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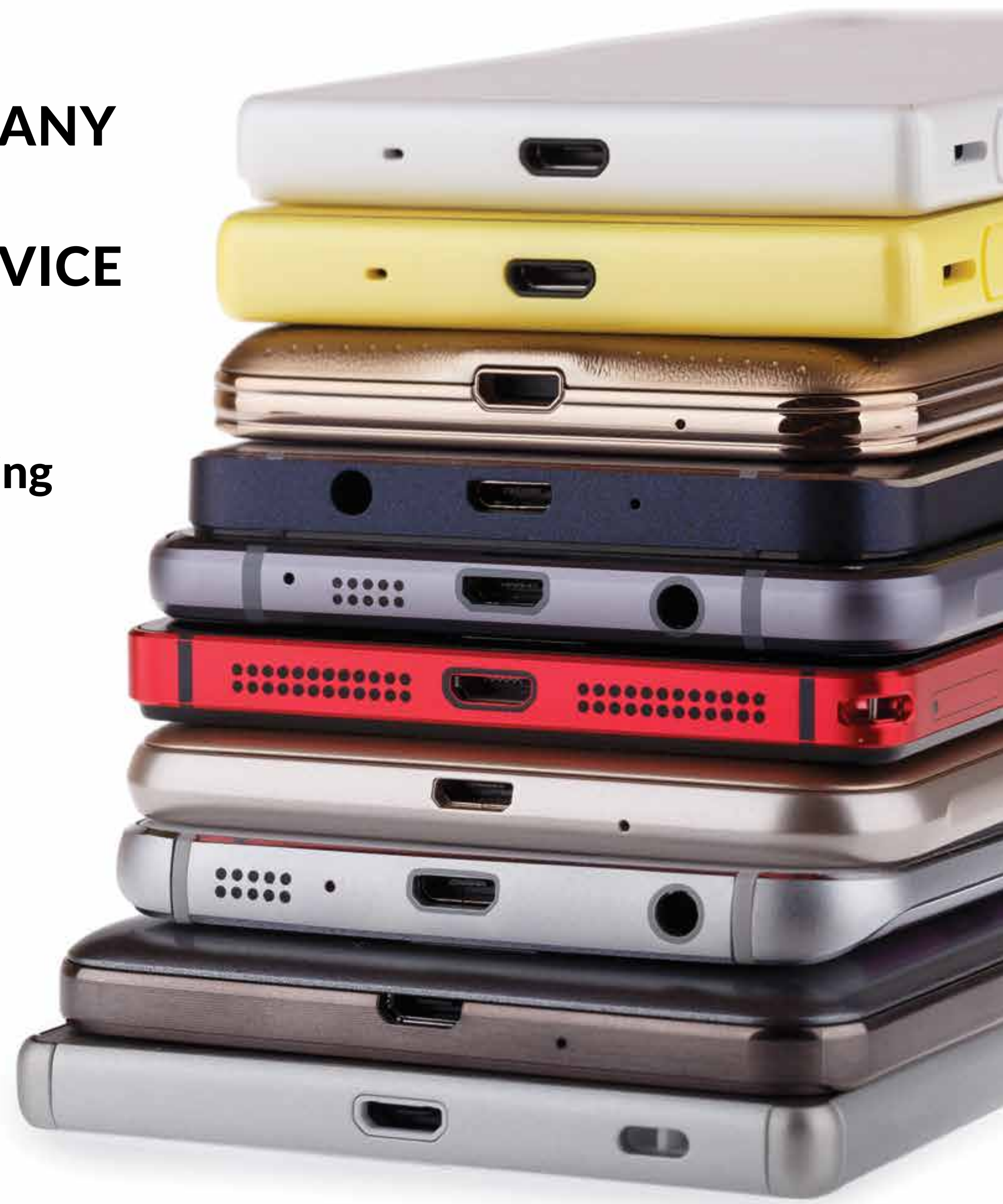

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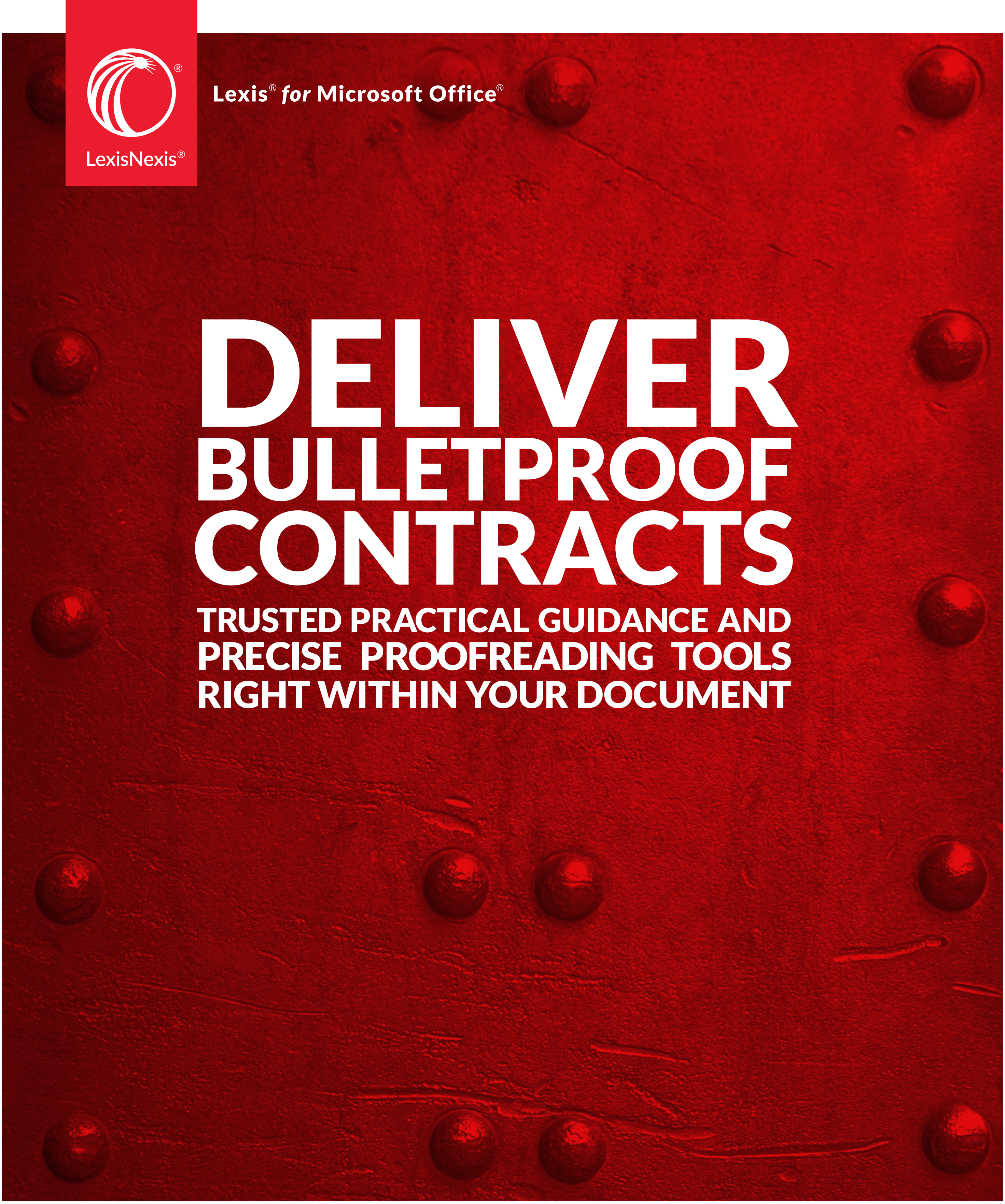

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SUMMER 2017 (Volume 2, Issue 3)

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Eric Bourget, Editor-in-Chief

SUMMER IS UPON US AND FOR MANY of us this may provide an opportunity to catch up on work that has built up from earlier in the year or spend time pursuing additional clients. For others, it may mean a chance to take a vacation or visit family and friends. For some, it may provide the opportunity to explore something new, and we are doing the same. A new look and improved functionality will be coming soon to Lexis Practice Advisor. Thanks to feedback from many of our customers, we are re-designing our practical guidance product to improve and simplify your experience as a user. This new layout and intuitive design will make it considerably easier to find the practical content you need. Overall, the new interface for Lexis Practice Advisor will be considerably easier to use—saving you valuable time. We hope you will like these upcoming changes and we are anxious to hear your feedback.

Our summer edition of the Lexis Practice Advisor Journal includes coverage of some emerging topics including the potential advantages and disruptions that artificial intelligence (AI) will have on the legal profession. Microsoft Assistant General Counsel Dennis Garcia reviews the benefits and legal concerns and suggests ways your firm or legal department can prepare for the inevitable movement of AI into the legal world.

Data privacy concerns remain in the forefront. Cross-device tracking for monitoring consumer behavior and creating customer profiles can lead to exposure. This edition includes recommendations on ways your or your client's company can avoid liability when using these techniques to identify consumer interests or when using cross-device tracking services.

Our contract drafting advice focuses on how a basic tenet of contract law—mutual assent between the parties—becomes a landmine in the world of Internet contracts. Browsewrap agreements are online agreements in which some hyperlinked contractual terms appear on a separate web page. The user's agreement is inferred by the customer's use of the website. This is evolving into a hot topic in contract law, with major internet companies such as Amazon and Barnes & Noble recently involved in related litigation. Timothy Murray, a well-established practitioner in the field of commercial contracts, offers lessons to help guide you and your client when designing content and links that can more clearly establish a user's agreement to the site's hyperlinked terms of use.

Additional drafting advice in this edition includes tips for writing a trademark cease and desist letter when a client's trademark is being infringed, plus the steps you should take to confirm priority of use and evaluate the extent and severity of the allegedly infringing use. We also feature guidance on drafting and negotiating joint marketing agreements.

In addition, our Market Trends analysis covers the Jumpstart Our Business Startups Act (JOBS Act) and related crowdfunding regulations. The expert Q&A in this issue features trends and major issues coming out of the 2017 proxy season, including the ongoing expansion of proxy access in large public companies. Finally, our ethics article discusses recent trends related to In-house counsel sanctions with some rather extreme results.

Whatever your summer plans might be we hope that the practical guidance, forms, checklists, articles, and curated primary and secondary content in Lexis Practice Advisor saves you time, allowing you to take that vacation, catch up on your workload, and obtain that new client.

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 600+ seasoned attorney authors, the Lexis Practice Advisor Journal offers fresh, contemporary perspectives and compelling insights on matters impacting your practice.

U.S. PATENT OFFICE LAUNCHES PTAB PROCEDURAL REFORM INITIATIVE

THE UNITED STATES PATENT AND TRADEMARK OFFICE (USPTO) is using five years of data and user experiences to shape its effort to improve proceedings before the Patent Trial and Appeal Board (PTAB).

With the enactment of the America Invents Act in 2011, the PTAB was charged with conducting proceedings to address challenges to existing patents. Those proceedings "have significantly changed the patent landscape by providing a faster, cost-efficient quality check on issued patents," the USPTO said. "Since AIA trials debuted in 2012, the USPTO has continuously looked for ways to improve the proceedings. Over time, we have listened to our stakeholders' experiences, and we have now compiled data derived from thousands of case filings and dispositions."

The USPTO said that the purpose of its initiative is to "ensure that the proceedings are as effective and fair as possible within the USPTO's congressional mandate to provide administrative review of the patentability of patent claims after they issue."

Among the procedures to be examined are those relating to multiple petitions, motions to amend, claim construction, and decisions to institute review.

In addition to evaluating input already received from businesses, inventors, intellectual property associations, trade groups, and patent practitioners, the USPTO is seeking additional feedback on its procedures and potential enhancements. Information may be submitted at PTABProceduralReformInitiative@uspto.gov. Updates on the progress of the initiative will be available on the PTAB's website.

-Lexis Practice Advisor Journal Staff

RESEARCH PATH: *Intellectual Property & Technology > Patents > PTAB Proceedings > Articles > PTAB Trials & Post-Grant Proceedings*

PRESIDENT TRUMP ISSUES EXECUTIVE ORDER ON FOREIGN WORKERS, PRODUCTS

PRESIDENT DONALD TRUMP HAS ISSUED AN EXECUTIVE order entitled "Buy American and Hire American," aimed at strengthening the federal government's preference for American companies and products in its procurement process and reforming the H-1B visa program for foreign workers.

The president ordered the heads of all federal agencies to "assess the monitoring of, enforcement of, implementation of, and compliance with Buy American laws within their agencies" and to "develop and propose policies for their agencies to ensure that, to the extent permitted by law, Federal financial assistance awards and Federal procurements maximize the use of materials produced in the United States."

Regarding the visa program, the president ordered the attorney general and the secretaries of state, labor, and homeland security to "suggest reforms to help insure that H-1B visas are awarded to the most-skilled or highest-paid petition beneficiaries."

The H-1B program, which was established in the Immigration and Nationality Act, allows foreign workers who meet educational and proficiency standards to live and work legally in the United States for up to six years when there is a shortage of American workers in fields such as science and information technology.

The president's order came several weeks after the U.S. Department of Justice (DOJ) issued a statement cautioning employers hiring workers under the H-1B program not to discriminate against American workers and two federal agencies announced plans to tighten H-1B procedures.

"The Justice Department will not tolerate employers misusing the H-1B visa process to discriminate against U.S. workers," Acting Assistant Attorney General Tom Wheeler of the Civil Rights Division said. "U.S. workers should not be placed in a disfavored status, and the department is wholeheartedly committed to investigating and vigorously prosecuting these claims."

Expressing its support for the DOJ's statement, the U.S. Department of Labor (DOL) has announced plans to step up its oversight of the H-1B program, saying that it will "rigorously use all of its existing authority" to investigate violations; consider changes to the Labor Condition Application, part of the H-1B application process; and "engage stakeholders on how the program might be improved to create greater protections for U.S. workers."

In conjunction with the DOL's initiative, the U.S. Citizenship and Immigration Services (USCIS), component of the Department of Homeland Security, said it "will take a more targeted approach" during visits to worksites where H-1B workers are employed, focusing on three areas: cases in which USCIS cannot validate an employer's basic business information through commercially available data, employers who have a high ratio of H-1B workers as compared to American workers, and employers seeking to hire H-1B workers to work offsite at another company's location.

USCIS has established an e-mail address (reportH1Babuse@USCIS.dhs.gov) for individuals to report suspected fraud. Individuals can also report suspected fraud by submitting Form WH-4 to the DOL's Wage and Hour Division or by submitting the HSI Tip Form to U.S. Immigration and Customs Enforcement.

-Lexis Practice Advisor Journal Staff

RESEARCH PATH: *Labor & Employment > Business Immigration > Visas > Articles > Temporary Worker Visas*

FINANCIAL CRIMES ENFORCEMENT NETWORK RENEWS REAL ESTATE GEOGRAPHIC TARGETING ORDERS TO IDENTIFY HIGH-END CASH BUYERS

THE FINANCIAL CRIMES ENFORCEMENT NETWORK (FINCEN) has announced the renewal of existing Geographic Targeting Orders (GTO) that temporarily require U.S. title insurance companies to identify the natural persons behind shell companies used to pay all cash for high-end residential real estate in six major metropolitan areas.

FinCEN has found that about 30% of the transactions covered by the GTOs involve a beneficial owner or purchaser representative that is also the subject of a previous suspicious activity report. This corroborates FinCEN's concerns about the use of shell companies to buy luxury real estate in all-cash transactions.

"These GTOs are producing valuable data that is assisting law enforcement and is serving to inform our future efforts to address money laundering in the real estate sector," said FinCEN Deputy Director Jamal El-Hindi. "The subject of money laundering and illicit financial flows involving the real estate sector is something that we have been taking on in steps to ensure that we continue to build an efficient and effective regulatory approach."

The GTOs include the following major U.S. geographic areas: all boroughs of New York City; Miami-Dade County and the two counties immediately north (Broward and Palm Beach); Los Angeles County; three counties in the San Francisco area (San Francisco, San Mateo, and Santa Clara counties); San Diego County; and the county that includes San Antonio, Texas (Bexar County).

-Pratt's Bank Law & Regulatory Report, Volume 51, No. 4

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

MORTGAGE PERFORMANCE CONTINUES TO IMPROVE

THE OVERALL PERFORMANCE OF FIRST-LIEN MORTGAGES continues to improve, and the number of loans in delinquency continues to decline, according to the Office of the Comptroller of the Currency's (OCC) most recent quarterly report on mortgages.

The report is based on data on first-lien residential mortgage loans serviced by seven national banks with large mortgage-servicing portfolios. The first-lien mortgages included in the OCC's quarterly report represent 35% of all residential mortgages outstanding in the United States or approximately 19.8 million loans totaling $3.45 trillion in unpaid principal balances.

The OCC Mortgage Metrics Report, Fourth Quarter 2016, showed 94.7% of mortgages included in the report were current and performing at the end of the quarter, compared with 94.1% a year earlier.

The report also showed that servicers initiated 45,495 new foreclosures in the fourth quarter of 2016, a decrease of 5.1% from the previous quarter and a decrease of 28.2% from a year earlier.

As first-lien mortgage performance improves, the number of loss mitigation actions declines. Servicers implemented 32,312 mortgage modifications in the fourth quarter of 2016, a 9.3% decrease from the previous quarter. More than 89% of the modifications reduced borrowers' monthly payments.

-Pratt's Bank Law & Regulatory Report, Volume 51, No. 4

RESEARCH PATH: *Finance > Real Estate Acquisition Financing > Mortgage/Deed of Trust > Articles > Mortgage/Deed of Trust*

NORTH CAROLINA PASSES A NEW VERSION OF ITS CONTROVERSIAL BATHROOM BILL

ON APRIL 3, THE UNIVERSITY OF NORTH CAROLINA TAR Heels won their sixth NCAA basketball championship, just months after the NCAA relocated preliminary rounds in its tournament from Greensboro, N.C., to Greenville, S.C. The NCAA's decision to relocate the games was a reaction to the North Carolina legislature's enactment of H.B. 2, the so-called "bathroom bill," which barred transgender individuals from using restrooms that match their gender identities.

Just four days earlier, on March 30, following a year of economic losses resulting from the refusal of a number of organizations—including the NCAA—to do business in the state, the North Carolina legislature repealed and replaced H.B. 2 with H.B. 142. The move came one week before the deadline for consideration to host future NCAA championship games

H.B. 2 was enacted after the city of Charlotte passed a nondiscrimination ordinance expanding protection against discrimination based on sexual orientation and gender identity and expression, and permitted transgender individuals to use the restrooms of their choice. Those protections were lost with the passage of H.B. 2 in March 2016.

In an effort to promote repeal of H.B. 2, the city of Charlotte repealed its nondiscrimination ordinance in December 2016, leaving LGBT individuals with no protections at the local level.

H.B. 142 removed the explicit ban on transgender individuals using the bathroom of their choice but added language stating that access to bathrooms based on gender can be regulated only by the state legislature and prohibiting local governments from enacting anti-discrimination laws related to public accommodations until December 2020.

On April 5, the NCAA announced that its board had voted "reluctantly" to allow post-season play in North Carolina. As a result, first- and second-round games will be played in Charlotte, N.C., in next year's NCAA men's basketball tournament.

-Adapted from Bender's Labor & Employment Bulletin, Volume 17• Issue No.5

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

CALIFORNIA SUPREME COURT INVALIDATES ARBITRATION AGREEMENT'S WAIVER CLAUSE

A PROVISION CONTAINED IN A CREDIT CARD'S arbitration agreement that waives the right to seek injunctive relief is contrary to public policy and is therefore unenforceable under state law, the California Supreme Court has ruled (McGill v. Citibank, N.A. 2017 Cal. LEXIS 2551).

The state high court held further that the Federal Arbitration Act (FAA) does not preempt state law on the issue.

As a result, the court said, Citibank, N.A., cannot force credit card customer Sharon McGill to arbitrate claims brought under the California unfair competition law (Bus. & Prof. Code, § 17200 et seq.), the Consumers Legal Remedies Act (CLRA) Civ. Code, § 1750 et seq.), the California false advertising law (Bus. & Prof. Code § 17500) and the state insurance code.

McGill, seeking to represent a class of Citibank customers, filed suit in California state court, challenging Citibank's marketing and application of a credit protector plan under which the bank agreed to defer or credit certain amounts on a customer's credit card account if a qualifying event such as unemployment or hospitalization occurred. Customers paid a premium for the plan based on their credit card balances.

Citibank petitioned to require McGill to arbitrate her claims on an individual basis, citing a provision in its arbitration agreement stating in part, "All Claims are subject to arbitration, no matter what legal theory they are based on or what remedy (damages, or injunctive or declaratory relief) they seek."

The trial court denied the petition with respect to the statutory claims; a state appeals court reversed and remanded, directing the trial court to order arbitration on all claims. McGill successfully petitioned the state Supreme Court for review.

Reversing the appeals court, the state high court held that public injunctive relief "remains a remedy available to private plaintiffs" under the three state statutes and that the arbitration provision "is invalid and unenforceable under state law insofar as it purports to waive McGill's statutory right to seek such relief."

The court also rejected Citibank's argument that the FAA preempts California law, finding the bank's interpretation of the statute "overbroad."

-Lexis Practice Advisor Journal Staff

RESEARCH PATH: *Labor & Employment >Discrimination and Retaliation > Claims and Investigations > Articles > Arbitration Agreements*

Timothy Murray MURRAY, HOGUE AND LANNIS

Contract Drafting Concerns: **Beware Browsewrap**

With the e-commerce explosion, sellers are peddling goods and services over their websites at unprecedented rates. From a contract law perspective, this ought to be a seller's nirvana: the seller alone establishes the legal terms to govern transactions conducted over its website without any haggling or negotiating, and without any battle of the forms in which a transaction is subject to the buyer's competing boilerplate.

BUT IN AN ALARMING NUMBER OF CASES, THE TERMS OF USE drafted to govern website transactions are held to be outright unenforceable due to the most basic failure imaginable: there's no mutual assent.

In the brave new world of Internet contracts, mutual assent isn't a fossil from first-year contract law class with no relevance to the real world; it's the rock star of contract jurisprudence. The failure to make sure the buyer assents to the website's terms of use is perhaps the ultimate contract-drafting landmine about which every commercial lawyer ought to be aware.

The Problem: Browsewrap

There are two main types of Internet contracts, with all manner of variations in between: clickwrap and browsewrap. Clickwrap agreements require users to expressly manifest assent (by clicking a button) to the website's terms of use before being allowed to conclude a transaction or continue using the site. From a contract law perspective, there is little controversy surrounding clickwrap agreements. They are akin to signing a traditional pen and ink contract.

The problem lies with browsewrap-type agreements, in which contractual terms of use are hyperlinked and presented on a separate page of the website, and the user is not required to click a button to manifest his or her assent. The user's assent is inferred from his or her use of the website.

Browsewrap-hyperlinked terms are frequently held to be unenforceable, but they will be enforced if the user (1) has actual or constructive notice of them and (2) manifests assent to them.

- **Actual notice.** If the user has actual knowledge of browsewrap terms (typically demonstrated by circumstantial evidence as opposed to the user's admission that he or she has read them), the terms will be enforced. Since the terms will almost always favor the website owner, if the terms would not otherwise be enforceable, a user will be punished for reading and admitting to having read the contract—a peculiar state of affairs that might be worthy of a policy debate.
- **Constructive notice.** The law generally does not hold the Internet user to *any* duty to go searching for a hyperlink to a website's terms of use. But even if a user does not have actual notice of the hyperlinked terms, he or she will be deemed to have constructive notice of them if the content and design of the website puts a reasonably prudent user on inquiry notice that the hyperlinked terms govern transactions involving that website.

Note a common problem: it is not enough that the hyperlinked terms themselves explicitly state that the terms govern use of the website. If the website that hyperlinks to the terms fails to alert a reasonable user that the terms govern, there is no reason for a user to visit the terms, and they won't be enforced.[1]

A. The hyperlink must be conspicuous. To show that a browsewrap agreement is enforceable, it is essential to prove that the hyperlink was conspicuous on the web page. To assess conspicuousness, courts examine a variety of factors, including size, color, typeface, and placement—and these factors must be viewed in the context of the web page's overall design.[2] That last point is crucial: it is not enough for a hyperlink to be in large font if the web page is chock-full of other hyperlinks in equal or larger font (because if everything is conspicuous, nothing is).

- **Classic inconspicuousness.** If the hyperlink is relegated to the bottom of the web page in inconspicuous font, and if there is no reason for the user to see it, courts will find the hyperlinked terms unenforceable. A common mistake is to put the hyperlink below the order button where there is no reason for a user to continue to scroll down to it.[3]

- **Inconspicuous because of clutter.** If the hyperlink is just one item on a web page filled with all manner of other links and information, courts likely will hold it's not conspicuous—at the very least, it raises a fact issue as to whether the hyperlinked terms are enforceable. A hyperlink that might otherwise be conspicuous on a less cluttered page is rendered inconspicuous when there is too much on the page competing with the user's attention.[4]
- **Bottom line.** The hyperlink has to stand out—and it has to be very close to the button that the user will click in order to proceed to use the site or to conclude a transaction.

B. Website must alert user that continued use will manifest assent to hyperlinked terms. Conspicuousness and the placement of the hyperlink are not enough. The web page also needs to contain an explicit notice that continued use of the website will manifest the user's assent to be bound by the hyperlinked terms.

Merely including a Terms of Use hyperlink near the relevant button a user must click to proceed is not enough—it does not tell the user that the hyperlinked terms will be binding if he or she proceeds. The website must alert the user to review the terms, or otherwise admonish him or her that by clicking a button to complete a transaction "you agree to the terms and conditions"—or words to that effect.[5] The more explicit, the better.

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1. Nguyen v. Barnes & Noble Inc., 763 F.3d 1171 (9th Cir. 2014); Herman v. SeaWorld Parks & Entm't, Inc., 2016 U.S. Dist. LEXIS 181173 (M.D. Fla. Aug. 26, 2016); Hines v. Overstock.com, Inc., 668 F. Supp. 2d 362 (E.D.N.Y. 2009). 2. Be In v. Google, Inc., 2013 U. S. Dist. LEXIS 147047 (N.D. Cal. 2013); Long v. Provide Commerce, Inc., 200 Cal. Rptr. 3d 117, 125–126 (Cal. App. 2d Dist. 2016). See also, Metter v. Uber Techs., Inc., 2017 U.S. Dist. LEXIS 58481 (N.D. Cal. 2017). 3. Specht v. Netscape Communs. Corp., 306 F.3d 17 (2d Cir. N.Y. 2002); Herman v. SeaWorld Parks & Entm't, Inc., 2016 U.S. Dist. LEXIS 181173 (M.D. Fla. Aug. 26, 2016); Hines v. Overstock.com, Inc., 668 F. Supp. 2d 362 (E.D.N.Y. 2009). See also, Metter v. Uber Techs., Inc., 2017 U.S. Dist. LEXIS 58481 (N.D. Cal. 2017) (alert about terms of use blocked by keypad so user could enter payment information). 4. Nicosia v. Amazon, 2016 U.S. App. LEXIS 15656 (2d Cir. 2016) (webpage had multiple buttons and promotional advertisements—between 15 to 25 different links and various text in four font sizes and six different colors—and commercial notices that distracted from the legal terms); Meyer v. Kalanick, 2016 U.S. Dist. LEXIS 99921, at *31 (S.D.N.Y. July 29, 2016) ("[I]t is hard to escape the inference that the creators of Uber's registration screen hoped that the eye would be drawn seamlessly to the credit card information and register buttons instead of being distracted by the formalities" of the Terms of Service hyperlink.). See also, Nghiem v. Dick's Sporting Goods, Inc., 2016 U.S. Dist. LEXIS 89429 (C.D. Cal. July 5, 2016). 5. Nguyen v. Barnes & Noble Inc., 763 F.3d 1171 (9th Cir. 2014). See also, Nghiem v. Dick's Sporting Goods, Inc., 2016 U.S. Dist. LEXIS 89429 (C.D. Cal. July 5, 2016).

Related Content

For more information on drafting Internet contracts, see

> **INTERNET CONTRACTS**

RESEARCH PATH: *Commercial Transactions > E-Commerce > Internet Business & New Media > Practice Notes > Key Points to Consider when Drafting and Negotiating Certain E-Commerce Contracts > Internet Contracts*

The Lessons

In one of the cases that held a browsewrap agreement unenforceable due to the absence of mutual assent, the court wrote this stinging indictment: "Very little is required to form a contract nowadays—but this alone does not suffice."[6] Yet, the absence of mutual assent with respect to browsewrap agreements is a problem that afflicts even sophisticated companies that are synonymous with Internet sales.

The client needs to be made aware that it isn't just the terms of use themselves that have contractual significance—the websites that hyperlink to them do, too.

In short, attorneys need to be directly involved in decisions about the design and content of websites that hyperlink to terms of use. The best set of terms in the world can't create a binding contract when the website that hyperlinks to them doesn't require users' assent. 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: *Commercial Transactions > E-Commerce > Internet Business & New Media > Articles > Key Points to Consider when Drafting and Negotiating Certain E-Commerce Contracts*

6. Hines v. Overstock.com, Inc., 668 F. Supp. 2d 362, 367 (E.D.N.Y. 2009).

Candice Choh and Kari Krusmark GIBSON, DUNN & CRUTCHER LLP

CONTRACTUAL JOINT VENTURES – DRAFTING AND NEGOTIATING JOINT MARKETING AGREEMENTS

A joint marketing agreement is a contract pursuant to which one or both of the parties will collaborate in order to promote the sale of product and service offerings of the other party. Such a contractual joint venture agreement may also be known as an alliance agreement, strategic alliance agreement, or co-marketing agreement, depending upon the client's preference and the specific nature of the relationship.

THIS ARTICLE ADDRESSES THE KEY ISSUES THAT THE PARTIES should consider before and during the negotiation and drafting of a joint marketing agreement. The scope of this article includes those relationships where one party will independently promote the other party's products to its customers and potential customers, as well as collaborative efforts by the parties, such as joint solicitations and bidding on requests for proposals (RFPs) from potential customers. This article does not address the terms and conditions of sale of products and services to customers.

Purpose

A joint marketing agreement can arise from a variety of circumstances. Companies typically enter into such an arrangement in order to take advantage of synergies between their respective products and services. In most cases, each party wants to sell the other party's complementary products and services alongside its own products and services, or combine its products and services with the products and services of the other party in a bid to a customer in order to provide a comprehensive solution and make its proposal more competitive. Many such arrangements arise in the context of a divestiture of a company or business unit where the parties to the transaction desire to continue an intercompany arrangement that existed prior to the divestiture. A joint marketing agreement or similar agreement is necessary in order to set forth the rules of the road for the parties' relationship.

Complexity of Terms and Conditions

Joint marketing agreements vary in their degree of complexity and specificity of terms. The purpose and nature of the alliance will determine the rigor of the terms and conditions that are included in the particular agreement. In some cases, the agreement might simply serve as a way for the companies to work together if and when they engage in joint marketing activities, with no firm commitments or obligations. In other cases, the success of the alliance might be vital to the ongoing success of one or both parties. For example, in the context of a divestiture, an acquirer's commitment to continue to work with the divesting party and promote the divesting party's remaining products and services may be part of the consideration for the transaction. In such circumstances, more extensive terms and detailed obligations, such as commitments to actively promote the products and services of the divesting party, quotas and remedies for failure to meet them, and governance and dispute resolution procedures, will be necessary in order to ensure compliance with the terms of the agreement and achievement of the objectives of the arrangement.

Another factor that will determine the complexity and stringency of the terms and conditions is whether the parties will have mutual obligations to promote the products and services of the other party or whether the obligations will be unilateral. If the terms and conditions are mutually enforceable, then the drafter should carefully consider the strictness of terms and severity of remedies since the other party will likely expect the drafting party to be held to the same standards.

Structure

A joint marketing agreement can be structured as a standalone agreement that includes all of the terms and conditions that will govern the parties' relationship. However, if the scope of the arrangement includes joint bidding on RFPs from potential customers or otherwise preparing joint customer solutions, then it would be best to structure it as a framework or master agreement. The master agreement would include each party's general obligations in support of the alliance as well as the terms and conditions that apply to all collaborations. The parties would then enter into a separate agreement under the master agreement, such as a statement of work or teaming agreement, for each customer-specific alliance, which would set forth detailed terms and conditions with respect to the particular opportunity. For the purposes of this article, such agreements are referred to as teaming agreements.

Each teaming agreement would, among other things:

- Identify the target customer
- Describe the solution and the components of the solution to be contributed by each party
- Provide the pricing that will be offered to the customer
- Set forth the responsibilities and timing for development of the proposal
- Identify whether the bid and ultimate relationship with the customer will be led by one party (i.e., as a prime contractor) with support from the other party (i.e., as a subcontractor) or whether the parties will approach the target jointly but hold separate contracts if the bid is successful

Ideally, a form of teaming agreement would be included as an attachment to the master agreement so as to provide for consistency of structure and terms and conditions across all customer engagements.

. . . ALL JOINT MARKETING AGREEMENTS SHOULD INCLUDE A MANAGEMENT AND GOVERNANCE STRUCTURE TO ENSURE REGULAR COMMUNICATION AND ESCALATION OF ISSUES THROUGH THE APPROPRIATE CHANNELS.

Term

The term of a joint marketing agreement varies depending on the purpose of the arrangement and the ease with which the parties can exit the agreement. In some cases, the agreement may continue until it is terminated. In other cases, the term may be specified and the agreement will set forth a process for renewal.

If the agreement includes a defined term, it is important to consider whether the agreement should provide for automatic renewal unless either party provides notice of non-renewal within a specified notice period, or whether renewal should require the affirmative advance agreement of the parties. The renewal structure will depend on the commitments that are made within the agreement and whether one or both parties might be disadvantaged if they were to extend the agreement on the then-existing terms and conditions. For example, if the agreement includes preferred pricing terms or a lucrative referral fee, the party extending those terms may not be agreeable to an extension without an opportunity for adjustment of the terms and conditions. An automatic renewal provision does not foreclose this possibility; however, if such party does not track the expiration date and notice windows, it will be committed to an extension of such terms if the other party elects to renew the agreement.

If the structure of the agreement is not mutual, the party receiving the most benefit from the agreement will likely prefer a structure whereby such party has the unilateral right to renew the agreement at its option for a specified number of renewal periods. However, the other party will likely be opposed to renewal without its consent and will attempt to condition renewal on mutual agreement or limit the number of unilateral renewal options.

Exclusivity

The parties to the agreement should consider whether any aspects of their relationship will be exclusive and whether there will be any carve-outs to exclusivity. In some cases, it may be appropriate for the parties to have a right of first refusal with respect to participation in any opportunities identified by either party for which the other party would be a suitable partner (e.g., due to such party's product and service offerings and fit with the target customer's needs). In such an arrangement, the party holding the right of first refusal should have a reasonable period of time to evaluate the opportunity and determine whether it wishes to participate. If that party declines the opportunity, or does not respond within the agreed time period, then the other party should be free to approach another potential partner with the opportunity.

In some cases, the scope of exclusivity might be narrower or there may be carve-outs to a broad exclusivity provision. For example, exclusivity might be limited to particular product and service lines or to a particular geographic area.

Even in relationships where the parties are not obligated to provide their counterparty a right of first refusal to participate in a joint bid, it would be practical for the parties to work together on an exclusive basis once they have decided to collaborate with respect to a particular opportunity. In such case, the parties should document their agreement with respect to the particular engagement in a teaming agreement in order to avoid situations where one or both parties has made investments in pursuit of the opportunity only to have the other party partner with another company. However, this obligation should be subject to certain exceptions—for example, if the applicable customer determines that the other party is not a good fit or if the parties are not able to come to an agreement with the customer on the price of the components of the solution that are to be provided by a party, then the other party should be permitted to seek support from another partner in order to meet the needs of the target customer.

Restrictions on Authorization

The parties should consider whether there will be any restrictions on a party's authorization to promote products on behalf of the other party. For example, the authorization may be limited to a subset of the other party's products and services or may be restricted to certain geographical markets or customer industries. This is an important consideration if a party wishes to preserve relationships, or comply with exclusive arrangements, with other partners with respect to particular products, industries, or markets, or if a party has concerns about controlling its brand and marketing efforts in particular areas.

Management and Governance

Regardless of the complexity of the agreement, all joint marketing agreements should include a management and governance structure to ensure regular communication and escalation of issues through the appropriate channels. The number of governance levels and frequency of contact will vary depending on the purpose of the relationship. If the sales that are triggered through the other party's efforts are a material portion of revenue for one or both of the parties, then the agreement should establish a more rigorous governance structure, with more frequent meeting and reporting requirements. A more detailed structure may also be appropriate if one or both parties is promoting a new product or is entering new markets through the alliance since the other party will be an important channel for feedback and sales information. However, if the relationship is not key to either party's success in the marketplace, then a less structured governance framework is probably more appropriate. The following are governance components that the parties should consider when establishing the governance structure for their relationship:

- **Alliance managers.** Each party should designate an individual to serve as its alliance manager, the person who will be the primary point of contact for communications from the other party with respect to the alliance and be responsible for compliance with its obligations under the agreement. If one or more of the parties' success is tied to the success of the alliance, or if there will be frequent contacts between the parties, it will be important to have ease of communication, continuity of personnel, and a strong working relationship. Therefore, the parties should consider whether a party's designated point of contact (or any other representatives) will be subject to the other party's approval, whether the individual(s) should be assigned to the alliance for a minimum duration, and whether one party will have the right to direct the other party to replace its alliance manager or other representatives in the event that issues arise. At a minimum, a party should provide notice within a specified period in the event of a change in the identity of its designee.
- **Steering committee.** For alliances that are particularly important to one or both parties, the parties may also want to establish a steering committee of more senior executives who will meet on a periodic basis defined in the agreement (which is often quarterly or annually). The number of representatives of each party and the roles of such individuals should be defined in the agreement. The steering committee is a forum for the parties to discuss strategic objectives, current and planned initiatives, market expansions, new products and services and changes to existing products and services, and opportunities for improvement.
- **Reports and meetings.** The agreement should outline periodic reporting and meeting requirements. As with other elements of the agreement, the frequency and nature of the meetings (e.g., in person, telephonic) will depend on the importance of the alliance to the parties. In addition to meetings resulting from the periodic planning process defined below, the parties should meet monthly or quarterly to review progress against alliance objectives and metrics, discuss status of proposals under development or under review by potential customers, and any issues affecting the alliance.
- **Non-solicitation.** Joint marketing agreements often prohibit the solicitation for employment of the other party's employees and contractors, subject to an exception for solicitation through general advertising during the term of the agreement and for a specified period of time thereafter. The parties should consider whether such a prohibition is appropriate given the particular circumstances. Such solicitation is of particular concern if the parties operate within the same industry such that the skills of the parties' employees are readily transferable to the other party's business and operations, or if a party has a successful sales organization and is concerned about losing talent to the other party. If such a provision is included, the parties will need to determine whether a specific remedy for hiring a party's personnel in violation of the provision will be specified. In many cases, the party that breaches the non-solicitation provision must pay as liquidated damages an amount equivalent to the solicited individual's salary or a multiplier thereof.

Alliance Activities

Following are areas that the joint marketing agreement should address to the extent applicable to the relationship.

General Cooperation Activities

The agreement should address any cooperation activities that the parties plan to undertake. General cooperation activities include:

- Exchanging information about, and providing demonstrations of, the parties' products and services
- Providing the standard terms and conditions of sale
- Informing each other's personnel about the arrangement
- Providing information and training on products and services to the other party's personnel
- Providing assistance to develop appropriate promotional materials that may be used for the purposes of the agreement
- Participating in conferences, trade shows, and seminars
- Sponsoring industry events
- Conducting joint sales calls to existing and prospective customers

Financial Contributions

The agreement should address whether the parties are required to make any financial contributions to support alliance activities. Each party's specific contribution for each year (or other time period) should be agreed in the applicable alliance plan.

Planning and Management

The joint marketing agreement should provide for a joint planning process for the conduct of alliance activities. It would be best practice for the agreement to require the parties to develop and agree to a business plan for each year or shorter time period during the term. If the time period is annual, the parties may wish to align the planning process with their fiscal year if each party has the same fiscal year. The plan would identify, among other things:

- The potential customers that the parties will target during such year
- The plan for carrying out alliance activities, including timing
- Revenue and sales mix targets
- The objectives and other goals that will be used to evaluate the success of the alliance for such year

The plan would then be reviewed and adjusted as necessary on a periodic basis throughout the year. The parties should also jointly develop and review a periodic (e.g., monthly or quarterly) report that tracks the parties' progress against the objectives established in the plan.

Additional Opportunities

In addition to the identification of targets through the mutual planning process described above, the agreement should address the process for submitting opportunities that are identified by a party independently. Each party should designate a contact for receipt of such sales leads from the other party. Following receipt of notice of a potential target, the receiving party should have a specified number of days to consider the opportunity and determine whether it desires to pursue the opportunity. If the parties decide to pursue the target, they would then determine each party's roles and responsibilities with respect to the proposal and ideally enter into a customer-specific teaming agreement as described above.

Registration of Sales Leads and Targets

If the scope of the agreement permits each party to independently promote the other party's products to its customers and potential customers, and there is a risk that the parties might be competing for the same customer, it would be wise to include a process for registration of sales leads. If a party identifies a particular target, that party would notify the other party through the agreed mechanism, and the other party would then be restricted from approaching that target for a specified period of time. The other party should be permitted to reject the registration, within a specified time period, if the target is an existing customer of such party or if such party is already in active discussions with the target. If the registration is not rejected within the specified time period, the parties may wish to deem the registration accepted.

Following registration of a sales lead, the registering party should be obligated to use reasonable efforts to close a sale with the target within a specified time period; if there is no sale within such time period, and the non-registering party does not agree to extend the time period, then the registration would be cancelled and the non-registering party would no longer be prohibited from engaging in a transaction with the target. However, if a party is continuing to use reasonable efforts to complete a sale at the time of expiration of the permitted time period, the parties may want to agree that such party will have an additional period of time to complete the sale.

The agreement should specify whether a party will be permitted to sell the other party's products and services directly to its customers (and identify which party's terms and conditions will apply to the sale), or whether the selling party will act as an intermediary, with the party whose products and services are being purchased entering into the agreement with the customer.

Sales Targets and Quotas

If the scope of the agreement permits each party to independently promote the other party's products to its customers and potential customers, the parties should consider including sales targets or firm quotas. This is particularly advisable where the parties have an exclusive relationship in order to ensure that a party's sales partner is using its best efforts to promote the sale of the other party's products and services. If sales targets and quotas are included in the agreement, then the parties should include specific remedies in the event that a party's sales partner is not performing in accordance with such targets or quotas for a specified duration of time, such as termination of exclusivity or termination of the agreement. The parties should also consider whether any product and service mix restrictions or requirements should be included in order to protect a party's profit margins.

Product and Service Availability

The parties should consider whether the agreement should include an obligation to maintain sufficient availability of the products and services that will be promoted by the other party. Subject to confidentiality restraints, it would be good practice to include an obligation for the parties to provide reasonable notice of discontinuations of, and changes to, products and services, as well as notice of new products and services.

Intellectual Property; Development of Promotional Materials

The agreement should address each party's responsibility for the development of, and rights in, promotional materials used in furtherance of the alliance. In many cases, each party will provide to the other party the standard marketing materials that it has produced for its products and services, and the parties will also collaborate on the development of materials to be used in support of the alliance.

Related Content

For additional information on joint venture contractual agreements, see

> DRAFTING A CONTRACTUAL JOINT VENTURE AGREEMENT

RESEARCH PATH: *Commercial Transactions > Joint Ventures > Joint Venture Agreement > Practice Notes > Contractual Joint Ventures*

For a detailed explanation on the licensing and ownership of intellectual property rights in contractual agreements, see

> ESTABLISHING INTELLECTUAL PROPERTY RIGHTS

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

For assistance in recognizing and addressing the issues that are relevant to drafting and negotiating indemnification, see

> ESTABLISHING INDEMNITY

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

For an overview on the types of damages that are related to a breach of a commercial contract and when and how those damages may be limited or waived, see

> DEFINING AND LIMITING REMEDIES

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

- **Pre-existing materials.** With respect to a party's pre-existing materials, the joint marketing agreement should provide that the originating party will retain all rights in and to such materials and grant the other party the right to use such materials for the term of the agreement, provided that such use should only be in the manner approved by the originating party and only for the purposes outlined in the agreement. The agreement should also address whether a party has the right to modify or create derivative works of the pre-existing materials of the other party and, if permitted, which party will own such derivative works.
- **Independently developed materials.** In addition, the agreement should address each party's rights in materials developed independently by one of the parties, including whether the other party will receive a license to use such materials in furtherance of the alliance.
- **Jointly created materials.** If the parties anticipate that they will jointly create marketing or other materials in furtherance of the alliance, then it is important to address ownership of such materials in the agreement. The parties should consider whether it is appropriate for the parties to jointly own such materials, or whether one party (e.g., the party that primarily contributed to the development of the material) should own the materials and the other party should be granted a license to use such materials for a specified duration.
- **Intellectual property.** The agreement should also address each party's right to use the name, trademarks, service marks, and other intellectual property of the other party, and restrictions and conditions on such use.

Compensation and Payment Terms

- **Referral fees and commissions.** The parties should determine whether each party will pay referral fees or commissions to the other party as an incentive for the promotion of the first party's products and services. If the agreement does provide for such payments, then the agreement should specify the frequency of such payments and include the payment terms.
- **Expenses.** The agreement should address the parties' responsibilities with respect to expenses incurred by a party in the conduct of the alliance activities. Typically, each party bears its own costs and expenses arising from the alliance.
- **Disputed amounts; set-off.** Many agreements permit a party to withhold payment of amounts claimed by the other party that the first party disputes in good faith, pending resolution of the dispute. If both parties have the ability to earn fees and commissions under the agreement, then the parties should consider also including a set-off right in the agreement.
- **Taxes.** Each party is typically responsible for the payment of taxes payable by such party in connection with its activities under the joint marketing agreement, in addition to taxes on its income and property.

Audits and Records Retention

The parties should consider whether each party will have the right to audit the other party's books and records relating to the agreement and, if such a right is included, the minimum required notice period and any assistance required from the audited party. If audit rights are included in the agreement, then the parties should also be obligated to retain records of the transactions under the agreement for a minimum period of time. The parties should also consider whether the costs of an audit should be borne by the audited party if the audit uncovers underpayments by the audited party.

Confidentiality

The joint marketing agreement should include a confidentiality provision that is substantially similar to the confidentiality provisions typically included in any other commercial agreement. The definition of confidential information should include, at a minimum, the terms and conditions of the agreement; the business plans developed pursuant to the agreement; trade secrets; and information regarding each party's business, customers, employees, service providers, strategies, and finances.

Representations and Warranties

The agreement should include standard representations and warranties by each party, including representations and warranties that:

- Each party has the power and authority to execute and deliver the agreement and perform its obligations thereunder.
- Each party's execution, delivery, and performance under the agreement does not and will not conflict with or constitute a default under any other agreement to which a party is bound.
- Neither party will make any commitments or agreements, or incur any liabilities, on behalf of the other party except as may be authorized by the other party in writing.

The agreement should include a disclaimer of all other warranties, whether express or implied, including the implied warranties of merchantability and fitness for a particular purpose with respect to the products and services of each party.

Insurance

The parties should consider whether each party should be obligated to obtain and maintain minimum insurance coverages. The types of insurance that would typically be required in this type of agreement include statutory workers' compensation, employer's liability, commercial general liability, automobile liability, and professional liability (errors and omissions) insurance. Additional coverages may be appropriate depending on the scope of the parties' activities under the agreement. The amounts of coverage vary by transaction, and each party should consult their respective risk management personnel for guidance. The agreement should also include standard conditions with respect to the applicable insurance policies, such as a requirement that the other party be named as an additional insured on the policies (where applicable), waivers of insured versus insured exclusions, and minimum credit ratings for the insurer.

Indemnification

The parties should give careful thought to the indemnification provisions in order to ensure that the indemnities are appropriately tailored to the activities that will be conducted by the parties under the agreement. Such provisions may provide for defense against and indemnification from losses relating to the following types of third-party claims:

- Claims alleging that any materials provided by a party to use in connection with the alliance infringe upon or misappropriate the intellectual property rights of a third party, with exceptions where the infringement is caused by unauthorized acts by the party seeking indemnification
- Claims arising from personal injury and property damage resulting from a party's acts or omissions (in some cases, this indemnity is limited to claims arising from a party's gross negligence or willful misconduct)
- Claims by customers and potential customers resulting from the other party's acts or omissions
- Claims arising from unauthorized representations made by a party on the other party's behalf and unauthorized liabilities incurred and agreements made on the other party's behalf

The agreement should also include the procedures that will be followed by the parties in the event that a party seeks indemnification under the agreement.

Limitations on Liability

The parties should consider whether it is appropriate to include a limit on monetary damages for which each party may be liable under the agreement. Joint marketing agreements typically include a waiver of indirect, incidental, consequential, special, and punitive damages. However, the parties should consider whether there should be any exceptions to the limit on monetary damages (if included) and the damages waiver. Examples of damages that might be excluded from the limit on monetary damages and, in some cases, the damages waiver include damages arising from a party's breach of its confidentiality obligations, losses resulting from indemnified claims, amounts owed by one party to the other under the agreement, and damages arising from a party's infringement or misappropriation of the other party's intellectual property.

Dispute Resolution

Careful consideration should be given to the process that will be followed in order to resolve disputes between the parties. Many agreements include an informal dispute resolution process that will be followed before the matter is escalated to a formal mechanism such as mediation, arbitration, or litigation. In such cases, the parties' designated contacts will attempt to resolve the dispute for a specified period of time prior to escalation to a more senior level of representatives or formal dispute resolution. With respect to formal

Related Content

For a comprehensive review of arbitration and guidance in drafting contractual arbitration clauses, see

> DRAFTING AN ARBITRATION CLAUSE

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For information on the possible grounds for the termination of a joint marketing agreement and the rights and obligations of the parties post-termination, see

> ESTABLISHING TERMINATION AND CANCELLATION RIGHTS

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

THE AGREEMENT SHOULD ADDRESS THE PARTIES' OBLIGATIONS UPON TERMINATION AND EXPIRATION OF THE AGREEMENT, INCLUDING THE OBLIGATION TO CEASE ALL MARKETING, PROMOTION, AND SALES ACTIVITIES; RETURN OR DESTROY MATERIALS AND CONFIDENTIAL INFORMATION . . .

dispute resolution mechanisms, in many cases alternative dispute resolution is preferred to litigation in order to provide for more expedient resolution of disputes.

Regardless of the dispute resolution procedures outlined in the agreement, the agreement should specify that each party will be entitled to seek immediate injunctive relief, without the need to comply with the dispute resolution procedures, in the event that the other party breaches its confidentiality obligations, or the other party infringes or misappropriates intellectual property of the first party.

Termination

Termination of the joint marketing agreement. The potential grounds for a party's termination of a joint marketing agreement are similar to those that might be found in other commercial agreements and include the following:

- The other party's material breach that is not cured within a specified period of time
- If applicable, the other party's failure to meet quotas for a successive number of months or other time period
- Convenience
- The other party's insolvency or a material adverse change in the other party's condition
- Change of control of the other party

Post-termination and expiration obligations. The agreement should address the parties' obligations upon termination and expiration of the agreement, including the obligation to cease all marketing, promotion, and sales activities; return or destroy materials and confidential information of the other party; and pay to the other party any outstanding amounts owed to such party.

Effect of termination on teaming agreements. The agreement should indicate whether termination of the joint marketing agreement will result in the termination of all teaming agreements in effect at the time of termination. The parties should carefully consider whether termination of the agreement should invalidate any proposals that are under consideration by a customer at the time of termination given the potential impact that such a decision might have on the parties' reputation in the marketplace.

Standard Contract Provisions

The joint marketing agreement should include the same standard terms and conditions that would be included in any commercial agreement, including the following:

- Entire agreement (i.e., integration clause)
- Amendment
- Assignment
- Waiver
- Governing law, jurisdiction, and venue
- Relationship of the parties
- Third-party beneficiaries
- Force majeure
- Compliance with law
- Severability
- Notices
- Survival
- Counterparts

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RESEARCH PATH: *Commercial Transactions > Joint Ventures > Joint Venture Agreement > Practice Notes > Contractual Joint Ventures*

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Strategies for Bringing Counterclaims or Separate Lawsuits **against Plaintiff Employees**

This article provides guidance to employers on bringing counterclaims or separate lawsuits against plaintiff employees who have initiated claims against the employer. Employers and their attorneys are usually well versed in the types of claims that employees can bring. However, the employee might not be the only one with a potential claim after an employment relationship sours—the employer may also have various contract, tort, or statutory claims against its employee.

RECOGNIZING AND PURSUING THESE CLAIMS CAN ENABLE an employer to protect its relationships and confidential information from the departing employee and to obtain financial and equitable redress for employee wrongdoing. At the same time, you must be cognizant of the risks inherent in pursuing an unjustified claim.

Procedure for Bringing Counterclaims

Rule 13 of the Federal Rules of Civil Procedure governs counterclaims in federal lawsuits. In a federal employment case, the defendant-employer must generally assert claims arising out of the same transaction or occurrence as the plaintiff-employee's claims in that lawsuit; the employer cannot bring such claims in a separately filed lawsuit. These types of claims are called compulsory counterclaims. For example, an employer's claim that a former employee violated his duty of loyalty to the employer may be compulsory in a discrimination lawsuit brought by the employee based on the employee's termination for those disloyal actions. This is because both the employer's and employee's claims would rely on much of the same evidence and derive from overlapping facts.

In contrast, a claim that does not qualify as a compulsory counterclaim is a permissive counterclaim, which an employer may assert either in the employee's lawsuit or in a separate lawsuit. For example, an employer would likely not have to assert a counterclaim against its former employee for the employee's post-termination breach of a non-compete agreement in a lawsuit that relates to the employer's pre-termination actions.

Employers should assert counterclaims in the answer to the employee's complaint, assuming the employer has decided to pursue these claims in the employee's lawsuit. If the employer identifies possible counterclaims after filing its answer, the employer should seek to file an amended answer that includes the new counterclaims as soon as possible. The employer's ability to file an amended answer will depend on Rule 15 of the Federal Rules of Civil Procedure (or possibly Rule 16, if the employer seeks to amend its answer after a court-set deadline for doing so).

Many states have rules of civil procedure modeled after the Federal Rules of Civil Procedure. However, the requirements and procedures for asserting counterclaims in state court may vary.

Assert Permissive Counterclaims or File a New Lawsuit?

When an employer has the option of either bringing permissive counterclaims against an employee or filing a separate lawsuit, various considerations may come into play.

Litigating all claims in one lawsuit is often the most efficient option, particularly where the claims have at least some factual overlap. Additionally, this approach provides the factfinder with a fuller picture of the parties' history, including facts that may undermine the employee's efforts to be perceived as an innocent actor.

With claims involving minimal factual overlap, however, the upside of litigating all claims in one lawsuit will be less. In this circumstance, an employer might decide to file a separate lawsuit rather than assert its claims in the employee's pending lawsuit. This approach may be desirable to avoid complicating the first lawsuit with multiple unrelated claims or to allow the employer to take advantage of a contractual venue selection provision that calls for litigation of its claims in a more attractive forum. If the employer's claim is for a small amount of damages, the employer might also consider filing a separate small claims action, which is typically much more informal and expeditious.

Types of Claims against Employees

Contract Claims

Contracts between the employer and employee—specifying what the employee will or will not do during and after employment—are a primary source of potential claims against the employee. Most commonly, such agreements contain restrictions that limit the employee's ability to harm the employer's business interests. However, the parties might also have agreed that the employee must take certain affirmative steps or achieve certain performance outcomes. Either type of contract can form the basis of a potential claim.

Restrictive Covenants

Employers often require their employees to sign contracts that contain restrictive covenants that limit the actions the employee can take during and/or after the employment relationship. These restrictive covenants can range from prohibitions on the use of the employer's confidential information (such as customer lists and business strategies), to solicitation of the employer's customers or other employees on behalf of some other entity, to subsequent employment with a competitor.

A primary hurdle to asserting a breach of contract claim is establishing the enforceability of the restrictive covenant. State law typically governs enforcement, and some states codify enforcement rules by statute. Although most states require reasonable restrictions, cases interpreting reasonableness can vary widely by jurisdiction. Accordingly, attorneys should familiarize themselves with the applicable case and statutory law in their states. Moreover, counsel should draft restrictive covenants with the most limited breadth, duration, and geographic reach that will adequately protect the employer's interests.

In addition to unreasonableness, a restrictive covenant could fail for lack of consideration. Some states view continued at-will employment as sufficient consideration, whereas others require something more. In states where continued employment does not suffice, courts may find adequate consideration if the employee agreed to the restrictive covenant as a condition for obtaining the job in the first place or in exchange for a payment or promotion after the employment relationship has begun. To improve the likelihood that a court will find a restrictive covenant to be enforceable, focus your arguments on establishing:

- Why the restriction is appropriately tailored to protect the employer's particular business interests and vulnerabilities –and–
- Why the employee benefited from entering into the agreement (because the employee obtained employment or some other additional benefit that he or she would not have otherwise received)

State courts vary in their willingness to modify (or blue-pencil) an unreasonable restrictive covenant to make it reasonable, instead of simply finding the entire agreement unenforceable. In blue-pencil states, you might also argue that the employee violated some more limited version of the restrictive covenant.

Once you establish enforceability of the covenant, you must surmount the remaining hurdles of proving a breach of the agreement and resulting damages. In addition to seeking damages, an employer will likely want to consider requesting equitable relief, which may include an injunction barring a former employee from disclosing the employer's confidential information, soliciting its customers or employees, or working for its competitors for some period.

Counterclaims in Response to Declaratory Judgment Actions

An employee subject to a restrictive covenant may seek a declaratory judgment that the restrictive covenant is void, thereby allowing the employee to take the actions ostensibly prohibited by the restrictive covenant. The employer can respond to such a claim with a counterclaim that seeks court enforcement of the restrictive covenant. In doing so, the employer should identify any specific conduct that the employer wants the court to prohibit, such as continued employment with a particular competitor or solicitation of a specific client.

Performance Metrics

Although less common, an employer might also have a contract that requires a certain level of performance from an employee. Higher-level employees, hired to achieve specific outcomes for the employer, will more likely have a contract with required performance goals. In the event that such a contract exists, the employer may be able to seek damages due to the employee's failure to meet these performance metrics.

In the absence of such a contract, a court is unlikely to allow an employer to recover damages for poor performance. Rather, many courts have explained that a dissatisfied employer's remedy for poor performance is simply to terminate the employment relationship—not to sue the employee for lost profits or other damages.

Tort Claims

An employer is not necessarily without a remedy if no contract governs the employment relationship. The employer can seek redress through state tort claims for many of the same types of conduct targeted by an employment contract. Such tort claims include breach of the fiduciary duties of loyalty and good faith and fair dealing as well as tortious interference. In addition, an employee who steals or defrauds his employer may also be susceptible to a conversion or fraud claim. Moreover, employers may have potential defamation claims against employees. We address these tort claims in greater detail below.

Breach of Fiduciary Duties of Loyalty and Good Faith and Fair Dealing

State law may impose fiduciary duties of loyalty as well as good faith and fair dealing on some categories of employees—most likely those who occupy positions with higher levels of responsibility, authority, and discretion.

An employee's fiduciary duties to his employer encompass many of the same obligations that employers often seek to impose through restrictive covenants. These include generally refraining from:

- Competing against the employer
- Usurping corporate opportunities
- Using the employer's confidential information to the employer's detriment –or–
- Otherwise acting in a way that undermines the employer's ability to reap the benefit of the employment relationship

However, fiduciary duty claims have some important limitations. First, as mentioned above, only certain higher-level employees owe their employer fiduciary duties. Second, fiduciary duties only constrain an employee during the existence of the employment relationship. Absent a separate contractual obligation, an employee is generally free to do as he or she pleases, including competing with his or her former employer, after the employment relationship ends. In addition, an employee can take limited steps to prepare to compete with the employer while still employed, assuming he or she disclosed those steps to the employer.

Tortious Interference

An employer may bring a tortious interference claim against an employee who knowingly and intentionally interferes with a present or prospective contractual or business relationship between his or her employer and a customer, employee, or other business partner of the employer.

A couple of points on such claims are worth noting. First, state law varies regarding claims for interference with a prospective relationship. Some states require a stronger likelihood than others that the relationship would have materialized, if not for the employee's interference. Second, state law typically requires that the interference is somehow wrongful. For example, the employee's conduct was dishonest, contrary to the employee's contractual obligations, or involved some sort of illegal action. In the absence of wrongful conduct, courts are reluctant to bar competitive efforts by former employees.

Conversion or Fraud

State conversion and fraud claims apply in the employment context just as in other contexts. Employers can use these tort claims to seek damages from employees caught stealing or otherwise defrauding them. See, e.g., Astra USA, Inc. v. Bildman, 914 N.E.2d 36, 58 (Mass. 2009) (affirming jury verdict of over $1 million against former pharmaceutical president for fraud, conversion, waste of corporate assets, and other offenses, and additionally allowing employer to recover compensation paid to president during period of disloyalty). An employer might also consider pursuing criminal theft or fraud charges against such an employee, which not only provides an alternative route for redress, but also sends a message to other employees about the seriousness of this conduct.

Defamation

Employees do not always just go to court when they think their employers have wronged them. Sometimes, they also go to the media or various government agencies with their complaints. If that occurs and the employee makes untrue statements, the employer may have a defamation claim against the employee.

Common law generally governs defamation claims. To prevail, an employer usually must show that the employee made a false statement to a third party that harmed the employer. An employee can defend against a defamation claim by establishing that the statement in question was neither false nor misleading, was made in good faith and with a reasonable belief of its truth, or was a mere statement of opinion.

An employer can increase the likelihood of prevailing on its defamation claim by marshalling evidence that the employee's utterance was a statement of fact (rather than opinion) and was objectively untrue, as well as that the employee could not have reasonably believed that the statement was true. The employer must also develop evidence of harm—for example, that the employee's statement caused it to lose business or damaged its reputation.

An employer should exercise caution about asserting a defamation claim in response to an employee's protected activity. Such activity may include reports to the government about an employer's alleged violation of anti-discrimination laws, the Occupational Safety and Health Act, the False Claims Act, or other federal and state laws or regulations. A court could construe such a defamation claim as retaliation for the protected activity, which many federal and state laws prohibit.

Statutory Claims

Various statutes may provide another basis for a claim by an employer against its employee. These include the federal Defend Trade Secrets Act and state laws that govern trade secrets, as well as the federal Computer Fraud and Abuse Act.

The Defend Trade Secrets Act

In 2016, the federal government enacted the Defend Trade Secrets Act (DTSA), which amends the Economic Espionage Act of 1996. See 18 U.S.C. § 1831 et seq. As discussed below, the DTSA provides employers a new weapon in their litigation arsenals for combatting trade secret theft. But, to avoid neutralizing this weapon, employers must provide notice of the DTSA's protections to employees.

The DTSA created a new federal cause of action by providing a federal civil right of action for employers and others for trade secrets misappropriation. 18 U.S.C. § 1836(b)(1). See Henry Schein, Inc. v. Cook, 2016 U.S. Dist. LEXIS 81369, at *13–17 (N.D. Cal. June 22, 2016) (employer demonstrated a likelihood of success that customer buying patterns and company marketing and pricing strategies are protected under the DTSA). Previously, those injured by trade secrets misappropriation could generally look only to state law for redress.

The DTSA offers a variety of remedies in the event of trade secrets theft, including injunctive relief, damages, double damages for willful and malicious misappropriation, and attorney's fees. 18 U.S.C. § 1836(b)(3). It also makes a short-term, ex parte court order available to seize stolen trade secrets and retain them in court custody pending a hearing (which must be held within seven days). 18 U.S.C. § 1836(b)(2); but see OOO Brunswick Rail Management v. Sultanov, 2017 U.S. Dist. LEXIS 2343, at *4–5 (N.D. Cal. Jan. 6, 2017) (considering and ultimately rejecting request for seizure as unnecessary: the court ordered the e-mail providers to preserve all relevant records, and the court ordered the former employees to refrain from accessing or modifying their company laptops or phones until the upcoming hearing). This is a powerful remedy that allows employers to promptly divest a current or former employee of confidential business information taken without authorization, thereby limiting the damage an employee might do with the trade secrets.

Employers must disclose carve-outs to trade secret protection. Importantly, the DTSA also requires employers to make certain disclosures in any employment contract "that governs the use of a trade secret or other confidential information" entered into or updated after May 11, 2016. 18 U.S.C. § 1833(3)(A). Specifically, an employer must disclose that an individual is immune from liability for disclosing a trade secret as follows:

- In confidence to a federal, state, or local government official, either directly or indirectly, or to an attorney, solely for the purpose of reporting or investigating a suspected violation of law or in a complaint or other document filed in a lawsuit or other proceeding, if such filing is made under seal
- To the individual's attorney or the court in a retaliation lawsuit if the individual files any document containing the trade secret under seal and does not disclose the trade secret, except pursuant to a court order

18 U.S.C. § 1833.

Failure to make these disclosures about the DTSA's immunity for whistleblowers and use of a trade secret in litigation bars an award of exemplary damages and attorney's fees against an employee who did not receive the disclosures. 18 U.S.C. § 1833(b)(3)(C). Accordingly, employers should ensure that they notify employees that they will not be liable for trade secret misappropriation in the above circumstances in any new employment agreements, as well as agreements or employment policies dealing with confidentiality or trade secrets.

Trade Secrets Misappropriation under State Law

Because the DTSA does not preempt state law, employers may also have remedies available under state law. Most states have laws modeled after the Uniform Trade Secrets Act. These statutes prohibit employees from misappropriating their employers' trade secrets. In addition, these statutes typically prohibit third parties (such as the employee's next employer) from using the misappropriated trade secrets, if the third party knows or should have known that the trade secret was stolen.

To take advantage of such a statute, an employer must establish that the confidential information rises to the level of a trade secret. Some states impose a higher bar than others. For example, many states reject trade secret misappropriation claims based on a stolen customer list, particularly where the list simply compiles names and contact information. As a general rule, the confidential information must have required some analysis or special effort or skill to create.

In addition, an employer must have made a reasonable effort to maintain the secrecy of the confidential information for it to qualify as a trade secret. These efforts may include limiting access to only those employees who require the information to perform their jobs, employing various security measures to protect the information (such as passwords or locked files), and requiring employees to sign contracts promising to maintain the information's confidentiality.

Computer Fraud and Abuse Act

The Computer Fraud and Abuse Act (CFAA)—codified at 18 U.S.C. § 1030 —is a federal criminal statute that provides a civil cause of action for individuals and entities that have suffered a loss of at least $5,000 because of another's unauthorized access to a computer or computer network. In the employment context, an employer may pursue a CFAA claim after an employee steals electronic data (such as a customer list or other important business document) from the employer.

An employer can establish the requisite damages in several ways. For example, the employer can seek remuneration for damage caused by the employee to the computer or network

Related Content

For more information on non-competes, see

> UNDERSTANDING, NEGOTIATING, AND DRAFTING NON-COMPETES

RESEARCH PATH: *Labor & Employment > Non-competes and Trade Secret Protection > Restrictive Covenants > Practice Notes > Non-competes*

For guidance in drafting non-solicitation agreements, see

> UNDERSTANDING, NEGOTIATING, AND DRAFTING CUSTOMER AND EMPLOYEE NON-SOLICITATION AGREEMENTS

RESEARCH PATH: *Labor & Employment > Non-competes and Trade Protection > Restrictive Covenants > Practice Notes > Non-solicitation Agreements*

For a step-by-step approach to creating non-disclosure agreements, see

> UNDERSTANDING, NEGOTIATING, AND DRAFTING NON-DISCLOSURE AGREEMENTS ON BEHALF OF EMPLOYERS

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For an outline of state laws regarding restrictive covenants, see

> CHART – STATE PRACTICE NOTES (NON-COMPETES AND TRADE SECRET PROTECTION)

RESEARCH PATH: *Labor & Employment > Non-competes and Trade Protection > Protecting Trade Secrets > Practice Notes > State Non-competes and Trade Secret Protection Practice Notes*

For a discussion on the elements of and defenses to retaliation claims, see

> UNDERSTANDING THE ELEMENTS OF RETALIATION CLAIMS

RESEARCH PATH: *Labor & Employment > Discrimination and Retaliation > Claims and Investigations > Practice Notes > Protecting the Employer During and After Investigations*

itself as well as costs incurred by the employer to investigate the employee's improper activities.

Similarly, the employer can establish that the access was unauthorized in multiple ways. For example, the employer can show that the employee was never authorized to access the specific data in the first place. In addition, the employer can show that a company policy barred the employee from accessing the data to use it for any reason other than his employer's benefit. See United States v. John, 597 F.3d 263, 272 (5th Cir. 2010) (holding that the employee "exceed[ed] authorized access" to the employer's computer when he used certain information to commit fraud, which the employer only allowed him to use for employer business); United States v. Rodriguez, 628 F.3d 1258, 1263–64 (11th Cir. 2010) (holding that the defendant employee "exceed[ed] his authorized access" when he accessed information from his employer's computer for a purpose in violation of the employer's policies); Ef Cultural Travel Bv v. Explorica, 274 F.3d 577 (1st Cir. 2001) (holding that an employee breached the duty of loyalty and "exceed[ed] authorized access" under the CFAA when he accessed the employer's computer and obtained the employer's confidential information against company policy to aid a competitor).

Moreover, the Seventh Circuit held that an employee engages in unauthorized access under the CFAA when he or she accesses information in a manner that breaches his or her duty of loyalty. See Int'l Airport Ctrs., L.L.C. v. Citrin, 440 F.3d 418, 420–21 (7th Cir. 2006). But see United States v. Valle, 2015 U.S. App. LEXIS 21028, at *49 (2d Cir. Dec. 3, 2015) (holding that if a defendant had permission to access information from a computer for any purpose, then accessing the computer does not violate the CFAA, even if he or she utilized the information for improper purposes); United States v. Nosal, 676 F.3d 854, 862–63 (9th Cir. 2012) (en banc) (holding that the CFAA does not extend to situations where an employee accesses a computer to which he or she normally has access to misappropriate trade secrets or other confidential information); WEC Carolina Energy Solutions LLC v. Miller, 687 F.3d 199, 205–06 (4th Cir. 2012) (an employee who downloaded an employer's confidential information, e-mailed it to himself, and gave the information to the employer's competitor did not violate the CFAA; the employee did not "exceed authorized access" to the employer's computer because the employer permitted the employee to access that computer as a part of his employment); Cloudpath Networks v. SecureW2 B.V., 157 F. Supp. 3d 961, 973 (D. Colo. 2016) (providing overview of circuit split regarding whether a party can prove unauthorized access by simply showing that an employee used his or her access "for purposes contrary to the employer/principal's interests" or whether a party must show that an employee used otherwise-permitted computer access "to obtain data the employer/principal has declared off-limits to that employee").

An employer may also prove unauthorized access by showing that it revoked a former employee's right to access upon termination of employment. Such revocation bars the employee from accessing the information directly, as well as indirectly through colleagues still employed by the employer. See United States v. Nosal, 844 F.3d 1024, 1028 (9th Cir. 2016) (holding defendant liable for obtaining protected information after his termination through individuals still employed at company; "once authorization to access a computer has been affirmatively revoked, the user cannot sidestep the statute by going through the back door and accessing the computer through a third party. Unequivocal revocation of computer access closes both the front and back door."). To protect against post-termination trade secrets theft, an employer should immediately revoke a terminated employee's access to its computer and e-mail systems, as well as expressly notify the individual that the employer prohibits any direct or indirect access. See also Facebook, Inc. v. Power Ventures, Inc., 844 F.3d 1058, 1067 (9th Cir. 2016) (although violation of a website's terms of use cannot be the sole basis for liability under the CFAA, access after express prohibition violates the CFAA).

The CFAA is an attractive option for employers for a couple of reasons. First, it provides a claim even if a restrictive covenant does not protect the stolen information and the data does not qualify as a trade secret. Accordingly, employers can seek damages and injunctive relief for the theft of a much broader scope of confidential or sensitive business information. Second, the CFAA establishes a basis for federal court jurisdiction, where there might otherwise be none.

Assess Risks of Bringing Claims against Employee

Although asserting a claim against an employee can be an appropriate course in many circumstances, overeager counterclaims or lawsuits occasion risks for both you and the employer.

The employer risks retaliation liability if the claim intends to penalize the employee for engaging in protected conduct (such as asserting a discrimination claim under the Americans with Disabilities Act , Title VII, or the Family and Medical Leave Act). Employers also risk liability in the form of a malicious prosecution claim. Various state and federal statutes may provide additional bases for sanctioning an unsupported claim. In addition, both you and the employer risk losing credibility with the judge by pursuing an unjustified claim. Accordingly, carefully consider the motivation and factual basis for any potential claim by an employer before the employer pursues it.

Courts look to multiple facts to evaluate whether an employer's claim was retaliatory. For example:

- **Timing.** A court will more likely find retaliation when the employer delayed in asserting a long-standing claim until after the employee filed his or her lawsuit. See Crawford v. Coram Fire District, 2015 U.S. Dist. LEXIS 57997, at *21 (E.D.N.Y. May 4, 2015) (noting that the employer's apparent delay suggests retaliation). Conversely, a court will less likely find retaliation when the employer immediately asserted its claim (or at least has a good explanation for any delay). See id. (reasoning that the employer's delay could be explained by the need to investigate the factual basis for its claim and secure appropriate counsel); Johnson v. Ultravolt, Inc., 2015 U.S. Dist. LEXIS 16013, at *15–16 (E.D.N.Y. Feb. 10, 2015) (finding no retaliation in part because there was no evidence that the employer delayed in asserting its claim).
- **Strength of claim.** A claim that appears weak and contrived is more likely to raise suspicions of retaliation than a well-supported claim. See Crawford, 2015 U.S. Dist. LEXIS 57997, at *21 (employees' admission of the conduct alleged by employer weighed against finding retaliation); Johnson, 2015 U.S. Dist. LEXIS 16013, at *12–14 (finding no retaliation in part because substantial, unrefuted evidence supported the claims); Stockdall v. TG Investments, Inc., 129 F. Supp. 3d 871, 878 (E.D. Mo. Dec. 30, 2015) (denying employer's motion for summary judgment on retaliation claim because employer's "empty [counter]claims" appeared to be designed "to increase the expenses of litigation and to force Plaintiffs to dismiss the suit"); but see Stockdall v. TG Investments, Inc., 178 F. Supp. 3d 810, 819 (E.D. Mo. Apr. 14, 2016) (granting judgment for employer on retaliation claim because former employees failed to present any supporting evidence at trial). Relatedly, an employer's request for an exorbitant, unjustified amount of damages also suggests a retaliatory motive. Johnson, 2015 U.S. Dist. LEXIS 16013, at *16 (noting lack of request for unreasonable amount of damages in finding no retaliation).
- **Threats.** Finally, any out-of-court threats of retaliation would obviously increase the risk that a court will find the employer's claim retaliatory. In fact, the mere threat of filing a retaliatory lawsuit suffices to constitute retaliation, even if the employer never actually files the lawsuit. See Brown v. TD Bank, N.A., 2016 U.S. Dist. LEXIS 45166, at *17–19 (E.D. Pa. Apr. 4, 2016); Walsh v. Irvin Stern Costumes, 2006 U.S. Dist. LEXIS 57398, at *6 (E.D. Pa. Aug. 15, 2006).

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

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HOW TO AVOID COMPANY LIABILITY WHEN USING **CROSS-DEVICE TRACKING DATA**

As Internet-connected mobile devices (e.g., smartphones, laptops, tablets, wearables, smart appliances, etc.) have become seemingly ubiquitous, consumers now have more ways than ever to access the Internet to interface with social media accounts, check e-mail, purchase goods and services, seek medical advice, watch cat videos, etc. However, consumers may not realize that such browsing behavior and account accesses can be monitored.

TRADITIONAL BROWSER TRACKING METHODS, SUCH AS web cookies and local shared objects, have typically not been as reliable in the mobile space. As such, the traditional methods are being replaced or supplemented with a method for tracking consumer behavior across multiple devices, commonly referred to as cross-device tracking.

In practice, various entities (e.g., service providers, content publishers, advertising companies, etc.) actively monitor consumer behavior, both online and offline, to generate detailed profiles of consumers. Cross-device tracking allows companies to further refine such profiles using data gathered for consumers across more than one of their devices. For example, a consumer may browse a particular vendor's website for an article of clothing via a web browser on their tablet, and an advertisement for that same vendor and/or article of clothing may show up in their social media feed accessed on their smartphone.

Two Main Approaches to Cross-Device Tracking

Advertisers typically rely on two main approaches to cross-device tracking: deterministic matching and probabilistic matching. Deterministic matching relies on some explicit identification by the consumer themselves, such as a username, e-mail address, mobile phone number, etc. Probabilistic matching methods may be used to associate the consumer between their devices by using device information such as the operating system, device make and model, IP address, etc. For example, if both devices have accessed content using the same IP address, one can make a calculated guess that the same consumer is using both devices. Further, if both devices have been used to access the same e-mail address, a stronger inference can be made that both devices are associated with the same consumer.

Privacy Concerns

While cross-device tracking can provide certain benefits to the user, such as a seamless experience across devices and applications, and provide a level of fraud protection and account security, cross-device tracking also presents a number of privacy concerns. As the International Association of Privacy Professionals (IAPP) noted in its practice guide to cross-device tracking, "[t]he variety of technologies used for cross-device tracking creates challenges for consent, notice, and opt-out standards."[1] For example, the data gathered as a result of monitoring consumer behavior can be stored, aggregated, and analyzed by various entities, all unbeknownst to the consumer. As a result, government agencies and industry trade groups alike have introduced guidelines and self-regulatory initiatives to address such privacy concerns.

Guidelines and Self-Regulatory Initiatives to Address Privacy Concerns

In one such example, in May 2015, the Network Advertising Initiative (NAI), an industry trade group of third-party network advertisers that develops self-regulatory standards for online advertising, introduced its Guidance for NAI Members: Use of Non-Cookie Technologies for Interest-Based Advertising Consistent with the NAI Code of Conduct.[2] The NAI Guidance covers, among other things, the transparency and notice requirements for NAI members. In particular, the NAI Guidance requires that for non-cookie technology, the privacy policy includes whether data is being collected using a non-cookie technology and a description of an easy-to-use opt-out mechanism that allows consumers to opt out of Internet-Based Advertising (IBA) with respect to a particular browser or device.

Another such example is from the Digital Advertising Alliance (DAA), an independent non-profit organization led by the leading advertising and marketing trade associations, which released specific guidance on the Application of the Self-Regulatory Principles of Transparency and Control to Data Used Across Devices[3]—enforcement of which began on February 1, 2017.[4] Similar to the NAI Guidance, the DAA's Principles require an opt-out mechanism; however, the DAA's Principles further require a disclosure that lists all third parties engaged in the collection of cross-device tracking data. Additionally, in accordance with the DAA's Principles, data collected from an opted-out device cannot be used for behavioral advertising on other devices, nor can data collected from other devices inform advertising on the opted-out device.

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1. https://iapp.org/resources/topics/cross-device-tracking/. 2. Network Advertising Initiative, *Guidance for NAI Members: Use of Non-Cookie Technologies for Interest-Based Advertising Consistent With the NAI Code of Conduct* 2 (2015) ("Beyond Cookies"), http://www.networkadvertising.org/sites/default/files/NAI_BeyondCookies_NL.pdf. 3. Digital Advertising Alliance, *Application of the Self-Regulatory Principles of Transparency and Control to Data Used Across Devices* 2 (2015), https://www.aboutads.info/sites/default/files/DAA_Cross-Device_Guidance-Final.pdf 4. Press Release, Dig. Advert. All., Digital Advertising Alliance Announces Enforcement of Cross-Device Guidance to Begin February 1, 2017 (Jan. 31, 2017), http://digitaladvertisingalliance.org/press-release/digital-advertising-alliance-announces-enforcement-cross-device-guidance-begin.

RESEARCH UNDERTAKEN BY THE FTC CONCLUDED THAT AN INCREASING NUMBER OF COMPANIES HAVE ADVERTISED USING CROSS-DEVICE TRACKING SERVICES. . . . FURTHER, THE FTC STAFF REPORT HIGHLIGHTED VARIOUS CIRCUMSTANCES IN WHICH CROSS-DEVICE TRACKING COMPANIES, PUBLISHERS, AND DEVICE MANUFACTURERS CAN RUN AFOUL OF THE FEDERAL TRADE COMMISSION ACT.

More recently, in January 2017, the Federal Trade Commission (FTC) released a Staff Report detailing the findings of a Cross-Device Tracking Workshop conducted by the FTC in November 2015 (Cross-Device Tracking: A Federal Trade Commission Staff Report (January 2017)). Research undertaken by the FTC concluded that an increasing number of companies have advertised using cross-device tracking services. To that end, the FTC Staff Report provided the following recommendations for those companies engaged in cross device tracking:

- Be transparent about data collection and use practices.
- Provide choice mechanisms that give consumers control over their data.
- Provide heightened protections for sensitive information, including health, financial, and children's information.
- Maintain reasonable security of collected data.

Further, the FTC Staff Report highlighted various circumstances in which cross-device tracking companies, publishers, and device manufacturers can run afoul of the Federal Trade Commission Act (FTC Act). Such circumstances that could implicate the FTC Act can include:

- Failure to provide truthful information about tracking practices[5]
- Failure to disclose cross-device tracking as a data collection/ tracking method[6]
- Failure to properly identify the types of information being collected and used[7]
- Failure to clearly and conspicuously disclose the limits of an opt-out that is limited to only certain types of tracking technologies[8]

To safeguard data collection practices associated with cross-device tracking, the FTC Staff Report advises companies to:

- Clearly and conspicuously disclose cross-device tracking practices by explaining to consumers what information is collected from the device, the entities that are collecting the information, and how they use and share the information collected.
- Offer consumers choices about how their cross-device activity is shared, and respect those choices.
- Do not refer to raw or hashed usernames/e-mail addresses as anonymous or aggregated data—the FTC has repeatedly held that data that is reasonably linked to a consumer or a consumer's device is personally identifiable. Accordingly, do not make blanket statements to consumers about not sharing personal information with third parties if such data is being shared.
- Refrain from engaging in cross-device tracking on data that the FTC has recognized as sensitive, warranting higher levels of protection, including health, financial, and children's information, as well as precise geolocation information, without the consumer's affirmative express consent.
- Take efforts to maintain reasonable security and properly secure data in order to avoid unexpected and/or unauthorized uses of data (e.g., as may be otherwise compromised via a data breach).

Conclusion

In summary, if your company uses data collected via cross-device tracking collection methods, be transparent about the data collected, how it is collected, and the intended use for the data. Additionally, allow consumers to have control over their data (e.g., opt-out mechanisms), recognize how collected and disseminated data collected via cross-device tracking can be classified (e.g., as personal information, sensitive data, etc.), and maintain reasonable security. L

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RESEARCH PATH: *Intellectual Property & Technology > Technology Transactions > Mobile Apps & Device > Articles*

Related Content

For more information on privacy policies, see

> DRAFTING PRIVACY POLICIES

RESEARCH PATH: *Intellectual Property & Technology > Technology Transactions > Mobile Apps & Devices > Practice Notes*

For a discussion of privacy considerations for mobile apps, see

> MOBILE APP PRIVACY CONSIDERATIONS

RESEARCH PATH: *Intellectual Property & Technology > Technology Transactions > Mobile Apps & Devices > Practice Notes*

5. Epic Marketplace, Inc., No. C-4389 (F.T.C Mar. 13, 2013) (complaint), https://www.ftc.gov/sites/default/files/documents/cases/2013/03/130315epicmarketplacecmpt.pdf. **6.** Press Release, Fed. Trade Comm'n, *FTC Issues Warning Letters to App Developers Using "Silverpush" Code* (Mar. 17, 2016), https://www.ftc.gov/news-events/press-releases/2016/03/ftc-issues-warning-letters-app-developers-using-silverpush-code. **7.** United States v. InMobi Pte Ltd., No. 3:16-cv-3474 (N.D. Cal. June 22, 2016), https://www.ftc.gov/system/files/documents/cases/160622inmobistip.pdf **8.** Beyond Cookies, *supra* note 2, at 9.

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Preparing for **Artificial Intelligence** in the Legal Profession

One of the very hot topics so far in 2017 is artificial intelligence (AI) and its potential disruptive impact on the legal profession. Questions ranging from, "Will AI replace lawyers?" to "Does it make sense to attend law school with the rise of AI?" to "How will AI impact the delivery, cost, and quality of legal services?" are being asked by those in and around the legal industry.

IN FACT, THE INTERSECTION OF AI AND THE LAW HAS recently captured the attention of major media outlets including *The New York Times* ("A.I. is Doing Legal Work. But It Won't Replace Lawyers, Yet"[1]) and *The Atlantic* ("Rise of the Robolawyers"[2]). In addition, nowadays you would be hard-pressed to attend a legal conference without a session, panel, or presentation on AI.

This article reviews the basics of AI, key use cases for AI in the legal profession, some primary AI-related legal issues, and steps that your law firm or in-house legal department may want to take to become AI-ready.

AI 101 for Lawyers

In his book "The Fourth Industrial Revolution,"[3] Klaus Schwab, executive chairman and founder of The World Economic Forum, begins by briefly reviewing the three earlier industrial revolutions that transformed our society and then devotes the remainder of the book to describing how our world recently entered a whole new era in which we will witness unprecedented major and rapid technological innovations. According to Schwab, these innovations will largely center in the physical, digital, and biological areas. AI has the potential to be a disruptive force in our "Fourth Industrial Revolution."

Like many newer and transformational technologies, there is no uniform definition for AI. An October 2016 report issued by the White House called "Preparing for the Future of Artificial Intelligence" states the following: "Some define AI loosely as a computerized system that exhibits behavior that is commonly thought of as requiring intelligence. Others define AI as a system capable of rationally solving complex problems or taking appropriate actions to achieve its goals in whatever real world circumstances it encounters." In addition, the concept of machine learning is an application of AI based on the premise that systems can learn by having access to data.

1. Steve Lohr, *A.I. Is Doing Legal Work. But it Won't Replace Lawyers, Yet*, N.Y. TIMES, (March 19, 2017), https://www.nytimes.com/2017/03/19/technology/lawyers-artificial-intelligence.html?_r=0
2. Jason Koebler, *Rise of the Robolawyers: How Legal Representation Could Come to Resemble Turbo Tax* THE ATLANTIC (April 2017), https://www.theatlantic.com/magazine/archive/2017/04/rise-of-the-robolawyers/517794/ 3. KLAUS SCHWAB, THE FOURTH INDUSTRIAL REVOLUTION, (World Economic Form 2016).

THERE ARE A NUMBER OF POTENTIAL APPLICATIONS FOR THE UTILIZATION OF AI SYSTEMS IN THE LEGAL INDUSTRY—ESPECIALLY AS THEY RELATE TO THE AUTOMATION OF REPETITIVE AND ROUTINE TASKS TO HELP LAWYERS PROVIDE SUPERIOR LEGAL COUNSEL AT A HIGHER LEVEL.

Leading technology companies are making major investments in the AI space and are actively recruiting AI talent. For example, last September my company, Microsoft, announced the formation of the Microsoft Artificial Intelligence and Research Group—consisting of more than 5,000 computer scientists and engineers—under the leadership of Microsoft Executive Vice President Harry Shum.

While AI has certainly received much attention and hype so far this year, it is important to remember that the AI field is very much in its infancy—which provides various opportunities and challenges for the legal profession.

Use Cases for AI in the Legal Profession

There are a number of potential applications for the utilization of AI systems in the legal industry—especially as they relate to the automation of repetitive and routine tasks to help lawyers provide superior legal counsel at a higher level. Let's review a non-exhaustive list of those use cases.

Conducting Legal Research

As most lawyers know, conducting legal research can be a tedious, monotonous, and time-consuming task. However performing timely and comprehensive legal research on a particular matter—especially as the law continues to evolve—is critically necessary and important for lawyers as they serve their clients. AI systems may be able to aid lawyers by performing legal research on relevant case law and applicable statutes in a faster and more thorough manner than what lawyers may be able to do on their own. Such AI systems may also be powerful enough to use data to predict the outcome of litigation and enable lawyers to provide more impactful advice to their clients in connection with dispute resolution issues.

Administrative Legal Support

I was recently asked if I had an administrative assistant. I said yes, I do, and my administrative assistant's name is Cortana—Microsoft's high-powered personal digital assistant. While the person who asked the question chuckled at me, the reality is that lawyers will increasingly be able to rely upon AI-powered digital assistants that become smarter as they learn more about you to perform the various necessary administrative functions that are part of any legal practice. Do you need to follow up with others, schedule travel, set up a meeting, or manage expenses (including in-house counsel's review of outside counsel invoices)? Some of my Microsoft legal department colleagues have even developed an AI-powered chatbot tool that they use along with their automatically generated out-of-office e-mail response when they are away from the office without any e-mail access. All of those tasks, and more, can be performed by digital assistants and free up time for you to provide higher value-added legal services to your clients.

Legal Document Generation and Review

An AI system may serve as a virtual concierge for the intake of client information and the preparation of standard and routine legal documents and agreements for the benefit of your clients. In addition, lawyers specializing in contract negotiation matters would appreciate an AI system that could provide a fast and thorough contract comparison whenever there is a battle of the forms between contracting parties regarding which standard contract terms should be utilized. An additional welcome step would be for an AI system to suggest suitable fallbacks or alternative contract provisions from a contracting party's repository of negotiated contracts to help address a particular contractual issue.

Performing Due Diligence

All lawyers know that conducting a comprehensive due diligence review in connection with the huge amounts of data that are part of any merger, acquisition, or other sophisticated corporate transaction is absolutely necessary. An AI system may provide an opportunity to perform such due diligence in a faster, cheaper, and more thorough fashion instead of relying on a high-priced and bleary-eyed team of lawyers.

Promoting a Stronger Compliance Culture

A sophisticated AI system with the capability to actively identify and analyze data patterns regarding internal company matters and employee activities may be helpful to an organization's compliance department. Using such a system could help organizations thwart the kinds of damaging high-profile ethics and integrity issues that have unfortunately become commonplace over the past few years.

Building More Robust Cybersecurity

AI systems with built-in data analytics capabilities can provide all organizations with the ability to become more cybersecure. For instance, AI systems could be utilized by law firms—which are increasingly being targeted by cybercriminals—to monitor and assess the data involving attempts to penetrate their information technology infrastructure so they can proactively identify trends and patterns and close security gaps to attain more robust cybersecurity. Law firms may be able to use such AI tools to their advantage by demonstrating to potential clients that they are more cybersecure than their competitors.

Complying with e-Discovery Requirements

Properly managing the production of the massive volumes of electronically stored information is of paramount importance during the litigation process. There are many e-Discovery technology solutions available in this growing marketplace. As an example, the Microsoft legal department uses the e-Discovery features of the Microsoft Office 365 cloud computing solution to improve the accuracy and usefulness of discovery results and save time and money—$4.5 million annually. AI-fueled systems could further transform e-Discovery technology solutions by providing additional levels of efficiency and cost savings to lawyers and legal departments tasked with managing their e-Discovery needs.

Enhanced Self-Help Legal Resources

Law firms, in-house legal departments, and non-profit legal aid organizations are increasingly providing legal self-help resources directly to their clients via web portals as a form of de-lawyering. Clients may often resist using those resources since they may lack a personal touch. An AI-powered chatbot and/or digital assistant could serve as a personal navigator to help clients utilize such self-help resources and may drive greater usage and adoption by clients.

Potential AI Legal Issues

Because AI is still an emerging technology, the various legal issues associated with it are also emerging. In the coming months and years lawyers will have plenty of opportunities to advise their clients on issues such as the following, and many others.

Data Privacy

In order for AI systems to provide valuable services, fundamentally they need to have access to and use large amounts of data. AI systems will also probably generate significant amounts of information. As a result, a buyer of AI-related services should understand how an AI solutions provider protects and uses its data. Since the AI world does serve to increase the surface area for potential targets for cybercriminals and because data privacy laws continue to evolve—for instance the European Union's new General Data Protection Regulation takes effect in May 2018—consumers of AI-related services should carefully evaluate AI providers and clearly understand what specific steps they take to appropriately safeguard data.

Law Enforcement Access to Data

Because the amount of data continues to grow and our laws have not been updated to keep pace with the change in the technology landscape, during the past few years we have seen various legal challenges between technology companies and the U.S. government pertaining to law enforcement access to data. Such challenges will likely become more common with the rise of AI systems. For instance, there was a recent well-publicized matter involving a search warrant request for Amazon to provide data involving its AI-powered Echo device as part of a murder case.[4]

Lack of Regulatory Framework & Standards

Since AI is still very much in its early stages, there are no meaningful AI-related laws or standards that can be relied upon—although given AI's dependence on data, applicable data privacy laws will be relevant. From a regulatory perspective, some may view AI as the Wild West. While this lack of an AI regulatory framework or standards can create some confusion and ambiguity, it does provide opportunities for lawyers to help build and develop this area from the ground up.

Legal Ethics

As lawyers use AI systems to deliver legal services, how do they ensure that they still comply with legal ethics rules such as the American Bar Association (ABA) Model Rules of Professional Conduct? Are lawyers exercising competence as required by ABA Model Rule 1.1 when they use AI systems to provide legal advice? How are a lawyer's responsibilities for nonlawyer assistance in ABA Rule 5.3 affected by AI systems? As AI systems are increasingly used by lawyers, it will be interesting to see whether the ABA Model Rules will evolve to specifically address AI use by lawyers and if state legal ethics associations will issue ethics opinions on AI—just like they have done for cloud computing.

4. State v. Bates, CR-2016-370-2 (Ark. Cir. Ct. 2016).

Intellectual Property Protection

Elements of an AI system may be subject to intellectual property protection—including patents. Presumably companies that are developing and investing in AI technologies are also devising their AI intellectual property strategies and seeking patents where applicable. As AI becomes more popular and advanced, only time will tell whether we will see AI patent litigation that is reminiscent of the smartphone patent litigation wars that we have witnessed in the past.

Liability

As lawyers adopt AI systems to render legal advice to clients, it is inevitable that such systems will make mistakes that may result in damages. How will liability be determined in such situations? Will lawyers be subject to negligence or malpractice claims from clients? How do lawyers mitigate these risks and other potential liability issues associated with AI?

Become AI-Ready

In all likelihood, AI will be a transformational technology that impacts all industries, not just the legal profession. These are some steps that lawyers can take to become AI-ready.

Establish an AI Legal Center of Excellence

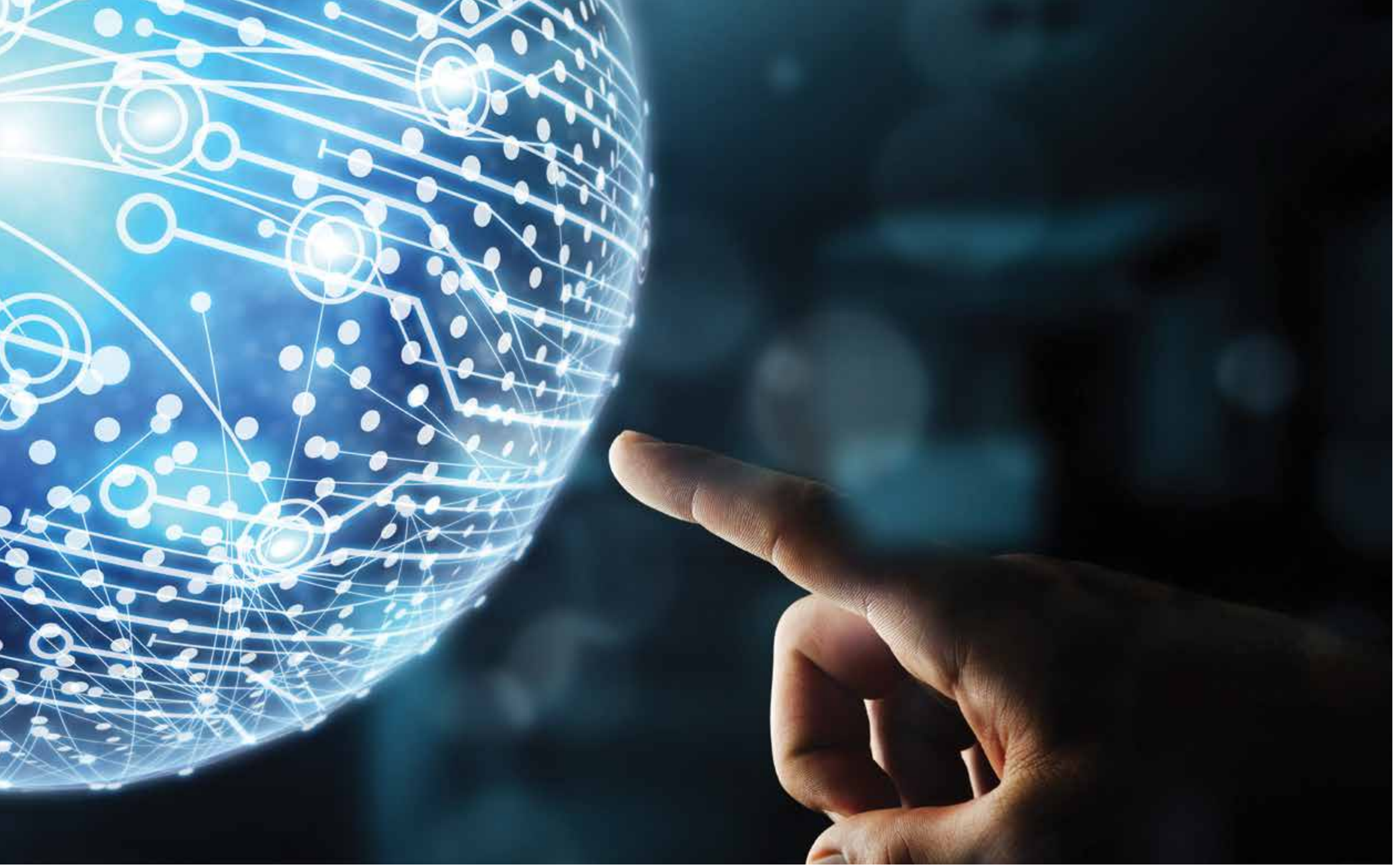
Appoint members of your law firm or legal department who can serve as your team's subject matter experts on AI to your AI Center of Excellence. Provide them with opportunities to train up and learn more about AI so they can be an AI Center of Excellence resource to other lawyers and your clients.

Embrace the Growth Mindset and Learn from Others

Remember there is so much to learn about AI, and this technology will continue to evolve and develop. Invest the time and energy to understand the basics of AI and how lawyers can use it as a tool to provide high-quality legal services. Since AI is currently such a top of mind subject, be sure to collaborate with fellow lawyers at law firms, in-house legal departments, and non-profit legal organizations to understand how they plan on deploying AI in their delivery of legal support. In addition, actively use social media resources like LinkedIn and Twitter to follow and keep abreast of developments in the AI space. Also, gain knowledge by attending AI-focused sessions and panels that are part of CLE programs, conferences, and webinars.

Don't Be Afraid to Fail

Traditionally, many lawyers have been viewed as being conservative and resistant to change. There may be a concern among lawyers that leveraging AI systems as part of their practice may be too risky. While there is no doubt that there will be some growing pains associated with AI, lawyers should not fear AI, as the potential long-term benefits in leveraging AI to help automate aspects of their legal services far outweigh the potential risks.



Develop Appropriate Internal AI Practices

As AI technology continues to evolve, consider developing some thoughtful guidelines and practices as to how your law firm or company may use AI as part of its business. Perhaps such procedures can be incorporated into your law firm's or company's overall technology strategy to address other disruptive Fourth Industrial Revolution innovations like cloud computing, the Internet of Things, big data, etc.

Over the next few years it will be fascinating to observe the impact that AI will have on the legal profession. Although some are of the mindset that AI may serve to replace lawyers and other legal professionals, I believe AI will result in a redeployment of legal resources and free up time for lawyers to perform more mission-critical work for their clients. While AI may offer lawyers leading technology and data-driven tools to provide efficient, quick, and impactful legal counsel to clients, AI is still not a substitute for a lawyer's own empathy, judgment, instinct, and personal relationship with clients. L

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Roberta Jacobs-Meadway and Roger LaLonde
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Drafting a Trademark Cease and Desist Letter

BEFORE SENDING A TRADEMARK CEASE AND DESIST LETTER on behalf of a client, it is imperative to conduct due diligence and to carefully consider the content and tone of the letter. Such letters may range from a polite invitation to negotiate terms for coexistence, to a request for information as to how the alleged infringer is willing to address your client's concerns, to a stern demand that the alleged infringer cease all use of a mark by a defined date. Assessing these issues is crucial to drafting an effective letter and may ultimately curb the need for litigation and lead to a favorable resolution for your client.

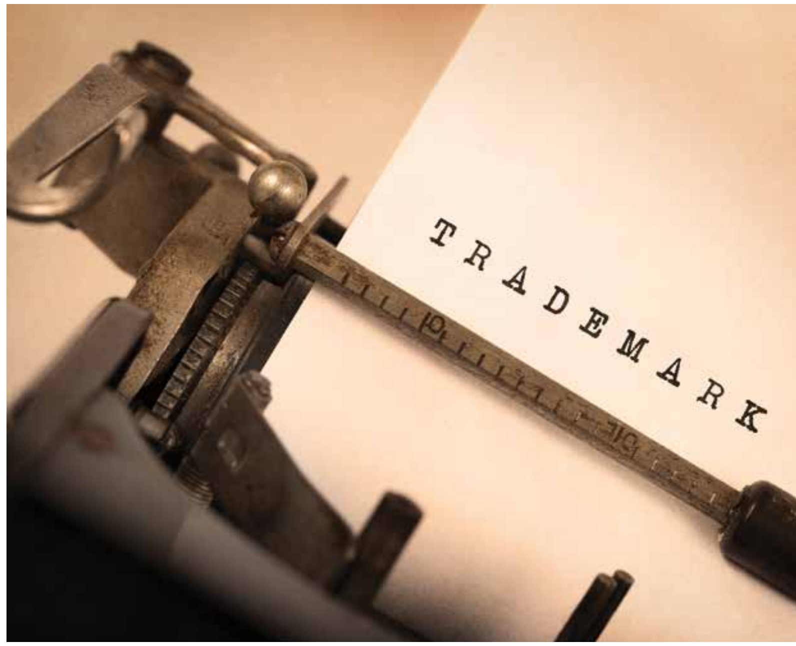
This article discusses pre-drafting due diligence and the key issues that your client should consider before sending a cease and desist letter. The article also offers guidance on effective letter drafting, including evaluating the letter's objective, tone, and demands.

Pre-drafting Due Diligence

A cease and desist letter should be viewed as a prelude to litigation. Thus, before sending a cease and desist letter, it is imperative to conduct an adequate investigation to identify the nature and extent of the allegedly infringing use. You should have a thorough understanding of the strength and viability of your client's potential claim and the business consequences of sending a cease and desist letter, so that the letter will not backfire against your client's interests.

The extent of diligence that is adequate in a given case depends on a number of factors. As discussed more fully below, you should take the following steps as part of the pre-drafting due diligence process:

- Identify and research the alleged infringer(s)
- Confirm priority of use
- Assess strength of your client's case, including (1) whether a likelihood of confusion exists between the alleged infringer's mark and your client's mark, (2) whether a pre-litigation survey should be commissioned, (3) the strength of any potential defenses, and (4) third-party issues/opportunities



- Assess risk of a declaratory judgment action
- Weigh business and legal ramifications
- Consider alternatives to a cease and desist letter

Include your client in the due diligence process, where appropriate, and discuss the results of the investigation and potential options and consequences with your client. If the client decides to send a cease and desist letter, you should next assess when the letter should be sent, based on any relevant timing considerations, and then draft the letter itself.

Identify and Research the Alleged Infringer(s)

When conducting due diligence, you should first identify and research the alleged infringer(s), which may include:

- The owner of the allegedly infringing mark (whether an individual or corporation)
- Corporate employees, directors, or shareholders of the mark owner
- Corporate parents (e.g., an intellectual property holding company), subsidiaries, or successors
- Licensees, franchisees, distributors, or retailers
- Any other parties who may be liable for contributory or vicarious infringement, such as a manufacturer, flea market operator, or landlord (see, e.g., Hard Rock Café Licensing Corp. v. Concession Servs., Inc., 955 F.2d 1143 (7th Cir. 1992))

Confirm in advance, to the extent possible, that the alleged infringer(s) are still in business and find valid addresses for them. Addresses may be listed on corporate registrations, domain name registrations, and/or websites of the alleged infringer(s). In some cases, addressing the letter to multiple locations can shorten the time you may otherwise spend resending letters that are returned as undeliverable.

Confirm Priority of Use

After identifying and researching the alleged infringer(s), you should next confirm that your client has priority of use. Because trademark rights are based on first use, the party that used a mark first has priority over third parties that make later use of confusingly similar marks (regardless of when or if the mark was registered).

As to your client, confirm that any claimed date of first use can be verified with documentary evidence. As to the alleged infringer, you should first determine whether the alleged infringer has registered or sought to register its mark. If the mark has been registered, the date of first use will be listed in the registration. If an intent-to-use application has been filed, the filing date of the application constitutes a constructive first use date for priority purposes (subject to the later issuance of a registration). 15 U.S.C. § 1057(c). Bear in mind, however, that an applicant is not bound by the filing date and may be able to establish an earlier date for the purpose of establishing priority.

If the alleged infringer has not registered or sought to register its mark, the date of first use can be difficult to identify with precision. In such instances, consider using tools available through the Internet such as:

- The Internet Archive's "Wayback Machine" (available at https://archive.org/web/)
- The WHOIS database

The Wayback Machine compiles periodic captures of web pages dating back to 1996. While this tool has limits—not all websites are captured, and the archived pages cannot be browsed in the same manner as normal websites—it can provide information as to how a company has used a mark on its website over time.

The WHOIS database is a searchable list of all currently registered domain names. It can be used to determine when a domain name that contains a mark was first registered and when that site was first available to the public. Internet Corporation for Assigned Names and Numbers has a fairly reliable WHOIS database (available at https://whois.icann.org/), but if you cannot find detailed information about a particular domain name owner, consider searching the database of the domain name registrar, which may contain more complete or additional information. All domain name registrars offer WHOIS search services (though the results may vary amongst registrars).

Remember to consider priority outside the United States as well if the businesses at issue are not strictly local. Each side may have priority in different jurisdictions, and certain jurisdictions may be more important than others. To open an issue in a less important jurisdiction and risk a problem in a more important one without due consideration of all of the implications may not serve anyone's interests.

Assess Strength of Your Client's Case

Once you have identified and researched the alleged infringer(s) and confirmed priority of use, you should next assess the strength of your client's case as part of your pre-drafting due diligence. Relevant considerations include:

- Whether a likelihood of confusion exists between the alleged infringer's mark and your client's mark
- Whether a pre-litigation survey should be commissioned
- The strength of any potential defenses
- Third-party issues/opportunities (i.e., whether your client should attempt to acquire any third-party rights that may be superior to those of your client)

Each issue is discussed in further detail below.

Likelihood of Confusion

Assessing the likelihood of confusion between your client's mark and the allegedly infringing mark is critical when conducting due diligence. Analyzing your case in this manner informs on the viability and strength of a potential trademark infringement claim, which will help to frame the letter's objective and tone. Remember that likelihood of confusion is a probability of confusion, not a possibility of confusion.

Likelihood of confusion is assessed based on a number of factors, including:

- The degree of similarity between the marks
- The degree of similarity between the goods and/or services
- The fame or strength of the senior mark
- The nature and extent of third-party use for the same or related goods and services
- The context in which purchase decisions are made (i.e., level of care)
- The degree of overlap in trade and promotional channels
- Any evidence of actual confusion
- The good or bad faith of the junior user

These factors vary slightly by circuit. See e.g., AMF Inc. v. Sleekcraft Boats, 599 F.2d 341 (9th Cir. 1979); Polaroid Corp. v. Polarad Elecs. Corp., 287 F.2d 492 (2d Cir. 1961) ; Sheridan v. E.I. DuPont de Nemours & Co., 100 F.3d 1061 (3d Cir. 1996).

No claim of trademark infringement is viable without some of the above factors weighing in a plaintiff's favor, especially the similarity of the marks factor and the similarity of the goods and/or services factor. The strength of your client's mark is also an important factor that can influence how the other factors are weighed.

Less distinctive marks receive a narrower scope of protection and, as such, are less likely to succeed in an infringement action unless the alleged infringer's mark is nearly identical and being used for nearly identical goods/services. Conversely, a highly distinctive or famous mark receives a wider scope of protection that can extend considerably beyond the goods/services identified in your client's registration. Note also that third-party uses of similar marks on related goods/services may lessen the strength of your client's mark.

Pre-litigation Surveys

Surveys (especially likelihood of confusion surveys) are often a critical aspect of trademark litigation. While surveys are typically commissioned at some point during the litigation itself, you should discuss with your client the propriety of a pre-litigation survey (i.e., a pilot survey) on the issue of likelihood of confusion. Pilot surveys on other issues, such as non-genericness or secondary meaning, may also be desirable in certain cases.

The object of a pilot survey is to ascertain in a directional, rather than projectable, manner the likely outcome of a full survey. It is still necessary to determine the appropriate survey universe, the appropriate control, and the appropriate wording so that questions are not leading or confusing, just as would be done for a full survey. However, a pilot survey is considerably cheaper than a full-scale, litigation-usable survey and may give a strong indication that confusion is or is not likely (and thus may impact your client's decision on whether to send a cease and desist letter).

You should also ask your client if it has previously conducted brand awareness surveys or other types of marketing and promotional research pertaining to its mark. The results of any market studies or research may aid you in assessing the fame or strength of your client's mark (which, as discussed above, is relevant to the likelihood of confusion inquiry).

Strength of Potential Defenses

Identifying the potential defenses that may be asserted by an alleged infringer, and the relative strength of such defenses, is another critical aspect of due diligence. The available defenses vary based on whether your client's registration has become incontestable (to gain incontestable status, a mark owner must have five years of continuous use of the mark in commerce following registration and must file an affidavit stating that the mark has been in such continuous use—see 15 U.S.C. § 1065).

If your client's registration has become incontestable, the registration is conclusive evidence of validity, ownership, and the exclusive right to use the mark in commerce, subject to the following statutory defenses:

- Fraudulent registration
- Abandonment
- Misrepresentation as to source
- Fair use
- Innocent local use
- Priority
- Use of the mark to violate U.S. antitrust laws
- Functionality
- Equitable principles (including laches, estoppel, and acquiescence)
- Genericness

These are generally the only defenses that may be asserted against an incontestable registration. See 15 U.S.C. § 1115(b); Park 'N Fly, Inc. v. Dollar Park & Fly, Inc., 469 U.S. 189 (1985).

If your client's registration has not become incontestable, an alleged infringer may assert "any legal or equitable defense or defect," including (but not limited to) the statutory defenses set forth above. Other common defenses asserted in trademark actions include:

- Mere descriptiveness (and no secondary meaning)
- Unclean hands
- Claim or issue preclusion
- Lack of jurisdiction
- First Amendment defenses
- Challenges to the registration (e.g., named applicant is not the owner, improper assignment)

Third-Party Issues/Opportunities

The number and nature of third-party uses of similar marks for similar goods or services not only impact the strength of your client's mark for likelihood of confusion purposes, as discussed above, but may also be relevant to your litigation strategy. Specifically, if a third party has rights in a mark that are superior to those of your client (i.e., because the third-party use predates your client's use), your client should consider acquiring those rights, with or without a license back, for the following reasons:

- To better your client's position vis-à-vis the alleged infringer (who may attempt to acquire the rights itself upon receiving a cease and desist letter, if your client has not already done so)
- To protect your client against a possible claim of trademark infringement brought by the third party
- To gain the benefits of incontestability (if the third-party's mark is registered and incontestable)

Assess Risk of a Declaratory Judgment Action

If a cease and desist letter states that the recipient's conduct is infringing, there is a risk that the recipient will seek a declaratory judgment in its home forum (the letter need not expressly threaten a lawsuit). This would prevent your client from selecting the timing and forum for the litigation or from electing not to proceed with litigation.

Declaratory judgment jurisdiction exists if "the facts alleged, under all the circumstances, show that there is a substantial controversy, between parties having adverse legal interests, of sufficient immediacy and reality to warrant the issuance of a declaratory judgment." A reasonable apprehension of suit is not necessary. MedImmune, Inc. v. Genentech, Inc., 549 U.S. 118 (2007); see also, e.g., Surefoot LC v. Sure Foot Corp., 531 F.3d 1236 (10th Cir. 2008) (applying *MedImmune* in a trademark case).

Various district courts have held, post-*MedImmune*, that a cease and desist letter (either alone or in combination with other circumstances) is sufficient to create declaratory judgment jurisdiction. See, e.g., Blue Ath., Inc. v. Nordstrom, Inc., 2010 U.S. Dist. LEXIS 72615 (D.N.H. July 19, 2010) (finding jurisdiction based on two cease and desist letters, which set out a prima facie case of trademark infringement, and a formal TTAB opposition on infringement grounds); Venugopal v. Sharadha Terry Prods., Ltd., 2009 U.S. Dist. LEXIS 43534 (W.D.N.Y. May 18, 2009) (finding jurisdiction based on a single cease and desist letter stating that any use of plaintiff's mark would infringe defendant's mark and subject plaintiff to liability for trademark infringement and unfair competition).

Against this backdrop, consider the following when assessing the risk of a declaratory judgment action:

- Is the client prepared to litigate in a forum outside its home forum?
- Is the alleged infringer a company with an incentive to litigate? For instance, has it made a major investment in the allegedly infringing product?
- Has the alleged infringer filed previous declaratory judgment actions or has it otherwise been litigious in the trademark context?

If your client is not certain it is prepared to litigate, consider a letter that merely expresses concern and asks how the recipient might be prepared to address that concern, without invoking any adversarial or accusatory language. Conversely, if your client fully intends to file a lawsuit against the alleged infringer, consider filing and serving the complaint prior to or contemporaneous with the cease and desist letter, or filing but not officially serving the complaint (to preserve priority in the event that the alleged infringer files a declaratory judgment lawsuit). Both methods convey the seriousness of your client's position and may also attract media attention, which may place some additional pressure on the alleged infringer to take some action in response.

Weigh Business and Legal Ramifications

There are situations in which business reality may clash with legal rights. For instance, an alleged infringer may be selling the accused product to a major customer of your client, who may be displeased if its business is inconvenienced by a disruption in the supply chain. Or the alleged infringer may itself be a major customer of your client with respect to other goods. Gaining a better understanding of such business realities and the relevant market and purchase context is an important part of due diligence. You should thus consult with your client to evaluate and weigh any potential business or legal ramifications prior to sending a cease and desist letter.

Consider Alternatives to a Cease and Desist Letter

Depending on the strength of your client's case, the gravity of the alleged infringement, and any relevant business and legal considerations, initiating contact with a cease and desist letter may not be the best strategy.

If your client's case is weak, the offending use is insignificant or likely to end soon, and/or your client is not prepared to litigate for any other reason (e.g., cost concerns, fear of distraction, or other adverse business consequences), consider:

- **Taking no action.** Sometimes, the sound advice is to take no action if the claim is not likely to succeed or if the cause for concern is minimal or already in decline.
- **Monitoring the use.** It may be wise in some instances to monitor the alleged infringer's application file (if applicable) and any changes in the nature or extent of the use, or to track evidence of confusion. If, contrary to expectations, the offending use persists or increases in concern over time, taking action can be reconsidered at a later date.
- **Non-legal business solutions.** Such business solutions might include a temporary price discount, additional advertising, etc. to counter the infringing use.

If your client's case is strong and/or the offending use is particularly egregious, consider:

- **Taking legal action without prior notice.** It is not necessary to send a cease and desist letter prior to filing an action if your client is intent on litigation. Alternatively, you might wish to file a complaint prior to or contemporaneous with sending a cease and desist letter (with a copy of the complaint attached to the letter) to guard against the risk of a declaratory judgment action. If your client chooses the latter option, consider filing but not serving the complaint (plaintiffs generally have 90 days from the filing date to serve a complaint). This strategy may give the alleged infringer an additional incentive to negotiate promptly in order to avoid the cost of answering the complaint and proceeding with federal court litigation. Media attention may also add some pressure to the alleged infringer if the complaint has been filed (and thus is publicly available) but not served.
- **Filing a motion for temporary restraining order (TRO).** In some instances, your client may wish to stop the infringing activity as soon as possible (e.g., if both your client and the alleged infringer will be present at a major trade show or other event, and the infringing use will cause immediate and irreparable harm to your client). Consider filing a TRO simultaneously with a complaint, without notice, under Fed. R. Civ. P. 65(b). If there is potential for a business resolution, consider:
- **Business discussions between the parties' key decision makers.** Such discussions may lead to an amicable and mutually beneficial resolution, while also saving your client the time and expense of unnecessary litigation.
- **Making the alleged infringer a licensee, customer, or vendor.** Pursuing this alternative depends on the situation, such as the quality of the junior user's product or service and whether an income stream may be the better outcome.

These alternatives are not necessarily exhaustive. Consult with your client regarding any other solutions that may be desirable based on the circumstances of the infringement and your client's business objectives.

IF THE ALLEGED INFRINGER HAS FILED AN APPLICATION THAT IS ABOUT TO BE OR HAS BEEN PUBLISHED, CONSIDER FILING AN EXTENSION OF TIME TO OPPOSE THE APPLICATION OR LODGING AN OPPOSITION TO SECURE THE ADVANTAGE OF THE TRADEMARK TRIAL AND APPEAL BOARD AS A FORUM.

Timing Considerations

If your client decides that sending a cease and desist letter is the best option, you must next determine when to send the letter. In certain situations there may be a need to act quickly—for instance, if the alleged infringer is about to promote or ship goods bearing the allegedly infringing mark in the imminent future, the alleged infringer may be more committed to the mark and more resistant to change. Additionally, in some jurisdictions, a delay of several months may prejudice the client's ability to secure preliminary injunctive relief in any future litigation. See, e.g., Citibank, N.A. v. Citytrust, 756 F.2d 273 (2d Cir. 1985).

There may also be sound reasons to delay for some period of time before sending the letter. For instance, a delay may be warranted in the following circumstances:

Client's mark not yet incontestable. If your client's trademark registration is not yet incontestable but will be eligible for that status shortly (i.e., five years after registration), consider sending a cease and desist letter after the mark becomes incontestable, especially if the mark is arguably descriptive. This is advisable because incontestable marks cannot be challenged on the ground of mere descriptiveness. Waiting to send the cease and desist letter guards against the risk that the alleged infringer will file a petition to cancel the registration on descriptiveness grounds, which could preclude incontestable status.

Secondary meaning in relevant market is unclear. If your client's mark is arguably descriptive and waiting for the registration to reach incontestable status is not an option, you should ensure that the mark has acquired distinctiveness, or secondary meaning, in connection with the relevant goods and services before sending a cease and desist letter. Sending the letter prior to this time may invite a premature attack on a potentially descriptive mark.

Alleged infringer has filed a trademark application. If the alleged infringer has filed an application that is about to be or has been published, consider filing an extension of time to oppose the application or lodging an opposition, to secure the advantage of the Trademark Trial and Appeal Board (TTAB) as a forum. As compared to district court litigation, TTAB proceedings are generally expedited, cheaper, and more narrowly focused.

Marketing and sales considerations. The main selling season for the goods at issue may impact the timing of a cease and desist letter. For instance, if the goods are sports-related merchandise, sending a cease and desist letter just prior to or during the sports season may be treated with more urgency than sending the letter after the season has concluded.

Multiple alleged infringers. There is no obligation to pursue all infringers at once, but consider the following:

- Does your client want to place all suspected infringers on notice?
- Would it be preferable to deal with those perceived to be weakest first?
- Would it be preferable to address the most serious threat(s) first?

The answers to these questions will help your client prioritize which alleged infringers should receive cease and desist letters and when such letters should be sent.

Guidance on Drafting an Effective Letter

Drafting an effective cease and desist letter on behalf of a client involves a number of considerations, including:

- Recipient(s)
- Content
- Tone

Each issue is discussed in further detail below, along with examples of common demands/requests.

Recipient(s)

There are generally a number of individuals and entities who may be deemed infringers in a given case. Potential infringers may include the individual or entity who owns the allegedly infringing mark, corporate employees/directors/shareholders, corporate parents/subsidiaries/successors, licensees, franchisors, distributors, and/or retail outlets where the goods are actively sold or services rendered.

Any of these individuals or entities may receive a cease and desist letter if they are engaged in infringement. However, to which person(s) the letter should ultimately be addressed depends on various efficiency-based considerations. For instance, is the manufacturer or owner of the mark located outside the United States? Is it likely that the distributor has little stake in the products or mark? Is the retailer the key to maintaining a particular venue for litigation?

Other considerations for specific entities include:

- **Manufacturer.** May or may not be responsible for use of mark.
- **Distributor.** May be located in more favorable forum than others in the supply chain.
- **Retailer.** May resolve issue if customers of the manufacturer stop selling goods bearing the mark.
- **Retailer's landlord.** May be an approach if a retailer ignores a cease and desist letter (under secondary liability principles).

Once you have determined which alleged infringer(s) should receive the cease and desist letter, consider addressing the letter to any trademark attorneys of record (who can be identified by searching USPTO records). If no such counsel can be ascertained, wherever possible identify the individual(s) acting as principal for the recipient. A cease and desist letter should be addressed to identifiable individuals with authority so that the letter is not misdirected and is treated seriously.

Conduct basic due diligence to confirm that each recipient is still in business and to verify all potential addresses. Do not solely rely on the address posted on the recipient's website or listed on the WHOIS registry. These are both good indicators that you may have the correct address, but if your matter is time sensitive, waiting for a letter to be returned as undeliverable may cause an unacceptable delay. Instead, also check the recipient's corporate registration status or run a business report through Hoover's or Dun & Bradstreet, if available.

Consider addressing the letter to multiple viable locations and, perhaps, send a copy of the letter to an appropriate e-mail address listed on the recipient's website in order to prompt a quick response. (Note, however, that if you also file and serve a complaint against an alleged infringer, an e-mail will not constitute valid service of process under Rule 4 of the Federal Rules of Civil Procedure.)

Content

Trademark cease and desist letters often follow a common pattern and flow and, with respect to issues that commonly arise, may be based on a template. As with any template, however, care must be taken to use the template only in appropriate circumstances and to make all the appropriate changes. Nothing can spoil the effect of a letter, or suggest a program of bullying, more effectively than leaving the wrong company name in the body of the letter or misidentifying the mark or goods.

A cease and desist letter generally includes the following elements:

- Identification of the complaining party, its business, relevant marks, and any U.S. registrations (if the infringement is limited to the United States)
- Identification of the challenged conduct/use
- Statement of basis for concern or complaint—may track likelihood of confusion factors in the relevant jurisdiction, such as two or more of the following:
  - Degree of similarity between the marks
  - Degree of similarity, identity, or overlap between the goods/services
  - Strength of your client's mark (based on length of use, advertising, other indicia of public recognition, market position, etc.)
  - Overlap in trade and promotional/advertising channels
  - Context of purchase decision
  - Evidence of actual confusion, if any (such as customer e-mails or other inquiries)
  - Any indication of bad faith in adoption of junior mark (e.g., former franchisee, rejected suitor for business)
- Identifications of action taken already (if any), such as securing an extension of time to oppose a trademark application
- Demand for action or other requests
- Time period within which response is expected
- Consequences (if any) for not taking the requested action
- Disclaimer that the letter does not constitute a complete recitation of all of the client's rights (e.g., a statement that all of the client's rights—stated and unstated—are hereby reserved)

Also consider attaching relevant exhibits to the cease and desist letter, such as copies of your client's trademark registration(s), images of the parties' goods or advertisements of services bearing the marks at issue, and/or copies of any relevant court or TTAB proceedings.

Tone

A number of considerations may inform the tone of a cease and desist letter, including:

- Objective of the letter
- The potential for a negative social media response
- The potential for a future business relationship between the parties
- Length of the allegedly infringing use
- Client's commitment to litigate in the absence of an agreement

…ANYONE SENDING A LETTER SHOULD EXPECT IT TO BE PUBLISHED ONLINE, WHETHER AS AN EXAMPLE OF TRADEMARK BULLYING OR OTHERWISE HELD UP TO RIDICULE. YOUR CLIENT MUST BE COGNIZANT THAT A SMALL MATTER MAY BE VIEWED BY THE PUBLIC IN A MANNER OUT OF PROPORTION TO THE ISSUE AT HAND…

Each consideration is discussed below.

Objective of letter. On one end of the spectrum, a client may merely wish to educate individuals and businesses who appear misguided or ignorant of trademark law and/or the client's trademark rights. This objective may be accomplished by using a soft, non-confrontational tone in the cease and desist letter. On the other end of the spectrum, a client may wish to make clear how strong its position is and that the client is not open to discussion or compromise. Letters with this objective generally employ a more aggressive tone and can be replete with citations to statutes, quotes from cases, and admonitions about injunctions, damages, and other adverse consequences of noncompliance. Other objectives may warrant a different or modified tone.

Potential for negative social media response. In pre-Internet times, cease and desist letters were generally only read by the recipient of the letter and its counsel. In today's Internet age, however, anyone sending a letter should expect it to be published online, whether as an example of trademark bullying or otherwise held up to ridicule. Your client must be cognizant that a small matter may be viewed by the public in a manner out of proportion to the issue at hand and adjust the tone of the letter accordingly.

Potential for future business relationship. If the parties' goods and services are related and your client would not be averse to granting a license to the junior user, the letter should reflect a good faith desire to reach a mutually beneficial resolution. The goal in such circumstances is to persuade, not intimidate. The letter should be written as a notice of concern with a request to open negotiations, rather than as a demand for action.

Length of allegedly infringing use. If the recipient has used the mark at issue for a number of years, the recipient may be more likely to defend such use. In such circumstances, your client might consider offering a license or an extended phase-out period and, in general, using a softer approach in the letter. Conversely, if the use has not yet begun (i.e., the recipient has filed an intent-to-use trademark application) or is relatively recent, the recipient may be more amenable to meeting your client's demands in order to avoid the uncertainty and expense of litigation. In such circumstances, a more aggressive tone and stance may be warranted.

Client's commitment to litigate. If your client fully intends to pursue litigation if the dispute cannot otherwise be resolved, the language in the letter should reflect this intention. If, however, your client does not wish to litigate or is in any way uncertain, aggressive language should not be used. Empty threats shred credibility and, significantly, may expose your client to the risk of a declaratory judgment action or embarrassment when over the top claims or demands go viral on the Internet.

Examples of Common Demands/Requests

One key way in which cease and desist letters differ is the demand for action or other requests. Some letters may simply express concern over the recipient's use, while others may demand a prompt cessation of use, a cessation of use with a phase-out period, a change in the identification of goods/services (if the recipient has filed a trademark application), or more extensive demands such as an accounting and/or destruction of products bearing the mark at issue. Letters may also request that a landlord take action against a retailer or other alleged infringer.

These possibilities are discussed below, along with sample language that may be used in each situation. Bear in mind that these demands/requests are not necessarily exhaustive and will vary from case to case.

Expression of concern. On the less aggressive end of the spectrum, a letter expressing concern over use of a similar mark, rather than demanding cessation of use, should be considered if the client's potential claim is not strong or if the client would like to initiate negotiations for licensing or concurrent use. A simple expression of concern might state: "We are bringing this issue to your attention and ask that you advise us as to how you intend to address this concern."

If your client is concerned about potential future use, consider language similar to the following:

> While [Client] is not currently concerned about the use of [Recipient's mark] in connection with the above-identified goods in class 10, which appear to function on a transdermal basis, the identification is written broadly and includes medical devices to monitor blood properties.
>
> Accordingly, although [Client] is not requesting that [Recipient] take any action at this time, we take this opportunity to make [Recipient] aware that [Client] reserves the right to object should [Recipient] expand its current use of the mark to connection with medical devices or diagnostic products for immunohematology.

Demand to change identification of goods/services in trademark application. If an allegedly infringing mark is the subject of a trademark application and the identification of goods/services is written broadly such that it might encompass the client's activities, or the client's goods and/or services are similar or related to only a selection of the identified goods/services in the application, then the client's interests may be best served by requesting an amendment of the identification.

Consider language such as the following:

> The application to register [Recipient's mark] in connection with medicines and pharmaceuticals is of concern to [Client], because the marks are nearly identical in sound and appearance, and the identification of goods is written broadly so as to potentially encompass goods that are related to or sold through the same channels of trade as those sold in connection with [Client's mark].
>
> Accordingly, we are requesting on behalf of [Client] that your client amend the identification of goods in the application to expressly exclude diagnostic preparations and products for analysis of blood and other body fluids, and that your client agree not to expand the use of its mark in connection with diagnostic preparations and products for analysis of blood and other body fluids.

Demand for cessation of use, with a phase-out period. In some circumstances, your client may wish to allow for a phase-out period (i.e., three months) during which the recipient of the letter can transition to a new name or mark, rather than demanding prompt cessation of use. A phase-out period may be desirable for various reasons, such as:

- To encourage compliance
- To discourage the recipient from mounting a social media response
- The use may have been inadvertent or in a mistaken belief that there was no problem
- The recipient is a small entity or a sole proprietor and the actual economic harm is minimal

Related Content

For an overview of trademark law, see

> TRADEMARK FUNDAMENTALS

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

For detailed guidance on trademark infringement litigation, see

> TRADEMARK INFRINGEMENT AND FALSE DESIGNATION OF ORIGIN CLAIMS, REMEDIES AND DEFENSES

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

For a sample cease and desist letter, see

> CEASE AND DESIST LETTER (TRADEMARK INFRINGEMENT)

RESEARCH PATH: *Intellectual Property & Technology > Trademarks > Trademark Counseling & Transactions > Forms*

For an overview of each circuit's factors when evaluating likelihood of confusion, see

> LIKELIHOOD OF CONFUSION FACTORS CIRCUIT-BY-CIRCUIT CHART

RESEARCH PATH: *Intellectual Property & Technology > Trademarks > Trademark Counseling & Transactions > Forms*

For more information on incontestability, see

> MAINTAINING & RENEWING U.S. TRADEMARK REGISTRATIONS – CLAIM OF INCONTESTABILITY

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

For a detailed discussion on trade dress, see

> TRADE DRESS FUNDAMENTALS

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

Consider language such as the following:

> We respectfully ask that [Recipient] take steps to phase out all use of [allegedly infringing material] as a mark and as a component of any mark or name or domain name in connection with its career management and human resource consulting services, and that such phase out be completed before the end of [date].

Demands beyond prompt cessation of use. On the more aggressive end of the spectrum, cease and desist letters can demand more than just a prompt cessation of use. For instance, a letter might contain the following language:

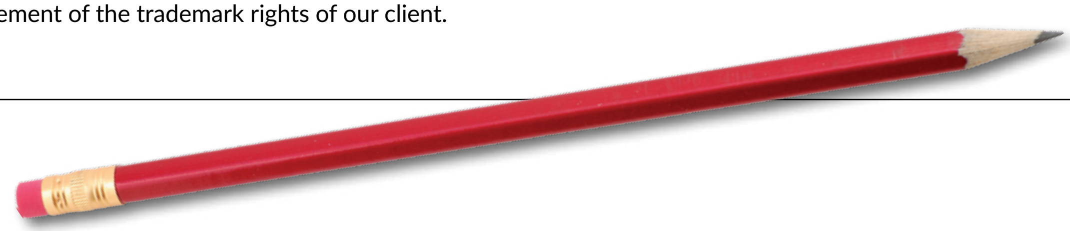
> On behalf of [Client], we request that your client (1) immediately cease all manufacture and sale of products having the infringing trade dress, (2) remove from inventory all products at issue, (3) destroy all beverage containers having the infringing trade dress, and (4) deliver to this office a full accounting of all sales of products having the infringing trade dress.

> We ask that you confirm in writing, no later than ten (10) days from the date of this letter, your client's intent to comply with the above requests. Please note that this letter is without prejudice to our client's rights, claims, and remedies, all of which it expressly reserves.

Letters with this type of tone may also be accompanied by attached documents showing an even greater level of preparedness for, and threat of, litigation. For example, if the offending use is egregious, you might consider attaching a draft complaint and/or a draft motion for a TRO or preliminary injunction to the letter. Going even further, you might consider attaching a copy of a complaint that has been filed, with a written commitment to serve the complaint if the recipient does not comply promptly with the client's demands.

Demand to Landlord. Your client might consider sending a cease and desist letter to a landlord if the alleged infringer, such as a retailer or flea market operator, has ignored previous requests to cease the infringement. Consider a demand such as the following:

> Your client, [NAME OF LANDLORD], is now on notice of this infringement. By knowingly allowing [NAME OF ALLEGED INFRINGER] to continue to engage in trademark infringement on its premises, your client is, from receipt of this notice forward, engaging in contributory infringement under the Lanham Act for which your client may be held liable for damages. Accordingly, our client demands that your client, [NAME OF LANDLORD], immediately take all steps commercially reasonable as landlord for the real property out of which [NAME OF ALLEGED INFRINGER] operates its business to terminate the use of the premises for the infringement of the trademark rights of our client.



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RESEARCH PATH: Intellectual Property & Technology > Trademarks > Trademark Counseling & Transactions > Practice Notes

John Popeo

Brokered Deposits and Strategic Planning Considerations

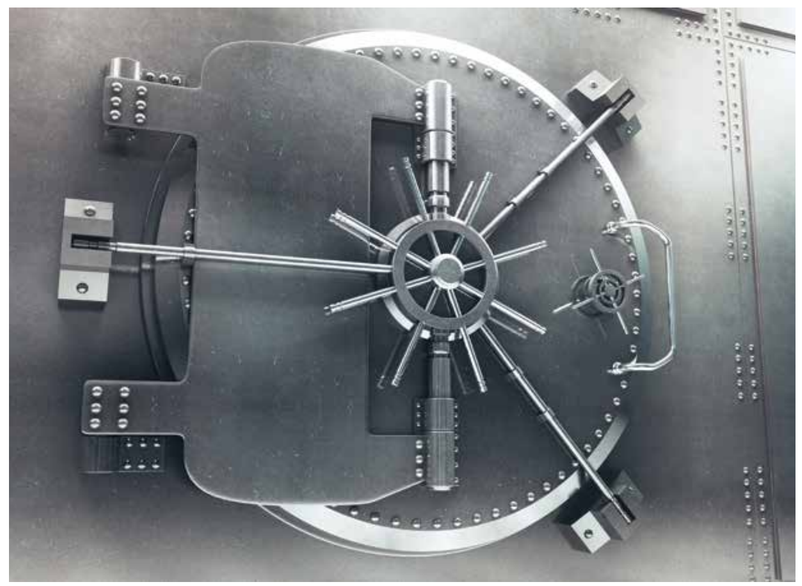
Overview

Brokered deposits are often viewed by insured depository institutions (IDIs) as a cost-effective source of liquidity and funding. Federal bank regulatory agencies, however, consider brokered deposits to be a less stable source of funding that contributed to the 2008 global financial crisis. This article provides an overview of brokered deposits and discusses applicable regulatory restrictions, including recent guidance by the Federal Deposit Insurance Corporation (FDIC) regarding the identification, acceptance, and reporting of brokered deposits (FDIC Guidance) by IDIs.

Core Deposits Compared to Brokered Deposits

The Federal Deposit Insurance Act (FDI Act), 12 USCS § 1811 et seq., broadly defines the term "deposit" as the "unpaid balance of money or its equivalent received or held by a bank or savings association." This sweeping definition encompasses nearly all funds subject to transfer or withdrawal by depositors at an IDI. For regulatory examination purposes, the federal bank regulatory agencies primarily distinguish between core deposits and brokered deposits.

Core deposits are not defined by federal banking statutes and regulations. Rather, core deposits are defined in the Uniform Bank Performance Report (UBPR), a supervisory tool used by examination staff of the federal bank regulatory agencies. Under the UBPR definition, core deposits are "the sum of demand deposits, all negotiable order of withdrawal (NOW) and automatic transfer service accounts, money market deposit accounts, other savings and time deposits under $250,000, minus all brokered deposits under $250,000." Notably, this definition specifically excludes brokered deposits. For regulatory examination purposes, core deposits include deposits that are "stable, lower cost [and] reprice more slowly than other deposits when interest rates rise. [Core] deposits are



typically funds of local customers that also have a borrowing or other relationship with the institution." As discussed below, federal bank regulatory agencies generally prefer core deposits to brokered deposits as a preferred method of funding.

Federal bank regulatory agencies consider the presence of core deposits and brokered deposits in evaluating liquidity management programs and assigning liquidity ratings for regulatory examinations. In connection therewith, the agencies assess whether an IDI has properly identified, measured, monitored, and controlled its funding risks. While federal bank regulatory agencies maintain there is no stigma attached to the acceptance of brokered deposits, regulatory examination staff tend to favor core deposits over brokered deposits as core deposits are viewed as a more stable, less costly funding source from long-term customers. Brokered deposits, on the other hand, are viewed as a more volatile funding source typically associated with interest rate sensitive deposits, or hot money, from customers consistently seeking a higher rate of interest.

In its Congressional report examining the relationship between core deposits and brokered deposits, the FDIC concluded that the probability of IDI failure is magnified if an institution is overly reliant on brokered deposits as a source of funding. The FDIC's report also noted that the concentration of brokered deposits has served as a strong indicator as to whether an IDI will fail. Consequently, the definition of the term brokered deposit is critical for IDIs subject to brokered deposit restrictions.

Definition of Brokered Deposit

The definition of brokered deposit is contained in Section 29 of the FDI Act and its implementing regulations are codified at 12 CFR Part 337. The FDIC, the Board of Governors of the Federal Reserve System (Federal Reserve), and the Office of the Comptroller of the Currency (OCC) have also issued guidance addressing the supervisory treatment of brokered deposits.

A brokered deposit is "any deposit that is obtained, directly or indirectly, from or through the mediation or assistance of a deposit broker." 12 USCS § 1831f; 12 CFR § 337.6(a)(5)(ii)(I). A deposit broker is broadly defined under the FDI Act and 12 CFR Part 337 to include:

> Any person engaged in the business of placing deposits, or facilitating the placement of deposits, of third parties with IDIs or the business of placing deposits with IDIs for the purpose of selling interests in those deposits to third parties; and an agent or trustee who establishes a deposit account to facilitate a business arrangement with an IDI to use the proceeds of the account to fund a prearranged loan.

FDIC Guidance provides additional clarification that "a brokered deposit may be any deposit accepted by an IDI from or through a third-party." In assessing whether a third party is a deposit broker, the FDIC considers, among other things:

- Whether a third party facilitates the placement of deposits
- The intent of a third party in any arrangement with an IDI
- The payment and type of fees paid by an IDI to a third party

The FDIC broadly interprets "facilitating the placement of deposits" to include any actions by third parties to connect IDIs with prospective depositors. As a result, third-party involvement between a depositor and an IDI generally causes deposits to become brokered and therefore subject to regulatory restrictions governing brokered deposits.

Recent FDIC Guidance, however, provides that brokered deposits may be reclassified for regulatory reporting purposes as non-brokered after a 12-month period during which no third party is involved with the deposit accounts. In this instance, the term third-party involvement includes:

- The IDI retaining the deposit account in the name of a deposit broker as agent for a customer
- A deposit broker continuing to receive fees after a deposit account is opened with the IDI
- A deposit broker having authority to make deposits or initiate withdrawals
- A deposit broker having access to customer account information

Exceptions

While there are a number of exceptions to the definition of deposit broker, the FDIC often construes those exceptions very narrowly. Exceptions are provided for:

- An IDI and its employees (not affiliates—as such term is defined by Sections 23A and 23B of the Federal Reserve Act and implementing Regulation W (12 CFR Part 223)). This exception is applicable to dual-hatted employees or those persons who are exclusively employed by the IDI but who may be licensed to sell securities and financial products on behalf of affiliates:
- An IDI's trust department in the administration of a fiduciary relationship not established for the primary purpose of placing funds in insured deposit accounts
- The trustee of a person or employee benefit plan, in respect of funds of such plan
- The trustee of a testamentary account

As discussed below, an additional exception exists for any third-party agent or nominee whose primary purpose is not the placement of funds with an IDI.

Primary Purpose Exception

The primary purpose exception is governed by the intent of the third-party agent or nominee in the deposit placing arrangement and applies to a third party who places funds with an IDI for a substantial purpose other than to obtain deposit insurance coverage for a customer. FDIC Guidance clearly states that this exception is not applicable if the intent of the third party is to earn fees, either through the IDI or another third party, in connection with the placement of deposits.

In applying the primary purpose test, the FDIC considers the facts and circumstances on a case-by-case basis. 12 USCS § 1831f(g)(2)(I); 12 CFR § 337.6(a)(5)(ii)(I). Where the FDIC has authorized the primary purpose exception, the FDIC has actively monitored and restricted the deposit placing activity. 12 USCS § 1831f(g)(2)(I). The FDIC may require, in connection with such restrictions, routine reporting requirements and regular status updates to ensure that the IDI is complying with applicable brokered deposits restrictions.

Reliance on the primary purpose exception has traditionally required FDIC approval. However, FDIC Guidance released on June 30, 2016, specifies that the primary purpose exception will no longer require a review and determination by the FDIC that the primary purpose exception is applicable in a given instance.

Endorsements

FDIC Guidance outlines a scenario in which deposits received by an IDI through an endorsement are not considered brokered deposits. FDIC Guidance points to an example where a third party makes a general endorsement of an IDI in exchange for a flat fee (i.e., a fee unrelated to the number of accounts or amount of deposits generated by the endorsement). As viewed by the FDIC, endorsements are not considered active marketing or facilitation by a third party on behalf of the IDI, provided that the endorsement does not appear in any promotional materials produced, developed, or disseminated by the third party. In such circumstances, the FDIC will not consider a third party to be a deposit broker. However, to qualify for this exception, the endorsement must appear in promotional materials produced and distributed by the IDI. Therefore, to rely on this exception, no endorsements of the IDI can appear in promotional materials produced or distributed by the third party.

Brokered Deposit Restrictions

The FDI Act and its implementing regulations restrict the use of brokered deposits and the rate of interest paid on such deposits for institutions that are less than "well-capitalized" under prompt corrective action (PCA) standards and regulations. 12 USCS § 1831o; 12 CFR § 337.6. An IDI that is well capitalized under PCA standards, may accept, renew, or roll over brokered deposits without restriction. However, an IDI that becomes "adequately capitalized" under the PCA framework (as shown below), may not accept, renew, or roll over any brokered deposit absent obtaining a waiver from the FDIC, as discussed below. 12 CFR § 337.10. Under no condition may an "undercapitalized," "significantly undercapitalized," or "critically undercapitalized" IDI accept, renew, or roll over brokered deposits.

Prompt Corrective Action Categories

PCA Category	Total Risk-Based Capital (RBC) Threshold Ratio	Tier 1 RBC Threshold Ratio	CET1 Threshold Ratio	Tier 1 Leverage Threshold Ratio
Well capitalized	≥10%	≥8%	≥6.5%	≥5%
Adequately capitalized	≥8%	≥6%	≥4.5%	≥4%
Undercapitalized	< 8%	< 6%	< 4.5%	< 4%
Significantly undercapitalized	< 6%	< 4%	< 3%	< 3%
Critically undercapitalized	Tangible Equity / Total Assets ≤ 2%	Tangible Equity / Total Assets ≤ 2%	Tangible Equity / Total Assets ≤ 2%	Tangible Equity / Total Assets ≤ 2%

Waiver Determinations

The IDI must show good cause in order for the FDIC to approve brokered deposit waiver requests, at the discretion of its board of directors. The FDIC has been increasingly reluctant to grant waivers following the global financial crisis of 2008. Waivers also generally cannot be sought by well capitalized IDIs in anticipation of becoming adequately capitalized.

The waiver application process and FDIC review can take considerable time. If an IDI successfully obtains a waiver, such institution would not be permitted to offer deposits at interest rates of more than 75 basis points above average national rates for deposits of similar size and maturity.

Related Content

For an overview of the capital requirements and related revisions to the prompt corrective action (PCA) framework in connection with regulatory capital adequacy requirements, see

> **BASEL III RISK-BASED CAPITAL REQUIREMENTS**

RESEARCH PATH: *Finance > Fundamentals of Financing Transactions > Regulations Affecting Credit > Practice Notes > Bank Regulation and Lending Powers*

For more information on the key changes to the U.S. bank regulatory capital framework that were created by Dodd-Frank, see

> **SUMMARY OF THE DODD-FRANK ACT BANK CAPITAL REQUIREMENTS**

RESEARCH PATH: *Finance > Fundamentals of Financing Transactions > Regulations Affecting Credit > Practice Notes > The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010*

Related Considerations for IDIs Holding Brokered Deposits

The classification of deposits as brokered can adversely impact IDIs beyond the considerations outlined above. As discussed below, the volume of brokered deposits held by an IDI can, among other things, affect its FDIC deposit insurance assessment rate, liquidity, and overall examination results.

Deposit Insurance Assessments

Holding brokered deposits can increase the deposit insurance assessments paid by an IDI to the FDIC. This increase can be up to 10 basis points depending on the IDI's size, risk profile, and ratio concentration of brokered deposits to core deposits. Under FDIC regulations, the brokered deposit adjustment, which increases an IDI's annual deposit insurance assessment rate, will apply (1) if an IDI's ratio of brokered deposits to domestic deposits exceeds 10% and (2) either (a) the IDI is not well capitalized under PCA standards, or (b) the IDI has a composite supervisory group rating (CAMELS rating) below a 2.

Liquidity Concerns

The Liquidity Coverage Ratio (LCR), as implemented by the federal bank regulatory agencies and codified at 12 CFR Part 249, requires and assumes that the outflow rate applicable to brokered deposits is higher than the corresponding outflow rate applicable to core deposits. As a result, banking organizations subject to the LCR that rely on brokered deposits are encouraged to include PCA-related downgrade triggers as part of their contingency funding plans.

Strategic Planning Considerations

Advisors to IDIs are encouraged to review FDIC Guidance and FDIC Advisory Opinions addressing brokered deposits exceptions. Counsel should also review the implications of holding brokered deposits with IDIs. For those well capitalized institutions that might foreseeably be downgraded to a lower PCA category, the IDI's management and board of directors should analyze alternative liquidity and funding sources and be prepared to discuss the results of such analysis with federal regulatory examination staff.

IDIs should also actively manage their liquidity and capital levels to maintain sufficient buffers to protect against any PCA downgrade or significant change in deposits. In connection with an IDI's strategic planning efforts, practitioners should work closely with IDIs to establish deposit concentration limits and memorialize deposit thresholds in the IDI's internal policies. With respect to brokered deposits, an IDI's internal policies should, at a minimum, address the institution's internal objectives and processes for measuring and managing liquidity risk.

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RESEARCH PATH: *Finance > Fundamentals of Financing Transaction > Regulations Affecting Credit > Practice Notes > Other Regulatory Issues*

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The Bona Fide Prospective Purchaser Defense in Bankruptcy

Under the Comprehensive Environmental Response, Compensation, and Liability Act (42 U.S.C. § 9601 et seq.) (CERCLA), current owners and operators of real property are strictly liable for costs to clean up environmental contamination regardless of whether the contamination existed prior to their ownership. Upon closing, a purchaser becomes a current owner under the statute and, therefore, has strict liability for such costs.[1]

THIS RESULTS IN ENVIRONMENTALLY CONTAMINATED properties typically having a significantly reduced market value and may render them completely unsellable. The rarely used Bona Fide Prospective Purchaser (BFPP) defense, however, may completely shield a prospective purchaser from CERCLA liability stemming from preexisting contamination and may facilitate the alienability of the contaminated property.

The BFPP defense shields a prospective purchaser from liability relating to contamination existing at the time of purchase even where the purchaser has knowledge of the contamination prior to closing. To avail itself of the BFPP defense, the prospective purchaser must meet the requirements of 42 U.S.C. §§ 9601(40), 9607(r). Most notably the prospective purchaser must (1) complete "all appropriate inquiries" (typically, a Phase I Site Assessment and sometimes a Phase II Site Assessment); (2) not cause the contamination at issue; (3) provide legally required notices with respect to the release of hazardous materials or contamination at the property; (4) provide appropriate care with respect to the contamination, including taking steps to stop any continuing release and prevent any threatened future release; (5) comply with government requests in connection with the cleanup; and (6) not be affiliated with any party that is potentially liable for the contamination.[2]

The standards discussed above require an extremely fact-specific inquiry and make it difficult for a prospective purchaser to acquire property with comfort that it is protected from environmental liabilities without a prior judicial determination. Since courts are hesitant to provide advisory opinions, the BFPP defense has rarely provided assurance to prospective purchasers.

1. 42 U.S.C. § 9601 and 1-1 Environmental Law in Real Est. & Bus. Transactions § 1.03. 2. See 42 U.S.C. § 9601(40).

CURRENT TENANTS ARE DEEMED CURRENT OPERATORS UNDER CERCLA AND, THEREFORE, HAVE STRICT LIABILITY FOR CLEAN-UP COSTS REGARDLESS OF FAULT.

A prospective purchaser, however, may find a way to avail itself of the protections of the BFPP defense through a bankruptcy sale. Upon a debtor's bankruptcy filing, the bankruptcy court retains jurisdiction over the debtor's assets. A debtor or bankruptcy trustee may sell the debtor's assets pursuant to Section 363 of the Bankruptcy Code (11 U.S.C. § 363). A Section 363 sale may only close after the bankruptcy court authorizes the sale to proceed by court order either upon motion on 21 days' notice to all interested parties or pursuant to a Chapter 11 plan, which requires a slightly longer timeframe but may provide other benefits such as exempting the transaction from transfer taxes.[3]

Since the sale may be approved by bankruptcy court order on relatively short notice, a unique opportunity is presented. The prospective purchaser of environmentally contaminated property can negotiate a closing condition that requires the prospective purchaser to close only if the court order declares the prospective purchaser as a BFPP. If the parties agree to this closing condition, a specific provision should be added to the purchase and sale agreement to reflect the prospective purchaser's conditional obligation to close and specify which party bears the costs of any proceedings associated with the bankruptcy filing and related BFPP determination. If ultimately granted, such relief would provide the prospective purchaser with an ironclad shield from CERCLA liability (subject to certain straightforward future obligations set forth in 42 U.S.C. § 9601(40)). The court would likely grant the relief upon a showing that the prospective purchaser satisfies the respective BFPP defense elements listed above.

This strategy presents the best of both worlds. The prospective purchaser will acquire the property with BFPP protection and the seller will realize maximum value for the sale. It should be noted, however, that the BFPP defense is only a defense with respect to CERCLA liability, and the potential purchaser should take care to evaluate any other liabilities that may exist under state or local laws. Notably, similar defenses are available to shield prospective purchasers from liability under state laws.[4]

Assuming the negotiations initially take place outside of the bankruptcy arena, the following is an outline of a strategy that sellers and prospective purchasers may implement to obtain BFPP protection for a prospective purchaser:

- Once a prospective purchaser decides to acquire the property if it can obtain BFPP protection, the prospective purchaser should approach the seller with its proposal (including entering into negotiations about closing conditions, any price reduction, sharing of costs, and extension of the closing date).
- If parties come to an agreement as to the terms of the transaction, the property owner should transfer ownership of the property to a special purpose entity (SPE). The SPE will have no assets other than the property, which will make the bankruptcy of the SPE distinct from other assets the seller may own.
- In exchange for title, the SPE will provide the transferee-property owner with a promissory note in the amount of the fair market value for the property. The sole asset of the SPE will then be the contaminated real property, and the sole creditor of the SPE will be the transferee-former property owner.
- The SPE would then file for Chapter 11 bankruptcy protection and contemporaneously file a motion to sell the real property to the prospective purchaser or a motion to confirm a pre-packaged Chapter 11 plan of reorganization. Notably, if the sale occurs within the context of a Chapter 11 plan, the transaction would be exempt from transfer taxes.
- The motion or plan will request that the purchaser be considered a BFPP and provide the requisite support necessary for the court to make such a determination.
- If the court agrees, the court will enter an order specifically declaring the prospective purchaser a BFPP and authorize the sale.
- The sale will then close, title will be transferred to the purchaser, and the purchaser will be shielded from CERCLA liability (subject to certain future obligations, as discussed above).
- The net sale proceeds would then flow from the SPE debtor to the transferee-former owner since the transferee is the sole creditor of the SPE.

This strategy can similarly be used for prospective assignees seeking to acquire lease rights at a contaminated property. Current tenants are deemed current operators under CERCLA and, therefore, have strict liability for clean-up costs regardless

3. See 11 U.S.C. § 363, 1146(a). 4. See, e.g., N.Y. E.C.L. § 27-1323(4).

Related Content

For additional information about environmental due diligence, see

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

RESEARCH PATH: *Real Estate > Commercial Purchase and Sales > Due Diligence > Practice Notes > Environmental Due Diligence*

For more information on bankruptcy in real estate transactions, see

> **WHEN A PURCHASER OR SELLER OF REAL PROPERTY GOES BANKRUPT**

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

Other LexisNexis Resources:

> **1-1 ENVIRONMENTAL LAW IN REAL EST. & BUS. TRANSACTIONS § 1.03**

of fault. Upon closing of a lease right sale, an assignee-tenant may fall into the current operator category and, therefore, will have strict liability for clean-up costs.

Under Section 365 of the Bankruptcy Code (11 U.S.C. § 365), a debtor or trustee may assume and assign its rights under a lease agreement to a third party. Such assignment may only occur with authorization from the bankruptcy court. Similar to a Section 363 order, the Section 365 bankruptcy court order authorizing the assignment could shield the assignee from CERCLA liability by holding that the assignee is a BFPP. This will provide the assignee with comfort that it is shielded from CERCLA liability and will enable the debtor or trustee to maximize the sale price for the lease rights. L

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

Proxy Season 2017

Q&A with Keir Gumbs

PARTNER AT COVINGTON & BURLING LLP

Keir Gumbs, vice chair of the Securities & Capital Markets Group and partner in the Washington, D.C. office of Covington & Burling LLP, regularly provides insights about the trends he observes in securities law and shareholder activism. Prior to joining Covington & Burling, Keir served in the Office of Chief Counsel in the SEC's Division of Corporation Finance and as Counsel to SEC Commissioner Roel C. Campos. He provides a unique perspective on corporate governance as a result of his public service and private practice experience. We recently sat down again with Keir and asked him to update our readers on the major issues that he is seeing during the 2017 proxy season.

Keir Gumbs

COVINGTON
COVINGTON & BURLING LLP

Institutional Shareholder Services (ISS) and Glass Lewis have announced modifications and updates to some of their proxy voting guidelines for the 2017 proxy season. These include guidelines relating to issues such as equity compensation plans, cash and equity incentive plans, say-on-pay proposals, director compensation, director overboarding, and undue restrictions on shareholders' ability to amend the bylaws. Where do you think ISS and Glass Lewis will have the most significant impact on corporate governance during the 2017 proxy season?

I think that proxy advisory firms as a general matter have historically had the most influence, and will continue to have that influence, with respect to executive compensation, and specifically with respect to their evaluation metrics and methodology for executive compensation that's been paid and for employee benefit plans, such as stock plans, incentive plans, and things of that nature. That is interesting because their recommendations with respect to director elections get a lot of attention, and their say-on-pay recommendations get a lot of attention, but I think that when you get down to it, where they have the most influence over decision-making by companies is in executive compensation plan design.

As an example, if a client is working on an equity compensation plan, and we're thinking about tax requirements, governance practices, best practices, and things of that nature, all of those things are very important because basically you want to comply with the law. But the place where otherwise a company would be unconstrained is with some of the elements of the plan design, such as limits on the types of awards that can be given, the level of specificity with respect to performance measures, limits on individual compensation that can be awarded under the plan, things of that nature, and most importantly, how much they can seek approval of for the plan to the extent that it is an equity incentive plan. And with respect to that question, particularly, I found in practice that ISS and Glass Lewis have an outsized influence.

I have seen clients dramatically change the incentive plans that they were going to seek shareholder approval of in response to expected concerns by ISS or Glass Lewis. I don't think that is going to change in 2017. I don't know that it's going to be much more pronounced in 2017 than it was in prior years, but I do continue to think that's the most significant influence that they have.

The next most important and influential area is probably around shareholder proposals, and this one I think can be a bit of a surprise because when people think about shareholder proposals, they think of them as the precatory requests that get sent in by shareholders that companies are not obligated to pursue. I think that's generally right, except that if you have a shareholder proposal that is approved by a majority of the shareholders, then there is the expectation that you will take action on it, or there is a risk that ISS or Glass Lewis will recommend or withhold votes against your directors the following year. That has really changed the dynamic around shareholder proposals. So companies spend a lot more time and money thinking about proposals when they get them, thinking about whether to implement them and, if so, how. To the extent that a company is not going to implement a shareholder proposal, the company is thinking very hard about what it needs to do in order to ensure that the proposal does not pass, because if it does pass, they have to do something. Those are the two areas that ISS and Glass Lewis have had the most significant influence historically, and I don't think that is going to change this year.

The SEC staff granted a number of no-action requests that were sought by companies in 2016. In light of the presidential election results, do you expect an increase in no-action requests by companies, and what do you expect the SEC response to be to no-action requests during 2017?

Regarding the influence that the Trump administration and the impending change at the SEC will have over shareholder proposals, for the most part, changes in administrations don't really influence in a very meaningful way the manner in which the SEC evaluates and decides no-action requests related to shareholder proposals. When I was at the SEC under the Bush administration, the White House and the White House's views on issues almost never, if ever, influenced decisions. I can't think of any instances where it influenced our decision-making process. We certainly were aware of the environment in which the decisions that we were making would be received and how that might influence the debate that was taking place, but at the end of the day we always looked at what does the rule say, what does the case law say, what does our precedent say, and based our decision on those factors. So I don't think that's going to change under this administration.

However, I do think there are other ways in which the change in administration can indirectly impact shareholder proposals and corporate governance and actually proxy access is a tremendous example of that. I'll give you two very specific ways in which the SEC and the leadership of the SEC influenced the proxy access debate. If you remember, 20 years ago proxy access did not exist. It was something that shareholders were asking for, but not something that the SEC had at that point been able to successfully address through rule-making or otherwise.

Under Mary Shapiro's tenure, the staff was evaluating two rule-making proposals relating to proxy access. One that would make proxy access universally required, and another where it would allow shareholders to submit proxy access shareholder proposals, which before they could not do. As I understand it, the SEC was debating these questions: Should we adopt both rules, should we just follow one approach, and if so, which approach is the best one? Should we just use the universal mandatory rule, or should we allow both of them? Ultimately after some significant debate, Chairwoman Schapiro decided to move forward with both proposals.

And at that time, most people, including me, looked at that decision and thought, "This is very odd." Because on one hand you have the universal proxy rule that all companies will be subject to, and at the same time they were adopting shareholder proposal amendments that allowed shareholders to basically enhance or expand those proxy access rights through the shareholder proposal process. It seemed odd, almost like a "belt and suspender" approach to proxy access.

In hindsight it turned out to be a genius move for someone who was an advocate for proxy access. That's because the rule that would have imposed proxy access on all public companies went away the following year. So then the SEC was stuck with the shareholder proposal amendments, which eventually allowed the creation and proliferation of proxy access regimes through the shareholder proposal process. When we look today at the number of companies that have adopted proxy access, which is somewhere over 400 in the beginning of March, we see the direct result of that decision by SEC Chairwoman Mary Shapiro. So that's one example of how decision-making by leadership at the SEC can directly influence no-action letters and ultimately corporate governance.

Similarly, two years ago SEC Chair Mary Jo White made a decision that significantly impacted the trajectory of proxy access. Under the shareholder proposal rule, there is an exclusion that lets a company exclude a proposal on the basis that it conflicts with a management proposal. The way it worked, as long as the two proposals addressed the same topic, even if the management proposal and the shareholder proposal were doing the opposite things, a company could exclude the proposal on the basis that they conflicted with each other. In the context of proxy access shareholder proposals, a lot of companies were thinking about adopting or putting forth their own management proposals relating to proxy access that would have taken a very different approach. For example, the shareholder proposal could have requested a proxy access bylaw with a 3% minimum ownership, and the company's proposal could impose a 5% or 7% minimum ownership requirement. Many companies wrote into the SEC to exclude those shareholder proposals on the basis that they conflicted with management proposals seeking to impose more restrictive thresholds.

Initially, the SEC staff agreed with companies that they could exclude proxy access proposals under the conflicting proposal exclusion because that position was consistent with what the staff had done historically from a no-action letter perspective. Then came letters and other expressions of concern from a number of institutional investors, including the Council of Institutional Investors and CalPERS, all pointing out that this was an outcome that would permit companies to undermine proxy access through the adoption of management proxy access bylaws that were significantly more onerous and basically made it impossible for shareholders to use.

SEC Chair Mary Jo White heard some of those concerns and directed the staff to stop issuing no-action letters based upon the conflicting proposal exclusion, at least until the staff could review the exclusion and decide if it made sense to apply it as had been applied historically. Following that review, the staff dramatically narrowed the way that they interpreted the conflicting proposal exclusion under Rule 14a-8, which meant that companies that wanted to exclude proxy access shareholder proposals either had to find a deficiency in the proposal, which is pretty hard to do since they are pretty well drafted, or they had to adopt their own proxy access bylaws and argue that they were substantially implemented. That result dramatically increased the uptick of proxy access bylaws between 2014 and 2017.

I think that decision by Mary Jo White is probably the single most significant decision impacting proxy access in the last 20 years, other than the previous decision by Mary Shapiro. But I think these illustrate the significant ways in which the next chair of the SEC could conceivably impact shareholder proposals going forward.

Dodd-Frank required companies to obtain shareholder approval of say-on-frequency, setting the time periods for shareholder votes on say-on-pay to one, two, or three years. The first round of say-on-frequency approvals occurred in 2011, and those companies are required to conduct the next round in 2017. How are companies handling this requirement in 2017, and what time period do you think most companies are asking for this year?

The first time around, I think companies went out with proposals that they actually wanted. Companies wanted three years because they thought it aligned well with their compensation plans, gave them more time to plan and prepare, and they weren't in this constant cycle of responding to or preparing for say-on-pay votes. Nevertheless, shareholders overwhelming favored an annual say-on-pay vote, so that's what most companies ultimately ended up with. The last number I saw was that 90% of companies had adopted an annual say-on-pay vote. So looking forward to this year, I think most companies, with maybe a few exceptions such as controlled companies, have decided that they are just going to ask for annual votes.

Why create an issue with shareholders when they don't have to? Most shareholders are used to doing one-year; most companies are used to doing say-on-pay every year. In terms of votes, most votes have been in favor of say-on-pay. Somewhere around 89% of companies received more than 90% approval on their say-on-pay vote. Because of that, I think companies would be loath to go back to where we were in 2011 and upset the apple cart by asking for triennial votes rather than annual. There will certainly be some companies that request triennial votes, but I think most companies have decided that annual say-on-pay votes are something that they are used to, so why create a lot of drama around something that is unnecessary?

What is the status of Dodd-Frank in 2017 as it relates to corporate governance, and do you have a prediction on what Congress and President Trump will do in 2017 with Dodd-Frank, both as to the existing regulations that have already been promulgated and the remaining areas where regulations have not yet been promulgated?

That is a million-dollar question. There are some things we can say with 100% certainty. I am 100% confident that the

drafts or proposals or even the adopted Dodd-Frank rules relating to corporate governance and executive compensation are not going to stay the same. For example, the pay-ratio rule is set to go into effect for next year, and the acting chair has already taken steps against the rule. It is highly likely that the SEC will either give some sort of exemptive relief to categories of companies from that rule or there will be temporary relief for everyone. They may suspend the rule for a year so they can do more study and evaluation, or there is the possibility that they will go back to the well and try to amend the rule in a way that makes it more business-friendly or at least less onerous.

And that's just at the SEC. Of course, there is the possibility that there may be a legislative attack on the pay-ratio rule that could eliminate the rule entirely or modify it substantially. My own view, and I think that of most observers, is that something is going to change and that the way that it is going to change is that these rules will either be amended substantially so that they are less burdensome for companies or that they will be temporarily halted. And of course there is the possibility that they will be repealed. I think that is the case for every single one of the Dodd-Frank rules.

Let me just say as an editorial, I thing getting rid of all of them is an overreaction. We just talked about the say-on-pay vote. The say-on-pay vote, while it had no direct correlation to the financial crisis, is easily one of the most significant corporate governance developments in the last decade because it has radically changed the way companies and investors engage. Before say-on-pay, some companies, maybe best-in-practice leading companies, engaged with their investors regularly. I'm not talking about dealing with analysts, I'm talking about going out and meeting with your investors and asking them what their governance concerns are, talking about company performance and executive compensation, all of those things. That happened, but a lot more sparingly than it happened after say-on-pay.

Today I think it is fair to say that most public companies that are subject to the say-on-pay vote engage in some form of investor engagement, whereas that was simply just not the case 10 to 20 years ago. I think that the rule has had a very meaningful positive impact on the way that companies engage with investors. So say-on-pay, while people could still engage without the rule, has given companies and investors good reason to get together and talk about how their relationship is going. A legislative focus on repealing on say-on-pay would miss the boat.

There is actually a great benefit that companies get from the say-on-pay vote, which I don't think Congress is necessarily aware of. Right now the proxy advisory firms use the say-on-pay vote to express their satisfaction or dissatisfaction with a company's executive compensation practices. They like what you are doing, they vote for say-on-pay; they don't like what you are doing, they don't vote for say-on-pay. But most importantly, they are not voting against your compensation committee members or the chair of your compensation committee. If you take say-on-pay away, you no longer have the say-on-pay vote as the buffer. I think it is much better for everyone to have this advisory vote where investors can register their dissent.

There appears to have been a move toward more transparency by corporations in dealings with shareholders, especially with large institutional shareholders. Do you think this is something that will continue?

It depends. People like transparency when they have good things to show. I think conceptually the idea of more transparency is definitely taking hold. But what that transparency looks like is the question.

I'll give you a great example—political spending. I think the ship on political spending has sailed. Most companies provide some level of detail around political spending and lobbying. However, that transparency only goes so far right now. For example, even among leading political disclosures, you will find very little information about trade associations and 501(c)(4)s and other types of tax-exempt organizations to which or through which companies engage in political activities. There is more transparency around these types of expenditures than was the case historically, but there is still a pretty significant disagreement between companies and shareholders about what is relevant for transparency disclosures, such as payments to and participation in trade associations and 501(c)(4) organizations.

Large public pension plans, public advocacy groups, proxy advisory organizations, and public officials such as Mary Jo White, have called for increased board diversity, especially gender diversity. Will the push for board diversity be a significant issue during the 2017 proxy season, and what do you see as the future of proposals for increased board diversity?

I think that among the investor crowd it will continue to be an issue. Even globally, board diversity is an issue that is not going away. But I think there is an important question about whether there are going to be any regulatory requirements that companies take action with respect to diversity. Whether with respect to disclosure about their diversity or the lack thereof in many cases, or just disclosure about their policies with respect to diversity, I think that is an open question.

Under a Clinton administration, I would have taken it for granted that there would have been rulemaking on the subject. Mary Jo White had directed the staff to explore potential rules relating to board diversity, and most institutional investors, certainly the large public pension plans, had expressed very strong support for the idea of enhancing diversity disclosures. But with the new administration, I think there will be more of a do-no-harm regulatory mindset. I think they are going to be a lot more focused on what do we need to do, what is an actual market requirement, as opposed to something that investors might like to have. So voluntary rulemakings, like board diversity, are likely to go away at least from a regulatory perspective even if shareholder advocacy on the topic continues.

Many institutional investors are considering a company's position on environmental and social issues when making investment decisions and are also submitting shareholder proposals that relate to environmental issues and climate change. What does the environmental battlefield look like for the 2017 proxy season? And are companies going to feel pressure in the future to disclose the financial impact that climate change may have on their operations?

With respect to climate change and environmental-related rule-makings or interpretive guidance, I think it's just not going to happen under this administration. Jay Clayton may come in as SEC Chair—from the perspective of a securities practitioner, he's got the experience. He knows what it's like to prepare these filings, he's been advising companies on compliance, disclosure, and governance; I think he gets it. From the perspective of someone who deals with the agency, and who loves securities law and who loves the policy issues related to securities regulation, it's comforting to know that he is someone who actually knows what the SEC does. Just like his predecessors, he is well-versed in securities regulation issues.

But for things like climate change and other environmental and social issues, it's a much more complicated picture: trying to figure out whether those kinds of factors are material in all circumstances, and if material at all, what about those issues are material; how do you describe those issues; and in the context of a rulemaking, which is extremely relevant to this administration, how do you demonstrate from a cost-benefit analysis that the disclosure or enhanced transparency or governance is going to benefit investors? I think that's a really hard thing to do.

I personally think these are important issues, but it is one thing to say that they are important qualitatively, but an entirely different thing to be able to say that investor confidence will go up this much, that the stock market will benefit that much, or that such disclosures would benefit the economy by a specified amount. In the absence of compelling data of that nature, it is highly unlikely that the SEC will do anything beyond what it has already done, which is basically saying that these issues are important and putting out guidance that explains for markets and for companies how they think climate change and environmental issues can be material, or the circumstances in which they can become material. I'd be very surprised if they do anything more than that.

Do you have any other observations or predictions about the 2017 proxy season? Are there any common themes emerging in the advice that clients are seeking related to this year's proxy season?

First, more of an observation rather than a prediction—proxy access continues to proliferate every day. We have a chart that we prepare that keeps track of proxy access adoptions and what provisions are included. It's hard to keep up. We had 32 new proxy access adoptions last month, and I think that is going to continue. Right now, many of the proxy access shareholder proposals that have been submitted or the bylaws that have been adopted are concentrated among the larger public companies, and I don't think people should assume that will continue to be the case. I think some institutional and retail investors are starting to take the concept of proxy access and try to push it down to smaller public companies. So we may end up in a world where more companies have proxy access.

The role of no-action letters is also incredibly important. Last year, a number of companies were able to exclude proxy access proposals under Rule 14a-8(i)(10) on the basis that they were substantially implemented by proxy access bylaws that those companies had adopted. This year there has been a change in the approach by shareholders. In addition to submitting proxy access shareholder proposals to companies that have not adopted proxy access, they have also started submitting what we call "fix-it" or "proxy access 2.0" shareholder proposals. These basically seek to ask companies to modify proxy access bylaws that they adopted in prior years.

These proposals raise a real question for the SEC staff. If a company has adopted proxy access already, such that they have adopted eight out of eleven provisions that the shareholders are asking for, what do you do when you have a shareholder that comes in the following year and is just focused on one of those provisions, like aggregation? That is what has happened this year. You have a bunch of companies that have adopted proxy access that this year received shareholder proposals that were only focused on the aggregation provisions included in those bylaws. Most of those proposals were looking to require companies to allow larger groups of shareholders, up to 50 shareholders as opposed to 20, to aggregate their shares in order to satisfy the minimum ownership requirements of their proxy access bylaws.

There have been a number of no-action letters from the SEC that addressed those proposals, and they are very hard to parse. There are a number of letters that came out on February 10, and in about half of them the SEC granted no-action and about half were denied. I think it is now pretty clear that companies that have adopted proxy access that receive one of these proxy access 2.0 proposals can exclude them if they can demonstrate through a share analysis, which is what many companies have done, that the amendment being sought by the shareholder proposal will have an immaterial impact on the number of shareholders that can rely on the company's proxy access bylaw.

Finally, it's very clear to me that the pendulum from a regulatory perspective is swinging in the opposite direction. Historically there has been a broadening and expansion of the SEC's influence in corporate governance and in securities regulation more broadly. In light of the changes in administration, that pendulum is going to swing in the opposite direction, at least from a regulatory perspective. But I don't think that is the end of the story.

The other piece of the ecosystem that is corporate governance is shareholders. My expectation is that going into the 2018 proxy season, as companies begin to get shareholder proposals, companies will get more shareholder proposals than they have received historically and that there will be more shareholder advocacy than there has been historically.

In addition, if some of the Dodd-Frank-related rules that the SEC adopted or is considering are repealed or watered down, I would fully expect that shareholders will pick up those additional provisions or requirements and incorporate them into shareholder proposals. For example, more shareholder proposals on pay ratio, shareholder proposals on pay for performance, proposals on clawbacks, hedging—all of those things that shareholders may have taken for granted because they were part of the regulatory scheme implemented following Dodd-Frank. So the pendulum of shareholder activism may swing toward more activism. L

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RESEARCH PATH: *Capital Markets & Corporate Governance > Proxy Statement and Annual Meeting > Shareholder Activism > Articles > Excluding Shareholder Proposals and Seeking No-Action Letters*

Devika Kewalramani MOSES & SINGER LLP

IN-HOUSE COUNSEL SANCTIONS: RECENT TRENDS

Disgorgement of legal fees is a harsh, but not unusual, penalty. Although this unforgiving sanction is more frequently imposed on outside counsel, it is not uncommon for in-house counsel to be required to disgorge and forfeit their compensation due to ethical violations.

CALIFORNIA HAS HISTORICALLY BEEN ONE OF THE stricter jurisdictions regarding disgorgement of outside counsel's legal fees. For example, in 2016, the California Court of Appeals required a law firm to disgorge $3.8 million based on the firm's failure to adequately disclose an actual conflict of interest between two existing clients.[1] California courts have also held fee forfeiture to be an appropriate remedy where outside counsel's personal conflict involving business transactions with his client permeated their entire relationship, leading to egregious ethical misconduct.[2]

Similarly, the U.S. Court of Appeals for the District of Columbia Circuit ordered outside counsel to pay their former client nearly $500,000—an amount representing a portion of the legal fees the attorney collected from the client, plus interest—due to an undisclosed current client conflict.[3] Likewise, New York courts have held that "[a]n attorney who engages in misconduct by violating the Rules of Professional Conduct [] is not entitled to legal fees for any services rendered."[4]

In-house counsel, like their outside counsel counterparts, are not shielded from being compelled by courts to disgorge their compensation as a remedy for violation of their ethical duties. For example, in 2015, the Supreme Court of New Jersey held that a corporate employer may seek disgorgement of a disloyal general counsel's compensation as a remedy for breaching the duty of loyalty, regardless of a finding of economic loss.[5]

Taking center stage in 2016 was another disgorgement case involving in-house counsel's ethical breaches, where the court engaged in an in-depth comparative analysis of the ethical issues impacting in-house counsel in the corporate setting. In Chism v. Tri-State Constr., Inc., 193 Wn. App. 818 (Wash. Ct. App. 2016), the Court of Appeals of Washington addressed whether the general counsel violated his ethical obligations to his corporate client by examining the key distinctions between lawyer/employee–client/employer arrangements on the one hand and conventional attorney-client relationships on the other, with a particular focus on wages and legal fees.

In the *Chism* case, a lawyer who formerly acted as outside counsel for a closely-held construction company became its general counsel in 2008 and was compensated with an annual salary of $190,000. Around that time, he admitted to spending only an average of 7.5 hours per week on legal work for the company and worked primarily from home. In 2011, he proposed being paid a $500,000 bonus, and the company's president, who was suffering from Alzheimer's disease, agreed. Ultimately, the company refused to pay the requested bonus and an additional bonus of $250,000, and the general counsel sued the company.

At trial, the jury found that the general counsel's bonus agreements were not the product of undue influence, and awarded him $750,000 for breach of compensation contracts by his former employer, plus $750,000 as exemplary damages for unlawful wage withholding. However, following the jury verdict, the judge ruled that the general counsel had violated his ethical and fiduciary duties when he negotiated his bonus payments with the company's Alzheimer's-stricken principal. The judge ordered him to disgorge $1.1 million of his award, premised on violations of Rule 1.5 (fees), Rule 1.7 (current client conflicts of interest), Rule 1.8 (business transactions with clients), and Rule 8.4 (misconduct) of the Washington Rules of Professional Conduct (which are based on the ABA Model Rules).

On appeal, the Court of Appeals of Washington reviewed the ethics rules individually to determine whether in-house counsel are bound by ethical and fiduciary obligations when negotiating compensation arrangements with their corporate employers and whether in-house counsel may be ordered to disgorge wages the same way outside counsel are required for breach of ethical or fiduciary duties to clients, as discussed below.

- **Legal Fees (Rule 1.5)**
  Under Rule 1.5, a lawyer is prohibited from agreeing to, charging, or collecting an unreasonable fee. The Court of Appeals rejected the company's claim that the general counsel violated the rule by negotiating substantial compensation in addition to his salary and benefits. The Court concluded that there is an absence of authority from Washington and elsewhere to support expanding Rule 1.5's application to "fees" to "wages contracts" in order to allow disgorgement.

- **Current Client Conflicts of Interest (Rule 1.7)**
  Rule 1.7 bars a lawyer from representing a client if there is a significant risk that the representation will be materially limited by the lawyer's personal interest. The Court of Appeals disagreed with the trial court's ruling that it was a conflict of interest for the general counsel to negotiate his $500,000 bonus with the company, without fully disclosing his self-interest in the transaction and the potential risks to the company. The Court observed that for a conflict to exist, the general counsel had to have "represented [the company] in its negotiations over his own wages" which would "cast doubt on the wage negotiations of scores of Washington attorneys—not only in-house corporate counsel…but also government attorneys and numerous nonprofit attorneys." The Court held that the trial court exceeded its authority by issuing a disgorgement order for a lawyer-employee's negotiation of a wage increase, noting its "unprecedented application of [Rule] 1.7 to in-house counsel" and the absence of supporting authority.

- **Business Transactions with Clients (Rule 1.8)**
  Under Rule 1.8, a lawyer is forbidden from entering into a business transaction with a client, unless the transaction is fair and reasonable to the client, after making full disclosure and advising it to consult separate counsel on the transaction. The Court of Appeals rejected the trial court's finding that the general counsel violated the rule by improperly negotiating his bonus arrangement and payment with the company without full disclosure and advice to confer with outside counsel. The Court clarified that there are "essential differences between fee agreements and wage contracts" and that if the rule were interpreted to include compensation agreements between a lawyer-employee and a current client-employer, then every agreement increasing a lawyer-employee's wages or benefits would fall within the rule. Given the lack of authority, the Court of Appeals declined to extend application of Rule 1.8 to the general counsel's conduct.

- **Misconduct (Rule 8.4)**
  Finally, Rule 8.4(c) proscribes a lawyer from engaging in conduct involving misrepresentation. The trial court held that the general counsel violated the rule by making numerous misrepresentations and providing "unreliable estimates" to the company regarding the hours he worked during specific time periods relating to his bonus arrangement and compensation package. The Court of Appeals disagreed with the trial court, noting that he supplied a "best estimate" of hours worked, and left to the company's discretion how to ascertain the bonus amount, without breaching the rule.

Ultimately, the Court of Appeals of Washington held that while a court has the authority to disgorge outside counsel's legal fees for breaches of ethical duties, courts are not empowered to disgorge in-house counsel's wages as a sanction for ethical violations. The Court noted that there are "important differences in the treatment of attorney fees versus wages" and observed that "whereas our Supreme Court has actively regulated attorney fees…it has not at all regulated attorney wages," and eventually concluded that "lawyer-employees are protected by the same wage and hour laws that apply to employees in comparable positions." Accordingly, the Court of Appeals reversed the trial court's ruling based upon novel interpretations of the ethics rules and remanded the case for entry of judgment consistent with the jury's verdict.

1. Sheppard Mullin Richter & Hampton LLP v. J-M Mfg. Co., 244 Cal. App. 4th 590 (Cal App. 4th 2016). 2. Fair v. Bakhtiari 195 Cal. App. 4th 1135 (Cal App. 2d 2011). 3. So v. Suchanek, 670 F.3d 1304 (D.C. Cir. 2012). 4. Shelton v. Shelton, 151 A.D.2d 659 (2d Dept. 1989), citing Brill v. Friends World Coll., 133 A.D.2d 729 (N.Y. App. Div. 1987). 5. Kaye v. Rosefielde, 223 N.J. 218 (N.J. 2015).

WHEN WEARING DIFFERENT HATS AS LEGAL/BUSINESS ADVISORS AND CORPORATE EMPLOYEES, IN-HOUSE COUNSEL MAY NEED TO CONSIDER PAYING SPECIAL ATTENTION TO THE CONTEXT AND CONTENT OF THEIR INTERACTIONS WITH THEIR COMPANIES, INCLUDING MAKING APPROPRIATE DISCLOSURES AND OBTAINING WRITTEN CONSENTS…

Disgorgement for ethical violations, while historically rare for in-house counsel, nonetheless appears to be an emerging trend as courts are more frequently awarding this form of remedy as a result of ethical violations. Review of *Chism* was sought and denied by the state's highest court. Chism v. Tri-State Constr., Inc., 186 Wn.2d 1013 (Wash. 2016).

The *Chism* case has been closely watched with mixed reactions from a cross-section of the legal community. The case underscores some important considerations for in-house counsel to keep in mind whenever they negotiate compensation packages or other agreements with their corporate clients. When wearing different hats as legal/business advisors and corporate employees, in-house counsel may need to consider paying special attention to the context and content of their interactions with their companies, including making appropriate disclosures and obtaining written consents, advising their companies to consult separate counsel where necessary, and clarifying the nature, scope, and implications of any employer/employee agreements they may enter into.

Undoubtedly, *Chism* is a unique case that sheds light on a number of important issues involving in-house counsel's relationship with a client-employer that appear to not have been addressed as closely by a U.S. court before. For example, what is the nature of in-house counsel's role; how is in-house counsel to be compensated; what ethical duties are owed to a corporate employer; and are in-house counsel akin to outside counsel who are regulated by the ethics rules and have a fiduciary relationship with their clients, or are in-house counsel comparable to corporate executives who are not governed by the ethics rules, but may owe certain fiduciary-type duties to the client-employer? These questions may arise for in-house counsel in jurisdictions around the country, regardless of where they are admitted or licensed and who their corporate employer is. The answers are not always clear.

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Related Content

For guidance on the application of the ABA Model Rules of Professional Conduct to in-house counsel, see

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Private Equity Co-investments Guide: Issues to Spot and Raise When Making a Direct Co-investment

INVESTORS OF MANY DIFFERENT STRIPES ARE EAGER to participate in private equity transactions as equity co-investors alongside private equity sponsors who source, lead, and execute on investment opportunities. These investors hail from portions of the financial landscape as diverse as hedge funds, strategic investors, high net worth individuals, and select limited partners in the sponsors' funds. Some investment funds themselves are dedicated to making equity co-investments as their primary investment mandate. Direct co-investment opportunities are prized in these investor communities because they offer the potential for superior economic return. Direct co-investments reside outside of the lead sponsor's fund. As a result, a co-investor's economic return is not reduced by the carried interest paid by the fund to the sponsor. The trade-off, if there is one, is that investments made outside the fund may result in greater concentration of risk than an investment made in the fund itself, as co-investors will typically invest in only some (and perhaps only one) of the investments made by the fund. Co-investors can mitigate this risk by attempting to build their own portfolio of co-investments, similar to the way a lead sponsor builds a portfolio within each fund.

The market for co-investment opportunities can be quite competitive. A user-friendly reputation and an ability to execute on deals quickly can be important factors in attracting and securing these opportunities. Co-investors typically enter the scene later in the overall timeline of a transaction,

after the sponsor has sourced the deal, completed substantial due diligence, and made significant progress in negotiating terms with the target company. Given these circumstances, co-investors may be asked to review and respond to draft documentation on short turnaround times, making decisions about what truly matters, what is a nice-to-have, and what they can live without in the deal's terms.

This article is intended to provide a guide for co-investors to identify and understand key topics that should be raised in negotiating terms for their co-investments and which initial drafts of the co-investment documents often do not address or address inadequately. This article contemplates a transaction structured as a minority co-investment of typically less than 10% in a private company in the United States. Needless to say, this guide is not intended to cover every issue that could arise in co-investment transactions. Other issues may be relevant depending on various factors, including, for instance, the type of security being acquired, the specific economic terms of the security, and the structure and size of the investment. The focus of this article is to highlight select items that are typically not addressed in the initial drafts of co-investment documents and which most lead sponsors, when asked, will address.

BEING A CO-INVESTOR ALMOST UNIVERSALLY MEANS BEING SUBJECT TO A DRAG-ALONG PROVISION, WHERE THE LEAD SPONSOR, OR SOME COALITION LED BY IT, HAS THE RIGHT TO COMPEL OTHER INVESTORS TO EXIT THE INVESTMENT ON TERMS AND TIMING CHOSEN BY THE LEAD SPONSOR.

Preemptive Rights—Holes to Plug

Even before closing a co-investment, it is not too early to think about your rights to make future investments and maintain your current ownership percentage. So-called preemptive rights or participation rights to subscribe for your pro rata portion (based on your current ownership position) of future issuances of equity and equity equivalents are almost universally offered to co-investors. You should insist on them in almost every circumstance. There are, however, at least two key aspects of preemptive rights that are often not addressed appropriately from a co-investor's perspective in the initial drafts of co-investment documentation. These aspects are discussed below.

Issuances by Subsidiaries

Preemptive rights should apply not only to issuances by the top-level company in which you are investing (i.e., the issuer), but also to issuances by any of its current or future subsidiaries. Issuers in private equity holding structures are often shell-like holding companies with all or substantially all business operations conducted through one or more subsidiaries. Imagine a scenario where a subsidiary issues a preferred class of equity to the lead sponsor or its affiliates. Absent a preemptive right over issuances by subsidiaries, the lead sponsor has made itself senior to your investment both financially (via the preference) and structurally (as its new investment is at a level in the structure closer to the income generating assets than yours).

Issuances in Connection with Future Acquisitions

Among the various common exceptions to preemptive rights is one for issuances of equity related to a future acquisition of another business. This exception is often drafted as an issuance made in connection with an acquisition. This drafting is ambiguous and allows for two interpretations of the scope of equity issuances exempted from your preemptive rights: (1) equity issued to the target or its owners as consideration for the acquisition itself and (2) equity issued to raise capital to fund the purchase price for the acquisition. An exception to your preemptive rights in the case of (1) is common and acceptable dilution, but you should not be excluded from participating in (2) because it is a capital raise. The good news is that the drafting fix is relatively simple: change "in connection with" to "as consideration for" and you have limited the scope of the exception to (1) only.

Special Purpose or Co-investment Vehicles

Many co-investment transactions are structured as investments in co-investment vehicles, aggregator entities, or other special purpose entities, rather than as investments by a co-investor directly alongside the lead sponsor into the same issuer entity (referred to below as the primary issuer). These vehicles are typically controlled and managed by an affiliate of the lead sponsor, as the managing member or general partner of the vehicle. This structure concentrates broad authority in the hands of the lead sponsor over the vehicle and the decisions it makes about the voting and transfer of the primary issuer's equity that it holds. Here again, this structure presents at least two key issues from a co-investor's perspective that are often not addressed in the initial drafts of co-investment documentation.

Pass It On Up

The operative language for many of the key substantive co-investor rights (such as tag-along rights, preemptive rights, and even rights to tax distributions) will reside in the primary issuer's governing documents. Unless these rights are passed through to your co-investment vehicle, you will have no independent right to determine whether to cause the co-investment vehicle to exercise them—that decision will belong to the managing member (or general partner) of the vehicle. You should request that these rights be passed through, or back-to-back rights be implemented into, the governing documents of your co-investment vehicle, so that you can effectively utilize them and make your own decision about how and when to utilize them.

Don't Hand Off the Keys

You likely decided to co-invest with the lead sponsor at least in part because of a relationship with the sponsor, which gives you a comfort level that the sponsor will do the right thing by you. But what if the sponsor assigns or delegates its rights to act as managing member or general partner of your vehicle? The governing documents for most vehicles impose tight transfer restrictions on your ability to transfer your rights, but none on the managing member or general partner to transfer or delegate its rights and authority to act in that role. You should request that the managing member (or general partner) remain the lead sponsor (or one of its affiliates) for the life of your investment or at least until the lead sponsor exits the investment to a substantial degree.

Future Restrictions—Don't Drag Me into a Non-compete

Being a co-investor almost universally means being subject to a drag-along provision, where the lead sponsor, or some coalition led by it, has the right to compel other investors to exit the investment on terms and timing chosen by the lead sponsor. Drag-along provisions typically contain broadly worded covenants requiring the dragged investors to take all actions requested, or execute all documents, or otherwise not impede the exit transaction. These provisions are also usually coupled with a power of attorney allowing the dragging investor(s) to act for the dragged investor(s). Many financial sponsors will themselves not agree to restrain their future investment options via a non-compete provision in favor of a purchaser as part of an exit transaction. They will view, appropriately, such restrictions on their future investment options as inconsistent with their fiduciary duties to their own investors. Some will agree to a limited non-solicit of the business's employees after an exit. Co-investors who are themselves financial investors or investment funds often will find their motives and needs aligned with the lead sponsor on these issues. Such provisions can be even more critical issues for other varieties of co-investors, such as a strategic investor, who cannot become restricted from competing with the divested business, if that industry is the same as or adjacent to its own, or barred from effectively hiring in its industry or adjacent ones.

You should request that these broadly worded covenants exclude any requirement to become bound by a non-compete, non-solicit, or similar restrictive covenant. At a minimum, you should not be required to sign any restrictive covenant if the lead sponsor will also not be bound by one of like duration and scope. If you or your affiliates have any commercial relationship with the divested company (such as a license, supply agreement, etc.)—and you may if you are a strategic investor—you or they should also not be required to modify its terms or extend or renew the commercial agreement by operation of these broadly worded covenants; those items should be expressly excluded from the drag-along's requirements as well.

Board Service—Protect Your Seat, and Know Who Is Indemnifying You

If your co-investment is substantial enough that you will be entitled to appoint a representative to the primary issuer's board of managers (or similar governing body), or you otherwise are offered a board seat and are willing to serve, here are a few items that do not always find their way into the co-investment documentation, but should.

Board Committees—Don't Be Left Out in the Cold

If board service is vital to your investment thesis, review the board's authority to delegate its powers to one or more board committees. If this occurs, and you do not have a right to sit on such committee(s), then the full board acting by (for instance) majority vote could delegate its power to consider a fundamental matter, like a sale process, recapitalization, or debt financing, to a committee, not nominate your representative to sit on the committee, and thereby effectively nullify your board seat as to those fundamental matters. Consider requesting that your board seat entitle you to sit on all board committees.

Subsidiary Boards

The same issue and risk applies to the boards of subsidiaries of the primary issuer. If a significant part of the overall business is conducted by one or more subsidiaries, substantial decisions affecting the business can be made by the board(s) of those subsidiaries. If your right to a board seat does not extend to a seat on those subsidiary boards as well, your ability to monitor and influence the direction of the business can be significantly compromised.

Know Your Indemnitor

If you have indemnification available to you from multiple sources (such as your fund or its affiliates and the issuer on whose board you will sit), it is important to request language in the issuer's governing documents delineating which indemnitor is primarily responsible for a claim related to your board service. Otherwise, your fund or its affiliates may be required to fund indemnification obligations before seeking contribution from the primary issuer based on the Delaware Chancery Court's decision in Levy v. HLI Operating Co., 924 A.2d 210 (Del. Ch. 2007). Its implications have been written about and analyzed extensively in the intervening years, but

Related Content

For a sample side letter to be used when forming a private equity fund, see

> **SIDE LETTER FOR A PRIVATE EQUITY FUND**

RESEARCH PATH: *Corporate and M&A > Private Equity > Fund Formation and Operation > Forms > Side Letters*

For a subscription booklet form to be used when forming a private equity fund, see

> **SUBSCRIPTION AGREEMENT FOR A PRIVATE EQUITY FUND**

RESEARCH PATH: *Corporate and M&A > Private Equity > Fund Formation and Operation > Forms > Subscription Agreements*

For an overview on fee and expense disclosure and documentation for private equity funds, see

> **PRIVATE EQUITY FEE AND EXPENSE DISCLOSURE**

RESEARCH PATH: *Corporate and M&A > Private Equity > Fund Reviews and Limited Partner Negotiations > Practice Notes*

For a discussion on the various remedies that investors typically negotiate for when investing in a private equity fund, see

> **INVESTOR REMEDIES**

RESEARCH PATH: *Corporate and M&A > Private Equity > Fund Formation and Operation > Practice Notes*

For a high-level overview of the attorney-client privilege as it relates to private equity investments and in-house counsel, see

> **WHAT SHOULD PRIVATE EQUITY FIRMS BE THINKING ABOUT WHEN IT COMES TO PRESERVING THE ATTORNEY-CLIENT PRIVILEGE?**

RESEARCH PATH: *Corporate and M&A > Private Equity > Fund Reviews and Limited Partner Negotiations > Practice Notes*

surprisingly, you will still find initial drafts of co-investment documents that do not include so-called *Levy* case language. This language specifically delineates which indemnitor is on the hook first for an indemnity claim by a director. The primary issuer itself, or its subsidiaries, are stated to be first in line, and all other sources (including your fund, your employer, or its affiliates) are expressly acknowledged and agreed to be the indemnitors of last resort. You should also request a director indemnification agreement from the primary issuer as part of your board service. That way, your rights to indemnification and advancement of expenses are a contractual promise from the primary issuer to you that cannot be modified later without your consent.

Management or Advisory Fees—Avoid Surprise Increases

You will frequently find that the lead sponsor has already included provisions protecting co-investors against transactions between the issuer (or its subsidiaries), on the one hand, and the lead sponsor and its other affiliates, on the other hand, unless the transaction is blessed by some coalition of other investors (e.g., a majority of the minority) or is a bona fide transaction on so-called arm's length terms. If some variant of that protection is not already in your co-investment documentation, you should ask for it. In cases where the protection is based on the transaction being (or not being) on arm's length terms, that is a prime opportunity to raise the issue of management or advisory fees paid to the lead sponsor or its affiliates. Various levels of management fees could be defended as market and therefore on arm's length terms, even if greater than the rate of management fees that pertained when you invested.

Most sponsors will agree to limit the magnitude of management fees payable by a portfolio company to a defined amount or to at least a defined methodology (such as, management fees may increase based on reaching certain earnings before interest, tax, depreciation and amortization [EBITDA] thresholds, up to an ultimate cap on the amount of fees) that is disclosed up front before you invest, and which cannot be changed without consent of a majority of the other investors. You should also request to see a copy of the management or advisory agreement itself to confirm that it terminates automatically on an exit transaction (so that the sponsor is not entitled to additional consideration or a buyout for agreeing to terminate it) and confirm that the lead sponsor (or its affiliates) is not indemnified for its own gross negligence or misconduct.

IPO Structuring—Don't Lose Out on the Up-C Benefits

For issuers that are limited liability companies or partnerships, nearly all co-investment documents will contemplate a potential restructuring of the company in anticipation of an IPO and will include provisions requiring members or limited partners to take actions to facilitate the conversion to corporate form and associated restructuring. Fewer will expressly contemplate an IPO structure known as an Up-C. Whether contemplated in the documents or not, an Up-C structure is available on the table as a potential IPO structuring option, and the lead sponsor can always decide to pursue it, via its powers to manage the issuer, as managing member or general partner, or via control of a majority of its board seats.

In brief, an Up-C structure involves creating a new corporation that becomes a member of the issuer (or limited partner in an issuer that is a partnership). The new corporation then issues shares to the public in the IPO and all pre-IPO members (or limited partners) remain as such, and the limited liability company (or partnership) maintains its status as a pass-through entity for tax purposes. This structure allows for the public to participate in the equity in a commonly accepted and understood manner (i.e., via an investment in a corporation) while also allowing the pre-IPO investors to continue to benefit from the issuer remaining a pass-through entity for tax purposes and being subject to a single layer of tax. The pre-IPO investors will then be given the option to exchange the issuer's private interests for equity of the public vehicle from time to time; each such exchange is a taxable event that results in an increase in the basis of the assets of the issuer (i.e., an amortizable tax shield).

It is a relatively common practice for the public shareholders to pay for this benefit via an agreement with some subset of the pre-IPO investor(s) called a tax receivable agreement. There is no obligation that all pre-IPO investors receive a tax receivable agreement. You should consider including language in your co-investment documents to the effect that, if the sponsor contemplates causing the issuer to engage in a public offering, the sponsor will discuss in good faith with you whether to utilize an Up-C structure and, if one is utilized, and if the sponsor or any affiliate receives or benefits from a tax receivable agreement, you and your affiliates will have the opportunity to receive or benefit from a tax receivable agreement on like terms if you desire.

Conclusion

In conclusion, being aware of some of these common issues and how to address them will enable you to focus your evaluation of co-investment opportunities and the ensuing negotiations of the co-investment terms. Raising some of these questions and making some of these requests earlier on in your pursuit of a co-investment opportunity will also help to avoid surprises or unanticipated results down the road in your relationship with the lead sponsor and/or the target company. L

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

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Market Trends: **JOBS Act**

Overview

The U.S. economy was spotlighted during an unprecedented national Presidential election in 2016 with campaign debate focused on the preservation and initiation of new jobs. This topic, of course, is not a new one. In response to the economic malaise following the 2009 financial crisis, the Jumpstart Our Business Startups Act of 2012 (112 P.L. 106, 126 Stat. 306) (JOBS Act), signed into law by President Obama on April 5, 2012, implemented striking changes to the Securities Act of 1933, as amended (Securities Act).

The JOBS Act mandated that the Securities and Exchange Commission (SEC) relax historically rigid financial regulations to enable fledgling start-ups and developmental companies to advertise their ideas and solicit individuals for investments in emergent enterprises. The statute also provided an on-ramp of greater disclosure flexibility for smaller companies to transition to public companies. The economic rhetoric of the recent presidential election raises the question as to whether these changes made a difference. How is the JOBS Act playing out in reality? Based on economic studies conducted by the SEC, unregistered exempt securities offerings have eclipsed registered offering activity in the years following the financial crisis and passage of the JOBS Act.

Given the utility of unregistered offerings in post-recession capital formation, this article focuses on 2016 trends in small capital formation relating to JOBS Act-mandated changes, including amended Regulation A (known informally as Regulation A+) for raises up to $50 million, recently effective Regulation Crowdfunding (Regulation CF) for online raises to $1 million, and Rule 506(c) (17 C.F.R. § 230.506) of Regulation D permitting public solicitations to tap into unlimited quantities of capital from accredited investors. This article also examines progress under Title I of the JOBS Act, which was adopted to provide access to public markets by smaller companies known as emerging growth companies.

Title III: Regulation CF (Effective since May 16, 2016)

A significant development last year was the promulgation of the SEC regulations under Title III – Crowdfunding, also known as the "Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012" or the "Crowdfund Act." These regulations became effective as of May 16, 2016. Touted by some as the best option under the JOBS Act for equity fundraising by pre-revenue ventures, the Regulation CF rules allow first-time investors to invest as little as $100. Although the term crowdfunding has been used for several years colloquially (in the real estate industry especially for the way real estate platforms raise capital by giving non-private equity investors access to deals), these platforms, some of which have an online presence, have raised capital under the exemption of Rule 506 of Regulation D under the Securities Act. Provided with the long-anticipated regulation, start-up companies are now permitted to tap funds up to $1 million in reliance on section 4(a)(6) (15 U.S.C. § 77d) of the Securities Act during a 12-month period. An issuer is not required to aggregate amounts sold under other non-crowdfunding offerings during the preceding 12-month period for calculating quantities that may be sold in a Regulation CF offering.

Newly Created Funding Portals

Regulation CF created a new category of financial intermediary, known as a funding portal intermediary. A funding portal is a broker acting as an intermediary in a transaction involving the offer or sale of securities under section 4(a)(6) for the account of others that does not do any of the following:

- Offer investment advice or make recommendations
- Solicit purchases, sales, or offers to buy securities offered or displayed on its platform
- Compensate promoters and others for solicitations or pay based on the sale of securities
- Hold, possess, or handle investor funds or securities

In addition, the SEC rules require these registered funding portal intermediaries to:

- Provide investors with educational materials
- Take measures to reduce the risk of fraud
- Make available information about the issuer and the offering on the portal
- Provide communication channels to permit discussions about offerings on the platform
- Facilitate the offer and sale of crowdfunded securities

Broker-dealers and funding portals that are registered with the SEC and members of the Financial Industry Regulatory Authority (FINRA) are permitted to act as Regulation CF intermediaries and facilitate the sale of crowdfunded securities. Effective January 29, 2016, FINRA adopted SEC approved FINRA Funding Portal Rules (Funding Portal Rules 100, 110, 200, 300, 800, 900, and 1200) and related forms (Form FP-NMA, Form FP-CMA, Funding Portal Rule 300(c) Form, and Form FP-Statement of Revenue), which are summarized in the FINRA Notice to Members 16-06 and available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=12218.

Portal Registrations during 2016

The SEC's electronic filing database EDGAR reveals 22 funding portals registered during 2016 by filing their Form Funding Portals with the SEC. Some commentators have predicted that given the number of issuers and the crowded space , 2017 will see the failure of one or more portals. Currently, data is not available to comprehensively quantify the capital raised or commitments. However, by some accounts, including the industry publications report Crowdfund Insider, crowdfunding investor commitments through December 16, 2016 have now surpassed $15 million. See *NextGen Crowdfunding Announces Title III Update: Equity Campaigns Surpass $15 Million Milestone*, Crowdfundinsider.com (December 16, 2016), https://www.crowdfundinsider.com/2016/12/93792-nextgen-crowdfunding-announces-title-iii-update-equity-campaigns-surpass-15-million-milestone/. This quantity could be dismissed as a slow start, but industry insiders seem confident in the exponential potential growth of this financing option for start-ups.

2016 FINRA Enforcement Action and Settlement with Crowdfunding Portal

In November 2016, FINRA shut down the Virginia-based crowdfunding portal uFundingPortal (UFP) for allegedly allowing 16 issuers to sell securities through the portal without having filed the requisite paperwork with the SEC and despite numerous other red flags. A representative of FINRA confirmed that the UFP crowdfunding portal case was the first FINRA settlement over alleged violations of the JOBS Act, according to a report by Law 360, https://www.law360.com/securities/articles/870969/finra-bars-crowdfunding-portal-in-1st-jobs-act-settlement.

FINRA's Letter of Acceptance, Waiver and Consent dated November 8, 2016 (the Settlement) stated in part that the portal "lacked a reasonable basis for believing that certain companies offering securities through its online crowdfunding portal had complied with applicable regulatory requirements; had reason to believe those companies or their offerings presented the potential for fraud or other investor protection concerns; included on its website issuer communications that it knew or had reason to know contained untrue statements of material facts or were other false or misleading; and did not reasonably supervise the activities of its online crowdfunding portal." See the Settlement at p. 2. FINRA stated UFP was thus in violation of Rules 301(a) and 301(c)(2) of SEC Regulation Crowdfunding and FINRA Funding Portal Rule 200(a), 200(c)(3), and 300(a).

Form C Disclosures - Industry

As a result of the effectiveness of Regulation CF, disclosure research indicates that approximately 377 Form C reports have been filed with the SEC. A sampling of 34 Form C reports and amendments filed in December 2016 reveal offerings in the following industries:

- Consumer services/products (5)
- Business services (1)
- Financial services (1)
- Technology (5)
- Entertainment, including gaming & sports (7)
- Restaurants/brewers/spirits/energy drinks (6)
- Manufacturing (2)
- Wholesale retail apparel (1)
- Agriculture (1)
- Online services (5)

Regulation Crowdfunding Securities Offered

In addition to common stock and debt offerings, the Regulation Crowdfunding offering statements filed in 2016 indicate that start-up issuers are increasingly offering a security entitled SAFE (Simple Agreement for Future Equity), which is not equity or a convertible note but more akin to a warrant that promises the investor an equity stake in the company if there is an initial public offering or other liquidity event. The SAFE does not typically offer an interest payment or contain a maturity date. At least one offering in the sampling contained a revenue sharing interest security offered to investors.

Interpretation in Crowdfunding Issuer Communications and Advertising

The Regulation CF advertising rules may not be intuitive for many businesspersons and lawyers. While Rule 204(a) (17 C.F.R. § 227.204) of Regulation CF provides that issuers and persons acting on the issuer's behalf may advertise the terms of the Section 4(a)(6) offering, the Compliance and Disclosure Interpretation (C&DI) by the staff of the Division of Corporation Finance of the SEC has clarified that advertising by an issuer may extend beyond the confines of the Rule 204(b) Tombstone-like notice. C&DI Question 204.03, released on May 13, 2016, provides that if the issuer's advertisement does not contain terms of the offering, the issuer is not restricted in providing notice of its offering through social media or other mediums, subject to anti-fraud rules. The terms of the offering are defined in the rules to include information about the securities including the type of security and the duration of the offering.

Notable Transactions

Regulation CF's groundbreaking deal in 2016 was by Beta Bionics, Inc., the artificial pancreas biotechnology company based in Boston, which closed its round of funding under Regulation CF of $1 million through equity shares sold on the crowdfunding portal Wefunder Portal, LLC (Wefunder). Beta's progress filing disclosed that Eli Lilly, the pharmaceutical maker of insulin, had previously invested in a Series A preferred round.

Other deals comprising the initial $10 million raised during the formative months of the regulation include issuers in the restaurant and entertainment sector:

- Brewer's Table – East Austin, LLC, a craft brewery, with $396,500 through portal NextSeed
- Cleveland Whiskey, LLC, an Ohio-based spirits company, with $731,164 raised selling LLC units on Wefunder
- Hops & Grain Production, LLC, a Texas-based craft microbrewery, raising $1 million through a debt offering facilitated on Wefunder
- Legion M Entertainment, Inc., a California-based fan-owned entertainment studio, raising its initial $1 million also through intermediary portal Wefunder

Intermediary Compensation

In each of the deals above hosted on the Wefunder platform, the progress report on Form C-U disclosed that the amount of compensation to be paid to the intermediary was 3% of the offering amount raised.

The progress report for the Brewer's Table deal disclosed that NextSeed charged the issuer 10% of the total offering amount as compensation for its services in connection with the offering, provided that NextSeed would only charge 5% for funds raised from investors referred by the issuer.

In a sampling of 34 Regulation CF offerings filed or amended during December 2016, the intermediary compensation ranged from 3%, in most cases, to 12% on the high end.

Deal Structures of Initial Title III Deals and Timeline

Structures of the initial Regulation CF deals described above as notable early transactions have been varied and included the following, based on the Form C filings:

- Beta Bionics, the first equity crowdfunding start-up, closed its Title III round selling 10,000 Class C common shares at $100 per share in a minimum-maximum offering of $50,000 minimum for a total investment of $1,000,000.00. The company's stock purchase agreement contains a Market Stand-Off Agreement, with the investors agreeing not to sell or transfer their shares (i.e., a lock up) for 180 days following effectiveness of a Securities Act registration. The offering funded in approximately three months from the initial filing on May 16, 2016.
- Brewer's Table, an early Title III offering, offered Revenue Sharing Notes in a minimum-maximum offering of $250,000 minimum and $300,000 maximum, with a minimum investment of $100. The offering exceeded its maximum by almost a third at $396,500. The deal also included a revenue sharing percentage of 5.25% of each month's gross revenue, commencing five months following closing. The offering funded its oversubscribed amount within 60 days.
- Hops & Grain also offered Revenue Sharing Notes in a minimum-maximum structure similar to Brewer's Table with a revenue sharing percentage of 10%. The company completed the full $1,000,000 placement within approximately four months between the initial filing and Form C-U progress update.
- Cleveland Whiskey sold non-voting Class D Units in a limited liability company entity. The offering closed within five months of its initial filing.
- Legion M Entertainment garnered its total investment by selling Class A common stock in a minimum-maximum offering with its minimum set at $500,000. The offering closed within three months of its initial filing.

TITLE IV: Regulation A+ (Effective since June 2015)

Increased Issuer Activity following Amendments to Regulation A under the JOBS Act

In the 12-18 months following the effectiveness of the Regulation A+ rules, companies took advantage of the exemption from securities registration afforded by Regulation A+ at a rate surpassing filings under the prior Regulation A regime. The prior Regulation A had an offering cap of $5 million, which was perceived as cost inefficient, according to the November 2016 study prepared for the SEC's Division of Economic and Risk Analysis. See A. Knyazeva, *Regulation A+: What Do We Know So Far?* (November 2016), https://www.sec.gov/dera/staff-papers/white-papers/Knyazeva_RegulationA-.pdf (the "Regulation A+ Study").

According to the Regulation A+ Study, prospective issuers have publicly filed offering statements for 147 Regulation A+ offerings, seeking up to approximately $2.6 billion in financing. Of those, approximately 81 offerings seeking up to approximately $1.5 billion have been qualified by the SEC. The study further provides that approximately $190 million reportedly has been raised during that period, but warns that such number likely understates the true amount raised due to reporting timeframes. See Regulation A+ Study at page 1.

Related Content

For an overview of how Regulation A+, Regulation Crowdfunding, and Regulation D compare, see

> REGULATION D, REGULATION A+, AND REGULATION CROWDFUNDING REQUIREMENTS CHART

RESEARCH PATH: *Capital Markets & Corporate Governance > Private Offerings > Private Placement of Equity Securities > Forms > Checklists*

For further information on the respective tiers in Regulation A+, see

> "REGULATION A-PLUS" TIER 1 AND TIER 2 OFFERINGS SUMMARY CHART

RESEARCH PATH: *Capital Markets & Corporate Governance > Private Offerings > Private Placement of Equity Securities > Forms > Checklists*

For information on the regulation of intermediaries and funding portals under Regulation Crowdfunding, see

> CROWDFUNDING INTERMEDIARIES

RESEARCH PATH: *Capital Markets & Corporate Governance > Investment Management > Broker-Dealer > Practice Notes > Broker-Dealer Registration and Regulation*

Size of Regulation A+ Deals

The Regulation A+ Study states that Tier 2 Regulation A offerings comprised approximately half of all offerings and over half of qualified offerings. As expected, a typical Tier 2 issuer was seeking to raise a larger amount. The median (average) amount sought by a Tier 2 issuer in a given offering was $20 ($26) million among all filings and $20 ($26) million among qualified offerings. By comparison, the median (average) amount sought by a Tier 1 issuer in a given offering was $6 ($10) million among all filings and $5 ($7) million among qualified offerings. See Regulation A+ Study at page 7.

Regulation A+ Offering Industry Distribution

The Regulation A+ Study further provided that the top industries filing Regulation A offering statements since effectiveness included business services, real estate, non-depository credit institutions, investment offices, and depository institutions. See Regulation A+ Study at page 19.

Regulation A+ Use of Intermediaries and Brokers

The Regulation A+ Study concluded that traditional underwriters were involved with less than 20% of the Regulation A offerings and that the underwriters named were involved in a number of the Regulation A offerings reviewed.

Registered broker-dealers, registered investment advisors, finders, or promoters were reported in the Regulation A+ Study to be used in approximately 38% of all offerings and 36% of qualified offerings. The reported rate of intermediary use was significantly higher for Tier 2 offerings, consistent with the higher incidence of nationwide solicitation and with the larger offer amounts in Tier 2 offerings. See Regulation A+ Study at page 11.

Timeline

The Regulation A+ Study's sampling of qualified filings reveals that the length of the SEC qualification process for new Regulation A offerings is a median time of 78 days from initial public filing to qualification as compared to an average of 228 days to qualify between 2002 through 2011 prior to the JOBS Act amendments. Perhaps not surprisingly, Tier 2 offerings were generally associated with a longer timeline than Tier 1 offerings, according to the Regulation A+ Study.

Trends in 2016 Regulation A Filings

In 2016, 218 Form 1-A registration statements were filed with the SEC. A sampling of 43 Form 1-A registration statements and amendments (total of 48) filed in December 2016 reveal offerings in the following industries with most of the offerings concentrated in real estate and business services:

- Real estate/construction (8)
- Crude petroleum & natural gas (1)
- Laboratory analytical instruments (1)
- Aircraft/transportation equipment (3)
- Pharmaceutical/medical/surgical (3)
- Finance services/mortgage bankers (2)
- Business services (11)
- Social media/communications (3)
- Entertainment/production/sports (6)
- Computer programming services/software (2)
- Semiconductors (1)
- Manufacturing (1)
- Home goods/consumer products (1)

Of the 4th quarter sampling filings researched, 19 were Tier 1 offerings and 29 were Tier 2 offerings.

Deal Structures

A random sampling of 10 Regulation A+ offerings filed in December 2016 found the following deal structures and terms:

- Nine of the 10 offerings were minimum-maximum best efforts offerings.
- Only one was a firm commitment underwritten offering with a syndicated selling group of underwriters with securities to be listed on The Nasdaq Stock Market LLC, and two additional offerings utilized SEC registered broker-dealers on a best efforts basis.
- Two of the 10 offerings contemplated the issuance of debt securities, including:
  - A debt offering issuing limited recourse obligations (LROs) in distinct series, each corresponding to a real estate development project to be financed by a commercial loan
  - A debt offering issuing 9% unsecured promissory notes.

Title II: Regulation D, Rule 506(c) (Effective since September 2013)

Rule 506(c) under Title II of the JOBS Act allows an issuer to solicit investors and advertise its offering provided the investment opportunity is confined to accredited investors. By some economists' accounts, the 506(c) offering continues to be underutilized by companies who in some instances would like to continue to rely on their pre-existing relationship networks to complete an offering. According to one economic analysis, amounts reported raised under Rule 506(c) remain a small fraction of the total (2%) of the capital reported as raised pursuant to Regulation D since the rule became effective on September 23, 2013, suggesting that most issuers of unregistered securities are not yet seeking investors through general solicitation and general advertising. See Bauguess, Rachita, Gullapalli, and Ivanov, *Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009-2014* (October 2015), at page 2 (the Regulation D Study).

The reticence to utilize the Rule 506(c) general solicitation flexibility appears to be due to regulatory uncertainty for standard advertising, vetting of accredited investor status, and liability concerns. Some issuers also fear the perception that use of general solicitation signals the market that the company lacks a pre-existing network of sophisticated investors and does not have favorable financing options.

Title I: IPO On-Ramp

The provisions of Title I of the JOBS Act created a category of emerging growth companies or issuers with less than $1 billion in annual gross revenue during their most recently completed fiscal year (EGCs). Title I, entitled "Reopening American Capital Markets to Emerging Growth Companies," was designed to revitalize initial public offerings (IPOs) by smaller issuers by reducing various disclosure and compliance requirements for emerging companies during a public offering and for up to five years thereafter. EGCs are provided with a phase-in period of up to five years to comply with the more burdensome disclosure and accounting requirements of federal securities laws. IPO companies have varied with their use of the EGC disclosure flexibility.

IPO Activity Post-JOBS Act

The data for the IPO market shows that during 2014 IPOs increased to 291, as compared to, 226 in 2013, but decreased during the first half of 2015, from 158 in 2014 to 101 in 2015 (which was still slightly stronger than first half of 2013). EGCs represented 85% of IPOs that have gone into effect since the JOBS Act's enactment through mid-2015. See Ernst & Young, *THE JOBS Act -2015 mid-year update* (September 2015) at page 1-2.

IPOs continued to slow in the second half of 2015 and declined sharply during 2016, with only 105 offerings pricing in total in 2016 raising $18.8 billion, an over 30% drop from 2015. See Renaissance Capital, US IPO Market 2016 Annual Review (December 16, 2016) (the Renaissance Report) at page 1.

EGC Disclosure Elections in Selected 2016 IPOs.

In 2016, the IPO activity sampling for this report of 10 high-performing IPOs showed that five of the sampling companies elected to disclose two years of financial statements, as opposed to three years, and four omitted or limited Compensation, Discussion and Analysis (CD&A).

IPO Industry Insights

According to the Renaissance Report, healthcare was the most active industry in the IPO market during 2016 with 40% of the total IPOs. See Renaissance Report at page 4. In the IPO market, technology IPO activity is expected to be spurred in 2017, following a two-year drought in technology IPOs. The report opines that technology companies have not proceeded to public markets to avoid public-market valuations. See Renaissance Report at page 1.

Related Content

For a discussion on state Blue Sky licensing regulations for crowdfunding intermediaries, see

> UNDERSTANDING STATE INTERMEDIARY LICENSING REQUIREMENTS FOR PARTICIPATION IN OFFERINGS

RESEARCH PATH: *Capital Markets & Corporate Governance > State Securities Regulation - Blue Sky Laws > Blue Sky Laws > Practice Notes > Intermediary Licensing*

For further information on crowdfunding, see

> AN OVERVIEW OF THE SEC'S CROWDFUNDING REGULATIONS

RESEARCH PATH: *Capital Markets & Corporate Governance > Private Offerings > Private Placement of Equity Securities > Practice Notes > Conducting the Private Offering*

For an overview of permitted issuer communications in general in registered offerings, see

> WHEN IS A COMMUNICATION AN OFFER OF SECURITIES? CHART

RESEARCH PATH: *Capital Markets & Corporate Governance > IPOs > Communications During the Offering Process > Forms > Checklists*

2017 Outlook

Will Regulation CF Buoy up Capital in 2017?

Based on the inaugural seven months of deal activity, some portals have been visibly active with Form C-U reports for its issuers being filed, while other registered portals have languished on the sidelines and will be crowded out by competition in 2017. Direct marketers are expected to participate in offerings on behalf of issuers and portals given that the SEC staff has provided clarifications on advertising in this context and the business and legal community has assimilated this information. Some excitement has been generated in the start-up finance industry, and by most accounts the Regulation CF funding will continue to gain momentum and uptick in 2017. Finally, portals are now becoming, and will likely continue to become, more specialized to cater to niche industry sectors, including real estate funds, biotechnology, and cloud-based technologies, as well as focus specifically on attracting accredited investors.

Secondary Market Development for Regulation A+

Market participants are interested in whether a secondary market will develop for trading in Regulation A securities. A sampling of the recently qualified Regulation A offerings reveals that Form 1-A filings either do not mention a secondary market or provide risk disclosure that a public market does not presently exist and is unlikely to develop in the future. The SEC's Regulation A+ Study does indicate that a number of the issuers purport to be quoted on Over The Counter or OTC markets while at least one issuer was seeking a New York Stock Exchange listing. A number of the offering statements contained disclosures that the issuer was planning to seek OTC quotation in the future. The viability of the enhanced Regulation A regime will depend, in part, on the issuer's ability to create trading markets and liquidity in the Regulation A securities.

Rule 506(c) May Gain Traction during 2017

During 2017, issuers will survey their options in the unregistered exempt market and may elect to take advantage of the online portal and general solicitation route under Rule 506(c) as the contours of JOBS Act advertising and general solicitation become more defined and focused. Several of the newly registered SEC portals display offerings by exemption type (including Rule 506(c) offerings (as well as 506(b), Regulation A, and Regulation CF)), making this option more readily available and visible to the accredited investor community inclined to browse and access these portal communities.

It remains to be seen if accredited investors will flock to the current portal community in mass, whether through financial intermediary involvement or direct marketing participants. Clearly, however, legal professionals and business persons are now warming up to less inhibited communications and offering solicitations—a cornerstone of the JOBS Act—breathing life into entrepreneurial dreams. L

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

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Kristin is a frequent speaker at seminars and universities. He is licensed to practice in New York and New Jersey. Kristin received his J.D. from Rutgers University School of Law. He is a member of the New York State Bar Association and American Bar Association.

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Freedom House Awards for Rule of Law

LexisNexis Legal & Professional received the **2017 Corporate Leadership Award from Freedom House** for activism in promoting and advancing the rule of law globally.

FREEDOM HOUSE **IS AN INDEPENDENT WATCHDOG** organization dedicated to the expansion of freedom and democracy around the world. For more than 75 years, it has been the mission of Freedom House to challenge unjust governments and defend civil liberties across the globe. This year's award recipients also included Secretary General of the Organization of American States Luis Almagro for his work on behalf of Venezuelan political prisoners, U.S. House Democratic Leader Nancy Pelosi (D-CA) for her human rights efforts, U.S. Senator Lindsey Graham (R-SC) for his foreign policy support, actor and activist Richard Gere for his advocacy on behalf of the Tibetan people, and clothier H&M for advancing supply chain transparency.

In the words of Freedom House President, Mike Abramowitz, the LexisNexis core mission to advance the rule of law in emerging and developed nations is bringing transparency to laws, furthering human rights, and strengthening judiciaries so people of those nations can better access justice, making LexisNexis a model for other corporations.

LexisNexis Chief Executive Officer Mike Walsh noted that "looking across the global landscape today, it's not hard to see the serious and often severe challenges facing society, particularly for the four billion people living outside the umbrella protection of the rule of law. Our focus is on continued leadership in advancing the rule of law because we know that when rule of law flourishes, citizens of the world experience a better life both economically and socially."

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