

The

LEXIS PRACTICE ADVISOR Journal™

Practical guidance backed by experts from Lexis Practice Advisor®

**TAX LAWS
EVOLVING TO
ENCOMPASS THE
NEW SHARING
ECONOMY**

**Due Diligence in Life
Sciences M&A Deals**



LexisNexis®

Winter 2015/16



LexisNexis®

Lexis Advance®

VAST & UNMATCHED EXCLUSIVE CONTENT & DEEPER ARCHIVES GIVE YOU A PANORAMIC VIEW SO YOU DON'T MISS A THING

Start your free trial today

LEXISNEXIS.COM/ADVANCE

45B+

PUBLIC
RECORDS

63%

MORE VERDICTS
& SETTLEMENTS

2.5M

FEDERAL AGENCY
DOCUMENTS

29

STEP EDITORIAL
PROCESS

PRACTICE NEWS

- 4** A BRIEFING ON EMERGING ISSUES
IMPACTING TRANSACTIONAL PRACTICE
*Business & Commercial, Banking & Finance, Labor &
Employment, Securities & Capital Markets, Real Estate*

PRACTICE NOTES

- 10** UNDERSTANDING THE NLRB'S
POSITIONS ON REGULATING
EMPLOYEES' SOCIAL MEDIA USAGE
Labor & Employment

- 18** CONFIDENTIALITY, NONDISCLOSURE
& SECRECY AGREEMENTS
IP & Technology

PRACTICE TRENDS

- 24** CHALLENGES OF TAXING
THE SHARING ECONOMY
Tax

- 28** CARSHARING GETS EASY
REGULATORY RIDE
Business & Commercial

PRACTICE PROFILE

- 31** A VIEW OF ASSET-BASED LENDING
WITH DAVID W. MORSE, BANKING
& FINANCE CHAIR, OTTERBOURG PC
Banking & Finance

PRACTICE PROJECTIONS

- 35** DUE DILIGENCE IN LIFE SCIENCES
MERGERS & ACQUISITIONS
Mergers & Acquisitions

- 46** "REGULATION A-PLUS" LIMITED PUBLIC
OFFERINGS UNDER SECURITIES ACT
SECTION 3(B)(2)
Securities & Capital Markets

- 52** FDA RELEASES FIRST TWO RULES UNDER
THE FOOD SAFETY MODERNIZATION ACT
Business & Commercial

PRACTICE POINTERS

- 56** DRAFTING AND NEGOTIATING EFFECTIVE
CLOUD COMPUTING AGREEMENTS
IP & Technology

- 66** DRAFTING ADVICE:
DEVELOPING SOCIAL MEDIA POLICIES
Labor & Employment

JURISDICTIONAL PRACTICE

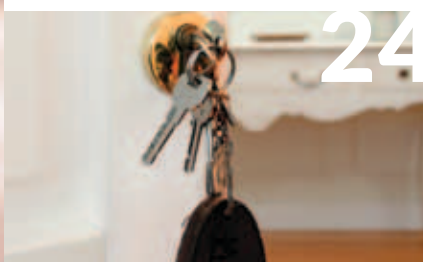
- 69** MANAGERS, AGENTS & ATTORNEYS
California Business & Commercial

GLOBAL PRACTICE

- 75** HONG KONG'S ROLE IN CHINA'S FINANCIAL
REFORM - THE ERA OF THE "NEW NORMAL"
Banking & Finance

ON BOARD

- 79** PROFILES OF LEXIS PRACTICE ADVISOR
JOURNAL™ ADVISORY BOARD MEMBERS
LINDA L. CURTIS & IRA HERMAN



The **LEXIS PRACTICE ADVISOR** Journal™

WINTER 2015-2016 (Volume 1, Issue 1)

EDITOR-IN-CHIEF

Eric Bourget

DIRECTOR OF MARKETING **Jae W. Lee**

MANAGING EDITOR **Lori Sieron**

PUBLISHING DIRECTOR **Ann McDonagh**

LEXIS PRACTICE ADVISOR SALES **Tom Everhart**

LEXIS PRACTICE ADVISOR **Scott Gabrielle**

PRODUCT MANAGEMENT

GROUP DIRECTORS **Eric Bourget**
Lindsay Bringardner
Richard Sobelsohn

DESIGNER **Jennifer Shadbolt**

CONTRIBUTING EDITORS

Banking & Finance **Robyn Schneider**

Oil & Gas, Jurisdiction **Cameron Kinvig**

Tax **Jessica Kerner**

Corporate Counsel **Anna Haliotis**

Mergers & Acquisitions **Dana Hamada**

Securities **Sharon Tishco**

Labor & Employment **Elias Kahn**

Intellectual Property & Technology **Jessica McKinney**

Real Estate **Lesley Vars**

Financial Restructuring & Bankruptcy **Cody Tray**

Business & Commercial **Lori Sieron**

ASSOCIATE EDITORS **Mary McMahon**
Erin Webreck

PRINTED BY **Cenveo Publisher Services**
3575 Hempland Road
Lancaster, PA 17601



EDITORIAL ADVISORY BOARD

Distinguished Editorial Advisory Board Members for The Lexis Practice Advisor Journal are expert practitioners with extensive background in the transactional practice areas included in Lexis Practice Advisor®. Many are attorney authors who regularly provide their expertise to Lexis Practice Advisor online and have agreed to offer insight and guidance for our new publication, The Lexis Practice Advisor Journal. Their collective knowledge comes together to keep you informed of current legal developments and ahead of the game when facing emerging issues impacting transactional practice.

Andrew Bettwy, Partner

Proskauer Rose LLP
Finance, Corporate

Glen Lim, Partner

Proskauer Rose LLP
Finance, Corporate

Julie M. Capell, Partner

Winston & Strawn LLP
Labor & Employment

Joseph M. Marger, Partner

Reed Smith LLP
Real Estate

Candice Choh, Partner

Gibson Dunn & Crutcher LLP
Corporate Transactions,
Mergers & Acquisitions

Timothy Murray, Partner

Murray, Hogue & Lannis
Business Transactions

S. H. Spencer Compton, VP, Special Counsel

First American Title Insurance Co.
Real Estate

Michael R. Overly, Partner

Foley & Lardner
Intellectual Property, Technology

Linda L. Curtis, Partner

Gibson, Dunn & Crutcher LLP
Global Finance

Leah S. Robinson, Partner

Sutherland Asbill & Brennan LLP
State and Local Tax

Tyler B. Dempsey, Partner

Troutman Sanders LLP
Mergers & Acquisitions, Joint
Ventures

Scott L. Semer, Partner

Torys LLP
Tax, Mergers and Acquisitions

James G. Gatto, Partner

Sheppard, Mullin, Richter &
Hampton LLP
Intellectual Property, Technology

Claudia K. Simon, Partner

Paul Hastings LLP
Corporate, Mergers & Acquisitions

Ira Herman, Partner

Thompson & Knight LLP
Insolvency and Commercial Litigation

Lawrence Weinstein, Corporate Counsel

The Children's Place Inc.

Ethan Horwitz, Partner

Carlton Fields Jordan Burt
Intellectual Property

Kristin C. Wigness, First V.P. & Associate General Counsel

Israel Discount Bank of New York
Lending, Debt Restructuring,
Insolvency

Patrick J. Yingling, Partner

King & Spalding
Global Finance

The Lexis Practice Advisor Journal (Pub No. 02380; ISBN: 978-1-63284-895-6) is a complimentary publication published quarterly for Lexis Practice Advisor® subscribers by LexisNexis, 230 Park Avenue, 7th Floor, New York, NY 10169. Email: lexispracticeadvisorjournal@lexisnexis.com | Website: www.lexisnexis.com/lexispracticeadvisorjournal

This publication may not be copied, photocopied, reproduced, translated, or reduced to any electronic medium or machine readable form, in whole or in part, without prior written consent of LexisNexis. Reproduction in any form by anyone of the material contained herein without the permission of LexisNexis is prohibited. Permission requests should be sent to: permissions@lexisnexis.com.

All information provided in this document is general in nature and is provided for educational purposes only. It may not reflect all recent legal developments and may not apply to the specific facts and circumstances of individual cases. It should not be construed as legal advice. For legal advice applicable to the facts of your particular situation, you should obtain the services of a qualified attorney licensed to practice in your state.

The publisher, its editors and contributors accept no responsibility or liability for any claims, losses or damages that might result from use of information contained in this publication. The views expressed in this publication by any contributor are not necessarily those of the publisher.

Send address changes to: The Lexis Practice Advisor Journal, 230 Park Avenue, 7th Floor, New York, NY 10169. Periodical Postage Paid at New York, New York, and additional mailing offices.

LexisNexis, the Knowledge Burst logo and Lexis Practice Advisor are registered trademarks and Lexis Practice Advisor Journal is a trademark of Reed Elsevier Properties Inc., used under license. Other products and services may be trademarks or registered trademarks of their respective companies.

Copyright 2015 LexisNexis. All rights reserved. No copyright is claimed as to any part of the original work prepared by a government officer or employee as part of that person's official duties.



Eric Bourget, Editor-in-Chief

TODAY'S LAWYER WORKS WITHIN A global legal framework, with a 24/7 direct line to clients via smartphone, increasing pressure to focus on the bottom line while supporting the client's top line. All now defined within the term "practicing law." In performing at exceedingly high levels at a breakneck pace, attorneys can no longer wait until legislation is enacted or case law is decided. Attorneys need to know of trends impacting their practice areas in order to keep up with the curve, set the path, and direct and execute the legal strategy of their client, all while in flight, and sifting through countless websites, blogs, and data, and traditional and non-traditional legal publishing services.

But it's not as bad as it seems. The legal industry has responded to this by continual innovation. Generally speaking, innovation is driven by a desire to address an unmet need. When an unmet need is addressed by a technological solution, the result produced is one that generates material efficiency gains. Furthermore, depending on the nature of the unmet need and the nature of the solution provided, technological solutions and innovations often result in material increases in the utility and amount of data analytics available to practitioners. In other words, client services can be delivered more efficiently, and oftentimes, deliverables benefit from the analysis and consideration of a greater number of data points which means decisions are more "informed." This in

turn makes life easier for attorneys to adapt to this ever-evolving market by enabling them not only to work faster but smarter.

Yet despite all of this innovation occurring in the legal industry, there has been a recent resurgence in legal magazines and journals. With fewer and fewer full-size, deep treatises published by leading legal minds, attorneys return to print and online journals to provide them with expert practice insights, trends, and forward-thinking articles to help them stay ahead of the curve. The Lexis Practice Advisor Journal was launched with exactly this in mind. It is our goal to keep you and your firm informed and prepared by providing you with emerging thoughts important to legal practice today. Lexis Practice Advisor provides continuously updated guidance written and edited by practicing attorneys. Our new addition, The Lexis Practice Advisor Journal, is a supplement to our complete Lexis Practice Advisor offering and one more way to help you and your firm stay up-to-date and prepared to tackle emerging developments impacting the transactional practice of law.

Welcome to the premiere edition of The Lexis Practice Advisor Journal.

Our mission

The Lexis Practice Advisor Journal™ is designed to help transactional attorneys start on point and finish big. This quarterly supplement to our online practical guidance resource, Lexis Practice Advisor®, brings you a sophisticated collection of practice insights, trends, and forward-thinking articles. Grounded in the real-world experience of our 300+ seasoned attorney authors, The Lexis Practice Advisor Journal offers fresh, contemporary perspectives and compelling insights on matters impacting your transactional practice.



ENERGY DEPARTMENT UNVEILS ROADMAP SEEKING TO DOUBLE U.S. ENERGY PRODUCTIVITY BY 2030

THE U.S. DEPARTMENT OF ENERGY HAS UNVEILED A strategic plan laying out a path businesses, state and local governments, consumers, and other stakeholders can use to double U.S. energy productivity by 2030.

The strategies and actions identified in the report, *Accelerate Energy Productivity 2030: A Strategic Roadmap for American Energy Innovation, Economic Growth, and Competitiveness*, included:

- States securing energy productivity through setting and updating vehicle and product codes and standards, and providing energy performance information to consumers;
- Utilities and regulators designing rates and related policies that more effectively align energy efficiency with utility business models; and
- Businesses reinvesting avoided energy costs.

“Cutting energy waste and doubling energy productivity will help American families save money on their energy bills, enable businesses to produce more while using less energy, and strengthen the U.S. clean energy economy,” Energy Secretary Ernest Moniz said in a statement. “This roadmap provides a path for families, businesses, and governments, among others, to follow. By taking steps to increase efficiency and cut waste, the U.S. will be more competitive globally and will see direct and long-lasting benefits for decades to come.”

The Roadmap focuses on scalable actions that, the Energy Department believes, have the potential to reduce energy consumption and support economic growth.

- *Pratt's Energy Law Report*, Volume 15, Issue 10*

FEDERAL TRADE COMMISSION STRESSES COMMITMENT TO PURSUING COMPANIES THAT FAIL TO PROTECT CONSUMER DATA

FEDERAL TRADE COMMISSION (FTC) Chairwoman Edith Ramirez issued a statement highlighting a ruling by the U.S. Court of Appeals for the Third Circuit that reaffirmed the FTC's authority to hold companies accountable for failing to safeguard consumer data. “It is not only appropriate, but critical, that the FTC has the ability to take action on behalf of consumers when companies fail to

take reasonable steps to secure sensitive consumer information,” Ramirez said.

On June 26, 2012, the FTC filed suit against Wyndham Worldwide Corporation and three of its subsidiaries for alleged data security failures. The FTC alleged that the failures led to fraudulent charges on consumers' accounts, millions of dollars in fraud loss, and the export of hundreds of thousands of consumers' payment

card account information to an Internet domain address registered in Russia. The agency charged that the security practices were unfair and deceptive and violated the FTC Act.

- *Pratt's Bank Law & Regulatory Report*, Volume 49, No. 9*



WILL INDEPENDENT CONTRACTOR STATUS SURVIVE NEW DOL GUIDANCE?

THE DEPARTMENT OF LABOR (DOL), through its Wage and Hour Division, issued an Administrator's Interpretation (AI 2015-1) focusing on the always complex issue of independent contractor versus employee classification under the Fair Labor Standards Act (FLSA). It makes clear the DOL has little tolerance for the concept of independent contractors, stating unequivocally that most workers "are employees under the FLSA's broad definitions." Although an administrative interpretation does not have the same legal impact and effect as agency regulations, this AI will no doubt become the hot topic of FLSA process and litigation.

In recent years, the DOL has focused its efforts on investigating misclassification as a priority item. Addressing this point, Administrator Weil writes that misclassification can deprive individuals of "important workplace protections such as the minimum wage, overtime compensation, unemployment insurance, and workers' compensation[.]" "Misclassification also results in lower tax revenues for government and an uneven playing field for employers who properly classify their workers."

The DOL, observing that the FLSA broadly defines "employ" as "to suffer or permit to work," adopts the court-developed economic realities test as the standard for resolving the independent contractor/employees status issue. The Administrative Interpretation provides guidance on each of the six factors in the economic realities test. Noting that economic dependence is the key, the test "focuses on whether the worker is economically dependent on the employer or in business for him or herself." "A worker who is economically dependent on an employer is suffered or permitted to work by the employer. Thus, applying



the economic realities test in view of the expansive definition of 'employ' under the Act, most workers are employees under the FLSA." AI 2015-1 lists the six factors as follows:

- Is the work an integral part of the employer's business?
- Does the worker's managerial skill affect the worker's opportunity for profit or loss?
- How does the worker's relative investment compare to the employer's investment?
- Does the work performed require special skill and initiative?
- Is the relationship between the worker and the employer permanent or indefinite?
- What is the nature and degree of the employer's control?

AI 2015-1 emphasizes that all factors are to be considered and there is no one factor, including the control factor, that is determinative of whether a worker

is an employee. These factors are not to be mechanically applied, "but with an understanding that the factors are indicators of the broader concept of economic dependence."

While not a new concept in this area of law, AI 2015-1 reminds that a "label" given to a worker is not determinative. "Thus, an agreement between an employer and a worker designating or labeling the worker as an independent contractor is not indicative of the economic realities of the working relationship and is not relevant to the analysis of the worker's status."

AI 2015-1 should be a wake-up call to all businesses currently using workers classified as independent contractors. The time to consult labor counsel is now before one or more of those independent contractors contacts the DOL or plaintiff's counsel. An ounce of prevention is worth a pound of cure.

- *Bender's Labor & Employment Bulletin*,
Volume 15, Issue No. 9*

INTERCEPTION OF NFL COMMISSIONER'S DECISION LEADS TO QUESTIONS REGARDING ENFORCEMENT OF FUTURE NFL DISCIPLINARY DETERMINATIONS



A REQUEST TO EXPEDITE THE APPEAL

of a ruling lifting the four-game suspension of Patriot's Quarterback Tom Brady has been approved and the appeal could now be heard as early as February 2016, around the time of the next Super Bowl. In a case largely watched because of its implications for New England's Super Bowl winning quarterback, a federal court overturned Brady's four-game suspension by the National Football League (NFL) Commissioner. The court did not, however, make any findings about whether or not Brady committed any of the offenses that the Commissioner relied upon in upholding the suspension. Instead, the court focused on perceived procedural deficiencies, "including (A) inadequate notice to Brady of both his potential discipline (four-game suspension) and his alleged misconduct; (B) denial of the opportunity for Brady to examine one of two lead investigators, namely NFL Executive Vice President and

General Counsel Jeff Pash; and (C) denial of equal access to investigative files, including witness interview notes."

The court's inquiry into those areas is somewhat surprising given the deference that courts are required to extend to arbitral awards and the fact that such issues would normally be for the arbitrator to decide. The court may have been influenced by the fact that the arbitrator in this instance was the chief executive officer of the NFL, the entity that conducted the investigation into Brady's alleged infractions and decided that he was sufficiently culpable to justify a four-game suspension. Although courts generally are required to defer to the award of an arbitrator except in rare circumstances, partiality on the part of the arbitrator is one of those circumstances. The NFL Players Association, arguing on behalf of Brady, had asserted that the award could not stand because "Commissioner Goodell was

'evidently partial[.]'" The court elected not to treat that issue in view of its decision to overturn the award on other grounds.

The NFL is appealing the decision in the U.S. Court of Appeals for the Second Circuit, and the issue of the Commissioner's partiality almost certainly will again be raised before that court. Indeed, the case raises a number of issues with which the Second Circuit most likely will have to contend. One of those issues may be whether arbitration under Article 46 of the collective bargaining agreement between the NFL Players Association and the NFL is the type of arbitration contemplated by the body of law dealing with judicial review of arbitral awards. That body of law presumes that the arbitration is conducted before an impartial arbitrator and impartiality necessarily implies an arbiter unrelated to the parties. Does that body of law apply to an award rendered by the CEO of one of the parties? Does the answer to the previous question change where, as in this case, the other party expressly agrees that the CEO may serve in the role of arbiter? If the award rendered in this case is an arbitration award subject to the judicial deferral doctrine, did the district court err by reviewing the merits of the case? May the Second Circuit vacate the Commissioner's award on other grounds (such as the partiality of the Commissioner)? This matter may not be finally resolved until after the Levi's Stadium clock has run on Super Bowl 50.

- *Bender's Labor & Employment Bulletin*,
Volume 15, Issue 10



JUSTICE DEPARTMENT HEIGHTENS SCRUTINY OF COMPANY EXECUTIVES

DESPITE SEVERAL MULTI-BILLION-dollar settlements with banks for their misdeeds in the 2008 financial crisis, the Justice Department has taken a lot of heat for failing to prosecute corporate executives. A new internal DOJ memo—"Individual Accountability for Corporate Wrongdoing"—issued by Deputy Attorney General Sally Quillian Yates may shift more of that heat to financial executives.

"One of the most effective ways to combat corporate misconduct is by seeking accountability from the individuals who perpetrated the wrongdoing," Yates stressed in the memo. "Such accountability is important for several reasons: it deters future illegal activity, it incentivizes changes in corporate behavior, it ensures that the proper parties are held responsible for their actions, and it promotes the public's confidence in our justice system."

"A Tall Order"

She noted that former Attorney General Eric Holder made clear that "as a matter of basic fairness, we cannot allow the flesh-and-blood people responsible for misconduct to walk away, while leaving only the company's employees and shareholders to pay the price."

The public expects and demands this individual accountability, Yates said. "Americans should never believe, even incorrectly, that one's criminal activity will go unpunished simply because it was committed on behalf of a corporation."

She acknowledged, however, that prosecutors face a number of challenges in pursuing financial fraud cases against individuals, especially high-level executives "who are often insulated from the day-to-day activity in which the misconduct occurs."

"The Rules Have Changed"

That's where the new DOJ memo comes into play. The memo takes six specific steps to hold individual corporate wrongdoers accountable. At the top of the list, Yates said, "effective immediately, we have revised our policy guidance to require that if a company wants any credit for cooperation, any credit at all, it must identify all individuals involved in the wrongdoing, regardless of their position, status or seniority in the company and provide all relevant facts about their misconduct. It's all or nothing. No more picking and choosing what gets disclosed. No more partial credit for cooperation that doesn't include information about individuals."

Yates called the change a substantial shift from prior DOJ practice. "The rules have just changed," she added. "Effective today, if a company wants any consideration for its cooperation, it must give up the individuals, no matter where they sit within the company. And we're not going to let corporations plead ignorance."

The memo describes five additional steps:

- Both criminal and civil attorneys should focus on individual wrongdoing from the very beginning of any investigation of corporate misconduct.
- Criminal and civil attorneys handling corporate investigations should be in routine communication with one another.

- Absent extraordinary circumstances, no corporate resolution will provide protection from criminal or civil liability for any individuals.

- Corporate cases should not be resolved without a clear plan to resolve related individual cases before the statute of limitations expires and declinations as to individuals in such cases must be memorialized.

- Civil attorneys should consistently focus on individuals as well as the company and evaluate whether to bring suit against an individual based on considerations beyond that individual's ability to pay.

She acknowledged that the changes may present challenges. "Some corporations may decide, for example, that the benefits of consideration for cooperation with DOJ are not worth the costs of coughing up the high-level executives who perpetrated the misconduct. Less corporate cooperation could mean fewer settlements and potentially smaller overall recoveries by the government. In addition, individuals facing long prison terms or large civil penalties may be more inclined to roll the dice before a jury and consequently, we could see fewer guilty pleas.

"Only time will tell. But if that's what happens, so be it. Our mission here is not to recover the largest amount of money from the greatest number of corporations; our job is to seek accountability from those who break our laws and victimize our citizens. It's the only way to truly deter corporate wrongdoing."

- *Pratt's Bank Law & Regulatory Report*, Volume 49, No. 10*

EXECUTIVE ORDER ESTABLISHES PAID SICK LEAVE FOR FEDERAL CONTRACTORS



PRESIDENT OBAMA SIGNED AN Executive Order requiring that federal contractors grant their employees up to seven paid sick leave days per year. Under the order, federal contracts will contain a clause requiring the contractors and their subcontractors to provide their employees with at least one hour of paid sick leave for every 30 hours worked. A contractor may, however, impose a 56-hour limit on the total number of paid hours that may be earned in a year.

Earned sick leave may be used for absences resulting from: (i) physical or mental illness, injury, or medical condition; (ii) obtaining diagnosis, care, or preventive care from a health care provider; or (iii) caring for a child, a parent, a spouse, or a domestic partner,

who has any of such conditions or needs for diagnosis, care, or preventive care. The leave must also be available for absences due to the care of “any other individual related by blood or affinity whose close association with the employee is the equivalent of a family relationship who has any of the conditions or needs for diagnosis, care, or preventive care described in ... (i) or (ii) ... or is otherwise in need of care[.]” Finally, in many circumstances involving domestic violence, sexual assault, or stalking, the leave may be used for absences needed to obtain additional counseling, to seek relocation, to seek assistance from a victim services organization, to take related legal action (including preparation for or participation in any related civil or criminal legal proceeding), or to assist an individual,

whose close association with the employee is the equivalent of a family relationship, in engaging in any of these activities. Contractors may not retaliate against employees who use the leave.

Leave earned may be carried over from year to year and must be reinstated for separated employees who are rehired within 12 months after separation. Unused leave is not, however, a benefit for which an employee must be compensated upon termination. The leave must be available to employees who give notice at least 7 calendar days in advance where the need for the leave is foreseeable, and in other cases as soon as is practicable. The order specifies that an employer may require limited certification of the need for leave in excess of 3 days.

The Executive Order directs the Secretary of Labor to issue regulations implementing the order by September 30, 2016 and the order is effective for contracts issued or solicited after January 1, 2017.

A policy statement, which has been and will continue to be hotly contested, provides that: access to paid sick leave will improve the health and performance of employees of federal contractors and bring benefits packages at federal contractors in line with model employers, ensuring that they remain competitive employers in the search for dedicated and talented employees. These savings and quality improvements will lead to improved economy and efficiency in Government procurement.

The Executive Order does not analyze the additional cost to the taxpayer of providing the paid leave.

- *Bender's Labor & Employment Bulletin* Volume 15, Issue 10*



AGENCIES FOCUS ON FAIR HOUSING ENFORCEMENT

U.S. ATTORNEY GENERAL LORETTA

Lynch said she is “more determined than ever to vigorously enforce the Fair Housing Act with every tool at [her] disposal—including challenges based on unfair and unacceptable discriminatory effects, particularly now that the Supreme Court has vindicated the [Justice Department’s] position that the Fair Housing Act encompasses disparate impact claims.”

Lynch pointed out that the Justice Department is exploring new ways to conduct its fair housing mission “more efficiently, more effectively and in ways that account for contemporary housing trends.”

She also noted that in just the last three years, the Department of Justice’s (DOJ) Civil Rights Division has filed more than 100 lawsuits, including 69 pattern or practice lawsuits, to combat housing and lending discrimination.

“I am proud to say that, in the past few months alone, we have made unprecedented advances,” Lynch added. “We have drawn on new technology, cutting-edge research and evidence-based strategies to conduct testing electronically—thereby dramatically expanding the reach of the Fair Housing Testing Program at a fraction of the time

and expense. And we are examining new fields and evolving industries that have not previously been subject to scrutiny to locate areas where discrimination is prevalent and to target the places where Americans are being systematically locked out, let down and left behind.”

Officials from DOJ, Housing and Urban Development (HUD), and the Consumer Financial Protection Bureau indicated that their agencies are all working on ongoing redlining investigations.

- *Pratt’s Bank Law & Regulatory Report, Volume 49, No. 10**

SEC ADOPTS RULE FOR PAY RATIO DISCLOSURE

A SHARPLY DIVIDED SECURITIES AND

Exchange Commission adopted a final rule that requires a public company to disclose the ratio of the compensation of its chief executive officer (CEO) to the median compensation of its employees. The new rule, mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act, provides companies with flexibility in calculating this pay ratio, and helps inform shareholders when voting on “say on pay.”

“The Commission adopted a carefully calibrated pay ratio disclosure rule that carries out a statutory mandate,” said SEC Chair Mary Jo White. “The rule provides companies with substantial flexibility in determining the pay ratio, while remaining true to the statutory requirements.” The new rule will provide shareholders with information they

can use to evaluate a CEO’s compensation, and will require disclosure of the pay ratio in registration statements, proxy and information statements, and annual reports that call for executive compensation disclosure.

To identify the median employee, the rule will allow companies to select a methodology based on their own facts and circumstances. A company can use its total employee population or a statistical sampling of that population and/or other reasonable methods. Companies can also apply a cost-of-living adjustment to the compensation measure used to identify the median employee. They also will be permitted to identify their median employee once every three years. Companies will be required to provide disclosure of their pay ratios for their first fiscal year beginning on or after January 1, 2017.

Commissioner Luis A. Aguilar said the Congressional mandate under Dodd-Frank section 953(b) “has proven to be one of the most controversial rules that the Commission has been required to undertake under the Dodd-Frank Act.” He noted that since Congress first required the Commission to promulgate this rule just over five years ago, the Commission has received over 287,000 comment letters, with over 1,500 individual letters and the rest form letters. “The diverse views expressed by these commenters reflect that Congress tasked the Commission with navigating a highly divisive subject—a boon or a bane, depending on one’s perspective,” Aguilar said.

- *Pratt’s Bank Law & Regulatory Report, Volume 49, No. 9**

*Copyright © 2015. Matthew Bender & Company, Inc., a member of the LexisNexis Group. All rights reserved. Materials reproduced from Pratt’s Energy Law Report, Bender’s Labor & Employment Bulletin and Pratt’s Bank Law & Regulatory Report with permission of Matthew Bender & Company, Inc. No part of this document may be copied, photocopied, reproduced, translated or reduced to any electronic medium or machine readable form, in whole or in part, without prior written consent of Matthew Bender & Company, Inc.



Marcia E. Goodman and Lori Zahalka MAYER BROWN LLP

UNDERSTANDING THE NLRB'S POSITIONS ON REGULATING EMPLOYEES' SOCIAL MEDIA USAGE

Section 7 of the National Labor Relations Act (NLRA) confers upon employees the right to engage in concerted activities for the purpose of collective bargaining or other mutual aid or protection. [29 U.S.C. § 157](#). NLRA section 8(a)(1) makes it an unfair labor practice for employers to interfere with, restrain, or coerce employees in the exercise of the rights guaranteed in section 7. [29 U.S.C. § 158\(a\)\(1\)](#). The National Labor Relations Board (NLRB) has vigorously policed both employers' social media policies and their disciplinary actions that relate to employees' social networking.

AN EMPLOYER'S SOCIAL MEDIA POLICY THAT INFRINGES upon employees' section 7 rights, or that could be interpreted by employees as infringing upon them, will be susceptible to charges of unfair labor practices. Likewise, employers that discipline employees for social media activity that constitutes protected concerted activity likely will be found to have violated the NLRA. This article explains the NLRB's decisions in order to enable you to better counsel employers on lawfully regulating and responding to employees' use (or misuse) of social media.

Crafting Social Media Policies that the NLRB Will Uphold

Employers developing social media policies must ensure that the terms of those policies do not violate the NLRA, and should analyze whether any social media activity upon which they wish to base disciplinary decisions falls within the NLRB's definition of protected concerted activity. The NLRB will find social media policies unlawful if it determines the policies interfere with—or might be interpreted by employees as interfering with—employees' rights under the NLRA. To make this determination, the NLRB analyzes the policy to determine if it uses overbroad or ambiguous language that would reasonably tend to chill employees' exercise of their rights to engage in concerted activities. The following sections contain tips on drafting and implementing social media policies to help ensure that they withstand the NLRB's scrutiny.

For a full annotated social media policy, see [Social Media Policy](#). See also [Developing Social Media Policies; Understanding Key Social Media Issues in Employment](#); and [Checklist – Addressing Social Media in an Employee Handbook](#).

The Context for Social Media Restrictions Matters

When drafting and reviewing social media policies, note that the context for any particular restriction will play an important role in whether or not that restriction complies with the NLRA.

EXAMPLE: Restricting Social Media Networking to Ensure Compliance with Securities Regulations

A national drugstore chain had a social media policy that directed employees to confine their social networking to matters unrelated to the company if necessary to ensure compliance with securities

regulations and other laws. It further prohibited employees from using or disclosing confidential and/or proprietary information, including personal health information about customers or patients. The NLRB found these restrictions lawful.

Employees could construe a provision that limits social media activity to topics unrelated to the company as a rule restricting employees from communicating about the terms and conditions of employment. Nevertheless, in this context, the NLRB found that employees would reasonably interpret the drugstore chain's policy provision to address only those communications that could implicate securities regulations. And, considering that the employer sold pharmaceuticals and that the restriction on disclosing confidential information referred in several places to customers, patients, and health information, employees would reasonably understand that this rule intended to protect the privacy interests of the employer's customers and not to restrain section 7 protected rights. [NLRB, Report of the Acting General Counsel Concerning Social Media Cases, 2012 NLRB OM Memo LEXIS 57, at 17 \(Jan. 24, 2012\)](#).

Incorporate Language from Other Employment Policies

Using examples of activity that the employer seeks to restrict will often provide the necessary context for a rule that restricts social networking. You can accomplish this by incorporating language and illustrations from the employer's other policies into the social media policy. Detailing the prohibited conduct will better enable employees to understand that the restriction is not directed at any form of protected activity.

EXAMPLE: Incorporating Non-discrimination or Harassment Policies

A social media policy can include language taken from a company's anti-discrimination or anti-harassment policy. Compare the following two restrictions:

- *Restriction 1.* Employees may not make discriminatory, defamatory, or harassing Internet posts about specific employees, the work environment, or work-related issues on social media sites.
- *Restriction 2.* Employees may not use social media to make posts about coworkers, supervisors, or the employer that are vulgar,

USING EXAMPLES OF ACTIVITY THAT THE EMPLOYER SEEKS TO RESTRICT WILL OFTEN PROVIDE THE NECESSARY CONTEXT FOR A RULE THAT RESTRICTS SOCIAL NETWORKING. YOU CAN ACCOMPLISH THIS BY INCORPORATING LANGUAGE AND ILLUSTRATIONS FROM THE EMPLOYER'S OTHER POLICIES INTO THE SOCIAL MEDIA POLICY. DETAILING THE PROHIBITED CONDUCT WILL BETTER ENABLE EMPLOYEES TO UNDERSTAND THAT THE RESTRICTION IS NOT DIRECTED AT ANY FORM OF PROTECTED ACTIVITY.

obscene, threatening, intimidating, harassing, or a violation of the employer's workplace policies against discrimination, harassment, or hostility, on account of age, race, religion, sex, ethnicity, nationality, disability, or other protected class, status, or characteristic.

Restriction 1 contains broad terms such as "defamatory" that specifically apply to discussions about work-related issues and arguably would also apply to protected criticism of an employer's labor policies or treatment of employees. Restriction 2, on the other hand, would not reasonably be construed to apply to section 7 activity because it appears in the context of a list of plainly egregious conduct. Therefore, the NLRB would likely find it lawful. [NLRB, Report of the Acting General Counsel Concerning Social Media Cases, 2012 NLRB OM Memo LEXIS 57, at 16-17 \(Jan. 24, 2012\)](#). To further dispel possible ambiguities, an employer may wish to name the other policies that its social media policy incorporates.

Do Not Place Burdens on Employees' Ability to Engage in Protected Activity

Employers should avoid any social media rules that place undue burdens on employees or that would tend to chill employees' engagement in protected concerted activity.

EXAMPLE: Invalid Overbroad Online Communications Policy

An employer's online communications policy dictated that employees who identified themselves as associates of the employer and published any work-related information online were required to use the following disclaimer: "The postings on this site are my own and don't necessarily represent the position, strategies, or opinions of [the employer]."

An NLRB administrative law judge (ALJ) observed that the rule could reasonably be read to apply to any communication posted online, which could be quite burdensome. The ALJ further found the disclaimer was manifestly broader than the employer's legitimate interest in preventing employees from speaking or

appearing to speak on its behalf. In this case, the employer had not demonstrated—and the ALJ found that it was "highly counterintuitive, and defie[d] common sense"—that employee discussions about the employer's "work-related information" online, or in the line at the post office, would likely be misunderstood as "a statement of the employer." [The Kroger Co. of Michigan v. Anita Granger, 2014 NLRB LEXIS 279, at *10 \(Apr. 22, 2014\)](#).

Savings Clauses

You should include in a social media policy a clause indicating that the employer will not construe or apply the policy in a manner that interferes with or restricts employees' rights under the NLRA. Such a clause may help inform employees that the policy generally does not apply to protected concerted activities. Note, however, that the NLRB has repeatedly stated that savings clauses alone do not cure an otherwise unlawful policy provision. See, e.g., [McKesson Corp., NLRB Case No. 06-CA-066504](#) (Office of Gen. Counsel Advice Mem. Mar. 1, 2012); [Giant Food LLC, 2012 NLRB LEXIS 896, at 8](#) (Associate General Counsel Division of Advice Mar. 21, 2012). The NLRB has reasoned that a savings clause paired with an unlawful policy provision does not give employees sufficient information to understand that protected activities are actually protected.

Policy Dos and Don'ts

The following sections list types of social media policy clauses that the NLRB will generally find lawful or unlawful.

Rules that the NLRB Will Likely Uphold

The NLRB will likely conclude that the social media provisions listed below do not infringe on employees' section 7 right to use social media to join forces with other employees to advocate for improvements to their working conditions.

These provisions avoid overbroad and ambiguous language through references to other policies and legal requirements and examples to illuminate terms that may otherwise be considered vague. Because

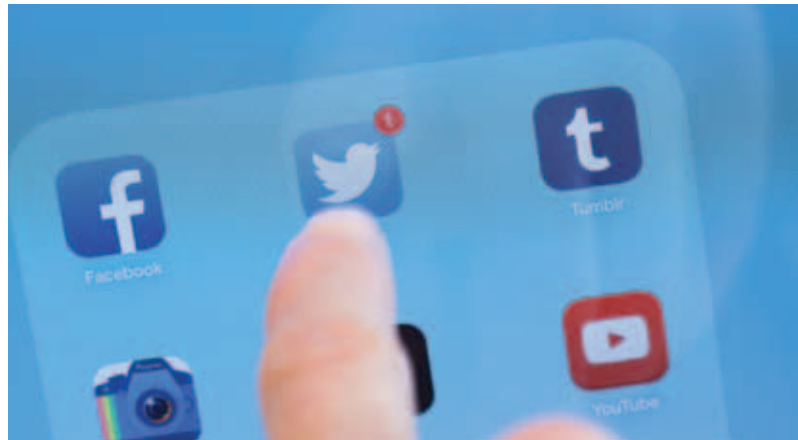
the rules are narrowly drawn, the associated obligations on the employees are reasonable and not overly burdensome.

Thus, the NLRB typically permits social media provisions that

- prohibit inappropriate postings that may include discriminatory remarks, harassment, and threats of violence or similar inappropriate or unlawful conduct;
- prohibit harassment or bullying, explicitly defined as offensive posts meant to intentionally harm someone's reputation or posts that could contribute to a hostile work environment on the basis of race, sex, disability, religion, or any other status protected by law or company policy;
- require employees to be respectful and professional to coworkers, clients, and competitors;
- require employees to maintain the confidentiality of the employer's trade secrets and private and confidential information, including information regarding the development of systems, processes, products, know-how, technology, internal reports, and procedures;
- request employees to respect the laws governing copyright, fair use of copyrighted material owned by others, trademarks, and other intellectual property, including the employer's own copyrights, trademarks, and brands;
- demand that employees not post anything on the Internet in the name of the employer or in a manner that could reasonably be attributed to the employer without prior written authorization from the employer;
- prohibit employees from pressuring their coworkers to connect or communicate with them via social media;
- request employees to confine their social networking to matters unrelated to the company if necessary to ensure compliance with securities regulations and other laws; and
- prohibit disclosure of information protected by the attorney-client privilege.

Rules that the NLRB Will Likely Invalidate

In contrast, the provisions listed in this section are broadly drafted and may conceivably be interpreted to infringe upon protected concerted activities. Although many of these examples appear at first glance to be reasonable, the NLRB scrutinizes policies for overbreadth and ambiguity. Rules that contain any language that may inhibit an employee from freely communicating about workplace issues—including criticizing the employer about terms and conditions of employment and labor policies and airing sensitive information about how the employer treats employees—are likely to be found to violate the NLRA. As discussed further below in the section on when concerted activity loses its protection, the NLRA



protects even false statements so long as they were not made maliciously with knowledge of their falsity.

Accordingly, the NLRB typically finds unlawful social media provisions that

- prohibit depictions of the employer's logo or company uniform;
- prohibit employees from using the company name, address, or other information on their personal social media profiles;
- ban all disparaging comments regarding the workplace, the employer, supervisors, and coworkers;
- restrict employees from revealing—including through the use of photographs—personal information regarding coworkers, company clients, partners, or customers without their consent;
- prohibit conduct that is generally offensive, discourteous, or rude, or require respect in general terms;
- bar untrue statements or statements that might damage the reputation of the employer or its staff;
- prohibit employees from disclosing or communicating any information of a confidential, sensitive, or non-public nature concerning the company to anyone outside the company without prior approval of the employer;
- require that social networking site communications be made in an honest, professional, and appropriate manner, without defamatory or inflammatory comments regarding the employer and its subsidiaries, and their respective shareholders, officers, employees, customers, suppliers, contractors, and patients;
- instruct employees to think carefully about "friending" coworkers;
- prohibit anonymous posts online; and
- prohibit discussion of legal matters.

Lawfully Disciplining Employees for Social Media Activity

An employer analyzing whether it can lawfully discipline an employee for his or her social media activity should consider

(1) whether the employee's activity is concerted and (2) whether it occurred under circumstances that fall within the scope of the NLRA's protection.

Is the Social Media Activity Concerted?

In general, for social media activity to qualify as concerted, the employee must take the action together with—or on the authority of—other employees and not solely by and on behalf of the individual employee. Activity can still rise to the level of concerted where coworkers are not involved if the activity continues a conversation or discussion among coworkers regarding working conditions. Personal griping over social media is usually not considered concerted activity because it is not done together with other employees.

Examples of Concerted Activity

An employer generally may not lawfully discipline employees for discussing with coworkers the terms and conditions of their employment, including compensation, staffing levels, discipline, and other important aspects of the employment relationship. Evidence that the employee(s) brought, or intended to bring these issues to management's attention or took other steps to advance their collective position will increase the likelihood that the NLRB will conclude that the employee(s) engaged in concerted activity. For example:

- In one case, an EMT posted on a former coworker's Facebook page that he should "think about getting a lawyer and taking [the employer] to court" and "contact the labor board too." The EMT made these remarks in response to another employee's post about getting fired for commenting on the condition of the

company's vehicles to a patient. The ALJ held that, viewed in its context, the EMT's posts were protected concerted activity because vehicle condition was a matter of mutual concern. The ALJ rejected the employer's argument that the employee's Facebook posts lost the NLRA's protection because they were accessible to customers or other third parties, noting the NLRB's long-standing position that concerted activity does not lose its protection just because it may have an adverse effect on a company's business. [See Butler Medical Transp. LLC, 2013 NLRB LEXIS 584 \(Sept. 4, 2013\).](#)

- In another case, an employee solicited opinions on Facebook about employee job performance and staffing levels in preparation for a meeting with a supervisor; in response, several coworkers commented about staffing levels and workload. The NLRB deemed the posts to constitute concerted activity because the employees were discussing working conditions with each other and their conversation related to a meeting with the employer about the terms and conditions of employment. See NLRB, Report of the Acting General Counsel Concerning Social Media Cases, Memorandum OM 11-74, at 3-5 (Aug. 18, 2011) (available at <http://apps.nlr.gov/link/document.aspx/09031d458056e743>).
- The NLRB also found that concerted activity occurred when an employee posted pictures and commentary on Facebook of a controversial sales event held by the employer. Employees had previously complained among themselves and to management about the inexpensive food and beverages offered at the event, which they thought would adversely affect sales of the product and their commissions. The NLRB brushed aside the fact that



no co-employees commented on the post and noted that the Facebook post continued the conversation that had occurred at a staff meeting and related to the employees' compensation, which is a term and condition of employment. See NLRB, Report of the Acting General Counsel Concerning Social Media Cases, Memorandum OM 11-74, at 6-9 (Aug. 18, 2011) (available at <http://apps.nlr.gov/link/document.aspx/09031d458056e743>).

- Another example of concerted activity occurred when an employee made negative comments about a supervisor on Facebook. The employee—responding to coworkers' Facebook conversation about drama in the workplace and another coworker's discipline—posted that she hated the employer and couldn't wait to get out of there. She also blamed the operations manager for much of the drama as well as the poor work environment. These statements followed previous workplace conversations and employee complaints to management about the operations manager's negative attitude and supervision. Although the post was phrased in terms of the employee's own dissatisfaction with the operations manager and the employer's operation generally, the NLRB found that the employee's Facebook post amounted to concerted activity. The employee shared these views as part of an ongoing conversation with coworkers about section 7 subjects related to terms and conditions of employment, including the discipline of another employee, inadequate supplies, and work scheduling. See [NLRB, Report of the Acting General Counsel Concerning Social Media Cases, 2012 NLRB OM Memo LEXIS 57, at 22-25 \(Jan. 24, 2012\)](#).

Examples of Non-concerted Activity

By contrast, the NLRB will not consider social media activity to be concerted when it does not involve coworkers but merely reflects personal gripes. Thus, an employer can terminate or discipline an employee for such activity without violating the NLRA. For example:

- A bartender who engaged in a Facebook conversation with a relative, in which he complained about his employer's tipping policy, commented that the employer's customers were "rednecks," and wished that the bar's patrons choked on glass as they drove home drunk, did not engage in concerted activity. No coworkers participated in the conversation and the posts did not continue any conversation with coworkers about the terms and conditions of employment. See [JT Porch Saloon & Eatery, Ltd., 2011 NLRB GCM LEXIS 24 \(Aug. 18, 2011\)](#); see also NLRB, Report of the Acting General Counsel Concerning Social Media Cases, Memorandum OM 11-74, at 14-15 (Aug. 18, 2011) (available at <http://apps.nlr.gov/link/document.aspx/09031d458056e743>).
- The NLRB also found no concerted activity when an employee posted on a public official's Facebook wall regarding paltry public funding for the employer's industry and complained about lack of vehicles and employees' ability to perform the job. The NLRB

noted that no evidence indicated that the employee discussed her concerns with her coworkers or planned to bring the issues to management's attention. See NLRB, Report of the Acting General Counsel Concerning Social Media Cases, Memorandum OM 11-74, at 15-16 (Aug. 18, 2011) (available at <http://apps.nlr.gov/link/document.aspx/09031d458056e743>).

- In another "personal gripe" case, the NLRB found that a retail employee's complaint on Facebook represented a personal gripe about a bad interaction with a manager about mispriced or misplaced items. His coworkers responded with comments of emotional support. The NLRB emphasized that the posting did not suggest that the employee sought to initiate group action with his coworkers. Rather, he merely expressed frustration over the interaction. His coworkers also appeared to interpret the employee's post as a personal gripe; their comments did not reveal any past or future group activity regarding the employees' terms and conditions of employment. See NLRB, Report of the Acting General Counsel Concerning Social Media Cases, Memorandum OM 11-74, at 17-18 (Aug. 18, 2011) (available at <http://apps.nlr.gov/link/document.aspx/09031d458056e743>).

Is the Concerted Social Media Activity Protected?

Once an employer determines that an employee has engaged in concerted activity, it must also determine if the concerted activity is protected under the NLRA. Concerted activity can lose the NLRA's protection if it is (1) maliciously untrue and made with the knowledge of its falsity, or (2) so egregious that it loses protection of the NLRA.


Importantly, the NLRB stringently applies both of these exceptions. With respect to the first exception, the NLRA protects an employee's criticism of an employer even if the criticism is false or defamatory. See Office of the General Counsel, Report of the General Counsel Concerning Employer Rules, Memorandum GC 15-04, at 7 (Mar. 8, 2015) (available at <http://apps.nlr.gov/link/document.aspx/09031d4581b37135>) (citing [Copper River of Boiling Springs, LLC, 2014 NLRB LEXIS 154 \(Feb. 28, 2014\)](#)). With respect to the second exception, the NLRB recognizes that "unionization and other protected concerted activity is often contentious and controversial," and therefore will not look askance at impassioned debates and provocative, discourteous, or offensive statements by employees engaged in concerted activity. See Office of the General Counsel, Report of the General Counsel Concerning Employer Rules, Memorandum GC 15-04, at 10 (Mar. 8, 2015) (available at <http://apps.nlr.gov/link/document.aspx/09031d4581b37135>).

Example of Unprotected Maliciously Untrue Concerted Activity


In [Butler Medical Transport LLC, 2013 NLRB LEXIS 584, at *14 \(Sept. 4, 2013\)](#), also discussed above, a second employee, whom the ALJ concluded was lawfully terminated, posted on Facebook:

“Hey everybody!!!!!! Im f[*****]’ broke down in the same s[***] I was broke in last week because they don’t wanta buy new s[***]!!!! Cha-Chinnngggggg chinnng-at [this] Convenience Store.” After a review of the employee’s maintenance records showed that the vehicle was not broken down when the employee made the posts and he testified at an unemployment insurance hearing that he was referring to his personal vehicle, the ALJ concluded that the posts were maliciously untrue and, therefore, not protected by the labor law.

Example of Unprotected Egregious Concerted Activity

Concerted activity can also be so egregious that it loses its protection under the NLRA. The NLRB applied this principle to Facebook activity in *Richmond Dist. Neighborhood Ctr.*, 2014 NLRB LEXIS 819 (Oct. 28, 2014). In *Richmond*, two employees engaged in a Facebook exchange shortly after the center offered to rehire them for the upcoming school year. In the exchange, the employees claimed that they would take students on “[f]ield trips all the time to wherever the f*** we want” and that the program could just “figure out the money.” *Id.* at *4. A supervisor at the center, who was Facebook friends with one of the employees, alerted the center to the posts. Subsequently, the center rescinded its rehire offers to the two employees. Although finding that the employees had engaged in protected activity, the NLRB nevertheless concluded that the center did not violate the NLRA, reasoning that “the pervasive advocacy of insubordination in the Facebook posts, comprised of numerous detailed descriptions of specific insubordinate acts, constituted conduct objectively so egregious as to lose the Act’s protection and render [the employees] unfit for further service.” *Id.* at *9. The *Richmond* case is the first to show how employees may exceed the protection of the NLRA on Facebook. 

[Marcia E. Goodman](#) is a partner in Mayer Brown’s Litigation & Dispute Resolution practice and serves as co-leader of the firm’s U.S. Employment and ERISA Litigation Action Group. [Lori Zahalka](#) is a partner in Mayer Brown’s Litigation & Dispute Resolution practice and a member of the firm’s U.S. Employment and ERISA Litigation Group.

 **LEXIS PRACTICE ADVISOR RESEARCH PATH:** [Labor & Employment > Privacy, Technology, and Social Media > Navigating Social Media > Practice Notes > Understanding the NLRB’s Positions on Regulating Employees’ Social Media Usage](#)

Lexis Practice Advisor subscribers may view additional Labor & Employment/Social Media in the Workplace content by following this [link](#).



Lexis Practice Advisor® Resource Center

WITH SO MANY FEATURES, WHERE DO YOU START?



Tips, guides, videos, FAQs and contributing author profiles

Make the most of Lexis Practice Advisor® tools and content.

Discover insights, product information, transactional topics, and detailed tutorials all in one place.

Visit the Resource Center to fine-tune your Lexis Practice Advisor experience.

WWW.LEXISNEXIS.COM/PRACTICE-ADVISOR-RESOURCES

Watch for our enhanced Resource Center coming soon!



Rebecca K. Myers VANDENBERG & FELIU, LLP

Confidentiality, Nondisclosure and Secrecy Agreements

CONFIDENTIALITY AGREEMENTS, ALSO REFERRED TO AS nondisclosure agreements (NDAs), or secrecy agreements, are legal agreements between parties specifying information that one or both of the parties consider confidential and prohibiting the other party from disclosing it. The party disclosing the information is commonly referred to as the “Disclosing Party” and the party receiving it is referred to as the “Receiving Party.”

Confidentiality agreements can exist in a variety of contexts, one of the most common being between an employer and its employee. They can also exist in a multitude of other arrangements, as well. For instance, they are commonly entered into with independent contractors, suppliers, and between parties considering a financial or business arrangement, such as with a potential investor or parties to a joint venture.

In the employment context, confidentiality agreements are beneficial to an employer because they allow the free-flow of confidential information within an organization in order to maximize business efforts but at the same time prohibit employees from using or disclosing confidential information, such as client lists, strategic plans, know-how, technologies, marketing strategies, and proprietary relationships outside the scope of their job responsibilities. They work similarly in other contexts as well – allowing information to pass to authorized parties without fear that it will enter the public domain.

Confidentiality agreements will bind the Receiving Party during the term of the agreement itself, and typically for a period thereafter, and prohibit the Receiving Party from using or disclosing confidential information outside of the scope of the relationship. For example, in the employment context, the Receiving Party is the employee and he or she will be bound



to a confidentiality obligation during the term of his or her employment and for a period after the employment ends.

When drafted and used properly, confidentiality agreements are an effective way to protect confidential information. Parties entering into confidentiality agreements should consider including several important clauses outlining their respective obligations (see below).

Mutual or Unilateral Obligations

Depending on the circumstances, a confidentiality agreement may contain mutual or unilateral obligations. Unilateral obligations are appropriate when only one party is disclosing information, such as when a Disclosing Party is sharing confidential information about the development of a new product and the Receiving Party, a potential investor, will only be providing publicly available information, such as interest rates and their experience in the industry. In this case, only one party (the inventor) is disclosing confidential information and only one party (the potential financier) is restricted by the agreement not to disclose confidential information to third parties.

Mutual obligations are appropriate when both parties are disclosing confidential information, such as when a company hires a vendor to develop proprietary software for the business and the parties must share confidential information about their respective software. In this situation, both parties are disclosing confidential information and both parties are restricted from disclosing what they have learned.

Definition of “Confidential Information”

There are three basic approaches to defining the confidential information covered by the agreement: (1) providing a general description; (2) providing a specific description; and (3) expressly marking the confidential information. There are advantages and disadvantages to each approach.

- **General description.** Providing a general description of the confidential information to be disclosed (such as “marketing information, sales strategies, procurement requirements, manufacturing, customer lists, and investors”) can be a good strategy to protect information that may expand with the business arrangement. A general description is broad enough that it will cover later-created confidential information as well as items that were not anticipated at the time the agreement was entered into. The drawback is that a definition with such breadth creates some legal and practical risks. Because it is not specific, it is difficult for a Receiving Party to fully understand its obligations and to apply the confidentiality agreement in day-to-day situations.
- **Specific description.** This is almost the other end of the spectrum. Here, the agreement will specifically identify the confidential information to be exchanged. This type of description is helpful in targeted, shorter-term relationships that are entered into for a particular reason, such as between a company and a software consultant or a company and a consultant on compensation issues. A specific description would not be the best choice in a longer-term relationship where the type of information intended to be protected will expand or change, such as in an employer/employee relationship.
- **Marking.** With this approach, the specific items that are designated as containing confidential information are stamped “Confidential.” The benefit of this approach is that nothing falls through the cracks in terms of the supplied definition. And the Receiving Party will have a tough time arguing that it was not on notice that the information was designated confidential by the Disclosing Party. The drawback to this approach is the administrative burden and practical ability of actually marking the items confidential, especially where items are intangible or bulky in nature.

An “Exclusions Clause” should also be considered. This carves out information that loses its confidential status through acts outside of the Receiving Party’s control. An Exclusions Clause is an important protection for the Receiving Party, as it excludes specific information from the definition of “Confidential Information.” The Exclusions Clause can contain anything the parties agree to, but most commonly it will exclude items that (1) are already known by the Receiving Party, (2) have become part of the public domain, (3) were received from a third party, and/or (4) were independently developed.

IP Ownership

Each party will represent that it retains the exclusive ownership and intellectual property rights in its respective confidential information, and that no license or any other interest in a party’s confidential information is granted or implied by the agreement.

The Disclosing Party may obtain a further layer of protection against third party IP rights, particularly in situations involving research and inventions. Including language that the information disclosed is provided without any express or implied representation or warranty, including without limitation that (i) it does not infringe any third party’s intellectual property rights, (ii) it is accurate or complete, or (iii) it will be suitable for the Receiving Party’s purposes, may help to limit the Disclosing Party’s potential liability.

Consideration

Like any other contract, confidentiality agreements require consideration, which means that the Receiving Party must receive something in exchange for its promise not to disclose the information.

In the employment context, if the confidentiality agreement is signed at the inception of employment, employment alone is usually sufficient consideration. However, if it is signed after employment begins, many states require fresh consideration for the employee’s promise, such as the payment of a bonus, promotion, additional vacation days, or enhanced benefits.

Outside the employment context, consideration will depend on the relationship of the parties. In an independent contractor relationship, the designation of “contractor” and payment for services provided in connection with that relationship, should be sufficient. In the case of a business alliance, such as a joint venture or the exchange of confidential information in connection with the consideration of a new business arrangement, the ability to fully consider the potentially beneficial arrangement is usually enough.

CONFIDENTIALITY AGREEMENTS ARE BENEFICIAL TO AN EMPLOYER BECAUSE THEY ALLOW THE FREE-FLOW OF CONFIDENTIAL INFORMATION WITHIN AN ORGANIZATION IN ORDER TO MAXIMIZE BUSINESS EFFORTS BUT AT THE SAME TIME PROHIBIT EMPLOYEES FROM USING OR DISCLOSING CONFIDENTIAL INFORMATION SUCH AS CLIENT LISTS, STRATEGIC PLANS, KNOW-HOW, TECHNOLOGIES, MARKETING STRATEGIES, AND PROPRIETARY RELATIONSHIPS OUTSIDE THE SCOPE OF THEIR JOB RESPONSIBILITIES.

Term of the Confidentiality Obligation

Confidentiality obligations are not typically intended to terminate when the relationship ends. Rather, most Disclosing Parties desire that the confidentiality obligations last at least as long as the information remains confidential. In reality, this could be as short as a few months or as long as indefinitely. The Receiving Party would prefer that the term is as short as necessary so that the obligations under the agreement are absolved as soon as possible. Because the parties may have very different ideas about how long the obligations will inure, it is always a good practice to expressly set forth the term of the prohibition in the confidentiality agreement.

Receiving Party's Duty to Protect Confidential Information

A confidentiality agreement should contain a clause requiring the Receiving Party to use a certain level of care in handling the confidential information. While some agreements provide that the Receiving Party must take reasonable measures to keep the information confidential, others require specific steps to protect the information, such as to keep it locked in a secure place or, if it exists electronically, to secure it through one or two levels of password-protected security. There could also be restrictions as to who may access the information and for what reason. A Disclosing Party should consider how secret and valuable the information being disclosed is and require efforts from the Receiving Party that would – at a minimum – protect the information to the same degree that the Disclosing Party uses.

Permitted Disclosures

A well-thought-out confidentiality agreement should provide the ability for the parties to disclose the confidential information in specific instances, such as when required by court order or other court proceeding. Depending on the relationship, there may be other circumstances where disclosure is permitted. Where a party is permitted to disclose the confidential information, the agreement should require that the Receiving Party provide notice to the Disclosing Party.

The notice provision should specify that the Disclosing Party shall be given written notice a certain number of days prior to the disclosure so that the Disclosing Party has an opportunity to intervene to protect its rights, if possible or necessary.

Return of Documents

Confidentiality agreements should provide for the return or destruction of confidential information at the conclusion or termination of the relationship. Since so much information exists digitally, in many instances it is more practical for the parties to agree to destroy each other's information and once concluded, send certifications that destruction is complete. With regard to electronic information, parties should consider to what extent destruction need occur. For example, must the Receiving Party destroy back-up tapes, slack space in its computer files? Or is it adequate that an average person would not be able to access the information without the use of computer imaging and advanced forensic tools?

Assignability

The decision to share confidential information with another party is a personal and subjective one. As such, confidentiality agreements typically contain clauses prohibiting either party from assigning the agreement to any other party, whether expressly or by operation of law. For instance, if a company retains a specialized software developer to write new source code to support existing applications, it may not want to give that developer the ability to assign the rights and obligations under the agreement. Sometimes, however, the agreement will permit the Disclosing Party to assign the agreement to a successor without the need (and administrative burden) for the Receiving Party to consent to such assignment.

Non-Solicitation

One, and sometimes even both, parties may be concerned about the other party soliciting its employees, customers, or suppliers. If this is the case, the parties should consider adding a non-solicitation term in the confidentiality agreement restricting the other party from engaging in such solicitation.

Third party contractors in particular often work in a specialized capacity for a company, and have regular contact with employees, customers, and/or vendors. Thus, it is important to hold third party contractors to a non-solicitation agreement prohibiting them from recruiting the company's employees away and/or soliciting business from the company's customers and vendors.

Governing Law

Confidentiality agreements usually contain a choice of law clause specifying that the law of the Disclosing Party's state controls. Without good reasons or unusually strong negotiating leverage, the Receiving Party is not likely to get the Disclosing Party to agree to application of another state's law. However, where both parties are disclosing confidential information, or the Disclosing Party has multiple locations, there may be some choice in the designation of the law. Therefore, parties should review the law of the potential states to fully understand any limitations or benefits each state may confer on the parties' rights and responsibilities.

Choice of law clauses are usually enforceable if the law selected bears some reasonable relationship to the confidentiality agreement, and so long as the public policy of the selected jurisdiction is not contrary to the subject matter of the confidentiality agreement.

Boiler Plate Clauses

As with any contract, the parties may wish to include some boilerplate provisions that are fairly standard and typically included in any contract. Boiler plate provisions can have an impact on the parties' rights under the agreement. Thus, although they are somewhat standard, the effects of their inclusion or exclusion should be carefully considered. Some of the more common provisions are:

Arbitration. Any disputes about the contract must be resolved through arbitration proceedings, not in a lawsuit.

Costs and attorneys' fees. The losing party in a legal proceeding must pay the prevailing party's legal fees.

Counterparts. Each party may sign the agreement separately and all parties do not have to be together at one time to sign.

Entire Agreement. The written contract represents the final agreement of the parties and any prior agreement or discussions of the agreement are replaced by the written contract. It also usually provides that any modification to the contract, in order to be effective and enforceable, must be in writing and signed either by both parties or by the party to be charged with the obligation.

Force majeure (also referred to as "Acts of God"). The agreement will be suspended or terminated in the event of unforeseen

disasters preventing performance (such as earthquakes, hurricanes, floods, fires, etc.).

Headings. The headings used throughout the agreement have no special significance and should not be used to interpret the agreement.

Indemnity. A guarantee by one party to the other that certain costs will be covered if actions or challenges are brought by third parties. These provisions usually have a cap on liability and a procedure for notifying the indemnifying party when its indemnity is triggered.

Jury trial waivers. If there is a court proceeding, the parties may waive their right to a jury trial and agree that a judge will hear and determine the dispute.

Notice. The mechanism by which each party will notify the other, such as when the agreement is terminated or when there is an impending court-ordered disclosure.

Publication. Whether or not the parties can make public the fact that they have a business arrangement, for marketing or other purposes.

Severability. The parties may agree that any provisions determined to be wholly or partially invalid can be struck from the agreement and the remainder of it will remain enforceable.

Venue. The court or arbitration panel has authority to hear a dispute arising from the agreement.



Limitations of Confidentiality Agreements

A confidentiality agreement does not give perfect protection to the owner of a trade secret or other confidential information. It is important to understand the limitations involved in one.

The major limitations are:

The agreement can only be enforced against the parties who are bound by it. It is therefore important to ensure that the person or organization to whom the information is disclosed is bound by the agreement. For example, if a company shares confidential information with a supplier but, in order to fulfill the request for services, that supplier must share the company's confidential information with a joint venturer, agent, or investor, the transmission of confidential information between the supplier and those additional parties is not protected. Accordingly, the Disclosing Party must take great care to ensure that any party receiving its confidential information is given a copy of the confidentiality agreement and signs and acknowledges that it has read and understands its obligations thereunder. This can be accomplished by understanding the manner in which a Receiving Party will handle its business obligations and including a provision in the confidentiality agreement obligating the Receiving Party to require any person who needs to know the Disclosing Party's confidential information to sign the confidentiality agreement.

The agreement is only as effective as a court says it is. While certain strong language and obligations contained in a confidentiality agreement may be effective to chill bad behavior on the part of a Receiving Party, if and when a confidentiality agreement is challenged in court (which may be a lengthy and costly process), the party seeking to enforce the confidentiality agreement bears the burden of proof to establish breach and injury. In addition, it likely will not reflect well on a Disclosing Party where a court perceives that there was unequal bargaining power during negotiations and overreaching by the Disclosing Party.

The true "confidential status" of the information at issue. An agreement that prevents a Receiving Party from revealing confidential information is enforceable only if the information sought to be protected is actually confidential. If a Disclosing Party cannot demonstrate that the information it seeks to protect is confidential or that the information is unique or extraordinary, a court will not enforce the confidentiality agreement. Therefore, if an agreement is challenged and ultimately determined unenforceable, such a finding can have a snowball effect on other confidentiality agreements that the Disclosing Party signed with other parties (employment agreements, supply agreements, consultant agreements) and may open the door to more litigation challenging those agreements.

Remedies


A confidentiality agreement must be "reasonable" to be enforceable. To determine reasonableness, courts will look at factors such as:

- the interests of the Disclosing Party in keeping the information secret;
- the period of time the information must be kept secret;
- the burden on the Receiving Party; and
- the interests of the public.

Acknowledgement of irreparable harm. Damages for breach of confidentiality under a breach of contract theory are typically difficult to quantify and the loss cannot be measured fully in money damages. Thus, the harm is irreparable. For these reasons, having the Receiving Party acknowledge that a breach of the agreement would result in irreparable harm to the Disclosing Party is helpful, although not determinative.

Liquidated Damages Clause. Because the harm may be impossible to quantify, the parties can consider adding a liquidated damages provision, setting a formula or sum certain due to the injured party upon breach of the agreement. The amount specified should be large enough to act as a deterrent to the Receiving Party. If the parties opt for a liquidated damages clause, however, they should be aware that, upon breach, a court is unlikely to find irreparable harm justifying an injunction since the agreed-upon liquidated damages provision acts as a substitute for irreparable harm and provides an adequate remedy at law. ■

Rebecca K. Myers is Of Counsel at Vandenberg & Feliu, LLP and focuses her practice on intellectual property law.

 **LEXIS PRACTICE ADVISOR RESEARCH PATH:** [Business & Commercial > Commercial Contracts > Confidentiality and Non-Disclosure Agreements > Practice Notes > Confidentiality Agreements](#)

LPA Subscribers may view additional information on Confidentiality and Non-Disclosure Agreements content by following this [link](#).



Lexis Practice Advisor® Author Center

MEET LEADING EXPERTS WHO SHARE THE LATEST THINKING ON TOPICS THAT SHAPE YOUR PRACTICE

A close-up photograph of a laptop screen showing the Lexis Practice Advisor website. The website features a header with the LexisNexis logo and navigation links. Below the header, there's a section titled "Lexis Practice Advisor®" with a search bar. The main content area includes a featured article with a photo of a man, a section for "Contributing Authors & Firms" with a list of authors, and a section for "LexisNexis® Authors" with a list of authors. The background of the image is a blurred office setting with a desk, a cup, and some papers.

Only at LexisNexis

- ✓ 300+ contributing attorney authors from firms and companies across the country
- ✓ A team of LexisNexis® authors with experience at outstanding firms

View our trusted team's profiles and credentials

WWW.LEXISNEXIS.COM/PRACTICE-ADVISOR-AUTHORS



Jessica L. Kerner

CHALLENGES OF TAXING **THE SHARING ECONOMY**

IN 2007, A HOTEL ROOM SHORTAGE IN SAN FRANCISCO prompted two roommates to create a website to rent out air mattresses in their apartment. Less than eight years later, the company they founded, Airbnb, has been valued at more than \$25 billion.¹ The success of Airbnb is mirrored in other “peer-to-peer” startups, such as Uber, Lyft, and HomeAway, which are capitalizing on technological advances that have allowed the creation of platforms to directly connect buyers and sellers.

The sharing economy has led to a host of tax headaches for taxpayers and tax authorities, in large part because of the new business models enabled by new technology that have not been contemplated by existing tax laws. Although this problem is not unique to the sharing economy (it has long been an issue in other industries, such as the telecommunications industry, where technological advances have surpassed existing tax laws), the proliferation of peer-to-peer startups in the sharing economy has garnered significant attention for the large number of federal, state, local, and international tax issues it has raised in a relatively short period of time. Many complex tax issues are raised by the sharing economy. A sample of the types of issues that arise in attempting to tax the sharing economy highlight the challenges that may be encountered in this endeavor.

How the Sharing Economy Operates

The sharing economy is driven by businesses that provide Internet-based platforms connecting buyers and sellers of goods and services. Two examples of the sharing economy at work are the accommodation and transportation markets. The short-term room rental market has been revolutionized by platforms like Airbnb, HomeAway, VRBO, and Flipkey that allow individuals to advertise entire homes or rooms in homes as short-term rentals. On Airbnb alone, rooms are available in 190 countries and 34,000 cities. In the transportation space, ride-sharing companies like Uber and Lyft are taking market share from traditional providers like taxi and limousine services. Uber is available in 60 countries worldwide, and Lyft operates in about 60 cities in the United States.

Although home rentals and ride sharing are increasingly mainstream and well known, peer-to-peer startups exist in many industries. For example, individuals can rent out their cars using RelayRides, lend money using Prosper or Lending Club, get paid for performing odd jobs through TaskRabbit, and host meals with Feastly.

Similar peer-to-peer transactions have taken place for decades, but the frequency of these transactions has increased dramatically with the growth of online platforms connecting buyers and sellers, creating multibillion-dollar businesses. According to Airbnb, 17 million guests used Airbnb this summer, setting a record of nearly 1 million rentals on August 8, 2015.² Technological changes are the primary enabler of this growth. Businesses based on the Web require little infrastructure and can expand worldwide in a relatively

short period of time. The growth of Airbnb to a value of more than \$25 billion in seven years again provides an excellent example.³ By comparison, the first Marriott hotel opened in 1957, and Marriott was valued at approximately \$21 billion in 2015. Uber, founded in 2009, has had a similar trajectory to Airbnb, having obtained a nearly \$51 billion valuation as of July 2015.⁴

Taxes and the Sharing Economy

Sales Tax Collection and Tax Administration

One of the difficulties with taxing the sharing economy is how to apply and collect sales and transaction taxes, such as the hotel occupancy taxes that may apply to short-term rentals. In many cases, tax laws do not place the burden for collecting these taxes on the company that facilitates the peer-to-peer transaction, but rather on individual sellers. However, these taxes are often not collected. This occurs for a variety of reasons. For example, consider the accommodation industry. In many cities, rentals of less than 30 days are illegal, and thus sales and occupancy taxes that would otherwise apply to these transactions are not collected. An October 2014 report by New York’s Attorney General estimated that private, short-term rentals booked through sites like Airbnb generated more than \$33 million in unpaid occupancy taxes and fees in New York City between 2010 and mid-2014.⁵ The report also estimated that 72% of Airbnb’s rentals during this timeframe violated New York zoning and other laws, such as the requirement that apartments can only be rented out for less than 30 days if the host is also staying in the apartment. Even where short-term rentals are legal and transaction tax laws place the burden of tax collection on the individual seller, the tax may not be remitted because it is burdensome for the individual seller to file the appropriate tax return and remit the tax to the state. It is also burdensome for the taxing authority to receive large numbers of small remittances and to monitor the compliance of the thousands of individuals who use peer-to-peer websites.

In some localities where short-term rentals had been illegal or there were questions about their legality under existing laws, the laws have been changed. One of the larger cities to amend its laws on short-term rentals is San Francisco, which passed a short-term residential rentals ordinance that requires owners and tenants of units to apply for permission from the city’s planning department to rent out their units. Applicants must meet a number of conditions, including living in the unit for most of the year, obtaining a business registration certificate, and providing proof of liability insurance. Once registered, the resident may rent out the unit while they are not present for up to 90 nights per calendar year. There is no limit on the number of nights that the unit can be rented while the resident is present in the unit. The resident, also known as the host, is required to file and pay San Francisco’s 14% transient occupancy tax (TOT) on the rental, unless the platform through which the property is rented is paying the tax on behalf of the host. Airbnb collects and remits the TOT for its San Francisco hosts. According to its website,

Airbnb also collects and remits taxes in about a dozen other local jurisdictions and statewide in North Carolina, Oregon, Rhode Island, and Washington.

Legislative Challenges with Modernizing Tax Laws

One of the reasons that state and local governments may not have addressed tax issues presented by the sharing economy is that they may be more focused on non-tax concerns. The non-tax-related issues may be seen as more pressing than the tax concerns as they include questions of safety, such as whether non-residents in a short-term rental would be prepared in case of fire, and concerns about the changing character of neighborhoods when short-term renters displace longer-term residents. In cities where housing is already limited, there may be concerns that widespread conversion of apartments into short-term rentals will increase housing shortages and further drive up housing costs. There are also issues related to competition with existing businesses and the potential for market distortions. For example, highly regulated taxicabs are forced to compete with unregulated companies that provide ride-sharing platforms. And, there may be insurance issues. For example, many individual insurance policies do not cover policyholders who use their vehicles on a for-hire basis. Many jurisdictions have existing laws and regulations to address some of these issues, and often



these laws make sharing transactions illegal. Some jurisdictions have amended their laws and permit sharing companies to operate, and individual transactions to take place, provided they follow the new rules. For example, earlier this year Virginia passed a law regulating transportation network companies (TNCs), which includes ride-sharing companies. TNCs are permitted to be licensed in Virginia by the state Department of Motor Vehicles provided they meet certain

requirements. These requirements include that the TNC must ensure that all drivers are at least 21 years old and have a valid driver's license, and the TNC must conduct background checks on all drivers. The vehicles used to transport passengers must be titled, registered, and properly insured. There are also licensing fees and annual service fees.

Another reason that legislatures may not have addressed tax issues is that tax reform, particularly where it is viewed as raising taxes, is often politically unpopular. Politicians often do not want to be in the position of imposing new or higher taxes, particularly on new and often very popular services.

Even when laws are updated to take into account new business models, those new laws may quickly become outdated. This happened recently in California. The California Public Utility Commission (CPUC) promulgated regulations addressing ride sharing. The regulations require TNCs to obtain a license from the CPUC, require a criminal background check on each driver, set up a driver training program, hold a certain amount of commercial insurance, and conduct car inspections. However, shortly after the California regulations were promulgated, the TNC model changed—the TNC companies added carpooling features. The CPUC asserted that the carpool feature violated California law, which prohibits transit companies from charging riders individually. The CPUC said that the ride-sharing companies either needed to request amended permits or obtain a legislative change.

The failure of tax laws to keep up with technology and changing business models has been a recurring theme in the taxation of several industries, including the telecommunications industry. For example, some may remember when long-distance telecommunications services were sold by the minute based on not only the length, but also the distance of the call. At that time, a Federal Excise Tax (FET) was imposed on long-distance service. The FET defined long-distance service as a service for which the tax varied based on the amount of time and distance of the call. When long-distance carriers stopped varying the charge for calls based on distance, the IRS took the position that the FET still applied. Long-distance carriers disagreed, and litigation ensued. Eventually, the IRS acquiesced. However, telecommunications tax controversy has continued as telecommunications technology has evolved. When voice over Internet protocol (VoIP) service became widely available in the early 2000s, the federal, state, and local tax treatment of this service was often unclear. Tax laws had generally been written to apply to traditional landline telephone services (e.g., local exchange telephone service and long-distance telephone service). Tax laws that were narrowly drafted to apply to exchange telephone service clearly did not apply to VoIP services. Other statutes were more unclear and created controversy and litigation over whether the tax applied to VoIP services. Over time, the laws were changed to apply more broadly, some even attempting to apply to future telecommunications service offerings.

Now, telecommunications technology has taken another giant leap forward with cloud-based telecommunications, and laws written for VoIP service are again outdated. It is often difficult to determine the appropriate sales or telecommunications tax treatment for these cloud-based services. Most sales tax laws do not contemplate these types of services, particularly with respect to determining which jurisdiction's taxes apply to the service. The laws have again failed to keep up with the technological changes, creating uncertainty and potential revenue loss for taxing jurisdictions. State legislatures are simply unable to keep up, as the legislative process is often long, and technology and business models change rapidly. Given the technological advances enabling new and continuously evolving business models associated with the sharing economy, similar risks are present in attempting to update laws to apply to the sharing economy. It is difficult to draft laws that will apply to products and services that have not yet been invented and business models that are not yet in existence. Where laws are updated to reflect current business models and product and service offerings, the laws may fail to keep up as technology and business models continue to change.

Tax Policy

In taxing the sharing economy, it is important not to create separate laws that apply only to the sharing economy. Doing so would violate two central tenets of tax policy: that taxpayers should be treated uniformly and that similar services and goods should be taxed the same. When similarly situated companies, or similar products and services, are subject to different tax treatment and to different regulations, it can result in unfair competition, which may lead to distortions in the market and litigation. For example, traditional taxi services are often heavily regulated by cities that collect substantial fees from taxis in exchange for licenses to operate. Ride-sharing companies (and their drivers) have largely operated outside of these regulations and have not been subject to these significant fees, which some attribute to being one of the reasons for their dramatic growth. With lodging, sales and hotel taxes can be as high as 10-20% depending on the location. When short-term rentals do not include these taxes, they have an advantage over hotels and other lodging establishments that are collecting these taxes, as it reduces the cost of the room for the consumer. However, legislatures and regulators must be careful when attempting to tax and regulate new business models that new disparities are not created.

The challenge of not creating new disparities when attempting to tax new services has been an issue in the telecommunications industry in the taxation of direct broadcast satellite (DBS) services, such as the services provided by Dish Network. With DBS services, which compete with traditional cable television service, customers receive television and other programming to their location through a satellite. When the relatively new DBS services were introduced, many existing taxes and regulatory fees that applied to cable television services, including franchise fees for the use of the public right-of-way to lay cable, did not apply to the new services. In modernizing their laws to apply taxes to DBS services, some states imposed taxes on DBS services that did not apply to cable services, or imposed taxes at rates that were higher than the taxes imposed on cable services, in an attempt to equalize the burden of taxes and fees borne by cable and satellite. The disparate treatment led to litigation as satellite providers challenged the laws as discriminatory. Many of these cases have often involved multiple appeals, including a Massachusetts case that the taxpayer appealed to the United States Supreme Court.⁶

Legislatures are again in the position of having to address the disparate treatment between largely unregulated new businesses that are often competing in industries with existing highly regulated and taxed businesses. Legislatures will need to be careful in attempting to equalize the burdens in order to not create the types of disparities they have in the past if they want to avoid litigation that is costly to both government and taxpayers.

Conclusion

As the sharing economy continues to grow and evolve, tax laws and policies will need to be continuously monitored, updated, and reformed. In attempting to modernize laws and level the playing field between existing and new business models, lawmakers should apply the usual principles guiding tax policy. Although governments have historically struggled to update tax laws and policy in response to technological changes, it is clear that technology will continue to advance and that governments need to be similarly forward-thinking in their tax policies with the goal of addressing new tax issues without stifling innovation. **L**

**Jessica Kerner J.D., LL.M. is a Content and Product Initiatives Manager for Lexis Practice Advisor*

1. "Value of Airbnb Hits \$25.5 Billion with Latest Round," *The Wall Street Journal* (June 29, 2015).

2. See "Airbnb Summer Travel Report: 2015," available here: <http://blog.airbnb.com/wp-content/uploads/2015/09/Airbnb-Summer-Travel-Report-1.pdf>.

3. "Value of Airbnb Hits \$25.5 Billion with Latest Round," *The Wall Street Journal* (June 29, 2015).

4. "Uber Valued at More than \$50 Billion," *The Wall Street Journal* (July 31, 2015).

5. The report is available at: <http://www.ag.ny.gov/pdfs/Airbnb%20report.pdf> (last visited Oct. 16, 2015).

6. *DIRECTV, LLC, et al. v. Mass. Department of Revenue*, 470 Mass. 647, 25 N.E.3d 258, 2015 Mass. LEXIS 94 (Mass. 2015); *petition for cert. filed* (U.S. June 18, 2015) (No. 14-1499).

Korey Clark

Carsharing Getting Relatively Easy Regulatory Ride



FOR-PROFIT RIDESHARING, OFFERING PASSENGERS RIDES for money, and carsharing, renting cars for short periods of time, have both been around for decades, really catching on only recently in their smartphone app-based iterations. But while the modern variety of ridesharing has riled a longstanding industry and government regulators alike, the equivalent form of carsharing seems to have encountered relatively little resistance. That may not last, however.

Carsharing appears to have originated in the 1940s with a cooperative in Zurich, Switzerland, called *Selbstfahrgemeinschaft*, or Sefage for short. According to an article published in *Transportation Quarterly* in 1998, that “early effort was mainly

motivated by economics. Individuals who could not afford to purchase a car instead shared one.” For-hire ridesharing dates back even further, to the “jitney craze” of 1914–1918, when the U.S. economy fell into recession following the start of WWI, and a few enterprising automobile owners began offering rides to streetcar passengers in exchange for a ‘jitney,’ the going nickel rate for a streetcar ride. The two transportation-sharing models proceeded to develop in fits and starts until the 2000s when a convergence of factors, including increasing traffic congestion in urban areas, shifting generational perspectives about car ownership, and the development of social networking technologies, gave impetus to the efforts of ridesharing services like Uber and Lyft, and carsharing operations like

Zipcar and Car2Go to take advantage of the underutilized capacity of passenger vehicles.

The rise of ridesharing—and Uber in particular—has been very disruptive to the generally more tightly regulated taxicab industry, spurring strong and occasionally even violent opposition from cab drivers. A number of cities across the country, including Eugene and Portland, Oregon, have also banned ridesharing companies or forced them to suspend operations. And two different California regulatory authorities recently ruled that Uber drivers were employees rather than independent contractors, posing a significant threat to the company's business model.

city, Mayor Charlie Hales said the city should figure out a way for the company to operate legally there.

"But we're not willing to be rolled," he added. "And we don't accept that someone is exempt from our regulations because they're cool and new."

Although the major car rental companies and even some car manufacturers, including Daimler AG, BMW, and Ford, have gotten into the carsharing business—joining dedicated carsharing services like Zipcar and Car2Go, as well as peer-to-peer services like Getaround and RelayRides, which allow individuals to rent out their own personal vehicles—Navigant Consulting recently placed the size of the industry worldwide at

THE RISE OF RIDESHARING – AND UBER IN PARTICULAR – HAS BEEN VERY DISRUPTIVE TO THE GENERALLY MORE TIGHTLY-REGULATED TAXICAB INDUSTRY, SPURRING STRONG AND OCCASIONALLY EVEN VIOLENT OPPOSITION FROM CAB DRIVERS... CARSHARING SERVICES HAVEN'T RECEIVED AS HOSTILE A RECEPTION.

Carsharing services haven't received as hostile a reception from the businesses they most directly threaten, traditional car rental companies. In fact, those companies have introduced their own short-term car rental services, including Hertz 24/7 (which recently ceased operation due to weak demand) and Enterprise CarShare. After launching its own service in 2011, Avis acquired Zipcar in 2013. And in stark contrast to the city bans on ridesharing, states, including California, Oregon, and Washington, have passed laws requiring car owners who rent out their vehicles to be members of carsharing programs to ensure they meet safety, insurance, and financial reporting requirements. The city of Indianapolis is even partnering in the development of a carsharing service there called BlueIndy.

The apparent disparity in the development of the two similar industries begs the question why that would be the case. One reason may simply be the size and growth rate of the leading ridesharing company, Uber. Founded just six years ago, the company was valued at \$41 billion last year—making it larger than Delta and American Airlines, which have been around since the 1920s—and it was just revalued at \$51 billion this year. That scale of development seems to have put some local governments on the defensive. As *The Wall Street Journal* reported in January, when Portland, Oregon filed suit against Uber last year seeking to halt the company's operations in that

\$1.1 billion and projected it would grow to \$6.2 billion by 2024, roughly an eighth of the size of Uber's current valuation. And as Wilson Wood, who heads the Carsharing Association, put it to *The New York Times*, the openness of the market means the arrival of companies like Daimler and Avis "isn't putting anybody out of business."

Uber's aggressive expansion tactics, which *The Wall Street Journal* described in a story earlier this year as charging into new markets, establishing a base of drivers and riders, and then mobilizing that base to counter resistance, don't appear to have ingratiated ridesharing with regulators either.

"It seems a lot of the time they turn up and say: 'We dare you to stop us,'" Ryan Heath, the spokesman for former European Commission Vice President Neelie Kroes, said of Uber, which had asked the EU to block a French law restricting its operations last year, according to the *Journal* story.

That story, headlined "How Sharp-Elbowed Uber Is Trying To Make Nice," chronicled how Uber has been working harder lately to find compromise with government entities. But the car-sharing service Car2Go—launched in Germany in 2008 by Daimler, maker of Mercedes-Benz luxury vehicles and the smart car, and now operating in several U.S. cities including New York, Miami, Portland, and Seattle—appears to employ a "play nice" approach from the outset.

“...EACH VEHICLE THAT GOES INTO FULL-TIME SERVICE FOR CARSHARING OBVIATES THE SALE OF FOUR TO SIX NEW CARS AND DELAYS THE SALE OF AS MANY AS SEVEN MORE... BY 2025, 20% OF ALL VEHICLES IN URBAN CENTERS WILL BE USED FOR CARSHARING.”

“Car2go was very cooperative with the city,” Laura Hammond, a spokesperson for the City of Eugene, told *Eugene Weekly* late last year, before Car2Go pulled out of the city after eight months of operation due to limited demand. “They actually came to us before they started operating.”

But carsharing is growing. As *The New York Times* reported in January, about 800,000 people were members of carsharing services in the United States last year, 44% more than in 2011, according to Susan Shaheen, codirector of the Transportation Sustainability Research Center (TSRC) at the University of California, Berkeley. And the possibly alcohol-related death of a 22-year-old Car2Go passenger in Miami two years ago suggests that it may only be a matter of time before carsharing comes under the same scrutiny ridesharing did after a series of negative incidents widely reported in the media, including an accident involving an Uber driver in San Francisco on New Year’s Eve, 2013, that left a six-year-old girl dead.

And while there don’t appear to be any large groups of individuals like taxi drivers protesting the operation of carsharing companies, that may also change with time. *The Los Angeles Times* reported in June that according to TSRC’s Shaheen, each vehicle that goes into full-time service for carsharing obviates the sale of four to six new cars and delays the sale of as many as seven more. Thilo Koslowski, a vice president at the information technology research firm Gartner Inc., estimates that by 2025, 20% of all vehicles in urban centers will be used for carsharing.

“Imagine all of a sudden 20% of your vehicles sales in the classic sense—to individuals who will be the only user of that car—go away,” he said.

Automakers like Daimler and Ford have been willing to experiment with ways to tap into the carsharing market, but it remains to be seen how those companies and others will respond to a 20% cut in their conventional auto sales.

Another potential stumbling block for carsharing is one-way rentals, also known as “free-floating” or “point-to-point” rentals, which allow users to pick up and drop off vehicles at any legal parking space within a carsharing service’s coverage area. The rental form was pioneered by Car2Go, and market watchers consider it to be a growth area.

“Point-to-point can quickly attract three to four times the number of members of a traditional round-trip service,” said Dave Brook, managing partner of international transportation consulting firm Team Red U.S.

To make their one-way services even more attractive to potential users, carsharing companies have been making arrangements for parking for their vehicles. Car2Go, for example, paid the District of Columbia \$2,890 for each car it operates in the city to allow users to park in metered spaces for free, according to *The New York Times*. And the *Indianapolis Star* reported that Indianapolis is granting access to metered and unmetered spaces for the vehicles in its BlueIndy service, which was “the most prominent” subject of complaints about that initiative, according to WCPO Cincinnati. It’s not too difficult to imagine parking becoming a heated issue in cities where parking is particularly hard to come by.

And although ridesharing and carsharing services are conceivably different enough to peacefully coexist, with the former facing roadblocks in some places while the latter cruises along, companies like Zipcar and Car2Go could encounter strong opposition from Uber down the road. **L**

* Article courtesy of State Net Capitol Journal News & Views from the 50 States™, www.lexisnexis.com/statenet.

Please direct inquiries to statenet@lexisnexis.com. Copyright © 2015 LexisNexis. State Net is a registered trademark and State Net Capitol Journal News & Views from the 50 States is a trademark of RELX Inc. No part of this document may be copied, photocopied, reproduced, translated or reduced to any electronic medium or machine readable form, in whole or in part, without prior written consent of RELX Inc.

A View of Asset-Based Lending

Q&A with David W. Morse

BANKING & FINANCE CHAIR AT OTTERBOURG P.C.



David W. Morse



What led you to choose commercial finance and institutional lending as your area of practice?

Serendipity is the word that comes to mind. While I knew that I preferred to do transactional work, I certainly never thought specifically about being a finance lawyer, much less a secured lending lawyer. I was fortunate that at the time I started at the firm there was a real need in the finance practice as the firm's business in that area was growing. Once here, part of my decision to stay in the field was to some extent a function of the firm's approach to training. New attorneys go right into a practice area and stay with it rather than doing rotations. As a result, you learn faster, so that you get to a point where you have substantive knowledge more quickly and can offer real assistance to clients in a much more significant way much earlier in your career. Having the expertise and being able to be helpful was a very positive aspect of being at the firm. I was also very fortunate to have people here at the firm that were great mentors and while certainly demanding, very supportive. Next thing you know—the years have gone by and you are a finance lawyer.

What do you think is the biggest challenge for attorneys working in your practice area?

The biggest challenge for attorneys representing lenders comes from the

current market forces that lenders confront. Looking back over the years, there has been a distinct evolution of the dynamic between lenders and borrowers. Financing has become as much a service as a product. Companies and sponsors looking for financing have very high expectations about the flexibility that they will be given from their lenders. The ongoing challenge is advising lenders and helping them understand the risks they are taking in trying to accommodate the demands of their customers. A lender needs to balance the level of risk it is prepared to take as an institution and for its shareholders with the borrower's needs and demands. Overall, to the extent that you are dealing with borrowers looking at their realistic needs you can usually solve the equation. More often than not, the answer lies in establishing the conditions and limits around terms of the arrangements in a way so that it works from the perspective of both parties.

Have there been any recent market developments that had a significant impact on your practice?

The market development that impacts my practice is the shift of supply and demand. In the market, a significant amount of dollars need to be deployed by financial institutions in order to achieve their earnings goals. At the same time, the number of borrowers is reduced

because of the large pools of cash held by corporates and private equity firms. There is a lot of liquidity in the market. So while the number of financing opportunities has declined, the supply of funds for borrowing has increased, not only because of the volume of the deposits held by banks, but from alternative lenders of all shapes and sizes. This poses multiple challenges. It has a ripple effect. Mergers and acquisitions activity is impacted because the sellers are demanding higher prices. Private equity firms are finding that it does not make economic sense for them to pursue certain acquisitions. Private equity groups (PEGS) are competing with strategic buyers. All of this affects M&A activity, which has an impact on lenders and the opportunities for them. Overall, the market is just very competitive. And then there are the regulators.

What is the current impact of regulation on the lending industry?

Even though it seems like old news, since the Leveraged Lending Guidance goes back to March, 2013, it did not really hit financial institutions until the fall of 2014 and in particular in November 2014 with the issuance of the Supplemental Leveraged Loan Guidance from the three regulators. That fall, there was also the issuance by the regulators of a “Matter Requiring Immediate Attention” (MRIA) to one major institution in the LBO arena that I think captured the industry’s attention.

Now institutions have to look at the transactions in a different way to address the concerns raised by the regulators and each institution is trying to figure out the best way to do that. In the meantime, as I mentioned, the pool of opportunities for deals is diminished. Lenders are between a rock and a hard place—trying to be more flexible so as to win deals, while at the same time addressing the concerns of the regulators. Ultimately

the financial institutions face the dilemma of balancing the need to grow and meet their earnings goals versus the regulators’ perception of their risks.

In the meantime, the regulatory environment has created new opportunities for unregulated lenders.

Do you see further regulation resulting from the release of the Leveraged Lending Guidelines?

Given that each year the regulators go into institutions and examine their portfolios in the annual Shared National Credit (SNC) reviews, it seems likely based on such examinations that there will be some further developments in how the institutions are applying the Guidance, although unlikely that there will be anything as comprehensive as what the regulators did in November 2014. Even though there may be further refinement of the Guidance, which is not technically a regulation, I would not expect the feedback from the regulators pursuant to the SNC to take the form of regulations per se. But there will be dialogue and challenges. At a philosophical level it is interesting how the regulators have chosen to do this and the expectations created because it is “Guidance”—not a regulation and not a law. The regulators were very clear that each institution has to develop its own rules and interpret the Guidance in its own way. For lenders that is very challenging. It seems like the regulators are trying to be accommodating and provide flexibility, which you would think would be positive from the banks’ perspective. On the other hand, it puts the institutions in a bind wondering if they are being too conservative or too relaxed in the interpretation of the Guidance. It will take at least one or two more SNC review cycles to get all of this nailed down to where it is more manageable.

Are any of these developments leading to new trends in the lending industry?

There are at least two significant developments. First, there is the decline in the more highly leveraged transactions.

Second, however, are the other aspects of the Leveraged Lending Guidance that sometimes get lost in all the noise. One of these is the Guidance’s references to the ability of a borrower to repay its debt within 5 to 7 years, 50% of total debt and 100% of secured debt. The PetSmart deal is a very interesting example of balancing those other elements. It was above 6x leverage. But there were other factors that made the institutions believe it was still within the Guidance.

Another, from a legal perspective, is the elements of “weak structures” that the Guidance identifies. These are issues that we consistently confront in the negotiation of the loan documents—whether it is talking about EBITDA (earnings before interest, taxes, depreciation, and amortization) add backs, the use of expansive baskets, or the reduced use of financial maintenance covenants versus incurrence covenants, or equity cures. All of these in some combination are specifically identified in the Guidance as elements of weak structures. These elements should lead to a trend for financial institutions to push back more when they get the requests from borrowers for the types of accommodations that the regulators have said are not desirable.

Have you worked on any deals that presented unique challenges? What made these deals challenging?

We do a fair amount of transactions with international elements, which is always interesting. It’s something I’ve been doing since the mid-1990s. These deals require a very intensive understanding

of the laws of the different jurisdictions that are involved in such transactions. I worked on a recent transaction that was challenging because it was an exit financing involving 10 countries. Managing that whole process, with the overlay of the bankruptcy issues, and a tight time frame, made for some real stress. Fortunately, we have a great team of experienced lawyers here at the firm who are more than capable of handling such circumstances. It was also very helpful that we have familiarity with the country-specific issues from our years of experience in doing international deals. Part of the process is to be able to describe the foreign law issues in a way that make senses to a U.S. lender. Having the knowledge base to be able to do this in multi-jurisdictional deals is one of the things that I like to think we bring as part of the “value-add” to our U.S. clients.

In another case, we were involved in a recent bankruptcy that had some challenges because our clients, the pre-petition secured lenders, did not end up doing the DIP (debtor-in-possession) financing. An affiliate of the equity sponsors came in to do the financing to protect their position and was able to do so on a third lien basis because of the value of the collateral that supported it. The equity sponsors were trying to protect their position so it made sense for them to provide the DIP financing on a very aggressive basis, and with manageable risk given the collateral values. That deal had some interesting twists and turns because the pre-petition lenders usually provide the post-petition financing as a defensive move.

What is one piece of advice you would give to a junior associate considering specializing in asset-based lending (ABL) or finance in general?

While specializing in finance generally offers great opportunities, asset-based

lending offers the opportunity to gain a particular breadth of knowledge that is extremely valuable for any attorney to have. It is a great training ground and ultimately leads to skills that can be valuable in any aspect of a finance practice. Someone with these skills and knowledge is always going to be needed. One of the things about asset-based lending is that it has all of the elements of lending plus you have all of the elements of the collateral and then the operational issues on top. You have to understand the Bankruptcy Code, the Uniform Commercial Code, letters of credit, some intellectual property law, the Perishable Agricultural Commodities Act and similar federal laws, the Federal Tax Lien Act, together with any number of industry-specific issues depending on the borrower’s business, including the different issues for a retailer versus a manufacturer, or how consignment arrangements work both from a legal perspective and a practical perspective, the rights of a surety providing a bond, etc. You may need to know about the Assignment of Claims Act or maritime law. You also have to understand what’s market in the ABL industry including for a smaller bilateral credit facility for a company that is not performing well or for a large syndicated facility for a company with significant cash flow. Not to mention intercreditor issues whether in the context of a first lien/second lien transaction or a split collateral structure or for a unitranche facility.

Last summer I was working on a \$2.3 billion credit facility at the same time that I was working on a \$10 million credit facility. Sometimes you have companies that are almost investment grade and sometimes you have companies that are about to file Chapter 11. That’s the diversity of what you are dealing with in asset-based lending. With that spectrum of transactions you acquire a lot of knowledge. For a new attorney it is a great opportunity.

As to advice to a junior attorney: bring a full dose of enthusiasm and curiosity and constantly look to expand your knowledge and hone your skills, both technically and in how you communicate. Communicating clearly and precisely will be critical to your success.

Of all of the work you do and deals you have arranged, what types of transactions do you enjoy handling the most?

There are two types of transactions that are particularly enjoyable. First, there are the international transactions, where structuring to deal with the laws of the different jurisdictions can require some creativity. In those countries where guarantees may be of limited value, you have to figure out who and where your borrowers are, while dealing with issues like retention of title and financial assistance. Or, for example, you may have regulatory issues in a jurisdiction like Singapore, but if there is a UK company, the lender may be willing to lend to the UK company in reliance on the guarantee from the Singapore company with “on-lending” by the UK to Singapore.

Acquisition financings that involve multiple layers of debt are another type of transaction that I enjoy working on. One clear trend that I did not mention earlier might be summarized as “convergence.” It is not uncommon to have an ABL facility, alongside a term loan B; or an ABL and a term loan and a high yield; or perhaps, instead, a first lien and second lien term loan, etc. As a result of these types of debt being side by side for the same company there is pressure to import concepts from one debt product to another, which has its risks and challenges. But these are fun because you need to be familiar with each of the products and both the market practice for each and how they work separately and together. And intercreditor issues are key. Dealing with

these issues is fun because when working in asset-based lending you get involved in workouts and bankruptcies that give you a real life understanding of many of the provisions in the agreements and their significance. It is satisfying to be able to bring those experiences into the negotiations and the drafting of the documents.

What are the most satisfying aspects of being a transactional attorney working in commercial finance and institutional lending?

Personally what I find very satisfying involves two aspects of a career in law.

Years ago, when I was looking for a job out of law school, I was in an interview at a firm with a very senior lawyer, a name partner in this particular firm, a litigator with a very tough attitude. He

asked me why I wanted to be a lawyer and sneered at me when I gave him my answer. Now here it is several decades later, notwithstanding his reaction, and although it may sound trite, my answer is still the same—helping the clients. There is nothing more satisfying than when a client comes to you with a situation or an issue and you are actually helping solve the problem. That is very satisfying.

The second aspect of what I do that I find satisfying comes from working with more junior attorneys and being able to talk to them about the issues, to challenge them and help them to begin to really think about what they are doing and why; helping them to see the connections between what we do or say and the substantive areas of law; and then figuring out how these abstract concepts actually play out in

reality, so that hopefully ultimately with a better understanding of the law and the practice, they can get more satisfaction from what they do—just as I have. **L**

David W. Morse is a member of the law firm of Otterbourg P.C. in New York City and is chair of the firm's banking and finance practice. He specializes in the representation of banks, hedge funds, commercial finance companies, and other institutional lenders in structuring and documenting loan transactions, including working capital facilities, financings for leveraged acquisitions, term loans, and second lien loans, as well as loan workouts and restructurings. In the course of his career, Mr. Morse has worked on numerous financing transactions confronting a wide range of legal issues raised by Federal, State, and International law.



LexisNexis®

“FOLLOW” MORE THAN FRIENDS AND COLLEAGUES



Put LinkedIn® to work for your practice, too Lexis Practice Advisor® on LinkedIn highlights the latest insights and guidance written by expert attorney authors on the topics that matter most to your practice.



Make “following” count—Follow Lexis Practice Advisor on LinkedIn

WWW.LEXISNEXIS.COM/PRACTICE-ADVISOR-LINKEDIN



Reb Wheeler MAYER BROWN LLP

DUE DILIGENCE IN **LIFE SCIENCES MERGERS & ACQUISITIONS**

THE LIFE SCIENCES INDUSTRY HAS BEEN AMONG THE MOST active sectors for mergers and acquisitions in recent years. There are a variety of issues that are uniquely or particularly relevant to life sciences companies and their products that will have important implications for evaluating, structuring, and negotiating transactions in the industry. It is especially important that counsel working on life sciences M&A deals understand these issues when conducting due diligence. While some aspects of legal due diligence in these deals will be more or less the same as in any M&A transaction, there are certain areas of due diligence that tend to assume particular significance in a life sciences acquisition. This article explores a number of such considerations, including (1) product-specific issues, such as intellectual property, marketing approvals, post-marketing obligations, and licensing and collaboration relationships; and (2) enterprise-level issues, such as compliance and supply chain considerations.

For present purposes, the “life sciences” sector is generally considered to include pharmaceuticals, health-oriented biotechnology products, and medical devices. Not all of the considerations discussed in this article will be relevant (or relevant in the same way) to participants in these different industry segments. This article is also focused on U.S.-specific issues in transactions involving U.S. targets. Many U.S. life sciences companies, of course, conduct business and have personnel and assets in multiple countries; international and cross-border issues will therefore often be an important focus in life sciences M&A deals as well.

Product Life Cycle and Market Exclusivity

Pharmaceutical companies and biotech firms often think about their products in terms of their life cycle. In the most common case, in the United States, a novel pharmaceutical or biotech product’s life cycle begins during its development—well before its approval by the FDA—and proceeds through a period during which the product enjoys an exclusive position in the marketplace and into a phase in which market share is ceded to competing generic or “biosimilar” products that can be substituted for the innovator product. The goal of innovator or “brand” companies is to maximize the period during which the product enjoys market exclusivity and to delay entry of generic or biosimilar competition for as long as possible. These considerations inform many aspects of a pharmaceutical or biotech company’s business and products, as the discussion below illustrates. It is often helpful, therefore, to bear these life cycle considerations in mind when undertaking product-focused due diligence on a life sciences target.

The most significant factors bearing on market exclusivity are intellectual property rights and regulatory exclusivity periods. Practitioners advising participants in life sciences

THE INTELLECTUAL PROPERTY UNDERLYING A DRUG, BIOLOGIC, OR MEDICAL DEVICE, AND THE LEGAL RIGHTS ASSOCIATED WITH THAT IP, ARE KEY DETERMINANTS OF WHETHER AND HOW LONG A PRODUCT IS LIKELY TO ENJOY AN EXCLUSIVE MARKET POSITION.

M&A deals need to understand these different sources of rights in order to help their clients properly assess a product’s legal positioning and negotiate and document transaction structures, different approaches to consideration, and other terms that appropriately take into account these key factors that bear on a product’s life cycle.

Life cycle management is less of a consideration for medical device companies. Medical devices do not benefit from the kinds of regulation-based market exclusivity that is available to drugs and biologic products and thus do not face generic competition in the same way that drugs and biologics do. Patent and trade secret protection can, however, have significant bearing on a medical device’s market posture.

Intellectual Property

The intellectual property (IP) underlying a drug, biologic, or medical device, and the legal rights associated with that IP, are key determinants of whether and how long a product is likely to enjoy an exclusive market position. Relevant intellectual property rights include:

- **Patents.** Patents are particularly important to life sciences companies given that they allow the holder to preclude others from making, using, selling, offering for sale, or importing the claimed invention during the patent term. Life sciences companies’ products are often covered by a number of different patents covering various aspects of the product or its manufacturing or use. In addition to composition of matter patents claiming the actual formulation of a drug or the technical specifications of a device, patents covering manufacturing processes, methods of use, and even distribution systems may also be obtained. Novel pharmaceutical and biologic products, and medical devices that must undergo clinical trials by virtue of a premarket application process, may be entitled to an extension of their patent terms pursuant to the Drug Price Competition and

Patent Term Restoration Act of 1981 ([98 Stat. 1585](#), [98 P.L. 417](#), [98 Stat. 1585](#)) (the “Hatch–Waxman Act”). The extension, designed to make up for the portion of the patent term lost during the clinical trial and approval process, can be for up to five years, provided, however, that the extension cannot result in an overall remaining patent term in excess of 14 years.

- **Trade Secrets.** Trade secrets can also be important, particularly where patent protection may not be possible or where the innovator seeks to protect an invention beyond the term of a patent.
- **Trademarks.** Though not typically as determinative a factor of market share as patent rights or trade secret protection, branding is also an important part of marketing innovative life sciences products. As such, trademarks should also be evaluated as part of due diligence.

Diligencing intellectual property issues associated with a drug, biologic, or medical device can become very technical and complicated. Any such effort should focus on a number of factors, including the following:

- **The nature and validity of the intellectual property and the target company’s rights in the IP.** Among other things, consideration should be given to the following:

- **Subsisting Patents:** What, if any, subsisting patents claim the product or its manufacture or use and what are their remaining terms?
- **Pending Patent Applications:** The likelihood that any pending patent applications claiming the product or its manufacture or use will be granted and whether and how the claims asserted in those applications might be narrowed.
- **Strength of Claims:** The strength of the claims included in patents and patent applications and the likelihood that they might be challenged by a generic or biosimilar entrant or that a competitor might be able to engineer around them.
- **Patent Term Extension:** For products that have not yet been approved, the prospects for patent term extension pursuant to the Hatch–Waxman Act, as described above.
- **Supplemental Claims/Additional Patents:** Whether there are opportunities to supplement the claims of existing patents or seek additional patents in respect of other aspects of the product.
- **Trade Secret Protection:** To the extent that the target relies on trade secret protection, the strength of its security and confidentiality procedures for safeguarding the secrecy of those trade secrets.

- **Trademarks and Trade Dress:** For marketed products, whether applications to the U.S. Patent and Trademark Office for the registration of trademarks or trade dress in respect of important branding elements of the product have been filed and allowed and, if so, the classes of use for which registration has been sought, as well as the target’s practices relating to marking, quality control, and enforcement.
- **Third-Party Infringement:** Any allegations by the target that third parties have infringed or otherwise violated its intellectual property rights, including the status of any pending litigation involving such allegations.
- **Freedom to operate.** Particularly for product candidates that have not yet reached the market, it is important to assess the risk that the product’s manufacture and/or commercialization might infringe a third party’s intellectual property rights. Although it may not be practical to conduct fulsome freedom to operate analyses for each of a target company’s products and product candidates, such analyses may be warranted for the most important products or candidates. Due diligence should also focus on any past or pending claims or allegations that the target is infringing a third party’s intellectual property and the terms of any settlement or other resolution relating thereto.
- **Third-party rights.** An important part of conducting due diligence on a target company’s IP is tracing the heritage of that IP and confirming that the target possesses all the rights it purports to possess in that IP. Practitioners should be on the lookout for the following situations:
 - **Incomplete Assignment of IP Rights:** Individuals involved in the conception of an invention were not party to invention assignment agreements or such invention assignment agreements did not effectively assign all rights to the purported IP owner, which could mean that the target is not the sole owner (or even an owner) of the relevant IP.
 - **Acquired IP:** IP was acquired by the target company or its predecessor from a third party, in which case counsel should review all relevant transfer documentation and confirm that the transfers have been properly recorded with the U.S. Patent and Trademark Office and applicable foreign equivalents.
 - **Collaboration IP:** IP was the product of a collaborative development effort by the target company and a third-party, in which case it is important to carefully review the terms of the collaboration agreement and other related agreements in order to assess ownership of the intellectual property, any limitations that may apply to the target company’s use of or ability to transfer the IP, and the

rights that the third party may have in the IP, as further discussed below.

Regulatory Exclusivity Periods

In the case of drugs and biologics, the other key determinant of a new product's prospects for market exclusivity in the United States, in addition to its patent coverage, is the regulatory exclusivity afforded to it in relation to its FDA approval. Developing new drugs and biologics commonly takes many years and involves enormous investments of money and resources. At the same time, innovators often apply for patents early in the development process. As a result, it is not uncommon for a number of years of the term of the patents covering a novel product or related process to have elapsed by the time the product is approved for sale. Congress has passed legislation to address this issue and ensure that innovators will have some period of exclusivity during which they will be able to market novel products free of generic competition in order to recoup their investment in a product's development. One such legislative fix is the patent term extension program provided for under the Hatch-Waxman Act, as described above. Other legislation has provided for additional periods of statutory exclusivity during which the FDA may not approve (and in some cases, may not accept) applications for competing generic or biosimilar products. It is important for counsel to understand these different possibilities for market exclusivity in order to assess (1) what forms of market exclusivity attach to a given product, (2) how much time remains on such exclusivity terms, and (3) whether there are possibilities for obtaining additional forms of exclusivity.

Pharmaceuticals

In the United States, pharmaceuticals and biologics must, in most cases, be approved by the FDA before they can be marketed to the public. Novel pharmaceutical products are typically approved pursuant to a new drug application (NDA). Generic pharmaceuticals are typically approved through a more streamlined process pursuant to an abbreviated new drug application (ANDA). In the case of conventional drugs, several types of statutory exclusivity are available, as follows:

- **New Chemical Entity (NCE).** NCE exclusivity is available for new drug products. NCE exclusivity means that the FDA cannot approve or even accept an ANDA or an NDA relying on §505(b)(2) for a generic product relying on the same active moiety during a period of five years after approval of the innovator drug's NDA.
- **Clinical Investigation (CI) Exclusivity.** CI exclusivity is available in some circumstances in which a product has an existing approved NDA and the sponsor conducts certain qualifying new clinical trials that support a change in the product's dosage form, a new indication, or a change from prescription

status to over-the-counter. If CI exclusivity attaches, the FDA is precluded from approving an application for a competing generic for a period of three years following approval of the supplemental NDA relating to such change or new indication, but not from accepting such an application.

- **Orphan Drug Exclusivity.** Products that target treatment of an indication that affects fewer than 200,000 patients in the United States and products for which the development costs are likely to exceed product sales may be designated orphan drugs. In that case, the product will enjoy seven years of market exclusivity following approval, during which the FDA will be precluded from approving an application for a competing generic product (but may accept such an application for filing). Companies pursuing orphan drugs are also eligible for certain research grants and tax credits, which make orphan drug designations even more sought after.
- **Pediatric Exclusivity.** To encourage testing of drugs and biologics on children, the FDA sometimes requests that manufacturers undertake certain clinical studies in pediatric populations. Manufacturers who undertake pediatric trials in response to the FDA's request benefit from an additional six months of exclusivity beyond whatever other exclusivity (including by virtue of patent terms) covers the product. Such additional exclusivity period covers all formulations, dosage strengths, and indications of the same drug.

Existing exclusivity and patent terms applying to marketed conventional drugs can be assessed relatively easily by referring to the FDA's publication, *Approved Drug Products with Therapeutic Equivalence Evaluations* (the "Orange Book"), which is accessible online through the FDA's website. See <http://www.fda.gov/Drugs/InformationOnDrugs/ucm129662.htm>. The Orange Book is searchable in a variety of ways and identifies the types of exclusivity attaching to listed drugs and when that exclusivity, as well as patent coverage, expires.

In the case of products in development for which an NDA has not yet been approved, a buyer will need to assess the current state of development efforts, when the NDA is likely to be filed (if it has not yet been filed) or where it stands in the approval process (if it has been filed), and whether an orphan drug designation or pediatric exclusivity may be available.

Biologics

Biologics are approved pursuant to a biologic license application (BLA), and biosimilar products are approved pursuant to an abbreviated BLA process. The Patient Protection and Affordable Care Act of 2010 ([124 Stat. 119](#), [111 P.L. 148](#), [124 Stat. 119](#)) (the "Affordable Care Act") established a separate regulatory exclusivity regime for biologics. Under that regime, a biologic using a novel biological structure is entitled

to data exclusivity for 12 years, meaning that the FDA will not accept an application for a biosimilar product claiming comparability to the applicable innovator biologic for a period of 12 years from approval of a BLA in respect of the innovator biologic. As with “small molecule” drugs, biologics can be eligible for a six-month extension with qualifying pediatric studies and can receive orphan designations.

The FDA has recently released the “Purple Book” (the formal name is *Lists of Licensed Biological Products with Reference Product Exclusivity and Biosimilarity or Interchangeability Evaluations*), which, in some respects, is to biologics what the Orange Book is to traditional drugs. See <http://www.fda.gov/Drugs/DevelopmentApprovalProcess/HowDrugsareDevelopedandApproved/ApprovalApplications/TherapeuticBiologicApplications/Biosimilars/ucm411418.htm>. The Purple Book is significantly more limited in its scope, however. Accordingly, for now, practitioners will need to evaluate the BLA and patents covering biological products in order to assess exclusivity.

Medical Devices

Unlike pharmaceuticals and biologics, medical devices do not benefit from any regulatory market exclusivity provisions. Accordingly, market exclusivity for medical devices will typically be determined by intellectual property and other barriers to entry, as discussed above.

Generic and Biosimilar Competition

As a public policy counterweight to market exclusivity for pharmaceutical and biologic products and the benefits exclusivity affords innovator companies, U.S. law has established pathways for generic and biosimilar products to reach the market once patent protection and regulatory exclusivity of the innovator, or “reference,” product has expired and sometimes earlier. As noted above, the timing of generic or biosimilar competition will almost always be a key consideration for buyers when assessing the value and prospects of a pharmaceutical or biologic product. It is therefore important for counsel to understand and be able to evaluate the prospects for and timing of generic competition for products involved in an acquisition.

Generics

In the case of pharmaceuticals, the Hatch-Waxman Act permits manufacturers of generic versions of approved drugs to utilize more streamlined applications for marketing approval. Most generic drugs are marketed under an ANDA. An ANDA filer is not required to carry out either animal or human trials to demonstrate safety or efficacy; rather, it must demonstrate that the generic product is “bioequivalent” to the reference product in that it performs the same way as the reference drug.

This is typically established through far more limited clinical trials than are required for new chemical entities.

As noted above, there are two key barriers to generic competition for pharmaceuticals: regulatory exclusivity and patents protecting the innovator drug. As discussed above, the type of regulatory exclusivity attaching to a particular innovator drug will dictate whether and when the FDA can accept or approve an ANDA in respect of a generic version of that drug. Applicants must address the issue of patent coverage by certifying in the ANDA one of the following with respect to the patents protecting the reference drug: (1) that no patent covering the reference drug was submitted to the FDA; (2) that all patents covering the reference drug that were submitted to the FDA have expired; (3) that the applicant seeks approval only once the applicable patents covering the reference drug expire; or (4) that the patent is invalid, unenforceable, or will not be infringed by the manufacture, use, or sale of the drug product for which the abbreviated application is submitted (a “Paragraph IV certification”).

The Hatch-Waxman Act requires that an ANDA filer must notify the holder of the NDA for the reference drug of its filing and further provides that the act of filing an ANDA with a Paragraph IV certification is an act of patent infringement such that the NDA holder has standing to initiate a patent infringement suit against the ANDA filer. If the NDA holder does so within 45 days after notice of the ANDA filing, the Hatch-Waxman Act establishes a 30-month stay during which the FDA cannot approve the ANDA unless the patent at issue expires or a court rules that there is no infringement or that the patent is invalid. If none of these occurs prior to the expiration of the 30-month stay and the regulatory exclusivity period covering the reference drug has lapsed, the FDA will be permitted to approve the ANDA for the generic product. If patent infringement litigation is still pending at the time of approval, however, any commercial launch of the generic product would be deemed “at risk” in that the generic company would face a substantial damages award in the event that it ultimately loses.

The Hatch-Waxman Act provides an important incentive for generic manufacturers to find their way through these regulatory and patent hurdles. The first manufacturer to file an ANDA for a generic version of a particular reference drug is generally awarded a 180-day marketing exclusivity period during which no other generic version of the same reference drug can be sold in the United States. This gives the “first-to-file” generic company a distinct advantage in terms of both pricing and market share over future generic entrants.

Given the high stakes involved in the timing of generic competition for a given drug, it is important that M&A

practitioners understand the various dimensions of the generic approval process so that they are able to assist buyers in determining how to appropriately factor the specter of generic competitors to a target's key products into their assessment of those products' value and future prospects. The existence or prospect of generic competition may also be taken into account in various deal terms, as discussed below.

Biosimilars

Biosimilar products are to biologics what generics are to traditional "small molecule" drugs, but obtaining FDA approval of a biosimilar is a significantly more time consuming, costly, and uncertain undertaking than obtaining approval of a generic drug. As the name implies, biosimilars are not exact replicas of the innovator biologic products. This creates a complicated situation for regulators endeavoring to develop streamlined approval pathways for biosimilar products while still ensuring their safety and efficacy are equivalent to that of the innovator biologics. This is a relatively new and still evolving area of law and policy in the United States and other countries.

The legislative basis for an approval pathway for biosimilars in the United States was established as part of the Affordable Care Act in 2010 and the FDA has published guidance relating to the approval of biosimilars in 2012 and 2014. Under this guidance, manufacturers are permitted to rely to some extent on safety and efficacy data filed in respect of the reference biologic, but the biosimilar still must be shown to have no significant clinical differences from the reference biologic. Because a biosimilar will never be exactly the same as an innovator product, demonstrating the requisite level of similarity will typically require a combination of structural analyses, functional assays, and data from animal and human studies. The FDA has significant discretion over what it will require for a particular biosimilar.

There are other differences between the approval process for a traditional generic product and a biosimilar. For example, biosimilar applicants are not required to make patent certifications and are not subject to an automatic 30-month stay if infringement litigation is initiated. They are, however, required to provide certain notices to the holder of the BLA for the reference product. As with generic products, the first applicant for a biosimilar version of a particular reference biologic is, however, entitled to a period of marketing exclusivity during which no other biosimilar based on the same reference product may be sold in the United States.

Because of the evolving nature of the approval process for biosimilars and the challenges associated with obtaining FDA approval for a biosimilar, competition from biosimilars is not yet the threat to biologic products as competition from generics is to traditional drugs. It seems inevitable that will

change, though, as regulators catch up with the science of biotechnology and manufacturers become more adept at replicating and manufacturing biosimilars. It therefore also seems inevitable that M&A practitioners will need to understand and keep up with this important and developing dimension of the life sciences industry in order to assist clients pursuing acquisitions of biotech targets in properly evaluating and planning for the likelihood and potential timing of biosimilar competition.

Licensing and Collaboration Agreements

In-licensing of intellectual property and product development collaborations in various forms are very common in the life sciences industry. Such arrangements can give rise to a range of considerations and traps for the unwary acquirer. Among other things, as part of due diligence, buyers and their counsel should assess the following in the context of in-licensing and collaborative development transactions:

- **Allocation of Rights.** Licensing and collaboration agreements often have elaborate provisions that allocate rights to develop and commercialize products using licensed or developed intellectual property and other resources between the parties. These provisions typically allocate rights based on both geographical territories and field of use (e.g., for particular therapeutic areas (like immunology) or particular diseases (like Hepatitis C)). Terms such as rights of first refusal and similar concepts that create the potential for an expansion or shifting of one party's rights may also be included. These provisions should be carefully reviewed to ensure that the buyer has a fulsome understanding of where and how a target's product or technology that is the subject of a licensing or collaboration arrangement may be exploited. An additional consideration is whether the counterparty could gain access to the buyer's preexisting IP after an acquisition, through a license grant that extends to the target's affiliates, for example.
- **Diligence Obligations Imposed on the Target.** Licensing and collaboration transactions commonly involve a requirement that the licensee or collaborator commit to exercise a certain level of diligence in carrying out its responsibilities under the collaboration, in respect of development activities, pursuing marketing approvals, or commercializing the product(s). Often these obligations are based on heavily negotiated definitions of "Commercially Reasonable Efforts" or "Reasonable Best Efforts." These may be either inwardly focused (e.g., a commitment to use a level of effort comparable to that which the party would use in relation to its other products) or outwardly focused (e.g., a commitment to use a comparable level of effort that participants in the industry would generally use in relation to a comparable

product). Buyers and their counsel should consider how these obligations will be construed post-closing. For example, would an inwardly focused diligence obligation pick up the efforts of buyer and its affiliates after an acquisition of the target? Is the diligence obligation consistent with buyer's intentions relating to the product or collaboration at issue? Perhaps buyer views a particular indication for which one of target's products is being developed as not commercially viable. The diligence obligations in the contract pursuant to which target has in-licensed that product may limit buyer's ability to abandon development of that indication. More generally, the status of target's relationship with its licensing and collaboration partners should be assessed. Such relationships are fertile ground for differing expectations and potential disputes, particularly when the stakes are higher for one party than the other or when one party is ceding significant control over an asset to the other party.

- **Non-Compete and Similar Limitations.** Non-competition, exclusive dealing, and similar covenants in licensing and collaboration agreements should be carefully assessed. Such covenants frequently either expressly bind affiliates (such that they could bind a buyer and its pre-closing affiliates) or establish protocols for dealing with competing products in which an acquirer may have an interest (such as mandating a divestiture of the competing product within some period after closing, or providing for a shifting of rights under the agreement if the product is not divested within the specified time period). Such terms warrant careful attention to ensure that buyer is not signing up to commitments that will have undesirable consequences for its existing products or business or result in loss or diminution of rights to a product that it is counting on retaining after the acquisition.
- **Change of Control and Assignment Provisions.** Licensing and collaboration agreements often include change of control clauses. Frequently, such clauses are highly negotiated and permit a counterparty to terminate the agreement or trigger a change in the contract terms if the buyer meets, or fails to meet certain criteria. For example, such provisions may be applicable in the context of an acquisition of the target company by a competitor of the collaboration partner or licensor; or they might come into play if the acquirer does not meet specified minimum financial criteria. Assignment clauses should also be carefully reviewed. Generally, an acquisition of a target company through a purchase of its equity or a merger or other statutory combination will not trigger a contractual prohibition on assignment unless the provision is crafted so as to deem such a transaction to be an assignment. Assignment clauses are much more important in the context of an asset purchase transaction. In the

IN-LICENSING OF INTELLECTUAL PROPERTY AND PRODUCT DEVELOPMENT COLLABORATIONS IN VARIOUS FORMS ARE VERY COMMON IN THE LIFE SCIENCES INDUSTRY. SUCH ARRANGEMENTS CAN GIVE RISE TO A RANGE OF CONSIDERATIONS AND TRAPS FOR THE UNWARY ACQUIRER.

context of a patent license agreement or a collaboration agreement involving a license to a third party collaborator's patents, it is important to remember that common law principles relating to assignment of contracts may be trumped by federal common law principles relating to transferability of patents. In many states, most contractual rights are assignable without consent absent an express contractual limitation to the contrary. In contrast, patent rights are generally not transferrable without the patentee's consent, such that if a contract does not expressly permit assignment of the contract, the license rights under the contract will likely not be assignable without consent.

Product Development Considerations

Bringing a new drug or biologic and certain types of medical devices to market is typically a very lengthy process fraught with legal and regulatory pitfalls. In addition to assessing the prospective market exclusivity the product is likely to enjoy once it is approved, there are a number of elements of the development process that acquirers and their advisors should be mindful of during the due diligence process, including the following:

- **Requisite Approvals.** Before a developer can begin clinical trials for a drug or biologic product involving human subjects, an investigational new drug application (IND) must be submitted to the FDA. Clinical studies of medical devices require a comparable filing called an investigational device exemption (IDE). Due diligence should include a review of target's open IND/IDE applications to ensure that ongoing clinical trials are being conducted in accordance with valid INDs/IDEs and that the target is adhering to the terms of such INDs and IDEs.

- **Contract Research Organizations.** Many companies engage third-party contract research organizations (CROs) to carry out clinical trials for their products. It is advisable to review the target's agreements with CROs to understand risk allocation provisions, insurance requirements, publication rights for investigators, and confidentiality obligations, among other things.
- **Confidentiality and Intellectual Property.** To the extent that third parties are involved in product development efforts, it is important to review agreements with those parties to ensure that they include appropriate confidentiality obligations and to assess the parties' respective rights to intellectual property arising from those efforts. It is also important to ensure that employees involved in the development of owned IP are subject to valid invention assignment agreements effectively assigning their rights in the underlying inventions to the target or have otherwise made such assignments.
- **Other Third-Party Rights and Obligations.** Many drug development processes do not begin and end exclusively within the control of the same party. Situations where development work has been transitioned to the target from another party or has been undertaken in collaboration with another party will require careful consideration.

Regulatory Obligations Relating to Marketed Products

Completing development and achieving FDA approval or clearance is in many ways just the beginning of a product's regulatory life. Life sciences companies are subject to a wide range of regulatory requirements specific to their products. It is important to involve regulatory specialists in any due diligence investigation of a life sciences target. A discussion of all the possible regulatory issues that can bear on a transaction is beyond the scope of this practice note; however, the following are among the more significant considerations:

- **Post-Marketing Commitments.** As part of its approval of a new drug or biologic product, the FDA will sometimes require an applicant to undertake additional "Phase IV" clinical trials or other studies to further assess the product's safety and efficacy, in specific populations or otherwise. It is important for buyers and their advisors to review such obligations and any reports to the FDA of their progress or outcome to understand what efforts and costs are involved and what implications their outcome may have for the product.
- **Labeling Requirements.** As part of a product's approval, the FDA will approve its label, which includes detailed prescribing information, warnings about side effects, contraindications, and other information. Once the product

is on the market, additional requirements can sometimes be imposed. For example, if there is a pattern of a particular serious adverse event occurring, the FDA may require that the manufacturer include a "boxed" warning highlighting that risk on the label. It is important to understand any such evolution in product labeling after its launch. The addition of a boxed warning after a product has been on the market suggests that there could be a basis for product liability claims associated with the side effect that had not previously been described or highlighted.

- **Risk Evaluation and Mitigation Strategies (REMS).** In situations where the FDA identifies a particular risk associated with a product that it determines cannot be sufficiently addressed with product labeling, it may direct the manufacturer to undertake a risk evaluation and mitigation strategy, or REMS, to mitigate such risk. REMS can take many different forms, and may involve medication guides or packaging inserts, a communications plan, elements to assure safe use (ETASU), an implementation system or some combination of these elements. REMS can become significant and costly commitments. In some cases, they can also pose an impediment to a product's commercial success. For example, ETASU elements can involve putting on physician training programs and certification programs for pharmacies, which can have the effect of limiting the community of those capable of prescribing the product and filling prescriptions. As part of due diligence, any REMS or potential REMS should also be carefully assessed.
- **Recalls, Market Withdrawals, Safety Alerts.** In circumstances where it is determined that specific quantities of products that have entered the market have been compromised or "adulterated" by virtue of a problem with the manufacturing process or otherwise, a manufacturer will typically undertake a recall or market withdrawal to remove the product from the marketplace. Usually the company takes such steps of its own volition, but in extreme cases, the FDA may direct that a recall or other corrective action be initiated. In circumstances where the FDA perceives a serious risk associated with a product, it will issue a safety alert that is posted to its web-based MedWatch adverse event reporting system and disseminated through other relevant channels. Buyers and their counsel should evaluate any recalls, market withdrawals, safety alerts, or similar events that a target company has experienced.

Product Liability

Product liability claims are, of course, a big concern for companies in the life sciences industry. Evaluating existing product liability claims and potential sources for future claims should be an important part of any due diligence effort for a

life sciences transaction. Where there is a history of claims or significant concern over future claims, it may be worthwhile to get the perspective of a product liability litigator as part of the diligence process. Things to consider include the following:

- **Nature of Past Claims.** To the extent the target has experienced product liability claims, do they relate to unrelated episodic issues or are they indicative of a more fundamental problem, such as a design flaw or systemic quality problem?
- **Class Actions.** Are any claims arising from similar circumstances likely to be aggregated into one or more class action suits?
- **Adverse Event Reporting.** Adverse event reporting should be reviewed with an eye toward identifying serious problems, or patterns of problems, with the target's products that could lead to claims. Particular attention should be paid to any serious or recurring adverse events that are not within the scope of the side effects or warnings contemplated on the relevant product's labeling.
- **Changes to Labeling.** Similarly, as noted above, a change or pending change to a product's label to include additional cautionary guidance could signal the possibility of claims associated with harm suffered by consumers of the nature addressed by the label change.
- **Misleading Statements.** Is there any indication that the target may have made misleading statements to the FDA in its application for approval of any of its products or otherwise in connection with the approval process? If so, such statements could support not only civil liability to injured consumers, but also potentially civil or criminal liability under the False Claims Act ([31 USCS § 3729](#)).
- **Insurance.** Consideration should be given to the target's insurance coverage for product liability claims, including its claims history.

Compliance

In addition to the regulatory hurdles that life sciences companies face in shepherding their products through the regulatory approval process and complying with product-focused regulations after approval, industry participants are also subject to extensive regulation of their operations. Various compliance regimes address a range of issues likely to be relevant to a target company, including how its sales force markets its products, its manufacturing operations, its pricing and price reporting in relation to different health care payers, and how it handles patient information. Non-compliance can be costly in terms of not only fines, but also restrictions on a target company's activities and increased regulatory oversight. Regulatory compliance matters a buyer should assess during due diligence include the following:

- **Sales Force Considerations.** One of the biggest sources of potential liability for a life sciences company is compliance missteps by its sales force. Among other potential problems, issues can arise in the form of:
 - submitting inaccurate government reimbursement forms, or causing or enabling healthcare providers to do so, which can lead to civil or criminal fraud claims and enforcement actions by federal and state regulators, including under the False Claims Act;
 - improper payments, benefits, or incentives to healthcare providers, which can lead to civil or criminal liability under the federal Anti-Kickback Statute ([42 USCS § 1320a-7b](#));
 - violations of the U.S. Foreign Corrupt Practices Act ([15 USCS § 78dd-2](#)) resulting from payments or gifts to foreign officials in order to obtain business or accommodations; and
 - promotion of products for "off-label" uses—uses for indications other than those for which the product has been approved—and use of unapproved promotional materials, all of which can lead to civil or criminal enforcement actions by regulators and civil lawsuits by consumers.

Due diligence of these kinds of compliance issues should include, among other things:

- an assessment of whether the target's sales force compensation structures give undue incentives for unlawful activities;
 - a review of any completed or pending regulatory investigations, enforcement actions, and lawsuits involving conduct of the target's employees;
 - a review of the policies and procedures and training programs the target company has in place for its sales force and other personnel;
 - an assessment of how the target has handled prior compliance problems;
 - an assessment of the target's compliance functions and their role and authority within the organization;
 - if the target uses a contract sales force, a review of the terms of its agreement with the provider; and
 - consideration of whether any identified deficiencies are "one-off" problems or indicative of a more widespread problem.
- **Requirements of Physician Payments Sunshine Act.** The Physician Payments Sunshine Act ([42 USCS § 18001](#)) imposes public reporting obligations on many life sciences companies in relation to any transfer of anything of value to physicians

or teaching hospitals. Disclosure must include the nature of the transferred items, the reason for the transfer, the identity of the recipient, and the reporting entity's product associated with the transfer. Non-compliance with these reporting obligations can result in the imposition of significant fines. Moreover, such required disclosure may reveal instances of violations or potential violations of the federal Anti-Kickback Statute or the False Claims Act, paving a smoother path for investigations and enforcement actions. Acquirers should carefully assess a target's policies and procedures for complying with these requirements, any instances of non-compliance, and the results of any compliance audit by the Department of Health and Human Services (the agency charged with enforcing these rules).

- **HIPAA Considerations.** The Health Insurance Portability and Accounting Act ([45 CFR 164.502](#)) (HIPAA) imposes stringent requirements for the handling of Protected Health Information or "PHI," as well as civil and criminal penalties for non-compliance. HIPAA and related privacy regulations are a significant area of concern for life sciences companies that are privy to health information of individuals, particularly as their requirements converge with the issues associated with data security in the era of "big data." Due diligence should include an assessment of:
 - the nature of PHI that has or may come into the target's possession, for example, in connection with clinical trials or by virtue of patient assistance programs;
 - the target's technological systems, policies, and procedures for handling and maintaining the security of PHI;
 - the findings of any internal or external audits that have been undertaken in respect of target's technological systems that process PHI and follow-up reports of steps taken to address any shortcomings identified; and
 - whether target has experienced any data breaches involving PHI and, if so, how they were handled.
- **Inspections.** The FDA carries out various types of inspections of facilities engaged in the manufacture of drugs, biologics, or medical devices. They can be routine or "for cause" and they can be narrowly focused or fulsome. An important part of due diligence is reviewing the reports of these inspections and particularly any notices of identified non-compliance with FDA requirements, which are reported on Form 483. To the extent that a manufacturer has received Form 483s, it is important to review subsequent communications between the company and the FDA to confirm that the identified problems were adequately resolved or are on a path to resolution. Form 483s are publicly available on the FDA's website. More serious issues or continued deficiencies can lead the FDA to issue a warning letter, which can be the

predicate to more serious enforcement action, including mandating the shut-down of a facility. Warning letters are also publicly available on the FDA's website.

- **Adverse Event Reporting.** Drug and biotech companies are obligated to implement systems to monitor adverse events involving their products that are reported to them and others with whom they do business. Once identified, the company must report the adverse event to the FDA Adverse Event Reporting System (FAERS). Medical device manufacturers are subject to a similar regime—medical device reporting (MDR)—in respect of malfunctions, deaths, and serious injuries involving their devices. The FAERS system is accessible to the public. Similarly, MDR reports are accessible through the FDA's Manufacturer and User Facility Device Experience (MAUDE) database. Due diligence should include a review of the nature and extent of adverse events reported in respect of the target's products on the FAERS system or MAUDE, as applicable. Extensive and/or a series of adverse events could signal a risk of product liability claims or regulatory action, such as a required labeling change. It is also important to evaluate a target's compliance with its adverse event reporting obligations as part of an overall assessment of the effectiveness of its compliance functions.
- **Settlements with Regulators.** In the highly regulated life sciences industry, it is not uncommon for participants to enter into settlement arrangements with regulators as part of the resolution of investigations or enforcement actions. Such settlements, which often take the form of Corporate Integrity Agreements (CIAs), can impose a range of different limitations or specific requirements on the company's operations, as well as increased regulatory oversight through audits and reporting obligations. Acquirers should carefully review the requirements imposed under settlements of regulatory investigations or claims, as well as the target's experience and performance under any CIA to which it may be subject. What policies and procedures have been implemented to comply with the requirements of the CIA? Has the target's compliance been audited? If so, what was the outcome? Counsel should also evaluate any implications the CIA or any other settlement may have on the target's ability to consummate the contemplated transaction.
- **New Frontiers.** In the current environment, as pharmaceutical and other life sciences companies search for new ways to expand their offerings and justify the cost of their products to payers, many are finding themselves enmeshed in new areas of regulation and, in some cases, finding that the regulatory landscape for some new products and services is undefined at best. For example, many companies are becoming involved in patient assistance and monitoring programs for patients using their products. Such programs

often give rise to questions of whether the company is practicing medicine or nursing within the meaning of state laws and whether additional licensing may be required. Many medical device companies are faced with a host of new issues associated with the wealth of data generated by biometric devices that access the Internet. Data privacy issues become particularly salient in that context. There are many other examples of changes like this that are resulting in a blurring of the boundaries between life sciences and healthcare, and giving rise to new regulatory questions and challenges that counsel should be mindful of.

Supply Chain

A functioning supply chain is part of the lifeblood of most life sciences companies. Manufacturers of not just finished products, but also active ingredients, excipients, and packaging components are subject to extensive FDA regulation. As a result, switching from one supplier to another is often not as simple as it would be in other industries. Switching suppliers, or even to a new facility of the same supplier, will often necessitate establishing the new site with the FDA as an approved supplier for the product or component involved, which can be a complicated and time consuming process. There can also be practical difficulties associated with transferring the technical process for producing a product or a component. Manufacturing antibodies for a complex biologic is often not something that is easily replicated by a new manufacturer in a new facility, for example. For these and other reasons, it is very important that due diligence in a life sciences M&A transaction include a careful review of the third-party relationships and agreements involved in the target's supply chain. Particular attention should be paid to the following:

- **Manufacturing and Supply Agreements.** Ideally, a target will have long-term supply agreements for any products that it does not manufacture itself and for key active ingredients and other components. The absence of agreements with any key suppliers should be flagged as a potential concern. For those manufacturing agreements that are in place, consideration should be given to terms dealing with, among other things:
 - exclusive purchase obligations, including the circumstances in which the target can obtain its requirements from another supplier and the supplier's obligations to assist in establishing an alternate supplier in that circumstance (or in anticipation of the possibility);
 - limitations on the supplier's ability to supply competitors with the same or comparable products;
 - the parties' respective obligations for assessing conformity of the supplied product or material with specifications and

the target's recourse in the event supplier supplies non-conforming product;

- obligations to maintain safety stock to mitigate the effect of any supply disruption;
 - term and renewal provisions; and
 - termination rights, particularly in the context of a change of control.
- **Quality Agreements.** Although not strictly required by U.S. law, the FDA has made clear that it expects drug and biologic companies to have in place quality assurance agreements with their suppliers setting out the parties' respective obligations for ensuring compliance with good manufacturing practices. Due diligence should include a determination of whether the target has entered into suitable quality agreements with each of its suppliers and if it hasn't, why not.
 - **Audits of Suppliers.** Life sciences companies often have the right to audit their suppliers and to receive copies of reports of audits by the FDA and other regulators. Reports of internal or governmental audits can reveal concerns with suppliers and are therefore another useful item to include in a due diligence review.

Conclusion

Life sciences companies and their products are subject to a variety of legal issues and regulatory regimes that are distinct from those in other industries. In order to conduct an effective due diligence exercise for an acquisition in the life sciences sector, it is important for counsel to understand the product-specific and enterprise-level considerations described in this article. **L**

Reb Wheeler is a partner at Mayer Brown LLP and is global co-chair of the firm's Life Sciences industry group. His practice focuses on mergers & acquisitions, joint ventures, private equity, securities, and other transactional matters. Reb has extensive experience advising participants in the pharmaceutical, biotech, and medical device sectors, ranging from new ventures and investors to some of the world's largest pharmaceutical and biotech firms.

 **LEXIS PRACTICE ADVISOR RESEARCH PATH:** [Mergers & Acquisitions > M&A by Industry > Life Sciences M&A](#)

Lexis Practice Advisor subscribers may view Mergers & Acquisitions/Life Sciences content by following this [link](#).



Robert N. Rapp CALFEE, HALTER & GRISWOLD, LLP

“Regulation A-Plus”

Limited Public Offerings under Securities Act Section 3(b)(2)

ON JUNE 19, 2015, U.S. SECURITIES AND EXCHANGE COMMISSION (SEC) rules implementing congressionally-mandated amendments to Section 3(b) of the [Securities Act of 1933](#) to modernize Regulation A under the Act, and launching “Regulation A-Plus,” became effective. The maximum permitted offering amount under Regulation A was raised from \$5 million to \$50 million, and significant changes to the regulatory structure for these limited public offerings were made. “Regulation A-Plus” is the characterization commonly applied to the reformulated Regulation A that is now covered by SEC rules adopted pursuant to Section 3(b)(2) of the Securities Act, which was added by the Jumpstart Our Business Startups Act (the JOBS Act) ([112 P.L. 106](#)). The rules provide for two tiers of offerings under updated and expanded Regulation A: Tier 1, for offerings of securities up to \$20 million in a 12 month period; and Tier 2, for offerings up to \$50 million in a 12 month period. Certain basic requirements are applicable to both Tiers, although for Tier 2 offerings there are additional disclosure and ongoing reporting requirements. Distinctions between the two include investment limitations and the application of state Blue Sky Laws.

Since the June 19, 2015 effective date for Regulation A-Plus, representatives of the Office of Small Business Policy of the SEC Division of Corporate Finance report more than forty issuers have filed Offering Statements or private draft Offering Statements, as now permitted under Regulation A-Plus. Several other filings have been withdrawn. To date, three have been declared qualified by the SEC. Others remain pending in the review process. Where applicable, the offering process includes review and qualification requirements under state Blue Sky Laws for those Regulation A-Plus offerings that are still



subject to state registration and qualification requirements, and for which the North American Securities Administrators Association (NASAA) “Coordinated Review Process” among states is now operating.

The JOBS Act and Securities Act Section 3(b)(2)

In Section 401 of the JOBS Act, Congress mandated the creation of a new exemption from registration requirements under the Securities Act for public offerings of up to \$50 million of securities within a 12-month period. The JOBS Act amended what was formerly Section 3(b) of the Securities Act (now Section 3(b)(1)), which establishes authority of the SEC to exempt offerings of securities up to \$5 million, to add a new Section 3(b)(2), directing the SEC to adopt rules exempting offerings up to \$50 million of securities offered and sold publicly, where certain disclosure requirements are met, and on such other terms, conditions, and requirements as the SEC may prescribe. “Regulation A,” a limited exemption for

public offerings of small issues adopted by the SEC pursuant to longstanding original Section 3(b) authority in 1936, had shown itself over time to be of little use to small business issuers when costs and complexity of the offering process were weighed against the limited amount of capital permissibly raised. Indeed, original Regulation A virtually disappeared from the capital formation landscape.

Although preserving general SEC small-issue exemption authority for offerings up to \$5 million in what is now Section 3(b)(1) of the Securities Act, Congress added Section 3(b)(2), directing the SEC, by rule or regulation, to add a class of securities exempted from registration under the Securities Act when the aggregate offering amount of all securities offered and sold within the prior 12-month period in reliance on the exemption does not exceed \$50 million. While generally authorizing the SEC to set the terms, conditions, and requirements it deems necessary in the public interest and for the protection of investors, Congress expressly prescribed the following for what is now commonly referred to as “Regulation A-Plus”:

- The securities may be offered and sold “publicly.”
- The securities shall not be restricted securities within the meaning of the federal securities laws and SEC rules.
- The civil liability provision in Section 12(a)(2) of the Securities Act shall apply to any person offering and selling the securities.
- The issuer may solicit in the offering prior to filing any offering statement, on such terms as the SEC may require.
- The SEC shall require the issuer to file audited financial statements annually.

Section 3(b)(2) limits Regulation A-Plus to the offer and sale of equity securities, debt securities, and debt securities convertible or exchangeable to equity interests, including any guarantees of those securities. The \$50 million maximum aggregate offering amount is to be reviewed by the SEC every two years, and *shall* be increased in such amount as the SEC determines to be appropriate. In the event the SEC determines not to increase the offering amount, it must report to designated House and Senate committees its reasons for not increasing the amount. Although not mandated by Section 3(b)(2), the SEC is expressly authorized to include among terms, conditions, or requirements for modernized Regulation A offerings: (1) a requirement for filing and use by issuers of an “offering statement” and related documents; and (2) “bad actor” disqualification provisions that are substantially similar to those in place for exempt private offerings pursuant to Rule 506 of Regulation D under the Securities Act. The SEC is also expressly authorized to require ongoing periodic disclosures

**TO SATISFY THE JOBS ACT
MANDATE IN SECTION 3(B)(2)
OF THE SECURITIES ACT,
THE SEC SET ABOUT TO CRAFT
A REVISION OF EXISTING
REGULATION A THAT WOULD
PROMOTE SMALL COMPANY
CAPITAL FORMATION WHILE
PROVIDING FOR MEANINGFUL
INVESTOR PROTECTION.**

regarding the issuer, its business operations, financial condition, corporate governance, use of investor funds, and other matters deemed appropriate.

Regulation A-Plus “Tier 1” and “Tier 2” Offerings

To satisfy the JOBS Act mandate in Section 3(b)(2) of the Securities Act, the SEC set about to craft a revision of existing Regulation A that would promote small company capital formation while providing for meaningful investor protection. On March 25, 2015, the SEC adopted rules to create two “tiers” of offerings: *Tier 1*, for offerings up to \$20 million (including no more than \$6 million on behalf of selling security holders) in a 12 month period; and *Tier 2*, for offerings up to \$50 million (including no more than \$15 million on behalf of selling security holders) in a 12 month period. In certain circumstances, including a first time offering by the issuer pursuant to Regulation A, the portion of the aggregate offering price attributable to selling security holders may not exceed 30% of the aggregate offering price of the Regulation A offering. Baseline requirements for both Tiers build on former Regulation A, and preserve, with some modifications, provisions regarding issuer eligibility, offering circular requirements, “testing the waters,” and “bad actor” disqualifications. Tier 2 offerings are subject to additional requirements in line with the Section 3(b)(2) mandates, including provisions for audited financial statements, ongoing reporting obligations, and certain limitations on sales. State securities law registration and qualification requirements for securities offered and sold in Tier 2 offerings to “qualified purchasers” are preempted. Tier 1 offerings remain subject to both federal and state registration and qualification requirements. The rules became effective on June 19, 2015.

Eligible Issuers

The issuer of securities to be offered and sold pursuant to either Tier 1 or Tier 2 of Regulation A must be an entity organized under the laws of the United States or Canada, or any State, Province, Territory or possession, or the District of Columbia, with its principal place of business in the United States or Canada, and which:

- Is not subject to reporting requirements under Sections 13 or 15(d) of the Securities Exchange Act of 1934, as amended, before the offering;
- Is not a development stage (“blank check”) company that either has no specific business plan or purpose, or has indicated that its business plan is to merge with an unidentified company or companies;
- Is not an investment company registered or required to be registered under the Investment Company Act of 1940, as amended (the “Investment Company Act”), or a business development company as defined in the Investment Company Act;
- Is not issuing fractional undivided interests in oil or gas rights, or any similar interest in other mineral rights;
- Has filed all reports it was required to file with the SEC, if any, during the two years before the offering, or for such shorter period that the issuer was required to file such reports;
- Is not, and has not been, subject to an order of the SEC denying, suspending, or revoking the registration of a class of securities pursuant to Section 12(j) of the Exchange Act that was entered within five years before the filing of the Regulation A offering statement;
- Is not subject to any “bad actor” disqualification, as discussed further below.

“Bad Actor” Disqualification

Bad actor disqualifications from use of Regulation A-Plus align with the provisions in Rule 506(d) of Regulation D, with the added disclosure requirement applicable to both Tier 1 and Tier 2 offerings that the issuer include in the Offering Circular a description of any matters that would have triggered disqualification, but which occurred prior to the effective date of the rule. Covered persons include managing members of limited liability companies, compensated solicitors of investors, underwriters, executive officers, and other officers participating in the offering, as well as beneficial owners of 20% or more of the issuer’s outstanding voting securities, calculated on the basis of voting power. Bad actor disqualifications from Regulation A also include, as triggering events, final orders or bars of certain state or federal regulators, and SEC cease-and-

desist orders relating to violations of scienter-based antifraud provisions of the federal securities laws or Section 5 of the Securities Act of 1933.

The Offering Process

The offering process for either Regulation A-Plus Tier 1 or Tier 2 offerings centers on the electronic filing with the SEC of an “Offering Statement” on Form 1-A. The key part of the Offering Statement is an “Offering Circular,” a narrative disclosure document. Except for solicitation communications, discussed below, no offer of securities may be made until the Offering Statement is filed. Thereafter, oral offers may be made, as well as written offers by means of solicitation communications meeting certain conditions, or a “Preliminary Offering Circular,” described further below. However, no sales of securities may be made until the issuer’s Offering Statement has been “qualified” by the SEC. Key elements of the offering process are summarized further below.

(1) Solicitation of Interest (“Testing the Waters”). At any time before the qualification of an Offering Statement, including before the non-public submission or public filing of the Offering Statement, an issuer or any person authorized to act on behalf of the issuer may solicit interest in a potential offering. Solicitation materials are made subject to the antifraud provisions of the federal securities law, and certain conditions apply. The communications must state that no money or other consideration is being solicited, and if sent in response, will not be accepted, and also that no offer to buy the securities will be accepted until the Offering Statement is qualified. The communication must also state that a person’s indication of interest involves no obligation or commitment of any kind. When used after the Offering Statement is publicly filed, the communication must either include the Preliminary Offering Circular or state from whom the most recent version of the Preliminary Offering Circular may be obtained, including contact information. This requirement may be satisfied by providing the uniform resource locator (URL) where the Preliminary Offering Circular, or the Offering Statement itself, may be obtained. The communication may include a means by which a person may indicate interest in the potential offering.

(2) The Offering Statement. Issuers must electronically file an Offering Statement with the SEC through the EDGAR System. The Offering Statement content is prescribed by Form 1-A under the Securities Act, and consists of three parts. Part I serves as a notice of certain basic information about the issuer and the offering, and helps confirm the availability of the exemption. Part II is the Offering Circular, a narrative disclosure document, which includes financial statements as required. Part III is comprised of required exhibits. Importantly, an issuer whose securities have not previously been sold

pursuant to a Regulation A offering or an effective registration statement under the Securities Act may submit a *draft Offering Statement* for non-public review by the SEC staff before public filing. Draft Offering Statements must also be submitted electronically through EDGAR. Provision for submission of draft Offering Statements is intended to allow a preliminary assessment of content and identification of staff concerns that could delay or prevent qualification of the offering when publicly filed.

(3) Financial Statement Requirements. Financial statements for Tier 1 and Tier 2 issuers include a balance sheet and related financial statements for the previous two fiscal years (or such shorter period as the issuer may have been in existence), which are dated not more than nine months before the date of non-public submission, filing, or qualification, with the most recent annual or interim balance sheet not older than nine months. Where interim financial statements are necessary, they must cover a period of at least six months. The financial statements of Tier 2 issuers must be audited in accordance with U.S. GAAP or the standards of the Public Company Accounting Oversight Board.

(4) The Offering Circular and Preliminary Offering Circular. Issuers in Regulation A-Plus offerings have always been required to utilize a structured disclosure document, the Offering Circular, containing information specified by Form 1-A. That requirement is preserved for offerings of either Tier under Section 3(b)(2) of the Securities Act. As with prospectuses in a registered offering, the Offering Circular for Regulation A offerings is the core of the Offering Statement filed with the SEC. The Offering Circular covers numerous categories of information about the issuer and the offering, and more closely aligns Regulation A disclosure with the smaller reporting company disclosure requirements for registered offerings, but with some specifically scaled elements. Also, for Tier 2 offerings, issuers are required to include audited financial statements.

After the Offering Statement is filed, but prior to its qualification by the SEC, issuers may offer the securities utilizing a Preliminary Offering Circular. The document must be identified as a Preliminary Offering Circular and include a prescribed legend highlighted by prominent type or otherwise stating, among other things, that the securities may not be sold, nor may offers to buy be accepted, before the Offering Statement filed with the SEC is qualified. The Preliminary Offering Circular must contain substantially the information required in the Offering Circular by Form 1-A, although certain pricing and related information may be omitted. It is filed with the SEC as part of the Offering Statement. Issuers that offer to prospective purchasers in reliance on the delivery of a Preliminary Offering Circular must, not later than two business

days after completion of a sale, provide the purchasers with a copy of the final Offering Circular, or a notice containing the URL where the final Offering Circular or the Offering Statement in which the final Offering Statement is contained, may be obtained.

(5) Investment Limitation. For Tier 2 offerings, investment limitations are imposed for sales to natural persons who are not accredited investors, as defined in Rule 501(a) of Regulation D. No sale may be made to a non-accredited purchaser if the aggregate purchase price paid for the securities is more than 10% of the greater of such purchaser's annual income and net worth, also as provided in Rule 501 of Regulation D. Issuers may rely on the representation of compliance by the purchaser, provided that the issuer does not know at the time of sale that any such representation is untrue. There is no investment limitation on sales to accredited investors. The investment limitations in a Tier 2 offering will not apply to the sale of securities that will be listed on a national securities exchange upon qualification. There are no investment limitations in Tier 1 offerings, which remain subject to regulation under state Blue Sky Laws.

(6) Integration with Other Offerings. For either Tier 1 or Tier 2 offerings, an integration safe harbor is provided, such that a Regulation A offering will not be integrated with:

- Any prior offers or sales of securities;
- Any subsequent offers and sales of securities that are:
 - (i) registered under the Securities Act; or (ii) made in reliance on Rule 701 of the Securities Act (offers and sales of securities pursuant to compensatory benefit plans or contracts relating to compensation); or (iii) made pursuant to an employee benefit plan; or (iv) made in reliance on Regulation S under the Securities Act; or (v) made pursuant to Section 4(a)(6) of the Securities Act (Crowdfunding); or (vi) made more than six months after completion of the Regulation A offering.

If none of the safe harbor criteria apply, whether subsequent offers and sales of securities will be integrated with the Regulation A offering will depend on particular facts and circumstances and application of long-established factors for determining whether offers and sales of securities should be integrated that are identified, for example, in Rule 502 of Regulation D.

(7) Insignificant Deviations from a Term, Condition, or Requirement. A failure to comply with a term, condition, or requirement for either Tier 1 or Tier 2 offerings will not result in a loss of the exemption from registration requirements under the Securities Act for any offer or sale to a particular individual or entity if the issuer establishes that: (1) the failure to comply did not pertain to a term, condition, or requirement

THE CONGRESSIONALLY MANDATED MODERNIZATION OF REGULATION A WAS INTENDED TO BREATHE NEW LIFE INTO A CAPITAL FORMATION ALTERNATIVE THAT HAD BEEN VIRTUALLY ABANDONED. IN ITS REINCARNATED FORM, REGULATION A-PLUS REMAINS A LESSER REGULATED FORM OF REGISTERED PUBLIC OFFERING, BUT ONE NONETHELESS INVOLVING MEANINGFUL COMPLIANCE BURDEN AND EXPENSE ON AN ON-GOING BASIS.

directly intended to protect that particular individual or entity; (2) the failure to comply was insignificant with respect to the offering as a whole, except that a failure to comply with certain baseline provisions such as issuer eligibility requirements and the offering amount limitations of Regulation A will be deemed to be significant to the offering as a whole; and (3) a good faith attempt was made to comply with all applicable terms, conditions, and requirements.

Periodic Reporting

Although issuers utilizing Regulation A-Plus for Tier 1 offerings do not become subject to Securities Exchange Act of 1934 periodic reporting requirements, and Tier 2 issuers may not become subject to those requirements if certain conditions are satisfied, all Tier 2 are subject to annual (Form 1-K) and semiannual (Form 1-SA) reports, as well as current event updates (Form 1-U), all of which are filed electronically with the SEC. Issuers may also be required to provide “special financial reports” to investors on either Form 1-K or 1-SA in the event that the Offering Statement did not contain audited financial statements covering certain time periods between the time the financial statements are included in Form 1-A and the issuer’s first periodic report due after qualification of the offering statement. Issuers conducting Tier 2 offerings exit the Regulation A reporting requirements at such time as they become subject to the Exchange Act reporting requirements. Also, Tier 2 issuers eligible to exit the ongoing reporting requirement may do so at any time by filing a Form 1-Z Exit Report after completing reporting for the fiscal year in which the offering statement was qualified, provided the securities to which the Offering Statement filed with the SEC are held of record by less than 300 persons (1,200 persons for a bank or bank holding company), and that the issuer has filed all reports due for a prescribed period of time before filing Form 1-Z, and offers and sales made in reliance on a qualified Offering Statement are not ongoing.

Issuers in Tier 1 offerings are not subject to any ongoing reporting requirements, other than the requirement to report the completion or termination of the offering on Form 1-Z.

Preemption of State Blue Sky Laws

Historically, Regulation A offerings were fully subject to registration and qualification requirements under state securities laws in the absence of an available exemption. That remains the case for Tier 1 offerings under Regulation A-Plus, which are perceived as a category of securities that is likely to be more local in character. However, for Tier 2 offerings, which are seen as involving a category of securities that is more national in character, state registration and qualification requirements are preempted to the extent that the securities are offered or sold on a national securities exchange, or are offered or sold to “qualified purchasers,” as that term is defined by the SEC. The preemption is made complete, however, as a result of adding Rule 256 ([17 CFR 230.256](#)) to Regulation A, defining “qualified purchaser” for purposes of National Securities Markets Improvement Act of 1996 (NSMIA), Securities Act section 18(b)(3), to include *any purchaser of a security in a Tier 2 offering*. NSMIA makes the offer and sale of any security to a qualified person, as the SEC shall define, into a NSMIA “covered security,” for which any state registration and qualification requirements are preempted. For Tier 2 offerings, although state registration and qualification requirements are preempted, state securities regulators retain antifraud enforcement authority and the authority to impose notice filing and fee requirements. As noted above, state authority over Tier 1 offerings, including registration and qualification requirements, remains fully applicable. Importantly, for those offerings NASAA has developed and implemented a “Coordinated Review Process” to streamline state review.

Two states, supported by NASAA, have challenged the Tier 2 state preemption provisions of Regulation A-Plus as improper

rulemaking by the SEC. Their challenge currently remains unresolved in the U.S. Court of Appeals for the D.C. Circuit.

Regulation A-Plus Utility?

When adopting the final rules for implementing Regulation A-Plus, the SEC recognized that its potential use for Tier 2 offerings will “depend largely on how issuers perceive the trade-off between costs of qualification and ongoing disclosure requirements and the benefits to issuers from access to a broad investor base, expansion of the offering size, and preemption of state securities law registration requirements and the potential for enhanced secondary market liquidity.” For Tier 1 offerings, obviously the costs attributable to state regulation must be added to the calculus, and the maximum offering amount limitation weighs more heavily in the decision to proceed under Regulation A versus alternative avenues in capital formation. Although a number of issuers have begun the Regulation A-Plus limited public offering filing and SEC review process, with only one of them so far qualified and several withdrawn, there is no evidence yet whether the trade-off will actually prove beneficial. Although Regulation A-Plus is a central feature of the JOBS Act, business start-ups raising seed capital will almost certainly look elsewhere to available true exemptions from registration and qualification requirements.


The JOBS Act focus on facilitating access to capital by business start-ups is clearly manifested in the changes to Rule 506 of Regulation D under the Securities Act of 1933, which permit general solicitation and advertising for sales of securities to accredited investors, and in the mandate for national crowdfunding. Although final rules implementing congressionally mandated national crowdfunding are not yet in place, an increasing number of states have adopted intrastate equity crowdfunding exemptions in their Blue Sky Laws or rules which, subject to limitations that largely mimic federal JOBS Act crowdfunding limitations and requirements, likely offer more practical, cost efficient small business capital raising alternatives than Regulation A-Plus. Critics of Regulation A-Plus argue that it does nothing meaningful to facilitate small business capital formation because of high costs, and because Tier I offerings remain subject to registration and qualification requirements under State Blue Sky Laws. Actual small business issuers, they argue, are no better off.

The congressionally mandated modernization of Regulation A was intended to breathe new life into a capital formation alternative that had been virtually abandoned. In its reincarnated form, Regulation A-Plus remains a lesser regulated form of registered public offering, but one nonetheless involving meaningful compliance burden and expense on an on-going basis. On that basis, some commentators have observed that Regulation A-Plus is

unlikely to provide any meaningful relief to small business issuers facing the challenge of efficient capital raising. It may, on the other hand, be attractive to larger, well-established private or semi-private companies that, for example, can look to Regulation A-Plus to raise debt capital, and for second stage financing in general. The array of issuers with Regulation A-Plus offering statements currently filed does not yet suggest an emergent user profile. The offering for which the first qualification of a Regulation A-Plus offering was granted is a Tier I offering of “Participation Interests” representing undivided fractional interests in the principal amount of loans made by the company for real estate projects. The issuer previously offered and sold various forms of securities in private placements or in reliance on other exemptions from federal and state registration requirements.

The current Tier I Regulation A-Plus offering, to be carried out by the issuer itself through a web-based platform, has been undertaken using the NASAA Coordinated Review Program, and company management has publicly endorsed the process. That said, an ultimate assessment of the utility of Regulation A-Plus for Tier 1 offerings by small business issuers will await more empirical evidence, although Tier II may well prove to be attractive relative to the costs when Blue Sky regulation is removed from the calculus. **L**

Bob Rapp is Senior Counsel in the Securities and Capital Markets Group of Calfee, Halter & Griswold, LLP, and is Distinguished Practitioner In Residence at the Case Western Reserve University School of Law, where he teaches Securities Regulation, Advanced Securities Regulation, and Law, Theory and Practice in Financial Markets.

 **LEXIS PRACTICE ADVISOR RESEARCH PATH:** [Securities & Capital Markets > State Securities Regulations - Blue Sky Laws > Blue Sky Laws > Practice Notes > “Regulation A-Plus” Limited Public Offerings under Securities Act Section 3\(b\)\(2\)](#)

Lexis Practice Advisor subscribers may view additional Blue Sky content by following this [link](#).

Breia L. Schleuss and Rachael Dettmann Spiegel FAEGRE BAKER DANIELS LLP

FDA Releases First Two Rules under the **Food Safety Modernization Act**



THE FOOD SAFETY MODERNIZATION ACT (FSMA) REPRESENTS one of the most sweeping and substantial changes to U.S. food safety laws in over 70 years. After years of delays in publishing final rules, the U.S. Food and Drug Administration (FDA) must adhere to court-ordered deadlines to release final rules throughout 2015 and 2016. The first two of these rules were released by the FDA on August 31, 2015. Compliance with the new rules is expected within one year, depending on the size of the company. Non-compliance with the FSMA's final rules may lead to significant business impacts for food and feed companies and may also increase risk to secured lenders in the food and feed industry.

What is the FSMA?

Following a number of large food safety outbreaks, some resulting in death, the FSMA was signed into law in January 2011. FDA Food Safety Modernization Act, Pub. L. No. 59-384, 124 Stat. 3885 (2011) (codified in scattered sections of 21 U.S.C.). It should be noted, for purposes of the FSMA, and throughout

this article, that the term “food” encompasses both human food and animal food.

The FSMA is broadly aimed at addressing three issues: (1) prevention of food safety outbreaks, (2) detecting and responding to food safety outbreaks, and (3) improving the safety of imported foods. The FSMA fundamentally shifts the FDA from being a reactionary agency—waiting for a food safety outbreak to occur before responding—to an agency focused on prevention—detecting and preventing food safety problems before they cause public harm. Before the FSMA, the FDA lacked authority to order a mandatory food recall. Under the FSMA, the FDA can now order a food safety recall and even shut down a facility if food poses a reasonable probability of causing a serious food safety outbreak. In addition, facilities will be subjected to more frequent FDA inspections, and FDA inspectors will have access to company food safety records.

A company that is affected by a recall or that has had its facility registration revoked by the FDA may suffer significant

and immediate costs, particularly if the company is unable to shift production to a different registered facility or cannot quickly obtain regulatory (and vendor) approval for the sale of its products after the recall has been managed. As a result, a company may need increased working capital very quickly (whether in the form of a bridge loan, an incremental term loan, or an accordion increase in its revolving line of credit), at the very time that its lender may be reassessing the risk profile of the company.

In addition, a foreclosing lender that has a lien on the company's assets may be unable to sell the food and feed products that have been subject to the recall, and no person—including a foreclosing lender—may sell or otherwise introduce into commerce any products that were produced during the time when a facility's registration has been revoked by the FDA. This may pose some very real consequences to a lender that has been viewing that collateral as a source of repayment, particularly at a time when a company may not have sufficient cash flow to repay the lender.

As a result, food and feed companies—and their lenders—should carefully consider a company's operations. Specifically, they could consider whether the company is adopting a risk-based hazard analysis plan in accordance with the FSMA to protect against the company's identified risks, whether the company has multiple registered facilities to which the company can shift production if needed, and whether the company has suffered material recalls in the past or has otherwise been identified by the FDA as having "high risk" products or facilities. Each of these items is discussed below.

Which food and feed companies are affected by the FSMA?

Congress intended the FSMA to strengthen food safety practices throughout the food and feed manufacturing supply chain. The FSMA impacts food manufacturers, animal feed manufacturers (including even ethanol facilities manufacturing co-products sold as animal feed), distributors, processors, foreign suppliers, certain storage facilities, and those that transport food or feed products. The FSMA also regulates growers of fruits and vegetables. It does not affect retail grocery stores or restaurants, nor does it cover processors of meat, poultry, and processed egg products—which are regulated by the U.S. Department of Agriculture's food safety requirements.

What will the first round of rules encompass? Although the FDA has been keen to solicit as much industry feedback as possible on the proposed rules, due to a court order, the FDA is now required to release final rules for the seven primary FSMA regulations throughout 2015 and 2016. The first two (and most significant) of these rules, concerning Preventive Controls for Human Food and Preventive Controls for Animal

Feed, were released August 31, 2015, in compliance with a court order. However, given the size and breadth of the initial rules, publication in the Federal Register is still pending. Both final rules will solidify requirements for covered entities' food safety plans. All but the smallest businesses will need to comply with these two rules within one year after they are released.

The FSMA and these two final rules will require each covered food facility (depending on the size of operation) to establish a safety program that should include, among other things:

- a hazard analysis and risk-based preventive control plan, which requires facilities to identify all known and reasonably foreseeable potential hazards and, if any of those hazards are significant, develop preventive controls sufficient to provide assurance that the food or feed will not be adulterated or misbranded;
- procedures for following good manufacturing practices (GMPs);
- a recall plan;
- environmental sampling and controls;
- allergen controls and labeling; and
- supplier verification and management.

Although preventive controls are not new to the food and feed industry—many companies employ similar methods already—the FSMA and these two final rules will broaden the scope of preventive controls regulated by the FDA and provide the FDA with significant enforcement powers. In addition, a "Qualified Individual" must now be engaged by a facility to prepare and oversee implementation of its food safety plan. Under the preventive control rules, a Qualified Individual is anyone who has undergone specialized training or who possesses relevant work experience to develop a food safety plan. A Qualified Individual may, but is not required to be, an employee of the facility. Each of the foregoing components of a food and feed safety program (including the engagement of a Qualified Individual and that individual's training) will need to be documented. For example, the FSMA requires that a hazard analysis and risk-based preventive control plan include procedures for product testing as appropriate to the facility, the food or the feed, and the nature of the preventive control. Product testing in and of itself, however, is insufficient; the FSMA also requires the facility to have written procedures for product testing, written corrective action procedures, and records of product testing. Food and Drug Administration, "Proposed Rule: Current Good Manufacturing Practice and Hazard Analysis and Risk-Based Preventive Controls for Human Foods," 21 CFR Parts 1, 16 and 117, Docket No. FDA-2011-N-0920 (2011). If the product testing is not documented, a facility will not be in compliance.

Considerations for Lenders

The FSMA and its final rules have three central tenets—prevention, inspection, and response—each of which may have important implications for secured lenders and their collateral.

Prevention and Documentation

The FDA's new focus on prevention and risk-based analysis should align nicely with a lender's interest in extending credit to companies that effectively identify and manage potential risks to the company's inventory and operations. Cf. Office of the Comptroller of the Currency, Bank Supervision Process: Comptroller's Handbook 18–19 (Sept. 2007) (describing "Supervision by Risk" and explaining that "[e]xaminers determine whether the risks a bank assumes are warranted by assessing whether the risks are effectively managed, consistent with safe and sound banking practices"). For example, the final rules for Preventive Controls for Human Food and Preventive Controls for Animal Feed will likely require companies to identify and evaluate all known and reasonably foreseeable biological, chemical, physical, and public health hazards associated with food or feed safety, and then evaluate those hazards to determine whether they are significant. "Significant hazards" will, under the final rules, likely require mitigation through adoption of hazard controls. These hazard controls and other preventive policies required by the FSMA may result in companies adopting expanded risk management policies for the protection of food and feed products, which may protect inventory (and thus, in some cases, a lender's collateral) from some risks.

A company's risk management policy is often requested by a lender when the lender is underwriting a loan. As a result of the FSMA, a lender could expand its request to ask for copies of the company's hazard analysis and risk-based preventive control plan, recall plan, and other documentation. A lender will not be in a position to comment on the sufficiency of any such plan or documentation, but the request may at a minimum initiate a conversation between the lender and the company as to whether the company is aware of the FSMA, whether the company believes it is subject to the FSMA, how the company is interpreting the FSMA, and (perhaps most importantly) the potential significant food and feed safety hazards identified by the company. Lenders might consider including failures to implement and follow hazard controls or other FSMA plans as events of default in the relevant loan documents.

Similarly, the FSMA and its final rules require companies to maintain extensive records, all of which must be provided to the FDA upon written or oral request. See, e.g., 21 U.S.C. § 350c (2012). Records must be maintained with respect to a company's monitoring, any episodes of material noncompliance, any corrective actions, and its verifications

**THE FDA NOW HAS ENHANCED
ENFORCEMENT AUTHORITY UNDER THE
FSMA. THE FDA CAN DETAIN FOOD OR
FEED PRODUCTS IF THE FDA HAS REASON
TO BELIEVE THAT FOOD OR FEED IS
ADULTERATED OR MISBRANDED...
THE FDA CAN ALSO ISSUE A
MANDATORY RECALL WHEN A COMPANY
FAILS TO VOLUNTARILY RECALL
UNSAFE FOOD OR FEED PRODUCTS
AFTER BEING ASKED TO DO SO.**

of efficacy of its preventive controls. A lender could—either in connection with a lender's underwriting due diligence or as part of an ongoing reporting covenant under the loan documentation—request disclosure of any recalls, any episodes of material non-conformance with the FSMA, any corrective actions taken by the company at any time, and copies of any correspondence with the FDA as a result of any of the foregoing. Evidence of frequent or material recalls or non-compliance might lead a lender to further investigate the nature of the food or feed products, the operations at the company's facilities, whether to adjust any borrowing base advance rates with respect to those food or feed products or associated receivables, or whether to add a reserve under the calculation of any borrowing base.

Inspection and Compliance

In addition to requiring companies to maintain extensive documentation, the FSMA provides the FDA with enhanced authority to inspect facilities. As a result of the FDA's finite budget, however, the FDA is focusing its inspection resources on those facilities and food or feed products that the FDA (in coordination with the USDA and the U.S. Department of Health and Human Services (HHS)) determine are "high risk." See, e.g., 21 U.S.C. § 350j (2012). The FDA intends to inspect each high risk facility at least once by 2016, and at least every three years thereafter. The FDA also intends to inspect other facilities at least once by 2018, and at least every five years thereafter. A lender could expand its reporting covenants under its loan documentation to require copies of any inspection reports, any FDA warning letters received by the company, and any corrective action plans. These inspection reports and other documents may supplement inspections or collateral audits that the lender may already be conducting.

When underwriting a loan, a lender could also ask a company to disclose whether any of its facilities or food or feed products has been identified as “high risk” by the FDA, USDA, or HHS. In addition, the loan documentation could incorporate a representation that, except as disclosed, neither the borrower nor any of its facilities or products has been identified by a governmental authority as a “high risk” facility or product. A “high-risk” facility or product may not necessarily be excluded from a borrowing base or from a lender’s collateral, but a “high-risk” identification may provide the lender with additional information about a company, its operations, or its products when the lender is structuring (or restructuring) its loan.

The general “compliance with laws” representations and covenants made by a company under its loan documentation could also be expanded to have the company represent that it is in compliance with the FSMA, the company’s own policies and procedures that it implemented to minimize the risks of food and feed contamination, and any corrective action plans that it enacted in response to any contamination or inspection report received by the company from the FDA.

FDA Enforcement Powers

While preventive controls required by the FSMA are designed to prevent future food or feed contaminations, hazards still exist. When issues arise, the FDA now has enhanced enforcement authority under the FSMA. The FDA can detain food or feed products if the FDA has reason to believe that food or feed is adulterated or misbranded; normally such an administrative detention lasts no longer than twenty days. The FDA can also issue a mandatory recall when a company fails to voluntarily recall unsafe food or feed products after being asked to do so. See, e.g., 21 U.S.C. § 350l (2012). Mandatory recalls are rare, as most companies will voluntarily recall products upon their own initiative or upon request by the FDA.

The FDA can now also suspend a facility’s registration if the FDA determines that the food or feed poses a reasonable probability of serious adverse health consequences or death to humans or animals. See, e.g., 21 U.S.C. § 350d (2012). If a registration is revoked, no person can sell “or otherwise introduce” into commerce products that were produced during the period of suspected contamination. 21 U.S.C. § 350d(b)(4) (2012). Violations may lead to penalties, imprisonment, and fines. Accordingly, notwithstanding any security interest that

a lender may have on the food or feed products, neither the company nor any foreclosing lender may be able to sell any product produced at the facility during this time. The value of any such collateral, and associated receivables, may effectively be reduced to zero—at the time the collateral is needed most. Whether the company has another facility and, if so, whether production can be shifted to the other facility during this time, could be of critical importance to the continued operations of the company.

The lender may also have a lien on the facility itself. Any owner, operator, or agent in charge of a facility engaged in manufacturing, processing, packing, or holding food or feed products must register the facility with the FDA and comply with the facility registration requirements. A lender may not want to foreclose on its lien and become the owner, operator, or agent in charge of a facility that has had its registration revoked by the FDA, depending on the steps and resources that may be needed to reinstate such registration before the facility can again be operable.

As a result of the enhanced enforcement powers given to the FDA under the FSMA, a lender may want to expand the reporting covenants and the events of default under its loan documentation to specifically require notice of and, where material, provide for an event of default upon the occurrence of any administrative detention, recall, or suspension of registration.

Bottom Line

Compliance with the FSMA and its final rules requires companies to invest additional time and expense for training, hazard analyses, policy implementation, equipment upgrades, and capital improvements for infrastructure changes. In return for this investment, the FDA, the food and feed companies and, indirectly, their lenders may benefit from increased information and preventive inventory and operational controls. When food safety issues do arise, however, the FDA’s expanded enforcement authority narrows a lender’s options with respect to potentially contaminated or misbranded food or feed product. **L**

***Breia L. Schleuss** is a banking and finance attorney, and **Rachael Dettmann Spiegel** is a food litigation and regulatory attorney, both of whom practice within the food and agriculture industry group at **Faegre Baker Daniels LLP**.*



Michael R. Overly FOLEY & LARDNER LLP

Drafting and Negotiating Effective Cloud Computing Agreements

Cloud computing involves accessing a provider's software and infrastructure remotely and often includes storing the customer's data with that provider. To that end, cloud computing agreements have some similarity to traditional software licensing agreements, but often have more in common with hosting or application service provider agreements. As such, the most critical issues and concerns that arise with hosting and application service provider agreements are equally applicable to cloud computing agreements.

IN A TRADITIONAL SOFTWARE LICENSING or hardware purchase engagement, the provider installs the software or equipment in the customer's environment. The customer can have the software or hardware configured to meet its particular business needs and retains control over its data. In a cloud computing environment, the software, hardware, and the customer's data are hosted by the provider, typically in a shared environment (i.e., many customers per server), and the software and hardware configuration is much more homogeneous across all customers. Accordingly, the customer's top priorities shift from configuration, implementation, and acceptance to service availability, performance (i.e., service levels), and data security and control. However, like a traditional software licensing agreement or hardware purchase agreement, provisions such as insurance, indemnity, intellectual property, limitations of liability, and warranties remain important.

Key issues to consider when drafting and negotiating cloud computing agreements include:

- Service availability
- Service levels
- Data – security, redundancy, ownership and use rights, and conversion
- Insurance
- Indemnification
- Intellectual property
- Limitation of liability
- Implementation
- Fees
- Term
- Warranties
- Publicity and use of the customer's trademarks
- Assignment
- Post-execution ongoing provider assessment
- Final risk assessment

Service Availability

A customer needs to continue to operate its business and have access to its data at all times. The customer must ensure that it has the proper contractual protections to address the various risks relating to service availability.

The customer may have no or limited access to the provider's services (which may be supporting a critical business function) and, perhaps more importantly, no access to its data stored on the provider's systems if the provider stops delivering services to the customer, perhaps due to

- a server being down,
- the failure of a telecommunications link,
- a natural disaster causing damage to the provider's data center,
- the provider withholding services because of a fee dispute, or
- the provider closing its business because of financial difficulties.

Service Levels

Appropriate service levels are needed to ensure that service availability is aligned with the customer's expectations, and should be delineated in the agreement. Also, the appropriate remedies should be available to ensure that the provider is incentivized to perform in accordance with the agreed-upon service levels. See Service Levels later in this article for uptime service level and the corresponding remedies.

Customer Data

Appropriate data protection provisions should be included in the agreement, including a provision that explicitly specifies the customer's ownership of any information stored by the provider for the customer, and a provision that requires the provider to (1) perform regular data backups to an off-site storage facility and (2) either deliver periodic copies of all data to the customer or provide the customer ongoing access to such data. See Data – Security, Redundancy, Ownership and Use Rights, and Conversion later in this article for data ownership and redundancy in more detail.

Disaster Recovery and Business Continuity

Customers should include disaster recovery and business continuity provisions requiring the provider to demonstrate and promise that it can continue to make the services available even in the event of a disaster, power outage, or similarly significant event. In the event of a prolonged outage, continuity of services should be provided through a secondary server, data center, or provider, as appropriate.

Too often the customer does not request these provisions or, even if it does, it does not read the actual provider policies and

procedures. The customer should review any related provider policies and procedures, and obtain contractual assurance regarding disasters and continuity. A sample provision of what the customer should ask of the provider is below.

Provider shall maintain and implement disaster recovery and avoidance procedures to ensure that the Services are not interrupted during any disaster. Provider shall provide Customer with a copy of its current disaster recovery plan and all updates thereto during the Term. All requirements of this Agreement, including those relating to security, personnel due diligence, and training, shall apply to the Provider disaster recovery site.

IN ANY CLOUD COMPUTING AGREEMENT, THE CUSTOMER SHOULD REQUEST A GENERAL PROVISION PROHIBITING THE PROVIDER'S WITHHOLDING OF SERVICES. THE PROVIDER SHOULD NOT WITHHOLD SERVICES BECAUSE OF A FEE DISPUTE.

Withholding of Services

In any cloud computing agreement, the customer should request a general provision prohibiting the provider's withholding of services. The provider should not withhold services because of a fee dispute. An example provision is provided below.

Provided Customer continues to timely make all undisputed payments, Provider warrants that during the Term of this Agreement it will not withhold Services provided hereunder, for any reason, including but not limited to a dispute between the parties arising under this Agreement, except as may be specifically authorized herein.

Bankruptcy; Financial Wherewithal

Typically, an agreement may include a provision providing the customer the right to terminate the Agreement in the event of a provider bankruptcy, and include a separate provision requiring the provider to assist in transitioning the services to a third party provider or to the customer in the event of expiration or termination of the Agreement. However, once the provider has declared bankruptcy, the provider's ability to assist the customer will be limited.

If a customer is not confident of a provider's financial stability, the customer should consider adding a provision that enables the customer to identify issues in advance. For example, a provision requiring the provider to deliver periodic reports on its financial condition enables the customer to assess ahead of time whether the provider will be able to continue to provide services. If the customer identifies any issues, it has an opportunity to take the appropriate action to minimize any negative impact. Provided below is a sample provision.

Quarterly, during the Term, Provider shall provide Customer with all information reasonably requested by Customer to assess the overall financial strength and viability of Provider and Provider's ability to fully perform its obligations under this Agreement. In the event Customer concludes that Provider does not have the financial wherewithal to fully perform as required hereunder, Customer may terminate this Agreement without further obligation or liability by providing written notice to Provider.

In-House Software Solution

In the event that a provider stops providing infrastructure services, the customer may be able to switch to another third party provider with comparable services or purchase the required equipment to replace the infrastructure services. However, the provider's software services may be unique and more difficult to replace. Therefore, for critical applications provided as a service, the customer should consider requiring the provider to make available or develop an in-house solution. A simple example of such a provision is below.

Customer may desire to license from Provider the necessary software and other technology (the "In-House Solution") to directly provide, maintain, and host the Software and related Services from Customer internal facilities or those of its agents. Customer may, in its discretion, elect to license the In-House Solution at the end of the Initial Term or any Renewal Term. In such event, after transition to the In-House Solution, the hosted portion of the Services shall terminate and the fees adjusted accordingly. Nothing in this Agreement, however, will be deemed or interpreted as a commitment on the part of Customer to deploy the In-House Solution.

The inclusion of this provision is very much dependent on the nature of the software provided as a service. The more critical the application, the more important it becomes that the provider be required to develop a long term in-house solution.

Service Levels

One of the most critical aspects in drafting and negotiating a cloud computing agreement is establishing appropriate service levels in relation to the availability and responsiveness of the services. Because the software and infrastructure are hosted by

the provider, outside the control of the customer, service levels fulfill two main purposes:

1. Service levels assure the customer that it can rely on the services in its business and provide appropriate remedies if the provider fails to meet the agreed service levels.
2. Service levels provide agreed-upon benchmarks that facilitate the provider's continuous quality improvement process and provide incentives that encourage the provider to be diligent in addressing issues.

The most common service level issues that the customer should address are:

- uptime,
- service response time,
- simultaneous visitors,
- problem response time and resolution time,
- data return, and
- remedies.

Uptime Service Level

The provider must provide a stable environment where the services are available to the customer at least during the customer's normal business hours, if not 24/7. Thus, the provider should agree that the services will have an uptime, or availability, of a certain percentage, during certain hours, measured over an agreed-upon period. An example of this type of provision is:

Provider will make the Services Available continuously, as measured over the course of each calendar month period, an average of 99.99% of the time, excluding unavailability as a result of Exceptions, as defined below (the "Availability Percentage"). "Available" means the Services shall be available for access and use by Customer. For purposes of calculating the Availability Percentage, the following are "Exceptions" to the service level requirement, and the Services shall not be considered Un-Available, if any inaccessibility is due to: (i) Customer's acts or omissions; (ii) Customer's internet connectivity; and (iii) Provider's regularly scheduled downtime (which shall occur weekly, Sundays, from 2 am – 4 am central time).

The specific service level targets depend on the facts and circumstances of each case, including the relative leverage during negotiation. Customers should not simply accept the default provider positions on uptime percentages, measurement periods, and exceptions, but should instead negotiate terms that address the customer's business needs. A customer should carefully consider the outage measurement window (e.g., daily, monthly, quarterly). Providers tend to

want longer measurement periods because they dilute the effects of a downtime, and thus make remedies less available to the customer.

As part of the SLA (service level agreement) obligations under the cloud computing agreement, customers should receive written documentation of a provider's scheduled downtime and ensure the window creates no issues for the customer's business. Customers may also request the provider be proactive in detecting downtime by explicitly requiring the provider to constantly monitor the "heartbeat" of all its servers through automated "pinging." This requirement should allow the provider to know very quickly that a server is down without having to wait for a notice from the customer.

The concept of "unavailability" should also include severe performance degradation and inoperability of any service feature. See Service Response Time Service Level below.

Service Response Time Service Level

The response time service level is closely related to and often intertwined with the uptime service level. The response time service level sets forth maximum latencies and response times for a customer's use of the services. Services that fail to provide timely responses to its users are effectively unavailable. As with the uptime service level, the specific service level target depends on the facts and circumstances of each case, including the complexity of the transaction, the processing time required, and how critical speed is to achieving the customer's business objectives.

For example, if a customer is accessing services over an Internet connection, then it should set the service level in terms of the Keynote Business 40 Internet Performance Index, which measures the average download time for 40 important business websites. This index is designed to provide a real-world means of assessing the impact of using the Internet to access information at well-known sites. Since certain areas of the Internet may be operating more slowly than others (e.g., because of heavy traffic or technical issues), the index is designed to take the average of response times using test sites set up over the country. This provides a better representation of response times, in general, of known websites. However, if the services are accessed over a leased line, then the Keynote Business 40 Internet Performance Index should be replaced with some other measure or by imposing a response time requirement measured at the provider's external router.

An example provision for a response time service level is:

The average download time for each page of the Services, including all content contained therein, shall be within the lesser of (i) 0.5 seconds of the weekly Keynote Business 40 Internet Performance Index (KB40) or (ii) two (2) seconds.

In the event the KB40 is discontinued, a successor index (such as average download times for all other customers of Provider) may be mutually agreed upon by the parties.

If the provider does not commit to a service response time service level, then the customer should ask that the provider at least share its history of response time measurements. The customer should also establish some ongoing management of risk in this area, such as conducting an end user satisfaction survey and requiring the provider to take action to improve any dissatisfaction with respect to service response.

Simultaneous Visitors Service Level

If the customer expects the services to support many simultaneous users, which is usually the case, then a service level should be included to explicitly specify such requirement. The customer should conduct an assessment and calculate the average number of users that it expects to use the service at any one time. That number could be a few dozen or tens of thousands. You should write the service levels to ensure that the provider's services are capable of supporting that number of users while still achieving all service levels.

Problem Response Time and Resolution Time Service Levels

The customer must include in the agreement the provider's obligation to timely resolve service level issues. Providers often include only a response time measurement, meaning the time period from when the problem is reported to when the provider notifies the customer and begins working to address the issue. These obligations typically fall short of what is necessary. Customers should include a resolution time measurement, meaning the time period from when the problem is reported to when the provider implements a fix or acceptable workaround.

Data Return Service Level

For services involving a critical business function or sensitive customer information, the customer should also add a service level that measures the time period between the customer's request for data and the provider's return of such data. This incentivizes the provider to deliver the customer data in accordance with those time-frame requirements, and provides additional assurance to the customer that it will be able to operate in the event that the provider stops providing services.

Remedies

Typically, remedies for failure to hit a service level start out as credits toward the next period's service. For example, a remedy might provide: for every X increment of downtime below the agreed-upon level in the measurement period, or for every Severity Level 1 support issue that the provider does not resolve within the stipulated time, the customer receives a credit of 5% of the next month's bill, up to a maximum credit of 75%.

The remedies should scale such that if repeated failure occurs, the customer should have the right to terminate the agreement without penalty and without having to wait for the current term to expire. Such a provision may read:

In the event the Services are not Available 99.99% of the time but are Available at least 95% of the time, then in addition to any other remedies available under this Agreement or applicable law, Customer shall be entitled to a credit in the amount of \$_____ each month this service level is not satisfied. In the event the Services are not Available at least 95% of the time, then in addition to any other remedies available under this Agreement or applicable law, Customer shall be entitled to a credit in the amount of \$_____ each month this service level is not satisfied. Additionally, in the event the Services are not Available 99.99% for (a) three (3) months consecutively or (b) any three (3) months during a consecutive six (6) month period, then, in addition to all other remedies available to Customer, Customer shall be entitled to terminate this Agreement upon written notice to Provider with no further liability, expense, or obligation to Provider.

Data – Security, Redundancy, Ownership and Use Rights, and Conversion

Ensuring customer ownership of its data, addressing the provider's use of such customer data, and safeguarding the security and confidentiality of customer data are very important in a cloud computing agreement. The provider should deliver details regarding, and agree to reasonable provisions addressing, its competency and its policies and procedures related to

- protection against security vulnerabilities,
- data backups,
- the use of customer data, and
- data conversion.

Data Security

The need for data security is obvious. A cloud computing provider may possess a customer's most sensitive data, including data that may be subject to state and federal regulations (e.g., personally identifiable financial and healthcare information). Loss of such data or unauthorized disclosure of the data is a significant concern. The customer is ultimately accountable for complying with applicable regulations, regardless of where the data is stored. Indeed, data breaches are costly for an organization. For a more detailed discussion on data breaches, Lexis Practice Advisor subscribers see [Planning for & Managing a Data Breach](#).

Customers must be mindful of the unique data security issues that arise in a cloud computing environment. For example, in

an ASP environment, a single physical server may be dedicated to the customer for hosting the application and storing the customer's data. However, in a cloud computing environment, technologies and approaches used to facilitate scalability, such as virtualization and multi-tenancy, may be stored on a physical server that is shared among the provider's customers, which may increase the risk of unauthorized disclosure.

Some data security risks can be managed by carefully considering the type of data that will be processed under a cloud solution. The customer should determine whether the cloud solution under consideration aligns with the data's sensitivity level. For example, general market research has a lower sensitivity level than trade secret information or data comprising personally identifiable information. Even if the data transmitted is not highly sensitive, it is always good practice to review the provider's data protection controls and reference those controls in the cloud service agreement.

To address data security issues, customers should determine

- the location of the data center where the data will be physically stored and who may have access to the data,
- the operator of the data center, and
- the provider's security practices.

Any cloud computing agreement should include specific contractual protections relating to data and information security.

Location of the Data Center

Data centers located in foreign countries may

- reduce or eliminate the customer's opportunity to inspect the location to ensure it complies with its information security requirements or
- dictate the jurisdiction and law governing the data. For example, personally identifiable information located in Europe may be governed by European law, regardless of the contract terms. This is a concern even if the data center is located in the United States, but help desk personnel, for example, access the data from a foreign country with limited security and privacy laws.

The customer should consider adding a restriction against offshore work and data flow to foreign countries, including a requirement that the data center (including the hosted software, infrastructure, and data) be located and the services be performed in the United States, and that no data be made available to those located outside the United States.

Operator of the Data Center

The customer should also identify the operator of the data center. If the provider is not operating the data center itself

(e.g., the provider is the owner of the software and will be providing support, but is using a third party data center to host the software), then the provider should be required to

- ensure that the third party host complies with the terms of the agreement (including the data security requirements),
- accept responsibility for all acts of the third-party host, and
- be jointly and severally liable with the third-party host for any breach by the third-party host of the agreement.

The customer should consider entering into a separate confidentiality and non-disclosure agreement with the third party host for the protection of the customer's data. Additionally, if the provider ever desires to change the host, the provider should be required to provide the customer advance notice, and the customer should be given time to conduct due diligence with regard to the security of the proposed host and the right to reject any proposed host.

Provider's Security Practices

Providers should be required to provide specific details in the agreement regarding baseline security measures, security incident management, and hardware, software, and security policies. These details should be reviewed by someone competent in data security – either someone within the customer's organization, a data security attorney, or a third party consultant. The provider's policies should address security risks particular to cloud computing, and services being delivered over the Internet and accessible through a Web browser (e.g., security risk relating to Adobe Flash that allows hackers to upload malicious Flash objects and launch attacks on users).

Some providers will not distribute copies of their security policies but will allow customers to come to the provider's site and inspect them. Such policy inspection should be done if the customer information at issue is very sensitive or mission-critical. A customer should compare the provider's policies to its own, and in fact, many customers demand the provider match the customer's policies. The customer should also consider verifying the provider's capabilities via a physical visit or SSAE 16 (IT internal controls audit) conducted by a third party, or both. It is becoming far more expected that providers regularly demonstrate to their customers that their security controls remain intact and robust.

Consider the following sample of a typical data security provision:

- **In General.** Provider will maintain and enforce safety and physical security procedures with respect to its access and maintenance of Customer Information that are (1) at least equal to industry standards for such types of locations, (2) in accordance with reasonable Customer security requirements,

and (3) which provide reasonably appropriate technical and organizational safeguards against accidental or unlawful destruction, loss, alteration, or unauthorized disclosure or access of Customer Information and all other data owned by Customer and accessible by Provider under this Agreement.

- **Storage of Customer Information.** All Customer Information must be stored in a physically and logically secure environment that protects it from unauthorized access, modification, theft, misuse, and destruction. In addition to the general standards set forth above, Provider will maintain an adequate level of physical security controls over its facility. Further, Provider will maintain an adequate level of data security controls. See Exhibit A for detailed information on Provider's security policies protections.
- **Security Audits.** During the Term, Customer or its third party designee may, but is not obligated to, perform audits of the Provider environment, including unannounced penetration and security tests, as it relates to the receipt, maintenance, use, or retention of Customer Information. Any of Customer's regulators shall have the same right upon request. Provider agrees to comply with all reasonable recommendations that result from such inspections, tests, and audits within reasonable time frames.

The cloud computing agreement should require that if a breach of security or confidentiality occurs, and it requires notification to the customer's customers or employees under any privacy law, then the customer should have sole control over the timing, content, and method of such notification. The agreement should also provide that if the provider is culpable for the breach, then the provider must reimburse the customer for its reasonable out-of-pocket costs in providing the notification.

You should further consider whether the cloud provider can meet discovery obligations and litigation holds in the event that the data held by the service provider is requested in connection with a lawsuit or investigation. If so, the agreed-upon process should be in the agreement.

Data Redundancy

Because the customer relies on the provider as the custodian of its data, the customer should demand that the cloud computing agreement contain explicit provisions regarding

- the provider's duty to back up customer data and the frequency of that backup, and
- the customer's ongoing access to such data or the delivery of such data to the customer on a regular basis.

A good place to start is for the customer to compare the provider's backup policies to its own and make sure they are

at least as stringent. Below is a sample provision addressing these obligations:

Provider will: (i) execute (A) nightly database backups to a backup server, (B) incremental database transaction log file backups every 30 minutes to a backup server, (C) weekly backups of all hosted Customer Information and the default path to a backup server, and (D) nightly incremental backups of the default path to a backup server; (ii) replicate Customer's database and default path to an off-site location (i.e., other than the primary data center); and (iii) save the last 14 nightly database backups on a secure transfer server (i.e., at any given time, the last 14 nightly database backups will be on the secure transfer server) from which Customer may retrieve the database backups at any time.

Data Ownership and Use Rights

The customer must clarify that it owns all data stored by the provider for the customer. In the event that the provider stops providing services and the customer requests the return of its data, there should be no dispute as to ownership of the data that resides on the provider's servers.

Because the provider will have access to, and will be storing, the customer's sensitive information, the agreement should contain specific language

- regarding the provider's obligations to maintain the confidentiality of such information and
- placing appropriate limitations on the provider's use of such customer information (i.e., confirming that the provider has no right to use such information except in connection with its performance under the cloud computing agreement).

Many cloud computing providers want to analyze and use the customer data that resides on their servers for their own commercial benefit; in particular, they are interested in the data customers create as they use the services. For example, the provider may wish to use the customer's data, aggregated along with other customers' data, to provide data analysis to industry groups or marketers. The provider may suggest that it will limit its use to de-identified customer data, and that such use is similar to Internet "cookies" that follow where a user goes and what a user does.

In the cloud, however, the customer data is proprietary and confidential to the customer and its business, and the customer should consider such use of any of its data very carefully. Most customers should conclude that the provider should not have any right to use the customer's data, whether in raw form, aggregated, or de-identified, beyond what is strictly necessary to provide the services. However, commercial use might be acceptable where the provider provides a service that directly depends on the ancillary use of such data, such as aggregating

customer data to provide data trending and analysis to the customer and similarly situated customers within an industry. If the agreement is silent as to the provider's use of customer data, the customer should discuss such uses with the provider and add a provider representation about which uses, if any, are permitted.

Data Conversion

Data conversion, both at the onset and termination of the cloud computing agreement, must be addressed to avoid hidden costs and being "locked in" to the provider's solution. When entering the relationship, the customer should confirm that its data can be directly imported into the provider's services or that any data conversion needed will be done at the provider's cost or at the customer's cost (with the customer's agreement). A customer should consider conducting a test run of the provider's mapping scheme to see how easy or complicated it will be (likewise when checking the provider's references, a customer should ask about data migration experiences). Lastly, the customer does not want to be trapped into staying with the provider because of data format issues. To that point, the agreement should include explicit obligations on the part of the provider to return the customer's data, both in the provider's data format and in a platform-agnostic format, and thereafter destroy all of the customer's information on the provider's servers, all upon expiration or termination of the agreement.

Here is a sample provision to illustrate this obligation:

At Customer's request, Provider will provide a copy of Customer Information to Customer in an ASCII comma-delimited format on a CD-ROM or DVD-ROM. Upon expiration of this Agreement or termination of this Agreement for any reason, Provider shall (a) deliver to Customer, at no cost to Customer, a current copy of all of the Customer Information in the form in use as of the date of such expiration or termination and (b) completely destroy or erase all other copies of the Customer Information in Provider's or its agents' or subcontractors' possession in any form, including but not limited to electronic, hard copy, or other memory device. At Customer's request, Provider shall have its officers certify in writing that it has so destroyed or erased all copies of the Customer Information and that it shall not make any use of the Customer Information.

Insurance

The customer should always address insurance issues in cloud computing situations, both as to the customer's own insurance policies and the provider's insurance. Most data privacy and security laws hold the customer liable for a security breach, whether it was the customer's fault or the provider's fault. Thus, the customer should help self-insure against IT risks, including those related to data and privacy issues, by obtaining a cyber-liability policy.

Cyber liability insurance can protect the customer against a wide range of losses. Most cyber insurance policies cover damages arising from unauthorized access to a computer system, theft or destruction of data, hacker attacks, denial of service attacks, and malicious code. Some policies also cover privacy risks like security breaches of personal information, may apply to violations of state and federal privacy regulations, and may provide reimbursement for expenses related to the resulting legal and public relations expenses.

Requiring the provider to carry certain types of insurance enhances the likelihood that the provider can meet its obligations and provides direct protection for the customer. The primary forms of liability insurance that a provider should be required to carry are

- technology errors and omissions liability insurance and
- a commercial blanket bond, including electronic and computer crime or unauthorized computer access insurance.

These types of insurance will cover damages the customer or others may suffer as a result of the provider's professional negligence or intentional acts by others (the provider's employees, hackers, etc.).

It is critical that the customer require that the provider have these sorts of policies and not just a general liability policy. Many commercial general liability policies contain a professional services exclusion that precludes coverage for liability arising from IT services as well as other exclusions and limitations that make them largely inapplicable to IT-related risks. The customer should also consider requiring the provider to list the customer as an additional insured on its policies; doing so allows the customer to go directly against the provider's insurance company in the event of a claim.

Indemnification

The provider should agree to defend, indemnify, and hold harmless the customer and its affiliates and agents from any claim where the provider breaches its confidentiality and data security obligations. Any intentional breach should be fully indemnified, protecting the customer from out-of-pocket costs or expenses related to recovery of the data and compliance with any applicable notice provisions or other obligations required by data privacy laws. In the event the data breach is not intentional, the provider may require a cap on its potential liability exposure, which may be reasonable depending on the type of customer data in question.

The provider should also agree to defend, indemnify, and hold harmless the customer and its affiliates and agents from any claim that the services infringe the intellectual property rights of any third party. This protects the customer

from out-of-pocket costs or expenses if some third party claims infringement.

Providers often try to limit the intellectual property indemnification only to infringement of copyrights. That is not acceptable, as many infringement actions arise out of patent or trade secret rights. The indemnity should extend to infringement claims of any "patent, copyright, trade secret, trademark, or any other proprietary rights of a third party." In addition, customers should avoid any restriction to patents "issued as of the Effective Date" of the agreement. Providers usually also limit the indemnification to "United States" intellectual property rights, which may be acceptable if the customer will not use the services outside of the United States. Regardless, the customer should consider whether its use of the services will occur overseas.

Intellectual Property

The customer must understand the impact of intellectual property rights on its business. If the provider will be performing significant implementation services (e.g., extensive software or hardware installation, configuration, or customization services) in connection with the cloud computing services, the intellectual property ownership structure proposed by a provider may not effectively address the customer's business needs. If the provider's intellectual property is incorporated into the work product delivered to the customer, then such provider intellectual property may be embedded in the customer's business processes as a result. This could encumber the customer's business by creating uncertainty about the customer's rights to such processes on which the business depends. Therefore, the customer should obtain ownership of any work product and a very broad license to use any provider intellectual property incorporated into any work product, so that it can retain sole control of the direction of its business and each of its underlying processes.

Even where significant implementation services are not being provided, and the customer is merely providing direction as to configurable screens that will be used by the customer, the customer should realize the potential impact on its business. As a provider may benefit from such ideas provided by the customer, the customer should consider adding a restriction against the provider using those same ideas in services delivered from the provider to any of the customer's competitors.

Limitation of Liability

The provider's limitation of liability is very important in a cloud computing engagement because virtually all aspects of data security are controlled by the provider. Thus, the provider should not be allowed to use a limitation of liability clause to

unduly limit its exposure. A fair limitation of liability clause must balance the provider's concern about unlimited damages with the customer's right to have reasonable recourse in the event of a data breach or other incident.

A provider's limitation of liability clause usually (1) limits any liability to the customer to the amount of fees paid under the agreement or a portion of the agreement (e.g., fees paid for the portion of the services at issue) and (2) excludes incidental, consequential (e.g., lost revenues), exemplary, punitive, and other indirect damages. While a customer may not be able to eliminate the limitation of liability in its entirety, it should ask for the following concessions:

- The limitation of liability should apply to both parties. The customer should be entitled to the same protections from damages that the provider is seeking.
- The following should be excluded from all limitations of liability and damages: (1) breach of the confidentiality and security provision by either party, (2) claims for which the provider is insured, (3) the parties' respective third party indemnity obligations, (4) either party's infringement of the other party's intellectual property rights, and (5) breach of the advertising/publicity provision. See [Publicity and Use of the Customer's Trademarks](#) section of *Drafting and Negotiating Effective Cloud Computing Agreements*.
- The overall liability cap (usually limited to fees paid) should be increased to some multiple of all fees paid (e.g., two to four times the total fees paid or the fees paid in the 12 months prior to the claim arising). The customer should keep in mind that the overall liability cap should not apply to the exclusions in the bullet point above.

Implementation

In the event significant implementation services are being provided, the definition of "services" in a cloud computing agreement should be broadly worded to capture all of the services being provided. For example:

"Services" shall mean Provider's provision of software and infrastructure services described in Exhibit A (Software and Infrastructure Services) and implementation services described in Exhibit B (Implementation Services), and any other products, deliverables, and services to be provided by Provider to Customer (i) described in a Statement of Work, (ii) identified in this Agreement, or (iii) otherwise necessary to comply with this Agreement, whether or not specifically set forth in (i) or (ii).

A broad definition of services limits the provider's claims of "out of scope" activity and requests for additional money.

In addition, the customer must fully understand its requirements and the capabilities of the services being

provided to determine if any additional features or functionality are needed. Any additional work required to support such features or functionality should be discussed and identified up front, as typically a cloud computing offering may have more limited configuration and customization options (e.g., multi-tenant application) in order for the provider to more efficiently manage the services and provide a more scalable solution. Any additional work agreed upon to support such features or functionality should be included in the description of services.

Fees

Typically, a cloud computing service is offered on a "pay-as-you-go" or "pay-per-use" cost structure (e.g., per virtual machine each hour, per gigabyte of storage each month, per active user each month). Accordingly, the agreement should provide for the ability to both add and remove resources, with a corresponding upward and downward adjustment of the service fees. The customer should negotiate rates for incremental and decremental use before signing the agreement, and should attempt to lock in any recurring fees for a period of time (one to three years). Thereafter an escalator based on a cost performance index (CPI) or other third party index should apply.

In addition, the customer should identify all potential revenue streams and make sure that the identified fees are inclusive of all such revenue streams. For example, the provider may attempt to charge additional fees for additional storage after a certain amount of data, or additional fees for software updates. The customer should ensure that these are included as part of the negotiated fees.

Term

Because the software and infrastructure are provided as a service, like any service, the customer should be able to terminate the agreement at any time without penalty upon reasonable notice (14 to 30 days). The provider may request a minimum commitment period from the customer to recoup the provider's "investment" in securing the customer as a customer (i.e., sales expenses and related costs). If the customer agrees, then the committed term should be no more than one year and the provider should produce evidence of its up-front costs to justify such a requirement.

Warranties

Beyond the warranties discussed above, there are other warranties that are typically included in a cloud computing agreement.

The provider should represent and warrant the following:

- The services will materially conform to the specifications and, to the extent not inconsistent with the specifications, provider's documentation.

- All services will be provided in a professional, competent, and timely manner by appropriately qualified provider personnel in accordance with the agreement and consistent with the provider's best practices.
- The provider will provide adequate training, as needed, to the customer on the use of the services.
- The services will comply with all federal, state, and local laws, rules, and regulations.
- The customer's data and information will not be shared with or disclosed in any manner to any third party by the provider without first obtaining the express written consent of the customer.
- The services will not infringe the intellectual property rights of any third person.
- The services will be free from viruses and other destructive programs.
- There is no pending or threatened litigation involving the provider that may impair or interfere with the customer's right to use the services.
- The provider has sufficient authority to enter into the agreement and grant the rights provided in the agreement to the customer.

Publicity and Use of the Customer's Trademarks

The customer's reputation and goodwill are substantial and important assets. This reputation and goodwill are often symbolized and recognized through the customer's name and other trademarks. Accordingly, every agreement should contain a provision covering any announcements and publicity in connection with the transaction. The provider should be prohibited from distributing any media releases or making other public announcements relating to the agreement, or otherwise using the customer's name and trademarks without the customer's prior written consent.

Assignment


The customer should be able to assign its rights under the agreement to its affiliates and other entities, which may become successors or affiliates due to a reorganization, consolidation, divestiture, or the like. To address any concerns the provider has about such an assignment, the customer can require any assignee to accept all of the customer's obligations under the agreement. Similarly, the customer should obtain assurance that any provider assignee will agree to be bound by all of the terms and conditions of the agreement, including without limitation, service level obligations.

Post-Execution Ongoing Provider Assessment


It is recommended that the customer and provider agree to implementation of a regular program of evaluating the provider's performance, under which the provider would be required to supply the requisite information to assess the services, notify the customer of any changes with regard to the provider, and provide any recommendations to improve the services. The customer could then use this information to perform ongoing risk assessments, and determine whether to continue the provider relationship.

Final Risk Assessment

If the customer has substantial leverage when negotiating a cloud computing agreement, then it should seek to obtain the protections described above. However, in circumstances where the customer does not have such leverage, providers may be resistant to such protections and any modification of its form contract provisions. Therefore, it may not be realistic to expect that the customer can obtain all of the protections listed above.

The customer must then evaluate the business risks, including whether the services support a critical business function, involve sensitive customer information, or are customer-facing. If the customer is not able to obtain the level of protection needed in the most significant areas of risk, then it should consider walking away from the transaction. If walking away is not an acceptable option, then the customer needs to focus on risk mitigation. For example, if the provider refuses to modify its uptime service level, arguing that it cannot separately administer such a service level for different customers, then the customer should negotiate improved remedies and exit rights for a failure of such service level. In this type of situation, where a customer is unable to obtain the appropriate contractual protections and chooses to proceed, the post-execution ongoing assessment of the provider relationship described above becomes even more important. For a sample cloud computing agreement, see [Cloud Computing Service Agreement \(Pro-Customer\)](#). 

Michael R. Overly is a partner and intellectual property lawyer with *Foley & Lardner LLP*.

 **LEXIS PRACTICE ADVISOR RESEARCH PATH:** [Intellectual Property & Technology > Software & Information Technology > Cloud Computing > Practice Notes > Drafting and Negotiating Effective Cloud Computing Agreements by Michael R. Overly, Foley & Lardner LLP](#)

Lexis Practice Advisor subscribers may view additional cloud computing content by following this [link](#).



Joseph Domenick Guarino DLA PIPER

Drafting Advice: Developing Social Media Policies

Social media platforms enable users to share ideas and exchange information in a highly effective manner. However, the use of social media by employees carries potential legal risks. These risks include the unauthorized disclosure of confidential and proprietary information, embarrassment stemming from an employee's online words or actions, and claims for unlawful discrimination and harassment for which an employer who is on notice may be held liable.

CONSEQUENTLY, ALL EMPLOYERS SHOULD CONSIDER including within their handbooks a social media policy that establishes rules and guidelines for communicating information relating to the company via social media. Additionally, you should advise employers to distribute their Social Media Policy as a standalone policy with its own acknowledgement form. This will underscore the importance of the policy to employees and, in the event of litigation, facilitate the employer's ability to prove that the employee knew of the policy's strictures.

In drafting a social media policy, you should consider the following:

- **Define social media broadly.** Given the rapid pace at which online communication platforms are being created and improved, a good social media policy should define social media broadly so that the policy does not become outdated shortly after its distribution.
- **Reiterate that company policies apply to online conduct.** Remind employees that policies, including EEO and confidentiality policies, apply to employees' social media activity. Further, you should detail the type of posts that the company prohibits (such as threatening or obscene posts). Invoking other policies in conjunction with specific provisions of the



Social Media Policy can also lend specificity to its terms. The National Labor Relations Board (NLRB) has found vague policies unlawful because employees may interpret them as infringing upon their rights under section 7 of the National Labor Relations Act (NLRA). When incorporating any other policies by reference, however, make sure that they are themselves current and lawful.

- **Address work usage.** Inform employees whether they are permitted to access social media at work and under what circumstances.
- **Protect intellectual property and proprietary and confidential information.** The NLRB will scrutinize provisions that limit

employees' disclosure or use of intellectual property and confidential information, so such provisions should be carefully tailored. With respect to intellectual property, the policy should inform employees about intellectual property rights and encourage them to abide by relevant legal requirements. The company may also ban employees from using the company's intellectual property for any business purpose without the company's permission. With respect to confidentiality provisions, be specific about the type of information covered and do not define confidential and proprietary information to include wages or other information related to the terms and conditions of employment.

- *Distance company from employee.* People often say or do things online that they would not say or do in an offline setting. To reduce the risk that a company will be faulted for employees' bad behavior online, you should advise employees that they may not state the Company has authorized them to speak on the Company's behalf unless they receive prior written authorization. You should also prohibit employees from advertising or selling the Company's products without such authorization.
- *Consider FTC guidelines regarding endorsements.* Furthermore, under the Federal Trade Commission's guidelines, an individual who gives endorsements or testimonials about a company's services or products must identify his or her relationship to the company. See 16 C.F.R. § 255.0 et seq. Thus, you should recommend that the employer state in its social media policy that when an employee posts about the company's services or products, the employee should state that he or she is an employee of the company, and that his or her views are not necessarily those of the company or its affiliates.
- *Consider employees' privacy rights.* The social media guidelines that you establish in the handbook must balance the legitimate business interests the employer seeks to protect with employees' privacy rights. You should ensure that employees have no expectation of privacy in publicly available social media postings. On the flip side, you should prohibit managers from "friending" subordinates on non-professional social media sites since that can be construed as the employer intruding on employee privacy. (Relatedly, you should advise employers not to seek to gain unauthorized access to their employees' social media accounts and not to request employees' social media passwords in the several jurisdictions which outlaw such conduct.)
- *Consider employees' NLRA section 7 rights.* Section 7 of the NLRA endows employees with the rights to organize, bargain collectively through chosen representatives, and engage

in concerted activity for collective bargaining or other mutual aid of protection. Section 7 has been interpreted to endow employees with the right to photograph and make recordings in furtherance of their protected concerted activity, including the right to use personal devices to take such photographs and make such recordings at least on non-work time. The NLRB devotes considerable attention to the social media policies of all employers (with unionized and nonunionized workforces) to determine whether they impinge, or could be construed to impinge, on employees' section 7 rights. Therefore, you should ensure that the social media rules and guidelines do not interfere with, among other things, employees' right to organize, express their personal opinions, or communicate on their own (or other employees') behalf about the terms and conditions of employment. Include language that disclaims the policy's intent to interfere with employees' rights under federal and state laws, including the NLRA.

Sample Social Media Policy

The Company recognizes that Internet-provided social media can be a highly effective tool for sharing ideas and exchanging information. However, the Company also seeks to ensure that social media usage serves its need to maintain its brand identity and integrity while minimizing actual or potential legal risks. The Company therefore establishes the following rules and guidelines for communicating employer information via social media. Violation of this policy may lead to disciplinary action up to and including termination of employment.

The Company defines "social media" broadly to include online platforms that facilitate activities such as professional or social networking, posting commentary or opinions, and sharing pictures, audio, video, or other content. "Social media" includes personal websites and all types of online communities (e.g., Facebook, LinkedIn, Yelp, YouTube, Twitter, Instagram, blogs, message boards, and chat rooms).

- Your social media activity is covered by all Company policies including, among others, the Company's EEO, No Harassment, Confidentiality, and Internet policies.
- You should not post content on social media that violates the Company's discrimination or harassment policies, or that is threatening or obscene.
- You may use social media for non-business purposes while at work, but only if (i) you are complying with all company policies, (ii) the activity does not interfere with your work or your coworkers' work, and (iii) you only use social media for an insignificant portion of your work day.
- You should not represent that the Company has authorized you to speak on behalf of the Company or that the Company

has approved your message, unless you receive prior written authorization to do so from the Company [or insert title of employee who can give approval]. If you do not receive written authorization to speak on behalf of the Company, you are strongly encouraged to state explicitly, clearly, and in a prominent place on the site that views expressed are the employee's own and not those of the Company or of any person or organization affiliated or doing business with the Company. Should you decide to make social media postings about the Company's services or products, you must expressly state in your postings that you are an employee of the Company and that your views are not necessarily those of the Company or its affiliates.

- You may not illegally disparage the Company's products/services, or the Company's vendors' or competitors' products/services. This means that you may not intentionally make maliciously false statements that denigrate the Company's products/services, or the Company's vendors' or competitors' products/services.
- You should not advertise or sell Company products via social media without the prior written approval from the Company [or insert title of employee who can give approval].
- The Company protects its copyrights, trademarks, and logos. You should respect the laws regarding copyrights, trademarks, rights of publicity, and other third-party rights. To minimize the risk of a copyright violation, you should reference to the source(s) of information you use and accurately cite copyrighted works you identify in your online communications. Do not infringe on Company logos, brand names, taglines, slogans, or other trademarks. You may not use the Company's (or any of its affiliated entities') logos, brand names, taglines, slogans, or other trademarks or other protected information or property for any business/commercial venture without the Company's Legal Department's [or insert title of employee who can give approval] express written authorization.
- The Company protects its confidential information (including its financial information, trade secrets, marketing lists, strategic business plans, competitor intelligence, business contracts, and other proprietary and non-public Company information that employees can access). You should not display or disclose such confidential information through social media without prior written approval from the Company [or insert title of employee who can give approval].
- The Company protects its premises and processes. You should not record audio/video or take pictures of non-public areas of the Company's premises or of the Company's processes and display such content through social media without prior written approval from the Company [or insert

title of employee who can give approval]. An exception to this rule would be to engage in activity protected by the National Labor Relations Act including, for example, taking pictures or making recordings of health, safety, and/or working condition concerns, or of strike, protest, or work-related issues, or other protected concerted activities.

- You should not display or post video or other images of, or material about, the Company's employees that are libelous, proprietary, harassing, bullying, discriminatory, retaliatory, or that can create a hostile work environment. Such conduct that would not be permissible in the workplace is not permissible between or among employees online, even if done during non-work hours and away from the workplace on personal devices or home computers.
- You should not display or post video or other images of, or material about, the Company's competitors, vendors, or customers without prior written approval from the Company [or insert title of employee who can give approval]. Under no circumstances may you post the Company's competitors', vendors', or customers' personally identifying information, such as social security numbers, credit card numbers, or phone numbers.
- Managers should not "friend" subordinate employees on non-professional social media sites.

The Company reserves the right to (and does) use software and search tools to monitor comments or discussions about it, its representatives, its products, its vendors and its competitors that are posted anywhere on the Internet, including social media.

The Company respects your right to communicate on your own (or other employees') behalf concerning terms and conditions of employment. Nothing in this policy is intended to interfere with your rights under federal and state laws, including the National Labor Relations Act, nor will the Company construe this policy in a way that limits such rights. **L**

Joseph Domenick Guarino is a partner in DLA Piper's Short Hills, New Jersey office. Assistance provided by [Erin Carney D'Angelo](#) (of counsel) and [Dianne Rose LaRocca](#) (associate) of DLA Piper's New York City office.

 **LEXIS PRACTICE ADVISOR RESEARCH PATH:** [Labor & Employment > Privacy, Technology, and Social Media > Navigating Social Media > Practice Notes > Developing Social Media Policies](#)

Lexis Practice Advisor subscribers may view additional Labor & Employment/ Social Media Policy content by following this [link](#).



Christiane Cargill Kinney LECLAIR RYAN

Managers, Agents and Attorneys

Before drafting any agreement for services to be provided to an artist by a personal manager, agent or attorney in the field of entertainment, it is important to understand the nature of these respective roles within the industry.

A PERSONAL MANAGER HELPS SHAPE AN ARTIST'S CAREER, provides advice and guidance to artists in their day-to-day career choices and development, and also assists in the creation of their public personae. Personal managers are often empowered to enter into binding contracts on behalf of the Artist through power of attorney. However, in contrast to agents, managers are not presently required to be licensed in California, nor are they regulated by the various guilds. Accordingly, while personal managers still owe a fiduciary duty to the artist and can be found liable for breach of those duties, the risk of aligning with an inexperienced manager is high. If you are representing an artist who is in search of a personal manager, make sure to do your homework to ensure the personal manager is well connected and experienced in their particular niche of entertainment. Artists in the entertainment field can include actors and actresses, musicians, directors, writers, models, comedians, cinematographers, and more. As such, you and your client should feel comfortable asking a prospective manager basic qualifying questions, such as: (1) What other acts/artists does that manager currently represent? (2) How long have they been in the business? and (3) What types of connections do they have in the Artist's particular field of entertainment? If they are well connected in one area of entertainment, but not in another, attempt to limit the scope of their services (and their ability to generate revenue from the client) to only the areas they have experience in. An artist with some clout may also be able to negotiate approval rights and eliminate or substantially reduce a manager's ability to act through power of attorney.

Because the majority of jurisdictions, including California, regulate and license booking agencies, managers are generally



precluded from providing booking services directly, and if such services are provided in violation of a state's licensing requirements, their management contract may be invalidated. (See, e.g., Talent Agencies Act, [Cal. Lab. Code § 1700 et seq.](#) (providing that any activity in procuring employment for an artist is subject to regulation and requires a license, even if no commissions were ever received for that service); [Park v. Deftones \(1999\) 71 Cal.App.4th 1465](#) (finding management contract void where personal manager secured performance engagements for music group without being licensed as a talent agency)). A standard management agreement will include as a term that the Artist acknowledges that the manager is not a talent agent and that his duties do not include procuring employment for the Artist. That said, [California Labor Code Section 1700.4\(a\)](#) acknowledges that the activity of "procuring, offering or promising to procure recording contracts for an artist" shall not of itself subject a person or a corporation to regulation and licensing under the statute, and thus this is an appropriate function for a manager to perform.

A HEAVILY NEGOTIATED DEAL POINT INVOLVES HOW LONG A PERSONAL MANAGER IS ENTITLED TO RECEIVE GROSS EARNINGS COLLECTED BY THE ARTIST AFTER THE EXPIRATION OF THE CONTRACT TERM. OFTENTIMES, DEALS ARE SUBSTANTIALLY NEGOTIATED, OR EXTENDED CONTRACTS ARE ENTERED INTO, DURING THE TERM OF THE MANAGEMENT AGREEMENT, AND MANAGERS WILL OFTEN EXPECT CONTINUED PAYMENTS UNDER THOSE CONTRACTS. IF YOU REPRESENT THE ARTIST, YOU WILL WANT TO NEGOTIATE A REASONABLE CAP TO POST-TERM PAYMENTS IF POSSIBLE.

Personal Management Agreement

A personal management agreement will often be written in letter form, with a typical term ranging from three to five years in length. Managers will want the longest possible term to ensure a return on their investment of time. However, when representing an artist, you may want to explore annual options for renewal or termination within the three- to five-year term, to ensure the manager is not causing the Artist's career to stagnate. In the music industry, managers may seek to negotiate the automatic extension of a contract term once their Artist enters into a recording agreement, often to be extended until the end of the then-current Album Cycle of that Recording Agreement. When dealing with any service contract, it is also important to note that such contracts may not exceed seven years in California. [Cal. Lab. Code § 2855; De Haviland v. Warner Brothers Pictures \(1944\) 67 Cal.App.2d 225.](#)

Managers are paid a percentage of an artist's "gross compensation," and accordingly, a manager will want an agreement to encompass as many entertainment-related activities as possible, allowing for the highest possible return on their investment of time. In contrast, when representing the Artist's interests, you will want to limit the scope of your client's industry-related activities encompassed by the agreement. For example, if the manager is representing a music artist and helping make connections within the music industry, you may want to carve out exceptions to the scope of the agreement if your client also wishes to start his or her own fashion line, fragrance, or other industry-related offshoot. This will factor into how the Artist's "gross compensation" is defined within the agreement. Managers normally earn between 10–25% of an artist's gross income, and this variance is generally reflective of a manager's experience and connections within the industry.

Many personal management agreements allow the Manager to receive all monies payable to the Artist, and to pay themselves their share before the Artist is paid. If you represent the Artist and want all money to be filtered directly through them, most Managers will seek the appointment of an independent third party business manager or certified public accountant to collect the Gross Earnings and render all accountings and payments to the Manager. This can be an expensive proposition for an artist at the earlier stages of their career, and therefore, you should ensure that the Artist's Gross Earnings achieve a certain platform before the formal retention of a business manager or CPA is required.

Another heavily negotiated deal point involves how long a personal manager is entitled to receive Gross Earnings collected by the Artist after the expiration of the contract term. Oftentimes, deals are substantially negotiated, or extended contracts are entered into, during the term of the management agreement, and managers will often expect continued payments under those contracts. If you represent the Artist, you will want to negotiate a reasonable cap to post-term payments if possible.

Other important clauses to consider in management agreements are the early termination of such agreements. For example, some Artists may wish to negotiate for a "key man" clause, particularly when an Artist is signing with a well-known or successful manager, which provides that if their manager leaves the management company or retires, the Artist is free to stay or walk away. Other common grounds for early termination of management agreements include material breach of the agreement by a party and failure of that party to cure within a reasonable time, as well as the Manager's unreasonable refusal to permit their Artist to negotiate, accept or execute any agreement for the offer of employment related to the Artist's career in entertainment. Service contracts

between artists and managers should also address the Artist's name and likeness rights, and whether express approval is required, how financial audits will be handled, as well as how disputes will be handled under the agreement. The choice of law provision can be particularly important in management agreements, as certain states may be considered "pro-manager" or "pro-artist." Alternative dispute resolution remains a popular alternative to litigation that the parties may agree upon as well. While many practitioners will find an arbitration provision most beneficial to companies who may be subject to multiple lawsuits, the process is generally less expensive for both parties, will often result in a final, binding ruling that is rarely subject to appeal, and allows for a resolution much earlier than traditional litigation outlets (depending upon the language of the agreement and the precise arbitration rules to be enforced).

Agreement Between Talent Agent and Artist

In the entertainment field, an agent seeks to procure employment for their client. They are the dominant dealmakers in the world of theater, book publishing, film, and television. In film and television, agents find actors roles or pitch screenwriters' works to studios, producers, and other actors. In music, agents may procure live engagements for musicians. In book publishing, agents may attempt to secure publishing agreements for authors. The relationship is generally exclusive as between the agent and artist for a particular field (although commercial and theatrical agents in TV and film are generally separate), and agents will often serve many artists at one time.

Representation contracts between talent agents and artists must be in writing. The only notable exception in which an oral agreement will be given effect is pursuant to [8 CCR 12002](#), where an agent directly procures employment for the Artist and the parties' oral agreement is ratified in writing within 72 hours. If the oral agreement is not ratified within 72 hours, it is voidable.

Agents are regulated by state statutes and required to be licensed. Accordingly, contracts between agents and talent are highly standardized with little room for negotiation. In California, talent agencies are subject to regulation by the Labor Commissioner pursuant to California Labor Code §§ 1700-1700.47, and must comply with detailed licensing requirements. In order to acquire a license to operate as a talent agency, one must complete a Talent Agency License Application with the Division of Labor Standards Enforcement (DLSE) of the California Department of Industrial Relations, and submit certain required documentation along with payment of the applicable fees.

All of the required forms necessary to license a talent agency may be found in the Lexis Practice Advisor forms tab here:

[Talent Agency Application — Application for Talent Agency License \(DLSE 351\)](#), [Talent Agency Application – Affidavits of Character \(DLSE 301-A\)](#), [Talent Agency Application — Personal Record \(DLSE 301-B\)](#), [Talent Agency Application – Talent Agency Premises Certification](#), [Nonexclusive Contract between Artist and Talent Agency \(DLSE 315A\)](#), [Exclusive Contract between Artist and Talent Agency \(DLSE 315B\)](#), [Request for Live Scan Service](#), [Talent Agency Application — Talent Agency Bond \(DLSE 306\)](#), and [Talent Agency Application — Talent Agency Sample Fee Schedule \(DLSE 315C\)](#). Detailed instructions for filing and renewal can be found within the Lexis Practice Advisor forms tab here: [Checklist — Talent Agency Application Process](#).

The Department of Labor provides all of the necessary forms on the following website: <http://www.dir.ca.gov/dlse/TalentAgencyLicense.html>. Detailed instructions for filing and renewal can be found at <http://www.dir.ca.gov/dlse/TalentAgencyInstructionsandInfo.pdf>. You can also call the Licensing & Registration Unit at (415) 703-4846 or email DLSE.licensing@dir.ca.gov to request that a package be sent to you via U.S. mail.

Any contract forms to be used by a talent agency in California must first secure approval from the Labor Commissioner and must set forth the fact that the talent agency is licensed by the Labor Commissioner of the State of California, as well as the date upon which the contract form was approved by the Labor Commissioner. [8 CCR 12003.1](#). Sample contract forms are provided on the California Department of Industrial Relations website, www.dir.ca.gov. (See [Form DLSE 315A](#)) (See [Form DLSE 315B](#)).

To submit contracts for approval, one must submit three copies of each form general services contract, one of which will be certified and returned to the newly approved agency. All contracts submitted must contain the provisions set forth in section 12001 of the California Code of Regulations and should be sent to the DLSE Licensing & Registration Unit at P.O. Box 420603, San Francisco, California 94142. Notably, a Labor Commissioner cannot withhold approval of a contract unless its terms would be unfair, unjust or oppressive to the Artist. (See [Cal. Lab. Code § 1700.23](#); [8 CCR 12003](#)). Copies of SAG, AFTRA, AFofM, AGVA, Writers' Guild, and Directors' Guild contracts need not be submitted for approval by the Labor Commissioner. Instead, if a talent agency intends to use these contracts, they must submit a letter to the Labor Commissioner stating which of the guild contracts they intend to use.

If a modification is made to an existing form, any substantial changes in the form of a previously approved contract must be submitted to the Labor Commissioner for approval and written consent. (See [Cal. Lab. Code § 12003.2](#)). Certain minor

modifications of contract forms previously approved by the Labor Commissioner that do not substantially change the substance do not require further approval. Such modifications are listed under Labor Code Section 12003.3 and include things such as a provision for the commencement of the term of the contract at some specified date in the future, which may be fixed by the occurrence of an event or contingency; the deletion of certain fields of endeavor from the scope of the agent's representation; a reduction in the compensation to be paid by the Artist to the talent agency; a waiver by the talent agency of commission or compensation to be received by the Artist; a reduction in the four-month termination period required by [8 CCR 12001\(e\)](#); any provision for additional or special services, facilities, or benefits to be rendered by the talent agency on behalf of the Artist; and any other modification which operates to the Artist's advantage. Because such modifications do not require further approval by the Labor Commissioner, these deal points are generally open for negotiation.

Agents are effectively subject to regulation by the various guilds or unions, which may require agents to agree to a code of conduct and restrictions on terms included in agent-talent contracts. In the majority of jurisdictions, an agent is limited to 10% of whatever employment they book for their client, and 10% is the norm. In California, a talent agency must file the Schedule of Commission Fees with the Labor Commissioner, and its fee schedule must be posted in the agent's office. Generally, the Labor Commissioner will approve up to a maximum fee of 20%, but guild franchise agreements limit the commission to 10%. Many times, an agent will negotiate that their client will get "scale plus 10 percent," but the agent may not take any portion of a client's per diem or living expenses for out-of-town employment opportunities. There is no "double-dipping" for an agent who tries to take on the role of manager as well. The two must be completely separate, and agents are not permitted to take on the role of personal manager in addition to their role as talent agent in order to exceed the 10% cap. The fee schedule defining how an agent is to be paid under the agreement must be approved by the Labor Commissioner, including the details of any payments to be made after termination of the agreement for employment procured during the agency term.

A talent agent agreement will often be written in letter form, signed by both parties with a typical term ranging from one to five years in length. In California, any representation agreement between a talent agency and an artist must include the term of the agreement, the compensation of the agent (see above), a termination clause, an arbitration or dispute resolution clause, and general provisions stating that the talent agent may advise, counsel, or direct the Artist in the development of their professional career; and that, subject

to the Artist's availability, that agent will use "all reasonable efforts" to procure employment for the Artist in the field(s) specified in the agreement. (See [8 CCR 12001](#).)

[California Code of Regulations, Title 8, Section 12001\(e\)](#) sets forth a four-month minimum termination period for agency agreements. As such, the termination clause must be mutually exclusive, providing that if employment is not found for the Artist in four or more consecutive months and that artist was willing and available to accept employment during those four months, either party *may* terminate the agreement (though neither is required to terminate).

With respect to arbitration or dispute resolution, such agreements are required to include a provision for all disputes to be submitted to arbitration under the California Arbitration Act pursuant to the terms of a contract or collective bargaining agreement ([Cal. Lab. Code § 1700.45](#); [Cal. Code Civ. Proc. §§ 1280-1294.2](#); see also [Ferrer v. Preston \(2006\) 145 Cal.App.4th 440, 446](#)), or if not applicable, to be submitted to dispute resolution by the Labor Commissioner ([Cal. Lab. Code § 1700.23](#); [8 CCR 12001\(f\)](#); [Cal. Labor Code § 1700.44\(a\)](#)).

Agreement Between Attorney and Artist

Attorneys in the entertainment field routinely provide legal services for an artist in the performing arts, handling a wide range of transactional, litigation, and arbitration matters. An entertainment practice can touch upon intellectual property, contract law, employment, bankruptcy, immigration, securities issues, product placement, advertising, clearance of rights, defamation, right of privacy issues, tax laws, and everything between. Entertainment attorneys are the dominant dealmakers in recording contracts and music publishing deals and should be skilled transactional attorneys well versed in entertainment contracts and the industries' customs and practices.

In California, agreements between a client and an attorney must be in writing and signed. The agreements often take the form of a letter signed by the client acknowledging acceptance of the terms. The agreement should specify the scope of services the attorney is being retained to provide and that the attorney has been retained primarily for legal services to ensure that an attorney's work is covered by their professional liability insurance. As with managers and agents, an attorney owes a fiduciary duty to their client. However, in distinction to other service contracts, there is no effective term of the agreement, as a client can always fire their attorney.

There are a number of different methods by which attorneys charge for their services, and the agreed-upon method of compensation must be set forth in the written agreement between the parties. Generally, attorneys will charge an hourly

rate (often requiring a retainer before commencing work), a contingency-fee arrangement, a flat-fee arrangement, or some combination thereof. The fee structure of an attorney's engagement is by far the most frequently negotiated term of such an agreement.

Hourly rates can vary significantly, depending upon the type and complexity of the case, the attorney's special skills and experience, and the average rates for legal services in that particular geographic area. Contingency fees often range from 5-10% of the client's "gross compensation," as defined within the agreement. In many entertainment contracts, "gross compensation" is defined broadly. Gross compensation may include things such as cash, salaries, advances, fees, royalties, residuals, repeat and/or rerun fees, gifts in lieu of compensation or other in-kind payments, bonuses, license fees, shares of profit, shares of stock, partnership interests, percentages derived from record, television, motion picture or other entertainment packages, and so on. However, it is common to exclude income that is not derived from or enhanced by the attorney's professional services. The percentage to be earned will depend largely upon the client's record for commercial success, with an attorney often taking a smaller percentage of gross compensation from a well-established artist. Sometimes the attorney may couple a smaller percentage of gross compensation with a reduced hourly fee arrangement. In both hourly and percentage fee arrangements, the client commonly pays all out-of-pocket costs. However, the fees charged cannot be illegal or unconscionable. The determination of conscionability of a particular fee is generally based on a weighing of various factors, including the amount of the fee in proportion to the value of services performed; the relative sophistication of the attorney and client; the novelty and difficulty of questions involved and the skill required to perform the legal services; the likelihood, if apparent to the client, that acceptance of the particular employment will preclude other employment by the attorney (for example, if it creates a conflict of interest with other potential clients); the amount involved and results obtained; the time limitations imposed by the client or circumstances; the nature and length of the professional relationship; the experience, reputation, and ability of the attorney performing services; whether the fee is fixed or contingent; the time and labor required; and the informed consent of the client to the fee. (See Cal. Rules of Prof'l Conduct, Rule 4-200(A)).

The terms of any *pro bono* arrangements (also known as free legal services, derived from the Latin *pro bono publico*, or "for the public good") should likewise be set forth in a written agreement. It is common for entertainment and intellectual property attorneys to handle matters on a *pro*

bono basis, particularly where the prevailing party may be entitled to recover their attorney's fees, such as provided for under the Copyright Act. Importantly, for purposes of recovering such fees, several courts, including the Ninth Circuit, have recognized that a party can "incur" fees even though the party was represented on a *pro bono* basis when that client's obligation to repay fees is contingent upon a party's successful recovery of fees under the statute. (See [Morrison v. Commissioner](#), 565 F.3d 658, 662-666 (9th Cir. 2009)). Thus, the inclusion of any contingent repayment agreement should be contained within the written agreement.

A word of caution to attorneys: Rule 7.3(a) of the Model Rules of Professional Conduct provides that a lawyer shall not by in-person, live telephone, or real-time electronic contact solicit professional employment when a significant motive for the lawyer's doing so is the lawyer's pecuniary gain, unless the person contacted is a lawyer, or has a family, close personal, or prior professional relationship with the lawyer. Pursuit of clients through these methods of solicitation, even when services are offered on a *pro bono* basis, may be considered in violation of Rule 7.3(a) when the case allows for the prevailing party to recover their attorney's fees, as this may be considered a significant motive for pecuniary gain.

Conflicts of interest routinely arise in this area of law, and attorneys should be cautious to clear all conflicts and/or obtain all necessary waivers, where appropriate. You should not represent a client if that representation will be directly adverse to a relationship with another client. (See [Cal. Rules of Prof'l Conduct, Rule 3-310\(D\)](#)). If a conflict exists, but you believe that your representation of a new client would not be adverse to a current client, you must disclose the conflict and each client must consent in writing to the dual representation. Attorneys should also undertake updated conflict checks on a routine basis, particularly when there is a new party to a case or deal that has not been previously searched, or an adverse situation has occurred that changes a party's role in the matter.

Other common clauses within a legal services agreement include choice of law provisions, providing for the agreement to be governed by a specified law, if the contract has a substantial relationship to the place whose law is chosen or there is another reasonable basis for the parties' choice of law, and application of that law will not contravene any strong California public policy. (See [Nedlloyd Lines B.V. v. Superior Court](#) (1992) 3 Cal.4th 459, 464-465). The agreement also routinely includes a clause providing for the parties to submit any fee disputes to arbitration. The State Bar of California has established procedures for arbitrating disputes over attorneys' fees in California, which are discussed in greater detail at [Cal. Bus. & Prof. Code § 6200 et seq.](#) Additionally, an attorney should indicate in writing, for both new clients and new engagements

with returning clients, if an attorney and/or law firm does not carry professional liability insurance pursuant to California Rule of Professional Conduct 3-410.

Special Considerations When Representing Minors

The entertainment industry is replete with talented child actors or pop stars under the legal age of majority (18 years of age in most jurisdictions, including California) and, accordingly, there are special considerations that an attorney should understand when dealing with contracts involving minors.

As a general rule, minors lack the capacity to enter into a legally binding contract and, accordingly, they may attempt to “disaffirm” or “void” the contract upon reaching the age of majority. Even when a parent or legal guardian approves the contract on the minor’s behalf, many jurisdictions, including California, do not require the minor to honor it (though it would be binding upon the adults themselves).

Where a parent or legal guardian executes a valid release agreement with respect to a minor’s performance or likeness, the minor’s right to disaffirm that contract is inapplicable. However, with respect to the right to future services, such as the personal service contracts discussed in this section, a minor’s right to disaffirm these agreements is the cause of true concern for many companies and entertainment professionals.

To respond to this growing concern, many states have now passed legislation in an effort to provide some reasonable certainty to employers in the entertainment industry. For example, in California, parties to a contract involving a performing artist or professional athlete under 18 years of age may seek court approval of the minor’s entertainment contract, which limits the minor’s right to repudiate or cancel the contract on the basis of their age at the time of signing. (See [Cal. Fam. Code § 6751](#)). The court-approval process is available to contracts in which a minor is employed “to render artistic or creative services” within any field of the entertainment industry.

Court approval in California may be sought by way of a petition filed in superior court by any party to the contract, after reasonable notice to all other parties to the contract as fixed by the court, with an opportunity for such other parties to appear and be heard. The petition should be filed in the county in which the minor resides or is employed or in which any party to the contract has its principal office. For purposes of such proceedings, a parent or legal guardian shall be considered the minor’s guardian ad litem for the proceeding unless the court determines that appointment of a different individual is required in the best interests of the minor. As an extra safeguard, many contracts will also require the parents


to guarantee future performance by the minor and not to interfere with their performance under the agreement, which would then be binding as between the adults entering into the agreement.

For an example of the Petition and Order for Approval of Minor’s Employment Contract see [Petition for Approval of Minor’s Employment Contract](#) and [Order Approving Minor’s Employment Contract](#).

Many jurisdictions also have a maximum term of employment involving a minor. However, in California, there is no specific limitation relevant exclusively to minors, but rather the general seven-year limitation to any personal service contract would apply.

[California Family Code Section 6752](#), also known as the “Coogan Law” (after child-actor Jackie Coogan), was enacted to protect the earnings of minors performing in the entertainment industry. This law requires the parents or guardians of such minors to establish a “Coogan Trust Account” and to notify the minor’s employer once that account is set up. The employer of the minor must then set aside and deposit 15% of the minor’s gross earnings into their trust account. If employers do not receive proper notification from parents within a specified time, they must send the set-aside funds to the Actors’ Fund of America, which then has an obligation to locate and notify parents of their obligations under the statute. [L](#)

[Christiane Cargill Kinney](#) is a partner at LeClair Ryan and Chair of the Firm’s Entertainment Industry team.

 **LEXIS PRACTICE ADVISOR RESEARCH PATH:** [California Business & Commercial > Entertainment Law > Practice Notes > Managers, Agents and Attorneys](#)

Lexis Practice Advisor subscribers may view additional California jurisdictional content by following this [link](#).

John Chrisman, David Richardson and Alan Lee

CORPORATE DEPARTMENT, HONG KONG OFFICE OF DORSEY & WHITNEY*

Hong Kong's Role in China's Financial Reform - The Era of the “New Normal”

As the Chinese leadership has announced a significant change in the course of development and direction, namely to focus more on the quality—not just quantity—of growth, Hong Kong is set to assume a new role in the era of the “new normal.” This article examines what the change of direction in China means for Hong Kong.

SINCE ADOPTING THE OPEN DOOR POLICY SOME 35 YEARS ago,¹ Mainland China² has largely completed the transition from a centrally planned economy to a market-based economy, while achieving remarkable growth during the process. In the second decade of the twenty-first century, the country is seeking sustainable growth and convergence towards high-income status.³ To this end, the Third Plenary Session of the Eighteenth Communist Party of China Congress, which took place in November 2013, put forward an ambitious and comprehensive agenda of reforms to start a new chapter in Mainland China's economic development.⁴

Historically, Hong Kong has always played a pivotal role in Mainland China's economic and financial reforms. The most important entrepôt for Chinese trade for decades, Hong Kong is the largest capital source of Mainland China's overseas direct investment, the center for cross-border Renminbi (RMB) trade settlement and offshore⁵ RMB business, as well as a major overseas capital market for Mainland Chinese enterprises pursuing IPOs on the Hong Kong Stock Exchange (HKSE).

As the Chinese leadership has announced a significant change in the course of development and direction, namely to focus more on the quality—not just quantity—of growth, Hong Kong is set to assume a new role in the era of the “new normal.” This article examines what the change of direction in China means for Hong Kong.

New Normal

The term “new normal” has become the People's Republic of China (PRC)⁶ government's favorite catchphrase⁷ of late. Within the Chinese context, “new normal” denotes the adoption of and transition towards a more sustainable economic growth model, which focuses more on quality and equity than sheer quantity. During the 35 years between 1978 and 2013, annual growth of the PRC economy averaged close to 10%.⁸ However, with economic growth figures decelerating to 7.7% in 2012⁹ and again in 2013,¹⁰ China appears to have entered a new phase of economic development, with the “new normal” being economic growth of lower quantity but higher quality.¹¹

1. “Open Door Policy” means the economic policy initiated by Deng Xiaoping in 1978 to open up China for foreign investment. 2. “Mainland China” in this article refers to the geopolitical area under the jurisdiction of the PRC, excluding Hong Kong, Macau, and Taiwan. 3. Press Release No. 14/260, International Monetary Fund, June 5, 2014. 4. See id. 5. “Offshore” in this article refers to the other jurisdiction areas of the PRC, in particular, Hong Kong; “Onshore” in this article refers to the jurisdiction of the PRC. 6. “PRC” in this article refers to the People's Republic of China, excluding Hong Kong, Macau, and Taiwan. 7. “In 2015, reform will set the tone for the new normal in China,” by Hu Shuli, South China Morning Post, January 1, 2015. 8. “GDP growth (annual %)” by The World Bank, available at <http://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG>. 9. See id. 10. See id. 11. “Adapt to a New Normal and March toward a New Stage (Study and Implement the Spirit of the Central Economic Work Conference),” by Li Wei, People's Daily, December 29, 2014.



The term “new normal” entails not only adjustment toward a slower pace in economic growth,¹² but economic reforms such as restructuring and rebalancing.¹³ In the “new normal” era, China’s GDP growth rate would no longer be the be-all and end-all factor; rather, the progress of fundamental economic reforms as resolved at the Third Plenum¹⁴ in late 2013 are set to become essential in the country’s transition from a fast-growing, developing economy based on investment in heavy industries¹⁵ and low-cost, manufactured exports¹⁶ to a more mature economy based on domestic consumption, as well as high-value goods and services.¹⁷

Going Global

In the “new normal” phase of economic development, as the pressure and urgency to upgrade its industries and restructure its economy intensify, China is becoming increasingly interested in overseas markets as solutions.¹⁸ The PRC government announced that it would increase financial support for Chinese enterprises to invest and operate overseas¹⁹ or, as an official statement on December 24, 2014²⁰ read, “going global.”

To facilitate the “going global” strategy, official approvals required for overseas investment will be made easier to

obtain,²¹ and procedures governing public listing, mergers and acquisitions, as well as banks setting up overseas branches, will also be simplified. China will strengthen financing support for exports of capital goods, encourage commercial banks to finance the entire industrial chain of equipment manufacture and promote the use of foreign exchange reserves.²²

“Going global” is an increasingly important objective not only for Chinese enterprises, but also for the government itself. The Central Economic Work Conference’s final statement promised to encourage Chinese enterprises to both invest overseas and expand their operations in other countries. In addition, the conference said that China would continue to promote the RMB as an international currency.²³

Hong Kong's Unique Advantages

In comparison with other cities in Mainland China, Hong Kong enjoys a unique advantage in financial services thanks to free trade, an open and flexible market, a freely convertible currency, and free flow of both information and capital. More importantly, Hong Kong has an independent judiciary and a business-friendly environment. These comparative advantages will be conducive, if not crucial, to Chinese enterprises and capital in “going global.”²⁴

¹². “China’s Economy Realized a New Normal of Stable Growth in 2014,” National Bureau of Statistics of China, January 20, 2015. ¹³. “China media: Growth fears,” BBC, January 20, 2015. ¹⁴. Officially the 3rd Plenary Session of the 11th Central Committee of the Communist Party of China. ¹⁵. The economic slowdown was especially visible in industry, particularly heavy industry, which was jolted by the real estate downturn in 2014, see supra note 12. ¹⁶. In 2014, the total value of exports was RMB 14,391.2 billion (equivalent to US\$2,319.1 billion), up by 4.9%, see supra note 12. ¹⁷. In 2014, the total retail sales of consumer goods reached RMB 26,239.4 billion (equivalent to US\$4,228.41 billion), a nominal annual rise of 12%, see supra note 12. ¹⁸. “China seeks to forge foreign demand for its industrial output,” by Lucy Hornby, Financial Times, January 26, 2015. ¹⁹. “China’s overseas direct investment is projected to rise at least 10% annually for the next five years, a trend that will soon make the country a net capital exporter,” said a senior commerce ministry official, reported in “China overseas direct investment seen rising 10% a year,” by Gerry Shih and Matthew Miller, Reuters. ²⁰. “China stresses finance for companies ‘going global,’” Xinhua, December 24, 2014; 署支持“出去升,” December 24, 2014. ²¹. China’s Ministry of Commerce revised its rules to reform the regulatory approval process in order to promote greater outbound investment on September 6, 2014, reported in “China: Rules Revised to Facilitate Overseas Investments,” by Laney Zhang, the Library of Congress, October 31, 2014. ²². See supra note 20.

International Securities Market

Possessing an active international securities market, Hong Kong has consolidated its position as one of the top IPO markets in the world,²⁵ consistently ranked in the top five globally for IPO fundraising. Much of the success of Hong Kong's equity market is attributed to Mainland China. Among the US \$29 billion in IPO funds raised last year on the HKSE, some 85% were from Chinese enterprises.²⁶

In addition to an outstanding securities market which helps Chinese enterprises raise necessary funds, Hong Kong also provides a platform for Chinese enterprises to enhance transparency and corporate governance standards, thereby promoting their international reputation.²⁷

In 2014, a total of HK \$227.8 billion (equivalent to²⁸ US \$29.39 billion) was raised, representing an increase of 33% on the HK \$171.3 billion (equivalent to US \$22.1 billion) raised the year before. In line with the Chinese "new normal" and "going global" strategies, retail, consumer goods, and services dominated with 46% of new listings, followed by financial services (including real estate) at 16%. It is estimated that 120 new companies will list in Hong Kong in 2015. Total funds raised are projected to reach HK \$200 billion²⁹ (equivalent to US \$25.81 billion). Small-and-medium-sized companies are expected to dominate the HKSE in 2015. Meanwhile, the retail, consumer products, services, and financial services sectors are also expected to take up a large share of new listings in 2015.³⁰ Below are two representative examples to illustrate the changing trends in the new era.

Case Study I: WH Group Limited

The Chinese food industry has come to realize that the era of the "new normal" has arrived.³¹ Insofar as food prices in the domestic market are concerned, grains went up by 3.1%, oil and fat, pork and fresh vegetables went down by 4.9%, 4.3%, and 1.5% in 2014,³² respectively. In this "new normal" phase of economic development, Chinese enterprises are seeking overseas markets as propellers for growth.

WH Group Limited (WH Group), the world's largest pork producer, acquired Smithfield Foods, Inc., the largest pork producer in the United States, by way of merger in September

2013.³³ WH Group subsequently listed on the HKSE in August 2014 and raised HK \$18.31 billion (equivalent to US \$2.36 billion) to refinance its debt. The global headquarters of WH Group is located in Hong Kong, overseeing its business operations in the PRC, United States, and other countries.

Chairman and CEO of WH Group, Wan Long, concluded that "listing in Hong Kong has always been consistent with our goal to establish a platform to support WH Group's global growth strategy. This move is also in line with our stature as the world's largest pork company, with an increasingly global reach. Being a listed company in a major financial center such as Hong Kong will raise our standing and enable us to attract more resources and talent, reinforcing our lead in the global pork and packaged meat market."³⁴

Case Study II: CGN Power Co., Ltd.

On January 28, 2015, during the State Council executive meeting, Premier Li Keqiang stated that China intended to create a competitive edge for its nuclear industry, which would become an integral part of its high-tech export. Within the general "going global" strategy, China clearly has an eye to export domestically produced nuclear power plants.³⁵ In 2014, the energy consumption per unit of GDP decreased by 4.8% compared with 2013.³⁶ CGN Power Co. Ltd. (CGN Power), China's largest nuclear power producer, raised HK \$28.21 billion (equivalent to US \$3.64 billion) in its initial public offering on the HKSE in December 2014. In its prospectus, CGN Power stated that it is considering investment in projects in foreign countries in accordance with its business development strategy.³⁷

On January 29, 2015, in the presence of Premier Li Keqiang and French Prime Minister Manuel Valls, CGN Power and EDF Energy, a British energy company, signed a cooperation agreement. On December 14, 2014, in the presence of Premier Li Keqiang and his Kazakh counterpart Karim Massimov, CGN Power and a Kazakh state-owned nuclear company signed a cooperation agreement. Both sides planned to set up a joint venture in Kazakhstan to fabricate nuclear fuel assemblies, ensuring nuclear fuel supply security for the sustainable development of Chinese nuclear power enterprises.³⁸

23. "China Sets Economic Reform Targets for 2015," by Shannon Tiezzi, *The Diplomat*, December 12, 2014. 24. "HK's financial hub role constantly refined," *Hong Kong Government News*, September 17, 2014. 25. *Hong Kong Pulls Into Second in IPOs*, by Prudence Ho, *The Wall Street Journal*, December 16, 2014. 26. "Speech by CE at Asian Financial Forum 2015," *Hong Kong Government Press Releases*, January 19, 2015. 27. "Speech by SFST at Hong Kong Institute of Chartered Secretaries Annual Dinner 2015," *Hong Kong Government Press Release*, January 14, 2015. 28. Exchange rate as of April 2015. 29. "Hong Kong expects to see over 100 new listings in 2015," PWC, 2015. 30. See id. 31. In 2014, the consumer price went up by 2.0%. Specifically, the price went up by 2.1% in urban areas and 1.8% in rural areas. Grouped by commodity categories, prices for food rose by 3.1%. See supra note 12. 32. See supra note 12. 33. Prospectus of WH Group Limited, dated April 15, 2014, available at <http://www.hkexnews.hk/listedco/listconews/SEHK/2014/0415/LTN20140415117.PDF>. 34. Press Release—WH Group Announces Details of Proposed Listing on Main Board of the HKEx, July 23, 2014. 35. "克署加中"出去, 方网, January 28, 2015. 36. See supra note 12. 37. Prospectus of CGN Power Co., Ltd., dated November 27, 2014, available at <http://www.hkexnews.hk/listedco/listconews/SEHK/2014/1127/LTN20141127047.pdf>. 38. Press Release—CGN plans to setup a joint venture in Kazakhstan to fabricate nuclear fuel assemblies, dated December 15, 2014, available at <http://en.cgnp.com.cn/n658564/n678421/c901866/content.html>.

Testing Ground

One of the unique roles of Hong Kong is acting as a testing ground for the PRC's financial market liberalization.

Although Mainland China is the world's largest exporter, the U.S. dollar remains the main settlement currency for global trade. PRC authorities set out the policy direction for freer cross-border capital flow and higher degree of convertibility of RMB in the Financial Development and Reform Plan for the 12th Five-Year Plan Period (2011–2015) published in September 2012.

Hong Kong is playing a vital role for the RMB in "going global." As the RMB is increasingly used outside Mainland China, Hong Kong continues to build upon its role as the testing ground for the PRC's financial reforms, and the place in which international use of RMB as a settlement, investment, and funding currency is being tested. Hong Kong's mature and stable financial markets, as well as regulatory mechanisms within the framework of "one country" allows Hong Kong to serve as a "firewall" for China's financial system, reducing systemic risk during the gradual opening of China's capital market.

As of late September 2014, a total of 149 authorized institutions in Hong Kong carried out RMB businesses, with a total amount of RMB deposits and certificates of deposit worth more than RMB 1.1 trillion³⁹ (equivalent to US \$177.24 billion), accounting for a quarter of the total deposits of non-Hong Kong authorized institutions in Hong Kong. In late September 2014, the balance of RMB loans increased to HK \$170 billion⁴⁰ (equivalent to US \$21.93 billion). RMB offshore bonds also developed rapidly, a total of 462 RMB-denominated bonds were issued in Hong Kong as of late October 2014, amounting to RMB 600 billion⁴¹ (equivalent to US \$96.67 billion).

Stock Connect Pilot Program


The Shanghai-Hong Kong Stock Connect (Stock Connect) was officially launched in November 2014,⁴² connecting the Hong Kong and Shanghai securities markets, allowing individuals and institutional investors of both places to participate in cross-border trade in each other's market directly. This pilot program, through enhancing mutual stock market access between Hong Kong and Shanghai, accelerates and facilitates

the gradual opening up of capital accounts in Mainland China, as well as the internationalization of RMB. It will also reinforce Hong Kong's position as an international financial center and strengthen Hong Kong's role as an offshore RMB business center. In the same month, the RMB conversion limit for Hong Kong residents of RMB 20,000 (equivalent to US \$3,222.48) per day was removed,⁴³ making it easier for Hong Kong residents to participate in the Stock Connect and other RMB-denominated financial transactions. This was conducive to the launch and sales of RMB investment products by financial institutions in Hong Kong.

Following the launch of the Stock Connect, Premier Li Keqiang said in January 2015⁴⁴ that a stock link with Shenzhen should be established. Hong Kong's top finance official and regulator said in February 2015⁴⁵ that preparations were under way to complete a direct stock exchange link-up between Hong Kong and Shenzhen.

Adding Shenzhen to the stock connect scheme will allow Hong Kong to provide access to Chinese equity markets without completely liberalizing the capital accounts. All orders must pass through broker-members of the HKSE, using RMB situated in Hong Kong to buy Chinese stocks. When a stock is sold, the RMB proceeds are delivered back to Hong Kong. This keeps the currency inflow for the purchase of Chinese stocks sealed off from the rest of the Chinese economy.

Conclusion

Hong Kong's financial services industry should be in an ideal position to assist Chinese capital and enterprises to "go global," within the context of China's financial reform in the "new normal" era. Hong Kong is also poised to retain established strength by continuing as the leading offshore RMB center in the RMB internationalization. 

John Chrisman is a partner, David Richardson is a member of the Board of Editors of The Banking Law Journal and a partner, and Alan Lee is an associate, in the Corporate Department of the Hong Kong office of Dorsey & Whitney. They can be reached at chrisman.john@dorsey.com, richardson.david@dorsey.com, and lee.alan@dorsey.com, respectively.

Article Courtesy of the Banking Law Journal Volume 132, Number 8.*

³⁹. Statistics of Renminbi Deposits and Cross-border Settlement, available at http://gia.info.gov.hk/general/201412/31/P201412310618_0618_139861.pdf. ⁴⁰. 政司司出席 2014 香港 全文, December 15, 2014. ⁴¹. See id. ⁴². "HKEx celebrates the launch of Shanghai-Hong Kong Stock Connect," HKEx New Release, Hong Kong Stock Exchange, November 17, 2014. ⁴³. "Removal of RMB conversion limit for Hong Kong residents," Hong Kong Monetary Authority, November 12, 2014. ⁴⁴. "Hong Kong-Shenzhen stock connect next, says Li Keqiang," by Enoch Yiu and He Huifeng, South China Morning Post, January 5, 2015. ⁴⁵. "Hong Kong-Shenzhen stock through train on track," by Enoch Yiu, South China Morning Post, February 2, 2015.

*Copyright © 2015. Matthew Bender & Company, Inc., a member of the RELX Group. All rights reserved. Materials reproduced from The Banking Law Journal with permission of Matthew Bender & Company, Inc. No part of this document may be copied, photocopied, reproduced, translated or reduced to any electronic medium or machine readable form, in whole or in part, without prior written consent of Matthew Bender & Company, Inc.

Linda Curtis

PARTNER, GIBSON, DUNN & CRUTCHER LLP



LINDA CURTIS IS A PARTNER AT Gibson, Dunn & Crutcher LLP, Los Angeles, and Co-Chair of the firm's Global Finance practice group. Her practice focuses on all aspects of corporate finance, with a specific focus in recent years on acquisition

financings. Linda also represents clients in debt capital markets transactions and other secured and unsecured senior, mezzanine and subordinated financings, and has experience in securitization transactions, debt restructurings and workouts. Her clients include public and private companies in a variety of industries, private equity firms, and commercial lending institutions.

For a number of years, Linda has been selected by Chambers and Partners as a leading lawyer in Banking and Finance for its Chambers USA America's Leading Lawyers for Business directories and as one of Southern California's "Super Lawyers" by Law and Politics and Los Angeles magazines. Most recently, she was recognized in the 2015, 2014 and 2013 editions of The Best Lawyers in America® in the category of

Banking and Finance Law. The Los Angeles Daily Journal named Linda to its 2015 list of Top Women Lawyers for being at the helm of industry-shaping deals. Linda also served as the president of the Los Angeles County Bar Association, one of the largest local bar associations in the country, from June 2014 to June 2015.

Linda received her J.D. from Stanford Law School where she was the articles editor for the Stanford Law Review. She has an M.B.A. from the Stanford Graduate School of Business. She received her B.A. from Oxford University and graduated summa cum laude from Princeton University where she was a member of the Phi Beta Kappa Honor Society.

GIBSON DUNN

Ira Herman

PARTNER, THOMPSON & KNIGHT LLP



IRA HERMAN IS A PARTNER IN Thompson & Knight's New York office. He concentrates his practice on domestic and cross-border insolvency matters, commercial

litigation, and related corporate governance issues. He regularly represents buyers of distressed assets and provides counsel concerning troubled commercial real estate, including securitized loans (CMBS). As a mediator, Ira has been able to facilitate the resolution of controversies involving U.S. and non-U.S. parties concerning bankruptcy and commercial law issues. Additionally, Ira works with for-profit and nonprofit entities on data privacy and cybersecurity issues.

Currently he serves as Steering Committee Chair for the New York City Bankruptcy Assistance Project. He is a member of the President's Council for the Food Bank for the City of New York. He is the Editor-in-Chief of the American Bankruptcy Institute's

(ABI) Section 363 Asset Sales Databank and Co-Chair of the ABI Assets Sales and Real Estate Committees. Ira is an Adjunct Professor of Law at Pace University School of Law and St. John's School of Law in the Bankruptcy LL.M. Program.

Ira received his J.D. from Boston University School of Law where he graduated cum laude with distinction and was the Editor of the Boston University International Law Journal. He has a B.A. in Political Science from Yeshiva University. Ira is a member of the New York State Bar and New York City Bar Associations.





INTERNATIONAL BAR ASSOCIATION LAUNCHES MOBILE APP THAT CAPTURES VERIFIABLE IMAGES TO AID PROSECUTION OF HUMAN RIGHTS ATROCITIES

EyeWitness to Atrocities App Uses LexisNexis Legal & Professional Technology to Securely Store Admissible Evidence

THE INTERNATIONAL BAR ASSOCIATION (IBA), with support from [LexisNexis Legal & Professional](#), launched the [eyeWitness to Atrocities app](#) – a new tool for documenting and reporting human rights atrocities in a secure and verifiable way so the information can be used as evidence in a court of law.

With social media increasingly the forum for communicating human rights, many online images have raised awareness of atrocities around the world but typically lack the attribution or information necessary to be used as evidence in a court of law. Now anyone with an Android-enabled smart phone – including human right defenders, journalists, and investigators – can download the eyeWitness to Atrocities app and help hold accountable perpetrators of atrocity crimes, such as genocide, crimes against humanity, torture and war crimes.

“The eyeWitness to Atrocities app will be a transformational tool in the fight for human rights, providing a solution to the evidentiary challenges surrounding mobile phone footage,” said IBA Executive Director Mark Ellis. “Until now, it has been extremely difficult to verify the authenticity of these images and to protect the safety of those brave enough to record them. As an advocate for the voiceless, the International Bar Association is dedicated to empowering activists on the ground who are witnessing these atrocities with the ability to bring criminals to justice.”

The design of the app is based on extensive research on the rules of evidence in international, regional and national courts and tribunals. It includes several features to

guarantee authenticity, facilitate verification and protect confidentiality by allowing the user to decide whether or not to be anonymous. “Putting information and technology in the hands of citizens worldwide has a powerful role to play in advancing the rule of law,” said Ian McDougall, EVP and General Counsel of LexisNexis Legal & Professional. “LexisNexis Legal & Professional’s world class data hosting capabilities will provide the eyeWitness program with the same technology that we use to safeguard sensitive and confidential material for our clients every day. It’s all part of our company’s broader commitment to advancing the rule of law around the world, as we believe every business has a role to play in building a safer, more just global society.”

How the App Works

When a user records an atrocity, the app automatically collects and embeds into the video file GPS coordinates, date and time, device sensor data, and surrounding objects such as Bluetooth and Wi-Fi networks. The user has the option of adding any additional identifying information about the image. This metadata will provide information integral to verifying and contextualizing the footage. The images and accompanying data are encrypted and securely stored within the app. The app also embeds a chain of custody record to verify that the footage has not been edited or digitally manipulated. The user then submits this information directly from the app to a database maintained by the eyeWitness organization.

Once the video is transmitted, it is stored in a secure repository that functions as a virtual

evidence locker safeguarding the original, encrypted footage for future investigations and legal proceedings. The submitted footage is only accessible by a group of legal experts at eyeWitness who will analyze the footage and identify the appropriate authorities, including international, regional or national courts, to pursue relevant cases.

“The IBA is proud to be spearheading the project and allocating \$1 million of IBA reserves as part of its efforts to promote, protect and enforce human rights under a just rule of law,” said David W. Rivkin, IBA President. The IBA is working in partnership with LexisNexis Legal & Professional, a part of RELX Group, which is hosting the secure repository, database and backup system to store and analyze data collected via the app. The IBA is also partnering with human rights organizations to put the app in the hands of those working in some of the world’s most severe conflict zones.

“The eyeWitness app promises to revolutionize the effectiveness of ground-level human rights reporting,” said Deirdre Collings, Executive Director of The SecDev Foundation, a Canadian research organization. “We also see the app’s usefulness for media activists in conflict and authoritarian environments who undertake vital but high-risk reporting. We’re proud to include eyeWitness in our training program for our partners in Syria and will be rolling it out across our projects in the CIS region and Vietnam.” The eyeWitness to Atrocities app is available as a free download for all Android smartphones. Follow this [link](#) for more information about the app.



LexisNexis®

Lexis® Securities Mosaic®

BECAUSE THE SECURITIES MARKET

NEVER STANDS STILL

AND NEITHER DO YOU

ACCESS A BROAD RANGE OF RESOURCES TO
PLAN THE NEXT MOVE YOU WANT TO MAKE

Not just the latest SEC filings, but so much more.

SEC Filings | SEDAR® Filings | Comment & No-Action Letters | Private Placement Memoranda | Agreements
Model Docs | Agency Docs | Laws & Rules | News | Law Firm Memos

Start your free trial today

LEXISNEXIS.COM/SECURITIES-MOSAIC-TRIAL

OR CALL 866-650-3600



**SEC FILINGS
DOCUMENTS**



**NO-ACTION
LETTERS**



**LAW FIRM
MEMOS**



LexisNexis®

Lexis Practice Advisor®

START ON POINT FINISH BIG

PRACTICAL GUIDANCE FROM 300+ EXPERT
ATTORNEY AUTHORS WHO GUIDE YOUR WAY



Start your free trial today

[LEXISNEXIS.COM/FINISH-BIG](https://www.lexisnexis.com/finish-big)

OR CALL 800.628.3612

300+

ATTORNEY
AUTHORS

11

PRACTICE
AREAS

900+

SEARCHABLE
DEAL POINTS