671 F.2d 141, 147 (5th Cir. 1982).

Safety Concerns

Safety concerns are highly relevant when considering whether a proposed accommodation imposes an undue hardship. Employers are not required to subordinate safety concerns to accommodate an individual's religious beliefs. Accordingly, courts frequently side with employers where the employer has a legitimate safety concern. For example:

- Where an employer refused to exempt a Sikh employee from the requirement that all machinists be clean-shaven in order to be able to wear a respirator with a gas-tight face seal in the event of potential exposure to toxic gases, the court held that the employer did not violate Title VII. See Bhatia v. Chevron U.S.A., Inc., 734 F.2d 1382, 1384 (9th Cir. 1984).
- Where a municipal agency refused to exempt Sikh employee from hardhat requirement because of the risk of injury and liability, the court found that the potential cost of exempting the employee (including the risk of injury to the employee) created an undue hardship. Kalsi v. N.Y.C. Transit Auth., 62 F. Supp. 2d 745, 759–60 (E.D.N.Y. 1998).

Dress Code and Uniform Policies

To substantiate an undue hardship caused by exceptions to dress code and uniform policies, employers need specific and credible evidence of the expense or hardship that the exception would cause. For example, an employer that presents objective evidence of direct monetary costs and operational burdens that a requested accommodation would impose should be able to defeat the employee's claim that the employer unreasonably denied the requested accommodation. E.g., EEOC v. Thompson Contracting, Grading, Paving, and Utilities, Inc., 499 F. App'x 275, 281–85 (4th Cir. 2012) (summary judgment affirmed dismissing a dump truck operator's claim that the employer failed to accommodate his request to not work from sunrise to

sunset on his Saturday Sabbath, rejecting the contention that the employer should be required to create a pool of substitute drivers to cover plaintiff's route).

Hypothetical hardships based on unproven assumptions will not usually support an undue hardship determination. The employer's conclusion that granting a single exemption might encourage other employees to request an exception—essentially a slippery slope argument—will almost never support the denial of an accommodation. For example:

- Where a rental car agency refused to grant a Muslim employee an exception to the company's uniform policy so she could wear a head covering while working at the rental counter, the court found that the employer could not articulate anything other than a hypothetical and speculative burden that the accommodation would impose. EEOC v. Alamo Rent-A-Car LLC, 432 F. Supp. 2d 1006, 1015-16 (D. Ariz. 2006).
- Where a server at a restaurant chain declined to cover religious tattoos on his wrist with long sleeves, the court was skeptical of the employer's unsubstantiated hardship claims and was unmoved by the employer's slippery slope argument. EEOC v. Red Robin Gourmet Burgers, Inc., 2005 U.S. Dist. LEXIS 36219, *18-20 (W.D. Wash. Aug. 29, 2005).
- Where a transit agency refused to allow Sikh and Muslim employees to wear religious headwear that did not have the agency's logo, the court expressed doubt about the agency's alleged hardships, one of which included the right to present the agency's chosen image to the public. United States v. N.Y. City Transit Auth., 2010 U.S. Dist. LEXIS 102704, *61-63 (E.D.N.Y. Sept. 24, 2010).

However, courts will uphold employers' decisions not to allow exceptions to dress code policies when they can show a true undue hardship, such as legitimate safety concerns. For example:

- Where a manufacturer of large and small metal parts refused to make an exception to its "pants only" policy for a female employee whose religious beliefs prohibited her from wearing pants (as opposed to modest skirts or dresses), the fact that the policy was designed to reduce exposure of skin to sharp metal parts and risk of loose clothing getting caught in machinery or parts on the production floor persuaded the court to rule in favor of the employer. EEOC v. Oak-Rite Mfg. Corp., 2001 U.S. Dist. LEXIS 15621, 35–36 (S.D. Ind. Aug. 27, 2001).

- Where a private correctional facility refused to make an exception to its dress code policy to allow Muslim employees to wear a khimar (a head covering or veil) because of concerns that a khimar could be used to smuggle contraband into the prison or could be used as a strangulation device in a conflict with an inmate, the Third Circuit ruled the employer's safety concerns outweighed the employees' religious beliefs. EEOC v. Geo Group., Inc., 616 F.3d 265, 273–75 (3d Cir. 2010).

Grooming and Personal Appearance Policies

Employers are usually not required to make exceptions to grooming and personal appearance policies for religious reasons. Courts recognize that employers that serve the public have a legitimate interest in upholding grooming standards for employees who regularly interact with the public, so as to present a workforce to its customers that is reasonably professional in appearance. Cloutier v. Costco Wholesale Corp., 390 F.3d 126, 135 (1st Cir. 2004). For example:

- Where a hotel denied a banquet waiter the right to work a shift where he presented with a noticeable beard in violation of the hotel's no-beard policy and claimed that his religion (Muslim) prevented him from shaving, the court held that the employer was not required to accommodate the employee. Hussein v. Waldorf Astoria, 134 F. Supp. 2d 591, 599 (S.D.N.Y. 2001).
- Where a retailer denied an employee's request to wear facial jewelry in accordance with her membership in the Church of Body Modification and in violation of the employer's personal appearance policy that prohibited all facial jewelry, the court sided with the company based on the company's right to control its public image. Cloutier v. Costco Wholesale Corp., 390 F.3d 126, 134–37 (1st Cir. 2004).
- Where a restaurant declined to consider a Sikh applicant for a general manager position based on the applicant's advice that his religion forbad him from shaving his beard to comply with the restaurant's grooming standards for managerial employees, the court concluded that "clean-shavenness is a bona fide occupational qualification for a manager of a restaurant." EEOC v. Sambo's of Ga., Inc., 530 F. Supp. 86, 91 (N.D. Ga. 1981).

When dealing with personal appearance and grooming policies, employers must be careful to engage in an interactive process to determine whether there is any accommodation that would eliminate the conflict with the individual's religious beliefs. In some cases, there may be a reasonable accommodation that eliminates the conflict, but still complies with the spirit of the employer's personal appearance and grooming policies.

The Evolving Landscape of Dress Code and Grooming Policies and Other Religious Accommodation Issues

Potentially, as the 21st century advances, changing societal norms may result in rulings more favorable to employees with respect to rigid grooming and attire policies, and potentially as to other accommodation issues. Already, courts have issued decisions that suggest accommodation may be appropriate with respect to female Muslim employees who need to wear hijabs despite the employer's stated concerns, such as the image it seeks to present to the public. See Equal Employment Opportunity Commission v. Abercrombie & Fitch Stores, Inc., No. 14-86, 575 U.S. ____, 2015 U.S. LEXIS 3718, at *8, 135 S.Ct. 2028 (June 1, 2015). See also Muhammed v. N.Y. City Transit Auth., 52 F. Supp. 3d 468, 479–85 (E.D.N.Y. 2014) (denying an employer's summary judgment motion with respect to a claim that the employer's transfer of an employee to work at a bus depot did not reasonably accommodate her religious requirement to wear khimar); United States v. N.Y. City Transit Auth., 2010 U.S. Dist. LEXIS 102704, at *61–63 (E.D.N.Y. Sept. 24, 2010) (denying an employer's motion for summary judgment with respect to a challenge to the employer's prohibition of headgear such as turbans and khimars). Due to rapidly changing developments regarding religious accommodation issues, it is essential to consistently monitor court decisions in this area. L

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RESEARCH PATH: ***Labor & Employment > EEO Counseling > Statutes, Theories, and Defenses > Practice Notes > Failure to Accommodate***

N. Peter Lareau

Understanding Financial Disclosure of **Persuader Activities**

THIS ARTICLE ADDRESSES THE PERSUADER REPORTING RULES under the Labor-Management Reporting and Disclosure Act (LMRDA).[1] For many years, the U.S. Department of Labor (DOL) had almost always maintained that an outside counsel's creation or review of written content that formed the basis of subsequent communications to employees was advice that did not subject the employer and attorney to persuader reporting obligations unless counsel communicated with employees directly. On March 24, 2016, the DOL promulgated a new rule stating that an outside attorney's creation or review of written materials that forms the basis of subsequent communications to employees trigger "persuader" reporting obligations if the goal of the written materials is to persuade employees concerning collective bargaining or union organization. We discuss federal district court holdings interpreting the new rule—including a Texas federal district court's June 27, 2016 ruling that enjoined the DOL's enactment of the new rule. The DOL will almost certainly appeal this decision. We examine the changes that this new rule would potentially cause in the context of the historical interpretation of the "advice exemption." Furthermore, we address the potential imposition of reporting requirements on law firms representing employers that are far more draconian than appear on the face of the new rule.

For additional information on communications between employers and employees during union campaigns, [Navigating an Employer's Communications with Employees During a Union Campaign]

Reporting Requirements Under LMRDA Section 203

Section 203 of the LMRDA requires, among other things, the disclosure of agreements or arrangements between employers and labor relations consultants (including attorneys) pursuant to which the consultant undertakes or agrees to undertake activities to directly or indirectly persuade employees regarding the exercise of their rights to organize and bargain collectively. Disclosure is also required of agreements or arrangements pursuant to which the consultant undertakes to supply information to an employer concerning the activities of employees or a labor organization in connection with a labor dispute involving such employer. Such disclosures are made on [Forms LM-10] (Employer Report) and [LM-20] (Agreement and Activities Report), respectively. Under an exception set forth in Section 203(c) of the LMRDA, reporting is not required if the consultant is "giving or agreeing to give advice" to the employer or is representing the employer before any

1. 29 U.S.C. § 433.

court, administrative agency, or tribunal of arbitration, or in collective bargaining. Under a Final Rule published by the Department of Labor's Office of Labor-Management Standards (OLMS) on March 24, 2016,[2] the scope of that exception was definitively narrowed from the interpretations previously adopted by the OLMS, such that the reporting requirement will cover most activities undertaken by counsel (and lay consultants) representing clients with respect to union organizational campaigns.

History of Reporting Requirement

Overview

With the exception of one brief period, the OLMS had always interpreted the term advice in the exception to Section 203 to exclude employer-consultant agreements from the reporting requirement if the consultant had no direct contact with employees and only provided to the employer (or supervisors) advice or materials for use in persuading employees.[3] However, the OLMS now believes that interpretation is overly broad for the following reason:

> Under the prior interpretation, reporting was effectively triggered only when a consultant communicated directly with employees. This interpretation left a broad category of persuader activities unreported, thereby denying employees important information that would enable them to consider the source of the information about union representation directed at them when assessing the merits of the arguments and deciding how to exercise their rights.[4]

In a Notice of Proposed Rule Making published in the Federal Register on June 21, 2011 (NPRM), the OLMS proposed to significantly narrow the interpretation of the term advice so that a wide range of consultant activities not then subject to the reporting requirement would no longer qualify for the exception.[5] Consistent with its expansion of the definition of the term advice to encompass a wide variety of consultant activities then excluded from the reporting requirement, the NPRM proposed revisions to Forms LM-10 and LM-20 that included a checklist of activities that would qualify as advice and, therefore, trigger the reporting requirement.[6] Finally, the NPRM proposed that Forms LM-10 and LM-20 be submitted electronically. The various changes contained in the NPRM incorporated, within the definition of advice, activities traditionally undertaken by management counsel but excluded from the reporting requirement.

Related Content

For an overview on the different phases of union organizing efforts, see

> UNDERSTANDING THE LANDSCAPE OF UNION ORGANIZING AND UNION CAMPAIGNS

RESEARCH PATH: *Labor & Employment > Labor-Management Relations > Union Organizing and Representation > Practice Notes > Union Organizing Basics*

For a detailed discussion of the strategies an employer can utilize to avoid union organizing efforts, see

> ADOPTING A UNION AVOIDANCE STRATEGY BEFORE UNION ACTIVITY SURFACES

RESEARCH PATH: *Labor & Employment > Labor-Management Relations > Union Organizing and Representation > Practice Notes > Pre-Petition Union Avoidance*

For additional information on how employers may lawfully respond to pre-petition union activity, see

> RESPONDING TO PRE-PETITION UNION ACTIVITY

RESEARCH PATH: *Labor & Employment > Labor-Management Relations > Union Organizing and Representation > Practice Notes > Pre-Petition Union Avoidance*

For more information on how employers may communicate with employees during a union campaign, see

> NAVIGATING AN EMPLOYER'S COMMUNICATIONS WITH EMPLOYEES DURING A UNION CAMPAIGN

RESEARCH PATH: *Labor & Employment > Labor-Management Relations > Union Organizing and Representation > Practice Notes > Campaign Communications with Supervisors and Employees*

On March 24, 2016, the OLMS adopted a Final Rule that "largely implements the Department's proposal in the NPRM, with [some] modifications of several aspects of the revised instructions as proposed."[7]

2. "Interpretation of the 'Advice' Exemption in Section 203(c) of the Labor-Management Reporting and Disclosure Act," 81 Fed. Reg. 15,924 (March 24, 2016) (hereinafter FR or Final Rule). **3.** For a more detailed history of the interpretation of the advice exemption see the Supplementary Information to the Final Rule, 81 Fed. Reg. 15,930-15,936. **4.** FR, 81 Fed. Reg. 15,924. **5.** "Labor-Management Reporting and Disclosure Act; Interpretation of the 'Advice' Exemption," 76 Fed. Reg. 36,178 (proposed June 21, 2011) (hereinafter "NPRM"). **6.** For example, the checklist for both the revised form LM-10 and form LM-20 listed the following activities, among others, as triggering the reporting requirement: (1) "Drafting, revising, or providing written materials for presentation, dissemination or distribution to employees[;]" (2) "Drafting, revising, or providing a speech for presentation to employees[;]" and (3) "Developing personnel policies and practices[.]" **7.** "Interpretation of the 'Advice' Exemption in Section 203(c) of the Labor-Management Reporting and Disclosure Act," 81 F.R. 15924 (Final Rule published March 24, 2016) (hereinafter Final Rule or FR). **8.** NPRM, 76 Fed. Reg. 36,178.

Enactment of the LMRDA

The LMRDA was enacted in 1959, partially in response to the findings of the Senate Select Committee on Improper Activities in the Labor or Management Field, commonly known as the McClellan Committee, which found "a number of instances of breach of trust, corruption, disregard of the rights of individual employees, and other failures to observe high standards of responsibility and ethical conduct"[8] in labor-management relations. The LMRDA was intended to correct these problems by opening to public scrutiny—by means of financial reporting and disclosure requirements—activities that frequently took place in the background.[9]

Regulatory Authority

Section 208 of the LMRDA[10] authorizes the Secretary of Labor to issue such rules and regulations as are necessary "to prevent the circumvention or evasion" of the LMRDA's reporting and disclosure provisions. Section 210[11] authorizes the Secretary to bring a civil action to enforce those provisions, and, under section 209,[12] willful violations of the reporting requirements, knowing false statements made in a report, and knowing failures to disclose a material fact in a report are subject to criminal penalties.

Statutory Reporting Provisions

Section 203(a) of the LMRDA[13] requires an employer to report any payment to, or agreement or arrangement with, a labor relations consultant pursuant to which the consultant undertakes activities (or agrees to do so) if an object of those activities is "to persuade employees to exercise or not to exercise, or persuade employees as to the manner of exercising, the right to organize and bargain collectively through representatives of their own choosing." The report must be one "showing in detail the date and amount of each such payment . . . [or] agreement . . . and a full explanation of the circumstances of all such payments, including the terms of any agreement or understanding pursuant to which they were made." The implementing regulations specify that the information be provided on Form LM-10.

Section 203(b)[14] of the LMRDA imposes similar requirements on labor relations consultants. It also requires consultants subject to this reporting requirement to report receipts and disbursements of any kind "on account of labor relations advice and services." The implementing regulations require reportable activity to be filed on Form LM-20, "Agreement and Activities Report," within 30 days of entering into the reportable agreement or arrangement. Any receipts resulting from a reportable agreement or arrangement must be filed on Form LM-21, "Receipts and Disbursements Report," within 90 days of the end of the consultant's fiscal year in which they were received.

Section 203(c)15 creates the exception:

> Nothing in this section shall be construed to require any employer or other person to file a report covering the services of such person by reason of his giving or agreeing to give *advice* to such employer or representing or agreeing to represent such employer before any court, administrative agency, or tribunal of arbitration or engaging or agreeing to engage in collective bargaining on behalf of such employer with respect to wages, hours, or other terms or conditions of employment or the negotiation of an agreement or any question arising thereunder.[16]

"PREPARATION OF WRITTEN MATERIAL BY A LAWYER OR OTHER INDEPENDENT CONTRACTOR WHICH HE DIRECTLY DISSEMINATES TO EMPLOYEES FOR THE PURPOSE OF PERSUADING THEM WITH RESPECT TO THEIR ORGANIZATIONAL OR BARGAINING RIGHTS IS REPORTABLE."

Overriding all is section 204, which exempts from the reporting requirement "any information which was lawfully communicated to [an] attorney by any of his clients in the course of a legitimate attorney-client relationship."[17]

Prior Regulatory Interpretation of Advice

Historically, regulations promulgated by the Department of Labor at 29 CFR §§ 405.6(b) and 406.5(b) addressed the advice exemption but merely tracked the statutory language and "did not set forth the Department's interpretation of the exemption."[18] However, in 1960, the Department took the position that drafting "speeches or written material to be delivered or disseminated to employees for the purpose of persuading such employees as to their right to organize and bargain collectively" constituted advice within the meaning of the statute.[19] In 1961, an article authored by a Department of

9. NPRM, 76 Fed. Reg. 36,178. **10.** 29 U.S.C. § 438. **11.** 29 U.S.C. § 440. **12.** 29 U.S.C. § 439. **13.** 29 U.S.C. § 433(a). **14.** 29 U.S.C. § 433(b). **15.** 29 U.S.C. § 433(c). **16.** Emphasis supplied. **17.** 29 U.S.C. § 434. **18.** FR, 81 Fed. Reg. 15,935. **19.** FR, 81 Fed. Reg. 15,92415,925.

Labor official stated that "the drafting of speeches or written material by a consultant or lawyer was reportable." The article continued that, while advice to a client about a speech or letter drafted by the client is not reportable, revision of the speech or letter by the lawyer or consultant would be reportable because the Department took the position that "reporting is required in any situation where it is impossible to separate advice from activity which goes beyond advice."[20]

In 1962, the Department of Labor revised its position on the correct interpretation of what constitutes advice. The revised position was reflected as guidance in Section 265.005 of the LMRDA Interpretative Manual (IM), a document that serves as guidance to the staff of the OLMS:

> The question of application of the "advice" exemption requires an examination of the intrinsic nature and purpose of the arrangement to ascertain whether it essentially calls exclusively for advice or other services in whole or in part. Such a test cannot be mechanically or perfunctorily applied. It involves a careful scrutiny of the basic fundamental characteristics of any arrangement to determine whether giving advice or furnishing some other services is the real underlying motivation for it.
>
> [I]t is plain that the preparation of written material by a lawyer, consultant, or other independent contractor which he directly delivers or disseminates to employees for the purpose of persuading them with respect to their organizational or bargaining rights is reportable . . . .
>
> However, it is equally plain that where an employer drafts a speech, letter or document which he intends to deliver or disseminate to his employees for the purpose of persuading them in the exercise of their rights, and asks a lawyer or other person for advice concerning its legality, the giving of such advice, whether in written or oral form, is not in itself sufficient to require a report. Furthermore, we are now of the opinion that the revision of the material by the lawyer or other person is a form of written advice given the employer which would not necessitate a report.
>
> A more difficult problem is presented where the lawyer or middleman prepares an entire speech or document for the employer. We have concluded that such an activity can reasonably be regarded as a form of written advice where it is carried out as part of a bona fide undertaking which contemplates the furnishing of advice to an employer. Consequently, such activity in itself will not ordinarily require reporting unless there is some indication that the underlying motive is not to advise the employer. In a situation where the employer is free to accept or reject the written material prepared for him and there is no indication that the middleman is operating under a deceptive arrangement with the employer, the fact that the middleman drafts the material in its entirety will not in itself generally be sufficient to require a report.[21]

In early 2001, the Department of Labor published a narrower interpretation of the advice exemption as a "notice of revised statutory interpretation," but did not request public comment.[22] On April 11, 2001, the Department rescinded the revised interpretation because of "insufficient evidence to justify the revised interpretation and a lack of notice-and-comment procedures."[23]

The Changes to the DOL's Interpretation of the Rule

The Final Rule, which a federal district court in Texas enjoined on June 27, 2016, rejects the concept that the application of the advice exemption depends upon whether or not the consultant has direct contact with employees and whether the employer is free to accept or reject the lawyer or consultant's advice. Under the Final Rule,

> exempt "advice" activities are . . . now limited to those activities that meet the plain meaning of the term: An oral or written recommendation regarding a decision or course of conduct. The rule restores the traditional meaning to the term whereby an attorney or a labor relations consultant does not need to report, for example, when he counsels a business about its plans to undertake a particular action or course of action, advises the business about its legal vulnerabilities and how to minimize those vulnerabilities, identifies unsettled areas of the law, and represents the business in any disputes and negotiations that may arise. It draws a line between these activities, which do not have to be reported, and those activities that have as their object the persuasion of employees—activities that manage or direct the business's campaign to sway workers against choosing a union—that must be reported. An employer's ability to "accept or reject" materials provided, or other actions undertaken, by a consultant, common to the usual relationship between an employer and a consultant and central to the prior interpretation's narrow scope of reportable activity, no longer shields indirect persuader activities from disclosure.[24]

The instructions on the revised reporting forms state:

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20. NPRM, 76 Fed. Reg. 36,178, 36,180 (quoting Benjamin Naumoff, Reporting Requirements under the Labor-Management Reporting and Disclosure Act, in Fourteenth Annual Proceedings of the New York University Conference on Labor 129, 140–141 (1961)). **21.** FR, 81 Fed. Reg. 15,924, 15,935-36. **22.** FR, 81 Fed. Reg. 15,924, 15,936. **23.** NPRM, 76 Fed. Reg. 36,178, 36,181–182 (citing 66 FR at 18864); FR, 81 Fed. Reg. 15,923, 15,936.

> An agreement or arrangement is reportable if a consultant undertakes activities with an object, directly or indirectly, to persuade employees to exercise or not to exercise, or to persuade employees as to the manner of exercising, the right to organize and bargain collectively through representatives of their own choosing (hereinafter "persuade employees"). Such "persuader activities" are any actions, conduct, or communications with employees that are undertaken with an object, explicitly or implicitly, directly or indirectly, to affect an employee's decisions regarding his or her representation or collective bargaining rights. Under a typical reportable agreement or arrangement, a consultant manages a campaign or program to avoid or counter a union organizing or collective bargaining effort, either jointly with the employer or separately, or conducts a union avoidance seminar.[25]

The instructions also provide that reporting an agreement or arrangement, which need not be in writing,[26] is triggered in the following circumstances:

> (1) A consultant engages in direct contact or communication with any employee, with an object to persuade such employee; or
>
> (2) A consultant who has no direct contact with employees undertakes the following activities with an object to persuade employees:
>
> (a) Plans, directs, or coordinates activities undertaken by supervisors or other employer representatives, including meetings and interactions with employees;
>
> (b) Provides material or communications to the employer, in oral, written, or electronic form, for dissemination or distribution to employees;
>
> (c) Conducts a seminar for supervisors or other employer representatives; or
>
> (d) Develops or implements personnel policies, practices, or actions for the employer.[27]

The revised interpretation of persuader activities is expansive. The new Form LM-10 includes the following examples:

- Planning or conducting individual employee meetings
- Planning or conducting group employee meetings
- Training supervisors or employer representatives to conduct such meetings
- Coordinating or directing the activities of supervisors or employer representatives
- Establishing or facilitating employee committees
- Drafting, revising, or providing speeches, written material, website, audiovisual, or multimedia content for presentation, dissemination, or distribution to employees, directly or indirectly (including the sale of off-the-shelf materials where the consultant assists the employer in the selection of such materials)
- Developing employer personnel policies designed to persuade, such as when a consultant, in response to employee complaints about the need for a union to protect against arbitrary firings, develops a policy under which employees may arbitrate grievances
- Identifying employees for disciplinary action, reward, or other targeting based on their involvement with a union representation campaign or perceived support for the union
- Coordinating the timing and sequencing of union avoidance tactics and strategies[28]

With respect to conduct that involves both advice and persuader activities, the Final Rule rejects the prior interpretation, pursuant to which the advice exemption would prevail, resulting in non-reportable conduct. Instead:

> If the agreement or arrangement provide[s] that the consultant [will]engage in persuader services, among other services, the filer must explain the full fee arrangement for all services required by the agreement or arrangement and describe fully the persuader services, regardless of the duration or extent of the persuader services in relation to other services provided.[29]

24. FR, 81 Fed. Reg. 15,924, 15,926. **25.** FR, 81 Fed. Reg. 15,924, 15,947. **26.** FR, 81 Fed. Reg. 15,924, 15,944. **27.** FR, 81 Fed. Reg. 15,923 15,924, 15,938. **28.** FR, 81 Fed. Reg. 15,924, 16,027–28. **29.** FR, 81 Fed. Reg. 15,924, 15,979.

Application of Revised Rules to Attorneys

The Final Rule, which a federal district court in Texas enjoined on June 27, 2016, makes it clear that the revised rule applies to attorneys as well as lay consultants:

> We have carefully reviewed comments submitted by the American Bar Association (ABA), other associations of attorneys, law firms representing employers, and other commenters, urging the Department to adopt an interpretation that would differentiate between attorneys and other labor relations consultants and essentially exempt attorneys from reporting any activities other than those in which they communicate directly with employees. Importantly, although the ABA sought to include a provision in the bill that became the LMRDA that would have achieved this result, Congress struck that provision from what became law. The commenters' position has been rejected by the courts in cases where attorneys engaged in persuader activities unsuccessfully raised this privilege argument as a defense to their failure to report such activities. Moreover, the ABA and other commenters on this point have failed to advance any argument that attorneys who engage in the same activities as non-attorney consultants to counter union organizing campaigns—activities and circumstances significantly different from those typically involved with legal practice—should be able to avoid disclosing activities identical to those performed by their non-attorney colleagues in guiding employers through such campaigns.[30]

However, the Final Rule also provides that it:

> ensures that no reporting is required by reason of a consultant merely giving "advice" to the employer, such as, for example, when a consultant offers guidance on employer personnel policies and best practices, conducts a vulnerability assessment for an employer, conducts a survey of employees (other than a push survey, i.e., one designed to influence participants and thus undertaken with an object to persuade), counsels employer representatives on what they may lawfully say to employees, conducts a seminar without developing or assisting the employer in developing anti-union tactics or strategies, or makes a sales pitch to undertake persuader activities. Reporting is also not required for merely representing an employer in court or during collective bargaining, or otherwise providing legal services to an employer.[31]

Filing Form LM-10

Who Is Required to File

Under the Final Rule, an employer is required to file revised Form LM-10 if the employer made any agreement or arrangement with a labor relations consultant or other independent contractor or organization (Consultant) pursuant to which the Consultant undertook activities for the purpose of directly or indirectly: (1) persuading employees to exercise or not to exercise, or how to exercise, the right to organize and bargain collectively; or (2) furnishing the employer with information concerning activities of employees or of a labor organization in connection with a labor dispute in which the employer is involved.[32]

What Must Be Disclosed

Among other things, the revised Form LM-10 requires disclosure of:

- The name and address (including e-mail address and Employer Identification Number) of the employer filing the form[33]
- If different, the name and address (including e-mail address) of the CEO of the employer filing the form[34]
- The name and address (including e-mail address) where records necessary to verify the report are maintained[35]
- Legal status of the employer filing the report (individual, partnership, corporation, etc.)[36]
- Whether services performed under the agreement are: (1) to persuade employees to exercise or not to exercise, or how to exercise, the right to organize and bargain collectively; or (2) to supply an employer with information concerning the activities of employees or a labor organization in connection with a labor dispute involving the employer[37]
- The name, address (including e-mail address), and Employer Identification Number of the consultant party to the agreement[38]
- Date of the agreement[39]
- Terms and conditions of the agreement[40]
- The types of activities performed or to be performed by the Consultant, including completion of the form's itemized checklist[41]
- The period during which services under the agreement are to be performed[42]

30. FR, 81 Fed. Reg. 15,924, 15,928. **31.** FR, 81 Fed. Reg. 15,924, 15,928. **32.** Part C of LM-10 as revised by Final Rule. The LM-10 as revised is hereinafter referred to as Rev. LM-10). **33.** Rev. LM-10, Item 3. **34.** Rev. LM-10, Item 4. **35.** Rev. LM-10, Item 5. **36.** Rev. LM-10, Item 7. **37.** Rev. LM-10, Part C. **38.** Rev. LM-10, Item 12. **39.** Rev. LM-10, Item 13.a. **40.** Rev. LM-10, Item 13.b. In addition to a detailed description of the agreement, a copy of the agreement must be attached to the form. Rev. LM-10, Item 13.b. **41.** Rev. LM-10, Item 14.a. **42.** Rev. LM-10, Item 14.b.

- "Extent performed"[43]
- The name, address (including e-mail address), telephone number, and Employer Identification Number of any person or entity actually performing services under the agreement [44]
- A description of the group of employees to which the persuader activities under the agreement are aimed[45]
- The labor organization representing or seeking to represent the employees[46]
- The date of each payment under the agreement, including: the amount of payment; kind of payment (payment or loan, in cash or property); whether paid in form of a loan; and the full circumstances of the payment, including the terms of any oral agreement or understanding pursuant to which it was made[47]

How and When to File

Form-LM 10 must be completed online, electronically signed, and submitted along with any required attachments to the Department using the OLMS Electronic Forms System (EFS).[48] It must be submitted within 90 days after the end of the employer's fiscal year.[49]

Filing the Form LM-20

Who Is Required to File

Pursuant the Final Rule, the Instructions to the revised Form LM-20 state that it must be filed by "[a]ny person who, as a direct or indirect party to any agreement or arrangement with an employer undertakes, pursuant to the agreement or arrangement," any persuader activity.[50] A "person" includes, among others, labor relations consultants and other individuals and organizations. Further a person "undertakes" persuader activities not only when he/she performs the activity but also when he/she agrees to perform the activity or to have it performed.[51]

What Must Be Disclosed

Among other things, the revised Form LM-20 requires disclosure of:

- The name, address (including e-mail address), and Employer Identification Number of the consultant filing the report[52]
- The name and address (including e-mail address) where records necessary to verify the report are maintained[53]
- Fiscal year covered by the report [54]
- Legal status of the consultant filing the report (individual, partnership, corporation, etc.)[55]
- The name, address (including e-mail address), and Employer Identification Number of the employer party to the agreement[56]
- Date of the agreement[57]
- Whether services performed under agreement are: (1) to persuade employees to exercise or not to exercise, or how to exercise, the right to organize and bargain collectively; or (2) to supply an employer with information concerning the activities of employees or a labor organization in connection with a labor dispute involving the employer, except information for use solely in conjunction with an administrative or arbitral proceeding or a criminal or civil judicial proceeding [58]
- Terms and conditions of the agreement[59]
- The types of activities performed or to be performed by the Consultant, including completion of the form's itemized checklist[60]
- The period during which services under the agreement are to be performed[61]
- "Extent performed"[62]
- The name, address (including e-mail address), and Employer Identification Number of any person or entity actually performing services under the agreement[63]
- A description of the group of employees to which the persuader activities under the agreement are aimed[64]
- The labor organization representing or seeking to represent the employees[65]

Form LM-20 does not, itself, require financial disclosure in connection with persuader activities. However, persons or entities required to file the LM-20 are also required to file Form LM-21 "Receipts and Disbursements Report." That report is discussed in the next section.

How and When to File

Form-LM 20 must be completed online, electronically signed, and submitted along with any required attachments to the Department using the OLMS Electronic Forms System (EFS).[66] It must be submitted within 30 days after it is entered into.[67]

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43. Rev. LM-10, Item 14.c. It is not clear exactly what this means and the Instructions do not address the issue. **44.** Rev. LM-10, Item 14.d. **45.** Rev. LM-10, Item 14.e. **46.** Rev. LM-10, Item 14.f. **47.** Rev. LM-10, Item 15.a-d. **48.** Instructions to Rev. LM-10, Part VI How to File. **49.** Instructions to Rev. LM-10, Part V When to File. **50.** Rev. LM-20, Part II. The instructions to Rev. LM-20 make clear that "agreement or arrangement" is to be construed broadly and that such an agreement or arrangement may be written or oral. Rev. LM-20, Part II. **51.** Rev. LM-20, Part II. **52.** Rev. LM-20, Item 2. **53.** Rev. LM-20, Item 3. **54.** Rev. LM-20, Item 4. **55.** Rev. LM-20, Item 5. **56.** Rev. LM-20, Item 6. **57.** Rev. LM-20, Item 7. **58.** Rev. LM-20, Item 9. **59.** Rev. LM-20, Item 10. In addition to a detailed description of the agreement, a copy of the agreement must be attached to the form. Rev. LM-20, Item 10. **60.** Rev. LM-20, Item 11.a. **61.** Rev. LM-20, Item 11.b. **62.** Rev. LM-20, Item 11.c. It is not clear exactly what this means and the Instructions do not address the issue. **63.** Rev. LM-20, Item 11.d. **64.** Rev. LM-20, Item 12.a. **65.** Rev. LM-10, Item 12.b. **66.** Instructions to Rev. LM-20, Part VI How to File. **67.** Instructions to Rev. LM-20, Part V When to File.

Filing Form LM-21

Not directly addressed in the Final Rule, Form LM-21 is the financial disclosure report that must be filed by any person required to file Form LM-20.[68] The extent of disclosure required by the LM-21 (as presently written)[69] is vast and will prove enormously burdensome and objectionable to all filers.

The General Instructions for completing Form LM-21 with regard to receipts and disbursements[70] provide:

> Receipts of any kind received directly *or indirectly* from employers *on account of labor relations advice or services,* and disbursements of any kind made directly or indirectly in connection with such services, must be reported with respect to each fiscal year during which payments were made or received as a result of any agreement or arrangement with an employer where the object is, directly or indirectly: (1) To persuade employees to exercise or not to exercise, or to persuade them as to the manner of exercising, the right to organize and bargain collectively through representatives of their choice or (2) To supply the employer with information concerning activities of employees or a labor organization in connection with a labor dispute involving such employer.

There is an exclusion for "agreements or arrangements that cover services relating exclusively to: (1) advising the employer; (2) representing the employer before any court, administrative agency, or tribunal of arbitration, and (3) engaging in collective bargaining on the employer's behalf with respect to wages, hours, or other terms or conditions of employment or the negotiation of any agreement or any questions arising under the agreement."[71] However, the instructions also make clear that such exclusions are "applicable only to an agreement or arrangement which covers no [persuader] activities reportable . . . . If the agreement or arrangement provides for any [persuader] activity, you must report the information required for the entire agreement or arrangement." In addition to financial disclosure of receipts related to labor relations advice and activities, Form LM-21 also requires detailed disclosure of any disbursements to persons performing services related to the agreement.[72]

Most important, the Department of Labor takes the position, with the approval of the courts, that an attorney or consultant who engages in persuader activity for even one client "must then report *for all labor clients—persuader or non-persuader—all receipts received from each of them on account of labor relation advice or services and disbursements of any kind—persuader or non-persuader*—in connection with such services."[73]

Challenges to the Final Rule

As of this writing two decisions in cases challenging the rule have been issued. In the first, *Labnet, Inc. v. Perez,*[74] the DOL narrowly escaped the imposition of an injunction prohibiting the DOL from enforcing the Final Rule. There, the U.S. District Court for the District of Minnesota concluded that "that portions of the new rule conflict with the LMRDA"[75] but refused to enjoin its enforcement because "it appears that the regulation's potentially valid applications may outnumber its potentially invalid ones, and . . . there is only a minimal threat of irreparable harm."[76]

The DOL did not fare as well in *National Federation of Independent Business v. Perez,*[77] the second decision to consider the issue. There, the court enjoined enforcement of the Final Rule in its entirety, concluding that there was a substantial likelihood that the plaintiffs in that case would prevail on their claims: (1) that the Department lacked the statutory authority to promulgate the Rule;[78] (2) that the Rule is arbitrary, capricious, and an abuse of discretion;[79] (3) that the Rule violates free speech and association rights protected by the First Amendment;[80] (4) that the Rule is unconstitutionally vague in violation of the due process clause;[81] and (5) that the Rule violates the Regulatory Flexibility Act.[82]

With respect to the substantive issue, the court held (as had the *Labnet* court) that there was substantial likelihood that the Final Rule exceeded the Department's statutory authority "by effectively eliminating the [LMRDA's] Advice Exemption contrary to the plain text of Section 203(c)."[83] Unlike the court in *Labnet,* however, the court in *National Federation* concluded that the plaintiffs had met their burden of demonstrating the need for injunctive relief pending a decision on the merits. In this regard, it distinguished the decision in *Labnet* because of the difference in complaining parties (attorneys v. trade associations) and the fact that *Labnet* was decided on motion, without the benefit of an evidentiary hearing.[84]

Consequences if the Final Rule is Enforced

If enforced, the Final Rule will drastically alter the cast of characters in representation case dramas. Few, if any, management attorneys who represent employers in these cases limit that representation to advice as defined in the

68. Instructions to Rev. LM-20, Part III What Must Be Reported **69.** Revision of Form LM-21 is currently a subject of rulemaking by the Department of Labor, as set out in the DOL's "Semiannual Unified Agenda and Regulatory Plan," The DOL has estimated that a proposed rule on the Form LM–21 will be published in September 2016. FR, 81 Fed. Reg. 15,992, n.88. **70.** Instructions to Form LM-21, Part IX.A.4 (emphasis supplied). **71.** Instructions to Form LM-21, Part IX.A.4. **72.** Instructions to Form LM-21, Part IX.C.7. **73.** *Price v. Wirtz,* 412 F.2d 647, 649 (5th Cir. 1969) (emphasis supplied; citing *Douglas v. Wirtz,* 353 F.2d 30 (4th Cir. 1965), cert. denied, 383 U.S. 909 (1966). **74.** 2016 U.S. Dist. LEXIS 81884 (D. Minn. June 22, 2016). **75.** 2016 U.S. Dist. LEXIS 81884, at *1. **76.** 2016 U.S. Dist. LEXIS 81884, at *38. **77.** *National Federation of Independent Business v. Perez,* No. 5:16-cv-00066-C (N.D. Tex. June 27, 2016) (hereinafter "*National Federation*"). **78.** *National Federation* at 45–51. **79.** *National Federation* at 51–56. **80.** *National Federation* at 56–64. **81.** *National Federation* at 64–68. **82.** *National Federation* at 68–71. **83.** *National Federation* at 68–71. **84.** *National Federation* at 82 n.14. **85.** 2016 U.S. Dist. LEXIS 81884 at *45.

Rule; almost all engage in conduct that constitutes reportable persuader activities. Employers will be sensitive to the public release of information regarding their expenditures for combatting a union organizational drive, but lawyers and law firms will be hypersensitive to the release of what most will view as confidential information regarding the identity of their clients and fees received from those clients.

Although the Final Rule portrays its demarcation of advice and persuader activities as a fairly simple, black-and-white determination, the real world actuality is quite different. For example, does informing an employer faced with an organizational drive that, under the National Labor Relations Act, it may permanently replace economic strikers, constitute legal advice or a persuader activity? Does it make a difference whether or not the attorney/consultant is aware that the client faces an organizational drive and intends to actively resist it? If an employer specifically requests an attorney to write a speech the employer intends to deliver to employees in order to make certain that the speech does not give rise to unfair labor practices, is the attorney rendering legal advice or engaging in persuader activities?

The court in *Labnet* had difficulty with the DOL's position on this matter, observing

> By starting with the premise that, if something is persuader activity, it cannot possibly be advice, DOL ends up struggling mightily to define as non-advice activity that any reasonable person would define as advice. And in the course of that struggle, DOL ends up drawing lines that are simply incoherent.[85]

The court in *National Federation* agreed and enjoined enforcement of the Rule. It is clear that the fate of the Final Rule is far from settled and will most likely be resolved by the Supreme Court. L

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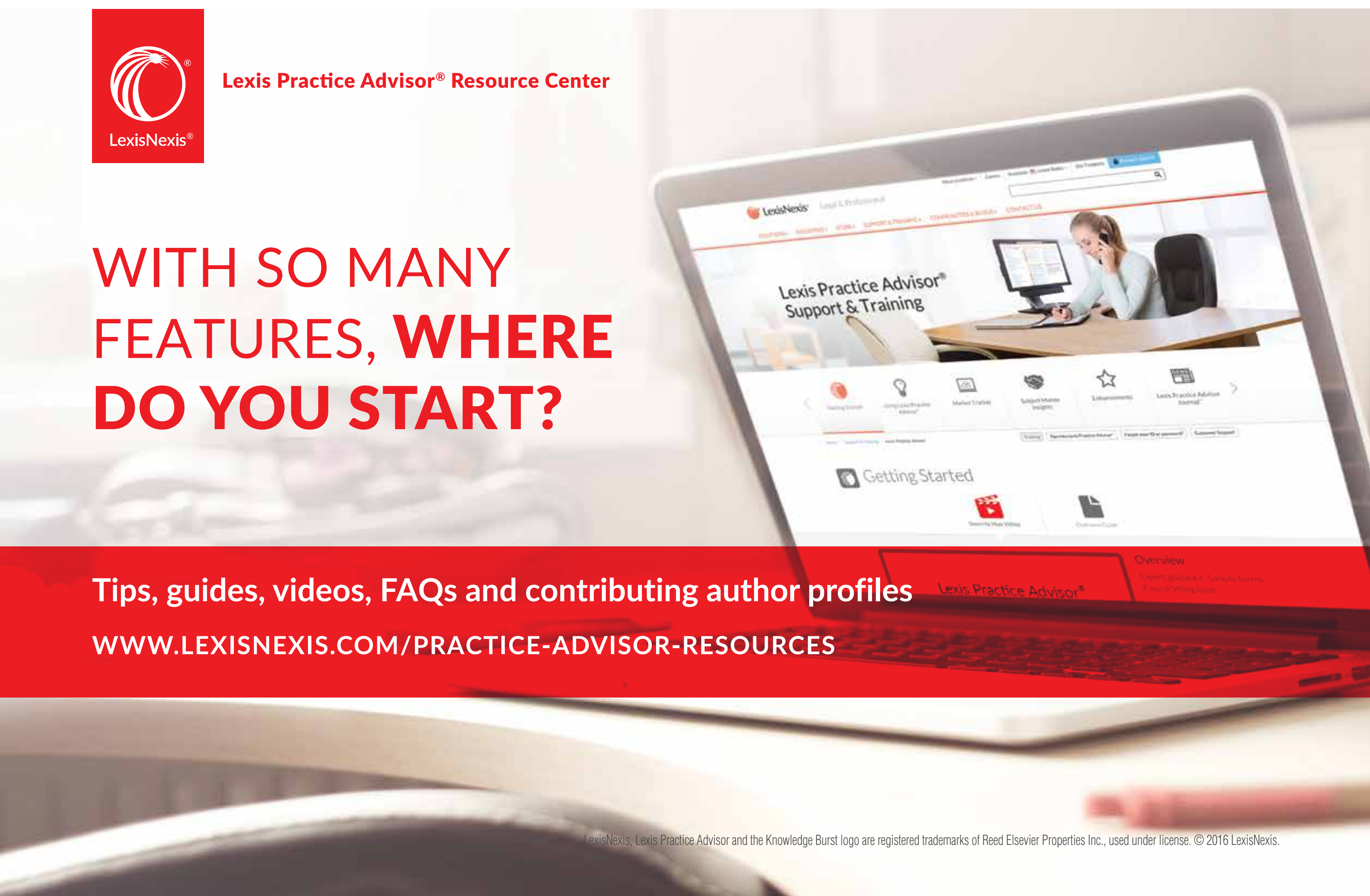
RESEARCH PATH: *Labor & Employment > Labor-Management Relations > Union Organizing and Representation > Practice Notes > Campaign Communications with Supervisors and Employees*



Ethan Horwitz CARLTON FIELDS

Strategies and Opportunities in an America Invents Act World – **Choices of Venue**

TODAY, BOTH PATENT OWNERS AND ACCUSED INFRINGERS have multiple choices of venues in which to litigate the validity of a patent. There is the historic option of a patent infringement case in the federal courts. Increasingly, the International Trade Commission (ITC) is being chosen as a venue. And while historically there were some post-grant procedures in the United States Patent and Trademark Office (USPTO) to litigate validity, the options for such procedures have expanded considerably under the America Invents Act (AIA), which established the new post-grant proceedings of inter partes review (IPR),[1] post-grant review (PGR),[2] and a transitional program for covered business method patents (CBM).[3]

With these options, a patent owner must decide where to file and an accused infringer may decide where to defend itself. Each option has different advantages and disadvantages, making the venue decision in a specific case a complex one with different competing issues.

1. Inter partes review (IPR) is a new post-grant proceeding (replacing inter partes reexamination) created by the AIA in which the Patent Trial and Appeal Board (PTAB) reviews the patentability of one or more claims in an issued patent based only on grounds that could be raised under 35 U.S.C. §§ 102 or 103 and only on prior art patents or printed publications. For a full explanation, see the Lexis Practice Advisor IP Glossary. 2. Post grant review (PGR) is a new post-grant trial proceeding established by the AIA for patents with an effective filing date on or after March 16, 2013. A petitioner (any person other than the patent owner) may challenge the validity of such patents on any grounds under 35 U.S.C. § 282(b)(2) or (3), including anticipation, obviousness, lack of utility, lack of eligible subject matter, or inadequate disclosure (except for failure to disclose the best mode). The petition must be filed no later than nine months after the patent or reissue patent was granted. For a full explanation, see the Lexis Practice Advisor IP Glossary. 3. For purposes of the Transitional Program for Covered Business Method Patents established by the AIA, a "covered business method patent" means a patent that claims a method or corresponding apparatus for performing data processing or other operations used in the practice, administration, or management of a financial product or service, except that the term does not include patents for technological inventions. See 37 C.F.R. § 42.301(a). For a full explanation, see the Lexis Practice Advisor IP Glossary.

Relevant Characteristics of the Venues

District Court

There are many characteristics of a district court patent litigation, but only some of them are relevant to the decision of whether to pursue action there or in the USPTO or ITC. The main factors relevant to the decision of venue are juries, damages, speed/slowness, counterclaims, burden of proof, eBay considerations for an injunction, and multidistrict consolidation:

- **Juries.** Both sides can request a jury in district court patent litigation, and there are many factors to consider when determining whether requesting a jury is appropriate, such as whether you have a good story and whether you have a simple story. With a very complicated technical explanation of how a patent is invalid, a jury may not be the best audience. Similarly, if there are legal issues to explain, such as why priority should not be awarded based on a prior application because of the differences in the specifications, a jury may not be a good audience. On the other hand, a simple, strong story may work well in front of the jury. Another consideration is the commonly held belief that plaintiffs generally do better with juries and that damages are higher with juries than with judges.
- **Damages.** The district court is the only place to recover damages. Damages are not available in the ITC, and certainly not available in the USPTO.
- **Speed/slowness (depending upon where).** For speed, a case may be filed in the Eastern District of Virginia and be on a rocket docket. From that speedy venue, the venues range up to the very slow districts—in one case in the U.S. District of Massachusetts, for example, it took the parties over five years to get to trial and an additional three plus for the district court to issue its decision.[4] Even in jurisdictions that run relatively quickly, however, it is unclear how long the case is going to take; civil cases may be pushed aside for criminal cases and a judge's timing varies within a jurisdiction.
- **Counterclaims.** The only place for effective counterclaims is the district court. Thus, a plaintiff who knows the accused infringer has good patents to assert may not want to be in the district court. The jury is going to hear why both the plaintiff and the defendant infringe, and it may get very complicated.
- **Burden of proof.** In the district court or the ITC, invalidity must generally be proved by clear and convincing evidence.[5] In addition, when invalidity is based on prior use, there are strict proof requirements; infringement must be proven by the preponderance of the evidence.
- ***eBay* considerations for injunctions.** District courts do not automatically issue injunctions for patent owners. In *eBay*,[6] the Supreme Court held that the traditional four-factor test for injunctive relief applies equally in patent cases. Thus, district courts must consider (1) whether there is irreparable injury, (2) what other remedies are available, (3) a balancing of the hardships between plaintiff and defendant,[7] and (4) the public interest.
- **Multidistrict consolidation.** Since the AIA, a plaintiff can no longer include multiple unrelated defendants in the same action.[8] But if there are different defendants across different jurisdictions, the litigation could end up in a multidistrict consolidation where all those cases are consolidated for pretrial procedures. Consolidation is not just for discovery, but for all pretrial procedures. So, a *Markman* hearing is conducted in the multidistrict consolidation, and summary judgments may also be determined there.[9]

ITC

There are numerous factors to consider in litigating Section 337 cases at the ITC.[10] However, a number of these factors significantly affect the decision of where to file, including domestic industry, importation, ALJ, OUII, speed, stays, lack of effective counterclaims, in rem jurisdiction, and joinder. Each is described below:

- **Domestic industry.** The ITC was created to defend U.S. business, and therefore, the ITC looks to whether there is a domestic business to defend; that domestic industry must obviously be in the United States and must be related to the patent.[11] The ITC's requirement that a case involve a domestic industry relating to the patent can be as simple as an investment in plant and equipment in the United States relating to the patent or an investment in exploiting the patent, such as research and development, licensing, and engineering.

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4. Polaroid Corp. v. Eastman Kodak Co., 789 F. 2d 1556, 1557 (Fed. Cir. 1986). **5.** Osram Sylvania v. Am. Induction Tech., 701 F. 3d 698, 699 (Fed. Cir. 2012). **6.** eBay Inc. v. MercExchange, LLC, 547 U.S. 388, 391 (2006). **7.** Compare this to the ITC where you need not show a balancing of these hardships. *See* Spansion, Inc. v. Int'l Trade Com'n, 629 F. 3d 1331, 1336 (Fed. Cir. 2010). **8.** 35 U.S.C.A. § 299. **9.** A *Markman* hearing, also known as a claim construction hearing, is a pretrial hearing where the court determines the meaning of words from patent claims that are in dispute in a patent infringement lawsuit. The findings in a *Markman* hearing affect many issues in a patent case, such as infringement, invalidity, etc. The name stems from a Supreme Court decision, Markman v. Westview Instruments, Inc., 517 U.S. 370 (1996), which held that courts and not juries must construe the claims. **10.** Section 337 of the Tariff Act of 1930 authorizes investigation of alleged infringement of U.S. patent rights and provides for the enforcement of other intellectual property rights. For a full discussion of issues in ITC litigation, see Ethan Horwitz & Lester Horwitz, Horwitz on Patent Litigation, Ch. 15 (Matthew Bender 2015). **11.** 19 U.S.C.S. § 1337.

- **Importation.** The ITC only deals with imports; domestic products are not under its purview.[12] The ITC will not stop products from being manufactured and sold in the United States; it will only stop products from being imported into the United States. For example, if a chip is made in the United States and then shipped overseas to be packaged, when the package with the chip comes back into the United States, that return trip back into the United States is an importation the ITC can stop.

  Also, there must be a relationship between the infringement of the patent and the product and its features. Unlike in district court, where an infringement is an infringement regardless of how extensive it is, the ITC will look to the extent the patented feature fits into the overall product and determine whether it is worthy of stopping importation. For example, if the patent is for the chip itself, the ITC will likely stop the chip from being imported. If a phone is being imported that contains that chip, ideally a complainant will want to show how the patented aspect of the chip allows the phone to do certain things and that those are the very things that make the phone sellable. There is a difference as to whether the patented chip merely does what can be done by any chip or whether there is something unique about the patented aspect of this chip that allows the phone to have the feature being advertised, such that the chip is an integral part of the marketing of the product.

  A last example is a refrigerator with a time display that uses a chip; that time display chip is so remote to the basic function of the refrigerator that the ITC is unlikely to issue an injunction for that refrigerator based on infringement by the chip.

- **ALJ.** The ALJ (Administrative Law Judge), not a jury, decides an ITC case. The ALJ gives an opinion and then the commission actually issues a decision. The senior ALJs are very well-versed in patent issues as much of what they do is deciding patent cases. ALJs know patent law very well; they also have experience picking up technology and often have technical clerks to help.

- **OUII: The Office of Unfair Import Investigations.** There are three different parties to an ITC litigation: (1) the complainant (the patent owner); (2) the respondent (the party accused of infringing); and (3) the public, represented by the OUII. OUII attorneys very often have technical degrees and patent backgrounds and know the issues very well. And, not always, but very often, the ALJs look to the OUII attorneys for advice because they have been very steeped in the case throughout discovery and are impartial.

- **Speed.** The ITC must issue a decision within 12–16 months from initiation of the action, and in complicated cases that period could be extended up to 18 months.[13] So, usually, the trial is 9 to 13 months from initiation of the case. If you are a respondent, you find out about the case on day one. Often, on day 30, the case is initiated, and then nine months later, you start trial. And very often, if discovery has not been completed, it really doesn't matter because an extension is unlikely.

- **Stays.** There are no stays of ITC actions for post-grant procedures in the USPTO.

- **No effective counterclaims.** There are counterclaims in ITC actions. However, the counterclaims are separated out and sent to the district court as an independent case so that there is effectively a one-sided case in the ITC.[14] The only issues are whether the respondent is infringing the patent and whether the patent is valid and enforceable. So, from the patent owner's point of view, the only risk in an ITC case is that the patent may be held invalid, and even that may not be binding. The ITC decision has no res judicata effect but can have a persuasive effect in a later case in the district court.

- **In rem jurisdiction.** The ITC has jurisdiction over the products being imported, not personal jurisdiction over the parties in the case.[15] This means that service is easy. The ITC serves other parties by mail; there are no Hague Convention issues involved and no delays because of the Hague Convention. Another consequence of the ITC being an in rem proceeding is that there is no balancing of the equities to be considered in issuing an injunction. There is a balancing for the public interest, but the damage to defendant is technically not a factor in the case.[16]

- **Joinder.** Before the AIA, you could historically sue 100 different parties in the district court who were independently infringing; under the AIA, you can now only sue related defendants. For example, the manufacturer, the seller, and the user of a specific product can be sued in one action; different manufacturers cannot be sued in the same case. By contrast, even after the AIA, the ITC has no limitations as to the number of different unrelated parties that can be included in the action.[17]

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12. *Id.* **13.** 19 C.F.R. § 210.42. **14.** 19 U.S.C. § 1337(c). **15.** Sealed Air Corp. v. Int'l Trade Com'n, 645 F. 2d 976, 986 (1981). **16.** *See supra* note 4. **17.** However, when there are a large number of respondents named, the ITC may request that they be reduced.

Related Content

For more information on remedies for patent infringement, see

> PATENT FUNDAMENTALS

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

For a detailed discussion of the post-issuance challenge procedures in the America Invents Act, see

> THE FUNDAMENTALS OF POST-ISSUANCE CHALLENGE PROCEDURES: IPR, PGR & CBM

RESEARCH PATH: *Intellectual Property & Technology > PTAB Proceedings > Post-Issuance > Practice Notes > Post-Issuance Challenge Procedures*

For additional information on choosing a favorable venue for patent litigation, see

> PATENT LITIGATION FUNDAMENTALS

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For an overview of the factors to be considered in litigating Section 337 patent cases at the International Trade Commission, see

> THE FUNDAMENTALS OF ITC SECTION 337 INVESTIGATIONS (PATENT INFRINGEMENT)

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Post-Grant Procedures in the USPTO

There are a number of post-grant procedures in the USPTO and they vary. Some may be brought by the patent owner (reissue,[18] supplemental examination,[19] and ex parte reexamination[20]) and some by others (ex parte reexamination, post-grant review,[21] inter partes review,[22] and covered business method proceedings[23]).[24] Some are ex parte, some inter parte. Some have trials, some do not.

These various proceedings have characteristics that need to be taken into account when determining whether to use them as opposed to a district court or ITC proceeding. Specifically, factors to consider relate to amending or clarifying claims, burden of proof, estoppel effect, the lack of live testimony (usually), strengthening the patent, speed (sometimes), limited discovery (if any), limited basis for invalidity (for some), and expense.

- **Amending or clarifying the claims.** There are different post-grant procedures, and in some you can amend the claims and in some you cannot. In some you can theoretically amend the claims, but as a practical matter, permission to amend is rarely granted. But even if the claims cannot be amended, they can be clarified. The statements made in the post-grant procedure are considered in interpreting the claims.[25] There is a significant advantage for a patent owner to look at the defendant's product, file a post-grant procedure, and say things to make the claims read on defendant's product.

  Some ex parte procedures allow amendments to the claims. In fact, in a reissue, a patent owner can actually expand the claims within the first two years after grant. A patent owner can amend the claims in ex parte reexamination and inter partes review to limit the claims. But it is difficult; although technically possible and having actually occurred in some cases, the USPTO's Patent Trial and Appeal Board (PTAB) has made it very difficult to amend the claims.[26]

  The Federal Circuit has held that intervening rights only apply to amendments of claims, not to clarifying claims.[27] So, if the claim language has not changed, but through statements in the USPTO the meaning of the claims has changed, there are no intervening rights.

- **Speed (sometimes).** Inter partes review, post-grant review, the transitional program for covered business method patents, and derivation proceedings are supposed to be completed within one year from institution, with a six-month extension possible. In reissues, there are no time limits. For ex parte reexaminations, the law says they are to be done with "special dispatch."

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18. Reissue applications may be used to correct accidental errors in patents that cause the patent to be wholly or partly inoperative or invalid. For a full definition, see the Lexis Practice Advisor IP Glossary, https://advance.lexis.com/api/permalink/c720afd3-5326-4b22-9e44-e32950860813/?context=1000522. **19.** Under the AIA, a patent owner may request a supplemental examination of a patent in the USPTO to consider, reconsider, or correct information believed to be relevant to the patent. After the request is filed, the USPTO conducts the supplemental examination and decides whether a substantial new question of patentability exists. If it does, ex parte reexamination will be ordered (see footnote 20, below, for a definition of ex parte reexamination). For a full explanation, see the Lexis Practice Advisor IP Glossary, https://advance.lexis.com/api/permalink/49793b20-b828-4efd-9b6c-3f57a44d5fe2/?context=1000522. **20.** An ex parte reexamination is a procedure in which the USPTO reviews the validity of a patent. It can be instituted by any person at any time. Only the patent owner may participate in an ex parte reexamination proceeding, and only prior art patents or printed publications may be considered. For more details, see the Lexis Practice Advisor IP Glossary, https://advance.lexis.com/api/permalink/0b577373-eecb-46ad-8c16-adfa6affc64f/?context=1000522. **21.** *See supra* note 2. **22.** *See supra* note 1. **23.** *See supra* note 3. **24.** Derivation proceedings will not be dealt with in this article. **25.** There are courts that have actually stayed a patent litigation saying there is no way to complete a patent litigation because it cannot do a *Markman* hearing until it sees what additional statements are being made in the USPTO proceeding that is taking place. *See* Roblor Marketing Grp., Inc. v. GPS Indus., 633 F. Supp. 2d 1341 (S.D. Fla. 2008). **26.** *See* dissent in *In re* Cuozzo Speed Tech., LLC, 793 F.3d 1268, 1271 (Fed. Cir. 2015).

- **Burden of proof.** In the district court and in the ITC, invalidity must be proven with clear and convincing evidence. In the USPTO, there are two different standards. One is the preponderance of evidence applicable to inter partes review, post-grant review, covered business methods, and derivation proceedings. In a reissue and in ex parte reexamination, there is the usual application standard.

- **Limited discovery.** There are different standards for discovery in the inter partes procedures in the USPTO. Obviously, in ex parte proceedings, there is no discovery. In post-grant reviews, there is limited discovery directly related to the issues. In inter partes review, discovery is limited to the discovery necessary in the interest of justice.

  In general, if a declaration is filed in an inter partes proceeding, the other side can depose the declarant and look at the documents related to that declaration. Getting discovery beyond that is difficult. In order for a party to get further discovery, the PTAB generally requires the party to show exactly what it wants, show that the information exists, and show how it will be relevant.[28] There is no general discovery; a party must identify a specific witness who knows specific information or identify a specific document with specific information. What this effectively means is, unless a party knows about relevant information in advance and can identify it, it is not going to get discovery on that information.

  Thus, for example, where prior art (i.e., evidence that the subject or invention is already known) is based on a prior use by a third party who is cooperative with an accused infringer, the accused infringer can file an inter partes procedure and set forth only the issues that are favorable (within the limit of the duty of candor), and it will be difficult for the patent owner to get full discovery.

- **Limited to validity.** In post-grant procedures, there are no issues of infringement, no counterclaims, and no damages involved; the proceeding is limited to the issue of validity.

- **Estoppel effect.**[29] Parties to a post-grant review are prevented from raising anything that was or *reasonably could* have been raised.[30] Parties to an inter partes review are prevented from raising in litigation anything that was raised or *could* have been raised. The difference between "could" have been raised or "reasonably could" have been raised is not clear. Thus, in these proceedings, any prior art before the PTAB is off limits in a later litigation, though it may be combined with other new art under 35 U.S.C. § 103. But even in situations where there is no estoppel effect, when a stay is requested in the district court, the court may require an accused infringer to agree that it is estopped from raising any prior art filed in the USPTO proceeding.[31]

- **Limited basis.** Some post-grant reviews have very limited bases, while others are wide open. For example, a reissue can be based on any relevant information. Supplemental examinations and post-grant review may be based on any relevant information. Ex parte reexamination and an inter partes review can be based upon patents, published applications, print publications, and the like; they cannot be based on prior use.

- **No live testimony (usually).** Some post-grant proceedings have what is called a "trial." But, the PTAB trial is very different than a trial in the district courts. The PTAB trial consists of the filing of declarations and depositions of the declarants, and basically after all those depositions, the PTAB receives final briefs and can hear final arguments. It is rare that there is an actual witness giving testimony before the PTAB. In fact, the patent community was surprised when the PTAB finally allowed some live testimony, but you can generally count upon the fact that live testimony will likely not be permitted.[32] There are "trials" in inter partes review, post-grant reviews, covered business methods, and derivation proceedings as well. These trials are the way just described and are not real trials.

- **Less expensive.** The PTAB is not cheap but is dramatically less expensive than district court or the ITC. The filing fees are sometimes expensive, but usually, the two greatest costs of litigation are trial and discovery and, as explained above, neither exists before the PTAB to any real extent.

- **Cleansing of the patent.** A patent owner can cleanse the patent if there is a defect such as in inventorship and inequitable conduct, even if the inequitable conduct is intentional, but not if the accused infringer has raised it first.[33] If the accused infringer has not raised it or if it is an ex parte proceeding and the accused infringer has not yet raised it in court, the post-grant procedure can eliminate it as an issue.

Issues in Choosing a Venue

After looking at the characteristics of the venues, the next consideration is determining where to file. The patent owner can bring an ex parte proceeding to strengthen the patent in the USPTO, a district court action, or an ITC action; all three jurisdictions are available. The accused infringer—or even a

27. Marine Polymer Tech., Inc. v. Hemcon, Inc., 672 F. 3d 1350, 1351 (Fed. Cir. 2012). **28.** 37 C.F.R. § 42.51 (2015). **29.** Every proceeding, ex parte or not, has estoppel effect for the patent owner. But there is also an effect on third parties not even involved; prior art in the proceeding has a higher burden of proof in later litigation: clear and convincing evidence. **30.** 35 U.S.C. §§ 315, 325. **31.** Coho Licensing LLC v. Glam Media, 2014 U.S. Dist. LEXIS 131284 (N.D. Cal. Sept. 17, 2014). **32.** *See e.g.*, K-40 electronics, LLC v. Escort, Inc, No. IPR2013-00203 (P.T.A.B. Aug. 29, 2013).

party who has not yet been accused—can bring an action in the USPTO, and in some cases an accused infringer can bring a declaratory judgment in the district court, but not in the ITC. The accused infringer can even file in the USPTO after a case is brought in the district court or even after the ITC case has been filed. The problem with a post-grant proceeding after the filing in the ITC is that there will not be a stay in the ITC, which is going to proceed very quickly. But very often, if a post-grant proceeding is filed, a stay of a district court litigation will be available if done correctly and quickly; namely, an accused infringer cannot wait until trial is about to take place to file in the USPTO and expect a stay. But the odds are, if done correctly, a stay will issue.

With this in mind, the issues to consider in choosing a venue are:

- **The *Markman* hearing.** The first consideration is who is going to do the *Markman* hearing. In the ITC, the ALJ does it. In the district court, the court does it. In the USPTO, the Patent Office does it.

  The second consideration for *Markman* hearings is that in the district court and the ITC, the standard for the *Markman* interpretation is the proper meaning of the claims. In the USPTO, there are different standards. In reissue, post-grant review, and inter partes review, the claims are given their broadest reasonable interpretation.[34] The USPTO has established that standard for initial applications and has also applied it to these proceedings. In an ex parte reexamination, the standard is the proper meaning, as in the district court and the ITC.[35]

  One of the issues a patent owner is faced with is whether he or she can live with the broadest possible interpretation when prior art is evaluated. An accused infringer may want the broadest possible interpretation because it pulls in more of the prior art with a better chance of invalidating the patent.

- **Burden of proof.** In the district court and the ITC, invalidity must be proven by clear and convincing evidence.[36] In the USPTO, the standard is a preponderance of the evidence.[37] In reissue and ex parte reexamination, the standard is the same as an original application. There are cases where this burden of proof makes a difference; there have been cases where the district court held the patent valid and infringed, a later USPTO proceeding invalidated on the same art, and the Federal Circuit did not see a problem with that.[38] It stated that the two rulings were not contradictory because the USPTO has a different job than the district court and a different standard than the district court.

  But there is also the practical issue of going before a jury. A jury is used to a preponderance of evidence standard and a beyond a reasonable doubt standard, like you see on TV trials. But a clear and convincing standard may mean to a jury that they have to find something dramatic in order to invalidate the patent. A jury may not understand a clear and convincing standard even if the judge explains it properly.

- **Cost.** The USPTO is much cheaper. For a lot of companies, this is the most important factor in deciding where to file.

- **Speed.** In the ITC, the trial is usually held in 9–13 months, with a decision issued from 12–16 months. The district court can range from a very short time in the rocket docket to who knows how long. And, in the USPTO, many proceedings are completed within one year.

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33. 35 U.S.C. § 257. **34.** *In re* Cuozzo Speed Tech, LLC, 793 F.3d 1268 (Fed. Cir. 2015). However, certiorari has been granted in that case and this issue has been argued before the Supreme Court. Also, there are exceptions when the patent is about to expire. **35.** 37 C.F.R. § 1.510(b)(2). **36.** Motorola Mobility, LLC v. Int'l. Trade Comm'n, 737 F. 3d 1345, 1348 (Fed. Cir. 2013). **37.** Ethicon v. Quigg, 849 F. 2d 1422, 1428 (Fed. Cir. 1998). **38.** *See In re* Swanson, 540 F.3d 1368, 1369 (Fed. Cir. 2008).

THE TYPE OF AIA PROCEEDINGS MATTERS. COURTS ARE MORE LIKELY TO ISSUE A STAY WHEN THERE IS A SPECIFIC DEADLINE IN THE USPTO BY WHICH A DECISION MUST BE ISSUED.

- **Stays.** One of the advantages of bringing a post-grant proceeding, especially against non-practicing entities, is a stay in the district court. The cost is reduced because discovery and motion practice are not proceeding. Also, with a post-grant proceeding, the patent owner is on the defensive because the only issue is one that the patent owner cannot win; it can only not lose.

  The factors used to determine whether a district court will issue a stay are:[39]

  - **Would the stay unduly prejudice the other side?** Very often for a non-practicing entity, this is difficult because only the question of damages remains. Following the Supreme Court's *eBay* decision,[40] it is less likely that an injunction will issue. If only damages are in issue (e.g., as in most cases filed by non-practicing entities), it will be difficult to show that a stay will unduly prejudice the plaintiff.
  - **Will the stay simplify trial?** In the USPTO, the patent owner, if it loses, is clearly bound by the result and the case disappears. If the patent owner wins, then very often the accused infringer cannot raise those same issues in the district court, so the post-grant proceeding will simplify trial. And even in cases where the accused infringer will not be bound, a court may only issue a stay if the defendant agrees to be bound by the post-grant proceeding result.[41]
  - **Progress of the case.** If an inter partes proceeding is filed the day after service of the complaint, a stay is much more likely than if it is filed the day before trial is about to start. Where along that line of continuums is the switch from more likely to less likely is not clear, but obviously the faster a post-grant proceeding is filed, the more likely the stay.
  - **Other factors.** The court will entertain other considerations, not specifically included in the first three, in deciding whether a stay is appropriate.

  So, the earlier the better. If you file the post-grant proceeding before the district court action is brought, a stay is likely. If it is filed just after the district court action is filed, a stay is still likely. If filed much later, there is a question about whether a stay will issue. Also, the type of AIA proceedings matter; courts are more likely to issue a stay when there is a specific deadline in the USPTO by which a decision must be issued.

- **Counterclaims.** Counterclaims may only be effectively brought in district court. So, this can be a key issue when there are cases in the ITC, in the district court, and in the USPTO. Whoever wins the first decision has a major advantage; odds are that settlement is going to be very favorable to whoever wins the first round.

- **Jury.** Whether there is a jury is a key factor. In the district court, there are juries and live witnesses. In the ITC, there is no jury; some ALJs allow live witnesses for direct and cross-examination, while some ALJs have declarations for direct testimony and only live cross-examination. Further, in the ITC, there can be a very limited cross-examination; cross and direct do not go back and forth and back and forth until everybody is finished. There is only one round of redirect, and then recross, with no ability for re-redirect if something new comes up in recross, unless the ALJ decides to allow it.

  In the USPTO, there is obviously no jury and a very technical audience. So, it is important to consider who has a good story, who has a sympathetic witness, and who may have facts that look bad on first blush but with detailed explanation can be overcome. All of these things go into the decision of whether to demand a jury. And even on validity, once a party has a jury in its favor, many other things become a lot easier. So, a jury is a significant factor in whether to choose the district court, the ITC, or the USPTO.

- **Damages.** Only the district court can award damages. In the ITC, you may be granted an injunction, which can disrupt the other side's business and may be a way of damaging them enough that they agree to settle by paying, but there are no

39. See Premier Int'l Assoc. LLC v. Hewlett-Packard, 554 F. Supp. 2d 717, 718 (E.D. Tex. 2008). **40.** eBay Inc. v. MercExchange, LLC, 547 U.S. 388, 391 (2006). **41.** Evolutionary Intelligence, LLC v. Millenial Media, Inc., 2014 U.S. Dist. LEXIS 81090 (N.D. Cal. June 11, 2014).

formal damages. And obviously in the USPTO, there are no damages whatsoever; only validity is an issue.

- **The effect of USPTO decisions on trials.** A significant consideration when determining venue is that after a decision in a post-grant proceeding, there may be no second bite at the apple in the district court or in the ITC. If invalidity involves a good story, you may not want to take a risk in the USPTO, because that good story may disappear and never go in front of a jury. After a post-grant proceeding, what could have been raised or what reasonably could have been raised is no longer available in court.

  But there is also the effect of validity being out of the picture at a later trial on infringement. Very often, the patent owner must balance a fine line between why the patent is valid (why it is limited in certain ways and therefore overcomes the prior art) and why it infringes (why it is broad in certain ways and therefore encompasses what defendant is doing). Now, technically, the Markman hearing produces the same meaning of the claims for both invalidity and infringement. But as a practical matter, there is more leeway to argue infringement if a patent owner does not have to worry about validity; the patent owner does not have to worry about balancing a limited claim for validity purposes and a broad claim for infringement purposes.

- **Discovery.** Especially with prior art of a prior sale, in the USPTO a party will have very little discovery for the other side to attack the basis of the prior sale. A party will be able to put its best witness up. There is a very limited ability to go behind that witness and get the testimony of other witnesses and documents other than what was produced. And so, with limited discovery, a party may not want to be prevented from getting full discovery and being bound so that it cannot raise the same issue later at trial.

Balancing the Issues

Neutral Factors

Many of the issues used to determine the jurisdiction in which to litigate are party neutral, meaning that they can apply equally to either a patent owner or an accused infringer:

- **Expense.** Both sides will benefit from the lower cost of a PTAB proceeding. However, when one party can bear the cost better, that party may not want to litigate in a venue that evens the playing field by not requiring the other, less wealthy party to spend significant sums.

- **Discovery.** The lack of full discovery in the PTAB proceeding will hinder the side that needs the discovery the most. When the PTAB proceeding is based on paper prior art (patents and publications) the need for discovery is reduced but may still exist. For example, expert declarations may often contain testing done by others. While an expert should supervise the tests, the supervision may be satisfied by the expert testifying that this lab has been used for years and is trusted. The ability to depose the lab is limited.

  In cases where the prior art is use-based, the lack of discovery at the PTAB proceeding is even more critical. If the claim is that the patent owner offered the invention for sale, then the patent owner—within limits of candor—can put up its best witness and characterize the offer its own way. There is little, if any, ability in the PTAB proceeding to go beyond the witness and depose others. The patent owner may wish to choose a PTAB proceeding for this reason. On the other hand, if the prior offer for sale was done by a third party, the patent owner will have difficulty getting additional discovery of that third party who may have an interest in invalidating the patent.

- **Jury.** Either side may have a very complex issue or state of facts that makes the PTAB proceeding the better way to go. In addition, either side may have an appealing story that may work better before a jury.

Patent Owner Factors

There are a number of factors that a patent owner should consider in choosing a venue:

- **Cleansing the patent.** Except when the issue has already been raised in litigation, a patent owner can cure things like inventorship issues and inequitable conduct in a post-grant proceeding.

- **Ex parte post-grant proceedings.** Obviously, it is easier to win ex-parte. The ex-parte post-grant procedures give the patent owner that advantage and allow it to put prior art before the USPTO and gain the clear and convincing standard for validity in a later court or ITC action.

- **Counterclaims.** The district court permits counterclaims whereas the post-grant proceedings do not and the ITC effectively does not. There are a number of factors to consider on this issue, including whether there is an effective counterclaim, whether the patent owner's claim will be stayed for a post-grant proceeding, or whether the counterclaim will be allowed to proceed if the patent owner's claim is stayed.

42. A patent file wrapper is an electronic or paper folder that contains all of the documents pertaining to a particular patent application. The file wrapper contains a complete record of proceedings in the PTO, from the filing of the initial patent application to the issued patent, as well as all the communications between the inventor and the PTO.

- **Speed.** It is usually the patent owner that wants to rush through the litigation, but not always. Often, a PTAB proceeding with strict deadlines will be faster, but some district courts are even faster, and the ITC is always fast.
- **Damages.** While a declaration of validity or an injunction against imports may be important, and the cases in the PTAB or the ITC may lead to a later damages judgment, the prospect of immediate damages in district court does have an effect on the ability to settle favorably.
- **Whipsaw validity and infringements.** Technically, a claim's meaning does not change when considering validity and infringement. However, the reality of a trial is that there is a distinct advantage of merely arguing infringement and not having to worry about contradicting a position on validity.
- **Fresh *Markman* hearing.** While there are sometimes disputes over what a defendant is doing, most litigation revolves around how to describe what defendant is doing and how to fit it into the claim language. Imagine being able to write the file wrapper knowing what issues will arise with defendant's product.[42] The statements made in a post-grant proceeding are part of the file wrapper. After seeing defendant's product, a post-grant proceeding may be filed where statements can be made to later use in a *Markman* hearing; there are no intervening rights where the claim is not changed, even if its meaning has been changed to expand the scope of the claim.

Accused Infringer Factors

- **Stays.** A post-grant proceeding, if brought quickly enough, will often stay a district court proceeding but not an ITC proceeding. The post-grant proceeding is not very cheap but much cheaper than the other two alternatives.
- **Burden of proof.** To invalidate in the district court or the ITC, the burden is for the most part clear and convincing evidence, and prior use must be proven with strong evidence. In the USPTO, the standard is the same as for applications and much easier to show. In addition, statistics are starting to show that patents have serious problems in PTAB proceedings.
- ***Markman* hearing.** The standard in the district court and ITC is the proper meaning of the claims whereas in PTAB proceedings it is the broadest reasonable meaning. The use of a broader meaning pulls in a broader range of prior art, and the choice of a PTAB proceeding provides the additional benefit of having an audience with a lot of experience evaluating prior art.
- **No two shots at validity.** For the most part, after a PTAB proceeding, an accused infringer will have lost the ability to present an invalidity case in district court or the ITC. If the invalidity story is a good one, such as how the accused infringer had the invention prior to the patentee, this may resonate better with a jury than with the PTAB.

Conclusion

The decision regarding where to file a patent claim is a complicated one. The easy way out is to opt for the cheaper PTAB proceeding; however, there are many other factors to consider. If the PTAB route is the wrong way to go, the later district court or ITC proceedings will be just as expensive, but with less of a chance to win.

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Stuart Gelfond and Burcin Eren

The NYSE's Complex Shareholder Approval Rules: **Issuing New Securities? Do You Need Shareholder Approval?**

THE NEW YORK STOCK EXCHANGE (NYSE) HAS SPECIFIC requirements applicable to listed companies to receive shareholder approval in connection with certain transactions, including issuing equity and convertible securities, which are in addition to any applicable requirements under state law and SEC rules. Although these rules can be seen as complex and technical, it is very important to understand them, especially considering the extra time and expense that may come with the shareholder approval process. Under Section 312.03 of the NYSE Listed Company Manual, shareholder approval by a majority of votes cast on a proposal is a prerequisite to issuing securities in connection with any of the following situations.

Equity Compensation Plans and Arrangements

Pursuant to Section 303A.08, with limited exemptions explained below, shareholders must be given the opportunity to vote on all equity-based compensation plans, which are defined as plans or other arrangements that provide for the delivery of equity securities (either newly issued or treasury shares) of the listed company to any employee, director, or other service provider as compensation for services. Moreover, a compensatory grant of options or other equity securities that is not made under a plan is considered an equity compensation plan under the NYSE rule and triggers a shareholder vote.

In addition, shareholder approval is required for a material revision of an equity compensation plan, which includes but is not limited to the following:

- A material increase in the number of shares authorized under the plan, with two exceptions:
  - Increases that reflect a reorganization, stock split, merger, spin-off, or similar transaction
  - Automatic increases or automatic grants under a "formula plan," provided that the term of the plan is not more than 10 years:
    - Examples of automatic grants pursuant to a formula are (1) annual grants to directors of restricted stock having a certain dollar value; and (2) matching contributions, whereby stock is credited to a participant's account based upon the amount of compensation the participant elects to defer.

- If a plan contains no limit on the number of shares available and is not a formula plan, then each grant under the plan will require separate shareholder approval regardless of whether the plan has a term of not more than 10 years.

- An expansion of the types of awards available under the plan
- A material expansion of the class of employees, directors, or other service providers eligible to participate in the plan
- A material extension of the term of the plan
- A material change to the method of determining the strike price of options under the plan
  - A change in the method of determining the fair market value from the closing price on the date of grant to the average of the high and low price on the date of grant is not a material change.
- The deletion or limitation of any provision prohibiting repricing of options:
  - Under the NYSE rules, a "repricing" means any of the following or any other action that has the same effect:
    - Lowering the strike price of an option after it is granted
    - Any other action that is treated as a repricing under generally accepted accounting principles
    - Canceling an option at a time when its strike price exceeds the fair market value of the underlying stock, in exchange for another option, restricted stock, or other equity, unless the cancellation and exchange occurs in connection with a merger, acquisition, spin-off, or other similar corporate transaction
- A plan that does not contain a provision that specifically permits repricing of options is deemed to prohibit repricing. As a result, any actual repricing of options issued under such a plan would be considered a material revision of a plan even if the plan itself is not revised.

It is important to note that an amendment will not be considered a material revision if it curtails rather than expands the scope of the plan in question.

The NYSE provides certain exemptions to the rule and does not consider the following to be equity compensation plans; therefore, no shareholder approval is needed:

- Plans that are made available to shareholders generally, such as a typical dividend reinvestment plan
- Plans that merely allow employees, directors, or other service providers to elect to buy shares on the open market or from the listed company for their current fair market value, regardless of whether:
  - The shares are delivered immediately or on a deferred basis
  - The payments for the shares are made directly or by giving up compensation that is otherwise due (for example, through payroll deductions)

In addition, as explained in more detail below, the NYSE does not require shareholder approval of employment inducement awards, certain grants, plans, and amendments in the context of mergers and acquisition transactions, and certain specific types of plans as long as they are made with the approval of the listed company's independent compensation committee or the approval of a majority of the listed company's independent directors and the NYSE is notified in writing.

Employment Inducement Awards

- An employment inducement award is a grant of options or other equity-based compensation as a material inducement to a person or persons being hired by the listed company or any of its subsidiaries, or being rehired following a bona fide period of interruption of employment.
- Inducement awards also include grants to new employees in connection with a merger or acquisition.
- The listed company must disclose in a press release the material terms of the award, including the recipient(s) of the award and the number of shares involved, promptly following a grant in reliance on this exemption.

Mergers and Acquisitions

- There are two exemptions related to whether approval is required for an employee compensation plan that apply in the context of mergers and acquisitions:

  1) Shareholder approval will not be required to convert, replace, or adjust outstanding options or other equity-compensation awards to reflect the transaction.

  2) Shares available under certain plans acquired in corporate acquisitions and mergers may be used for certain post-

transaction grants without further shareholder approval. This exemption applies to situations where a party that is not a listed company following the transaction has shares available for grant under preexisting plans that were previously approved by shareholders. Shares available under such a preexisting plan may be used for post-transaction grants of options and other awards with respect to equity of the entity that is the listed company after the transaction, either under the preexisting plan or another plan, without further shareholder approval, so long as:

(i) The number of shares available for grants is appropriately adjusted to reflect the transaction.

(ii) The time during which those shares are available is not extended beyond the period when they would have been available under the preexisting plan, absent the transaction.

(iii) The options and other awards are not granted to individuals who were employed, immediately before the transaction, by the post-transaction listed company or entities that were its subsidiaries immediately before the transaction.

A plan adopted in contemplation of a merger or acquisition transaction would not be considered preexisting for purposes of this exemption.

- Any shares reserved for listing in connection with a transaction pursuant to either of these M&A exemptions would be counted by the NYSE in determining whether the transaction involved the issuance of 20% or more of the listed company's outstanding common stock and thus required shareholder approval under the NYSE as explained below in more detail.

Qualified Plans, Parallel Excess Plans, and Section 423 Plans

Shareholder approval will also not be required for:

- Tax qualified plans under Section 401(a) of the Internal Revenue Code (the Code) such as employee stock ownership plans (ESOPs) or 401(k) plans
- Employee stock purchase plans intended to meet the requirements of Section 423 of the Code
- A parallel excess plan, which is defined as a pension plan that is designed to work with a tax-qualified plan to provide benefits that exceed the applicable Code limits on contributions, compensation, and benefits.
  - In order to be a parallel excess plan, the plan must (1) cover all or substantially all employees of an employer who are participants in the related qualified plan whose annual compensation is in excess of the limit specified in the Code, (2) have terms that are substantially the same as the qualified plan that it parallels except for the elimination of the applicable Code limits, and (3) provide that no participant receives employer equity contributions under the plan in excess of 25% of the participant's cash compensation.

Certain Issuances of Common Stock, or Securities Convertible into or Exercisable for Common Stock

Shareholder approval is required prior to the issuance of common stock, or of securities convertible into or exercisable for common stock, if the number of shares to be issued or that may be convertible or exercisable exceeds either 1% of the number of shares of common stock or 1% of the voting power outstanding before the issuance, in any transaction or series of related transactions, to:

- A director, officer, or substantial security holder (those controlling 5% or more of the company's shares or voting power) of the company (each defined as a related party)
- A subsidiary, affiliate, or other closely related person of a related party
- Any company or entity in which a related party has a substantial direct or indirect interest

Under a recent exemption adopted on December 31, 2015, these requirements do not apply to the sale of stock for cash by an early stage company, which is defined as a company that has not reported revenues in excess of $20 million in any two consecutive fiscal years since its incorporation, provided that the early stage company's audit committee (or a comparable committee comprised solely of independent auditors) approves the transaction prior to completion. The early stage company exemption covers only sales for cash and is not available for stock issuances in connection with an acquisition.

> If the related party involved in the transaction is classified as such solely because such person is a substantial security holder, and if the issuance relates to a sale of stock for cash at a price at least as great as each of the book and market value of the issuer's common stock, then shareholder approval will not be required unless the number of shares of common stock to be issued, or unless the number of shares of common stock into which the securities may be convertible or exercisable, exceeds either 5% of the number of shares of common stock or 5% of the voting power outstanding before the issuance.[1]

Under the NYSE rules, voting power outstanding refers to the aggregate number of votes that may be cast by holders of those securities outstanding that entitle the holders thereof to vote generally on all matters submitted to the company's security holders for a vote.

Shareholder approval is required for the issuance of securities convertible into or exercisable for common stock if the stock that can be issued upon conversion or exercise exceeds the applicable percentages. This is the case even if such convertible or exchangeable securities are not to be listed on the NYSE. Only shares actually issued and outstanding (excluding treasury shares or shares held by a subsidiary) are to be used in making the calculations above. Shares reserved for issuance upon conversion of securities or upon exercise of options or warrants will not be regarded as outstanding for this purpose.

Issuances Covered by the "20% Rule"[2]

Shareholder approval is required prior to the issuance of common stock, or of securities convertible into or exercisable for common stock, in any transaction or series of related transactions if:

- The common stock has, or will have upon issuance, voting power equal to or in excess of 20% of the voting power outstanding before the issuance of such stock or of securities convertible into or exercisable for common stock.
- The number of shares of common stock to be issued is, or will be upon issuance, equal to or in excess of 20% of the number of shares of common stock outstanding before the issuance of the common stock or of securities convertible into or exercisable for common stock.

However, shareholder approval is not required for any such issuance involving:

- Any public offering for cash

Related Content

For more information on when companies that are listed on the NYSE must seek shareholder approval in general, see

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

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

For additional information on when NYSE listed companies must seek shareholder approval for equity compensation plans, see

> DISCLOSING EQUITY COMPENSATION PLANS

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

- Any bona fide private financing, if such financing involves a sale of:
  - Common stock, for cash, at a price at least as great as each of the book and market value of the issuer's common stock
  - Securities convertible into or exercisable for common stock, for cash, if the conversion or exercise price is at least as great as each of the book and market value of the issuer's common stock

Bona fide private financing is defined as a sale in which either:

- A registered broker-dealer purchases the securities from the issuer with a view to the private sale of such securities to one or more purchasers.
- The issuer sells the securities to multiple purchasers, and no one such purchaser, or group of related purchasers, acquires, or has the right to acquire upon exercise or conversion of the securities, more than 5% of the shares of the issuer's common stock or more than 5% of the issuer's voting power before the sale.

Shareholder approval is required for the issuance of securities convertible into or exercisable for common stock if the stock

1. NYSE Listed Company Manual 312.03(b), http://nysemanual.nyse.com/lcm/Help/mapContent.asp?sec=lcm-sections&title=sx-ruling-nyse-policymanual_310.00&id=chp_1_4_12 2. Prior to December 21, 2006, this rule included an exception from the required calculations for issuances of treasury stock. Under that exception, shareholder approval for securities issuances was only required if the securities were not already listed and shares repurchased and held as treasury shares were still considered listed. Under the limited transition period provided by the NYSE, if a company executed a binding contract prior to October 23, 2006, with respect to the issuance of common stock, the existing treasury share exception continues to be available for that transaction.

that can be issued upon conversion or exercise exceeds the applicable percentages. This is the case even if such convertible or exchangeable securities are not to be listed on the NYSE. Only shares actually issued and outstanding (excluding treasury shares or shares held by a subsidiary) are to be used in making the calculation above. Shares reserved for issuance upon conversion of securities or upon exercise of options or warrants will not be regarded as outstanding for this purpose.

Change-of-Control Transactions

Shareholder approval is required prior to an issuance that could result in a change of control of the issuer. The NYSE does not define change of control and the NYSE staff has not historically provided any clear written guidance as to its scope. Nevertheless, the NYSE's 2005 decision in the transaction that involved Banco Santander of Spain, Sovereign Bank and Independence Community Savings (the Sovereign case) indicated that the NYSE considers all facts and circumstances to determine whether a change of control has occurred instead of following a strict numerical test. Indeed, the NYSE implied in the Sovereign case that even smaller transactions that involve less than 20% of the issuer's outstanding shares may be deemed to be a change of control transaction, and thus trigger a shareholder vote, if certain specific veto and other rights are also given, such as the right to appoint directors or to terminate or veto the appointment of the CEO.

Financial Viability Exception

NYSE also provides an additional exception from the shareholder approval requirements in situations where the delay in securing stockholder approval would seriously jeopardize the financial viability of the company. This exception is generally used under extreme circumstances, such as when there is a real risk of bankruptcy, and requires an approval from the NYSE in advance. In addition, in order to take advantage of this exception, the company's audit committee must expressly approve the reliance on this exception by the company, and the company must mail to all shareholders, not later than 10 days before issuance of the securities, a letter alerting them to its omission to seek the shareholder approval that would otherwise be required by the NYSE and indicating that the audit committee has expressly approved the exception.

So, What If You Are Not Sure Whether You Should Seek Shareholder Vote Before Issuing Securities?

Companies listed on the NYSE need to consider these rules carefully before issuing securities in order to understand whether their contemplated transaction would trigger a shareholder vote. The NYSE does not issue interpretations or guidance on its rules; however, the NYSE is willing to engage in discussions regarding interpretation of the shareholder approval rules. Depending on the circumstances, listed companies should discuss questions relating to shareholder approval and their potential transactions with their counsel and potentially NYSE representatives sufficiently early for the calling of a shareholders' meeting and the solicitation of proxies where shareholder approval may be involved.

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Understanding Real Estate **Joint Ventures**

As funds raised in the 2006–2008 heyday of private equity reach the ends of their 10 year terms, there has been a surge of restructurings of those funds utilizing a stapled secondary structure. The widely publicized $1.2 billion restructuring in March 2016 of a 2008 vintage buyout fund managed by private equity pioneer Thomas H. Lee is the latest example of this trend, showing that private equity fund restructurings have become mainstream.

REAL ESTATE JOINT VENTURES ARE ESSENTIALLY A WAY TO match capital needed or desired for a real estate acquisition or development by an operating party (referred to herein as the operating member) with a real estate capital provider (referred to herein as the capital member). The real estate capital provider's business is to invest capital in real estate assets or projects but not necessarily to source and operate real estate assets.

Typically, a capital member is interested in entering into a joint venture with an operating member that is an expert in particular markets and/or asset classes as well as day-to-day management and reporting duties. The operating member of the joint venture usually has the ability to source, acquire, debt finance, manage, and/or develop properties in certain asset classes and/or geographic regions but may or may not have the ability to contribute material capital to the joint venture (hence the need for a capital member).

A common joint venture structure is a structure whereby the capital member and the operating member form a new limited liability company. The parties then enter into an operating agreement (also referred to herein as the joint venture agreement) for such limited liability company, which sets forth the parties' agreement as to their respective rights regarding (1) distributions of profits, (2) management rights and control over decisions of the limited liability company, (3) exit rights

and transfer rights with respect to the sale or transfer of membership interests in the joint venture, and (4) all other applicable rights and remedies. See Limited Liability Company Operating Agreement for a sample joint venture agreement. See Joint Venture Organizational Chart for a visual depiction of a standard joint venture structure.

Key Components of the Joint Venture Agreement

There are several components of a joint venture agreement that are oftentimes heavily negotiated and a major focus of the parties to the agreement.

Capital Contributions

The joint venture agreement must clearly set forth the capital contribution obligations of the parties to the agreement. The purpose of the capital contribution provisions is to make clear what the parties' respective responsibilities are to contribute capital to the joint venture. See [Article IV of the Limited Liability Company Operating Agreement] for sample capital contribution provisions.

First, the joint venture agreement must specify the mandatory initial capital contributions to be made by each of the parties to acquire the asset. The initial capital contribution is part of the basic business transaction and can of course be any negotiated amount. Some typical formulations for initial capital contributions can be 95%/5% or 90%/10%, where the operating member of the joint venture contributes a minor portion (5%–10%) of the equity capital and the other member provides most of the equity capital. A 50%/50% formulation is not uncommon where the operating member has sufficient capital and wants to retain more control and a larger share of the economics of the deal.

The joint venture agreement must also specify any mandatory additional capital requirements of the parties. The responsibilities of the parties with respect to their capital contributions are largely influenced by the type of real estate asset being purchased. Very often, in stabilized acquisition type transactions (for example, the purchase of developed real property that the parties have no plans to improve or further develop), the parties, particularly the party investing the larger portion of the cash equity, will not agree to be obligated to make additional capital contributions that are more than their percentage share of the initial amount of equity (the initial capital contribution) to acquire the asset.

If the transaction involves a transitional asset (meaning an asset where there are contemplated future capital expenditure items, for example where there are plans to improve or further develop the real property that is the asset) the parties may agree on funding their percentage share of such budgeted and contemplated amounts. In this case, the joint venture agreement should include a provision obligating the members to make additional capital contributions to the extent that the transaction involves future capital contribution obligations for which members are required to invest rather than just having an option to do so.

Where the transaction is more in the nature of a ground up development, the parties will likely need to agree to fund (1) budgeted amounts, (2) any cost overruns (meaning unforeseen costs in excess of the budgeted amounts), and (3) any other unforeseen costs (perhaps up to a maximum amount).

Another scenario where the parties often agree to contribute their share of future unknown expenses is where there are non-discretionary expenses. Non-discretionary expenses are expenses such as real estate taxes, insurance, compliance with law, and life safety issue costs. The main reason for these additional mandatory capital contributions is to provide a workable and practical process for one party to fund needed expenses even if the other party fails to fund and to provide an economic disincentive for a party not to fund their share (in each case pursuant to two typical remedies, member loans or dilution), as further discussed below.

Certain key issues to consider when drafting capital contribution provisions are:

- Whether one member or both members are entitled to make capital calls from the other members
- The mechanics of notice and timing for making additional capital contributions
- The interest rate to be charged on any member loans (see below) depending on the appropriate level of disincentive against the failure to fund for the transaction
- The dilution (see below) formula to be used to calculate the increase of the funding member's membership interest, and the corresponding decrease of the non-funding member's membership interest, depending on the appropriate level of disincentive against the failure to fund for the transaction

As noted above, member loans and dilution are the two typical remedies for failure to fund a mandatory additional capital contribution. A member loan allows (but does not obligate) one party to fund their share of the expense as well as the other party's share (if such party refuses to do so). The member making the loan is then entitled to the priority return, together with interest, of such additional amount funded (with such payments being made before any further payments to the non-funding party). To the extent that the joint venture agreement allows for member loans, the repayment mechanisms must be clearly stated.

Dilution has a similar effect (but can be more punitive depending on the applicable calculation formula). Dilution is a remedy whereby the funding member's membership interest in the joint venture and thus the percentage of economics in the transaction increase, and the non-funding member's membership interest in the joint venture and such non-funding member's economics correspondingly decrease.

In addition to member loans or dilution, a failure to fund could also expressly constitute a default by the non-funding member and entitle the funding member to all other rights and remedies (e.g., damages).

- Clarify in the promote provision that the increased amount payable to the operating member above the hurdle is paid to that operating member in addition to the operating member's percentage share of the non-promoted portion of the applicable distribution (e.g., operating member to receive 20% of the distribution and then both operating member and capital member to each receive its percentage share of the remaining 80%).

Economic Percentages and Control

The respective economic interests of the parties to the joint venture agreement will often directly correlate to the respective percentage of capital contributions made by each party. This may include a capital contribution credit to the operating member in the amount of the agreed value of a real estate asset that the operating member already owns and is contributing to the joint venture. Typical structures as to economic percentages may be 90% capital member and 10% operating member, 95% capital member and 5% operating member, or 50% each. The more capital an operating member contributes to the joint venture, the more an operating member may be able to negotiate control and/or protective rights with the capital member. See Management of Limited Liability Companies for further detail on control rights and their correlation to capital contributions.

Certain Fees

Often, the operating member of the joint venture will be entitled to certain fees based on their sourcing, management, and services relating to the real estate asset that is owned by the joint venture. The joint venture agreement (or an ancillary agreement such as a property management agreement) should therefore clearly set forth: (1) the type of fees that will be paid and to whom they should be paid, (2) the amount of such fees, and (3) the timing of payment. The list below sets forth examples of common fees and amounts paid to the operating member (or an affiliate thereof). See Section 7.5 of the Limited Liability Company Operating Agreement for a sample provision describing the fees to be paid.

- **Acquisition fee.** It is common for an acquisition fee to be paid to the operating member. An acquisition fee is a fee that is paid in recognition of the operating member's sourcing of the transaction and typically paid upon closing the purchase of the real estate asset. Often, such fee is 1% of the purchase price of the real estate asset or the total capitalization (i.e. the purchase price and any additional or initial additional capital and/or debt in connection with the acquisition of the asset payable upon the acquisition of the real estate asset).
- **Financing fee.** A financing fee, which may be approximately 1% of any mortgage and/or mezzanine debt sourced by the operating member or capital member, as applicable, may

Waterfall Distributions

The most important economic and business provisions of a joint venture agreement are the waterfall provisions. These provisions set forth (1) which party receives what portion of any net operating proceeds and/or capital proceeds from the asset and (2) the relative priority of distribution of such proceeds. See Section 6.2 of the Limited Liability Company Operating Agreement and Distributions Clause (Joint Venture Agreement) for a sample waterfall provision.

Often, the waterfall distribution is structured such that the capital member will receive a return of its capital invested first, prior to the return of any capital invested by the operating member. The capital member may then also receive a return on its capital invested (often calculated on an internal rate of return basis). However, the economic agreement may instead call for distributions to go to both parties based on the parties' respective percentage of membership interests until both parties receive the return of and/or on their invested capital. Thereafter, further proceeds are often distributed on a promote basis (see Preferred Return, Hurdle, and Promote below).

Other important issues to address when drafting waterfall provisions are:

- Clarify that waterfall distributions are made only after any member loans are repaid with applicable interest.
- Clarify that waterfall distributions are to be adjusted to any change in the percentage membership interests resulting from dilution.

be paid to such sourcing member. This fee is typically paid at the time the loan closes and is in consideration for the sourcing member's arrangement and procurement of the financing transaction. It should be noted that it is much less common for a capital member to agree to such a fee being paid to the operating member than in prior market cycles.

- **Asset management fee.** An asset management fee is a fee paid to the operating member for managing the investment and coordinating the day-to-day operation of the asset; preparing budgets, business plans, and recommendations; complying with mortgage loan documents; and for accounting and tax reporting and other functions. Such fee is often 1% per annum of the initial total equity invested.
- **Property management fee.** The operating member may have an affiliated property manager that manages the real estate asset. In connection with this management, the joint venture pays a market property management fee to such affiliate (that would otherwise be payable to a third-party property manager.) This fee is often 3%–4% per annum of the gross revenue received from the real estate asset.
- **Leasing fee.** The operating member may have an affiliated leasing manager that procures tenants for the real estate asset. The joint venture pays a leasing commission (at market rates) to such affiliate that would otherwise be payable to a third party (or the full commission is split in a market co-broke arrangement between the operating member's affiliate and a third-party broker).
- **Development fee.** The operating member may perform development and/or construction management services, and in connection therewith, the joint venture pays a market rate development fee. Such fee is often 3%–4% of the actual hard costs of construction.
- **Disposition fee.** The joint venture agreement may call for a disposition fee to be paid. This type of fee is payable when the real estate asset is sold and is often 1% of the sales price.

Preferred Return, Hurdle, and Promote

As part of the waterfall provisions, the amount of proceeds distributed to one party (usually the capital member) before and in priority to the other member (usually the operating member) is often referred to as the preference or pref. The aggregate amount of such pref is often based on a stated internal rate of return (IRR) percentage amount. For example, a pref is paid to the capital member until the capital member receives the return of its capital and a return thereon such that the capital member has received a 7% IRR thereon. In that example the 7% IRR is often referred to as the hurdle. Once the hurdle is met, the operating member may catch up on any unreturned portion of its capital as well as an agreed IRR thereon, and/or the operating member is often entitled to receive an increase in the percentage of the distributions it gets above the operating actual percentage interest in the joint venture. This increase is often referred to as the promote.

Management

Prior to selecting a management structure, the jurisdiction of formation of the company must be determined for purposes of confirming that the management structure selected is appropriate under the relevant state statute governing limited liability companies. See Selection of Jurisdiction of Formation for a Limited Liability Company for further discussion of jurisdiction selection. As discussed in Selection of Jurisdiction of Formation for a Limited Liability Company, limited liability companies are frequently formed in Delaware because of Delaware's business-friendly statutory scheme, which allows for great flexibility and provides a large base of precedent governing company matters. State law should also be consulted to see if there are any restrictions and/or requirements concerning fees, fiduciary duties, and non-compete obligations that are commonly imposed upon managers unless expressly waived (to the extent possible) in operating agreements.

Once it has been confirmed that the jurisdiction of formation does not restrict how the limited liability company can be managed, then the following management structures should be considered as to which will best achieve the goals of the members:

- Manager/member managed with one manager in control
- Manager/member managed with joint control
- Manager/member managed with one member in control subject to certain major decision rights
- Board of managers

The type of management structure is usually determined by the extent of the members' capital contribution to the company. For further discussion of the advantages and disadvantages of each management structure as well as additional details regarding selecting a management structure, See Management of Limited Liability Companies.

Major Decision Approval

The management structure of the joint venture will often provide for certain decisions to be made by the joint venture that require either the approval of the capital member or the joint approval of both members. As such, the joint venture agreement must clearly indicate: (1) which decisions are major decisions and (2) that with respect to such decisions, no act will be taken without the express approval of the capital member or both members, as applicable. Typical examples of joint venture major decisions are:

- Sale of the real estate asset
- Refinancing of the real estate asset
- Material capital expenditures
- Acquiring new real assets
- Filing for bankruptcy protection

The list above is not exhaustive but rather should serve as a starting point. See Article VIII of the Limited Liability Company Operating Agreement for a sample provision regarding major decisions (which includes an expansive list of major decision types).

The significance of deeming a decision a major decision is that it requires the consent of someone other than the party managing the joint venture. There is a potential that parties could fail to come to an agreement on a major decision, which is commonly referred to as a deadlock. Thus, it is important to carefully draft procedures for resolving potential disputes. See the section below entitled Major Decision Deadlock Resolution Mechanisms for further discussion of deadlock resolution options and provisions.

The deadlock resolution mechanisms often involve one party exiting the joint venture so that the joint venture can proceed to operate under the control of the remaining party. The parties to the joint venture have taken great care to come together to create a venture and likely contributed a great deal of time and assets to the joint venture. It is important to carve out from triggering the deadlock resolution mechanisms certain more minor disagreements that may arise during the life of the joint venture so that it is possible for the joint venture to continue to operate with its initial members. An example of a type of major decision that may not warrant a full deadlock resolution process (as described below) is the failure to agree on a new operating budget for a given year, which instead could be resolved by using the prior years' approved budget plus increases based on the consumer price index (CPI) and/or increases to fund actual growth in non-discretionary expenses (e.g., real estate taxes and insurance).

Certain important issues to address in drafting the Major Decision provisions include:

- What negative control the non-managing member should have (i.e., what decisions cannot be made by the manager unless approved by the non-managing member). The amount of negative control by the non-managing member often correlates directly to the relative percentage of capital each member contributes.
- What would be unreasonable for the capital member to decide without the consent of the operating member or without the operating member having certain of the major decision deadlock resolution mechanisms described hereafter (e.g., if the capital member can sell the asset at a substantial loss in a down market, the operating member can lose its opportunity for its fees and the promote that may materialize if the asset was not sold until market conditions improve).

Major Decision Deadlock Resolution Mechanisms

The joint venture agreement typically sets forth several resolution mechanisms should the parties be unable to agree on a major decision that requires the approval of both members. Below is a summary of typical resolutions. A resolution mechanism is important so that the real estate asset or project is not stuck in limbo based on a failure of the parties to agree on a particular action indefinitely. Certain important issues to consider in drafting the provisions described below include: (1) what "lock-out" periods are appropriate for the transaction (e.g., what minimum period of time, if any, should elapse prior to any of the below being triggered); and (2) the inclusion of detailed closing mechanics such as (a) time period to elect, (b) posting of any at risk deposits, (c) providing for representations and warranties from the transferring party, (d) requirement to convey good title to the interests free and clear of all liens and encumbrances, and (e) closing date.

- **Buy/sell.** One or both parties may have a right to trigger a process whereby one party will buy the other out of their interest in the joint venture. The party triggering the buy/sell is typically required to send an offer that simultaneously acts as an offer to either buy the other member's interest in the joint venture or, alternatively, sell the triggering member's interest in the joint venture, in each case, for the consideration set forth in such offer. The party receiving the buy/sell offer then has the option to either (1) sell its interest to the triggering partner; or (2) buy the triggering member's interest, in each case, for the consideration set forth in the offer. See Article XIV of the Limited Liability Company Operating Agreement for a detailed Buy/Sell provision. See also Buy/Sell Clause (Joint Venture Agreement) for additional drafting notes and considerations.
- **Right of first offer.** One or both parties may have a right to trigger a process whereby one party has a right to first make an offer to buy either the real estate asset or the other party's interest in the joint venture. The other party may then seek a third-party buyer. If a third-party offers an equal or lesser price than the other partner's offer, the asset or interest must be sold to the partner that made the offer at that partner's prior offer price. See Section 11.3 of the Limited Liability Company Operating Agreement for a detailed Right of First Offer provision.

- **Right of first refusal.** One or both parties may have a right to trigger a process whereby one party has a right to subsequently match any third-party offer to buy either the real estate asset or the other party's interest in the joint venture. See Section 11.5 of the Limited Liability Company Operating Agreement for a detailed Right of First Refusal provision.
- **Drag-along rights.** One member may have the right to "drag" the other member into a sale of the interests in the joint venture such that the other member would also be required to sell its interest in the joint venture on the same terms that the triggering member is selling its interests. The drag-along right is a mechanism to allow the member who can trigger same to be able to cause a transfer of all of the interests (i.e. including the interest of the other members who is thus being "dragged") in the joint venture (and thus cause the monetization of the investment) without the consent of the "dragged" partner. See Section 11.6 of the Limited Liability Company Operating Agreement for a detailed Right of First Offer provision.
- **Tag-along rights.** One member may have the right to "tag" the other member so as to be able to elect to participate in a sale of the interests in the joint venture such that the tagging member would also have the right to sell its interest in the joint venture on the same terms that the triggering member is selling its interests. As the inverse to a "drag," the "tag" allows the member with the right to "tag" to get the benefit of the sale of interests in the asset at the price that the other member was able to obtain and to protect itself from having a new partner with whom it does not want to continue the transaction. See Section 11.9 of the Limited Liability Company Operating Agreement for a detailed Tag Along provision.
- **Put right.** One member may have a "put" right. A put right allows the member exercising the put to require the other member to buy the putting member's interest in the joint venture. The consideration for buying the putting member's interest is typically agreed to initially and, for example, may be based on fair market value as determined by a third-party appraisal. See Section 11.8 of the Limited Liability Company Operating Agreement for a detailed Put Right provision.
- **Call right.** One member may have a "call" right to require the other member to sell its interest in the joint venture to the calling member for consideration as agreed to initially (e.g., perhaps based on fair market value based on third-party appraisal). See Section 11.7 of the Limited Liability Company Operating Agreement for a Call provision.
- **Arbitration.** A joint venture agreement may include an arbitration mechanism to resolve certain major decisions for which a full unwind of the joint venture would not be desirable.

Related Content

For a sample joint venture agreement, see

> LIMITED LIABILITY COMPANY OPERATING AGREEMENT

RESEARCH PATH: *Real Estate > Joint Ventures > Joint Venture Agreement > Forms > Joint Venture Agreement*

For a visual depiction of a standard joint venture structure, see

> JOINT VENTURE ORGANIZATIONAL CHART

RESEARCH PATH: *Real Estate > Joint Ventures > Joint Venture Agreement > Practice Notes > Structuring and Planning*

For further detail on control rights and their correlation to capital contributions, see

> MANAGEMENT OF LIMITED LIABILITY COMPANIES

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For further discussion of the advantages and disadvantages of each management structure as well as additional details regarding selecting a management structure, see

> MANAGEMENT OF LIMITED LIABILITY COMPANIES

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For additional drafting notes and considerations, see

> BUY/SELL CLAUSE (JOINT VENTURE AGREEMENT)

RESEARCH PATH: *Real Estate > Joint Ventures > Joint Venture Agreement > Forms > Buy/Sell Provisions*

Transfer Restrictions

It is typical for the joint venture agreement to restrict the operating member from transferring any controlling or other material interest in the joint venture. From the capital member's perspective, this restriction is preferable because the capital member is making an investment with reliance upon a particular operating member's skills and experience. Therefore, the joint venture agreement will typically require the consent of the capital member to any such transfer of a controlling or material interest.

Conversely, a capital member does not often agree to restrict its ability to transfer its interest in the joint venture since the capital member needs greater liquidity (and in any event the capital member does not hold the operating expertise). However, since the operating member may have similar concerns as to who their partner in the joint venture may become, an operating member may have the ability to trigger certain rights similar to those listed in the section entitled Major Decision Deadlock Resolution Mechanisms so that the operating member has a right to buy out the capital member as an alternative to having to accept a new capital member.

Often, parties that are capital members are capital members in many different transactions through a variety of entities and have a large and complex corporate structure. Capital members often require the flexibility to move investments to different entities depending on their needs at the time. Even if a capital member were to agree to certain transfer restrictions restricting its ability to transfer its interest in the joint venture to a third party, a capital member will usually require the right to transfer its interest to any subsidiary or any other entity owned, controlled, or managed by the initial capital member and/or its principals. This provides the capital member some flexibility to manage its business while still providing the operating member comfort that its partner in the joint venture will continue to consist of an entity under the same umbrella of ownership, control, and/or management as its current partner.

Defaults and Remedies

As a basic matter, a defaulting party would be liable to the other party for actual damages. However, that may not prove to be a particularly effective remedy as the other party is often a single purpose entity without other assets other than its interest in the joint venture, which may or may not have value at any given time. Thus, other typical remedies may include:

- Removal of operating member from management and major decision approval rights if the operating member is in material default or fails to meet certain agreed performance standards and/or return projections. As a result, the capital member may then control the joint venture's day-to-day management and the major decisions, and the operating member may no longer have the major decision deadlock resolution options as described above.
- An offset of any losses against distributions that would otherwise have been paid to the defaulting party.
- Dilution of the defaulting party's interest in the joint venture. (See dilution discussion above.)
- Termination of the right of the operating member to asset management, property management, and/or disposition fees and/or the loss of future payment of any "promote" that would otherwise be payable to the defaulting party.

Defaults of a Joint Venture under a Loan Agreement

If it is anticipated that the joint venture will obtain third-party financing, it is likely that one or more members (or principals thereof) will need to execute one or more of a payment, completion, performance, and/or non-recourse carve-out guaranty and an environmental indemnity in connection therewith. It is common for the parties to the joint venture to enter into an indemnity agreement allocating the share of any potential liability with respect to any losses incurred under any such guaranty or indemnity. Further, if one party exits the joint venture pursuant to one of the major decision deadlock resolution mechanisms or otherwise, such party should seek to be released under any guaranty for any liability occurring after the date they have exited the venture. If a lender will not agree to that point, the parties can also allocate liability pursuant to an indemnity agreement.

Conclusion

Parties to a joint venture agreement should take great care at the beginning of the business transaction to carefully lay out and draft an operating agreement that clearly reflects the parties' obligations and rights with respect to the joint venture. Particular time and attention should be paid to the following sections: (1) percentage interests, (2) capital contributions (including remedies related to failure to fund the same), (3) distributions, (4) tax, (5) fees, (6) management and control, (7) transfer restrictions, (8) deadlock and exit mechanisms, and (9) remedies. L

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Rule of Law: Introducing the Rule of Law Impact Tracker

TO FURTHER THE GOAL OF ADVANCING the rule of law around the world, LexisNexis Legal & Professional has launched a first-of-its-kind interactive rule of law awareness tool, the LexisNexis Rule of Law Impact Tracker.

According to the United Nations, approximately four billion people live outside the protection of the rule of law. There is growing recognition by lawyers, businesspeople, governments, academics, NGOs, and citizens that the rule of law is a cornerstone for sustainable global development. The Rule of Law Impact Tracker is a unique way for users to see, in numbers, the impact that the advancement of the rule of law has on such development.

"The rule of law provides the foundation for how we live, the freedoms we have, and the degree of security that we enjoy. International companies also know that a strong rule of law is crucial for doing business. Our analysis quantifies the transformational impact [that the] rule of law has on sustainable social and economic development, as well as what's possible if we work together to effect change," said Mike Walsh, CEO of LexisNexis Legal & Professional.

The Rule of Law Impact Tracker brings together the best available data from the World Justice Project, the World Bank, and Transparency International to allow users to explore why the rule of law is vitally important to sustainable global development and to visualize what is truly possible if the rule of law grows around the world.

The World Justice Project Rule of Law Index is the most respected and comprehensive analysis of how well countries perform in the rule of law. Countries are scored against 44 rule-of-law indicators across eight categories, based on interviews with 100,000 households and 2,400 experts around the globe. The categories are:

- Government powers
- Absence of corruption
- Open government
- Fundamental rights
- Order and security
- Regulatory enforcement
- Civil justice
- Criminal justice

One hundred two countries have been indexed with a score of between zero and one, with one representing the strongest rule of law. The scores differ greatly from country to country. Venezuela ranks the lowest for rule of law with a score of 32%, and Denmark leads the way at the most advanced end of the scale, scoring 87%. The United States scores 73% and ranks 19th, below Japan, Germany, the United Kingdom, and Australia.

A country's rule of law score on the World Justice Project's Rule of Law Index closely correlates to five important indicators of economic and social development: GDP per capita, child mortality, homicide rates, corruption, and life expectancy. The Rule of Law Impact Tracker enables users to calculate the effects that improvements in the rule of law mean score would have on each of these indicators.

Based upon the statistical correlations among the World Justice Project Rule of Law Index and these five measures of economic and societal health, a 10% increase in the rule of law mean score during the next decade would result in:

- GDP per capita going up by about $7,000 per person
- Child mortality rates declining from 24 to 16 deaths per 1,000 live births
- Crime going down by more than 30%
- Average life expectancy increasing by more than two years

The Rule of Law Impact Tracker is a part of the effort of LexisNexis Legal & Professional in support of the Business for the Rule of Law (B4ROL) initiative, which was launched by the United Nations Global Compact last year. The B4ROL Framework offers a guide for businesses around the world in taking proactive, voluntary actions to support the rule of law in their everyday operations and relationships as a complement to respecting the rule of law.

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