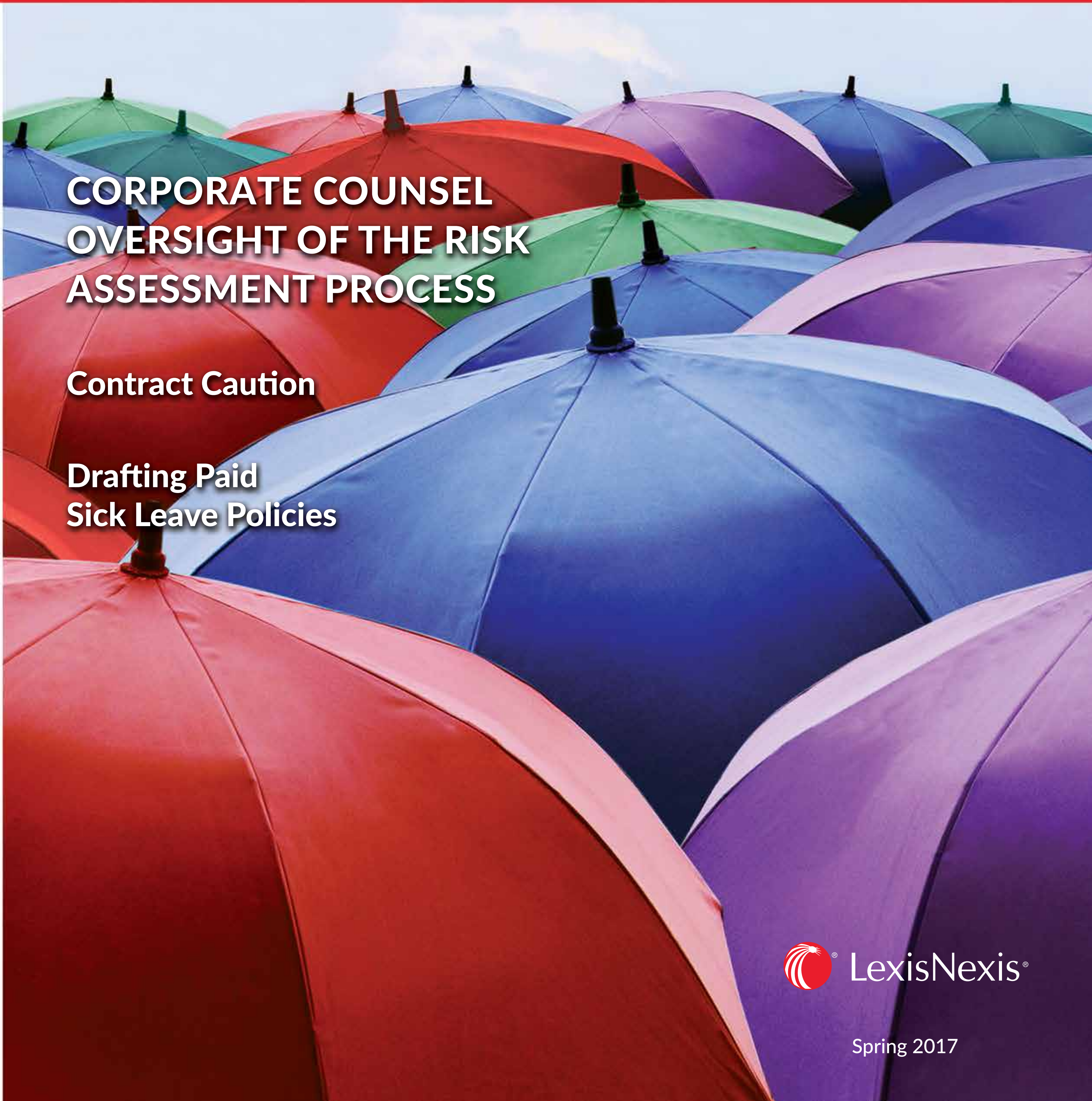
The LEXIS PRACTICE ADVISOR Journal™ SPRING 2017 www.lexispracticeadvisor.com

The LEXIS PRACTICE ADVISOR Journal™

Practical guidance backed by experts from Lexis Practice Advisor®



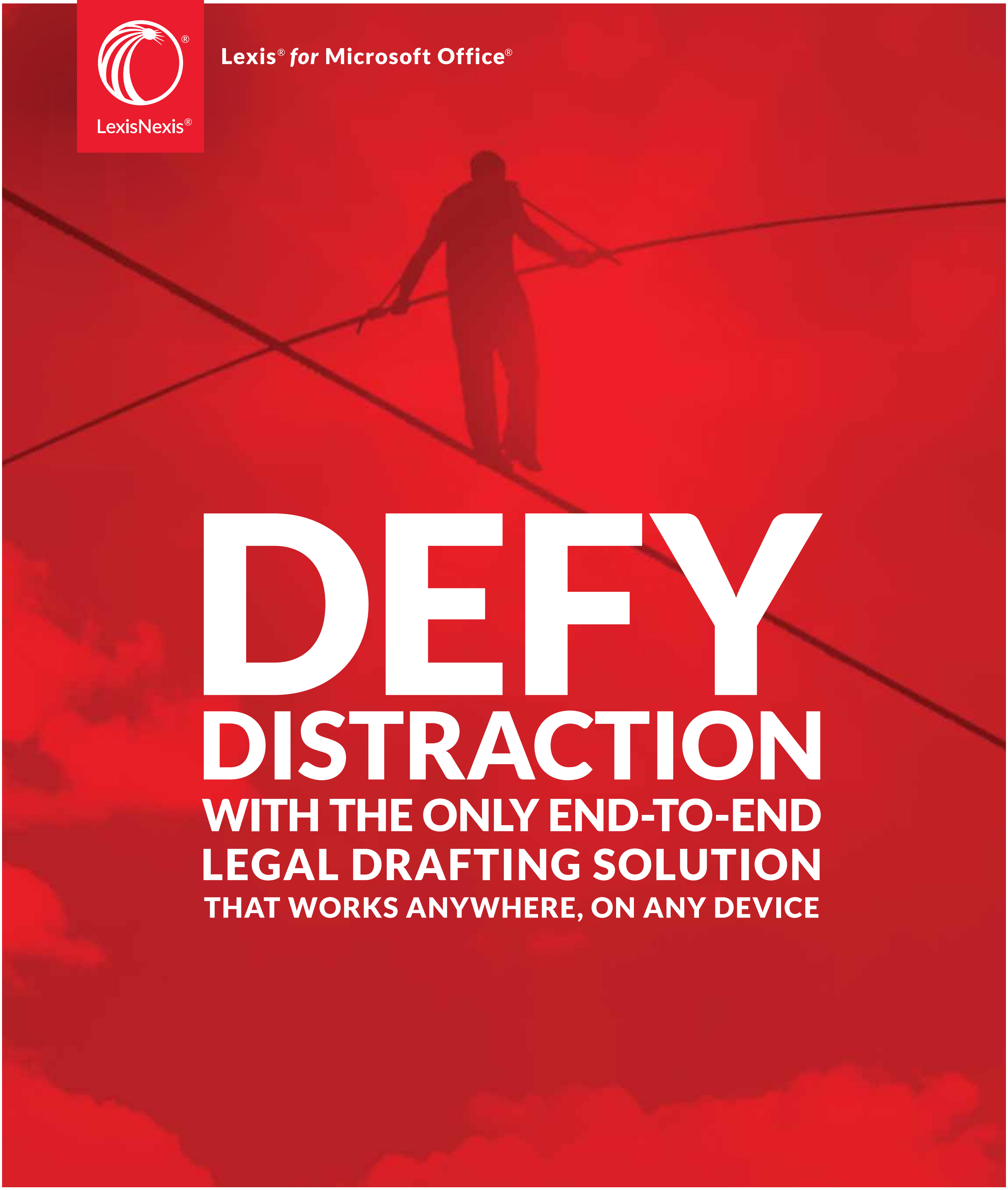
CORPORATE COUNSEL OVERSIGHT OF THE RISK ASSESSMENT PROCESS

Contract Caution

Drafting Paid Sick Leave Policies

LexisNexis®

Spring 2017


LexisNexis®
Lexis® for Microsoft Office®
DEFY
DISTRACTION
WITH THE ONLY END-TO-END
LEGAL DRAFTING SOLUTION
THAT WORKS ANYWHERE, ON ANY DEVICE

Contents SPRING 2017

The
LEXIS PRACTICE ADVISOR Journal™

SPRING 2017 (Volume 2, Issue 2)

EDITOR-IN-CHIEF
Eric Bourget

VP, LEXIS PRACTICE ADVISOR AND ANALYTICAL	**Rachel Travers**
VP, ANALYTICAL LAW & LEGAL NEWS	**Aileen Stirling**
DIRECTOR OF PRODUCT MARKETING	**Jae W. Lee**
MANAGING EDITOR	**Lori Sieron**
PUBLISHING DIRECTOR	**Ann McDonagh**
DESIGNER	**Jennifer Shadbolt**

CONTRIBUTING EDITORS

Finance	**Robyn Schneider**
Banking Law	**Matthew Burke**
Capital Markets	**Burcin Eren**
Commercial Transactions	**Anna Haliotis**
Corporate Counsel, International	**Edward Berger**
Financial Restructuring & Bankruptcy	**Cody Tray**
Employee Benefits & Executive Compensation	**Bradley Benedict**
Intellectual Property & Technology	**Jessica McKinney**
Labor & Employment	**Elias Kahn**
Mergers & Acquisitions	**Dana Hamada**
Oil & Gas, Jurisdictional	**Cameron Kinvig**
Real Estate	**Lesley Vars**
Tax	**Jessica Kerner**
ASSOCIATE EDITORS	**Maureen McGuire** **Mary McMahon** **Erin Webreck** **Ted Zwayer**
PRINTED BY	**Cenveo Publisher Services** **3575 Hempland Road** **Lancaster, PA 17601**

LexisNexis®

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

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.

Eric Bourget, Editor-in-Chief

RECENTLY, I VISITED WITH SEVERAL law firms and discussed with multiple partners and associates how they keep up with current awareness within each of their practice areas. We discussed how the Lexis Practice Advisor Journal is an excellent tool in which one can easily review articles on trending topics within his or her practice area and obtain relevant practical guidance, forms, and checklists. Every article in the Journal contains a Research Path that identifies where the article can be found within Lexis Practice Advisor. If you are reading a digital copy of the Journal, then each Research Path includes a link that will take you directly to the product. In addition, we have greatly increased the number of links to related content within every article that link to both Lexis Practice Advisor and Lexis Advance to make it easier for you to find expanded coverage.

In this edition, we focus on an important emerging issue for companies, corporate legal departments, and firms who advise them—oversight of the risk assessment process. We provide this guidance because companies and firms are constantly having to review, update, and improve their compliance programs and evaluate the increasing number of risks that could compromise company, customer, and personal data. We have included an article written by Gary Deutsch, author of our *Risk Assessments for Financial Institutions* and *Practices and Procedures for Financial Institution Risk Management*, a leading expert and advisor who works with financial institutions in audit, lending, financial, and operational areas.

Our contract drafting concerns article is full of surprises for anyone who drafts agreements or litigates contract cases. It offers lessons from a recent decision where the court interpreted a contract containing many common provisions designed to limit financial exposure in the event of a breach and held all of them invalid in the interest of fairness. This decision is full of insights about the limitations of contract drafting and serves as an eye-opener for every attorney who writes or negotiates contracts.

Paid sick leave policies have been getting attention lately as employers adjust to new regulations and requirements that vary from state to state. We provide a survey of state laws and the type of leave required, along with guidance for drafting paid sick leave policies.

Our Market Trends article discusses the volatility of the high yield market over the last year, reviews some notable recent deals, and provides a look ahead at trends in high yield bond issuances for 2017, including potential impacts of the Trump presidency and the potential for interest rate hikes.

This edition also provides practical tips that employers can follow to address, defend, and avoid harassment claims and includes a sample anti-harassment policy. In addition, this edition includes a look at Emerging Growth Companies and the advantages they enjoy when offering securities, plus a primer on debt recharacterization in bankruptcy cases.

Our mission

The Lexis Practice Advisor Journal™ is designed to help attorneys start on point. This supplement to our online practical guidance resource, Lexis Practice Advisor®, brings you a sophisticated collection of practice insights, trends, and forward-thinking articles. Grounded in the real-world experience of our 550+ seasoned attorney authors, the Lexis Practice Advisor Journal offers fresh, contemporary perspectives and compelling insights on matters impacting your practice.

HHS AGENCY PROPOSES RULE TO STABILIZE INSURANCE MARKETPLACE

THE CENTERS FOR MEDICARE & MEDICAID SERVICES (CMS) issued a proposed rule aimed at stabilizing individual and small group health insurance markets in anticipation of Congress' possible repeal and replacement of the Affordable Care Act.

CMS, an agency within the Department of Health and Human Services, administers a number of health care–related programs, including Medicare, Medicaid, the Children's Health Insurance Program (CHIP), and the Health Insurance Marketplace.

The proposed rule would make changes to special enrollment periods, the annual open enrollment period, guaranteed availability, network adequacy rules, essential community providers, and actuarial value requirements.

Specifically, the rule proposes (1) expanding pre-enrollment eligibility verification to those who enroll through special enrollment periods using the HealthCare.gov platform, (2) allowing insurers to collect premiums for unpaid coverage before enrolling the policyholder in the next year's plan, (3) providing greater flexibility to insurers to provide patients with more coverage, (4) deferring to the states' reviews of qualified health plans, (5) establishing a revised proposed timeline for the Qualified Health Plan certification and rate review process for 2018, and (6) shortening the open enrollment timeline for 2018 from Nov.1–Jan. 31 to Nov. 1–Dec. 15.

Dr. Patrick Conway, acting CMS administrator, said that the proposal "will take steps to stabilize the Marketplace, provide more flexibility to states and insurers, and give patients access to more coverage options." The proposed changes "will help protect Americans enrolled in the individual and small group health insurance markets while future reforms are being debated," he said.

The proposed rule can be accessed at https://www.federalregister.gov/documents/2017/02/17/2017-03027/patient-protection-and-affordable-care-act-market-stabilization.

-Lexis Practice Advisor Journal Staff

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

TRUMP'S TWO-FOR-ONE PLAN FOR REGULATION REDUCTION

PRESIDENT TRUMP CONTINUES HIS PUSH TO REIN IN federal regulations. On January 30, he called the Dodd-Frank Act a disaster and signed an executive order ("Reducing Regulation and Controlling Regulatory Costs") that calls for a two-for-one regulatory rollback. The order comes on top of the regulatory freeze announced on Inauguration Day and President Trump's remark a week later that "we think we can cut regulations 75%, maybe more."

The executive order states that "it is essential to manage the costs associated with the governmental imposition of private expenditures required to comply with Federal regulations. Toward that end, it is important that for every one new regulation issued, at least two prior regulations be identified for elimination, and that the cost of planned regulations be prudently managed and controlled through a budgeting process."

The order sets forth a regulatory cap for Fiscal Year 2017 that states, "Unless prohibited by law, whenever an executive department or agency publicly proposes for notice and comment or otherwise promulgates a new regulation, it shall identify at least two existing regulations to be repealed."

It also directs the heads of all agencies "that the total incremental cost of all new regulations, including repealed regulations, to be finalized this year shall be no greater than zero, unless otherwise required by law or consistent with advice provided in writing by the Director of the Office of Management and Budget (Director)."

Although the president said, "We're going to be doing a big number on Dodd-Frank," the White House has reportedly clarified that the executive order does not apply to the Consumer Financial Protection Bureau (CFPB) and other federal bank regulators that are independent agencies.

Readers will recall, however, that the CFPB's status as an independent agency could change under the PHH Corp. v. CFPB decision handed down on October 11 by the U.S. Court of Appeals for the D.C. Circuit. Stay tuned.

-Pratt's Bank Law & Regulatory Report, Volume 51, No. 3

RESEARCH PATH: *Finance > Fundamentals of Financing Transactions > Regulations Affecting Credit > Articles > Other Regulatory Issues*

TECH COMPANIES, PRIVACY GROUPS URGE HOUSE PASSAGE OF EMAIL PRIVACY ACT

A GROUP OF MORE THAN 60 TECH COMPANIES, CIVIL society organizations, and trade associations has asked the House of Representatives to act quickly to approve the Email Privacy Act (H.R. 387), which would amend the Electronics Communications Privacy Act (ECPA) by tightening warrant requirements for government access to digital content.

In a letter addressed to Rep. Bob Goodlatte (R. Va.), chairman of the House Judiciary Committee, and Rep. John Conyers (D. Mich.), the committee's ranking member, the group said that the amendment "represents true bipartisan, commonsense reform on privacy."

The bipartisan bill, which is being considered for the second time by the House, would do away with the ECPA's "180-day rule," which allows law enforcement to obtain access to emails without a warrant after 180 days, and would negate the Justice Department's interpretation of the ECPA "that the act of opening an email removes it from warrant protection."

The signatories, which include Google, Verizon, Yahoo, AOL, Facebook, and the American Civil Liberties Union, said that the bill "would ratify the Sixth Circuit's decision in U.S. v. Warshak, which held that email content is protected by the Fourth Amendment and that law enforcement access requires a probable cause warrant."

The group expressed its pleasure that the bill does not exempt civil agencies from the warrant requirement, saying that such a provision "would have expanded government surveillance power and undermined the very purpose of the bill."

The bill, sponsored by Rep. Kevin Yoder (R. Kan.) and Rep. Jared Polis (D. Colo.), was passed unanimously by the House in April and referred to the Senate Judiciary Committee but was not considered by the full Senate before the end of the 114th Congress.

-Lexis Practice Advisor Journal Staff

RESEARCH PATH: *Corporate Counsel > Confidentiality, Privacy and Data Security > Drafting Privacy Policies > Articles > Key Privacy Considerations*

EEOC REVIEWS PUBLIC COMMENTS ON WORKPLACE HARASSMENT ENFORCEMENT GUIDANCE

THE U.S. EQUAL EMPLOYMENT OPPORTUNITY COMMISSION (EEOC) is reviewing public input on a proposed enforcement guidance for addressing harassment in the workplace.

Public input was accepted through March 21 about the 75-page guidance, which sets forth the EEOC's interpretation of the federal anti-harassment laws that it is charged with enforcing. The guidance focuses on the three components of a hostile work environment claim: whether the conduct at issue was based on the complainant's legally protected status, whether the conduct was sufficiently severe or pervasive to create a hostile work environment, and whether there is a basis for holding the employer liable.

The Commission noted that a June 2016 report issued by its Select Task Force on the Study of Harassment in the Workplace revealed that almost one-third of the approximately 90,000 charges it received in fiscal year 2015 included a workplace harassment allegation.

"This enforcement guidance is a companion piece to the Task Force Report," the EEOC said. "The Task Force Report focuses on identifying ways to renew efforts to prevent harassment, and this enforcement guidance explains the legal standards for unlawful harassment and employer liability."

The proposed guidance provides various examples of workplace behavior and indicates whether the conduct constitutes harassment under federal law. In addition, the document suggests proactive measures that employers can take to prevent harassment from occurring, including a commitment to creating and maintaining a culture of respect, adoption of a clear and comprehensive anti-harassment policy, institution of an effective and accessible harassment complaint system, and effective harassment training.

The proposed guidance is posted at https://www.regulations.gov/document?D=EEOC-2016-0009-0001. All input will be posted publicly at www.regulations.gov. After a review of the input, the EEOC will consider making revisions before finalizing the guidance.

-Lexis Practice Advisor Journal Staff

RESEARCH PATH: *Labor & Employment > Discrimination and Retaliation > EEO Laws and Protections > Articles > Harassment*

Timothy Murray MURRAY, HOGUE & LANNIS

CONTRACT DRAFTING CONCERNS

A Cautionary Tale: When a Court Disregards Common Contractual Provisions Designed to Protect Your Client—In the Interest of Fairness

RECENTLY A TEXAS COURT CONSTRUED A CONTRACT replete with common provisions designed to limit the supplier's financial exposure in the event of its breach and proceeded to hold every one of them inoperative in the interest of fairness. *CGBM 100 v. Flowserve US*, 2016 U.S. Dist. LEXIS 179517 (S.D. Tex. December 29, 2016) is a cautionary tale about the limitations of contract drafting, and every attorney who drafts contracts could benefit by understanding its lessons.

The Case[1]

Plaintiffs were under contract with CITGO (not a party in the case) to load two barges with coker feed, transport it across a waterway, and then unload it. To perform the CITGO contract, plaintiffs needed four pumps capable of pumping coker feed at a flow rate of 3,500 gallons per minute.

The defendant, Flowserve, assured plaintiffs that even though its standard pumps did not meet the required flow rate, Flowserve could redesign its standard pumps to meet plaintiffs' specifications. Based on Flowserve's assurances, plaintiffs entered into a contract to purchase the pumps from Flowserve at a cost of $1.3 million.

Flowserve's promise to achieve the required flow rate was not included in the parties' written contract. The parties' written contract contained all manner of standard provisions designed to limit Flowserve's financial exposure in the event of its breach. These included:

- A disclaimer of warranty clause
- A merger or integration clause
- A clause limiting plaintiffs' remedies to repair or replace the pumps, at Flowserve's option
- A damages cap limiting monetary damages to the price of the pumps
- A clause excluding any liability on Flowserve's part for "special, consequential, incidental or penal damages"

After the pumps were installed, plaintiffs claimed they failed to achieve the required flow rate. According to plaintiffs, Flowserve, contrary to its promises, had not redesigned its standard pumps prior to installation but merely made minor and inadequate adjustments to them and instructed plaintiffs to run the pumps at a higher-than-normal speed. This method proved inadequate and caused severe vibrations to the barges.

Flowserve attempted, without success, to repair the pumps before demanding what the court would later call "substantial sums of money from Plaintiffs to continue its repair efforts . . . ." When plaintiffs refused to pay, Flowserve stopped working on the pumps. The alleged breach caused plaintiffs to incur approximately $2.5 million in damages to retain the services of a company to temporarily perform its CITGO contract and another company to redesign the pumps to perform as required.

Plaintiffs sued Flowserve for, *inter alia*, breach of express warranty and fraud. Flowserve moved for summary judgment and argued that its alleged promises regarding the pumps' capabilities were barred by the contract's disclaimer and merger clauses and that plaintiffs' damages were limited by the clear terms of the contract. The court disagreed.

The Court Holds That Provisions Designed to Protect Flowserve Were Inoperative

The court held that the jury could find each of the clauses that ostensibly protected Flowserve was ineffective to shield Flowserve from the consequences of its breach.

The Disclaimer of Warranty Did Not Disclaim the Warranty

The court held that Flowserve's promise to achieve the required flow rate constituted an express warranty, and "[t]hat promise was the primary basis of the bargain upon which Plaintiffs relied in authorizing the purchase of the pumps."

But the contract also contained a disclaimer of warranty clause that "would negate or limit that warranty" (the court did not quote the actual language). The court concluded it could not reconcile the warranty with the disclaimer, so according to the clear words of U.C.C. § 2-316(1), the disclaimer was inoperative. See also U.C.C. § 2-313, Official Comment 4 ("A clause generally disclaiming 'all warranties, express or implied' cannot reduce the seller's obligation with respect to such description and therefore cannot be given literal effect under Section 2-316.").

The lesson is clear: a party cannot both give, and disclaim, an express warranty.

The Merger Clause Did Not Negate the Prior Oral Warranty

The contract also contained a merger or integration clause designed to signal that the written contract is the complete and exclusive statement of the terms of the parties' agreement.

The court held that the merger clause did not bar consideration of Flowserve's prior oral warranty, saying that the merger clause can offer Flowserve no escape since it cannot be seriously contended that plaintiffs intended the written contract to be a complete and exclusive statement of the terms of the agreement. The warranty was a basis of the parties' bargain, the court explained, so the merger clause could not undo it.

1. The facts recited here are those considered in connection with the defendant's motion for summary judgment, which means they are construed in the light most favorable to the plaintiffs, the non-movants.

The treatment of merger clauses varies from jurisdiction to jurisdiction. ". . . [M]ost contemporary viewers of contract are unwilling to accept the doctrinaire" view that merger clauses are "conclusive, except for mistakes, fraud and attempts at reformation." Corbin on Contracts § 25.8 (2016).[2] "According to the Restatement (Second) of Contracts and most major writers, a merger clause should not be treated as definitive, but should be given weight based on the circumstances under which it was adopted, including the complexity and sophistication of the contract and the parties." Corbin on Contracts § 25.8 (2016).

Plaintiffs also pleaded a claim for fraud, and the court refused to dismiss it on summary judgment despite the merger clause. The majority of jurisdictions hold that fraud, without restriction, is admissible to challenge the validity of a written agreement. *Riverisland Cold Storage, Inc. v. Fresno-Madera Production Credit Assn.*, 55 Cal. 4th 1169, 1171, 291 P.3d 316, 317, 151 Cal. Rptr. 3d 93, 94, 2013 Cal. LEXIS 253, *1 (Cal. 2013).

The contract at issue did not contain a non-reliance clause in addition to a merger clause (the two clauses are often paired together). While it is far from certain that inclusion of such a clause would have been dispositive, the court suggested it might have. "The merger clause does not express Plaintiffs' intent to disclaim ***reliance*** on Flowserve's representations and, instead, to rely upon their own judgment," the court wrote. Another court[3] recently explained that "non-reliance," "no-reliance," or "anti-reliance" clauses "state that the parties to the contract did not rely upon statements or representations not contained within the document itself," which "has the binding effect of negating an action based on fraud in the inducement. Although some courts have adopted a contrary approach, this appears to be the rule in the majority of jurisdictions."

The Court Disregarded (1) the Clause Limiting Plaintiffs' Remedies to Repair or Replacement of the Pumps, (2) the Damages Cap, and (3) the Exclusion of Consequential and Incidental Damages

Based on the facts before it, the court held that a jury could conclude that the limited remedy spelled out by the contract failed of its essential purpose and did not provide a "fair quantum of remedy" to plaintiffs. The court opened the door for the jury to award damages far in excess of what the contract, as written, ostensibly allowed.

Failure of Essential Purpose

Under U.C.C. § 2-719(2), "[w]here circumstances cause an exclusive or limited remedy to fail of its essential purpose, remedy may be had as provided in this Act." This means that when a contract spells out an exclusive, limited remedy, if the seller fails to provide the remedy, the U.C.C.'s default monetary remedies (including not just direct damages but consequential and incidental damages as well) are restored.

The court invoked the failure of essential purpose concept here even though, in addition to the repair or replacement remedy, the contract also permitted limited money damages up to the price of the pumps ($1.3 million). There is some judicial reluctance to invoke the concept where money damages are available. See, e.g., *Fish Net, Inc. v. Profitcenter Software, Inc.*, 2013 U.S. Dist. LEXIS 148661, *29 (E.D. Pa. Oct. 15, 2013) (remedy did not fail of its essential purpose since the contract allowed limited money damages). But see *Marvin Lumber & Cedar Co. v. Sapa Extrusions, Inc.*, 964 F. Supp. 2d 993, 996, 2013 U.S. Dist. LEXIS 108700, *1, 81 U.C.C. Rep. Serv. 2d (Callaghan) 279 (D. Minn. 2013) ("limiting damages to the purchase price would essentially amount to no remedy at all and fails of its essential purpose.").[4]

2. *E.g.*, *Jacobson v. Hofgard*, 2016 U.S. Dist. LEXIS 26802 (D.D.C. 2016): ". . . the mere presence of an integration clause does not automatically preclude claims premised on representations or omissions that fall outside the contract." Integration clauses should not be used to play a game of "gotcha," the court wrote. 3. *Billington v. Ginn-LA Pine Island, Ltd., LLLP,* 2016 Fla. App. LEXIS 7718, 41 Fla. L. Weekly D 1204 (2016). 4. In addition, many, but by no means all, jurisdictions hold that when a limited remedy fails of its essential purpose, if the contract also contains an exclusion of consequential and incidental damages (as this one does), that exclusion remains valid. *See, e.g.*, *Corbin on Contracts Desk Edition* § 29.04 (2017). The court did not deal with this conundrum.

Fair Quantum of Remedy

The court also held that that the jury was entitled to disregard the contract's limited remedies because they did not provide a "fair quantum of remedy" to the aggrieved plaintiffs.

The implication is that even when an otherwise valid contract spells out a limited remedy, the limited remedy will not be operative if it isn't "fair."

It might seem jarring to modern practitioners, steeped in the traditions of freedom of contract, that a court could invalidate a mutually agreed-upon provision that is not unconscionable on the basis of *fairness*. But this isn't a rationale that the *CGBM* court invented from whole cloth. The Official Comments to the U.C.C. state, *inter alia*:

> . . . it is of the very essence of a sales contract that at least minimum adequate remedies be available . . . . [T]here [must] be at least a fair quantum of remedy for breach of the obligations or duties outlined in the contract. . . . .
> [W]here an apparently fair and reasonable clause because of circumstances fails in its purpose or operates to deprive either party of the substantial value of the bargain, it must give way to the general remedy provisions of this Article.

U.C.C. § 2-719 cmt. 1.

Indeed, a contractual provision that limits the remedy to direct damages or a money back guarantee may be invalidated if it does not place the aggrieved party in the position it would have occupied had the contract been performed. See, *e.g.*, *Marvin Lumber & Cedar Co. v. Sapa Extrusions, Inc.*, 964 F. Supp. 2d 993 (D. Minn. 2013); *Holbrook v. Louisiana-Pacific Corp.*, 2015 U.S. Dist. LEXIS 35862 (N.D. Ohio Mar. 23, 2015); *E.F. Johnson Co. v. Infinity Global Tech.*, 2016 Tex. App. LEXIS 8795, 90 U.C.C. Rep. Serv. 2d (Callaghan) 533 (Tex. App. Dallas 2016).

At what point does a court cross the line from insuring "a fair quantum of remedy" to improperly rewriting a contract to correct a bad deal made by one of the parties? The line is not always distinct. In the *CGBM* case, the court held that the limited remedy provided on the face of the contract "would deprive Plaintiffs of the substantial value of their bargain with Flowserve."

The court cited in support of its holding *E.F. Johnson Co. v. Infinity Global Tech.*, 2016 Tex. App. LEXIS 8795, 90 U.C.C. Rep. Serv. 2d (Callaghan) 533 (Tex. App. Dallas 2016). In that case, EFJ acted as exclusive distributor of Infinity's GPS-Mic and made an "irrevocable and non-cancellable" promise to take and pay for a minimum purchase of the GPS-Mic over three years. After just one year, EFJ terminated the agreement and refused to take or pay for any more units. Infinity and a co-defendant sued EFJ, and a jury awarded damages against EFJ in excess of $2.5 million, plus attorney's fees. On appeal, EFJ argued that the damages should

Related Content

For a detailed discussion on the use of warranties and representations in contracts, see

> DRAFTING REPRESENTATIONS AND WARRANTIES

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

For examples of representations, warranties, conditions, rights, and covenants in commercial contracts, see

> REPRESENTATIONS, WARRANTIES, COVENANTS, RIGHTS, AND CONDITIONS IN COMMERCIAL AGREEMENTS

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

For assistance in understanding and drafting contractual merger clauses, see

> DRAFTING A MERGER CLAUSE

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

For information on contractual clauses that define or limit remedies, see

> DEFINING AND LIMITING REMEDIES

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

For guidance on the nature of damages that are available under the Uniform Commercial Code (UCC) see

> DAMAGES AND REMEDIES UNDER THE UCC

RESEARCH PATH: *General Practice > Supply of Goods and Services > Contract Formation > Practice Notes > Breach and Damages* have been capped at the total amount EFJ paid Infinity at the time of the termination—$49,600—in accordance with the limitation-of-liability provision of the parties' contract. The court rejected that argument, holding that limiting EFJ's damages would deprive Infinity of the substantial value of its bargain and would not provide it a "fair quantum of remedy." The limitation-of-liability provision was unreasonable, and thus unenforceable.

Practice Tips and Lessons of CGBM

Without opining on the correctness of the *CGBM* court's decision, the case offers valuable lessons on matters that come up with regularity in drafting contracts.

- A client cannot give and disclaim an express warranty. A purported disclaimer of "all other warranties, express or implied" in the contract cannot undo a bona fide express warranty. If the client makes assurances about a product's capabilities and the other party relies on them, the client should not expect the written contract to save it from all responsibility it if it fails to live up to the assurances.
- The client needs to be cautioned about making promises outside the written contract. Any promises about the product should be carefully worded and included in the document so that there is no dispute about them.

The client also needs to understand that promises he or she makes after contract formation may be relatively easy to enforce since merger and non-reliance clauses are not a bar to post-formation communications. See, e.g., U.C.C. § 2-313, Comment 7 (post-formation warranties may become modifications of the contract).

- If the client insists on having a very limited repair or replace remedy, it needs to be prepared to deliver on its promises—if it doesn't, it risks losing all the other protections in the contract designed to limit its liability.
- Even if the seller promises to return the buyer's money in the event of a breach, that may not be a legally sufficient remedy to make the buyer whole if the buyer incurs all manner of additional foreseeable expense due to the breach.
- The overarching and most daunting lesson of all: the written contract is not an impenetrable fortress that can whitewash the client's responsibility from the consequence of its actions. Fairness is sometimes a force more potent even than freedom of contract. L

Timothy Murray is the coauthor of the Corbin on Contracts Desk Edition (2017) and the biannual supplements to Corbin on Contracts. He practices law as a partner in Murray, Hogue & Lannis in Pittsburgh, Pennsylvania, where he has represented all manner of clients in business disputes and transactional matters.

RESEARCH PATH: *Corporate Counsel > Contract Formation > Contract Clauses > Articles > Disclaimers of Warranty*

Richard D. Glovsky LOCKE LORD LLP

Examining Harassment Claims

THIS ARTICLE ADDRESSES PROTECTED STATUS HARASSMENT issues, a subset of discrimination claims that arise where an employee alleges that he or she was subjected to unwelcome conduct in the workplace due to the employee's protected status (race, sex/gender, age, disability, national origin, etc.). It focuses on the elements of these claims and defenses to them. It also provides practical tips that employers can follow to address, defend, and avoid harassment claims.

Most harassment allegations assert that the employer created a hostile work environment that negatively impacted the terms and conditions of an employee's employment. But it is important for employers to remember that not all harassment is illegal. Most federal and state laws only prohibit harassment that is "severe or pervasive." One, or even a few, questionable incidents do not usually amount to unlawful harassment.

Not All Harassment Is Illegal

Many employees do not understand that not all harassment is illegal; it must be premised upon a particular protected category. Federal law, for example, prohibits harassment based on the following grounds:

- Race
- Color
- Religion
- Gender/sex
- Age
- Disability
- National origin
- Ethnicity
- Citizenship status
- Genetic information
- Military status
- Qualified medical leave
- Reporting discrimination

Many state jurisdictions have their own equal employment opportunity (EEO) laws that protect employees who fall into additional protected categories. For example, many states and the District of Columbia have enacted laws prohibiting discrimination on the basis of sexual orientation. To cite another example, Michigan bans discrimination on the basis of height and weight.

Localities have also adopted categorical protections. For instance, New York City protects the unemployed from discrimination, while Broward County in Florida prohibits discrimination on the basis of political affiliation.

Because protected classifications vary from state to state and even city to city, when advising employers about potential harassment claims, you should be familiar with the laws of each state, county, and municipality where the employer is located.

Types of Harassment Claims

Generally, there are two types of unlawful harassment:

1. **Hostile work environment.** A hostile work environment exists when an employee's workplace is so permeated with discriminatory intimidation, ridicule, abuse, and/or insult that it alters the terms and conditions of the employee's employment and creates a hostile work environment.
2. ***Quid pro quo* harassment.** *Quid pro quo* harassment occurs where conditions of employment or job benefits are dependent upon an employee submitting to unwelcome conduct (usually sexual advances) or where an employer retaliates against an employee who rejected such unwelcome conduct.

Elements of a Harassment Claim

Generally, a valid claim for harassment must demonstrate the following:

- The employee is a member of a protected class.
- The employee was subjected to unwelcome verbal or physical conduct.
- The unwelcome conduct was due to the employee's membership in a protected class.
- The unwelcome conduct affected a term, condition, or privilege of employment.

Alfano v. Costello, 294 F.3d 365, 373–74 (2d Cir. 2002).

EEO Laws Are Not a Workplace Civility Code

Not all unwelcome conduct in the workplace that an employee might consider harassing affects a term, condition, or privilege of employment. The courts have been clear that federal and state anti-harassment laws are not intended to serve as a civility code for employers to implement in the workplace. As the U.S. Supreme Court has explained, Title VII of the Civil Rights Act of 1964 (Title VII) does not prohibit "genuine but innocuous differences in the ways men and women routinely interact with members of the same sex and of the opposite sex." Faragher v. City of Boca Raton, 524 U.S. 775, 788 (1998).

"[S]imple teasing, offhand comments, and isolated incidents (unless extremely serious)" do not alter a "term, condition, or privilege" of employment. Id.

Hostile Work Environment

Many employees attempt to establish a claim of harassment by showing that the unwelcome conduct created a hostile work environment and, as a result, altered a term, condition, or privilege of the employee's employment. However, the courts have generally defined a hostile work environment as a workplace that is permeated with discriminatory intimidation, ridicule, and insult that is sufficiently severe or pervasive to alter the conditions of an employee's employment. Harris v. Forklift Systems, 510 U.S. 17, 21 (1993).

When determining whether conduct is sufficiently severe or pervasive to create a hostile work environment, courts view the alleged behavior both objectively and subjectively. That is, the unwelcome conduct must be both behavior that a reasonable person would find hostile and behavior that the employee actually finds to be hostile.

The Objective Test

It is not uncommon for employees to believe they were harassed, but more often than not, an objective review will come to a contrary determination. Whether alleged unwelcome conduct meets the objective test depends upon an analysis of the circumstances, which typically includes an analysis of the following:

- **The frequency of the conduct.** There is no magic number of instances of unwelcome conduct that will create a hostile work environment. When dealing with verbal harassment, courts typically require repeated instances of harassment that continue despite the employee's objection. Aulicino v. N.Y.C. Dep't of Homeless Servs., 580 F.3d 73 (2d Cir. 2009) ("racist comments, slurs, and jokes . . . must be more than a few isolated incidents of racial enmity").
- **The severity of the alleged conduct.** The more severe the conduct, the fewer number of instances necessary to create a hostile environment. For example, many courts have found that a single instance of physical assault (both sexual or nonsexual) can sufficiently alter the conditions of employment as to create a hostile work environment, but a single unwanted touching or utterance of a slur does not usually create a hostile work environment. See Richardson v. New York State Dep't of Corr. Serv., 180 F.3d 426, 437 (2d Cir. 1999) (observing that a single sexual assault may be sufficient to alter the terms and conditions of the victim's employment).
- **Whether the alleged conduct or comments are humiliating or physically threatening.** Comments due to an employee's protected category status that are humiliating and behavior that is physically threatening in nature (but does not rise to the level of a physical assault) can establish a hostile work environment. Examples such as conduct that invades an employee's personal space (such as backing the employee up against a wall or into a corner) or frequent comments in front of others that are not justified and that degrade or humiliate an employee may create a hostile work environment.
  - **Qualified privilege.** Note that if an employee makes a defamatory statement about another employee accused of harassing and humiliating conduct, the employer has a qualified privilege to convey this information within the company while investigating the harassment allegations, if it does so in good faith. See Vickers v. Abbott Labs., 308 Ill. App. 3d 393, 400–06, (1999) (employer had qualified privilege and did not abuse it when it made statements to current and former subordinates of a manager during investigation of alleged sexual harassing behavior by the manager). See also McCone v. New England Tel. & Tel. Co., 393 Mass. 231 (1984) (qualified privilege exists for intra-company statements made in good faith to department heads); Hollowell v. Career Decisions, Inc., 100 Mich. App. 561 (1980) (there is a qualified privilege for intra-company statements made in good faith to those with responsibility for the employer as a whole, such as members of the board of directors).
- **Whether the alleged conduct unreasonably interferes with the employee's work performance.** Behavior that unreasonably interferes with an employee's work performance typically involves conduct that makes it more difficult for the employee to perform his or her job. For example, unfounded comments that undermine an employee's authority with subordinates or clients or inexplicable exclusion from company-sponsored events may help an employee to establish a hostile work environment. Murray v. Visiting Nurse Service, 528 F. Supp. 2d 257, 278, (S.D.N.Y. 2007) (citing Alfano v. Costello, 294 F.3d 365 (2d Cir. 2002)).

No single factor determines whether a work environment is so hostile that it is unlawful; whether a hostile work environment exists depends on analysis of all relevant facts and circumstances. Harris v. Forklift Systems, 510 U.S. 17, 23 (1993).

The Subjective Test

The subjective test requires that the target of harassment believes that the environment is hostile. The employee's burden to establish this element of a harassment claim is relatively easier to meet than the objective test. However, an employer can defeat this element of a harassment claim by showing that the employee tolerated the behavior without asserting a protected category complaint, delayed in reporting it, or assented to or invited the conduct that he or she alleges was harassing. It is important to note that the subjective test does not necessarily require the employee to prove that (1) he or she felt physically threatened or (2) the harasser's intent was hostile.

Case Examples Where Harassment Did Not Create a Hostile Work Environment

The following are examples of judicial rulings finding that alleged conduct did not create a hostile work environment:

- **Isolated incidents did not rise to a hostile work environment.** In *George v. Leavitt,* the court concluded that statements by three coworkers over a six-month period that the employee should never have been hired, should "go back to Trinidad" or "go back where [she] came from," and told to "shut up" and allegations that the employee was not given

Related Content

For a discussion of state EEO laws, see

> CHART – STATE PRACTICE NOTES (DISCRIMINATION AND RETALIATION)

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

For information on best practices for complying with Title VII of the Civil Rights Act of 1964, see

> COMPLYING WITH TITLE VII

RESEARCH PATH: *Labor & Employment > Discrimination and Retaliation > EEO Laws and Protections > Practice Notes > Title VII and the Pregnancy Discrimination Act*

For guidance for employers to comply with the Age Discrimination in Employment Act (ADEA), see

> ADDRESSING THE ADEA'S MANDATES

RESEARCH PATH: *Labor & Employment > Discrimination and Retaliation > EEO Laws and Protections > Practice Notes > Age Discrimination in Employment Act* the type of work she deserved were isolated instances that did not rise to the level of severity necessary to find a hostile work environment. George v. Leavitt, 407 F.3d 405 (D.C. Cir. 2005). Instead, the court concluded that the allegations "constitute exactly the sort of 'isolated incidents' that the Supreme Court has held cannot form the basis for a Title VII violation." Id.

- **Supervisor's conduct was not severe or pervasive.** In *Hockman v. Westward,* the court concluded that a supervisor's conduct—which included comments to a female employee about another female employee's body, slapping the employee on the rear end with a newspaper, grabbing or brushing up against the employee's breasts and rear end, and attempting to kiss the employee—was not so severe or pervasive that it created a hostile or abusive work environment. Hockman v. Westward Communs., LLC, 407 F.3d 317 (5th Cir. 2004).
- **Single incident of intentional touching and a comment about employee's body not sufficient to rise to hostile work environment.** In *Quinn v. Green Tree Credit Corp.,* the court found that a supervisor's statement that a female employee had the "sleekest ass" in the office plus a single incident of "deliberately" touching the employee's breasts with some papers that the supervisor was holding in his hand were insufficient to create a hostile work environment. Quinn v. Green Tree Credit Corp., 159 F.3d 759 (2d Cir. 1998).

Case Examples Where Conduct Created a Hostile Work Environment

The following are examples of decisions where the court ruled that alleged conduct, if it in fact occurred, could create a hostile work environment:

- **Use of racist nicknames, graffiti, and slogans, among other harassing actions, constituted a hostile work environment.** In *Cerros v. Steel Techs.*, supervisors and coworkers espoused the philosophy that "if it ain't white it ain't right" and referred to the plaintiff using racially derogatory nicknames, coworkers slashed the tires on the employee's car, racist graffiti was painted on the bathroom walls, and the plaintiff did not receive the same on the job training as similarly situated white employees. Cerros v. Steel Techs., Inc., 288 F.3d 1040 (7th Cir. 2002).
- **Sexist comments and conduct by supervisor and coworkers, among other harassing conduct, constituted a hostile work environment.** In *Williams v. GMC,* the alleged conduct included (1) comments by a supervisor (such as "You can rub up against me anytime," and "Back up; just back up" after plaintiff was bending over and supervisor walked up behind her); (2) conduct of coworkers (which included one coworker addressing the employee "Hey slut" or another saying "I'm sick and tired of these f[-]ing women," after throwing a box in the employee's direction); and (3) pranks by coworkers (such as locking the employee in her work area) were sufficient to create a hostile work environment. Williams v. GMC, 187 F.3d 553 (6th Cir. 1999).

Quid Pro Quo Harassment

Quid pro quo harassment occurs when an employer conditions employment or the receipt of job benefits on the employee submitting to unwelcome conduct (usually sexual advances) by a supervisor or where an employer retaliates against an employee who rejects a supervisor's advances. The elements of a *quid pro quo* claim of sexual harassment track those of a harassment claim, except that the employee must also show that either his or her submission to the unwelcome advances was an express or implied condition of employment or advancement or the receipt of job benefits. The employee may also demonstrate that his or her refusal to submit to a supervisor's advances detrimentally impacted the terms and/or conditions of his or her employment.

Paramour Exception

Not all types of sexual favoritism violate EEO laws. For example, Title VII generally does not prohibit preferential treatment of an employee engaged in a consensual romantic relationship with a supervisor or decision-maker. Where one party to a romantic relationship may favor the other party (i.e., the paramour) to the detriment of other employees, the result—while perhaps unfair—is not a violation of Title VII. The rationale for this conclusion is that the disadvantaged employees, usually including both men and women, were not treated less favorably because of their genders. Tenge v. Phillips Modern Ag Co, 446 F.3d 903, 910 (8th Cir. 2006).

Employer Liability

In addition to the factors outlined above, for an employer to be liable for harassment, an employee must also prove that he or she suffered a "tangible employment [adverse] action" and that the alleged harasser was his or her "supervisor." For an employee to demonstrate harassment by coworkers or non-employees, he or she must prove that the employer knew, or should have known, about the harassment and failed to address it. Faragher v. City of Boca Raton, 524 U.S. 775, 799 (1998).

Employer Liability for Harassment that Results in a Tangible Adverse Employment Action

An employer is strictly liable for harassment by supervisors of an employee in a protected category that results in a tangible adverse employment action such as a termination or demotion (vicarious liability). Claims of this nature are essentially disparate treatment claims asserting that an employee suffered

an unlawful adverse employment action due to his or her protected category status.

A tangible employment action is a significant change in employment status that usually results in direct economic harm to the employee. Faragher v. City of Boca Raton, 524 U.S. 775, 808 (1998).

Examples of tangible employment actions include:

- Hiring and firing
- Promotion or failure to promote
- Demotion or a change in job duties that diminishes an employee's opportunities for promotion or salary increases
- Suspension and other forms of discipline
- Assignment to a lesser position or reduction of job duties
- A decrease in benefits or compensation

Insignificant changes in any employee's employment status (such as a simple change in job title) generally do not amount to a tangible employment action.

Employer Liability for Harassment by Supervisors

Definition of Supervisor

The U.S. Supreme Court has clarified the definition of a "supervisor" for purposes of vicarious liability for hostile work environment claims, explaining that a supervisor is someone that the employer has authorized "to effect a significant change in employment status, such as hiring, firing, failing to promote, reassignment with significantly different responsibilities, or a decision causing a significant change in benefits." Vance v. Ball State Univ., 133 S. Ct. 2434, 2443 (2013). The Supreme Court rejected EEOC guidance offering a more narrow definition of supervisor that included employees within the alleged victim's chain of command or that directed the purported victim's daily work activities.

In *Vance,* the Supreme Court did recognize, however, that employees may be supervisors in circumstances when they may not have the final say regarding significant changes in an employee's employment status, but do make recommendations that are given substantial weight by the ultimate decision-maker. Vance, 133 S. Ct. at 2452.

The Faragher-Ellerth Defense

Where harassment by a supervisor rises to the level of a hostile work environment but does not result in a tangible job action, an employer can assert an effective affirmative defense if it can show that it exercised reasonable care to prevent and promptly address the harassment, and the employee failed to take advantage of the preventative measures it offered. This defense, commonly is known as the *Faragher-Ellerth* defense, is based on two Supreme Court decisions: Faragher v. City of Boca Raton, 524 U.S. 775 (1998) and Burlington Industries, Inc. v. Ellerth, 524 U.S. 742 (1998).

To establish an *Faragher-Ellerth* affirmative defense, an employer must show both that:

- It exercised reasonable care to prevent and promptly address alleged harassment.
- The employee unreasonably failed to take advantage of preventative or corrective opportunities provided by the employer.

The Employer's Duty to Exercise Reasonable Care

An employer establishes the first element of the *Faragher-Ellerth* defense by showing it took reasonable care to prevent and promptly correct the alleged harassment at issue. Generally, an employer will satisfy this standard when it has adopted and enforces comprehensive anti-harassment policies and complaint procedures that are communicated to all employees.

While courts give complaint procedures considerable weight when considering whether an employer exercises reasonable care, policies are not an absolute requirement. Cajamarca v. Regal Entm't Grp., 863 F. Supp. 2d 237, 249-50 (E.D.N.Y. 2012). For example, a small employer may be able to show that it exercised reasonable care even in the absence of a formal written policy. For larger employers though, it is most prudent to adopt a formal policy and complaint procedure.

The Employee's Duty to Take Advantage of Preventative or Corrective Opportunities

To defeat an employee's claim utilizing the *Faragher-Ellerth* defense, an employer must also show that the complaining employee unreasonably failed to take advantage of preventative or corrective opportunities provided by the employer. Employers typically satisfy this element by showing that the employee failed to timely file a complaint, failed to cooperate with the employer's efforts to investigate the employee's allegations, or that the employee unreasonably rejected the employer's proposed resolution of the employee's assertions.

Moreover, when an employee delays reporting alleged harassment and the employer can show that the delay exacerbated the effects of the harassment, the employer can diminish its exposure by avoiding damages that occurred during the period of delay.

An employee can excuse his or her delay by offering a reasonable explanation. However, whether an employee's explanation is reasonable is a fact-specific inquiry. The following rulings illustrate circumstances where the excuse offered by an employee for the delay in asserting a claim of harassment may be reasonable:

- **Legitimate concern that employer would not take the complaint seriously.** An employee's concern that his or her employer would not take his or her complaint of harassment seriously may excuse a delay in asserting his or her claim if the employee provides evidence that the employer ignored similar complaints in the past or if the employer's complaint procedure required the employee to register his or her concerns with the purported harassing supervisor. Leopold v. Baccarat, Inc., 239 F.3d 243, 246 (2d Cir. 2001).
- **Risk of retaliation.** An employee's failure to complain may be reasonable in circumstances where he or she had a credible fear of retaliation. An employee may not rely on his or her subjective belief, however, and must prove, for example, that the employer retaliated against employees who made similar complaints in the past. See, e.g., Reed v. MBNA Marketing Systems, 333 F.3d 27, 37 (1st Cir. 2003).
- **Obstacles to complaints.** An employee's failure to complain also may be excusable where the employer unnecessarily impeded his or her ability to complain by, for example, making the official recipient of the complaint unreasonably inaccessible or by adopting intimidating or burdensome reporting requirements. See, e.g., EEOC v. V & J Foods, Inc., 507 F.3d 575, 578 (7th Cir. 2007).

To protect themselves, it would be most prudent for employers to institute complaint procedures that allow employees to report harassment not only to their immediate supervisors, but also to human resources or other management representatives. The policy should also make clear that employees who report alleged harassment or participate in a related investigation will not be subjected to retaliation.

Employer Liability for Harassment by Coworkers and Third Parties

An employee can hold an employer vicariously liable for harassment by coworkers or third parties. However, to hold his or her employer liable for harassment by coworkers or others, an employee must demonstrate that the employer both:

- Knew or should have known about the harassment
- Failed to take prompt remedial action

Freeman v. Dal-Tile Corp., 750 F.3d 413, 423 (4th Cir. 2014).

How the employer addresses unlawful harassment depends on the nature of the alleged conduct. At the outset, the employer may want to consider removing the complaining employee from the harassing environment (by, for example, relocating the employee or the alleged harasser to another work station) and conducting an investigation to ascertain the full nature of the problem. Once the investigation is complete, the employer can assess whether further action (such as training, discipline, or further monitoring of the alleged harasser) is appropriate.

Assembling Harassment Defenses

The following section summarizes common defenses employers may wish to consider asserting in response to harassment claims.

Continuing Violation Doctrine

In some cases, employees allege harassment claims that extend over a period of months or years. The continuing violation doctrine allows employees to assert facts relating to claims of harassment that happened before the applicable limitations period began if they are part and parcel of conduct that occurred after the limitations period began.

For example, if the statute of limitations on a hostile work environment claim began on February 10, 2016, and the claimant alleges that her manager inappropriately touched her on March 17, 2016, January 10, 2016, and December 1, 2015, the incidents on January 10, 2016 and December 1, 2015 would normally be time-barred because the statute of limitations began on February 10, 2016. However, under the continuing violation doctrine, a court may allow those time-barred facts into evidence to bolster a plaintiff's harassment claim because they represent continuous behavior similar to the March 17, 2016 allegation.

The continuing violation doctrine does not apply to discrimination claims that involve discrete actions such as a termination, demotion, or denial of a position. AMTRAK v. Morgan, 536 U.S. 101, 117 (2002).

Employers can defeat the continuing violation doctrine by showing a time gap between the time-barred harassment allegations and the incidents alleged in an actionable harassment claim. See, e.g., Weeks v. New York State Div. of Parole, 273 F.3d 76, 84 (2d Cir. 2001) (two-year time gap is usually too long to establish a continuing violation). An employer can also defeat a claimant's harassment continuing violation contention if the employee is unable to show that the employer's actions before and after the limitations period are part of the "same actionable hostile work environment practice." Morgan, 536 U.S. at 120. For example, if a claimant asserts infrequently occurring and unrelated actions that different managers perpetrated, it is unlikely that he or she will be able to establish a continuing violation. An employer's "intervening action," such as disciplining the alleged harasser, may also serve to interrupt a continuing hostile work environment and help defeat a plaintiff's assertion of a continuing violation theory. Morgan, 536 U.S. at 118.

The Faragher-Ellerth Defense (Harassment by Supervisors)

The *Faragher-Ellerth* defense is an affirmative defense that employers may use to defend harassment and hostile work environment claims against supervisors and provides an exception to the general rule that employers are vicariously liable for the harassing conduct of their supervisors. The *Faragher-Ellerth* defense is based on two U.S. Supreme Court decisions—Faragher v. City of Boca Raton, 524 U.S. 775 (1998) and Burlington Industries, Inc. v. Ellerth, 524 U.S. 742 (1998). It permits an employer to avoid liability for harassment claims based upon the actions of supervisors if the employer can show that it exercised reasonable care to prevent and promptly correct any harassing behavior, the employee failed to take advantage of preventative or corrective opportunities provided by the employer, and the employer did not take a tangible job action against the employee.

Courts routinely decide cases in the employer's favor where the employee failed to take advantage of the employer's internal complaint process. Typically, if the employer did not fire the claimant (or take another tangible job action), had an EEO policy, and the claimant failed to report the harassment, then a *Faragher-Ellerth* defense will be available.

Standard of Liability for Harassment by Non-supervisors

The Supreme Court has held under federal law that an employee may only hold an employer responsible for non-supervisor harassment if the employee can show that the employer was "negligent in failing to prevent harassment from taking place." Vance v. Ball State Univ., 133 S. Ct. 2434, 2453 (2013). The Court stated that "the nature and degree of authority wielded by the harasser is an important factor to be considered in determining whether the employer was negligent." Id. at 2451. Courts must also assess "[e]vidence that an employer did not monitor the

Related Content

For an examination of the scope of the protection against discrimination found in 42 U.S.C. § 1981 and the damages available to successful plaintiffs, see

> SECTION 1981 EMPLOYMENT DISCRIMINATION CLAIMS

RESEARCH PATH: *Labor & Employment > Discrimination and Retaliation > EEO Laws and Protections > Practice Notes > Section 1981*

For a thorough discussion on the claims under, defenses available, and compliance with and enforcement of the Americans with Disabilities Act of 1990 (ADA), see

> AMERICANS WITH DISABILITIES ACT: NAVIGATING EMPLOYER REQUIREMENTS AND MAKING REASONABLE ACCOMMODATIONS

RESEARCH PATH: *Labor & Employment > Discrimination and Retaliation > EEO Laws and Protections > Practice Notes > Americans with Disabilities Act*

For more detail on disparate treatment claims, see

> UNDERSTANDING DISPARATE TREATMENT

RESEARCH PATH: *Labor & Employment > Discrimination and Retaliation > EEO Laws and Protections > Practice Notes > Disparate Treatment*

workplace, failed to respond to complaints, failed to provide a system for registering complaints, or effectively discouraged complaints from being filed." Id. at 2453.

Harassment Not "Severe or Pervasive" under Federal Law

Under federal EEO laws, for harassment to be actionable it must be "severe or pervasive." Harris v. Forklift Systems, 510 U.S. 17, 21 (1993). To determine whether harassment meets this standard, courts will look to the frequency and severity of the alleged conduct; whether it is physically threatening or humiliating, or a mere offensive utterance; and whether it unreasonably interferes with an employee's work performance. Murray v. Visiting Nurse Services, 528 F. Supp. 2d 257, 277–78 (S.D.N.Y. 2007) (citing Alfano v. Costello, 294 F.3d 365 (2d Cir. 2002)). Petty slights, minor annoyances, and a lack of manners do not give rise to an actionable harassment claim. It is not easy for plaintiffs to establish "severe or pervasive" conduct. Employers should assert its absence whenever appropriate.

Harassment Unrelated to a Protected Characteristic

While it may seem elementary, many employees simply do not understand that EEO laws only prohibit harassment that is based on a protected characteristic (e.g., age, race, gender) and do not prohibit all types of harassment. Faragher v. City of Boca Raton, 524 U.S. 775, 788 (1998). It is not uncommon for an employee to claim that a manager is harassing him or her because the manager does not like the employee. However, the Supreme Court has repeatedly stated that Title VII and other federal EEO laws are not meant to create a "general civility code" for the American workplace. In other words, EEO laws do not prohibit abusive language, personality conflicts, or snubbing by coworkers or supervisors unless the conduct is severe or pervasive and related to a protected characteristic. Employers should be prepared to raise this defense if the complainant attempts to characterize non-actionable harassment as actionable.

Inadequate Notice to Employer of Harassment

Courts will not hold employers liable for harassment if the employee's complaints do not put the employer on notice that the employee is being harassed due to a protected characteristic. Vague statements by an employee concerning coworkers' conduct are often not sufficient to put the employer on notice of prohibited harassment. See, e.g., Murray v. New York Univ. College of Dentistry, 57 F.3d 243, 250 (2d Cir. 1995) (female employee's complaint to the employer that a male patient "stared at her" and "tried to get her attention from across a hallway" did not adequately notify the employer of harassment based on the female employee's gender); Schiraldi v. AMPCO Sys. Parking, 9 F. Supp. 2d 213, 221 (W.D.N.Y. 1998) (An employee alleged to her supervisor that a coworker "wouldn't leave her alone" and "called [her] names." A different employee said to same supervisor: "Please keep [the same coworker] away from me, he's bothering me." The court held that these comments did not indicate that the female employees' coworker's actions were based on the female employees' sex; thus, they did not adequately notify the employer that their harassment allegations related to a category protected by the law).

Not Objectively nor Subjectively Hostile

To assert an actionable claim of harassment the complaining employee must show an "objectively hostile or abusive work environment, and the victim must also subjectively perceive that environment to be abusive." Alfano v. Costello, 294 F.3d 365, 373–74 (2d Cir. 2002). To be an objectively hostile work environment, a reasonable person must find the accused's conduct created a hostile work environment based on a protected characteristic. To be a subjectively hostile work environment, the complaining employee must actually perceive the work environment to be hostile due to a protected characteristic. When available, employers should be quick to assert that a plaintiff cannot prove an objectively or subjectively hostile work environment.

No Interference with Work Performance

One of the factors that courts assess in determining whether conduct amounts to unlawful harassment is whether the alleged harassment "unreasonably interferes with [the] employee's work performance." Harris v. Forklift Systems, 510 U.S. 17, 23 (1993). Courts have dismissed harassment claims, at least in part, because the plaintiff could not demonstrate that the alleged harassing behavior affected his or her job performance. See Murray v. Visiting Nurse Servs., 528 F. Supp. 2d 257, 278 (S.D.N.Y. 2007) (citing Alfano v. Costello, 294 F.3d 365 (2d Cir. 2002)) (plaintiff's hostile work environment claim was not actionable because the plaintiff "testified that the alleged harassing comments did not affect his 'work performance,' and that, regardless of the comments, he 'got things done'"); Portee v. Deutsche Bank, 2006 U.S. Dist. LEXIS 9153, at *40 (S.D.N.Y. Mar. 7, 2006).

Avoiding Harassment Claims

Because harassment claims can be very costly to defend regardless of whether they have merit, employers should take the following measures to help avoid these types of claims:

- **Implement EEO policies.** Every employer should have broad and clearly defined equal employment opportunity policies in place that prohibit discrimination and harassment on all bases protected by federal, state, and local civil rights laws. These policies should clearly address conduct that could constitute harassment. It is good practice for employers to provide these policies to all new hires and require that all employees annually acknowledge receipt of them. Employers should review these EEO policies at least once a year to address any changes in applicable laws.
- **Training.** Employers should ensure that all employees—but especially supervisory employees and those involved in making hiring and firing decisions—receive training on their EEO policies. Doing so will serve to both prevent workplace harassment and prevent employees from successfully bringing harassment claims by satisfying a key element of the *Faragher-Ellerth* defense.
- **Implement EEO complaint procedures.** An employer's EEO policies should also include a procedure for employees and applicants to raise concerns about harassment to human resources or management, particularly when the employee believes his or her supervisor has unlawfully harassed him or her. A complaint procedure that is communicated to all employees will help the employer to promptly remediate potential harassment situations and insulate it from liability against claims related to harassment that the employee failed to report.
- **Review all terminations.** It is good practice for employers to require that managers and supervisors consult with human resources before disciplining or terminating employees to ensure that the impending action does not result in liability for the employer.
- **Document all disciplinary actions, including terminations.** While not determinative, it is wise practice for employers to document employee misconduct and job performance deficiencies. Employees alleging discrimination will attempt to utilize as evidence of discrimination inconsistencies between, for example, annual employment evaluations and the reasons articulated by an employer to explain an adverse job action. Obviously, adverse job actions, including terminations, are often fully justified based upon conduct occurring most recently. However, actions taken as a result of an employee's continuous misbehavior and/or performance deficiencies will be more easily defended if the employee's personnel record supports them.

Richard D. Glovsky, a partner in Locke Lord's Boston office who co-chairs the Firm's robust Labor and Employment Practice Group, handles employment litigation, including class actions, wage and hour issues, and discrimination and retaliation claims. Dick prosecutes cases for Fortune 500 companies and other businesses to protect their trade secrets and to prevent former employees from violating non-competition and non-solicitation obligations. He also is a valued counselor on employment related matters. Dick is a former Assistant United States Attorney and Chief of the Civil Division of the United States Attorney's Office for the District of Massachusetts.

RESEARCH PATH: *Labor & Employment > Discrimination and Retaliation > EEO Laws and Protections > Practice Notes > Harassment*

Anti-harassment Policy

This form is an Anti-harassment Policy that underscores the employer's commitment to providing a respectful workplace free from unlawful harassment. It includes practical guidance and drafting notes. All employee handbooks must include an Anti-harassment Policy.

The Company is committed to providing a work environment free of sexual harassment or any form of unlawful harassment, discrimination, or retaliation.

Harassment or unlawful discrimination against individuals on the basis of race, color, religion or creed, gender/sex, including pregnancy, national origin or ancestry, ethnicity, citizenship status, genetic information, military or veteran status, age, and physical or mental disability, or any other classification protected by applicable local, state, or federal laws is illegal and prohibited by Company policy. Such conduct by or towards any employee, contract worker, customer, vendor, or anyone else who does business with the Company will not be tolerated.

Any employee or contract worker who violates this policy will be subject to disciplinary action, up to and including termination of his or her employment or engagement. To the extent a customer, vendor, or other person with whom the Company does business engages in unlawful harassment, discrimination, or retaliation, the Company will take appropriate action to remedy the situation.

DRAFTING NOTE:
The employer should describe possible consequences for engaging in harassing activity that alert employees to the importance of the Anti-harassment Policy while retaining the employer's flexibility to respond as it sees fit.

Prohibited Conduct

Sexual Harassment

The Company expressly prohibits any form of unlawful harassment based on a characteristic protected by law, including but not limited to sexual harassment. Unlawful interference with the ability of Company employees to perform their expected job duties will not be tolerated.

Specifically with regard to sexual harassment, the Company prohibits unwelcome

(1) sexual advances or requests for sexual favors; and

(2) all other verbal, physical, or visual conduct of a sexual nature, particularly where

- submission to such conduct is made either explicitly or implicitly a term or condition of an individual's employment or engagement,
- submission to or rejection of such conduct by an individual is used as a basis for decisions concerning that individual's employment or engagement, or
- it creates a hostile or offensive work environment.

Sexual harassment includes, but is not limited to, unwelcome sexual advances, requests for sexual favors, lewd, vulgar, or obscene remarks, jokes, posters or cartoons, and any unwelcome touching, pinching, or other physical contact.

DRAFTING NOTE:
Because what constitutes harassment may not always be readily apparent to employees, an Anti-harassment Policy should define harassment and provide examples of conduct that might be considered harassment. You should tailor the examples provided in the policy to the relevant jurisdiction (for example, some states and localities protect sexual orientation, gender identity, unemployment status, marital status, and other characteristics), and you should consider tailoring the examples provided in the policy to the type of workplace or work the company's employees perform.

Other Forms of Harassment

Other forms of unlawful harassment or discrimination may include racial epithets, slurs and derogatory remarks, stereotypes, jokes, posters or cartoons based on race, religion, color, national origin, sex, age, disability, genetic information, military status, or any other classification protected by applicable local, state, or federal laws.

Prohibited harassment might occur through the use of the Company's electronic communications system or through other online conduct.

Complaint Procedure and Anti-retaliation

In the event you believe that a violation of this policy has occurred, please follow the Complaint Procedure. The Company will investigate your complaint and take appropriate remedial action.

No one will be subject to, and the Company prohibits, any form of discipline, reprisal, intimidation, or retaliation for good faith reports or complaints of incidents of harassment of any kind, pursuing any harassment claim, or cooperating in related investigations.

This list is illustrative only, not exhaustive. All forms of harassment are prohibited both in the workplace and at employer-sponsored events.

If you have further questions or concern, please contact the undersigned at this special telephone number [Insert number]. Please also check our website at [Insert website] for updated information.

Sincerely,

[*Insert name of company representative*]

DRAFTING NOTE:
It is essential that the policy refer employees to the employer's complaint procedures in the event they believe that a violation of the policy has occurred with an assurance that the employer will investigate and take appropriate remedial actions. If an employee asserts a claim of harassment, an employer's Anti-harassment Policy may serve as a defense against liability. An employer may present an affirmative defense and avoid liability by demonstrating that it exercised reasonable care to prevent and promptly correct any harassing behavior and the employee unreasonably failed to take advantage of any preventive or corrective opportunities that the employer provided.

Policy provided by Joseph D. Guarino, a partner at DLA Piper. His practice emphasizes the representation of management and employers in labor and employment matters, including both preventive counseling and litigation.

RESEARCH PATH: *Labor & Employment > Employment Policies > Equal Employment Opportunity > Forms > Anti-harassment Policies*

Robert D. Starin K&L GATES LLP

Taxation of **Carried Interest**

The tax treatment of carried interest has for many years been a high-profile target for potential reform. "Carried interest" refers to the share of profits or gains from investment received by a manager of a private equity fund, hedge fund, or similar investment vehicle, which is typically unrelated to any capital investment by the manager.

UNDER EXISTING LAW APPLICABLE TO ENTITIES TREATED as partnerships for U.S. income tax purposes, carried interest is generally taxed at favorable long-term capital gain rates. Many lawmakers view this treatment as inequitable, under the premise that long-term capital gains should apply to returns from the investment of capital, rather than receipts for the provision of services. In the private equity world, proposed legislation to close the carried interest "loophole" could have a profound impact on the economics and structure of investment funds and their portfolio companies. This article addresses the U.S. federal income tax treatment of carried interest paid to private equity fund managers, as well as potential changes in the law that could impact this treatment.

Economics of Carried Interest

Carried interest is designed to reward fund managers for identifying and managing investments. While fund managers receive a fixed management fee, the bulk of their profits is typically derived from carried interest that is contingent on the success of the underlying investments. Private equity funds are generally structured as limited partnerships, with the capital investors holding limited partner interests and the manager setting up a special purpose vehicle as the general partner. Because of the beneficial tax treatment described in more detail below, fund managers' "carry" is structured as a special class of equity in the underlying investment partnership rather than a contingent success-based fee.

There are two primary methodologies for calculating carried interest: net profits and gross profits. Under the more common net profits methodology, carried interest is calculated as a

percentage (usually 20%) of the profits generated from the fund's investments less expenses, which typically include management fees and other overhead expenses that are not capitalized into the costs of investments.

Example 1

Assume a fund raises capital of $100 million, and ultimately sells its investments for $250 million, resulting in a gain of $150 million. Assume further that the fund incurs $15 million of expenses, including management fees. Using net profits to calculate the manager's carried interest, the fund would realize $150 million in gains minus $15 million of expenses, for a net gain of $135 million. The manager's carried interest would be $27 million (i.e., 20% of the $135 million net gain). Under the fund's distribution waterfall, first, investors would receive a return of their capital contributions in the amount of $100 million, and then the remaining proceeds would be split $108 million/$27 million between the investors and the manager. Thus, the investors and manager have each borne a pro rata share (i.e., 80/20) of the $15 million of expenses.

Alternatively, under the gross profits methodology, the manager's carried interest is based on the gain from investments without taking into account the management fee or other overhead expenses.

Example 2

Using the same facts as Example 1, the manager's carried interest is equal to 20% of the $150 million gain from investments, or $30 million. Under the fund's distribution waterfall, investors would first receive a return of their capital contributions in the amount of $100 million, and then the remaining proceeds would be split $105 million/$30 million between the investors and the manager. Here, the investors have economically borne the entire amount of fund expenses. Clearly, the net profits model is more efficient for investors.

The timing of carried interest distributions can also vary in a manner that generates different economic consequences to the investors. Because funds make multiple investments that are liquidated at different times, it is necessary to determine when carried interest is calculated. Under one model, sometimes referred to as the "European Model," the entire amount of the investors' capital contributions must be returned prior to the manager participating in profits. Alternatively, under a "Deal-by-Deal Model," profit is determined and carried interest paid on an investment-by-investment basis.

Example 3

To illustrate the difference between the European Model and the Deal-by-Deal Model, assume a fund raises $100 million in capital contributions and makes four investments of $25 million each. In year 3, Investment A is sold for $50 million. In year 4, Investments B and C are sold for $50 million and $40 million, respectively, and in year 5, Investment D is sold for $10 million. In the aggregate, the fund has generated gross profits from investments of $50 million. For purposes of simplicity, assume the fund incurs no expenses.

Under the European Model, the entire $50 million generated from Investment A in year 3 is distributed to the investors as a return of their capital contributions. In year 4, the $50 million in proceeds from the sale of Investment B is distributed to the investors to return the remainder of their capital contributions. The $40 million in proceeds from Investment C is then distributed $32 million/$8 million to the investors and the manager respectively. In year 5, the $10 million proceeds from the liquidation of Investment D is split $8 million/$2 million between the investors and the manager. In the aggregate, the investors received a return of their $100 million of capital, and the remaining $50 million of profits was split $40 million/$10 million between the investors and the manager.

Example 4

Under the same facts as Example 3 by applying a Deal-by-Deal Model, the first $25 million in proceeds in year 3 from the sale of Investment A is distributed to the investors to return their capital in respect of that investment, and the remainder is split $20 million/$5 million between the investors and manager respectively. Similarly, in year 4, the first $25 million in proceeds from the sale of each of Investments B and C are distributed to the investors, and the remaining $25 million and $15 million respective profits from each of these investments are split between the investors and the manager on an 80/20 basis (i.e., $32 million to the investors and $8 million to the manager). However, the sale of Investment D in year 5 generates a loss, meaning that the entire $10 million in proceeds is distributed to the investors.

This example illustrates a distortion caused by the Deal-by-Deal Model. In years 3 and 4, the manager received total distributions of carried interest in the amount of $13 million; however, the total profit from fund investments was only $50 million, meaning that the manager should have only received $10 million in total carried interest distributions. In order to prevent this result, funds typically include a manager "clawback" provision, whereby the manager is required to return previously distributed carried interest amounts to the extent it would otherwise receive more than 20% of the overall profits from the fund.

The taxation of carried interest and political controversy surrounding it should be viewed against this economic backdrop (i.e., investors effectively compensating fund managers by permitting them to participate in investment gains without making a corresponding capital investment).

Taxation of Carried Interest under Existing Law

While politicians frequently refer to the "carried interest loophole" and propose to "repeal" carried interest, the Internal Revenue Code of 1986, as amended (the Code) does not contain specific provisions relating to carried interest. Rather, the taxation of carried interest under existing law is a product of (1) differential tax rates to individuals on ordinary income vs. capital gains and (2) the general taxation regime applicable to partnerships (including limited liability companies and

. . . IF A PARTNERSHIP RECOGNIZES A GAIN FROM THE SALE OF A CAPITAL ASSET THAT IT HAS HELD FOR MORE THAN ONE YEAR, ITS PARTNERS ARE TAXED ON THEIR SHARE OF THIS GAIN AS LONG-TERM CAPITAL GAIN.

other entities that are treated as partnerships for income tax purposes). Partnerships are "pass-through" entities for income tax purposes. A partnership files an income tax return, but does not pay income tax. Rather, its partners are taxed on their allocable share of the partnership's income, whether or not it is distributed. Partners typically are not taxed when the income is subsequently distributed. This single level of taxation makes a partnership an attractive form of entity for investors.

Although a partnership does not pay income tax, the character of its income, gain, and loss is determined at the entity level. Section 702(a)(2) of the Code. Thus, if a partnership recognizes a gain from the sale of a capital asset that it has held for more than one year, its partners are taxed on their share of this gain as long-term capital gain.

A partner's share of a partnership's income, gain, loss, and items thereof is generally determined by the partnership agreement. Section 704(a) of the Code. The Treasury Regulations under Section 704 of the Code contain a complex set of rules for determining whether the partnership's allocations will be respected, and income, loss, and items thereof are subject to reallocation if it is determined that the allocations do not comply with the general requirement that the allocations are consistent with the partners' economic interests in the partnership. Generally speaking, there is no requirement that a partner's share of profits be equivalent to its proportionate equity investment in, or capital ownership of, the partnership.

Accordingly, under existing law, an individual partner who is allocated a share of a partnership's long-term capital gain will be taxed on that share at long-term capital gain rates, even if the partner made no investment or a disproportionately small investment in the partnership. This is the crux of the perceived windfall that fund managers derive from carried interest. Outside of the partnership context, individuals typically are taxed at favorable capital gain rates only on gains generated from investments of their after-tax dollars. By virtue of the application of the partnership taxation regime, fund managers are able to pay tax at favorable capital gain rates on gains derived from their efforts, but from the fund investors' capital.

This tax benefit to the fund manager, and the impact to fund investors, is illustrated by the following simple example:

Example 5

A private equity fund receives total capital contributions of $100 million from its investors and ultimately liquidates its investments for aggregate proceeds of $150 million. The investors are allocated $40 million of long-term capital gain (assuming a 20% carried interest), which increases their tax basis in the fund to $140 million; they then receive a liquidating distribution of $140 million. The manager is allocated $10 million of capital gain, which increases its basis in the fund to $10 million, and then receives a $10 million liquidating distribution. At a federal capital gain rate of 20%, the fund manager generates a net after-tax return of $8 million.

Alternatively, if the manager were not a partner in the fund and received a management fee equal to 20% of net gains rather than an allocation of carried interest, the investors would be allocated $50 million of long-term capital gain and an ordinary deduction of $10 million. Their tax basis in the fund would be increased to $140 million and they would receive a liquidating distribution of $140 million. The manager would be taxed at ordinary income rates on the $10 million management fee; at a maximum federal rate of 39.6%, the fund manager generates a net after tax return of $6.04 million. Note that in today's market, the majority of investors in private equity funds are tax-exempt entities or corporations, and are thus indifferent to receiving an ordinary deduction for the payment of the management fee as compared to a reduction in long-term capital gains resulting from the carried interest allocation.

Carried interest is essentially a form of profits interest, for which there is a substantial amount of developed law. A "profits interest" refers to an interest in future profits and appreciation in value of the assets of a partnership. At the time of issuance, a profits interest does not have a capital account associated with it and thus the holder would not be entitled to any proceeds if the partnership were to sell its assets for their fair value on the date of issuance of the profits interest and distribute the proceeds in liquidation of the partnership. Rev. Proc. 93-29, 1993-2 CB 344.

The IRS has confirmed, in Revenue Procedure 93-27, that it will not treat the grant of a profits interest in exchange for services provided as taxable to the recipient if the profits interest entitles the holder to share only in gains and profits generated after the date of issuance (and provided that certain other requirements are met). Thus, businesses organized as partnerships frequently issue profits interests to key service providers because they are not taxable at grant, but the holder will be considered to be a partner from and after the time of vesting and will be eligible for long-term capital gain treatment upon a liquidity event if the relevant holding period is met. Under current law the ability of a partnership to allocate profits and gains in a manner that is disproportionate to contributed capital is thus fundamental to equity compensation strategies.

Private equity funds, in particular, frequently use profits interests to incentivize management of acquired portfolio companies to help drive value. The following example provides a simple illustration:

Example 6

A private equity fund (Fund) contributes $50 million to a special purpose limited liability company taxed as a partnership (Buyer), which uses the funds to acquire a company, taxed as a "C" corporation (Target), for $50 million. Buyer issues a profits interest to the CEO of Target. Under the terms of Buyer's LLC agreement, the first $50 million of proceeds from a future sale of Target by Buyer will be distributed to the Fund. Thereafter, 5% of any additional proceeds will be distributed to the CEO and the remainder will be distributed to the Fund. The CEO's interest is not taxable at the time of grant because it has no liquidation value; if Target were sold for its value on the date of grant (i.e., $50 million), the CEO would receive no proceeds. After three years, Buyer sells Target to a third party for $100 million. The CEO receives $2.5 million of proceeds (5% of the excess proceeds above the initial $50 million investment); she is allocated a concomitant amount of capital gain from the sale and thus is taxed at long-term capital gain rates.

Thus, the ability to specially allocate capital gains to service providers is fundamental to private equity structuring at both the fund and portfolio company levels.

Proposed Legislation

Because the tax treatment of carried interest results in long-term capital gains for payments that are generally considered to be compensation for investment management services, and because these rules tend to ultimately benefit high-income individuals, it has for many years been a target for legislative amendment. Politicians from both major political parties tout closing the "carried interest loophole" as a primary aspect of their tax reform agendas. During the past decade, lawmakers have introduced various versions of legislation intended to address the income tax treatment of carried interest. Congress' failure to date to pass legislation altering the tax treatment of carried interest is considered to be a result of Congressional inertia rather than any substantive ideological differences between political parties.

Much of the proposed legislation has attempted to recharacterize amounts constituting carried interest as ordinary income, notwithstanding that the genesis of the income is a capital transaction at the partnership level.

Related Content

For additional information on tax considerations for private equity funds and managers, see

> UNRELATED BUSINESS TAXABLE INCOME

RESEARCH PATH: *Corporate and M&A > Private Equity > Tax Matters > Practice Notes*

For an analysis of the U.S. Foreign Account Tax Compliance Act, see

> FATCA AND PRIVATE EQUITY

RESEARCH PATH: *Corporate and M&A > Private Equity > Tax Matters > Practice Notes*

The most recent legislation on the subject, sponsored by Representative Sander Levin (D-MI), was introduced to the House of Representatives in 2015. The bill, entitled the "Carried Interest Fairness Act of 2015" (114 H.R. 2889, referred to herein as the "Levin Bill") is a revised version of legislation that was previously introduced, and would add a new Internal Revenue Code section in subchapter K (i.e., the subchapter of the Code dealing with partnership taxation) entitled "Special Rules for Partners Providing Investment Management Services to Partnerships."

The Levin Bill provides that (a) net capital gain allocated to holders of an "investment services partnership interest" is treated as ordinary income, and (b) gain on the sale of an "investment services partnership interest" is treated as ordinary income. While this would appear to be a relatively simple remedy to the perceived problem, there are several nuances and complexities impacting the scope and interpretation of the rule.

The recharacterization applies to an "investment services partnership interest," which is generally defined as an interest in an "investment partnership" held by an individual or entity in connection with the conduct of a trade or business that primarily involves performing one or more of a list of specified services. These services include providing advice regarding investment in, purchasing or selling a specified asset, managing, acquiring or disposing of a specified asset, arranging financing for the acquisition of a specified asset, or any activity in support of the foregoing. This definition in turn implicates two key terms: "specified asset" and "investment partnership."

An "investment partnership" is a partnership substantially all of whose assets are specified assets and more than half of whose contributed capital is received from investors in exchange for partnership interests that constitute investment property. The Levin Bill defines "specified asset" as securities, real estate held for rental or investment, partnership interests, commodities, cash or cash equivalents, or derivative contracts relating to any of the foregoing. The bill includes a look-through rule, whereby interests in a lower-tier partnership or a foreign corporation are disregarded as specified assets, and the partnership is deemed to directly hold the assets of the lower-tier entity for purposes of determining whether substantially all of its assets are specified assets.

The proposed legislation includes a key exception for "qualified capital interests." A "qualified capital interest" is a portion of a partner's interest in partnership capital that is attributable to cash or property contributed to the partnership in exchange for the interest, amounts included in income by the partner under [Section 83 of the Code] upon the receipt of the interest as compensation for services, and net income previously allocated in respect of that interest. Capital gain allocated in respect of a qualified capital interest would not be recharacterized as ordinary income if allocations of partnership items are made to the qualified capital interest in the same manner as such allocations are made to other qualified capital interests held by unrelated partners who do not provide investment management services. In other words, to the extent that a partner's allocation of partnership capital gain is deemed attributable to its partnership capital (rather than services provided) and is proportionate to the allocations to other partners holding similar interests, it would not be treated as ordinary income.

The impact of the proposed investment services partnership interest rule, together with the qualified capital interest exception, is that a partner's share of partnership gain would retain its character as capital gain to the extent it is proportionate to the partner's capital investment; to the extent the partner's share of partnership gain exceeds its proportionate investment, it is treated as ordinary income.

The following example illustrates the application of the proposed legislation to a relatively simple partnership structure.

Example 7

Assume a fund raises $100 million of capital, of which $1 million constitutes an investment by the manager of its own capital. The manager also receives a 20% carried interest. The fund ultimately liquidates its investments for total proceeds of $200 million, with $100 million of net gain. The manager receives (1) $1 million as a return of its invested capital, (2) $800,000 as its 1% pro rata share of the gain allocated to the investors, and (3) $20 million of carried interest. The manager's 0.8% interest in partnership gain attributable to its capital contribution is treated as a "qualified capital interest" and the $800,000 gain allocation in respect of that interest would be taxed as long-term capital gain. Its $20 million carried interest allocation is not received with respect to a qualified capital interest and thus is treated as ordinary income to the manager.

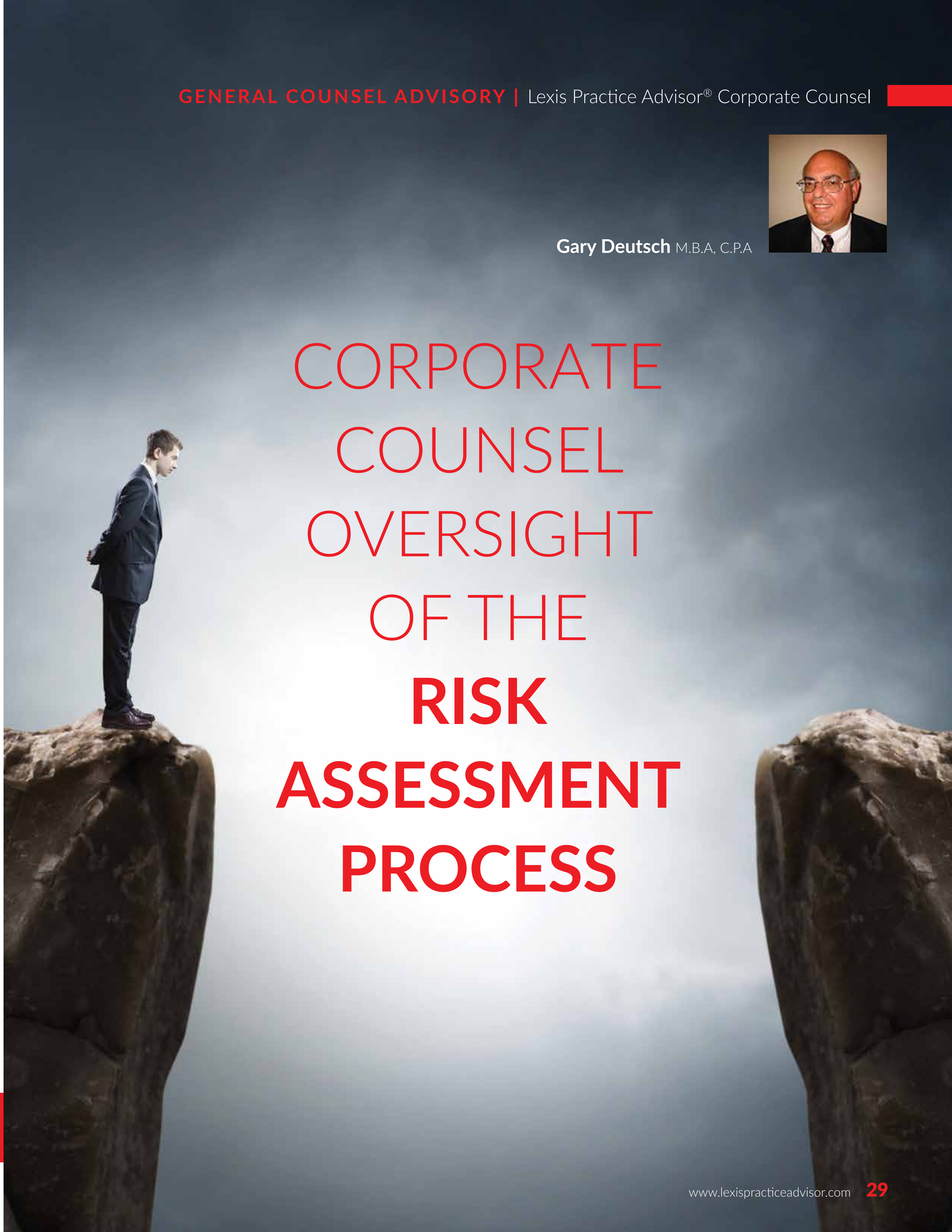
The Levin bill differs in approach from another recent proposal for altering the taxation of carried interest. In 2014, former Representative Dave Camp (R-MI), the then House Ways and Means Committee Chairman, released draft carried interest legislation (113 H.R. 1, referred to herein as the Camp Proposal) as a component of a broad tax reform bill. The Camp Proposal would create a fiction whereby (1) the investors are deemed to loan 20% of their capital to the manager, (2) the manager is deemed to invest the loaned proceeds and earn carried interest on this equity investment, and (3) the manager is subject to ordinary income tax on imputed interest arising from the loan at a rate equal to the long-term applicable federal rate plus 10%. Rather than recharacterizing all returns that are disproportionate to capital investment as ordinary income, the Camp Proposal attempts to tax the manager on the benefit of effectively using other investors' capital to generate an economic return.

As of the time of this writing, neither the Levin Bill nor the Camp Proposal has been approved by either house of Congress. However, because lawmakers from both political parties generally favor a change to the tax treatment of carried interest, it would seem likely that carried interest legislation will ultimately be enacted that would raise the effective rate of tax applicable to carried interest received by fund managers. L

Robert D. Starin is a partner at K&L Gates LLP. Mr. Starin's practice emphasizes federal, state, and international tax issues and general corporate issues for both foreign and domestic clients. He has worked on numerous transactions involving mergers and acquisitions (U.S. domestic and cross-border), divestitures, complex joint ventures, and inbound and outbound investments. He advises public and private corporations, limited liability companies and partnerships on various tax matters, including choice of entity, structuring of international operations, and executive compensation issues.

RESEARCH PATH: *Corporate and M&A > Private Equity > Tax Matters > Practice Notes*

Gary Deutsch M.B.A, C.P.A



CORPORATE COUNSEL OVERSIGHT OF THE **RISK ASSESSMENT PROCESS**

AS COUNSEL FOR ONE OR MORE BUSINESSES TYPES (for-profit and/or non-profit), you are often asked to advise on many different types of legal and regulatory compliance issues, but how well prepared is any business to incorporate your advice into its daily routine? At issue is the process a business uses to manage legal risk. Here are some key questions to consider:

- What is the board's (or owner's) perspective on risk? Are they risk takers or risk averse?
- What is their tolerance for risk? How much are they prepared to lose if they don't follow your advice? Have they factored risk tolerance into their annual budget and strategic planning projections?
- Do they establish controls over risks? Do they make sure that those controls are tested periodically to ensure the organization is adequately protected within their risk tolerance?
- How do they communicate the controls that need to be in place? Do they include the controls in policies and procedures? If they do, are the policies and procedures routinely updated to ensure they include the most current controls needed to prevent or detect risks?
- Do they receive routine reports from management indicating that employees responsible for implementing controls are doing so per updated policies and procedures?
- Do they receive periodic risk assessments from management to identify risks inherent in the business as well as the effectiveness of management's efforts in risk management and actions to mitigate risks when necessary to keep the organization moving toward the board's plans within their risk tolerance?

The answers to these questions may expose some weaknesses in the risk management process that could lead to increased exposure to losses. Even if the answers do not expose significant risk management process weaknesses, attorneys need to review management's risk assessments to form their own conclusions about the adequacy of the risk management process. Furthermore, even with a well-functioning risk management process, organizations are exposed to unexpected losses. For instance, significant changes in laws and regulations may be difficult to factor into plans until the structure of the changes have become clear. Risks that rarely occur, like natural disasters, or those occurring unexpectedly, like hacker attacks, cannot easily be included in plans except as contingency or reserve factors. Transferring those types of risks through insurance may be advisable if the transfer is cost-effective.

What Corporate Attorneys Need to Understand about Risk Assessments

Risk assessments evaluate an organization's inherent risks or the risks that are imbedded in the nature of the business. Here are some examples:

- Hospitals are at risk for violating HIPAA laws, medical billing errors, spreading diseases, and many other risks unique to the medical field.
- Retailers are at risk for massive data breaches, exposing customers to fraud, and theft such as shoplifting.
- Manufacturers are at risk for workplace accidents and OSHA violations.
- Non-profits are at risk for fraud that could lead to tarnished reputations and reduced contributions.
- Financial institutions are at risk for regulatory safety and soundness violations that could lead to onerous controls over operations.

Of course, this list is only a sampling of the types of risk that are unique to (inherent in) various organizations. Understanding risk assessments can help attorneys assess the legal risks that the board (or owner) needs to consider in their planning and risk tolerance determination.

The Risk Assessment Process

Before discussing the risk assessment process, it's important to understand that even small organizations need to consider the interaction among the various functions, departments, divisions, products, and services that operate within an organization. This interaction requires an enterprise approach to the risk management process (called enterprise risk management or ERM). Here's an example.

> ABC Corp. makes widgets. They decide to launch a new widget and outsource the manufacturing process to XYZ LLC. The new widgets start selling well and ABC's accounts receivable grow accordingly. However, shortly after the new widgets reached customers, there was feedback that the widgets weren't operating as ABC marketed. After an investigation, it was determined that XYZ LLC had a defect in a component part of the widget. While the investigation was underway, ABC's accounts payable department paid XYZ under the contract provisions for the new widget. The accounts receivable department, credit department, supply management function, and accounts payable did not communicate with one another, resulting in accounts payable paying an XYZ invoice that should have been withheld pending the results of the investigation. If accounts receivable, credit, or supply management had provided accounts payable with a copy of the manufacturing agreement with XYZ as well as a notification that there was a defect part investigation, accounts payable would have been alerted to the defect part provision, allowing for payment to be withheld pending investigation.

An assessment of payment risks focused solely on the accounts payable department may have identified the weakness noted in this example after the payment had been made to XYZ. However, an ERM risk assessment may have identified the lack of communications among the accounts receivable department, credit department, supply management function, and accounts payable as a control weakness that if corrected could have prevented the payment to XYZ.

Sample ERM Risk Assessment Questionnaire

This sample ERM risk assessment questionnaire for outsourced vendor contracts may have helped identify the payment issue discussed above. This assessment is not a legal review—it is a review of operational and security-related provisions to ensure that the organization's interests are continuing to be protected.

When evaluating ABC's outsourcing arrangement with XYZ, the following operational and technology contract issues should be considered:

- Does ABC's internal auditor have the right to periodically review vendor activities? This review should identify the areas of risk and the levels of risk to be reviewed and recommend and perform audit procedures as needed that may require the vendor's cooperation.
- Does the contract provide for ABC's right to perform updates to due diligence to ensure that the vendor has a sufficient number of qualified staff members to perform the contracted work?
- Does ABC have the right to receive timely notice from the vendor of any key staffing changes?
- Does the contract adequately define the expectations and responsibilities for both parties based on the current operating environment?
- Are the scope, frequency, and cost of work to be performed by the vendor subject to change as necessary to protect the operations and security of ABC?
- Does the contract provide for the opportunity to reset responsibilities for providing and receiving information, such as the manner and frequency of reporting to senior management and the board about the status of contract work?
- Does the contract establish the protocol for changing the terms of the service contract, especially for expansion of work if significant issues are found, and stipulations for default and termination of the contract?
- Does the contract state that any information pertaining to ABC must be kept confidential?
- Does the contract specify the reports and the related documents needed to evaluate the performance of contractual obligations?
- Does the contract specify the period that vendors must maintain the reports and documents?
- Does the contract state that outsourced services provided by the vendor may be subject to regulatory review and that examiners will be granted full and timely access to the appropriate reports and related documents prepared by the outsourcing vendor?
- Does the contract state that reports are the property of ABC, that ABC will be provided with any copies of the related documents it deems necessary, and that employees authorized by ABC will have reasonable and timely access to the documents prepared by the vendor?
- Does the contract prescribe a process (arbitration, mediation, or other means) for resolving problems and for determining who bears the cost of consequential damages arising from errors, omissions, and negligence?
- Does the contract state that the vendor will not perform management functions, make management decisions, or act or appear to act in a capacity equivalent to that of an employee or a member of management of the institution, and will comply with professional and regulatory independence guidance?

This risk assessment together with a policy stating that all affected parties within ABC must be notified of outsourced contract provisions, changes to contracts, and violations of terms, if any, could have prevented the payment issue in this example.

The discussion below will focus on an overview of the ERM risk assessments process.

Conducting ERM Risk Assessments

The Committee of Sponsoring Organizations (COSO) issued the "Enterprise Risk Management - Integrated Framework" in 2004 to assist organizations worldwide with principles-based guidance for designing and implementing effective enterprise wide approaches to risk management or enterprise risk management (ERM) as this process is appropriately named.

COSO defines its ERM framework as "a process, effected by an organization's board of directors, management, and other personnel, which is applied in strategy setting and across the enterprise. The goal of ERM is to provide reasonable assurance regarding the achievement of organizational objectives by identifying events that may affect the organization and managing risk to be within the organization's risk appetite."

The COSO framework provides guidance in the following general areas:

- Definitions for essential ERM components
- Key ERM principles and concepts
- Ideas for developing a common language to communicate ERM risks
- A development path for ERM

COSO's ERM guidance moves beyond theory to explain how ERM integration into processes can help to balance risks and rewards. Consider the following risk assessment issues—does the institution's ERM approach:

- Align risk appetite and strategy
- Identify and manage cross-enterprise risks
- Provide integrated response to multiple risks
- Link growth, risk, and return
- Seize opportunities
- Ration capital based on risk appetite
- Enhance risk-response decisions
- Minimize operational surprises and losses

The traditional non-ERM approach to conducting risk assessments is to have the organization's financial function carry them out on a monthly, quarterly, or yearly basis. During the process, errors are detected and corrected and people are considered the primary source of risk. Operational plans focus on short-term risks.

Following the ERM performance approach, risk assessments are continuous and performed by management of the various organization functions. ERM stresses that everyone controls and achieves the organization's strategic plan and controls are focused on all risks, not just a risk selected in isolation. Errors are prevented and processes are the primary source of risk, not people.

The strategic plan focuses on long-term risk. Therefore, a well-functioning ERM program will provide for the systematic internal assessment of risks based on the following criteria:

- Place limited reliance on third-party risk assessments.
- Identify and plan for contingent risks.
- Create incentive for organizational units to minimize contingent risks.
- Use multiple risk management tools and metrics.
- Develop flexible and adaptive risk models.
- Aggregate net and gross loss exposures in addition to plans for expected (routine) losses.
- Implement credible stress testing that is actionable.

The ERM program should also provide for open communications among organizational units, risk management staff, senior management, and board members, as well as corporate counsel, to enhance enterprise level decision-making about major risks and to react faster to emerging issues.

However, look for signs that the ERM program is not working. Here are some signs to consider:

- Increasing risk concentrations are not disclosed in reports to management and the board.
- Organizational units use different risk models that do not produce consistent results.
- There is a lack of buy-in that risk issues and assessments should be shared.
- Risk models are rarely updated to reflect evolving risks.
- The mindset that someone else will be performing the risk analysis and assessment.
- Contingent risks and unintended consequences of risks are not identified.

To ensure that the organization's ERM program is functioning as intended, ask management and the board the following questions:

- Are risk-and-capital concepts used to quantify risk/return trade-offs, in dollars where possible?
- Does the ERM program quantify the destructive power of correlated risk factors across the enterprise?
- Are operational risk ERM resources directed toward big risks?
- Is out of the box thinking used on ERM to see all business risks and interactions?
- Is ERM information embedded in business metrics (risk-adjusted pricing/performance)?

Although ERM may sound like a risk management approach that is best suited to large organizations, keep in mind that smaller organizations may be practicing ERM without a formal ERM program. In smaller organizations, owners, the board, and management may be the same people or certainly a small group who can recognize risks more easily due to the small size of the organization. Corporate counsel can also help by providing an objective combined legal and business perspective on risks that the others may not recognize as they are immersed in daily activities.

Core Risk Assessment Components

There are two core components of ERM risk assessments. The components should be designed to answer the following questions:

- What is the organization's inherent level of risk?
- How well is risk being managed within the organization?

Below is a brief overview of each of these components.

Inherent Risk Assessment

Inherent risk is defined as the possible damage to earnings, capital, or reputation because of an organization's involvement in a certain line of business. This risk exists in each line of business, regardless of the level of management control in place. For example, credit risk associated with attracting new business is typically higher than the risk of extending additional credit to existing customers. When a risk is inherent, the frequency with which a risk event occurs and results in a loss, and the extent of exposure to such losses, can be managed. The risk frequency and severity of exposure can be directly managed through the processes the organization uses to identify, measure, monitor, and control risk. The inherent risk assessment is intended to identify those risks that are specific to a line of business. The management of risk assessment discussed in the next section is designed to evaluate the processes the organization uses to identify, measure, monitor, and control risk.

The inherent risk assessment is divided into three main sections: historic, predictive, and impact. The first section, historic, is intended to assess past loss experience within the industry as well as the organization's actual historical loss experience. Since the past is often a poor guide to what might happen in the future, the predictive part of the assessment is intended to assess the potential for future adverse events in each risk category. The impact section addresses the expected result from significant adverse events.

Exhibit A includes sample assessment standards and a rating system to measure inherent risk. In this exhibit, a rating of 9 indicates that there is a strong likelihood of an adverse impact on earnings, capital, or reputation, but only if management controls are not in place or functioning properly. Since effective management controls can mitigate risks, the assessment should evaluate the organization's total inherent risk exposure separately from the assessment of current management policies and processes in place to control the risk as discussed in the following section.

Exhibit A

Sample Inherent Risk Assessment Risk Rating

Risk Rating	Risk	Risk Description
7 to 9	High	High potential for a serious and substantial impact on the organization's earnings, capital, stability, or reputation.
4 to 6	Moderate	Modest potential of an adverse impact on the organization's earnings, capital, stability, or reputation.
1 to 3	Low	Small potential for a significantly adverse impact on the organization's capital, earnings, stability, or reputation.

It is important to assign a score for each category of risk. Any categories that are not applicable should be scored zero. Also, comment on reasons for assigning any score of 7 to 9 since those risks will need to be evaluated for risk mitigation controls.

Management of Risk Assessment

Organizations profit by taking measured risks. However, they can lose money or even fail by not managing those risks. Effective risk management means integrating several elements, including strategy, organization, policies and procedures, process and controls, measurement/monitoring, technology, and reporting.

Management of risk can significantly reduce volatility and the potential damage to earnings, capital, or reputation. Management cannot, however, eliminate risk, especially when an organization assumes levels of inherent risk associated with their line of business.

In the preceding section, we discussed the need to assess an organization's inherent risks. The second core risk assessment component is to evaluate the quality of the management of those inherent risks.

Exhibit B includes sample assessment standards and a rating system for the management of risk assessment. A rating of 9 indicates that there is a strong likelihood of an adverse impact on earnings, capital, or reputation, but only if current management controls are not in place or functioning properly. Accordingly, as with the inherent risk assessment, evaluate the organization's total risk exposure separately from the management policies and processes that are currently in place to control the risk.

Risk Rating	Risk	Risk Description
7 to 9	High	Management practices significantly increase the potential for a substantial adverse impact on capital, earnings, stability, or reputation.
4 to 6	Moderate	Management practices present modest potential for an adverse impact.
1 to 3	Low	Management practices minimize the potential for a serious and substantial impact on the bank's capital, earnings, stability, or reputation.

It is important to assign a rating for each category of risk. Also, comment on reasons for assigning a grade of 7 to 9 since those risks will need to be evaluated for risk mitigation controls.

Corporate Counsel's Role in Risk Assessment Compliance

Corporate counsel can have a significant impact on compliance with the board's objectives through oversight of the ERM risk assessment process in the following manner:

- Communicate the legal implications of business (for-profit and nonprofit) risk issues to risk managers to assist them in preparing ERM risk assessments.
- Provide effective guidance to the board and management on how to implement and enforce strong corporate governance to protect shareholders, stakeholders, members, and donors.
- Review policies and procedures (which include risk management controls) to ensure the documents are properly vetted from a legal perspective.
- Assist with quantifying risks through an understanding of regulatory fines, costs of litigation, and other related costs.
- Provide routine risk management guidance to risk managers throughout the organization based on the results of court cases.

To accomplish these and other related roles, counsel must participate as an advisor to the risk management team that creates and implements the periodic ERM risk assessments. Counsel should:

- Review all risk assessment questionnaires to ensure they incorporate legal guidance and risk trends.
- Monitor the results of risk assessments to evaluate the potential implications for meeting the board's strategic objectives within their risk tolerance.
- Provide guidance to the board on risk trends and ranking risk priorities.

Counsel's oversight role should be objective as well as a routine part of the oversight process, which traditionally includes the internal and external audit functions as well as other oversight positions such as the chief risk officer. In addition, the board should allow counsel to work directly with the oversight functions and human resource and regulatory compliance managers to assist with evaluating risks inherent in the organization and the effectiveness of management in managing those risks.

Identifying Trending Risks

Corporate counsel can assist the board and management in identifying trending risks that should be considered in ERM risk assessments. Below are some examples of the types of risks that counsel might consider.

Invasion of Privacy

A hacker accesses ABC, Inc.'s account information through a financial institution's website and sells the information to a third party. ABC sues the institution, alleging that it was negligent in safeguarding the account information and that ABC suffered economic loss as a result of the account breach.

Loss or Damage to Electronic Customer Data

ABC, Inc. applies for a loan on an institution's website. A loan officer sends an e-mail to ABC concerning the status of the application. ABC later alleges that the e-mail contained a virus that deleted all financial records from one of ABC's servers. ABC demands that the institution compensate them for the cost of reconstructing the data and for losses suffered when ABC could not access data to file tax returns on time.

Denial, Impairment, or Interruption of Service

A hacker institutes a denial of service attack on ABC, Inc.'s website, shutting down the site for more than 24 hours. During that time, a customer attempts to access his account to pay an outstanding invoice. Because ABC's website is down, the payment is deemed late before the customer can complete the electronic payment. The customer alleges that the delay caused by the denial of service caused a loss of service from ABC that resulted in a loss of business for which ABC is responsible.

Unauthorized Access to a Customer Account

A hacker accesses ABC, Inc.'s account through their financial institution's website and uses personal information in the account records to obtain credit cards in ABC's name. When the credit card issuers attempt to hold ABC liable for the unpaid charges, ABC sues their financial institution for failing to safeguard their confidential information.

Loss of Business Opportunity

ABC, Inc. wires funds online from their corporate account at Bank A to their payroll account at Bank B. The funds are not transferred due to a systems malfunction at Bank A. When ABC's payroll processor cannot verify that ABC has sufficient funds on deposit to pay employees through direct deposit, ABC is late paying its employees. ABC sues Bank A, alleging that their business was adversely impacted when their employees were not paid on time.

Libel, Slander, and Defamation, or Other Actionable Oral or Written Disparagement

ABC states on its website that its product is superior to competitor products. A customer sues ABC after he purchases a product from them, alleging that he could have obtained a better product from a competing vendor. Although ABC obtains dismissal of the complaint, significant defense costs are incurred.

. . . COUNSEL CAN ASSIST THE BOARD AND RISK MANAGERS WITH IDENTIFYING INDUSTRY-SPECIFIC RISKS.

Infringement of Copyright, Misappropriation of Ideas, or Plagiarism

ABC, Inc. obtains a report from a consultant concerning issues facing ABC's market to support their claims of superior service. In preparing the report, the consultant copies extensively from another report, written by the consultant's former partner. ABC places the report on its website for informational purposes, along with other information ABC provides to attract new customers. The consultant's former partner sues ABC, alleging that ABC plagiarized his work.

Infringement of Trademark, Trade Name, or Service Mark

ABC, Inc.'s marketing department develops several slogans and phrases to emphasize the quality of their new service. ABC includes these slogans on the home page of its website. However, the marketing department neglects to seek the advice of an intellectual property attorney as to whether any of the slogans are already in use by other companies. A national corporation, which has registered two of the slogans as service marks, sues ABC.

Extortion

ABC, Inc. terminates an employee who feels he has been unjustly treated. In retaliation, he threatens to disseminate confidential information over the Internet unless a year's salary is wired to a specified account within 24 hours.

Ransomware

Ransomware is malware that restricts access to an infected computer system until the user pays a ransom to the malware operators to remove the restriction. For instance, ransomware might systematically encrypt files on ABC, Inc.'s server hard drives. The drives become difficult or impossible to decrypt without paying the ransom for the encryption key.

Payment Systems

ABC Inc.'s financial institution incurs credit risk in different forms, depending on the type of transaction and the institution's role in the transaction. Here are examples:

ACH Credit Entries

For ACH credit entries, the Originating Depository Financial Institution (ODFI) incurs credit risk upon initiating the entries until ABC funds the account at settlement. The Receiving Depository Financial Institution (RDFI) incurs credit risk if it grants ABC funds availability prior to settlement of the credit entry.

ACH Debit Entries

For ACH debit entries, the ODFI incurs credit risk from the time it grants ABC funds availability until the ACH debit can no longer be returned by the RDFI. ODFIs generally charge back a returned ACH debit to the originator. But the ODFI may suffer a loss if, for example, the originator's account has insufficient funds or has been closed. The RDFI's credit risk from a debit entry arises if it allows the debit to post and overdraw its customer's account.

Institutions implement credit-risk controls that:

- Establish underwriting standards
- Require analysis of originators' creditworthiness–and–
- Set appropriate credit exposure limits

Institutions with more complex ACH programs or institutions that do not mitigate credit risk through holdbacks or reserve accounts have more expansive credit-risk management systems. These credit risk issues can adversely impact ABC's ability to maintain its banking relationships.

Human Resources

The risk assessment of Human Resources (HR) functions requires input from leaders in all disciplines within the organization. Leaders in marketing, sales, operations, finance, etc.—all should be asked for their opinions, ideas, and thoughts on risk areas such as:

- Hiring and selection
- Training and development
- Productivity
- Organizational planning
- Reward and recognition
- Administration

It may be helpful to have an HR expert participate or provide leadership in the process, but it would be a mistake to hand off assessment of the HR functions to one or two HR staff people when the assessment questions and considerations require input from many disciplines within the organization.

Data Theft Risk Mitigation Example

The risks described above would require an assessment of their potential impact on the organization (ABC, Inc. in the examples). In addition, the assessment should identify and prioritize risks and provide for risk mitigation controls where necessary. Since this type of risk assessment is focused on specific risks, it is less comprehensive than the organization-wide ERM risk assessments previously described.

Below is an example of a risk assessment that is focused on a specific risk. This risk topic is data theft technology risks. When evaluating how to protect against technology risks, it is important to identify the ways that an organization can be attacked. Attacks take many forms, from breaking into a computer room and stealing data files to a trusted employee who gets around controls because of their trusted position. A summary follows of the typical ways that hackers and thieves carry out their attacks and typical risk mitigation control procedures that may prevent the attacker from succeeding.

Posing as a Customer

Risks

- A thief uses an assumed or stolen identity to pose as a customer of ABC, Inc. and attempts to open an account with ABC.
- A thief uses a stolen credit card number from ABC to illegally purchase goods and services from ABC.

Procedures

Implement, update, and manage:

- Customer identification procedures
- User signup procedures
- Transaction limitation procedures
  - Dollar limits per transaction
  - Credit lines access limits
  - Cash management user approval criteria
  - Wire limitations
  - ACH origination limits
  - Transaction settlement procedures

Using Technology to Launch an Attack

Risks

- A thief attempts to break through Internet security measures to illegally gain access to ABC's online banking services.
- A thief attempts to steal data from ABC's customer databases, using hacker tools over the Internet.

Procedures

Install, update, and manage:

- Network perimeter controls (firewalls and intruder detection)
- Data integrity controls (encryption)
- Virus prevention management
- Software patch management

Taking Advantage of a Trusted Employee Position

Risks

- An ABC employee uses his or her knowledge of network security weaknesses to access systems and steal customer data.
- An employee does not enforce security controls and allows another person to steal customer data.

Procedures

Manage and monitor:

- Human access controls (passwords)
- System overload and capacity management
- Backup and recovery procedures (protection from unexpected shutdowns)

Identifying Industry-Specific Inherent Risks

In addition to identifying risk trends as discussed above, counsel can assist the board and risk managers with identifying industry-specific risks. These risks are the inherent risks that were discussed earlier in this article. Below are some examples of the risks inherent in a sampling of industries. Counsel should work with the board of each organization they represent to understand, monitor, and evaluate through ERM risk assessments the risks inherent in those industries.

Banking

Credit risk is the current and prospective risk to earnings or capital arising from an obligor's failure to meet the terms of any contract with the bank or otherwise to perform as agreed. Credit risk is found in all activities in which success depends on counterparty, issuer, or borrower performance. It arises any time bank funds are extended, committed, invested, or otherwise exposed through actual or implied contractual agreements, whether reflected on or off the balance sheet.

Risk assessments should consider both the quantity of credit risk and the quality of credit risk management. Quantity of credit risk is derived from the absolute amount of credit exposure and the quality of that exposure. How much credit exposure a bank has is a function of:

- The level of loans and other credit/credit-equivalent exposures relative to total assets and capital–and–
- The extent to which earnings are dependent on loan or other credit/credit-equivalent income sources

Quality of credit risk management involves the adequacy of controls over the process of originating, funding, and overseeing loans until they are paid according to the loan agreement.

All else being equal, banks that have higher loans-to-assets and loans-to-equity ratios and that depend heavily on the revenues from credit activities will have a higher quantity of credit risk. The quality of exposure is a function of the risk of default and risk of loss

in assets and exposures comprising the credit exposure. However, the risk of default and loss is not always apparent from currently identified problem assets. It also includes the potential default and loss that will be affected by factors such as bank risk selection and underwriting practices; portfolio composition; concentrations; portfolio performance; and global, national, and local economic and business conditions.

To determine the quantity of credit risk, risk assessments must consider an array of quantitative and qualitative risk indicators. These indicators can be leading (rapid growth), lagging (high past-due levels), static (greater/less X%), relative (exceeds peer/historical norms), or dynamic (trend or change in portfolio mix). Many of these indicators are readily available from call report and Uniform Bank Performance Report information. Other indicators, such as a bank's risk tolerance or underwriting practices, are more subjective.

It is important to note that banks can exhibit an increasing or high level of credit risk even though many, or all, traditional lagging indicators or asset quality indicators are low. Although a qualitative indicator may have the opposite effect on credit risk that a quantitative indicator has (the one may mitigate the other's effect), the indicators can also work together (the one may add to the other's effect). While each type of measure can provide valuable insights about risk when viewed individually, they become much more powerful for assessing the quantity of risk when viewed together.

Health Care Workers

Every health care worker can influence the risks related to the health, safety, and welfare of patients. Health care workers are defined as everyone that works within a health care facility.

A risk assessment within a health care facility should provide for a thorough evaluation of the workplace to identify anything that may cause harm to patients. The assessment should consider how probable and severe the risk is and determine what measures should be taken to prevent or control the harm from occurring.

Here is a sample outline of the typical risk assessment:

- Identify hazards to patient health.
- Decide what patients are at risk and how the risk might arise.
- Conduct and evaluate the seriousness of the risks identified.
- Document assessment findings.
- Propose action steps to improve patient safety.
- Identify who will be responsible for implementing revised policies, procedures, and personnel training.
- As risks are identified, update the risk assessment and take corrective action.

The outcome of the risk assessment should be to create awareness of hazards and risks, identify who may be at risk, and determine if existing control measures are adequate or if alternative controls

Related Content

For additional information on performing risk assessments, see

> **RISK ASSESSMENT**

RESEARCH PATH: *Corporate Counsel > Compliance Risk Assessment and Governance > Compliance Programs and Risk Assessment > Practice Notes > Risk Assessment*

For guidance on creating a compliance program, see

> **CREATING A COMPLIANCE PROGRAM**

RESEARCH PATH: *Corporate Counsel > Compliance Risk Assessment and Governance > Compliance Programs and Risk Assessment > Practice Notes > Compliance and Ethics Programs*

should be implemented. Ideally, controls will be designed to prevent injuries or illnesses based on a prioritization of the seriousness of health hazards.

Health care facilities have a legal obligation to limit unprotected exposures to pathogens, the transmission of infections associated with procedures, and the transmission of infections associated with use of medical equipment, devices, and supplies. Risk assessments should address the adequacy of control measures to manage the facility's obligations to safely care for patients.

Retailers

Retailers are exposed to many risks due to the need to provide customers with direct physical and online access to their products and services. One access point that has resulted in losses for many retailers is incidents in which a skimming device is physically implanted (tampering) on an asset that reads magnetic stripe data from a payment card (e.g., ATMs, gas pumps, POS terminals, etc.).

Some of the risk assessment issues to consider are:

- Does the retailer design (or buy) tamper-resistant terminals?
- Do they use tamper-evident controls?
- Do they have cameras to watch for tampering?
- Are consumers encouraged to protect their PINs?
- Are consumers encouraged to let the retailer know if something looks out of the ordinary at an ATM, payment terminal, or gas pump?

The objective for risk mitigation controls is to make it harder for criminals to carry out their plans or to detect the heist more quickly if prevention isn't possible.

Cybersecurity Insurance

Cybersecurity has become a significant risk issue for all organizations. Hackers can attack from throughout the world and mostly remain undetected. These criminals are well funded and can attack for profit or to achieve political objectives. Often the risk implications of successful attacks can be debilitating and can result in reputational damage. There is also the potential for significant costs related to remediating these attacks, which is why the insurance industry has created cybersecurity insurance policies.

Since there is presently little actuarial basis for underwriting these policies, actual underwriting requires a due diligence investigation into an organization's internal risk management practices and external business dependencies, including vulnerabilities related to the organization's suppliers, sub-suppliers, and vendors. In addition, the underwriter's risk analysis considers threats arising from insiders, inadequate physical security, and international travel. Underwriting also evaluates how consistently the organization has adopted, implemented, and enforced an engaged cybersecurity culture that works toward risk prevention and prompt detection if prevention fails.

The results from the insurer's underwriting provide an objective look at the organization's enterprise risk including potential high-priority vulnerabilities. Once the insurance is in place, the insurer will conduct periodic risk assessments to gain insight into evolving cybersecurity risks.

Even if the organization decides not to purchase cybersecurity insurance, the insight gained from participating in the underwriting process may uncover invaluable cyber risk insight based on the insurer's exposure to multiple industries. L

__Gary M. Deutsch__, CPA, MBA, CMA, CBA, CIA, has worked extensively with financial institutions in audit, lending, financial, and operational areas. He has served in senior positions for regional banks as VP of Finance, Real Estate Loan Officer, and Senior Audit Manager. Mr. Deutsch served as a consultant to financial institutions in strategic planning, profit improvement, financial management, and merger- and acquisition-related studies while working at KPMG. Mr. Deutsch is the President of BRT Publications LLC, a professional authoring company serving the financial industry. He has written numerous financial industry books and guides, including **Risk Assessments for Financial Institutions**, *a LexisNexis/Sheshunoff publication.*

RESEARCH PATH: *Corporate Counsel > Compliance Risk Assessment and Governance > Compliance Programs and Risk Assessment > Articles > Risk Assessment*

Joseph M. Marger REED SMITH LLP

Real Estate Due Diligence in Corporate and M&A Transactions

In almost every asset purchase, stock purchase, and merger transaction (generally referred to in this article as M&A transactions), the purchaser will acquire an ownership or leasehold interest in at least one real estate asset. However, the real estate asset(s) do not drive a typical M&A transaction. In most cases, a particular real estate asset will only have significance because of how it will be used in the purchaser's business operations after closing (i.e., the real estate only has incidental value).

IF REAL ESTATE IS NOT DRIVING THE TRANSACTION, the purchaser may be inclined to forego, substantially limit, or postpone the real estate due diligence commonly performed in a real estate transaction. This article provides general guidance and practice tips for a real estate attorney assisting with the real estate due diligence in such an M&A transaction.

Preliminary Items

Timing

The real estate component of an M&A transaction runs more smoothly if real estate due diligence is addressed in the early stages of the transaction. M&A transaction agreements rarely include a due diligence period, and much of the due diligence is performed before contract signing. By addressing real estate due diligence early in the transaction, the purchaser can:

- Identify real estate costs (e.g., transfer taxes) that may be material in the purchaser's pricing decision
- Gain negotiating leverage on real estate issues
- Modify the deal structure to mitigate real estate issues
- Account for real estate due diligence items requiring significant lead time in the deal timeline
- Otherwise factor real estate due diligence considerations into its decision-making process

Confirm the Transaction Structure

The real estate due diligence process varies depending upon how the M&A transaction is structured. At the outset, make sure you completely understand the applicable transaction structure. The three most common structures are asset purchases, stock purchases, and mergers.

Related Content

For a detailed discussion on the salient benefits and drawbacks when choosing a transaction structure, see

> **BENEFITS AND DRAWBACKS OF ASSET PURCHASE, STOCK PURCHASE AND MERGER STRUCTURES**

RESEARCH PATH: *Real Estate > Corporate Transactions > Due Diligence > Practice Notes > Structuring and Planning*

For a basic form of a lease abstract, see

> **LEASE ABSTRACT**

RESEARCH PATH: *Real Estate > Office Leasing > Closing and Other Ancillary Documents > Forms > Lease Abstract*

For more information on environmental due diligence in corporate transactions, see

> **ENVIRONMENTAL DUE DILIGENCE IN M&A TRANSACTIONS**

RESEARCH PATH: *Real Estate > Corporate Transactions > Due Diligence > Practice Notes > Environmental Due Diligence*

For guidance in understanding and allocating environmental liabilities in a transaction agreement, see

> **ALLOCATING ENVIRONMENTAL RISKS IN THE TRANSACTION AGREEMENT**

RESEARCH PATH: *Real Estate > Corporate Transactions > Transaction Documents > Practice Notes > Transaction Documents*

For a more thorough discussion on the environmental risks that are encountered in real estate transactions, see

> **ENVIRONMENTAL DUE DILIGENCE IN REAL ESTATE TRANSACTIONS**

RESEARCH PATH: *Real Estate > Corporate Transactions > Due Diligence > Practice Notes > Environmental Due Diligence*

For additional information on choosing a transaction structure, see

> **SELECTING A STRUCTURE**

RESEARCH PATH: *General Practice > General Commercial and Contract Boilerplate > Contract Boilerplate and Clauses > Secondary Materials > Termination and Cancellation*

- **Asset purchase.** In an asset purchase, the purchaser acquires all (or a portion) of the seller's assets. Unless successor liability is imposed pursuant to applicable laws, the purchaser is only liable for those obligations of the seller (if any) that the purchaser expressly assumes under the transaction documents.
- **Stock purchase.** In a stock purchase, the purchaser acquires all of the ownership interests in the target company, and the target company's assets and liabilities remain the same.
- **Merger.** In a merger, two companies are combined, and the surviving company succeeds to all assets and liabilities of the disappearing company.

For a complete understanding of the applicable transaction structure, you must confirm specific factual information. For stock purchases and mergers, confirm whether the purchaser is acquiring an entire company or a division. For asset purchases, confirm the specific real estate assets to be acquired and how the purchaser intends to take title to those assets; for example, the purchaser may want each asset to be transferred to a separate single-purpose subsidiary company. For mergers, confirm the type of merger and whether the surviving entity is the target, the purchaser, or a subsidiary of the purchaser. Ask whether pre- and post-transaction structure charts are available. Structure charts provide a clear and concise summary of the transaction and are likely to include the above factual information.

Other Confirmation Items

A variety of other transaction-specific items are relevant to the purchaser's real estate due diligence plan. To review a complete list of these considerations go to the full practice note in Lexis Practice Advisor at *Real Estate > Corporate Transactions > Due Diligence > Practice Notes > Due Diligence.*

Establishing a Real Estate Due Diligence Plan

Each M&A transaction is different, and each transaction has a unique real estate due diligence plan that is influenced by a variety of factors, including many of the transaction-specific items described above. Typically, the most significant factor is the relative importance of the real estate in the context of the overall transaction.

- **Relative importance of real estate.** The purchaser may not have considered the real estate at all in deciding on the transaction. Depending on the circumstances, you may be asked to help the purchaser evaluate the relative importance of the real estate in the context of the overall transaction.
- **Fundamental differences.** In a real estate purchase and sale agreement, the seller does not typically make representations regarding title, survey, and other real estate matters that can be easily determined in customary real estate diligence. In an M&A transaction agreement, however, the seller typically makes comprehensive representations regarding such matters.
- **Your supportive role.** Your role is to work in conjunction with corporate counsel to help the purchaser make an informed decision about the real estate due diligence plan, including the scope of the real estate due diligence in light of the scope of representations and warranties in the corporate transaction documents. To make an informed decision, the purchaser must also understand the utility of customary real estate due diligence and how real estate issues can materially impact the costs, timing, or other aspects of the transaction. Depending on the purchaser's real estate acumen (oftentimes M&A purchasers have little), you may need to educate the purchaser on customary real estate due diligence and provide specific examples of how real estate issues can impact the transaction.

The remaining sections of this article address essential categories of real estate due diligence in the context of a typical M&A transaction.

Title

You should first help the purchaser choose a title due diligence plan. You should then oversee the execution of that plan, including, if applicable, ordering title searches, reviewing title exceptions, and negotiating owner's title policies or endorsements thereto.

Establishing a Title Plan

To make an informed decision on a title due diligence plan, the purchaser must have the following basic information.

- **Covered risks.** Depending on the purchaser's real estate acumen, as a preliminary matter you may need to educate the purchaser on the purpose and utility of title insurance and provide a few examples of the covered risks including ground leases and other long term leases.
- **Survey.** Depending on the purchaser's real estate acumen, you may need to explain that a comprehensive title review is impossible without a current survey of the property.
- **Title search costs and timing.** Let the purchaser know approximately how long it will take the title company to complete a title search in each applicable jurisdiction. Also let the purchaser know that the title company may only charge a nominal fee for a title search: even if the purchaser does not want to pay for title insurance, a search may reveal material title issues at little cost.
- **Title policy costs.** Provide the purchaser the title policy rates and fees for each applicable jurisdiction.
- **Non-imputation endorsement.** In the case of a merger or a stock transaction, inform the purchaser that the owner's policy will not cover any loss resulting from:
  - Any unrecorded transaction agreed to by the target
  - Any title defect unknown by the purchaser but known by the target

These coverage exclusions significantly diminish the value of an owner's policy. A non-imputation endorsement (if available in the applicable jurisdiction) may eliminate these coverage exclusions in whole or in part. However, the seller may be unwilling to deliver the affidavit and indemnity required by the title company to issue the endorsement. Without a non-imputation endorsement, the purchaser may conclude that the costs of an owner's title policy outweigh the benefits.

Title Review Options

Purchasers in M&A transactions have a diverse set of title review options. These range from relying solely on the seller's title-related representations in the transaction agreement to performing a comprehensive title review for each property, with numerous customized options in between. A comprehensive title review may be performed for certain material properties, with other properties receiving limited or no title review. If timing is an issue, instead of new searches, review may be limited to the seller's existing title policies (if any). Instead of all title documents, the review may focus on specific types of issues or specific categories of documents, such as liens, purchase options, real estate tax deferral or abatement agreements, and development agreements. Providing a few examples of the various title review options may make it easier for the purchaser to determine an appropriate deal-specific scope of review.

Title Insurance Options

Purchasers in M&A transactions also have various title insurance options. Depending on the transaction and the policy terms, coverage may still apply under the seller's existing title policies following the transaction. If coverage applies, the purchaser may prefer to rely on the existing policies in lieu of obtaining new policies, especially if the policies are relatively recent and the insured amounts closely approximate current market values. Even if the purchaser wants coverage to be brought current, a "date-down" endorsement (if available) may be more cost-effective than a new policy. In the case of a stock transaction or merger, keep in mind the coverage exclusions for matters known (or agreed to by) the target (as described above).

Lender Requirements

If a lender is financing the transaction, confirm the lender's title insurance and other real estate due diligence requirements. Any material differences in requirements should be identified and resolved as early as possible in the transaction.

- **Simultaneous-issue savings.** The purchaser may not be aware of simultaneous-issue savings. If the lender insists on a loan policy for a particular property and the purchaser previously indicated it did not want a new owner's policy, reconfirm whether the purchaser wants an owner's policy after letting the purchaser know the amount that the loan policy premium will be discounted if the purchaser also obtains a new owner's policy.

Executing the Title Plan

The following bullet points include practice tips and other information that you may find useful in overseeing the execution of the purchaser's title due diligence plan.

- **Obtain the seller's existing title documentation.** First, make sure the seller has provided the purchaser copies of (1) any existing title policies (and surveys) and (2) any recorded exceptions or other title documents in the seller's possession. Even if the purchaser does not want any title due diligence, having easy access to this documentation will benefit the purchaser after closing.
- **Place the title order.** If a title order is required, the transaction will typically run more smoothly if you place the title order and serve as the purchaser's primary point of contact with the title company. The purchaser may ask you to select the title company; unlike a pure real estate transaction, the parties may not have any significant title company relationships or preferences. If asked, select a reputable title company (with a national scope if there are multiple states involved) that you are comfortable with and that can accommodate the timing and other particulars of the transaction.
  - If the transaction involves financing, before placing the order, confirm that the title company satisfies any applicable lender requirements (e.g., maximum risk limits).
  - When placing the order, provide the title company with:
    - Copies of any existing title policies or other title documentation obtained from the seller (this may expedite processing times)
    - The purchaser's title requirements
    - The lender's title requirements
    - A comprehensive distribution list
  - The Schedule B-1 requirements will vary depending on the structure. Make sure the title company has a brief description of the transaction structure and copies of applicable transaction structure charts.
  - Request delivery estimates for the title searches and periodically check to confirm the searches will be delivered on schedule.
- **Title review**
  - Confirm the process for delivering completed title reviews and to whom the reviews will ultimately be delivered. Prepare a form of title review checklist consistent with the applicable scope of review and tailored for the intended recipient (e.g., lawyer or businessperson); use that form for each title review.
  - Promptly submit comments to any owner's policies or endorsements that the purchaser wants to obtain in connection with the closing of the transaction. Monitor the title company to make sure comments are promptly addressed.
- **Title issues.** Regardless of the process for delivering completed reviews, promptly share any material title issues with the lead attorney. If contract signing has already occurred, the purchaser may not have any leverage unless the issue(s) are sufficiently material exception(s) to a representation and warranty made by the seller in the transaction agreement (this circumstance is unlikely for M&A transactions where the real estate is not a key asset).
- **Mitigating title issues.** Several methods of mitigating title issues are listed below. Whether a particular mitigation method will be available to (or adequately protect) the purchaser will depend on the nature and materiality of the title issue, its susceptibility to cure, the purchaser's negotiating leverage, and other transaction-specific factors.
  - *Seller indemnity.* The seller may agree to specifically indemnify the purchaser in the transaction agreement (or, if contract signing has already occurred, an amendment) for the applicable title issue. Depending on the magnitude of the particular issue in the context of the overall transaction, the seller may agree that the particular indemnity will not be subject to any basket (i.e., minimum amount of damages that the purchaser must suffer before the seller's indemnity will apply), liability cap, or similar limitations on the seller's indemnities in the transaction agreement.
  - *Excluding the property.* If the transaction is an asset sale, it may be possible to exclude the property with the applicable title issue from the transaction.
  - *Seller cure / Delete exception.* The title company may be willing to delete the title exception causing the applicable title issue based on seller curative action. For example, the seller may be in possession of an unrecorded termination agreement for the title exception.
  - *Affirmative insurance.* Even if the title company will not delete the title exception causing the applicable title issue, it may be willing to provide the purchaser affirmative insurance on the basis of certain actions taken by the seller (e.g., the seller providing the title company an indemnity or escrow deposit for the applicable title exception).
- Make sure parties are in agreement on requirements. If any policies or endorsements are to be issued in connection with the closing, make sure the parties agree who is responsible for satisfying each Schedule B-1 requirement.

Survey

As with title, you should first help the purchaser choose a survey due diligence plan, and then you should oversee the execution of that plan.

Establishing a Survey Plan

In order to make an informed decision on a survey due diligence plan, the purchaser must have the following basic information.

- **Function of surveys.** You may need to educate the purchaser on the function and value of surveys. As part of that education, provide a few examples of issues disclosed by a survey (e.g., lack of access, utility easement running under the improvements, encroachments, etc.) and explain that the title policy will not provide coverage for any matters that would be disclosed by a current survey.
- **Relation to title.** You may need to inform the purchaser that title and survey review go hand-in-hand and that it would be unusual to review a survey without also reviewing the title for the property in question.
- **Costs and timing.** Provide the purchaser cost and timing estimates for new or updated surveys in each applicable jurisdiction (bearing in mind that new or updated surveys can be expensive and require a long lead time) and consider a national survey company to coordinate your efforts for multi-property transactions.

Survey Review Options

Purchasers in M&A transactions have various survey review options. A comprehensive survey review may be performed for certain material properties, with other properties receiving limited or no survey review. Options include:

- **No review.** No review by the purchaser. Under this option, the purchaser relies solely on the seller's survey-related representations in the transaction agreement.
- **Existing survey.** Review the most recent survey obtained by the seller. This scope of review would be useful only if no material alterations (e.g., expansion) have been performed that would render the survey inaccurate. Ideally, the transaction agreement would include a representation from the seller that no such alterations have been performed.
- **Survey update.** If there is a recent survey for a particular property, ordering an update of that survey (instead of a new survey) may result in significant time and cost savings. Also consider if the existing survey can be updated merely by a visual inspection if there have been no changes to the footprint of the improvements, making it acceptable for title insurance purposes.
- **New survey.** If the purchaser wants to obtain a new survey for a particular property, consider the items below.
  - *Is an American Land Title Association (ALTA) survey necessary?* If no survey or title policy has ever been prepared for the property in question, and/or the property in question consists of an assemblage of large tracts of land acquired in numerous transactions (e.g., forestland owned by a paper company), the purchaser may not approve the costs and/or timing of an ALTA survey. A standard physical survey or a computer-generated boundary survey added to a recent satellite image of the property may be sufficient.

- *Table A items.* If the purchaser wants a new ALTA survey:
  - Depending on the property type and other factors, many of the Table A items commonly requested in a pure real estate transaction involving an office, retail, or multifamily property may be inappropriate.
  - For certain non-standard properties that are very large in size (e.g., a power station located on, but not close to any boundary line of, a 100-acre parcel), it may be appropriate to select Table A, Item 15, which permits use of photogrammetric mapping and other alternative technologies (in lieu of on-the-ground measurements) to show the location of certain improvements. The selection will likely result in significant cost and time savings, and precise on-the-ground measurements of the improvements would not be as important for such a property.

- **Confirm lender's survey requirements.** If a lender is financing the transaction, once the purchaser has determined its preferred scope of survey review, confirm whether the purchaser's requirements are consistent with the lender's and, if they are not, promptly resolve any differences with lender's counsel.
- **Confirm title company's survey requirements.** Confirm whether the title company will remove the standard survey exception on the basis of applicable surveys set forth in the survey requirements agreed to by the purchaser and the lender. Typically, the title company will not remove the exception unless it receives an ALTA survey that is no more than six months old. The title company may agree to remove the survey exception (typically only for a lender's policy) if it receives an older ALTA survey together with an affidavit from the seller that there have been no alterations that would render the survey inaccurate or with a current visual inspection confirming no changes in the footprint of the improvements.

Executing the Survey Plan

The following bullet points include practice tips and other information that you may find useful in overseeing the execution of the purchaser's survey due diligence plan.

- **Get seller's surveys.** Confirm the seller has provided copies of any surveys in the seller's possession. Even if the purchaser does not want any survey review, these may be helpful to the purchaser post-closing, and the survey may be certified to the seller and the benefits thereof transferred by merger or stock sale.
- **Order survey updates and/or new surveys.** As with title, the transaction will typically run more smoothly if you order the new surveys and/or survey updates and serve as the purchaser's main point of contact with each surveyor. Provide each surveyor the applicable survey requirements (as agreed to by the parties) and a comprehensive distribution list (which should include the applicable title company and the lender's counsel contacts, among others); follow up to confirm that the surveyor understands and is able to adhere to those requirements. Obtain delivery estimates and periodically check in to confirm the applicable surveyor remains on schedule.
- **Order flood zone determination certificates.** If the purchaser does not want to obtain a survey update or new survey for any particular property, suggest at least obtaining a current flood zone determination certificate from a reputable provider (if the purchaser's insurance consultant does not obtain same as a matter of course) to ensure that appropriate flood insurance (if available) will be in place. These certificates are inexpensive and can typically be obtained very quickly and may well be required by any lender.
- **Survey review**
  - Incorporate the applicable survey review items into the form of title review checklist described above.
  - If any new surveys or survey updates are being obtained:
    - Send any comments as quickly as possible (complete your review as soon as possible and ask the lender's counsel and title company to do the same).
    - Send all of the parties' comments to the surveyor at the same time. This tends to make the survey revision process more efficient and accurate; ideally, you should incorporate the title company and the lender's counsel's comments with your own.
    - Monitor the surveyors to ensure timely delivery of all revised surveys.
- **Survey issues.** Promptly disclose any material survey issues to the lead attorney. There are various methods of mitigating survey issues, including a specific seller indemnity, seller curative action, and excluding the applicable property from the transaction (in the case of an asset sale). The viability of a particular method will depend on the transaction specifics, and as mentioned above, the purchaser may have very little leverage if the issue is first discovered after contract signing.

Zoning

As with title and survey, you should first help the purchaser choose a zoning due diligence plan, and then you should oversee the execution of that plan.

Establishing a Zoning Plan

To make an informed decision regarding a zoning due diligence plan, the purchaser must have the following basic information.

- **Purpose of zoning report.** You may need to educate the purchaser on the purpose of a comprehensive zoning report and provide examples of items that it typically discloses, including:
  - Whether the use of the property is permitted in the applicable zoning district
  - The extent of any nonconformities
  - Whether the applicable nonconformities are considered legally nonconforming
  - Any rebuilding restrictions in the event of a casualty
  - Any open zoning, building, or fire code violations
- **ALTA survey required.** In your discussions with the purchaser, explain that the zoning company needs a current ALTA survey to complete a comprehensive zoning report (without such a survey, the zoning company will be unable to compare the facts on the ground with the zoning code requirements).
- **Zoning endorsement.** Also explain that a title company will not be able to issue a zoning endorsement without issuance of a comprehensive zoning report.
- **Law and ordinance coverage.** Without a current zoning report, it may be difficult to ascertain law and ordinance insurance coverage needs.
- **Costs and timing of new reports.** Let the purchaser know that depending on the municipality and other variables, a comprehensive zoning report may not be available until 30 to 60 days after the order is placed. Certain zoning companies are able to produce more limited summary reports in about a week. As zoning reports are relatively inexpensive, cost is rarely a factor in a purchaser's decision as to whether to obtain a zoning report for a particular property.
- **Review existing reports.** If timing is an issue, reviewing the seller's existing zoning reports may be useful (assuming the reports are relatively recent, and there have been no material alterations or changes in use).
- **Confirm lender's zoning requirements.** As with title and survey, once the purchaser has determined its preferred scope of zoning review, confirm whether the purchaser's requirements are consistent with the lender's and, if not, promptly resolve any differences with lender's counsel.

Executing the Zoning Plan

- **Seller's zoning materials.** As with title and survey, obtain any zoning reports or other zoning materials (e.g., variances, use permits, and certificates of occupancy) in the seller's possession.
- **Ordering zoning reports.** As with title and survey, the transaction tends to run more smoothly if you order the zoning reports and serve as the purchaser's main point of contact with the zoning company. When placing the order, provide the zoning company any relevant documentation (e.g., variances, use permits, and certificates of occupancy) obtained from the seller as well as a comprehensive distribution list. Obtain delivery estimates and periodically check in to confirm the zoning company remains on schedule.
- **Zoning review**
  - Confirm the process for delivering completed zoning reviews and to whom they will ultimately be delivered.
  - Prepare a form of zoning review checklist consistent with the applicable scope of review and tailored for the intended recipient (e.g., lawyer or businessperson); use that form for each zoning review.
  - If any new zoning reports are being obtained:
    - Send any comments you have as quickly as possible (complete your review as soon as possible and ask lender's counsel to do the same).
    - Send all the parties' comments at the same time, which tends to make the revision process more efficient and accurate; ideally, you would incorporate any comments of lender's counsel with your comments.
    - Monitor the zoning company to ensure timely delivery of all revised reports.
- **Zoning issues.** The discussion of survey issues above applies equally to zoning issues.

Transfer Taxes

Advice on real estate transfer taxes is an essential component of the real estate diligence. Ideally, this advice would be provided before contract signing because:

- Real estate transfer tax exposure may be material to the purchaser's pricing decision (particularly in jurisdictions with high transfer tax rates such as Philadelphia and New York City).
- Modifications to the deal structure may reduce or eliminate certain transfer taxes that would otherwise apply.

- The parties can negotiate who will pay the transfer taxes and include the negotiated resolution in the applicable transaction agreement or provide for appropriate indemnification if the obligation to pay transfer tax on the transaction is unclear.
- The parties can minimize uncertainty regarding the amount of transfer tax by specifically allocating a portion of the purchase price to the applicable real estate.

The transfer tax analysis in an M&A transaction tends to be significantly more involved than in a pure real estate transaction. Depending on the jurisdiction, transfer taxes may apply not only to a direct transfer of title but also to an indirect transfer resulting from a transfer of a controlling interest in an entity that holds title to the applicable real estate. Transfer tax regimes vary substantially from jurisdiction to jurisdiction, particularly with respect to indirect transfers. Whether a particular jurisdiction's indirect transfer tax regime will apply to the transaction in question may depend on a variety of factors, including:

- The jurisdiction's definition of controlling interest (a common definition is more than 50% of the applicable ownership interests)
- The tier of ownership interests being transferred (e.g., entity holding title, intervening subsidiary entity, or ultimate parent entity)
- Whether any exclusion or exemption applies to the transaction (e.g., certain jurisdictions exclude transfers of ownership interests that are publicly traded)
- Given the complexity in this area, research and analysis of the applicable state, county, and local laws should be performed by competent state and local tax attorneys. Your role is to (1) make the purchaser and lead counsel aware of the importance of the real estate transfer tax analysis, (2) provide the tax attorneys the factual information needed for their analysis (pre- and post-transaction structure charts for each real estate asset are particularly helpful), and (3) provide other support and assistance (as requested).

Lease Review

If the transaction includes any real estate occupied or used by the target or its subsidiaries pursuant to a lease, lease review will be an important component of the real estate due diligence.

Complete Lease Files

As a preliminary matter, confirm that there is a complete lease file for each applicable leased property. In addition to the original lease, the lease file should contain copies of all amendments and supplemental documents (e.g., commencement date agreement, lease guaranty, and any documentation incorporated by reference). Make sure all agreements are fully executed and that no pages, exhibits, riders, or schedules are missing.

Assignability

The preliminary question is whether any landlord consent rights are triggered by the lease assignment in the form of the transaction in question. This lease question must be addressed in any transaction where the target or a subsidiary is a tenant under a lease, not just asset sales: changes in control or ownership of the tenant, mergers, and/or assignments by operation of law may be treated as an assignment pursuant to the express terms of the lease or as a matter of applicable state law.

Lease provisions addressing assignments are often extensive and complex, and the bullet points below outline a subset of related issues that should be reviewed and summarized in order for the purchaser to understand the lease scenarios that the transaction may trigger.

- **Lease is silent.** A minority of states require landlord consent for an assignment even if the lease is silent. Therefore, if the lease does not include assignment provisions, you must then research whether landlord consent is required pursuant to applicable state law.
- **Is change in control an assignment?** Similarly, as mentioned above, for a stock transaction, if the lease does not address changes in control or ownership of the tenant, you must research applicable state law to see whether the transaction in question is treated as an assignment as a matter of law.
- **Carve-outs to landlord consent.** If the lease's assignment provision was negotiated by the tenant, the provision may stipulate certain permitted transfers that do not require landlord consent (e.g., transfer to an affiliate of the tenant, a successor by merger, or a successor acquiring all or substantially all of the tenant's assets). You may need to obtain more transaction specifics or otherwise consult with the lead attorney(s) to determine whether the transaction is in fact a permitted transfer.
- **Procedural requirements.** If landlord consent is not required, is the landlord nonetheless entitled to prior written notice of the transaction or to review and approve the form of any assignment document for certain criteria, and/or do other procedural requirements apply under the lease?
- Approval standard.
  - If landlord consent is required, is it conditioned upon the satisfaction of any particular requirements?
  - Does the lease specify a standard for the landlord's approval?
  - If a lease does not specify a standard, in most jurisdictions, the landlord is not required to act reasonably.
  - If the landlord is required to act reasonably, does the lease specify reasonable grounds for withholding consent?
- **Landlord response time.** Does the lease require the landlord to respond within a specified time period? If so, what is that period and does the lease provide that a failure to respond results in deemed approval?
- **Transfer premium.** Does the lease entitle the landlord to share any consideration received by the tenant in connection with a lease assignment? This calculation can be difficult/problematic for assignments that are incidental to a larger corporate transaction. To the extent accurate, the parties may want to stipulate in the transaction agreement that no portion of the purchase price is allocable to the applicable leased property.
- **Recapture.** Does the transaction trigger a landlord recapture right? Is the lease below-market or are there any other factors to suggest the landlord may exercise that right? What impact would such an exercise have on operations?
- **Changed lease terms.** Will any lease terms change as a result of the transaction? Changed lease terms could result in unexpected increase in expenses and/or operational burdens for the acquirer. For example, a lease may provide for a fair market rental increase in the event of an assignment and/or stipulate that certain special options of the tenant (e.g., extension, termination, purchase, or expansion options) are extinguished upon an assignment.
- **Guaranty.** If the tenant's obligations under the lease are guaranteed by an affiliate, the lease documents may require that a new guarantor execute a replacement guaranty in connection with the transaction. Provide a brief description of the guaranteed obligations, as well as the replacement guaranty process (including any landlord approval rights with respect to the guarantor).
- **Termination rights.** If the landlord or tenant has any unilateral termination options under the lease, summarize the material terms of same. The lease may either be highly important or the purchaser may prefer that a lease be terminated at the closing instead of assigned (particularly where the assignment process is anticipated to be costly, difficult, and/or time-consuming).

- **Purchase option.** If the lease includes a purchase option, summarize the material terms of same. The purchaser may prefer to purchase the applicable leased property simultaneous with the closing.
- **Subletting.** What restrictions (if any) apply to subletting? In the case of an asset sale, would entering into a sublease avoid a difficult landlord consent process for an assignment?

Reviewing the issues above enables the purchaser to make an informed decision on structuring an approach. Depending on the importance of a particular leased property, if the process of obtaining a required landlord consent is expected to be extremely costly, difficult, and/or time-consuming, there may be an alternate structure acceptable to the purchaser that would eliminate that process. Depending on the transaction type, lease terms, and other factors, structuring alternatives may include:

- Excluding the applicable leased property from the transaction (in the case of an asset sale)
- Terminating the applicable lease in connection with the closing (if the lease affords the tenant a unilateral termination option)
- Exercising a purchase option for the applicable property in connection with the closing (if the lease affords the tenant a purchase option)
- Entering into a sublease instead of an assignment (if the lease requires landlord consent for an assignment but not a sublet)

Lender Requirements

If a lender is financing the transaction, confirm as soon as possible whether the lender will require a mortgage or other lien with respect to any leased location and/or any related personalty or fixtures of the tenant and whether same will require landlord's consent. A tenant's leasehold lender or a senior secured credit lender may also require the purchaser, as the new landlord, to execute a landlord consent and/or statutory lien waiver under applicable state law.

Other Lease Issues

In some M&A transactions, the leases are reviewed for assignability issues only. The scope of review is the purchaser's business decision, but it is your job to make sure that decision is informed.

The purchaser's post-closing plans for each leased location, including which operations (if any) the purchaser plans on conducting, will inform the appropriate scope of review. Before discussing the scope of review with the purchaser, provide the purchaser (and be familiar with) the use, location, and lease term (including renewal and purchase options) for each lease. This basic lease information will help the purchaser finalize its post-closing plans and identify any lease extension(s), exclusions, or terminations that the purchaser may want to require in the transaction agreement.

The purchaser may decide that certain leases require more thorough review than others. For example, the purchaser may only want a comprehensive review of certain types of leases (e.g., ground leases, leases with a remaining term that exceeds a specified minimum, and leases that are critical to the purchaser's post-closing operations). For other leases, the purchaser may prefer a more limited review, focusing on key provisions that may need to be addressed in the transaction agreement and/or that could impose material economic and/or operational burdens. For a complete list of key lease provisions that are commonly reviewed, go to the full practice note in Lexis Practice Advisor at *Real Estate > Corporate Transactions > Due Diligence > Practice Notes > Due Diligence.*

Lease Review Format

If there are numerous leases to be reviewed only for a select number of lease terms/issues, a chart may be the most user-friendly review format. If a purchaser wants a comprehensive review of a particular lease, a narrative abstract may be preferred.

Consents, Estoppels, and Other Third-Party Lease Documents

Your lease review will determine which lease-related documents should be obtained from any landlords or other third parties prior to or at the closing. Any required landlord consents will typically be a closing condition. Depending on the importance of the lease and other factors, other lease-related documents (e.g., landlord estoppel, non-disturbance agreement, and lease extension) may be addressed in the transaction agreement either as a closing condition or as a commercially reasonable efforts undertaking of the seller.

Unless the applicable leases specify a form, the forms of landlord estoppel and other lease-related documents should either be provided (or reviewed and approved) by you. You should also coordinate the lender's review and approval of any such forms.

Work with the target's real estate attorneys to establish a plan and timeline for obtaining the lease-related closing documents. As the purchaser is unlikely to have any relationship with the landlords, typically the target and its real estate attorneys will initiate discussions with the landlords and take the lead. Request that no documentation is sent to the applicable landlord or other third party until both you and the lender have had an opportunity to review and comment; any comments should be sent as quickly as possible to minimize delay in an already time-consuming process. Request periodic status updates to keep up-to-date on any delays/issues.

Environmental Diligence

Environmental diligence is typically performed by specialists (e.g., environmental attorneys and other professionals), and a thorough discussion can be found in Lexis Practice Advisor, Environmental Due Diligence in M&A Transactions, under *Real Estate > Corporate Transactions > Due Diligence > Practice Notes > Environmental Due Diligence.*

***Joseph Marger** is a Partner in Reed Smith's Real Estate group. He has substantial experience in all aspects of the sale and acquisition of real estate, both single asset and portfolio transactions, including industrial and commercial single-user facilities, shopping centers, hotels, office buildings and multi-family residential properties. He is equally experienced in real estate finance, including sale-leaseback and build-to-suit financing transactions, traditional loan documentation for borrowers and institutional lenders for construction and development and stabilized assets, including securitized transactions.*

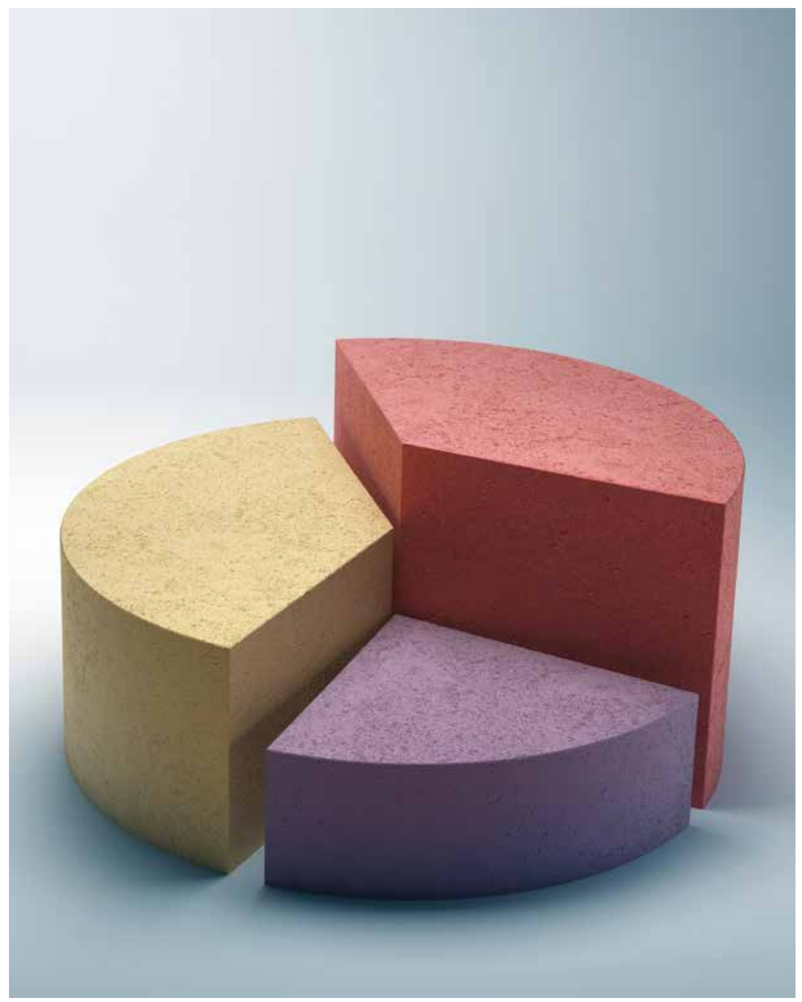
RESEARCH PATH: *Real Estate > Corporate Transactions> Due Diligence > Practice Notes > Due Diligence*

Ira L. Herman BLANK ROME LLP

The Recharacterization of Loan Agreements under Applicable Bankruptcy and Non-Bankruptcy Law

The Statutory Predicate for Recharacterization

To increase their share of a finite bankruptcy pie, creditors, debtors and other parties in interest in a case will seek to reduce or eliminate competing claims. This objective may be accomplished using various provisions of the Bankruptcy Code. Section 502(b)(1) is the statutory provision providing for the objection to, and disallowance of, claims based on the applicable laws and rules and by the enforcement of any agreement between or among the relevant parties. Section 510(c) is the statutory provision that governs the equitable subordination of claims where the claim arises from or is tainted by the inequitable conduct of a party as a result of such bad conduct. Subordination does not eliminate claims; rather, it results in the subordinated claim being removed from one class of claims and placed in a class that is afforded a lower priority in the pecking order of the payments to be made in a bankruptcy case. In many instances, a subordinated claim receives no distribution. By virtue of the subordination, the claimants remaining in the class formerly occupied by the subordinated claim may benefit essentially by receiving a proportionate share of a distribution that would otherwise have been paid to the now subordinated claim.



The Bankruptcy Code, however, is silent with regard to the recharacterization of a purported claim[1] as something less (i.e., an equity security interest). Because no section of the Bankruptcy Code expressly provides for recharacterization, it has been left to the courts to determine whether or not they have the authority to recharacterize.

1. A "claim" under Section 101(5) of the Bankruptcy Code includes the "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured."

Most courts, when asked to consider recharacterization, have held that the bankruptcy courts have the authority to do so. A majority of the courts authorizing recharacterization, including the Third, Fourth, Sixth, and Tenth Circuits, have found that bankruptcy courts may recharacterize pursuant to the broad equitable powers granted by Section 105(a) of the Bankruptcy Code. *In re* SubMicron Sys., 432 F.3d 448, 454 (3d Cir. 2006); Dornier Aviation (North America), Inc. v. Official Comm. of Unsecured Creditors (In re Dornier Aviation), 453 F.3d 225, 231 (4th Cir. 2006); Sender v. Bronze Group, Ltd. (*In re* Hedged-Investments Assocs., Inc.), 380 F.3d 1292, 1297 (10th Cir. 2004); *In re* AutoStyle Plastics, Inc., 269 F.3d 726, 748, 750 (6th Cir. 2001). The "bankruptcy court's equitable powers have long included the ability to look beyond form to substance." *In re* Dornier Aviation (North America), Inc., 453 F.3d at 233. In fact, the equitable power of the court to recharacterize is viewed as essential to effectuating the Bankruptcy Code's priority scheme. *Id.* at 233; *In re* AutoStyle Plastics, Inc., 269 F.3d at 748; *In re* Hedged-Investments Assocs., Inc., 380 F.3d at 1298.

The Fifth and Ninth Circuits have found that recharacterization is required in appropriate circumstances by Butner v. United States, 440 U.S. 48, 54 (1979), when applicable non-bankruptcy law would characterize something that at first glance may look like a loan as a contribution to capital. *In re* Lothian Oil, Inc., 650 F.3d 539, 542–43 (5th Cir. 2011); Official Comm. of Unsecured Creditors v. Hancock Park Capital II, L.P. (*In re* Fitness Holdings Int'l, Inc.), 714 F.3d 1141, 1148 (9th Cir. 2013).

In *Lothian Oil*, the Fifth Circuit held that recharacterization of a purported debt as a capital contribution is permitted and that recharacterization is not limited to claims of insiders.[2] As stated above, the Fifth Circuit's approach to recharacterization differs from the several circuits that rely upon the equitable powers of a bankruptcy court as the basis for recharacterization. Rather than relying on the Section 105(a) "all writs" provision of the Bankruptcy Code, the Fifth Circuit applied state law to recharacterize a claim as an equity security interest by employing Section 502(b)(1) of the Bankruptcy Code—the Bankruptcy Code section that provides for the allowance and disallowance of claims. The Fifth Circuit reasoned that resorting to the general equitable powers of the bankruptcy court was inappropriate because it was unnecessary to do so, since Section 502(b)(1) explicitly grants authority to bankruptcy courts to allow and disallow claims. Thus, the Fifth Circuit's analysis focused on the governing agreement and applicable state law, and not bankruptcy law, when deciding what rights were actually created by the agreement of the parties, despite any descriptive labels used by the parties (i.e., substance over form).

Related Content

For additional information on recharacterization, see

> **UNDERSTANDING RECHARACTERIZATION**

RESEARCH PATH: *Bankruptcy > Case Administration and the Estate > Proofs of Claim > Practice Notes > Proofs of Claim*

For additional information on subordination, see

> **UNDERSTANDING SUBORDINATION**

RESEARCH PATH: *Bankruptcy > Case Administration and the Estate > Proofs of Claim > Practice Notes > Proofs of Claim*

The reasoning employed by the *Lothian* court appears to be sound. Thus, insiders and non-insiders alike in jurisdictions that follow the *Lothian Oil* approach must be concerned with the recharacterization risk with respect to a transaction that at first blush may be set up to create a claim for a debt, but in reality documents a contribution of an equity security interest. Of course, under *Lothian Oil*, the risk to insiders will only exist in states like Texas that do not distinguish between insiders and non-insiders under their laws with regard to recharacterization.

The Seventh Circuit is an outlier with respect to recharacterization, as it has not "definitively stated whether [it] recognize[s] a cause of action for recharacterization. FCC v. Airadigm Commc'ns, Inc. (*In re* Airadigm Commc'ns, Inc.), 616 F.3d 642, 657 n. 11 (7th Cir. 2010). However, the Seventh Circuit has acknowledged that other circuits that have decided the issue have permitted recharacterization in appropriate circumstances.

One potential result of the differing approaches employed by the circuits is forum shopping. Parties with questionable "loans" to companies that have a choice of venue may seek to have the borrower/debtor file for bankruptcy relief in a jurisdiction where the authority of a bankruptcy court to order recharacterization is limited or uncertain. Another potential result is that the U.S. Supreme Court will be called upon to address the circuit split.

2. An "equity security" is defined as either "(A) share in a corporation, whether or not transferable or denominated 'stock', or similar security; (B) interest of a limited partner in a limited partnership; or (C) warrant or right, other than a right to convert, to purchase, sell, or subscribe to a share, security, or interest of a kind specified in subparagraph (A) or (B) of this paragraph." 11 U.S.C. § 101(16).

The Eleven Factors to be Considered with Regard to a Recharacterization Contest

In *AutoStyle*, the Sixth Circuit held that a bankruptcy court has the inherent power to recharacterize a claim as an equity interest since bankruptcy courts have judicial authority to use their equitable powers to allow or disallow claims. Using *Roth Steel Tube Co., v. Comm'r of Internal Revenue* as a guide, the Sixth Circuit developed 11 factors to be considered when determining whether a bankruptcy court should recharacterize a claim as an equity interest. The factors to be considered are as follows:

1. The wording used in the instruments evidencing the indebtedness
2. The presence of a fixed maturity date and schedule of payments
3. The presence of a fixed rate of interest and schedule of interest payments
4. The source of repayments (whether they are fixed or tied to the success of the business)
5. The adequacy of capitalization
6. The identity of interest between the creditor and the stockholder (or holder of a similar ownership interest)
7. The security for repayment of the loan
8. The borrower's ability to obtain financing from outside lending institutions (as opposed to from an Insider or Affiliate, as those terms are defined in Section 101 of the Bankruptcy Code)
9. The extent to which repayment is subordinated by the operative documents to the repayment of debts payable to other creditors of the borrower
10. The extent to which an advance was used to acquire capital assets
11. The presence of a sinking fund to provide repayments

No one factor controls. The courts, therefore, review the facts of each case pertaining to each of the 11 factors. Generally, a transaction negotiated at arm's length between a willing lender and an unrelated willing borrower will lead a court to defer to the transaction documents, rather than recharacterizing the transaction. See *In re* SubMicron Sys., 434 F.3d at 455 n.8 (listing various multi-factor tests); Dornier Aviation, 453 F.3d at 233–34; Hedged-Inv., 380 F.3d at 1298; Fin Hay Realty Co. v. United States, 398 F.2d 694, 696 (3d Cir. 1968).

Although the Fifth Circuit applied state law to recharacterize and disallow a claim under 502(b)(1) of the Bankruptcy Code in *Lothian Oil*, the court analyzed the agreement in question using an analytical model that was virtually indistinguishable from the 11-factor test used by courts that recharacterize using their general equitable powers. See, e.g., Sender v. Bronze Group, Ltd. (*In re* Hedged-Invs. Assocs. Inc.), 380 F.3d 1292, 1298 (10th Cir. 2004) (citing multiple other cases; citations omitted). Where, as in Texas, applicable state law directs the court to apply the prevailing multi-factor test, the results achieved in the Fifth and Ninth Circuits are likely to be substantially similar to the results reached by courts that recharacterize pursuant to Section 105(a) and employ the 11-factor analytical model.

When a loan complies with the formalities for a valid loan agreement and the advanced funds are treated as a loan in the borrower's business records, courts are typically reluctant to recharacterize a loan as an equity contribution, even when the borrower was undercapitalized. In *SubMicron Systems*, 434 F. 3d at 457, for example, the court concluded that an existing lender's loan to an undercapitalized debtor had been properly characterized as a debt when the lending documents called the advances debt and established a fixed maturity date and fixed interest rate. Although the company was undercapitalized, the court concluded that the loan had been made to the distressed company in an attempt to protect the lender's existing loans.

The court in *In re Hedged-Investments Assocs., Inc.*, 380 F.3d at 1298 declined to recharacterize an advance documented as a loan as equity, noting that the transaction documents fulfilled the proper formalities and that the lender had the right to enforce payment of principal and interest. Furthermore, the lender did not have control of management, and the debtor could have secured funds from other lenders at around the time of the transaction. Although the debtor was thinly capitalized, the loan did not have a fixed maturity date, the payment of interest out of a pooled investment account could have been an indication of an equity contribution, and the compliance with formalities and the parties' evident intent that the transaction was to be a loan showed that the transaction had established a debt.

Likewise, in American Twin LTD.. P'ship v. Whitten, 392 F. Supp. 2d 13, 22–23 (D. Mass. 2005), the court concluded that the notes at issue were debt, not equity, emphasizing the compliance with formalities in the issuance of the notes. Although the lender was a minority shareholder, the lender did not control the debtor, and the funds were advanced for operating expenses, which is generally indicative of debt. Furthermore, although the debtor was undercapitalized, its ultimate failure was caused by its poor business model and other similar factors.

Similarly, in Gernsbacher v. Campbell (*In re* Equip. Equity Holdings, Inc.), 491 B.R. 792, 855–62 (Bankr. N.D. Tex. 2013), the court concluded that although several factors supported characterizing the advance of funds as equity, the balance of factors weighed in favor of the conclusion that the formalized notes represented debt. Despite the undercapitalization of the debtor, the tight correlation between equity interests and the values associated with the notes, and the creditor's control of the majority of the debtor's stock, the court heavily weighed the formal characterization of the notes as debt and the debtor's business records' treatment of the notes as debt. Moreover, the funds were used to reduce senior debt and to provide working capital, which weighed in favor of characterizing the funds as a loan. Finally, although the debtor was undercapitalized, there were other causes for the debtor's ultimate financial failure.

On the other hand, when the transaction lacks formalities, especially when the party advancing funds is an insider, courts are more likely to recharacterize the alleged debt as equity. In *In re Dornier Aviation (North America), Inc.*, 453 F.3d at 234, the Fourth Circuit concluded that an insider transaction that failed to comply with certain formalities of a loan actually constituted an equity contribution. Where the loan lacked a fixed maturity date, the debtor was not required to pay the loan until it became profitable, the debtor had a loan history of unprofitability, the debtor's liabilities after restructuring far exceeded its assets, and the purported creditor assumed the debtor's losses, the transaction represented an equity investment rather than debt. Although the purported creditor argued that transfers of inventory cannot constitute an equity investment, the court concluded that adopting such a position would simply incentivize equity investors to structure their capital contributions as sales of inventory.

Even where the transaction is evidenced by a so-called "promissory note," courts may ignore nomenclature where the parties do not conduct their business as lender and borrower. In *Miller v. Dow (In re Lexington Oil & Gas Ltd.)*, 423 B.R. 353, 366 (Bankr. E.D. Okla. 2010), the court recharacterized a claim as an equity interest, despite the execution of a promissory note, because the payment obligation in the documents was solely dependent on the profitability of the borrower. The court stated that in order for a transaction to give rise to a true claim, there must be a reasonable expectation that the repayment obligation does not solely depend on the success of the borrower's business. *Id*. at 365. In *Lexington*, the delay of the obligation to pay any principal or interest for a two year period under the governing documents was further evidence that the purported lenders actually provided equity. Finally, the undercapitalization of the borrower and the failure of the capital providers (the purported lenders) to take prudent actions to protect their rights as lenders—for example, by providing for payment of accrued interest when the notes were rewritten, was evidence that the purported loan transaction was in reality a transaction that provided for an equity investment.

Applying the 11-Factor Test: In re SIAG Aerisyn, LLC

A decision from the U.S. Bankruptcy Court for the Eastern District of Tennessee Southern Division is instructive. Paris v. SSAB Enters, LLC (*In re* SIAG Aerisyn, LLC), 2014 Bankr. LEXIS 4586, at *5 (Bankr. E.D. Tenn. Nov. 3, 2014). During the 90-day period prior to the SIAG bankruptcy filing, it paid a creditor, SSAB, approximately $2.6 million. After the bankruptcy filing, SIAG sued SSAB to avoid these payments as preferential under Section 547(b) of the Bankruptcy Code.

A trustee (including a debtor-in-possession in a Chapter 11 case) may avoid a transfer as a preference only if the transfer (1) was to or for the benefit of a creditor, (2) was for or on account of an antecedent debt owed by the debtor before the transfer was made, (3) was made while the debtor was insolvent, (4) was made on or within 90 days before the date of the debtor's bankruptcy filing, and (5) enables such creditor to receive more than the creditor would receive if the transfer had not been made and the debtor's bankruptcy were a Chapter 7 case. The only element of plaintiff's case at issue was whether SIAG, as debtor, was insolvent when it paid SSAB during the 90 days prior to the bankruptcy filing. The court never reached the issue of insolvency, as it was called upon first to decide whether the advances SIAG received from one of its affiliates was really a loan (debt) or actually a capital contribution, giving rise to an equity interest, rather than to a claim.

The court never actually answered the insolvency question. This is because it first had to rule on SSAB's motion for partial summary judgment as to whether the advance SIAG received from an affiliate was a loan (claim) or a capital contribution (equity interest).

Facts

The relevant facts of *SIAG* are as follows:

During the two years prior to the bankruptcy filing, SIAG received approximately $11.5 million in advances from an affiliate. In its schedules, SIAG listed a claim owed to its affiliate in the amount of approximately $9.9 million as "advance from parent." As of the petition date, SIAG had repaid approximately $2.4 million to its affiliate.

Defendant SSAB argued that Section 547(b) did not apply because SIAG was solvent at the time the debtor made the transfers to SSAB, as the advances from SIAG's affiliate actually

THE LAW REGARDING RECHARACTERIZATION BY BANKRUPTCY COURTS IS DEVELOPING RAPIDLY. THE ANALYSIS IS FACT-INTENSIVE AND NOT ALWAYS CONSISTENT. PARTIES ENTERING INTO A TRANSACTION MUST BE AWARE OF THE INSOLVENCY RISK AND DOCUMENT THEIR TRANSACTIONS CORRECTLY TO ACHIEVE A DESIRED OUTCOME.

were an equity contribution and not a loan. SSAB relied on *AutoStyle* to support its position that the $9.9 million should be recharacterized as an equity investment. After reviewing the *AutoStyle* factors, the court concluded that there were genuine issues of material fact as to whether SIAG and its affiliate intended the advances to be a loan or a capital contribution.

Analysis

Upon consideration of the first *AutoStyle* factor, the court found that the existence of the note itself was not dispositive on the recharacterization issue. The trustee provided a copy of the note evidencing the parent's advance to the debtor, corporate meeting minutes, and a unanimous written consent signed by the debtor's board of managers. SSAB challenged this evidence, arguing that the failure to create the note prior to the first advances and SIAG's failure to classify the note as a promissory note rather than an advance in its schedules meant that the transaction was an equity investment disguised as a loan. Another fact relied upon by SSAB was the failure of SIAG's affiliate to file a proof of claim. Though the court agreed that several facts raised doubt as to whether the note was truly a "note," the court held that the existence of the note itself established genuine issues of fact.

Upon consideration of the second *AutoStyle* factor, the note at issue was a demand note. Demand notes typically do not have a fixed maturity date or repayment schedule. An advance without a fixed maturity date and fixed obligation to repay looks a lot more like an equity investment than a loan. The court found that this factor weighed in favor of SSAB's position.

Upon consideration of the third *AutoStyle* factor, the presence of an interest rate and the calculation of interest were enough for the court to decide that this factor weighed against partial summary judgment that the advance was an equity contribution.

Upon consideration of the fourth *AutoStyle* factor, the court determined that as a rule, if repayment is tied to the success of a borrower's business, the transaction looks like an equity investment rather than a loan. SIAG's former vice president and CFO testified that the parties understood that SIAG would make periodic payments to an affiliate only if SIAG generated sufficient cash from operations. The court determined that was inconclusive and, therefore, this factor weighed against partial summary judgment.

Upon consideration of the fifth *AutoStyle* factor, the court considered, among other things, the testimony of the debtor's former vice president and CFO that SIAG was substantially undercapitalized and the advances at issue were necessary to operate the business. There was also evidence that another affiliate provided SIAG with an initial investment of $5 million and that SIAG's net income was approximately $2.2 million during the first months of its operation. Based on that evidence and evidence of SIAG's solvency presented by SSAB, the court found that genuine issues of material fact existed as to whether SIAG was undercapitalized at the relevant time.

Upon consideration of the sixth *AutoStyle* factor, the court found it unclear whether the affiliate's advances to the debtor were in proportion to its equity interest in SIAG. The more proportionate a stockholder's advance is to the stockholder's ownership interest in a borrower, the more likely an advance was intended to be a capital contribution. On the other hand, a sharply disproportionate ratio between a stockholder's percentage ownership interest and the amount advanced indicates that the advances were intended to be loans. SIAG's operating agreement and other testimony suggested that the affiliate making the advances was not SIAG's owner. The demand note, however, stated that the affiliate, through one of its subsidiaries, owned a 70% equity interest in SIAG.

Upon consideration of the seventh *AutoStyle* factor, the court determined that the demand note indicated that there was no collateral provided by SIAG to secure repayment of the amount of the advances in question. Absence of security for an advance suggested to the court that the advances were in the nature of an equity contribution.

Upon consideration of the eighth *AutoStyle* factor, the court sought to determine whether an unaffiliated reasonable creditor would act in the same manner as the affiliate that made the advances. The evidence suggested SIAG would almost certainly have struggled to obtain financing from an unaffiliated lending source. There was no evidence that SIAG even tried to obtain alternative financing. Despite finding that this factor weighed in favor of recharacterization, the court noted that this factor was not dispositive because it is often the case that struggling companies can only obtain loans from an affiliate.

Upon consideration of the ninth *AutoStyle* factor, the court determined that even though SIAG made two repayments, the parties also understood that SIAG would only make repayments after it paid its vendors. An advance that is last in line behind the claims of all other creditors raises doubt as to whether such advance is a true loan, giving rise to a claim. The court found this factor neutral.

Upon consideration of the tenth *AutoStyle* factor, the court determined that when a borrower uses an advance to pay operating expenses, rather than to acquire capital assets, an advance looks more like bona fide debt. In this case, the court found that SIAG needed and used the advance to fund operations expenses. Thus, this factor militated in favor of a finding that the advances were a true debt obligation giving rise to a claim.

Upon consideration of the eleventh and final *AutoStyle* factor, the court found that the absence of a sinking fund to secure repayment indicates that an advance was a capital contribution and not a true loan giving rise to a claim. An accountant testified that demand notes are usually not accompanied by a repayment schedule or a sinking fund because demand notes are usually paid with earnings. Thus, this final factor weighed against partial summary judgment, since it was not dispositive one way or the other on the recharacterization issue.

Unsurprisingly, due to the conflicting evidence adduced with regard to the 11 *AutoStyle* factors, the court concluded that there were genuine issues of material fact as to whether the SIAG and its parent intended the advance to be a loan or a capital contribution.

Conclusion and Some Practical Guidance

The law regarding recharacterization by bankruptcy courts is developing rapidly. The analysis is fact-intensive and not always consistent. Parties entering into a transaction must be aware of the insolvency risk and document their transactions correctly to achieve a desired outcome.

The *Lothian Oil* decision is important because variations between state laws could yield different outcomes in recharacterization cases based on underlying state law (i.e., cases litigated in the Fifth and Ninth Circuits). For example, in *Lothian Oil,* although the district court found that it could not recharacterize non-insider debt claims under federal law, the Fifth Circuit reversed because Texas law had no *per se* rule limiting recharacterization to the claims of insiders.

What makes *SIAG* such an interesting case is its clear and focused application and analysis of the evidence in relation to each of the 11 *AutoStyle* factors. The Fifth Circuit decision in *Lothian Oil* is similarly instructive. Thus, these cases can be used for guidance by (1) transactional lawyers when called upon to document a deal, and (2) bankruptcy lawyers, trial lawyers, and the courts when they next face a contest regarding the status of an advance and are asked to answer the question—is it a debt or really a capital contribution?

Although several of the *AutoStyle* factors cannot be altered at the time a transaction is being documented and closed (e.g., the identity of the creditor with the shareholder and the participation of the creditor in management), other factors can indeed be controlled. As a practical matter, and consistent with the lessons of *SIAG* and *Lothian Oil*, a party making an advance intended to be paid back as a loan would be well served to:

- Back up the loan with formal documentation, including a standard promissory note
- Make the loan only on normal business terms by imposing an interest rate and payment terms comparable to those which could be obtained from a unaffiliated lender –and–
- Avoid terms that are red flags for claim recharacterization, such as:
  - A contingency on the obligation to repay
  - Redemption provisions
  - Provisions granting voting power to the note holder

Ira L. Herman is a partner at Blank Rome, LLP. He concentrates his practice on distressed public debt issues, insolvency matters involving upstream and midstream oil and gas companies, and distressed M&A, in addition to traditional bankruptcy and insolvency matters.

RESEARCH PATH: *Bankruptcy > Case Administration and the Estate > Proofs of Claim > Practice Notes > Proofs of Claim*

Guidance on Emerging Growth Companies

Q&A with Michael Labriola, Michael Nordtvedt, and Megan Baier

WILSON SONSINI GOODRICH & ROSATI LLP

Michael Labriola

Michael Nordtvedt

Megan Baier

What is an Emerging Growth Company (EGC)?

Under the Jumpstart Our Business Startups Act (the JOBS Act) (112 P.L. 106, 126 Stat. 306), which was passed in April 2012, a company qualifies as an emerging growth company (EGC) if at the time of its initial public offering (IPO) total annual gross revenues were less than $1 billion during its most recently completed fiscal year. EGC status affords an issuer the ability to enjoy certain reduced disclosure requirements, including providing fewer years of historical audited financials and reduced compensation disclosure, and reduced corporate governance requirements, particularly around internal controls over financial reporting and say-on-pay advisory votes. A company will retain EGC status until the earliest of the:

- Fifth anniversary of the company's IPO
- Last day of the first fiscal year in which its annual gross revenue exceeds $1 billion
- Date it becomes a large accelerated filer, meaning the last day of the fiscal year in which it (1) has a public equity float held by non-affiliates of $700 million or more (measured as of the last business day of its second fiscal quarter of such year); and (2) has been a reporting company under the Securities Exchange Act of 1934, as amended (the Exchange Act), for at least 12 calendar months
- Date on which the company has issued more than $1 billion in non-convertible debt during the preceding three-year period

Other than excluding certain types of issuers, such as issuers of asset-backed securities and investment companies registered under the Investment Company Act of 1940, there are no restrictions on companies qualifying for EGC status. In addition, companies organized in foreign jurisdictions as well as in the United States can qualify as EGCs.

What are the relevant statutes and regulations governing securities offerings by EGCs?

A securities offering by an EGC is generally governed by the same statutes and regulations as those by non-EGCs, with the exception of the additional provisions of the JOBS Act and the Fixing America's Surface Transportation Act (the FAST Act) that apply to EGCs. The following key statutes and regulations govern a typical securities offering by an EGC:

- **Securities Act of 1933 (the Securities Act) and the rules and regulations promulgated thereunder.** The Securities Act regulates the offer and sale of securities, including those of EGCs. Generally speaking, any securities offered or sold in the United States must be registered or otherwise exempt from registration under the Securities Act.
- **Exchange Act and the rules and regulations promulgated thereunder.** The Exchange Act addresses the ongoing obligations attendant with listing a class of securities on a national stock exchange, including periodic reporting and the initial registration of the class. In addition, a company with a large number of stockholders (excluding holders of most compensatory equity) may also be subject to the reporting requirements of the Exchange Act. Companies (other than banks and bank holding companies or savings and loan holding companies) with either (1) 2,000 or more stockholders or (2) 500 or more stockholders who are not accredited investors are required to register.
- **Regulation S-K promulgated under the Exchange Act.** This set of rules interplays with the Securities Act forms on which the offering is filed to provide specific disclosure requirements. Regulation S-K is also the framework for non-accounting-specific disclosures in reporting under the Exchange Act.
- **Regulation S-X promulgated under the Exchange Act.** This set of rules addresses the various accounting-specific disclosures required in Securities Act forms. Regulation S-X is also the framework for accounting-specific disclosures in reporting under the Exchange Act.
- **The JOBS Act.** The JOBS Act specifically amended the Securities Act and Exchange Act to provide for certain reduced disclosure, reporting, and governance requirements for EGCs. Most notably, the JOBS Act reduced the audited financial statements required in a Securities Act filing from three prior fiscal years to two, deferred internal control reporting for up to five years following an IPO, reduced the executive compensation disclosures required, permitted testing-the-waters communications outside of the offering, and allowed EGCs to review their Securities Act registration statements with the SEC on a confidential basis.
- **The FAST Act.** The FAST Act further enhanced certain benefits under the JOBS Act for EGCs. Most notably, the FAST Act provided further flexibility for EGCs to begin the SEC review process on Securities Act registration statements without all the required years of audited financial statements if those statements would not be required later when the registrant planned to launch the offering.
- **Regulation G promulgated under the Exchange Act.** This set of rules addresses a registrant's use of financial measures not calculated in accordance with generally accepted accounting principles (non-GAAP financial measures). Regulation S-K also addresses the use of non-GAAP financial measures included in a registration statement filed under the Securities Act for an offering by an EGC, but Regulation G extends broadly to any public disclosure of material information made by the registrant that contains a non-GAAP financial measure.
- **Regulation FD promulgated under the Exchange Act.** This set of rules addresses the selective disclosure of material nonpublic information.
- **Regulation M promulgated under the Exchange Act.** This often overlooked set of rules addresses the timing of certain purchases and sales by a registrant in its own securities. This is relevant to EGCs that are already listed and may be engaged in any activity, including activity by affiliates, to repurchase its securities at a time proximate to a distribution of securities.

What is the typical process for securities offerings by EGCs, including general steps, timeline, key transaction documents, due diligence process, and required regulatory and stock exchange filings?

The IPO Process for EGCs

EGCs receive key accommodations during the IPO process. The IPO on-ramp contemplated by the JOBS Act relaxed certain regulatory barriers that policy-makers believed were keeping EGCs from accessing the public markets. These accommodations include, among other benefits, confidential submission and review of IPO registration statements, reduced financial statement audit and disclosure requirements, and the ability to engage in oral or written test-the-waters communications with certain types of sophisticated investors before filing a registration statement with the Securities and Exchange Commission (SEC). This response focuses on the IPO process for an EGC, which is the principal point in its lifecycle where an EGC first benefits from its differentiated status as an EGC.

Key Transaction Documents and Regulatory and Stock Exchange Filings

The documents and filings required in the IPO process for an EGC generally mirror those in the process for non-EGCs. Some of the key documents in the IPO process are described below.

Draft Registration Statement

A registration statement provides key financial and non-financial information about the company, its business operations, and the securities being offered to the public. The JOBS Act allows an EGC to submit a draft of its registration statement and exhibits to the SEC on a confidential basis via the EDGAR system. The confidential submission and review process provides EGCs with greater control over the timing of their IPO process and keeps them out of the public spotlight during the planning phase of the transaction. Although the SEC staff has stated that they will review a confidential submission in draft form so long as it at least complies with the financial statement requirements, EGCs generally should provide a reasonably complete and high quality draft to the staff to reduce the likelihood of a long comment process and as a courtesy. In addition, although the confidential draft submission is not initially filed, it eventually becomes publicly available on EDGAR as part of the registration process. EGCs are also reminded that to the extent they have members of the Financial Industry Regulatory Authority (FINRA) involved in the offering, they will be required to file the draft confidential registration statement with FINRA for review as well.

As part of its draft registration statement, EGCs are required to include only two fiscal years of both audited financial statements and abbreviated selected financial data. (By comparison, non-EGCs generally must provide three years of audited financial statements and five years of selected financial data.) However, despite the JOBS Act's accommodation, some EGCs choose to provide more than the minimum two years of financial information in the selected financial statements and also sometimes in the audited financial statements to provide greater transparency to investors. Providing more information to prospective investors may have a positive impact when marketing the IPO.

Relevant to both the draft registration statement as well as ongoing reporting once public, EGCs require fewer named executive officers in their summary compensation table under Item 402 (17 C.F.R. § 229.402) of Regulation S-K compared to non-EGCs. An EGC may have as few as three named executive officers, including the CEO and the two next most highly paid executive officers of the company. Non-EGCs that are not smaller reporting companies are required to have at least five named executive officers (assuming they have that many executive officers), including the CEO, CFO, and the next three most highly paid executive officers.

Under the JOBS Act, EGCs can also engage in written or oral test-the-waters communications with certain types of sophisticated investors while the registration statement is still under review. Although limited to qualified institutional buyers (QIBS) and institutional accredited investors, these communications allow EGCs to gauge investor interest in a contemplated offering of securities without violating the gun-jumping rules of the Securities Act of 1933, as amended (the Securities Act). However, EGCs should be careful regarding the timing and content of such communications, as information in the draft registration statement is likely to change and antifraud provisions of the federal securities laws still apply to test-the-waters communications. In addition, the SEC may request copies of any written test-the-waters materials.

Registration Statement (Preliminary and Final Prospectuses)

EGCs must publicly file their IPO registration statement at least 15 days prior to the start of the road show for their offering. This filing will include the preliminary prospectus for marketing the offering.

Later in the process, following pricing, a final prospectus—updated with pricing information and further detail on the underwriting syndicate—must be prepared and filed with the SEC.

Listing Application with Stock Exchange

Securities issued in an IPO are not restricted securities, so they can be freely resold after the initial sale except to the extent they are also control securities. Companies contemplating an IPO typically apply for listing on a major stock exchange such as the New York Stock Exchange (NYSE) or the NASDAQ Stock Market (NASDAQ). An EGC could, of course, conduct an IPO without listing, but market forces would generally dictate that the EGC list the class of equity on an exchange to ensure there will be ongoing reporting and an aftermarket for the securities.

Each stock exchange publishes information about its listing requirements and standards, the process for listing, and fees. EGCs should become acquainted with the various listing requirements and corporate governance standards early on in the planning process, so any necessary changes can be made (e.g., compliance with corporate governance standards on director and board committee independence). Although EGCs have the ability to take advantage of certain reduced reporting requirements, the independence requirements of the exchanges are as rigorous for an EGC as they are for a non-EGC.

Underwriting Agreement

The underwriting agreement is the primary agreement for the sale of the securities in a public offering. It contains details about the terms of the public offering, as agreed by the issuing company and the group of investment banks that will work together as a syndicate to underwrite the securities offering. Most EGC underwriting agreements are identical to their non-EGC counterparts but for a few additional representations about the issuer's status as an EGC as well as the conduct of any test-the-waters activities by the EGC and its underwriters.

High-profile IPOs, including those of some EGCs, are typically underwritten on a firm commitment basis in which the underwriters commit to purchase the shares from the company at a negotiated discount and then resell the shares to the public.

The underwriting agreement will generally also contain an over-allotment option (greenshoe), which typically gives underwriters 30 days to purchase additional shares—often up to 15% of those sold in the offering—at the offering price.

Comfort Letters

As a condition to the underwriting, the company's auditors will be requested to deliver a comfort letter to the underwriters and the board of directors. The comfort letter confirms the auditor's independence with respect to the issuer, describes the procedures performed by the auditor on the issuer's financial statements, and provides certain negative assurance as to changes in those financial statements since the date thereof. In addition, the comfort letter provides certain assurance as to various financial and related information that is presented in the registration statement that is derived from the issuer's books and records on which the auditor performed procedures.

Lock-up Agreements

In an effort to promote an orderly trading market following the offering, the managing underwriters generally require the company and key stockholders to sign lock-up agreements. Lock-up agreements require a company's directors, officers, and existing stockholders not to sell any securities of the company for a period of time after the commencement of the public offering. This lock-up period for an EGC is now typically limited to 180 days, since the JOBS Act effectively eliminated the booster shot rules from FINRA and the NYSE that provided for certain extension of lock-up periods if the release date coincided with an issuer's material public announcements. Not long after the JOBS Act, FINRA largely eliminated the booster shot provisions for non-EGCs as well.

Related Content

For guidance on the drafting and completion of a preliminary prospectus for an initial public offering (IPO), see

> PREPARING THE REGISTRATION STATEMENT AND PRELIMINARY PROSPECTUS FOR AN IPO

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

For more information on the SEC registration statement review process, see

> UNDERSTANDING THE SEC REVIEW PROCESS

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

For assistance in drafting risk factors for the registration statement of the IPO of an emerging growth company (EGC), see

> HOW TO DRAFT RISK FACTORS FOR A REGISTRATION STATEMENT

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

For a detailed explanation about conducting the due diligence review for an IPO, see

> MANAGING THE DUE DILIGENCE PROCESS FOR AN IPO

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

For a checklist of the IPO requirements for an EGC, see

> IPO REQUIREMENTS FOR EMERGING GROWTH COMPANIES CHECKLIST

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

General IPO Timeline for an EGC

A general overview of the steps and timeline of the IPO process for an EGC is summarized below. An EGC usually takes about the same amount of time for an IPO as a non-EGC. However, the key difference is that an EGC will generally be completing the SEC review process confidentially, which allows an EGC substantially more control over the public message regarding commencement of an IPO. For example, an EGC can complete a rigorous SEC comment process without close public scrutiny as to its expected launch timing. This helps protect EGCs from negative market conditions that are external but are often blamed on issuers that have publicly filed and failed to launch their offerings.

Week 1	✓ Conduct organizational meeting ✓ Begin due diligence
Weeks 2–4	✓ Draft registration statement ✓ Continue due diligence
Weeks 5–6	✓ Finish drafting registration statement at the financial printer ✓ Submit draft registration statement confidentially to SEC
Weeks 10–12	✓ Approximately four weeks after date of initial confidential submission, receive review comments from SEC on the draft registration statement ✓ Revise draft registration statement ✓ Submit revised draft registration statement to SEC, along with response letter to comments
Weeks 13–14	✓ Continue to resolve comments from SEC ✓ Submit additional revised draft registration statements, as necessary
Weeks 15–16	✓ Make first public filing of registration statement at least 15 days prior to the start of road show
Week 17	✓ Once SEC comments have been resolved, print preliminary prospectus ✓ Begin road show
Weeks 19–20	✓ Request that the SEC declare the registration statement effective ✓ Price the offering, sign the underwriting agreement, and commence trading ✓ File the final prospectus with SEC ✓ Close the offering

Due Diligence

Due diligence will vary across industries, rather than by EGC and non-EGC status. For example, issues and concerns faced by a software company will almost certainly differ from those faced by a midstream oil and gas company, even if both technically qualify as EGCs. Due diligence for the software company will likely focus more on intellectual property, licensing agreements, and customer lists; the review for the oil and gas company may emphasize documenting ownership of tangible property, partnership and joint venture agreements, and compliance with environmental regulations. Regardless of industry, due diligence will likely extend across certain important areas, including basic corporate documents, financial information, and information about directors and officers. Although EGCs are permitted to file draft confidential registration statements with the SEC, most EGCs attempt to complete material due diligence and factual backup verification prior to any disclosure that will eventually become public to avoid creating a factual record for plantiffs' lawyers later that might suggest the EGC was lax in its reporting ability.

Legal counsel typically requests the following information during IPO due diligence:

- Basic corporate documents, including certificate of incorporation, bylaws, and board minutes
- Comparable documents for any subsidiary
- Stockholder information, including stockholder lists
- Information with respect to any issuance of securities, including copies of agreements
- Financial information
- Copies of material agreements
- Operational information, including lists of suppliers and manufacturers
- Sales and marketing information
- Industry information
- Director and officer information, including compensation plans and other agreements
- Employee information, including organizational charts and copies of agreements
- Intellectual property, including lists of patents and licensing agreements
- Tangible property, including copies of leases and documents of title
- Litigation information
- Insurance information
- Partnership or joint venture agreements
- Foreign operations
- Government regulations and filings

What specific continuous disclosure and corporate governance requirements apply to EGCs?

- Once public, EGCs are generally subject to the same ongoing disclosure and corporate governance requirements that apply to non-EGCs, with several key differences highlighted below.
- EGCs are exempt from the requirement that a public accounting firm attest to internal controls, as required by Section 404(b) of the Sarbanes-Oxley Act. However, most try to comply with the underlying internal controls requirements even if they do not provide the public report until required.
- EGCs are exempt from the mandatory say-on-pay vote requirement as well as the related shareholder advisory votes on the frequency of say-on-pay votes. Most EGCs take advantage of this exemption.
- EGCs are exempt from the chief executive officer pay ratio disclosure rules, as required under The Dodd-Frank Wall Street Reform and Consumer Protection Act (111 P.L. 203, 124 Stat. 1376). Most EGCs take advantage of this exemption.
- EGCs are exempt from formal requirements for compensation discussion and analysis (CD&A) in periodic reporting. Most EGCs take advantage of this exemption.
- EGCs are exempt from any new or revised financial accounting standard as issued by the Financial Accounting Standards Board until such accounting standard becomes broadly applicable to private companies. Many EGCs opt out of this extended transition period, choosing to voluntarily comply with such standards as they are adopted. However, it is important to note that this election is irrevocable. Practice on this was historically mixed. However, as the new revenue recognition rules are the first major accounting standard that allows delayed adoption by EGCs, many EGCs are now taking advantage of this where permitted.
- EGCs also enjoy reduced financial disclosure requirements for future registration statements, such as for follow-on offerings. Most EGCs use this to the extent they have not subsequently filed additional financial statements under the Exchange Act.

What are the regulatory trends affecting EGCs?

A handful of key trends are likely to affect EGCs in the near term, including:

- Accounting regulations
- The SEC's recent calls for comments on business and financial disclosure effectiveness
- The SEC's recent evaluation of the definition of accredited investors

Accounting regulations are expected to have the most substantial effect on EGCs in the coming months, particularly as U.S. GAAP continues efforts to converge with international financial reporting standards (IFRS). Most notably, recent changes in revenue recognition under U.S. GAAP will begin to affect EGCs in financial years beginning on or after December 15, 2017.

The SEC also recently solicited comments on Regulation S-K and various disclosure topics in an effort to improve the quality of its rulemaking under Regulation S-K. The results of those comment responses will likely begin to show effects in SEC rulemaking in the coming months and years.

Finally, in December 2015, the SEC issued a report on various considerations that may be addressed in determining the definition of accredited investors, which is key to the ability of EGCs to raise capital in exempt transactions. The SEC's report

> . . . IT SEEMS LIKELY THAT NEW SEC RULEMAKING WILL SLOW DOWN IN THE COMING MONTHS OR ACTIONS MAY BE TAKEN TO SCALE BACK EXISTING SECURITIES REGULATIONS.

suggested that the number of households that were originally considered to be accredited investors when the rulemaking was last evaluated was a substantially lower percentage of U.S. households and that the dollar-value criteria may need further consideration to ensure that the definition continues to appropriately include only investors that can more readily protect themselves and do not require the mandated disclosure of a registered offering. The staff also considered other factors such as professional background that might include other investors that would not previously have been deemed an accredited investor. Although the staff has not disclosed further comment, it is likely that any rulemaking in this area could have a profound effect on EGCs.

The SEC has also signaled a potential scaling back of regulations generally in connection with the Republican majorities in Congress and a Trump White House. In January 2017, a Republican commissioner of the SEC indicated that further rulemaking on Dodd-Frank would be delayed and suggested some or all of Dodd-Frank was subject to imminent repeal. Although uncertain, it seems likely that new SEC rulemaking will slow down in the coming months or actions may be taken to scale back existing securities regulations.

What are the commercial trends affecting EGCs?

In recent months, several EGCs have financed late-stage private rounds of finance from somewhat unusual sources as valuations grew for the largest unicorn (i.e., privately-estimated enterprise valuation in excess of $1 billion) and decacorn (i.e., privately-estimated enterprise valuation in excess of $10 billion) EGCs. The JOBS Act substantially increased the minimum number of holders of a class of an EGC's securities that would trigger an automatic requirement to begin publicly reporting. In addition, the enhanced flexibility that the JOBS Act brought to general solicitation under private placement exemptions further broadened the ability of EGCs to remain private for longer periods. Combined with volatility in the market, more EGCs were opting to postpone IPOs in late 2015 and throughout 2016. Investors that historically invest upon an IPO or later, such as mutual funds, were increasingly entering the pre-IPO market to avoid missing out on opportunities to invest in attractive EGCs that appear to be staying private longer. This trend seems to be abating somewhat as investors and EGCs alike are increasingly wary of such investments and the onerous conditions that come with them, including an EGC's potential inability to achieve an IPO as hoped.

What practice points can you give to lawyers working with EGCs?

In addition to the legal implications, lawyers working with EGCs must be mindful of the business implications of their disclosure and governance decisions. For example, EGCs are afforded much greater flexibility in implementing and certifying internal controls as compared to non-EGCs. However, that does not necessarily mean that an EGC should not implement stronger internal controls over financial reporting concurrently or prior to an IPO. The risk of a restatement or fraud is just as great for an EGC, and the issuer's directors, officers, and underwriters continue to expect a due diligence defense for offerings of securities. Simply complying with the SEC-mandated disclosure may not always be sufficient to protect the issuer and investors. EGCs should consult closely with their lawyers, auditors, and bankers to make sure that their decisions reflect both legal practice and market practice that is consistent with the risks of their business. L

Michael Labriola is a partner working in Wilson Sonsini Goodrich & Rosati's Washington, D.C., and New York City offices, where he counsels public and private technology and emerging growth companies through all stages of their growth. His practice focuses on corporate and securities law, including general corporate representation, public offerings, venture capital financings, and mergers and acquisitions. Michael Nordtvedt is a partner at Wilson Sonsini Goodrich & Rosati, focusing on the representation of public and private technology, medical device, and life sciences companies through all stages of their growth, as well as investment banks and venture capital and private equity firms. Michael specializes in corporate and securities law, including general corporate representation, public offerings, private placements, and mergers and acquisitions. Megan Baier is a partner at Wilson Sonsini Goodrich & Rosati, specializing in corporate and securities transactions, with a focus on the life sciences, health care, and technology sectors. She also has considerable experience counseling publicly held companies on general corporate representation, SEC compliance, disclosure matters, and complex securities law issues. Assistance provided by Mark Bass, Keegan Drake, and Michael Moesel, Wilson Sonsini Goodrich & Rosati LLP.

RESEARCH PATH: *Capital Markets & Corporate Governance > Industry Practice Guides > Emerging Growth Companies > Practice Notes > Industry Practice Guides*

DRAFTING PAID SICK LEAVE POLICIES

While no federal statute requires that employers provide paid sick leave for employees, [Executive Order 13706] mandates that, effective January 1, 2017, covered federal contractors give employees up to seven days of paid sick leave each year. See [80 FR 54697]. It remains to be seen if the Trump Administration will rescind this executive order.

IN ADDITION, RECENT LEGISLATION AT THE STATE AND local level has increasingly driven employers in affected jurisdictions to implement and maintain paid sick leave policies.

This checklist provides issues to consider when you assist employers with drafting paid sick leave policies. Generally, paid sick leave policies should (1) conform with applicable laws, (2) define employee eligibility, (3) explain how paid sick leave will be accrued, and (4) describe how paid sick leave may be used. Since paid sick leave laws vary by jurisdiction, check the state and local laws where the employer is located to ensure your policy fully complies with applicable law.

Conform Policy with Applicable Laws

Follow these steps to ensure that any paid sick leave policy is legally enforceable in your jurisdiction:

- **Meet the minimum requirements of current laws.** Before drafting or revising an employer's paid sick leave policy, familiarize yourself with any applicable laws (including Executive Order 13706; see 80 FR 54697) and determine whether they apply to the employer. You may find that the employer is exempt from the law if, for example, the statute only applies to employers with a certain number of employees, and the employer falls below that threshold. If a paid sick leave law applies to the employer, review the statute to ensure that the employer's policy adheres to the law's requirements.
- **Discuss pending legislation with the employer.** Find out whether a new state or local paid sick leave law will be enacted in the near future or whether there is a pending proposal to amend a current law. Discuss the pending legislation and legal trends with the employer to alert it to the need to implement a new or updated policy.
- **Consider multiple jurisdictions.** If the employer has employees located in more than one location, different paid sick leave laws may apply to its various employees. Consider how applicable paid sick leave laws diverge and to which employees they apply. In doing so, decide whether the employer should have multiple paid sick leave policies or one company-wide policy. Because a company-wide policy must meet the minimum requirements of all jurisdictions, it could increase the employer's costs compared with having separate policies for each jurisdiction. On the other hand, it is easier to manage and update a single policy than several jurisdiction-specific policies.

CONSIDER WHETHER THE EMPLOYER MUST OFFER PAID SICK LEAVE TO ALL EMPLOYEES OR JUST EMPLOYEES IN CERTAIN ROLES… IF THE APPLICABLE LAW ALLOWS YOU TO APPLY THE POLICY ONLY TO CERTAIN ROLES, HOWEVER, WEIGH THE EFFECT THIS WILL HAVE ON THE MORALE OF THOSE EMPLOYEES WHO WILL NOT RECEIVE THE BENEFIT.

Determine Employee Eligibility for Benefits

Ascertain whether the company's employees are eligible for paid sick leave as follows:

- **Determine minimum hours.** Ascertain whether employees need to work a minimum number of hours to qualify for paid sick leave. For example, under California's Healthy Workplaces / Healthy Families Act (HWHFA) of 2014, individuals are eligible for paid sick leave only if they work for the same employer for at least 30 days within one year from the first date of employment. Cal. Lab. Code § 246(a).
- **Assess eligibility based on job duties.** Consider whether the employer must offer paid sick leave to all employees or just employees in certain roles. For example, Connecticut's paid sick leave law only applies to "service workers," a term defined by a list of work classifications in that law. Conn. Gen. Stat. § 31-57r. If the applicable law allows you to apply the policy only to certain roles, however, weigh the effect this will have on the morale of those employees who will not receive the benefit.

Decide How Paid Sick Leave Accrues

Determine how employees should accrue paid sick leave by taking the following measures:

- **Decide on incremental accrual versus lump sum.** Employees can accrue paid sick leave in many ways. An employer may elect to have the leave accrue gradually or as a lump sum at the beginning of a benefit year. Consider what method will work best for the employer. Providing the full benefit lump sum at the start of the year avoids the need to track accrual and ensures compliance with any state or local law requiring a minimum accrual rate. On the other hand, incremental accrual avoids the possibility of employees using all of their annual sick leave immediately after it is provided.
- **Determine accrual rates.** If the employer uses an accrual system, ensure that the rate meets or exceeds any accrual rates required by law.
- **Analyze accrual for new employees.** Review whether the applicable paid sick leave law mandates that sick days begin to accrue on the first day of employment or at a later date and decide the best option for the employer given its business needs. While the employer cannot preclude new employees from accruing paid sick leave as provided by the relevant statute, an employer with a strong need for new hires may want to offer a greater rate of accrual for new employees as a recruitment tool. Consider whether the employer can and should apply the policy for new employees to reinstated employees as well. Reinstatement provisions are discussed in more detail below.
- **Set an appropriate 12-month period.** The accrual and use of paid sick leave is typically measured over a 12-month cycle. Decide whether the employees' 12-month accrual period should be a calendar year or based on each employee's hiring anniversary date. If you use the calendar year, determine how to pro-rate paid sick leave during an employee's first year of employment.
- **Determine maximum accrual.** Decide on the maximum number of hours of paid sick leave that an employee may accrue. Further, state whether the maximum is an annual limit or a cap on the amount of paid sick leave an employee may bank at any given time. For example, if the policy states that employees may never have more than 40 hours of paid sick leave at any given time, but does not set an annual limit on accrual, employees may end up accruing more than 40 hours per year by consistently using enough sick leave to keep themselves below the hours ceiling.
- **Decide on a carryover policy.** Determine what will happen to paid sick leave hours that an employee accrues but does not use by the end of the benefit year. Options include:
  - Allowing employees to carry the hours over to the next benefit year
  - Eliminating the hours –or–
  - Paying out the value of those hours to the employees

In making this decision, consider the legal requirements as well as the impact on the employer's business. If the hours are lost at the end of the year, employees may be motivated to find ways to use paid sick leave, particularly in the final month of the benefit year. Further, while paying out the value of employees' accrued hours increases payroll costs, such a policy may increase productivity by incentivizing employees to abstain from using paid sick leave.

- **Determine whether to pay out accrued paid sick leave at termination.** Decide what to do with employees' accrued but unused paid sick leave when their employment terminates. Depending on what the law permits, the employer could either pay out the remaining paid sick leave or deem it forfeited. If the applicable law allows forfeiture and the employer prefers the forfeiture option, advise the employer to include a section in its written sick leave policy stating that employees will forfeit all accrued but unused paid sick leave when employment terminates.
- **Decide on a reinstatement policy.** Check applicable laws to determine whether former employees who are reinstated within a certain period of time must receive their previously accrued paid sick leave upon rehire. Generally, employers do not need to reinstate paid sick leave that the employer paid out at the employee's termination.

Related Content

For more information on paid sick leave, see

> **DEVISING EMPLOYEE SICK LEAVE POLICIES**

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

For a sample sick leave policy, see

> **SICK LEAVE POLICY**

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

For assistance in drafting a policy for paid time off (PTO) in lieu of vacation, sick, and/or other paid time off, see

> **PAID TIME OFF (PTO) AND SICK DAYS POLICY**

RESEARCH PATH: *Labor & Employment > Attendance, Leaves, and Disabilities > Attendance and Time Off > Forms > Paid Time Off (PTO) and Leave-Sharing Policies*

For information on state and local sick leave statutes, see the "Family, Medical, Sick, Pregnancy, and Military Leave" column of

> **CHART – STATE PRACTICE NOTES (ATTENDANCE, LEAVES, AND DISABILITY MANAGEMENT)**

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

Consider Employee Usage of Paid Sick Leave

Determine how employees should use paid sick leave by following these measures:

- **Determine the allowable circumstances for taking paid sick leave.** Include a list of qualifying conditions for using paid sick leave.
- **Set a pay rate.** The policy should provide that employees taking paid sick leave will earn the same pay rate they would have received had they worked those hours. The policy should also state that the employer does not consider paid sick leave to be hours worked for the purpose of calculating overtime.
- **Decide whether to limit usage.** If the employer's policy allows employees to attain more paid sick leave than the statute mandates (e.g., due to carryover from the previous year), consider limiting the amount of paid sick leave employees may use annually to the minimum statutory amount.
- **Set increments for usage.** Determine the minimum number of hours that an employee must use when taking paid sick leave. Lower increments allow employees more flexibility in using the time but could also be disruptive to the employer's business. Check applicable laws to determine if a minimum or maximum increment is required.
- **Include a non-discrimination/anti-retaliation provision.** The policy should state that no employee will face discrimination, harassment, or retaliation as a result of the employee's use of paid sick leave consistent with the employer's policy.
- **Require reasonable documentation.** Determine what documentation the employer can and should require from employees who take paid sick leave (e.g., a doctor's note for absences of a certain length). Consider drafting a provision stating that the employer will not pay sick leave until the employee has provided such documentation, to the extent permitted by law.
- **Decide whether to require employees to use paid sick leave when taking medical leave.** If an employee's time off is also covered by the Family and Medical Leave Act (FMLA) or state equivalents, consider requiring that employees use up all accumulated paid sick leave for qualifying leaves before utilizing unpaid medical leave. Further, consider requiring the unpaid leave to run concurrently with the employee's paid sick leave, so that the employee does not get to use the leaves cumulatively. See 29 C.F.R. § 825.207(a). Check state and local laws to ensure that the employer may implement these policies in its jurisdiction.
- **Prohibit misuse of paid sick leave.** State that employees who use paid sick leave fraudulently may incur discipline up to and including termination.
- **Set a notice period.** Determine how much notice an employee must provide before taking paid sick leave, within the confines of applicable law. State who the employee should notify (e.g., a supervisor, another upper management employee, and/or the Human Resources department) and that the notice should be in writing if practicable. If the paid sick leave is unexpected, ask that the employee give notice as soon as possible.
- **Assess paid sick leave usage by new employees.** Decide when new employees should become eligible to use their paid sick leave. Some state and local laws allow for a 90-day window where employees accrue paid sick leave but cannot use it.
- **Create a process for questions, complaints, and appeals.** Include information about who employees should contact if they have questions about the policy, feel they have not received proper paid sick leave, have been denied the opportunity to use accrued paid sick leave, or have faced discrimination, harassment, or retaliation as a result of taking paid sick leave. This may be the Human Resources department, a supervisor, another upper management position, and/or an anonymous hotline.

Make Any Required Postings

Some paid sick leave laws require employers to make postings concerning applicable paid sick leave requirements in a prominent place (some laws may provide an option for making an electronic posting). For example, under Executive Order 13706, covered contractors have to post a notice provided by the U.S. Department of Labor in a conspicuous place (or electronically). See 80 FR 54697.

Draft, Distribute, and Retain the Policy

Adhere to these final steps in the drafting process, including distributing the policy and complying with recordkeeping requirements:

- **Write and distribute the policy.** Clearly delineate the provisions of the employer's paid sick leave policy in a written document, and have the employer distribute it to all employees to whom it applies. Should the employer make any changes to the policy, the employer should do so in writing and redistribute the updated policy. The employer should not apply any changes retroactively.
- **Ascertain recordkeeping requirements.** Advise the employer what documents the employer must maintain and for how long. Consider what legal actions the employer may face and the applicable statutes of limitations. L

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

Guidance for Employers on Navigating Paid Sick Leave Laws

This chart summarizes state paid sick leave laws and notes which states do not have such laws. It does not discuss municipal ordinances but does indicate local governments that do have such laws where there is no statewide law. This chart is intended for private employers.

Note also that while no federal statute requires that employers provide paid sick leave for employees, Executive Order 13706 mandates that, effective January 1, 2017, covered federal contractors give employees up to seven days of paid sick leave each year. See 80 FR 54697. It remains to be seen if the Trump Administration will rescind this executive order.

The chart covers the following:

- Jurisdictions that have paid sick leave laws
- Employers and employees who are covered under paid sick leave laws
- How employees accrue sick leave and when they can use it
- Whether unused paid sick leave carries over from year to year
- Notice and posting requirements under paid sick leave laws
- Penalties for non-compliance

For more information on sick leave requirements, see Additional Resources below.

Is there a paid sick leave law?	Permissible uses for leave under state law	Employer coverage and employee eligibility under state law	Accrual, usage, carryover, and payout under state law	Notice and posting requirements under state law	Penalties under state law
ARIZONA					
Yes (effective July 1, 2017). Proposition 206, 2016 Bill Text AZ V. 5, Ariz. Rev. Stat. Ann. § 23-371-381	Effective July 1, 2017, employees may use paid sick leave for illness or injury and other family and personal emergencies. Ariz. Rev. Stat. Ann. § 23-373(A)(1-4).	Effective July 1, 2017, an employer is broadly defined in Ariz. Rev. Stat. Ann. § 23-371(F) but excludes the state of Arizona or the United States. An employee is defined, with certain exclusions, in Ariz. Rev. Stat. Ann. §§ 23-362(A), 23-371(G).	Effective July 1, 2017, ongoing accrual of sick time based on hours worked. Carry over permitted, no separation payout. Ariz. Rev. Stat. Ann. § 23-372(A), (B), (D)(4), (F).	Effective July 1, 2017, written notice of rights to employees plus notification of available sick leave in each paycheck. Ariz. Rev. Stat. Ann. § 23-375(A), (B).	Effective July 1, 2017, fines of $250 to $1,000 plus interest and monitoring and inspections. Ariz. Rev. Stat. Ann. §§ 23-364, 23-374, 23-375(E).
CALIFORNIA					
Yes. Cal. Lab. Code § 245. The cities of Long Beach, Los Angeles, Oakland, San Francisco, and Santa Monica also have paid sick leave laws.	For general preventative and diagnostic health care, domestic violence, assault, and stalking. Cal. Lab. Code § 246.5.	Coverage includes employers with at least one employee who works more than 30 days in a year and all employees who work more than 30 days in a year. Cal. Lab. Code § 246(a)	Ongoing accrual based on time worked, and carry-over of all banked hours (capped at 48 hours). No separation payout. Cal. Lab. Code § 246.	Notice of sick leave rights must be posted. Cal. Lab. Code § 247. Paychecks must state how much banked sick leave employees have. Cal. Lab. Code § 246.	An administrative penalty up to $4,000 is available. This may include three times the value of paid sick days withheld, fines, liquidated damages, and interest. Cal. Lab. Code § 248.5
CONNECTICUT					
Yes. Conn. Gen. Stat. § 31-57s. Applies only to service workers as defined in Conn. Gen. Stat. § 31-57r(7).	For preventive, diagnostic, and health care treatment of employee and family member, and assault or domestic violence assistance. Conn. Gen. Stat. § 31-57t(a).	Coverage applies to employers with 50 or more employees and employees who are hourly or non-exempt from FLSA. Conn. Gen. Stat. § 31-57r(4), (7).	Ongoing accrual based on hours worked. Conn. Gen. Stat. § 31-57s(a), (b). No payout at end of employment. Conn. Gen. Stat. § 31-57t(d).	Employers must provide notice of sick leave policy and terms upon hiring. Notice may be provided by displaying a poster in a conspicuous place. Conn. Gen. Stat. § 31-57w.	Employer liability of $500 for every incident of retaliation, $100 for any other violation, and liable for all appropriate relief due to the employee. Conn. Gen. Stat. § 31-57v(c).

Is there a paid sick leave law?	Permissible uses for leave under state law	Employer coverage and employee eligibility under state law	Accrual, usage, carryover, and payout under state law	Notice and posting requirements under state law	Penalties under state law
ILLINOIS					
No required paid sick leave law, however see Employee Sick Leave Act (ESLA) 820 Ill Stat. Ann 191/1 et. seq.	Illness or injury to self, spouse, or certain relatives. 820 Ill. Comp. Stat. Ann. 191/10 (a).	Limitations apply based on employer type.	Employers may limit based on length of service. 820 Ill. Comp. Stat. Ann. 191/10 (b).	No requirement under the ESLA.	ESLA does not provide any penalties, damages or remedies.
MARYLAND, NEW JERSEY, NEW YORK, PENNSYLVANIA					
No applicable state law. Some Individual municipalities have paid sick leave laws, including New York City, Chicago, Philadelphia, Pittsburgh, Trenton, Newark, and Montgomery County, MD.	No applicable state law.	No applicable state law.	No applicable state law.	No applicable state law.	No applicable state law.
MASSACHUSETTS					
Yes. Massachusetts General Laws Paid Sick Time. Mass. Gen. Laws ch. 149, §§ 148C, 150.	Permitted uses include preventative, diagnostic, and health care treatment of employee or family member, along with domestic violence assistance. Mass. Gen. Laws ch. 149, § 148C(c).	Law applies to employers with 11 or more employees. Mass. Gen. Laws ch. 149, § 148C(d)(4). Employees may use on 90th calendar day following start of employment. Mass. Gen. Laws ch. 149, § 148C(d)(1).	Ongoing accrual based on time worked, and 40 hours of carry-over permitted. No payout at end of employment. Mass. Gen. Laws ch. 149, § 148C(d)(1), (4), (7).	Notice required, may be by poster in a conspicuous place in English and other required languages. Mass. Gen. Laws ch. 149, § 148C (o); ch. 151A, § 62A(d)(iii).	Employees may recover treble damages, as liquidated damages, plus litigation costs and reasonable attorney's fees. Mass. Gen. Laws ch. 149, § 150.
MINNESOTA					
If employer provides sick leave, must include family illness as well as employee's illness. Minn. Stat. § 181.9413. Minneapolis and St. Paul have local laws.	For preventative care, health care treatment, and safety leave for domestic violence, sexual assault, or stalking. Minn. Stat. § 181.9413(a), (b).	Coverage applies to employers with 21 or more persons on at least one site. Minn. Stat. § 181.940 Subd. 3. All employees at any site owned or operated by the employer are eligible. Minn. Stat. § 181.940 Subd. 2.	Employer may limit safety and family leave (except for children, Minn. Stat. § 181.940, Subd. 4) to 160 hours a year. Minn. Stat. § 181.9413(c). No accrual, carryover, or payout.	Employer must notify employees if they are entitled to sick leave and must post notice on their premises. Minn. Stat. § 181.9436.	Employee may be awarded damages, costs, reasonable attorney's fees, and receive injunctive and other equitable relief for violations. Minn. Stat. § 181.944.

Is there a paid sick leave law?	Permissible uses for leave under state law	Employer coverage and employee eligibility under state law	Accrual, usage, carryover, and payout under state law	Notice and posting requirements under state law	Penalties under state law
OREGON					
Yes. Or. Rev. Stat. §§ 653.601 et. seq.	Preventative care and health care treatment for employee and family member; safety leave for domestic violence, sexual assault, or stalking. Or. Rev. Stat. § 653.616.	Coverage applies to employers with 10 or more employees, including piece-rate and home health workers. Or. Rev. Stat. § 653.606(1)(a). Payment for accrued leave must be at regular pay rate. Or. Rev. Stat. § 653.606(5)(c)(A).	Ongoing annual accrual up to 40 hours based on time worked, and carry-over of 40 hours. No separation payout. Or. Rev. Stat. § 653.606(1)(a), (4)(a), (5)(a), (7).	Employers must provide notice of sick leave in handbook/manual or workplace posting. Quarterly notice of unused and accrued. OAR 839-007-0050(1)(a), (1)(b), (5).	Employee may file a labor complaint or a civil action, Or. Rev. Stat. §§ 659A.820, 659A.885. Employers are liable for civil penalties up to $1,000. Or. Rev. Stat. §§ 653.651(1)(2), 659A.855.
VERMONT					
Yes. Vt. Stat. Ann. tit. 21, §§ 481 et. seq. (effective January 1, 2017).	Preventative and health care treatment for employee and family; child care if schools closed; and safety leave for domestic violence, assault, or stalking. Vt. Stat. Ann. tit. 21, § 483.	Coverage applies to those employed 18 or more hours a week (at least 20 weeks a year) at employer doing business in or operating within Vermont. Vt. Stat. Ann. tit. 21, § 481(1), (5)(B).	Employees earn up to 24 annual hours through 2018 and up to 40 hours after. Carry over permitted; no separation payout. Vt. Stat. Ann. tit. 21, §§ 482(a), (b), (c), 483(d), (e).	Employer must notify employee of sick leave rights at hiring; must post conspicuous notice of policy at place of business. Vt. Stat. Ann. tit. 21, § 483(j).	Employer, including officers, may be liable for a fine up to $5,000. Vt. Stat. Ann. tit. 21, §§ 345(a), 483(m).
WASHINGTON					
Yes (effective Jan. 1, 2018). Wash. Rev. Code § 49.46.020(4). Initiative Measure No. 1433, 2016 Bill Text WA V. 3.	As of Jan. 1, 2018, employee and family medical care; child care if schools closed; safety leave under the domestic violence act. Wash. Rev. Code §§ 49.76.010-49.76.150)	Coverage effective Jan. 1, 2018. Wash. Rev. Code § 49.46.020(4). Employer defined under Wash. Rev. Code § 49.46.010(4), and employee defined under Wash. Rev. Code § 49.46.010(3).	Ongoing accrual based on time worked. Carry-over of 40 hours. No separation payout. 2016 Bill Text WA V. 3, § 5(1)(a), (d), (j), (k).	The Washington Department of Labor and Industries (Department) must adopt rules relating to notification procedures. 2016 Bill Text WA V. 3, § 10.	The Department must adopt rules for the enforcement of rights and protecting employees from retaliation for the lawful use of paid sick leave. 2016 Bill Text WA V. 3, § 10.

Is there a paid sick leave law?	Permissible uses for leave under state law	Employer coverage and employee eligibility under state law	Accrual, usage, carryover, and payout under state law	Notice and posting requirements under state law	Penalties under state law
WASHINGTON, D.C.					
Yes. D.C. Code § 32-131.01 et seq.	Diagnosis, preventative care, and treatment for employee and family member; safety and social services for domestic violence, assault, or stalking. D.C. Code § 32-131.02(b).	Covers any legal entity that employs or exercises control over the wages, hours, or working conditions of an employee. D.C. Code § 32-131.01(3)(A). Employee defined in D.C. Code § 32-131.01(2).	Ongoing accrual based on time worked and on the size of the employer. Employees may use after 90 days of employment. D.C. Code § 32-131.02(a)(1), (2), (3),)c)(1).	Employer must post notice of rights in a conspicuous place, subject to $100 to $500 daily penalty. D.C. Code § 2-1931(5). D.C. Code § 32-131.09(a), (b), (c).	Employee may bring a civil or administrative action. Employers may liable for back pay, damages, attorney's fees, and penalties of $500 to $2.000. D.C. Code § 32-131.12(a)-(g).

The following states have no applicable state law: Alabama, Alaska, Arkansas, Colorado, Delaware, Florida, Georgia, Hawaii, Idaho, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Michigan, Mississippi, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, New York, North Carolina, North Dakota, Ohio, Oklahoma, Pennsylvania, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Utah, Virginia, West Virginia, Wisconsin, and Wyoming.

Related Content

NON-JURISDICTIONAL RESOURCES

> DEVISING EMPLOYEE SICK LEAVE POLICIES

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

> CHECKLIST – DRAFTING PAID SICK LEAVE POLICIES

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

> SICK LEAVE POLICY

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

Additional Resources by state can be found on Lexis Practice Advisor

RESEARCH PATH: *Labor & Employment > Attendance, Leaves, and Disabilities > Other Types of Leave > Practice Notes > Complying with State and Local Paid Sick Leave Laws Chart*

RESEARCH PATH: *Labor & Employment > Attendance, Leaves, and Disabilities > Other Types of Leave > Practice Notes > Miscellaneous Leaves under State Law or Employer Policy*

David Azarkh and John O'Connell SIMPSON THACHER & BARTLETT LLP

Market Trends: High Yield Debt Offerings

Overview: The High Yield Roller Coaster Continues

The most appropriate word to describe the high yield market in 2016 is volatility. There were some rough patches when few issuers tested the waters—particularly during the first quarter—but over the course of the year, a number of windows opened up with favorable market backdrops for issuing new high yield bonds. For example, in February 2016 the United States saw a meager $8.6 billion of new high yield issuances, whereas April 2016 saw a robust $31.8 billion. The ebb and flow of 2016 was no different from 2015, with $38.4 billion of new high yield issuances in April 2015 and just a sparse $3.1 billion in December 2015.

After record issuance levels in North America and Europe in 2013 and 2014, the high yield market turned volatile in 2015 and into 2016, due in large part to falling oil prices and increased political and financial instability both in the United States and abroad. In the United States, new high yield issuance in 2016 declined for the fourth consecutive year to $229 billion, primarily due to commodity concerns, particularly with respect to defaults in the energy sector, which increased in 2015 and continued to rise in 2016. Throughout the year, investors remained concerned about macroeconomic weakness in many leading economies, the ever-present uncertainly around the timing of interest rate increases, and the potential for continued increased default levels in certain sectors exposed to commodity price unpredictability such as oil, natural gas, coal, and iron ore.

In addition, the Federal Reserve's 2013 guidance to banks regarding limiting credit to finance acquisitions with high debt-to-EBITDA ratios continued to affect acquisition financing structures in 2016 and dampened the market for high yield bonds used to fund leveraged buy outs (LBOs). This policy has had a particularly disproportionate impact on acquisition

financing strategies for private equity firms and their portfolio companies, which have historically relied on financing from banks as the primary source of acquisition funding, with such debt often refinanced in the high yield market. U.S. high yield issuers also grappled with important court decisions that have affected the ability of issuers to restructure their bonds outside of bankruptcy. The high-profile bankruptcy of Caesar's Entertainment in January 2015, for one, gave investors heightened reason to proceed with caution before investing in bonds related to highly leveraged buyouts.

But 2016 also showed signs of promise for a high yield rebound in 2017. Notably, as issuers and investors adjusted to recent interest rate increases in the United States and stimulus measures from the European Central Bank, new high yield issuance volumes increased over the latter part of 2016. Notwithstanding widespread market volatility in December 2015 following the first interest rate increase by the Federal Reserve since the financial crisis, the U.S. economy has continued to expand and unemployment figures have continued to decline. In December 2016, another rate increase by the Federal Reserve signaled confidence in continued growth in the U.S. economy. Such rate increases are expected to continue in 2017. In addition, in the aftermath of the highly contentious U.S. presidential election, bond yield prices increased significantly, with investors seeming to show initial consensus that the incoming administration and Republican Congress could stimulate the U.S. economy if they follow through on their promises to invest in infrastructure, deregulate, and cut corporate tax rates. The effect of the new administration, however, remains to be seen. On the whole, most banks on the street expect an uptick in high yield volume in 2017, with the average consensus forecasting $237 billion in new issuances. In sum, the latter half of 2016 showed a few promising signs of life for the 2017 high yield market.

Notable Transactions

Dell-EMC

During the summer of 2016, Dell completed an offering of $20 billion aggregate principal amount of secured first lien notes and a subsequent offering of $3.25 billion aggregate principal amount of senior unsecured notes to fund its acquisition of EMC, which created the largest privately controlled technology company in the United States. By securing the notes issued in connection with its first offering, Dell was able to obtain an investment grade rating for those notes and a covenant package with traditionally investment grade, covenant-light terms, all while satisfying the steady investor appetite for investment grade rated bonds that the market observed through the first half of 2016 and further satisfying funding conditions necessary to completing the acquisition. Dell's unsecured notes offering, which contained a more traditional high yield covenant package, was rated below investment grade and sold into the high-yield market. Dell closed the acquisition of EMC in September 2016.

Other Megadeals

Dell wasn't the only sizable offering in 2016 as a number of issuers took advantage of favorable windows. In April 2016, Numericable-SFR, a French cable operator and telecommunications services company, issued $5.19 billion of high yield notes in a single tranche, representing the largest-ever issuance of a single tranche of high yield rated paper. A month prior to the Numericable offering, Western Digital issued an aggregate of $5.3 billion of high yield bonds spread across secured and unsecured tranches to finance its acquisition of rival SanDisk. Other issuances of size included Altice ($4.25 billion), Prime Security Services ($3.14 billion), and Dish DBS ($2.6 billion).

Related Content

For a detailed discussion on the use of high yield covenants, see

> **COVENANTS: HIGH YIELD VS. INVESTMENT GRADE**

RESEARCH PATH: *Capital Markets & Corporate Governance > Debt Securities Offerings > Rule 144A/Regulation S Debt Offerings > Practice Notes > Key Documents and Provisions*

For guidance on the drafting of restrictive covenants and transfer provisions of indentures governing debt securities issued in Rule 144A (17 C.F.R. § 230.144A)/Regulation S transactions, see

> **DRAFTING AN INDENTURE FOR A RULE 144A/REGULATION S ISSUANCE**

RESEARCH PATH: *Capital Markets & Corporate Governance > Debt Securities Offerings > Rule 144A/Regulation S Debt Offerings > Practice Notes > Key Documents and Provisions*

For assistance in drafting a closed end indenture, see

> **INDENTURE (RULE 144A AND/OR REGULATION S DEBT OFFERING)**

RESEARCH PATH: *Capital Markets & Corporate Governance > Debt Securities Offerings > Rule 144A/Regulation S Debt Offerings > Forms > Transaction Documents*

Spin-Off Related High Yield Financings

The year also featured a couple of unique high yield financing structures utilized in spin-off related transactions. Olin Corporation, in connection with its acquisition of Dow Chemical's chlorine products business, and Hilton Grand Vacations, in connection with its spin-off from Hilton Worldwide into a stand-alone timeshare business, employed similar high yield offering structures to acquire strategic assets from affiliates and, in turn, retire existing indebtedness owed by such affiliates. The issuing entities in each transaction initially issued high yield notes directly to affiliates (as opposed to investors in regular way transactions) in exchange for certain assets held by such affiliates. The high yield notes were subsequently exchanged by such affiliates in debt-for-debt exchanges with certain financial institutions that held outstanding debt owed by such affiliates. Following the debt-for-debt exchanges, the notes were resold by the financial institutions to investors in Rule 144A/Regulation S transactions. Execution of these structures played pivotal roles in achieving tax-free treatment of the larger spin-off transactions.

High Yield Offering Process

The timeline of a typical high yield offering has remained relatively unchanged. An offering is launched by the distribution of what is called the "red" (i.e., the preliminary offering memorandum or prospectus) to investors, which is typically accompanied by a press release announcing the transaction. For debut issuers or a significant transaction, the issuer may then go on the road following launch to meet with investors while the banks are building the book of potential allocations to investor accounts and determining deal pricing. The bankers work with the issuer to determine the length of the roadshow. A formal roadshow can be as short as three days and as long as two weeks, depending on the nature of the transaction. Investors may provide feedback through the bankers to the issuer that affects the terms of the particular security, including requesting particular changes to the proposed covenant package. The banks will instruct investor accounts that books close by a certain time on the final day of the roadshow, which is the deadline for submitting an order in the bonds. Once books close, the bankers will schedule a pricing call later that day with the issuer in which the bankers and the issuer will agree to the terms of the deal (i.e., the coupon, issue price, maturity, call schedule, etc.).

After the pricing call, a pricing term sheet is sent to investors to confirm sales and the issuer and underwriters sign the underwriting agreement, pursuant to which the underwriters agree to purchase the securities from the issuer. Once a securities transaction is priced, the securities begin trading. As part of the pricing terms, the parties will also schedule a closing date, which is typically the third business day following the date of pricing (commonly known as a T+3 basis), and the securities offering will close on that date. A secured transaction may close on a T+5 basis and certain deals may close on a T+7 or T+10 basis to accommodate an acquisition or tender offer.

Extensive roadshows are less common in today's market. For a repeat high yield issuer, of which there were quite a few of in 2015 and 2016, launch and pricing are often accelerated to a single day, referred to as a drive-by offering. The offering launches before the market opens, followed by a single or several investor calls and pricing later that afternoon. If the market is familiar with the issuer, there is often no need to have a formal roadshow to meet with accounts and, as a result, the process is accelerated.

Over the last few years, issuers seeking to execute high yield bond offerings, particularly in the European Union, have increasingly used non-deal roadshows through which issuers meet with potential investors to introduce their business and financial profile without providing any material non-public information or announcing the intention to execute a particular transaction. After completing such meetings, issuers determine whether or not to proceed with an offering. If they go forward with a transaction, they tend to follow the traditional offering structure described above, subject to any applicable marketing regulations in non-U.S. jurisdictions. Non-deal roadshows are helpful to issuers as they reduce the risk of a failed deal. However, there are many hoops to jump through for both issuers and bankers, including determining the information permitted to be provided at the meetings, when the meetings are held in relation to a formal deal launch, the role of bankers at the meetings, who may attend the meetings, etc.

High Yield Deal Terms in 2016: A Look Back

High yield trends and covenant changes during a particular year (whether loosening or tightening) depend on the market backdrop at the particular time of issuing the bonds and the particular industry. In addition, the credit rating of the issuer and other factors, such as the existence of a sponsor, new issuer strategies, and investor familiarity with the issuer always make a difference in the outcome of the overall covenant package. During the course of 2016, the general theme, in line with the lower volume of high yield offerings, was investors continuing to scrutinize the covenant packages. When investors become more selective and have more time to digest a particular covenant package, they are likely to push for investor-protective changes to the covenant package, leaving it to the issuer to determine whether to accept modifications or potentially pay a higher coupon on the bonds. Sometimes the changes can be fairly benign, such as tightening a particular basket or tweaking a particular definition. At times, however, the changes can be more drastic, such as a wholesale introduction of a new covenant. This is really a short way of saying that the high yield covenants in 2016 have not changed much, but there are a couple of items to note.

Change of Control

The change of control covenant continues to be a hot button for investors, especially when it comes to two aspects. First, many definitions of change of control do not contain what is known as the merger prong. That prong provides that, among other things, a change of control includes a merger or consolidation in which the equity holders of the issuer before the transaction do not represent a majority of the equity ownership of the surviving entity. This is typically the prong regulating parent to parent public company mergers. The rationale for excluding it is that the equity ownership in a public company is so diverse that no one would really control the surviving entity. However, an increasing number of investors in 2016 high yield deals

requested to include this prong for their protection, regardless of whether or not the issuer is public.

The second item that investors have pushed back on is the double trigger change of control concept. This concept has always existed in investment grade bond offerings and has slowly crept into the high yield world. However, during 2016 many investors objected to this concept. In a double trigger change of control provision, a put or obligation to repurchase the bonds is triggered only if there is both a change of control and a ratings downgrade from one or more rating agencies within a specified period following the announcement of the change of control. While this provision is still extremely common in investment grade bond offerings and offerings with cross-over covenant packages (as discussed below), it has received some pushback in typical high yield packages.

Make-Whole Premium

On September 19, 2016, in *Wilmington Savings Fund Society, FSB v. Cash America International, Inc.*, the U.S. District Court for the Southern District of New York granted summary judgment in favor of Wilmington Savings Fund Society, as trustee for the holders of Cash America International, Inc.'s senior notes due 2018, holding that a spin-off by Cash America of a significant subsidiary violated restrictions on asset sales and consequently resulted in an event of default under the indenture governing the notes. See Wilmington Sav. Fund Soc'y v. Cash Am. Int'l, Inc., 2016 U.S. Dist. LEXIS 127421 (S.D.N.Y. Sep. 19, 2016). The court held that the indenture permitted the trustee to seek to enforce any provision under the indenture as a remedy for default and held in particular that the trustee could require Cash America to pay a make-whole premium (which would ordinarily be payable only in connection with a voluntary prepayment of the notes by the issuer prior to the scheduled maturity of the notes), without requiring the trustee to accelerate the notes. Similar issues were addressed by two other courts in cases involving Momentive as well as Energy Future.

Some issuers started making changes to the default provisions in their indentures to address the issue raised by these cases in late 2016. In particular, these issuers added language to indentures to clarify that redemption premiums will only be payable in connection with voluntary early prepayment of the bonds and will not be payable upon the occurrence of an Event of Default or upon any involuntary acceleration of the bonds. However, in recent months, such changes were denounced by Covenant Review, which is an organization that analyzes covenants on behalf of investors. Covenant Review put out multiple articles saying that these types of changes have led to the "end of covenants" because issuers will simply be able to voluntarily default under their indentures and not have to pay a make-whole or other premium as a result. There were even a handful of deals done in January 2017 where these changes were removed from the covenant package after launch and prior to pricing, due to investor concerns. While the ink is still fresh on this topic and it may take different twists and turns, make-whole premiums may continue to be a focal discussion in 2017.

Wholesale Changes

There were a couple of instances of high yield deals in 2016 that launched with one set of covenants and priced with a completely different set of covenants, which is rare. For example, one issuer launched a debt offering with a typical cross-over covenant package, which means that the covenant package had lien, sale-leaseback, change of control, and merger covenants customarily included in investment grade rated covenant packages but did not have the typical debt, restricted payment, and other covenants included in most high yield covenant packages. Given the challenging market backdrop and industry conditions at the time of the launch, investors clamored for a full high yield covenant package. As a result, the issuer, the banks, and their respective counsels were required to negotiate a full high yield covenant package in an 18-hour period and draft a supplement reflecting these covenants in order to be able to price the following day. While it is rare for covenant packages to change so dramatically, the transaction illustrates the challenges issuers may face launching offerings during windows of particularly low high yield volume or tough industry conditions.

THE SEC IS EXPECTED TO CONTINUE TO FOCUS ON AND SCRUTINIZE NON-GAAP FINANCIAL MEASURES THROUGHOUT 2017, WITH A PARTICULAR EYE TO UNUSUAL ADJUSTMENTS, WHICH WILL ALSO IMPACT HIGH YIELD BONDS ISSUED UNDER RULE 144A IN AN UNREGISTERED CONTEXT BECAUSE SUCH ISSUANCES TEND TO TRACK MOST SEC GUIDANCE.

High Yield Disclosure Trends in 2016: Increased Scrutiny of Non-GAAP Measures

High yield issuers have long supplemented U.S. generally accepted accounting principles (GAAP) with non-GAAP financial measures, in particular earnings before interest taxes depreciation and amortization (EBITDA) and EBITDA adjusted to exclude certain items (Adjusted EBITDA). Non-GAAP financial measures provide additional information tailored to the particular issuer's business and/or industry in order to help investors better measure issuer performance and evaluate ability to service indebtedness. Regulation G (17 C.F.R. § 244.100–102) and Item 10(e) (17 C.F.R. § 229.10) of Regulation S-K set forth the SEC's core framework for the use of non-GAAP financial measures in SEC filings. Principally, the rules require that whenever an issuer publicly discloses material information that includes a non-GAAP financial measure, the issuer must accompany that non-GAAP financial measure with a presentation of the most directly comparable GAAP financial measure and a reconciliation between the non-GAAP measure disclosed and the most comparable GAAP financial measure. The rules seek to bridge the gap for investors by requiring issuers to disclose the adjustments they are making to GAAP financial measures.

In May 2016, the SEC issued new and revised guidance regarding the use of non-GAAP measures in registered offering materials and other SEC disclosure documents, which is available at https://www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm. In addition to providing greater clarity with regard to the use of non-GAAP financial measures, the guidance highlights certain specific concerns of the SEC with respect to the use of non-GAAP financial measures, in particular with respect to presenting adjustments that result in non-GAAP measures that are potentially misleading to investors. The SEC noted examples of potentially misleading non-GAAP measures, such as measures (1) with adjustments that exclude normal recurring cash operating expenses necessary to operate an issuer's business, (2) presented inconsistently between periods, and (3) that exclude certain non-recurring charges but do not exclude non-recurring gains achieved during the same period. In addition, issuers with SEC-registered securities have noticed a substantial uptick in the number of SEC comments focusing on the use of non-GAAP financial measures and related disclosures. The SEC guidance mainly seeks to reinforce prior guidance and not impose new requirements. The SEC is expected to continue to focus on and scrutinize non-GAAP financial measures throughout 2017, with a particular eye to unusual adjustments, which will also impact high yield bonds issued under Rule 144A in an unregistered context because such issuances tend to track most SEC guidance.

Industry Insights

Consistent with prior years, issuers' abilities to negotiate covenant packages were to a degree impacted by the overall performance of their respective industries. For example, issuers in the oil and gas space, in light of the rising default rates throughout the industry, were at times forced to accept tighter covenant packages than issuers of comparable credits in other industries. Issuers in the financial services and technology, media, and telecommunications spaces, on the other hand, were more likely to achieve favorable terms and greater covenant flexibility. But while an issuer's industry certainly plays a role in the outcome of a covenant package, it is only one piece of the larger puzzle. Over the years, it has become apparent that private equity backed issuers generally achieve more favorable covenant packages than their industry peers. Other factors, such as the credit rating of the issuer, new issuer strategies, and investor familiarity with the issuer consistently factor in the outcome of the overall covenant package as well.

High Yield in 2017: A Look Ahead

The trends in high yield bond issuances change based on the state of the market. When the market is hot and demand for high yield paper is great, issuers and sponsors endeavor to push the envelope in terms of covenant packages. As a result, there tends to be more flexibility in issuer favorable covenants, most frequently expanding the debt, lien, and restricted payment covenants. When the market cools off and demand dissipates, issuers are often forced to accept tighter covenant packages in order to execute transactions. As 2017 begins, volatility once again remains the primary theme, but there are signs that it could be the strongest year in high yield since 2014. Some of the trends that may impact the high yield market in 2017 include the following:

- **The effect of a Trump presidency.** Although President Trump stated that he intends to expand the economy through investment in infrastructure, deregulation (in particular with respect to environmental and health care regulations as well as portions of Dodd-Frank), and cutting corporate tax rates, his ability to execute his agenda remains to be seen. The sentiment across the high yield market at year-end 2016 mirrored the bullishness of the equity markets, with estimates for 2017 high yield new issuance as high as $300 billion based on a favorable corporate and economic growth environment. This bullishness, however, has been tempered with uncertainty as to the Trump administration's positions on international trade, border taxes, and the possibility of eliminating the corporate tax deduction for interest expense. While the market waits to see if changes in the corporate and economic environments are actually achieved, there is cautious optimism for growth in the high yield markets during 2017.
- **Volatility.** Since the recession in 2008, there has been an increasing amount of volatility in the high yield market. The global political and macroeconomic environments remain in flux due, among other things, to the ongoing Greek crisis, sluggish growth in China, the recession in Japan, Brexit, and the wider European recovery. And while the results of the recent U.S. presidential election have some investors excited about U.S. growth, the positions and policies of the incoming administration with respect to international trade could have significant impacts on the global economy, in particular in emerging economies, that further exacerbate the volatile high yield markets.
- **The LBO market.** As mentioned earlier, in 2013 the Federal Reserve issued guidance regarding leveraged finance lending that would cap target companies in LBO transactions at high debt-to-EBITDA leverage ratios (a 6x ratio). While merger and acquisition volume remained relatively stable in the wake of the Fed's guidance, the 6x ratio has significantly impacted banks' ability to provide lending as part of acquisition financing structures and has had a chilling effect on leverage buyouts in particular, since many acquired companies tend to be levered over 6x. As a result, the number and average sizes of LBOs continue to decrease during 2016, and this trend may continue into 2017.
- **The Fed and interest rates.** Although the current head of the Federal Reserve, Janet Yellen, has stated that she intends to finish out her term, there is still uncertainty as to whether the Fed's policy toward gradual rate hikes will remain the same. Many investors indicate that they expect additional interest rate hikes over the course of 2017. Uncertainly as to the timing and degree of interest rate hikes may create patches of headwind in the high yield markets.
- **Dry refinancing market.** There are still a few years before a significant number of issuers will reach a maturity wall for high yield bonds requiring refinancing. For example, in 2016, approximately $52 billion of bonds reached maturity. While that number is expected to grow over the coming years to roughly $100 billion in 2017, $140 billion in 2018, and $190 billion in 2019, it is nowhere near the $500 billion maturity wall expected in 2023 or later. Until then, the market will remain largely dependent on opportunistic and strategic issuers.
- **Global recession.** While the majority sentiment on the U.S. economy remains bullish as 2017 begins, certain economists maintain that there is the possibility of a recession. Whether the United States is entering a recession, or whether it will in the next 12 to 18 months or on a longer timeframe, is not known. Furthermore, if there is a recession, it is uncertain as to what the extent or duration will be. As the answers to these questions firm up, the 2017 high yield market will respond.

As of the date of this article, there are promising signs for 2017 with the pipeline starting to fill out, but the year remains ripe with uncertainty. Despite volatility, the high yield market has proven to be resilient and survive the highest of the highs and the lowest of the lows, and in 2017, it will need to be resilient once again. L

David Azarkh is a Partner in Simpson Thacher's New York office and a member of the Firm's Corporate Department. David's primary area of concentration is capital markets. David regularly represents underwriters, corporate clients, and private equity sponsors in securities offerings ranging from high yield and investment grade debt offerings, leveraged buyouts, initial public offerings and other capital markets transactions. He also assists companies with compliance, reporting, and establishing corporate governance programs. ***John O'Connell*** *focuses his practice at Simpson Thacher & Bartlett LLP on advising clients on capital markets transactions. He regularly represents investment banks, corporate issuers, and private equity sponsors in connection with securities offerings ranging from initial public offerings, follow-on and secondary offerings, high yield debt offerings, and investment grade debt offerings.*

RESEARCH PATH: *Capital Markets & Corporate Governance > Market Trends > Debt > Practice Notes > Recent Trends in Debt Capital Markets*

Claudia **Simon** PARTNER, SCHULTE ROTH & ZABEL LLP

CLAUDIA SIMON IS A PARTNER AT Schulte Roth & Zabel LLP. She represents public and private clients in mergers and acquisitions transactions, including tender offers, stock acquisitions, asset acquisitions, joint ventures, divestitures, cross-border acquisitions, auction transactions, defensive strategies, and going-private transactions. She has extensive experience in transactions involving public company targets and chairs the ABA's Strategic Buyer / Public Target Deal Points Study.

Claudia also represents investment banking firms in connection with their roles as financial advisors in mergers and acquisitions. In addition to her work in the acquisitions arena, Claudia handles securities and general corporate law matters.

Claudia graduated *magna cum laude* from the University of San Diego School of Law. She is a member of the American Bar Association Committee on Mergers and Acquisitions and serves as vice-chair of the Market Trends Subcommittee.

Schulte Roth&Zabel

S.H. Spencer **Compton** FIRST AMERICAN TITLE INSURANCE CO.

S.H. SPENCER COMPTON IS A VICE president and special counsel in the National Commercial Services Division of First American Title Insurance Co., New York Division, and has served in the same capacity since 2001. He also oversees certain New York 1031 exchange transactions for First American Exchange Company.

With his background in finance / commercial real estate and leasing, Spencer is an invaluable resource to First American's wide-ranging institutional, corporate, and high net worth client base. He is a frequent contributor to the New York Law Journal, the New York State Bar Association's Real Property Law Journal, and The Practical Real Estate Lawyer. He is a prolific CLE lecturer and presenter and is a faculty member for the Practicing Law Institute. Spencer is the budget officer for the New York State Bar Association's real property law section.

First American Title Insurance Company

Sustainable Growth: **The Business and Economic Incentives for the Rule of Law**

BUSINESS SUPPORT FOR THE RULE OF LAW IS NOT ONLY "the right thing to do," it also makes good economic sense. That is the theme of "Sustainable Growth: The Business and Economic Incentives for the Rule of Law," a webinar first presented in May 2016 and now available online.

Moderated by John Hoyles, Chief Executive Officer of the Canadian Bar Association, the webinar features Ursula Wynhoven, Chief Legal Officer for the United Nations, and Ian McDougall, Executive Vice President and General Counsel for LexisNexis Legal and Professional.

"There are lots of definitions of the rule of law," McDougall said, but four factors are key: equality under the law, transparency of the law, an independent judiciary, and accessibility to legal remedies.

Citing the work of the United Nations Global Compact (https://www.unglobalcompact.org/), which she oversees, Wynhoven said that the rule of law "means all societal actors, including governments, businesses, and individuals, are equally accountable to clear, fair, and predictable laws."

McDougall cited research showing a strong correlation between the rule of law and a number of socioeconomic effects, including GDP per capita, child mortality rates, corruption, and homicide rates. "It is directly good for business," he said, "because when you have a situation where there is strong rule of law, you have a situation where you have higher GDP and also various other things happen."

Companies can support the rule of law through their core businesses, strategic social investment, and public policy engagement, Wynhoven said. She cited the work of LexisNexis, as part of its core business, in providing access to legal materials. "Of course a critical first step in being able to comply with the law is to know what it is," she said.

McDougall noted Lexis' partnership with the International Bar Association in developing the eyeWitness to Atrocities app, which allows mobile phone users to take video of suspected human rights violations, then download the video to a secure Lexis server for transmission to a panel of human rights experts. Once the video is transmitted to the server, it leaves no trace on the user's mobile device. "This is an example of being able to take your core skills, in our case, the ability to use technology, and to deploy them with a partner, in this case, the IBA, in order to advance the course of the rule of law," he said.

Saying that companies can use their commitment to the rule of law to promote their business, McDougall pointed to a marketing campaign by Unilever promoting its Sustainable Living Plan to double the size of its business while reducing its environmental footprint. "By promoting yourself in that way, you can create an enormous amount of brand value. People will want to come and do business with you if you are acting in an ethically based way," he said.

The webinar, which is CLE-eligible in many states, is available through Lexis University at http://www.lexisnexis.com/university/Catalogue.aspx?searchterm=rule%20of%20law.

LexisNexis Legal & Professional has committed its corporate resources to supporting the rule of law with this mission: "At LexisNexis® Legal & Professional, we're working to bring the percentage of people living outside the umbrella protection of the rule of law down to zero through our day-to-day business operations, products and services, and actions as a corporate citizen."

For more information, visit https://www.lexisnexis.com/en-us/rule-of-law/default.page.

LexisNexis®

Lexis Advance®

TRENDING FOR GOOD REASON

MORE ATTORNEYS ARE TURNING TO LEXISNEXIS® THAN EVER BEFORE

32%

Increase

in Lexis® or Lexis Advance® usage between 2012 – 2016*

24%

Decrease

in Westlaw® or WestlawNext usage between 2012 – 2016*

Start your free trial today

WWW.LEXISNEXIS.COM/TRENDING

800.628.3612

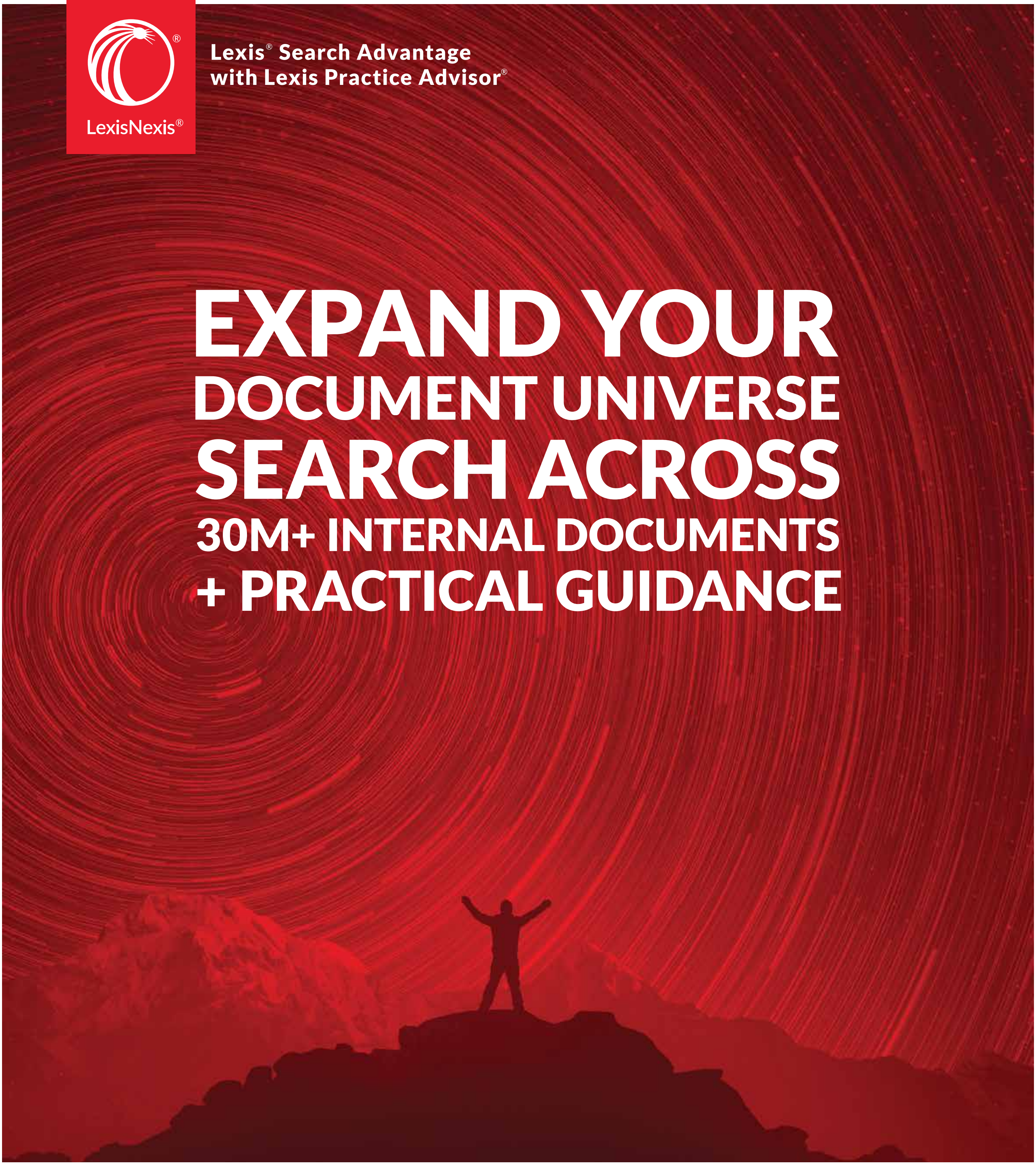
26K NEWS SOURCES

200+ DAILY LAW360® LEGAL ARTICLES

65B+ PUBLIC RECORDS

1.43M TRIAL COURT ORDERS

**Information based on findings from the 2012 – 2016 American Bar Association Legal Technology Survey Reports.*



Request a demo

LEXISNEXIS.COM/SEARCHMORE

877.235.3888

AGNOSTIC SOFTWARE

30M+ **DOCUMENTS WITH** ONE SEARCH

550+ **ATTORNEY** AUTHORS

14 **PRACTICE** AREAS