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FALL 2017

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TOP TEN PRACTICE TIPS: INITIAL PUBLIC OFFERINGS

Establishing Compliant Health Reimbursement Accounts

Handling I-9 Investigations by Government Agencies

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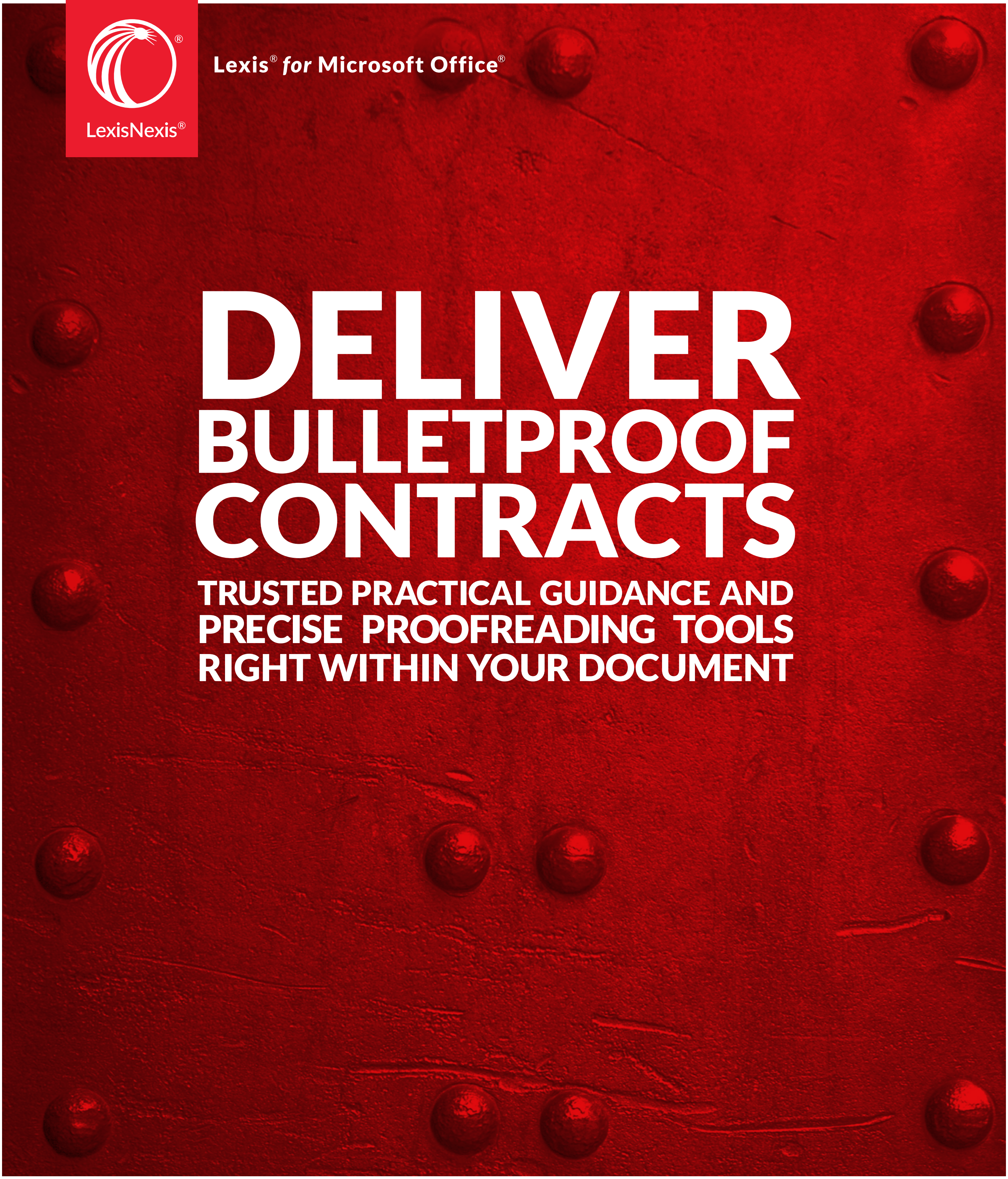

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FALL 2017 (Volume 2, Issue 4)

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Eric Bourget, Editor-in-Chief

IN ORDER TO HELP YOU PRACTICE MORE efficiently and effectively, we continually strive to find ways in which we can provide you with more practical content that is easy to find and digest. We want to aid you in your practice by providing you with guidance from experts in your field who can share their experiences, lessons learned, and insights directly with you. We understand there are only so many hours in a day and that you have an abundance of ways in which you can locate and review primary, secondary and practical legal content, so it is our goal to make this process as seamless as possible.

In this edition of the Lexis Practice Advisor Journal, we are launching a new regular segment, the Top 10 Tips by Experts series, that will help you digest practical content more efficiently. This new segment is being added to the Lexis Practice Advisor product to provide you with condensed tips and insights across a single topic from multiple expert practitioners. It will bring you insights written by top experts in their respective fields, including practice chairs at top firms. These guides will provide coverage on a variety of topics or tasks with an emphasis on the most significant practice points for in-house and issuer's counsel on various capital markets and corporate governance topics. This first installment covers initial public offerings. Due to the significant and continual growth in the technology sector and the number of IPOs resulting from the same, there is a strong demand for attorneys with IPO expertise. This article provides insights on regulations affecting this sector, lays out some typical securities offerings and structures, and warns of unique risk factors associated with this industry due to its highly competitive nature and the constant influx of new products and services.

Our In-House Insights article offers guidance on how to navigate the compliance risks related to designing and administering health reimbursement accounts (HRAs). The article includes suggested ways to structure and operate employer-sponsored HRAs in order to avoid those potential traps. Another item designed to assist general counsel includes advice for employers about properly handling I-9 investigations by government agencies. With growing attention on immigration regulations, this timely article also includes a checklist of best practices for handling I-9 government audits.

After years of uncertainty as to whether copyrights could adequately protect artistic clothing designs, we provide you with an in-depth look at a recent Supreme Court decision about the use of the copyright doctrine to protect original designs. Although the decision is limited in scope, the article offers guidance about the types of artistic designs that may be protected and steps counsel should take in order to best protect clients' original concepts.

Other items in this edition include a look into the benefits of mediation when disagreements arise with construction projects. This is a common area of disputes due to the length and complexity of the projects themselves and the agreements surrounding potential issues such as defects, timing, delays, and changes in specifications and scope. This edition also includes several drafting advice items, one focusing on strategies and practical tips to consider when drafting a motion to dismiss a patent infringement complaint, and another on reconciling non-matching terms in commercial agreements.

We hope that our new Top 10 Tips by Experts series helps you in your day-to-day practice by providing you with more practical insights, tips, and know-how from a multitude of experts enabling you to practice with more confidence.

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

SEXUAL ORIENTATION DISCRIMINATION UNDER TITLE VII REMAINS HOT-BUTTON ISSUE

RECENTLY, THREE OF THE U.S. CIRCUIT COURTS OF APPEAL addressed the issue of whether discrimination on account of an individual's sexual orientation is precluded by Title VII of the Civil Rights Act of 1964 (42 U.S.C. § 1981).

In the first case, Evans v. Georgia Regional Hospital, 850 F.3d 1248 (11th Cir. 2017), the Eleventh Circuit held that it was not. A petition for en banc review is pending.

In the second case, Anonymous v. Omnicom Grp., Inc., 852 F.3d 195 (2d Cir. 2017), a Second Circuit panel agreed, but only because it was constrained by circuit precedent. The concurring opinion in the Second Circuit case argued strongly that the issue should be revisited en banc and the circuit precedent overturned.

In the third case, Hively v. Ivy Tech Community College of Indiana, 853 F.3d 339 (7th Cir. 2017), the Seventh Circuit, sitting en banc, became the first federal appellate court to hold that Title VII prohibits discrimination on the basis of sexual orientation. In doing so, the en banc Hively court, in large part, adopted the theories advanced in the concurring opinion of the Second Circuit's decision in Omnicrom.

In a fourth case, the Second Circuit also decided it would review the issue en banc, agreeing to review a panel decision in Zarda v. Altitude Express, 855 F.3d 76 (2d Cir. 2017), in which the panel rejected the argument that sexual orientation discrimination is prohibited under Title VII. As with the decision in Omnicrom, the panel in Zarda relied upon earlier circuit precedent as precluding review of the issue. Oral argument in Zarda is set for September 26, 2017.

- Bender's Labor & Employment Bulletin, Volume 17, Issue 7

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

DEPARTMENT OF LABOR ASKS FIFTH CIRCUIT NOT TO REINSTATE OVERTIME RULES

THE DEPARTMENT OF LABOR (DOL) HAS ABANDONED its defense of new standards established by the Obama administration for employee classification under the Fair Labor Standards Act (FLSA), telling the Fifth Circuit U.S. Court of Appeals that it intends to begin its own rulemaking process on the issue.

Implementation of the new standards, which increased the salary threshold under the FLSA for classifying workers as exempt white-collar employees, was enjoined by U.S. Judge Amos Mazzant III of the Eastern of District of Texas on November 22, 2016, after 21 states and various business groups filed suit. Nevada v. U.S. Department of Labor, 218 F. Supp. 3d 520 (E.D. Texas 2016).

The standards, which were set to go into effect on December 1, would have increased the threshold for exempt employees from $455 per week or $23,660 annually to $921 per week or $47,892 annually, effectively extending overtime pay to an estimated 4.2 million Americans. The new standard also provided for automatic update of the threshold every three years, beginning January 1, 2020.

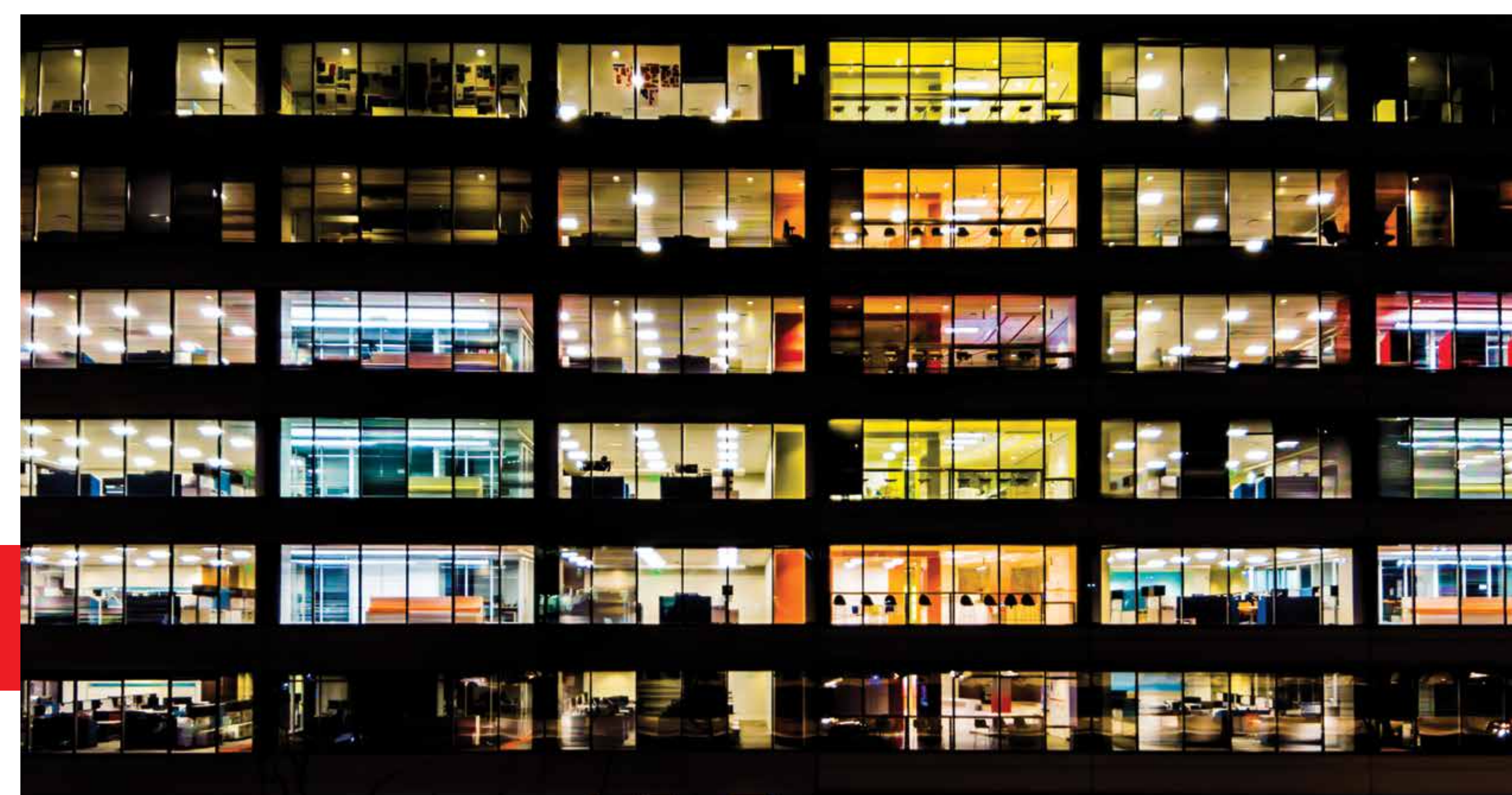
The DOL appealed, and the Fifth Circuit agreed to an expedited review. The DOL and the challengers filed briefs with the Fifth Circuit before President Donald J. Trump was sworn in, with the DOL's reply brief due on January 31, after the new administration took office. The appeals court granted the DOL's request for additional time to file its reply brief.

In that brief, filed on June 30, the DOL did not reiterate its earlier argument that the Fifth Circuit should reinstate the new rules but asked the appeals court to reverse the Texas court's holding that the department lacked the authority to establish a salary test.

"[T]he Department requests that this Court reverse the judgment of the district court because it was premised on an erroneous legal conclusion, and reaffirm the Department's statutory authority to establish a salary level test," the DOL said. "The Department requests that this Court not address the validity of the specific salary level set by the 2016 final rule ($913 per week), which the Department intends to revisit through rulemaking."

-Lexis Practice Advisor Journal Staff

RESEARCH PATH: *Labor & Employment > Wage and Hour > FLSA Requirements and Exemptions > Articles > Overtime Requirements*



CYBERSECURITY ASSESSMENT TOOL UPDATES PROVIDE PREPAREDNESS MEASURING PROCEDURES

THE FEDERAL FINANCIAL INSTITUTIONS EXAMINATION Council (FFIEC) released an update to its Cybersecurity Assessment Tool. The update to the assessment tool addresses changes to the FFIEC IT Examination Handbook.

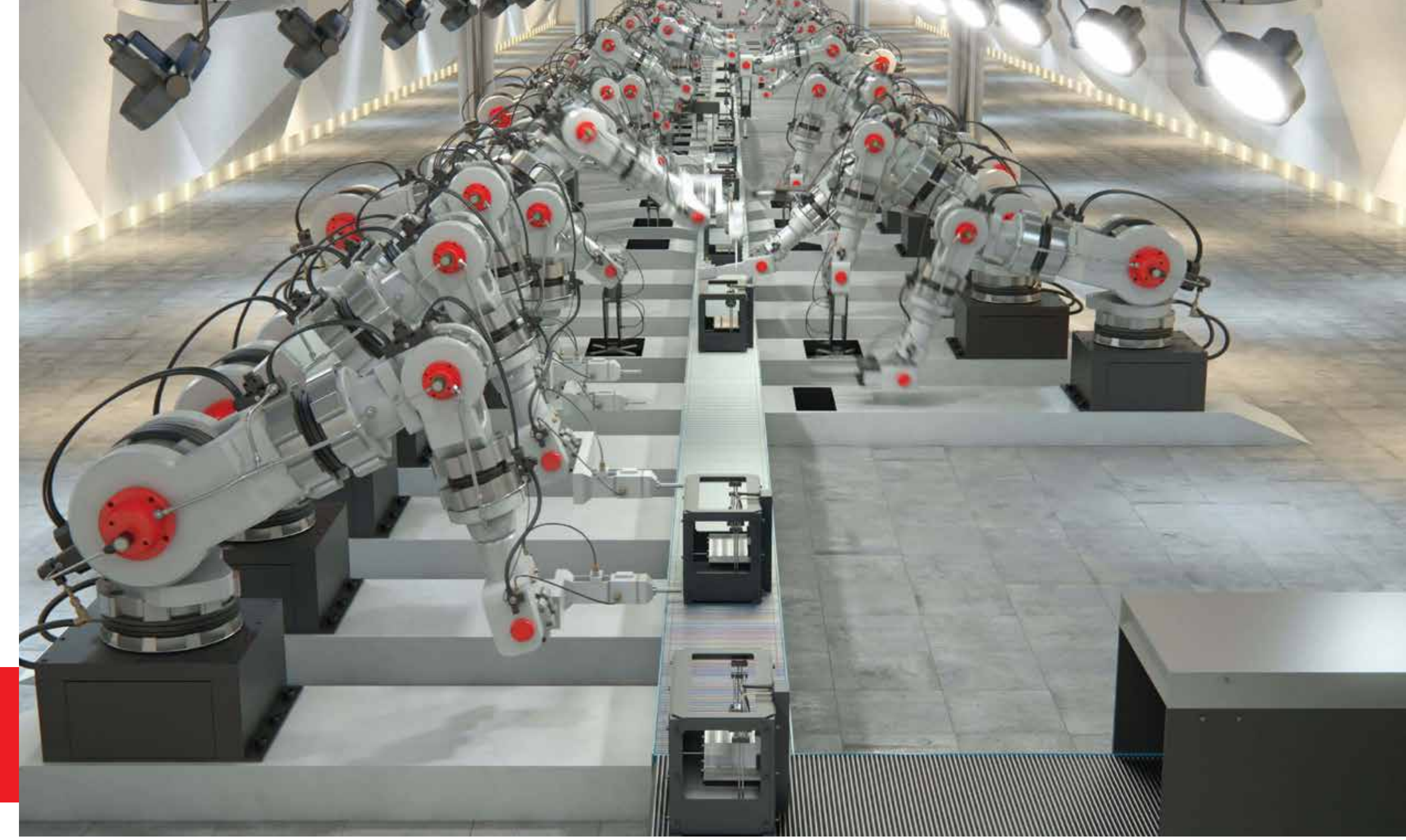
The FFIEC said the updated assessment tool, which was developed to help financial institution management determine the institution's risk profile, inherent risks, and cybersecurity preparedness, will also provide additional response options, allowing financial institution management to include supplementary or complementary behaviors, practices, and processes that represent current practices of the institution in supporting its cybersecurity activity assessment.

The FFIEC noted that the assessment tool provides "a repeatable and measurable process that financial institution management may use to measure cybersecurity preparedness over time."

"Use of the tool is voluntary, and financial institution management may choose to use the Assessment or another framework, or another risk assessment process to identify inherent risk and cybersecurity preparedness," the FFIEC added. "Management of financial institutions and management of third-party service providers are primarily responsible for assessing and mitigating their entities' cybersecurity risk."

- Pratt's Bank Law & Regulatory Report, Volume 51, No. 7

RESEARCH PATH: *Finance > Financial Services Regulation > Financial Institution Activities > Articles > Other Regulatory Issues*



U.S. SUPREME COURT TO DECIDE CONSTITUTIONALITY OF AIA PATENT REVIEW

THE U.S. SUPREME COURT HAS AGREED TO TAKE ON THE question of whether a provision of the America Invents Act (AIA) that created pretrial proceedings to address challenges to existing patents violates Article III of the U.S. Constitution.

The justices granted a petition by Oil States Energy Services LLC for review of a decision by the U.S. Court of Appeals for the Federal Circuit affirming a ruling by the U.S. Patent and Trademarks Appeal Board (PTAB) that invalidated several claims of its hydraulic fracturing patent.

That decision came in an infringement action filed by Oil States against Greene's Energy Group LLC, one of its competitors. Greene's responded to the suit with an allegation that the Oil State patent is invalid. The PTAB reviewed the patent, under procedures set forth in Section 6 of the AIA, and found several claims invalid. The Federal Circuit affirmed. Oil States Energy Servs., LLC v. Greene's Energy Grp., LLC, 639 Fed. Appx. 639 (2016 U.S App. 8870).

In seeking review, Oil States argued that the review process established in the AIA violates the Constitution by allowing a government panel to extinguish private property rights. "Suits to invalidate patents must be tried before a jury in an Article III forum, not in an agency proceeding," Oil States argued. Further, Oil States contended, even if the review process is constitutional, its application violates the rights of patent holders to take advantage of the patent amendment process, and the high court should clarify the standard to be used by the PTAB in reviewing patents.

Opposing review, Greene's argued that it is "settled case law" that patents are "mere 'public rights'" susceptible to review by a non-Article III tribunal. Greene's also dismissed Oil States' argument on the amendment process, arguing that it was not presented to the Federal Circuit and that clarification of the standard of the review is not necessary.

The high court granted limited review to the constitutional issue. Oral arguments will be heard after the justices return from their summer recess in October.

RESEARCH PATH: *Intellectual Property & Technology > Patents > PTAB Proceedings > Articles*

MODEL RISK MANAGEMENT GUIDANCE ADOPTED BY THE FDIC

THE FEDERAL DEPOSIT INSURANCE CORPORATION (FDIC) is adopting the Supervisory Guidance on Model Risk Management previously issued by the Board of Governors of the Federal Reserve System (SR 11-7) and the Office of the Comptroller of the Currency (OCC Bulletin 2011-12).

The guidance addresses supervisory expectations for model risk management, including model development, implementation, and use; model validation; and governance, policies, and controls.

The FDIC noted that it does not expect the guidance will pertain to FDIC-supervised institutions with under $1 billion in total assets unless the institution's model use is significant, complex, or poses elevated risk to the institution.

The FDIC also observed that some FDIC-supervised institutions have increased their reliance on models for various functions, such as credit management, operational risk, valuation, and stress testing. The FDIC highlighted that:

- Model risk management should be commensurate with each institution's risk exposure, as well as the complexity and extent of its model use.
- An effective model risk management framework should include disciplined and knowledgeable development that is well documented and conceptually sound, controls to ensure proper implementation, processes to ensure correct and appropriate use, effective validation processes, and strong governance, policies, and controls.
- Use of vendor and other third-party models should be incorporated into the model risk management framework.

- Pratt's Bank Law & Regulatory Report, Volume 51, No. 7

RESEARCH PATH: *Finance > Financial Services Regulation > Financial Institution Activities > Articles > Other Regulatory Issues*

SUPREME COURT RULES ON KEY FAIR DEBT COLLECTION PRACTICES ACT ISSUE

THE U.S. SUPREME COURT UNANIMOUSLY HELD THAT A company may collect debts that it purchased for its own account without triggering the Fair Debt Collection Practices Act (FDCPA) requirements applicable to "debt collectors," a term that includes anyone who "regularly collects or attempts to collect . . . debts owed or due . . . another." Henson v. Santander Consumer USA Inc., 198 L.Ed. 177 (2d Cir. 2017).

The complaint alleged that CitiFinancial Auto loaned money to four consumers seeking to buy cars, that the consumers defaulted on those loans, and that consumer finance firm Santander Consumer USA Inc. then purchased the defaulted loans from CitiFinancial and sought to collect in ways that violated the FDCPA. The U.S. District Court for the District of Maryland and the Fourth Circuit U.S. Court of Appeals both held that Santander did not qualify as a debt collector because it did not regularly seek to collect debts "owed . . . another" but sought instead only to collect debts that it purchased and owned.

The Supreme Court affirmed those decisions in Justice Neil Gorsuch's first opinion as a member of the Court.

In response to the argument that Congress did not know in 1977 that the business of purchasing defaulted debt would blossom as it has, Justice Gorsuch wrote, "All this seems to us quite a lot of speculation. And while it is of course our job to apply faithfully the law Congress has written, it is never our job to rewrite a constitutionally valid statutory text under the banner of speculation about what Congress might have done had it faced a question that, on everyone's account, it never faced."

- Pratt's Bank Law & Regulatory Report, Volume 51, No. 7

RESEARCH PATH: *Finance > Financial Services Regulation > Financial Institution Activities > Articles > Other Regulatory Issues*

Arthur D. Robinson and Jonathan Ozner
SIMPSON THACHER & BARTLETT LLP

TOP TEN PRACTICE TIPS BY EXPERTS: INITIAL PUBLIC OFFERINGS

SENIOR EXECUTIVES AND OWNERS OF PRIVATE COMPANIES considering an initial public offering (IPO), or of public companies considering a spin-off or carve-out IPO of a subsidiary, business unit, or division, are undoubtedly aware of the many benefits of an IPO. These include:

- Liquidity for existing equity holders
- Increased access to capital
- Acquisition currency in the form of publicly-traded stock
- Enhancement of a company's profile

But the path to a successful IPO is also fraught with significant costs and potential pitfalls. To create the best chance for a successful process, in-house counsel, with assistance from their outside IPO counsel, should be mindful of the following:

1 Develop a plan for public communications during the IPO process.

The U.S. securities laws place restrictions on a company's ability to offer to sell its securities before filing a registration statement. The Securities and Exchange Commission (SEC) construes the phrase "offer to sell" broadly. Plan for these restrictions now by developing guidelines for public communications, such as content on the company website, press releases, interviews with executives, and speeches at industry conferences.

If the SEC views any of these communications as conditioning the market for an upcoming offering, referred to as gun-jumping, it can institute a cooling-off period by delaying the IPO. It may even require a company to include the gun-jumping communication in the registration statement. The SEC has, however, adopted rules allowing a company to continue to release factual (but not forward-looking) information about its business in a manner consistent with past practice during the IPO process.

2 Prepare company financial statements suitable for use in an IPO registration statement.

The general rule is that for the company going public, a registration statement must include:

- Two years of audited balance sheets
- Three years of audited statements of income, cash flows, and stockholders' equity

In addition, depending on when a filing takes place, an issuer may also need to include unaudited interim financial statements for the most recently completed quarter or year-to-date period.

The securities laws provide helpful accommodations for a class of issuers known as emerging growth companies (EGCs). Generally, an EGC is an issuer that had total annual gross revenues of less than $1.07 billion during its most recently completed fiscal year. An EGC:

- Is required to include only two years of audited statements of income, cash flows, and stockholders' equity.
- May omit audited financial statements that it reasonably believes will not be required to be included in its registration statement at the time of the contemplated offering.

The financial statements required for a registration statement have a few key differences from private company financial statements, the most important of which is the disclosure of segment information. Determining a company's segments is a critical step in preparing the financial statements to be included in the registration statement, as well as related disclosure in the management's discussion and analysis (MD&A) of financial condition and results of operations and other sections of the registration statement. The SEC may challenge your segment presentation, which could result in significant changes to the registration statement and delay your deal.

Issuers and their auditors need to confirm that the auditor is independent under Public Company Accounting Oversight Board (PCAOB) standards, which differ from the applicable independence rules for private companies.

3 Confirm that the company has the required financial statements for acquired businesses.

In addition to the issuer's financial statements, you may need separate financial statements for recently acquired businesses. Importantly, the financial statements of an acquired business need to be prepared in accordance with generally accepted accounting principles (GAAP) and, in the case of any annual financial statements, need to be audited. The test for whether you need to include financial statements of an acquired business under SEC Regulation S-X is based on the significance of such business to the issuer according to enumerated financial metrics. These tests of significance can produce surprising results and acquired businesses that may appear immaterial to the untrained eye could technically trigger this requirement.

The rules in this area are strict, and if the company does not have the required financial statements for a significant acquired business, you will need to apply to the SEC's Division of Corporation Finance to waive such requirement, and there is no guarantee the SEC will grant that waiver. It is advisable to be mindful of this requirement well in advance of an IPO (even if you think you are a year or two out) and consider pushing for audited financial statements or at least a cooperation covenant in your acquisition agreements.

4 Review the company's material contracts for competitively-sensitive information.

Issuers are required to file all material contracts not made in the ordinary course of business as an exhibit to the registration statement. Such exhibits will be publicly available. You may submit a confidential treatment request (CTR) with the SEC with respect to certain information contained in these exhibits. If the SEC grants the request, the relevant information will be redacted from the public filing. However, you should think carefully before pursuing a CTR. You will need to justify why the CTR should be granted, and the request must not be overly broad. The SEC may deny the request if it believes the information is material to investors in the IPO. It is a good idea to:

- Review the company's material contracts
- Determine whether any such contracts warrant confidential treatment
- Submit a CTR for any that do early in the process to ensure that such request does not cause a delay in the IPO

5 Review the company's shareholder agreements and capital structure to determine whether the IPO will trigger any specific rights or obligations.

Review the company's existing agreements (including its organizational documents, debt instruments, shareholder agreements, and equity award agreements) to determine whether any parties have rights in connection with the IPO or whether the IPO will trigger obligations under these agreements. For example, the filing of an IPO registration statement or completion of an IPO could trigger:

- A change of control provision under certain contracts resulting in a default or allowing a counterparty to terminate a contract
- Conversion rights if a company has outstanding convertible securities
- Vesting of outstanding stock options under equity award agreements or changes in pricing terms of awards
- Rights of certain existing shareholders to participate in or consent to the IPO

6 Work with the company's equity holders to determine the preferred post-IPO shareholder and governance structure.

The right board composition and governance structure for a new public company are driven by various factors, including stock exchange requirements, the preferences of significant pre-IPO shareholders, and marketing concerns.

The New York Stock Exchange and the NASDAQ Stock Market each have rules regarding the composition of boards and committees for listed companies, including with respect to director independence. An IPO issuer can take advantage of a transition period to comply with certain of these rules. If the company will have a controlling shareholder or group of shareholders post-IPO, it may also qualify for exemptions from certain of these rules.

Significant pre-IPO shareholders may be entitled to certain rights pursuant to a shareholders' agreement either already in existence or entered into in connection with the IPO. Newly public companies also typically adopt anti-takeover defensive measures at the time of an IPO, such as a classified board. A dual-class shareholder structure is especially popular with company founders in the technology industry and allows founders to maintain control of the company through a high-vote class of stock, even when the public investors own a majority of the economic value of the stock.

From a marketing standpoint, the underwriters may have a view on these governance structures and defensive measures. They may also recommend that an issuer have a certain number of qualified, independent directors in place at the time of the IPO, even if it could technically take advantage of an available transition period or controlled company exemption. Issuers should be cognizant of the concerns of proxy advisory firms and active institutional investors who may vote against (or recommend a vote against) directors if they are not happy with the board composition, governance structure, or anti-takeover measures instituted at the time of the IPO.

Related Content

For detailed information on conducting an IPO, see

> **PREPARING A CLIENT TO GO PUBLIC**

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

For an overview of U.S. securities laws, see

> **U.S. SECURITIES LAWS: AN OVERVIEW**

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

To learn about the IPO due diligence process, see

> **MANAGING THE DUE DILIGENCE PROCESS FOR AN IPO**

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

7 Make sure the company's compensation arrangements are in order.

The registration statement will require in-depth disclosure of the company's historical compensation arrangements, including the compensation received by top executives and directors in the year ended prior to the offering. In addition, you will need to disclose the compensation arrangements that are entered into in connection with the IPO or that will be in place post-IPO. These disclosure requirements will continue once the company is public.

Consider engaging a compensation consultant in anticipation of an IPO to help design public company compensation arrangements and benchmark against company peers. Issuers usually adopt a new equity incentive plan either in anticipation of, or at the time of, an IPO, typically with equity grants made to directors, officers, and key employees in conjunction with the IPO.

8 Build the internal resources necessary to complete the IPO and be a public company.

Issuers will rely extensively on outside counsel, auditors, and the underwriters to guide them through the IPO process. But companies also need to make sure they have adequate internal resources to complete an IPO and actually function as a public company post-IPO. Private companies will often build out their finance functions and internal legal teams in anticipation of an IPO. This build-out will continue as the company gets closer to completing an IPO and prepares to be a public company.

9 Consider whether an Up-C structure is right for the issuer.

IPO companies and their equity owners are increasingly using complex organizational structures to take advantage of the significant tax benefits they may entail. An Up-C structure allows a pass-through entity such as a limited partnership to go public while reducing the taxation typically associated with public C-corporations. Although these structures may involve additional complexity, the potential savings are significant. Up-C structures have become more popular in recent years and IPO investors are now more familiar with them and receptive to investing in companies utilizing these structures, despite the additional complexity.

10 Coordinate with any concurrent private offering.

If an issuer is considering an unregistered private offering shortly before or even concurrently with an IPO, be aware that the rules for private offerings differ from registered public offerings. Every private offering must have a valid exemption from registration under the Securities Act of 1933, which may limit the investors that can participate in and the procedures for conducting the offering. Failure to follow the applicable rules may result in the loss of the exemption an issuer is using for the private offering and/or result in the exclusion of the private offerees from being able to participate in the IPO. L

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

Jacob T. Muklewicz KIRTON MCCONKIE

HANDLING I-9 INVESTIGATIONS BY GOVERNMENT AGENCIES

This article provides guidance on responding to an investigation (i.e., an audit) by a government agency of an employer's I-9 records. The article mainly focuses on the Department of Homeland Security's (DHS) Immigration and Customs Enforcement (ICE) agency, which conducts most I-9 government audits.

ALL U.S. EMPLOYERS ARE REQUIRED TO VERIFY THE identity and work authorization of their U.S. employees hired after November 6, 1986, pursuant to the Immigration Reform and Control Act of 1986 (IRCA). Employers should document employment authorization verification on Form I-9. Further, employers are required by law to maintain the forms for government inspections.

Step 1: Who Performs Government Audits?

The following government entities may conduct Form I-9 audits:

- Department of Justice's (DOJ) Office of Special Counsel (OSC) for Immigration-Related Unfair Employment Practices
- Department of Labor (DOL)
- ICE, which carries out most I-9 government audits

OSC Investigations

The OSC investigates and prosecutes allegations of discrimination under Section 274B of the Immigration and Nationality Act (the Act or INA) (INA § 274B; 8 U.S.C. § 1324b). Investigations focus primarily on allegations of national origin and citizenship status discrimination in hiring, firing, and recruiting for a fee, but they also deal with unfair documentary practices during the I-9 employment verification process.

You must therefore advise employers that they may not specify which documents the employee must present to establish identity and employment authorization as this may lead to charges of discrimination by the OSC. You must also advise employers that they may not over-document (i.e., ask for more documents than necessary to complete the I-9 process) or require re-verification for certain classes of employees, such as lawful permanent residents. This may also lead to charges of document abuse by the OSC.

DOL Investigations

The DOL also has the authority to inspect Forms I-9. The DOL may in its discretion issue a Warning Notice to a person or entity alleged to have violated the employer sanctions provisions under INA § 274A (8 U.S.C. § 1324a) for the knowing hire of an unauthorized worker or the continuing employment of an unauthorized worker. This Warning Notice will contain a statement of the basis for the violations and the statutory provisions alleged to have been violated.

The DOL may also inspect Forms I-9 in connection with alleged violations of the Fair Labor Standards Act (FLSA) for failure of employers to pay required wages.

ICE Investigations

As stated above, ICE performs most I-9 government audits. It may inspect an employer's Forms I-9 at any time whether triggered by a complaint or on its own initiative. For the remainder of this article, we will focus on ICE as the investigating agency.

ICE audits employers' Forms I-9 and other documents to ensure that employers properly and timely complete the employment verification process required by IRCA. This article identifies chronologically the events that occur during an I-9 investigation by ICE and how you should assist employers in responding to and preparing for such an audit.

Step 2: What Steps Are Included in the Audit Process?

This section of the article addresses key phases of ICE's I-9 audit process and provides guidance on handling and responding to such audits.

Receiving and Reviewing the Notice of Inspection

ICE initiates an I-9 audit by serving a Notice of Inspection (NOI) compelling the production of I-9 forms and other relevant documents. ICE may serve an NOI with an attached document list or with a subpoena. ICE may serve an NOI and subpoena at an employer's headquarters. Alternatively, if the employer has offices dispersed throughout the United States, ICE may serve an NOI or subpoena at any individual office.

The NOI should clearly identify the employer subject to the I-9 audit. The NOI should also specify whether the employer must produce I-9 forms for only current employees or for current and terminated employees. The NOI will explain that the employer has three business days to gather and produce the requested I-9 forms and supporting documentation to ICE. 8 C.F.R. § 274a.2(b)(B)(ii). The NOI will additionally give the employer an option to waive the three-day notice period and immediately turn over the requested information. It will usually identify the date, time, and location for turning over the I-9 forms and other documentation that ICE may request.

Responding to a Notice of Inspection

The first thing the employer should do is to notify you as designated legal counsel. The employer must treat an NOI as any other service of process and immediately report through the appropriate internal channels. Since the law allows only three business days for the production of the I-9 forms and requested documents, it is important that the NOI receive immediate attention. If the employer allows only certain designated representatives to accept service of legal process, the receptionist or other administrative personnel must immediately notify designated legal counsel whenever ICE serves an NOI. If the ICE officer asks questions while serving the NOI, the investigative record will include any information it receives in response to these questions. Therefore, only you should provide information to ICE. Employees should advise ICE that they are not authorized to speak on behalf of the employer.

Never Waive the Three-Day Notice Period

In accordance with federal regulations, the employer has three business days to produce the I-9 forms and requested documents to ICE. 8 C.F.R. § 274a.2(b)(B)(ii). Even if the employer believes that the I-9 forms and other documents are in order, you should use the three days allowed by law to review all I-9 forms and other requested documents as well as make any allowable corrections.

Specifically, you should make sure that the employer has an I-9 form for each employee identified in the other documents that ICE requests. For example, ICE requests in most NOIs copies of the employer's payroll records and quarterly wage reports submitted to the appropriate state authorities. ICE requests these documents because it wants to identify all employees who have received compensation. The employer should have completed I-9 forms for each employee hired after November 6, 1986, and listed on payroll records and quarterly wage reports.

If the employer fails to produce I-9 forms for employees hired after November 6, 1986, and listed on payroll records and quarterly wage reports, ICE will penalize the employer for failing to complete I-9 forms for the employees. As explained below in the subsection entitled "Common Errors on Forms I-9," this is a substantive violation (as opposed to a less serious technical violation). Therefore, you and the employer should use the three-day period afforded by law to reconcile the employer's payroll records and quarterly wage reports to ensure that it produces an I-9 form for each employee hired after November 6, 1986.

Communicate Professionally with the ICE Agent as an Adversary

Service of an NOI is a legal process that can lead to significant civil and criminal penalties for non-compliance. See Developing an I-9 Policy and Best Practices for I-9 Compliance — Step 6: Determine How the Employer Prevents Liability for Unauthorized Workers. Therefore, you and the employer should not approach an I-9 audit initiated by ICE as a friendly exchange of documents. Any information that the employer's representatives divulge to ICE will be part of the administrative record. Therefore, only you as designated legal counsel should communicate with ICE.

Carefully Read the NOI and Any Accompanying Subpoena

An NOI or subpoena may come in a variety of forms—some may be vague, while others may be specific. The employer should understand the scope of the NOI or subpoena issued by ICE and, if possible, narrow it.

For example, you must pay close attention to whether the NOI requests I-9 forms for both current and terminated employees, as well as what time frames the NOI covers. Requests for terminated employees' I-9 forms do not always correspond to employers' retention requirements. If the NOI requests a subset of I-9 forms for terminated employees that the employer must retain, the employer should provide only that subset. However, if the NOI requests I-9 forms for terminated employees whose I-9 forms have been properly purged, you should notify ICE accordingly. The retention period for Forms I-9 for terminated employees is three years from the date of hire or one year from the date of termination, whichever is later. 8 C.F.R. § 274a.2(b)(D)(2)(A).

Sometimes ICE agents may request documents beyond the proper scope of an I-9 investigation. ICE's request for additional supporting documents must be relevant to the I-9 audit. If you believe that any documents that ICE requests are not relevant to the I-9 investigation, you must communicate to ICE in writing the reasons for the excessive scope of the NOI or subpoena.

Clarify Ambiguities in the NOI with the ICE Agent or Auditor

The ICE agent or auditor should provide his or her contact information or business card when serving the NOI. Every ICE agent or auditor handles audits differently. It is important to know the process that the agent or auditor will follow. Therefore, you should inquire about the ICE agent's or auditor's timeline, expectations, and process.

You should also confirm with the ICE agent or auditor any ambiguities in the NOI, which may include, but are not limited to, the following:

- **Which documents is ICE requesting?** For example, determine if the ICE agent or auditor is requesting only I-9 forms or I-9 forms and supporting documents as well.
- **In what format should the employer provide the information?** For example, some agents and auditors want the payroll records in Excel or Word or another electronic format rather than in hard copy form.
- **What is the exact time and date that the ICE agent or auditor will return to retrieve the I-9 forms?** If this information is not included in the NOI, you should negotiate when the ICE agent or auditor will retrieve the documents.
- **Which employees are subject to the NOI?** For example, is ICE requesting I-9 forms only for current employees or also for terminated employees?
- **Which are the employer entities or locations that are subject to the NOI?** This can be an issue if ICE serves the NOI at an employer's remote office and not at its headquarters. Whether or not to raise this issue is a strategic decision for you as designated legal counsel. Typically, if ICE serves only a single location and the NOI does not indicate otherwise, ICE is auditing only that location.

Production of Requested Documents

After confirming with the ICE agent or auditor the proper scope of the I-9 investigation, the employer must gather the I-9 forms and relevant supporting documents that ICE requests in the NOI or subpoena. ICE uses the supporting documents to confirm whether or not an employer has an I-9 form on file for each current and terminated employee as required by law.

After gathering the applicable I-9 forms and supporting documents, the employer, under your guidance must perform the following tasks before ICE's document production deadline:

- **Make sure that there are I-9 forms on file for all current and terminated employees.** Ensure this task is completed by checking each employee's name against employee, payroll, and tax records.
- **Make sure that all I-9 forms are properly completed.** For a checklist on completing Form I-9, see Checklist – Completing Form I-9.

ICE typically requests in an NOI or subpoena:

- Original I-9 forms and one photocopy for all current employees and all terminated employees that were either:
  - Hired within three years of the date of the NOI or subpoena –or–
  - Terminated within one year of the date of the NOI or subpoena

Storage of Forms I-9

Federal regulations allow employers to store I-9 forms on-site or off-site and in hard copy, on microfilm/microfiche, in an electronic format, or in any combination of the above. 8 C.F.R. § 274a.2(a)(2).

Regarding electronically-stored I-9 forms, federal regulations provide that at the time of an inspection by ICE, the person or entity required to retain the Forms I-9 must:

- Retrieve and reproduce (including printing copies on paper, if requested) only the Forms I-9 electronically retained in the electronic storage system and supporting documentation specifically requested by an agency of the United States, along with associated audit trails. Generally, an audit trail is a record showing who has accessed a computer system and the actions performed within or on the computer system during a given period of time –and–
- Provide a requesting agency of the United States with the resources (e.g., appropriate hardware and software, personnel, and documentation) necessary to locate, retrieve, read, and reproduce (including paper copies) any electronically-stored Forms I-9, any supporting documents, and their associated audit trails, reports, and other data used to maintain the authenticity, integrity, and reliability of the records.

8 C.F.R. § 274a.2(e).

You should provide, if requested, any reasonably available or obtainable electronic summary file(s), such as a spreadsheet, containing all of the information fields on all of the electronically-stored Forms I-9 requested by a requesting agency of the United States.

Additional Documents ICE May Request in an NOI or Subpoena

Apart from requesting Forms I-9, ICE may request the following items:

- **Copies of employees' documents.** The employer should keep copies of identification documents that employees submit during the hiring process (e.g., passports, IDs, Social Security cards, drivers' licenses, I-94s, I-151s, I-551s, I-688s, I-766s, or any other acceptable documents). Generally, employers may choose whether or not to retain copies of employees' documents together with their I-9 forms. However, if the employer chooses to keep copies of documents, it must do so indiscriminately for all employees. 8 C.F.R. § 274a.2(b)(D)(3).

  If the employer participates in E-Verify , then it must keep copies of employees' U.S. passports, U.S. passport cards, I-551s (Permanent Resident Cards commonly known as green cards), and I-766s (Employment Authorization Documents (EADs)).
- **Quarterly payrolls.** The employer should keep a copy of its last two quarterly payrolls, including payments to independent contractors. Although employers are not required to complete and maintain I-9 forms for independent contractors, employers may not knowingly hire independent contractors to employ foreign nationals who are not authorized to work lawfully in the United States. See 8 C.F.R. § 274a.5 .
- **List of employees.** The employer should keep a list including each employee's full name, date of birth, Social Security number, hire date, and termination date, if applicable. If possible, the employer should provide its list of employees in an electronic format such as an Excel spreadsheet, which ICE prefers.
- **List of contractors.** The employer should keep a list of all independent contractors/subcontractors including the full name, date of birth, Social Security number, and dates worked. If the independent contractor/subcontractor is a business entity, the employer should provide:
  - An Employer Identification Number (EIN)
  - A Taxpayer Identification Number (TIN)
  - A Social Security number (SSN) –and–
  - Address information, a telephone number, and an e-mail address

  If possible, provide this information in an electronic format such as an Excel spreadsheet. You should additionally provide copies of all information provided to independent contractors (IRS Form 1099).
- **Service agreements.** The employer should keep copies of all service agreements with independent contractors.
- **Corporate documents.** The employer should keep copies of the following:
  - EIN
  - TIN
  - Owners' Social Security numbers, addresses, telephone numbers, and e-mail addresses
  - Copies of articles of incorporation/organization, if applicable –and–
  - Copies of business licenses
- **Quarterly tax statements.** The employer should keep copies of quarterly tax statements (IRS Form 941).
- **Social Security No Match letters.** The employer should keep copies of any and all prior correspondence from the Social Security Administration (SSA) to the employer regarding mismatched or no-matched Social Security numbers. These forms are known as Employer Correction Requests or Requests for Employee Information and commonly referred to as No Match letters. Note that the SSA no longer issues such letters due to budgetary constraints.
- **E-Verify and SSNVS enrollment.** The employer should keep documentation confirming whether or not the employer is a current or previous participant in E-Verify or the Social Security Number Verification Service (SSNVS) and if so, provide the date(s) when the employer began using the program(s).
- **Copies of employees' documents required by E-Verify.** If the employer participates or has participated in E-Verify, it must provide copies of all results for E-Verify inquiries. In addition, it must provide photocopies of Permanent Resident Cards and EADs for employees who provided those documents for employment verification and were hired after the employer began participating in E-Verify.
- **SSNVS results.** If the employer participates or has participated in the SSNVS, it must provide copies of all results for SSNVS inquiries.

If Necessary, Request an Extension for Production of Documents

If the employer needs to extend the document production deadline, you must submit on its behalf a written request to ICE explaining why it needs an extension and provide a reasonable proposed timeline for when the employer will produce the documents. It is up to the specific ICE office and agency conducting the investigation as to whether ICE will grant an extension. The employer and you should never assume that ICE will grant an extension of the three-business-day document production deadline.

Related Content

For detailed information on Form I-9 requirements and compliance, see

> DEVELOPING AN I-9 POLICY AND BEST PRACTICES FOR I-9 COMPLIANCE

RESEARCH PATH: *Labor & Employment > Business Immigration > Employment Eligibility Verification > Practice Notes > I-9 and E-Verify*

For a discussion of the requirements of the Immigration Reform and Control Act, see

> VERIFYING EMPLOYMENT ELIGIBILITY (I-9 AND E-VERIFY)

RESEARCH PATH: *Labor & Employment > Business Immigration > Employment Eligibility Verification > Practice Notes > I-9 and E-Verify*

For a discussion of best practices in responding to I-9 audits, see

> CHECKLIST – BEST PRACTICES FOR HANDLING FORM I-9 GOVERNMENT AUDITS

RESEARCH PATH: *Labor & Employment > Business Immigration > Employment Eligibility Verification > Forms > I-9 and Verify*

Additional related resources:

For more information on I-9 enforcement, see

> BUSINESS IMMIGRATION LAW: STRATEGIES FOR EMPLOYING FOREIGN NATIONALS § 8.07

Obtain a Receipt for Documents Produced

The ICE agent or auditor will review the I-9 forms and other documents for at least several weeks or months, generally at an ICE field office. Therefore, before the document production deadline, the employer should make a complete copy of all I-9 forms and other documents provided to ICE.

When the employer provides the I-9 forms and other documents to ICE, it should request an inventory receipt from the ICE agent or auditor listing the documents that the employer produced to ICE. You should retain a copy of the inventory receipt issued by the ICE agent or auditor. If ICE were to allege that the employer failed to produce the documents listed in the NOI or subpoena, the inventory receipt would serve as evidence that the employer timely produced the documents ICE requested.

Step 3: What Are the Post-audit Notifications an Employer May Receive?

Once ICE completes the I-9 audit, it will provide written notification to the employer of the results of the audit. At this stage, ICE issues, as applicable, various notices, including the following:

- **Notice of Inspection Results.** This notice, also known as a compliance letter, is used to notify an employer that ICE found the employer to be in compliance. No response to ICE is necessary.
- **Notice of Discrepancies.** This notice advises the employer that based on a review of the I-9 forms and documentation submitted by employees, ICE is unable to determine some employees' work eligibility. The notice will list the employees for whom ICE was not able to determine work eligibility. The employer must give those employees listed on the notice a copy of the notice and give them an opportunity to present ICE with acceptable documentation establishing their employment eligibility. If the employees have acceptable documents, the employer must present the documents to ICE. The employer must terminate employees who are unable to present acceptable documents. Also, when reporting to ICE the status of employees, the employer should explain all of the practices that it has implemented in good faith regarding employment verification to mitigate potential civil fines.
- **Notice of Suspect Documents.** This notice advises the employer that ICE has determined that employees are unauthorized to work and advises the employer of the possible criminal and civil penalties for continuing to employ unauthorized workers. ICE gives the employer and employees an opportunity to present additional documentation to demonstrate work authorization if they believe the finding is in error. The employer must give those employees listed on the notice a copy of the notice and give them an opportunity to present acceptable documentation to ICE establishing their employment eligibility. If the employees have acceptable documents, the employer must present the documents to ICE. The employer must terminate employees who are unable to present acceptable documents. Also, when reporting to ICE the status of employees, the employer should explain all of the practices that it has implemented in good faith regarding employment verification to mitigate potential civil fines.
- **Warning Notice.** ICE issues this notice when it identifies substantive violations, but the circumstances do not warrant a monetary penalty because there is an expectation of future compliance by the employer. No response to ICE is necessary.
- **Notice of Intent to Fine (NIF).** The last written notification by ICE that an employer may receive regarding the results of an I-9 audit is a Notice of Intent to Fine (NIF). ICE will issue this notice when it has found substantive or uncorrected technical violations, as

well as violations for knowingly hiring and continuing to employ unauthorized workers. For more information on NIFs, see the section directly below.

Step 4: What Are the Employer's Potential Liabilities?

When ICE serves an NIF, it will also provide charging documents specifying the employer's violations. Within 30 days of receiving a NIF, the employer has the opportunity to either negotiate a settlement with ICE or request a hearing before the Office of the Chief Administrative Hearing Officer (OCAHO). If the employer takes no action after receiving an NIF, ICE will issue a Final Order from which there is no appeal. 8 C.F.R. § 274a.9(f) . After receiving a Final Order, the employer must pay the civil fines according to the terms specified in the order.

For detailed information on the range of civil fines and criminal penalties that ICE may impose upon an employer found to be in violation of the employer sanctions provisions of INA § 274A; 8 U.S.C. § 1324a , see Developing an I-9 Policy and Best Practices for I-9 Compliance — Step 6: Determine How the Employer Prevents Liability for Unauthorized Workers .

Appeals

If an employer requests a hearing of an NIF, OCAHO will assign the case to an Administrative Law Judge (ALJ) and send all parties a copy of a Notice of Hearing and the government's complaint. The Notice of Hearing spells out the procedural requirements for answering the complaint and the potential consequences of failure to file a timely response.

Many OCAHO cases never reach the evidentiary hearing stage because either the parties reach a settlement subject to the approval of the ALJ, or the ALJ reaches a decision on the merits through dispositive prehearing rulings.

The ALJ may make one of the following findings regarding the civil fines calculated by ICE in the NIF: (1) uphold the fines, (2) decrease the fines, or (3) increase the fines.

Step 5: What Are the Proactive Measures an Employer May Take to Minimize Liability?

Establish Office Procedures to Prepare for a Potential Audit

The first step the employer should take to prepare for potential government I-9 audits is to disseminate and maintain at all its offices in all locations updated instructions explaining how to respond to the service of any legal process, including an NOI or subpoena involving an I-9 audit by ICE. Also, the employer should maintain updated contact lists for service of legal process so that employees at reception desks or in satellite offices know whom to alert immediately after receiving an NOI or subpoena. Generally they should alert you (or other designated legal counsel) about the NOI. The employer should send clear, concise instructions to employees at all locations that if any employee receives an NOI or subpoena, he or she is not authorized to speak on behalf of the employer and therefore lacks consent to waive the three-day notice period. In addition, the employer should send clear, concise instructions to employees at all locations that only you as designated legal counsel are permitted to communicate with ICE agents or auditors.

Lawfully Purge Terminated Employees' Forms I-9

When an employer terminates an employee, the employer should calculate the date when it can lawfully purge the terminated employee's I-9 form. An employer may purge a terminated employee's I-9 form either three years from the date of hire or one year from the date of termination, whichever is later. 8 C.F.R. § 274a.2(b)(D)(2)(A).

After the employer calculates the purge date, it should store the terminated employee's I-9 form in an I-9 file reserved for terminated employees arranged by termination date. For example, if an employer hired an employee on January 1, 2016, and terminated him or her on January 1, 2017, the employer would calculate the purge date by adding three years to the hire date (January 1, 2016 + 3 years = January 1, 2019) and one year to the termination date (January 1, 2017 + 1 year = January 1, 2018). In this scenario, the later date of January 1, 2019, would be the purge date. The employer should store the terminated employee's I-9 form in a file drawer for terminated employees and place the I-9 form in a separate folder for January 2019. In February 2019, the employer should purge all I-9 forms for terminated employees in the January 2019 purge folder. By timely purging terminated employees' I-9 forms, the employer will avoid the imposition of any liability for an I-9 form that may have been improperly completed.

Note, however, that after receiving an NOI or subpoena from ICE, the employer cannot purge I-9 forms for terminated employees. If an employer were to do so, it would be liable for obstruction of justice. Since in most cases terminated employees are neither available nor willing to help the employer make correctable revisions to defective I-9 forms, the employer cannot eliminate its liability for such mistakes if it does not regularly purge I-9 forms for terminated employees before receiving an NOI or subpoena from ICE.

Prepare and Maintain Updated Organizational Charts

A significant issue in I-9 investigations is often which corporate entity is the target of the investigation. If an employer has several related corporate entities throughout the United States, it should maintain an accurate, updated organizational chart of all entities in all locations. These charts will be essential in explaining to ICE the employer's complex organizational structure and in potentially minimizing the scope of an I-9 investigation.

Know the Storage Location of All Documents That ICE May Request

Most importantly, the employer and its entities must know at all times where all current and terminated employees' I-9 forms are stored. Also, in anticipation of an ICE audit, for each electronic generation or storage system used, the employer and its entities must maintain complete descriptions of the following:

- The electronic generation and storage system, including all procedures relating to its use –and–
- The indexing system that permits the identification and retrieval of relevant documents and records maintained in an electronic storage system

The employer and its entities are not required to maintain separate indexing databases for each system if comparable results can be achieved without separate indexing databases. The employer must retain only those pages of the Form I-9 on which the employer, its entities, or employees enter data.

If the employer has over the course of time had different policies regarding the retention of employees' documents, it should have copies of all internal policy memoranda explaining which policy regarding employee document retention was in place during all times. By retaining copies of policy memoranda, the employer can avoid potential claims of discriminatory document abuse.

Conduct Internal I-9 Audits Annually

By conducting internal I-9 audits annually, the employer can make correctable revisions on I-9 forms and prepare the supporting documents that ICE most likely will request in an NOI or subpoena. In fact, ICE encourages employers to conduct self-audits. Note that only the employee may make a correctable revision or addition to Section 1 of Form I-9, and only the employer may make a correctable revision or addition to Sections 2 and/or 3 of Form I-9.

Common Errors on Forms I-9

ICE classifies errors on I-9 forms as either technical or substantive. Substantive violations are more serious infractions that could have led to the hiring of an unauthorized alien. After turning over I-9 forms to ICE, employers cannot correct substantive errors. Substantive errors subject employers to civil fines. For examples of substantive and technical errors, see U.S. Immigration and Customs Enforcement, "Worksite Enforcement: Guide to Administrative Form I-9 Inspections and Civil Monetary Penalties" (Nov. 25, 2008). L

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RESEARCH PATH: *Labor & Employment > Business Immigration > Employment Eligibility Verification > Practice Notes > I-9 and E-Verify*

Checklist - **Best Practices for Handling Form I-9 Government Audits**

This checklist is a guide for assisting attorneys in providing guidance to employers responding to a government audit of Forms I-9. This checklist also provides guidance on conducting a self-audit to avoid penalties associated with government audits.

Department of Homeland Security's (DHS) Immigration and Customs Enforcement (ICE) agency performs most I-9 government audits and may inspect an employer's Forms I-9 at any time. For purposes of this checklist, we will refer to ICE as the investigating agency, although the Department of Justice and Department of Labor may also perform I-9 audits.

Initiation of the Audit and First Responsive Step

ICE undertakes the following process when beginning an I-9 audit.

- ICE begins the administrative inspection process (audit) by serving the employer with a Notice of Inspection (NOI), compelling the employer to produce all Forms I-9.
- The employer must give the Forms I-9 to ICE three business days after the employer receives the NOI. (If enrolled in E-verify, the employer must also submit E-Verify case summaries).
- If the inspection is the result of a criminal investigation, ICE may reduce or eliminate the three-day notice period.

Additional Items to Prepare for ICE Agents

Employers and their attorneys may conduct an internal audit to make any revisions before producing the required Forms I-9 and the following documents that ICE may request:

- List of all current employees hired since 1986
- List of all employees terminated in the past three years
- Original or electronic copies of Forms I-9 for both categories of employees listed above
- Log of all corrections made during the internal audit

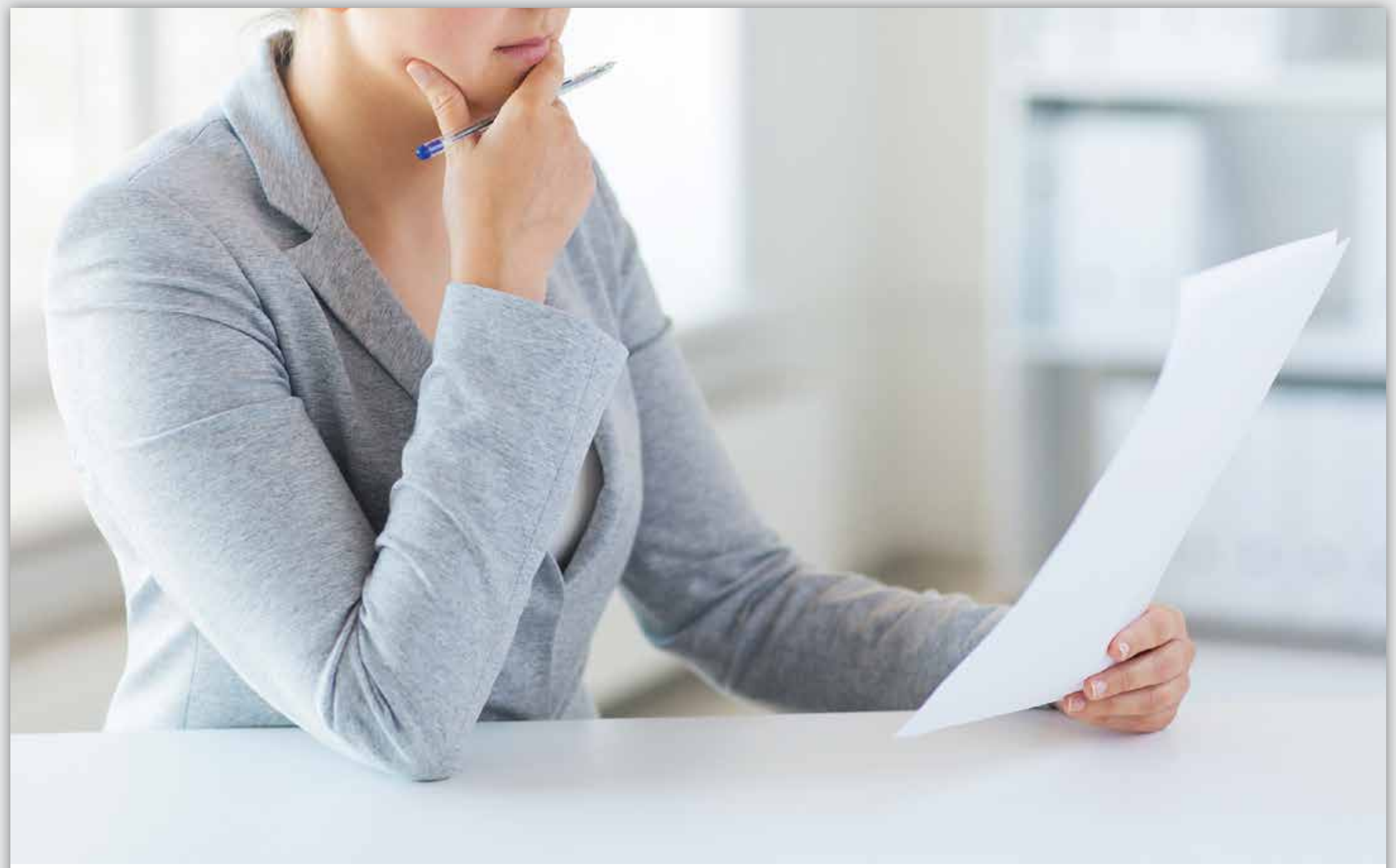
Conduct an Internal Audit

After reviewing the NOI, you should work closely and quickly with the employer's human resources manager, hiring manager, or personnel responsible for completing and maintaining the Forms I-9 for all employees.

For information on completing Form I-9, see Checklist – Completing Form I-9.

In three days, you should be able to take the following steps to reduce the employer's risk of penalties at the conclusion of the government audit:

- ✓ **Update employer's list of active employees hired (or re-hired) on or after November 6, 1986.** Employees hired before November 6, 1986, do not need completed Forms I-9 on file.
- ✓ **Update employer's list of all employees terminated within three years of the date of the NOI.** Ensure that you have a complete Form I-9 for all employees on each list.
- ✓ **Complete a new form I-9 for all active employees without a form on file.** View the employee's I-9 documentation and complete the form with the date you viewed the documentation. Do not backdate the form. The date of hire should be the employee's actual start date. Attach a memo to the employee's I-9 file explaining the discrepancy between the date of hire and the date the form was completed.
- ✓ **If you do not have a Form I-9 for terminated employees within the last three years, create a memo to the I-9 file explaining the absence of the I-9**. Keep this memo with the other Forms I-9. Date each memo and name the person drafting the memo.
- ✓ **Inspect sections 1 and 2 of Form I-9.** Check visa expiration dates to confirm continued employment eligibility. If you note deficiencies or inaccuracies, have the employee correct or complete section 1 and have the employer correct or complete section 2.



- ✓ **Inspect section 3 of Form I-9 to determine if re-verification of employee information is needed.** Re-verification is required if the employee's work authorization expired or the employer re-hired the employee.
- ✓ **If the Form I-9 is too difficult to revise, you may complete a new Form I-9.** Do not throw away the old form. The employer and employee should complete a new form and attach it to the old form in the I-9 file.
- ✓ **Inspect the copies of the eligibility documentation the employer used to complete Form I-9 (List 2 documents).** Employers need not make or keep copies of the documentation. However, if the employer makes copies it must retain them in the I-9 file with the accompanying Form I-9. If the employer keeps copies for one employee, it must keep copies for all employees.
- ✓ **Create an I-9 Compliance Revisions Log for every form with corrections.** The log should indicate the specific error identified and the correction made.

Present Required Documents for Inspection

At the end of the three-day notice period, the employer should present the Forms I-9 to the agent leading the inspection. Employers enrolled in E-Verify must also submit E-Verify case summaries with the Forms I-9 in response to an NOI.

The process for presenting the required documentation is as follows:

- The agent will instruct the employer on the specific manner in which the employer must deliver the required documents.
- The agent may inspect the original I-9 forms onsite and request copies of each form to be reviewed later at the agent's office.
- If the employer stores the I-9 forms electronically, it must reproduce or print the forms and any other document that the agent requested. The employer must also provide the agent with hardware and software necessary to inspect the electronic documents.

ICE Notices Prior to Completion of Audit

Before the audit is complete, the employer may receive one or more of the notices below from ICE:

- **Notice of technical or procedural failures.** This notice identifies the technical and procedural violations that the ICE agent discovered in the employer's Forms I-9. The employer has 10 days to make corrections. If the employer fails to correct these technical violations, each one will become a substantive violation.
- **Notice of discrepancies.** If ICE cannot determine an employee's employment eligibility from a review of the I-9 Form, the agent will request additional List 2 documents. Advise the employer to immediately provide the employee with a copy of the notice and provide the employee with more time to present additional eligibility documentation.
- **Notice of suspect documents.** If ICE determines the employee is not authorized to work in the United States, the employer will receive this notice. The notice advises the employer of possible criminal and civil penalties for continuing to employ the employee. Advise the employer to immediately provide the employee with time to present additional eligibility documentation to address the problem with the original documents. Present the new documentation to ICE as soon as possible. If ICE makes a second determination that the employee is ineligible to work in the United States, the employer must terminate that employee.

Final Audit Determination

Upon completion of the government audit, ICE will issue one of the three following Notices: (1) Notice of Inspection Results or Compliance Notice, (2) Warning Notice, or (3) Notice of Intent to Fine (NIF).

- **Notice of Inspection Results.** This notice states that the employer is in full compliance with the law and no further action is needed.
- **Warning Notice.** The warning notice will state that the audit identified substantive violations, but the government intends not to fine the employer or seek other penalties. It will also state that ICE expects the employer to be compliant in the future.
- **Notice of Intent to Fine.** ICE issues an NIF for substantive violations, uncorrected technical violations, and for knowingly hiring and continuing to employ unauthorized workers. When ICE serves an NIF on the employer, the government will also serve charging documents specifying the violations committed. The employer may negotiate a settlement with ICE or request a hearing before the Office of the Chief Administrative Hearing Officer. The employer must request a hearing within 30 days of the NIF date. If the employer takes no action, ICE will issue a Final Order and assess fines.

Fines

The penalties for I-9 violations are:

- The fines for knowingly hiring an unauthorized worker—or for continuing to employ an unauthorized worker after knowledge of ineligibility—range from $375 to $16,000 per violation that occurred on or before November 2, 2015, and range from $539 to $21,563 per violation that occurred after November 2, 2015.
- The fines for substantive Form I-9 verification violations—or for uncorrected technical violations—range from $110 to $1,100 per violation that occurred on or before November 2, 2015, and range from $216 to $2,156 per violation that occurred after November 2, 2015.

ICE may consider the employer's attempt to mitigate violations to enhance or reduce the fine assessed.

RESEARCH PATH: *Labor & Employment > Business Immigration > Employment Eligibility Verification > Forms > 1-9 and E-Verify*

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Copyrights in the Fashion Industry – Tips for Protecting Designs

THE U.S. SUPREME COURT CONFIRMED THAT ARTISTIC designs on clothing can be subject to copyright protection in Star Athletica, L.L.C. v. Varsity Brands, Inc., 137 S.Ct. 1002 (2017). This landmark decision follows years of uncertainty and inconsistent application of copyright doctrine in this important area. Although the case involved Varsity Brands' cheerleader uniforms with their particular arrangements of colors, shapes, stripes, and chevrons, the Court's ruling provides assurance to American fashion designers who often face an uphill battle to protect and enforce their original designs.

Protection of Fashion Designs in the United States

Guidance Following the *Varsity Brands* Decision

For attorneys representing designers, the *Varsity Brands* case serves as a reminder to register certain non-functional aspects of clothing with the U.S. Copyright Office. Moreover, when necessary, copyright owners can resort to the federal courts to enforce their rights against competitors and creators of knock-off designs. The Copyright Act provides extensive remedies for infringement of a registered work—including statutory damages and attorney's fees—so the impact of *Varsity Brands* could be substantial.

Over the past decade, Congress has considered a number of bills to protect apparel and other fashion designs, most recently the Innovative Design Protection Act of 2012. To this point no such legislation has been enacted. By contrast, the European Union and several European countries specifically protect fashion designs. Because there is no federal statute expressly protecting clothing, the availability of copyright protection—at least for surface decorations and other non-functional elements—is crucial.

Counsel for designers have attempted in the past to rely on others types of intellectual property, such as trade dress and design patents, to enforce designers' rights. These avenues are still available but each presents obstacles. To establish trade dress rights, a party typically must prove acquired distinctiveness—that is, consumer recognition as an identifier of source. This generally requires extensive use and promotion. Given the pace at which copycat designers spring into action, proving acquired distinctiveness can be an insurmountable obstacle. On the other hand, design patent protection extends only to works that are non-functional, novel, and nonobvious, which excludes many clothing designs. Moreover, the time and expense involved in obtaining patent protection often makes this impractical.

Copyright Protection and Separability

Copyright protects "original works of authorship," including pictorial, graphic, and sculptural works. 17 U.S.C. § 102(a). It does not protect useful articles such as clothing. However, under the separability doctrine, "the design of a useful article . . . shall be considered a pictorial, graphic, or sculptural work"—and therefore subject to copyright—"if, and only to the extent that, such design incorporates pictorial, graphic, or sculptural features that can be identified separately from, and are capable of existing independently of, the utilitarian aspects of the article." 17 U.S.C. § 101.

The road to copyright protection of non-functional clothing designs begins with Mazer v. Stein, 74 S.Ct. 460 (1954), in which the Supreme Court laid the foundation for the separability doctrine. That case involved statuettes featuring male and female dancing figures. The Court held that the statuettes were copyrightable, even though they were intended as bases for table lamps—unquestionably useful articles—which included electric wiring, sockets, and lamp shades. It recognized that "Congress intended the scope of the copyright statute to include more than the traditional fine arts." *Id.* at 468.

In Kieselstein-Cord v. Accessories By Pearl, Inc., 632 F.2d 989 (2d. Cir. 1989), another leading case in this area, the Second Circuit U.S. Court of Appeals held that a designer's decorative belt buckles were subject to copyright. While belt buckles generally are utilitarian objects, the court explained, "these are not ordinary buckles; they are sculptured designs cast in precious metals—decorative in nature and used as jewelry is, principally for ornamentation." *Id.* at 990. It found that the belt buckle patterns "rise to the level of creative art" and were copyrightable. *Id.* at 994.

The defendant—a competitor who admitted copying the plaintiff's belt buckles—argued that they were not subject to copyright because any artistic features were inseparable from the utilitarian aspects of the buckles. The court disagreed. While the plaintiff's designs could not be "physically" separated from the belt buckles, they could be separated "conceptually." *Id.* at 993.

Recent cases involving clothing designs have applied varying reasoning and reflect courts' struggles in this area.

- In Galiano v. Harrah's Operating Co., 416 F.3d 411 (5th Cir. 2005), the court held that the plaintiff's uniform designs for casino workers were not subject to copyright. It emphasized that the designs were not "marketable independently of their utilitarian function as casino uniforms." *Id.* at 422.
- In Chosun International, Inc. v. Chrisha Creations, Ltd., 413 F.3d 324 (2d Cir. 2005), the court held that the plaintiff's Halloween costumes (a lion, orangutan, and ladybug) may be subject to copyright. In reversing the trial court's dismissal, it found that certain features of the costumes such as heads or hands may "invoke in the viewer a concept separate from that of the costume's 'clothing' function, and that their addition to the costume was not motivated by a desire to enhance the costume's functionality *qua* clothing." *Id.* at 330.
- In Express, LLC v. Fetish Group, Inc., 424 F.Supp.2d 1211 (C.D. Cal. 2006), the court held that the design on the counterclaimant's tunic was entitled to copyright protection "because the lace and embroidery accents are totally irrelevant to the utilitarian functions of the tunic." *Id.* at 1224.
- In Jovani Fashion, Ltd. v. Fiesta Fashions, 500 Fed. Appx. 42 (2d Cir. 2012), cert. denied, 133 S.Ct. 1596 (2012), the court held that the plaintiff's prom dress design—including decorative sequins and crystals, satin ruching at the waist, and layers of tulle on the skirt—was not copyrightable. It found that these elements were not separable because they "enhance[d] the functionality of the dress as clothing for a special occasion"; thus, their removal would "adversely affect the garment's ability to function as a prom dress." *Id.* at 44.

Against this background, Varsity Brands, a leading producer of cheerleading uniforms, took its fight for copyright protection to the Supreme Court.

The Varsity Brands Case

Varsity Brands owns more than 200 copyright registrations for two-dimensional designs appearing on its cheerleading uniforms. But obtaining a copyright registration is one thing; enforcing it is another. In 2010, Varsity Brands sued Star Athletica, a competitor that it alleged copied its uniforms. Specifically, Varsity Brands alleged copyright infringement of five of its patterns shown below.

The U.S. District Court for the Western District of Tennessee held that the designs were not copyrightable and granted summary judgment in favor of Star Athletica. Varsity Brands, Inc., v. Star Athletica, LLC, 2014 U.S. Dist. LEXIS 26279 (W.D. Tenn. March 1, 2014). It determined that the designs could not be physically or conceptually separated from the "utilitarian function" of the uniforms as required under Section 101. The Sixth Circuit U.S. Court of Appeals reversed, finding the designs "separately identifiable" and protectable. Varsity Brands, Inc. v. Star Athletica, LLC, 799 F.3d 468 (6th Cir. 2015).

The Supreme Court granted certiorari. In a case that received widespread attention in both the legal and fashion communities, the Court received several amicus briefs, with the fashion industry generally supporting Varsity Brands. The Council of Fashion Designers of America, Inc. (CFDA) argued that a ruling in favor of Star Athletica "would have a swift and deleterious effect on United States fashion industry, leaving fashion designers defenseless against copyists and, thus, undermining their incentive and ability to continue pursuit of creating innovative, original designs." It emphasized the shift in the U.S. fashion industry over the past century from manufacturing to design, and the need to protect the works of American designers against piracy, particularly in view of new technologies:

APPENDIX TO OPINION OF THE COURT

Design 299A Design 299B Design 074 Design 078 Design 0815

WHILE VARSITY BRANDS' SURFACE DECORATIONS MAY BE SUBJECT TO COPYRIGHT, THE UNIFORMS THEMSELVES ARE NOT.

> While copying in the fashion industry is not a new problem, . . . new technologies have allowed for copying at a great scale, lower costs, and increasing speed. As one designer explained [at a House hearing]: "Digital photographs from a runway show in New York or a red carpet in Hollywood can be uploaded to the Internet within minutes, the 360 degrees images viewed at a factory in China, and copies offered for sale online within days—months before the designer is able to deliver the original garments to stores."

The Intellectual Property Owners Association and Fashion Law Institute, joined by various designers and fashion industry executives, also filed amicus briefs in support of Varsity Brands; while law professors and others filed amicus briefs in support of Star Athletica.

The Supreme Court's Decision

The Supreme Court considered the case "to resolve widespread disagreement over the proper test for implementing § 101's separate identification and independent-existence requirements." Varsity Brands, Inc., v. Star Athletica, LLC, 137 S.Ct. at 1007. It ruled in favor of Varsity Brands in a 6-2 decision. In a majority opinion written by Justice Clarence Thomas, the Court announced a two-part test for determining copyright protection in this area:

> [A] feature incorporated into the design of a useful article is eligible for copyright protection only if the feature (1) can be perceived as a two- or three-dimensional work of art separate from the useful article and (2) would qualify as a protectable pictorial, graphic, or sculptural work—either on its own or fixed in some other tangible medium of expression—if it were imagined separately from the useful article into which it is incorporated. *Id.*

Under this test, the Court held that Varsity Brands' designs may be subject to copyright, as long as they satisfy other prerequisites such as originality. "First, one can identify the decorations as features having pictorial, graphic, or sculptural qualities," the Court explained. "Second, if the arrangement of colors, shapes, stripes, and chevrons on the surface of the cheerleading uniforms were separated from the uniform and applied in another medium—for example, on a painter's canvas—they would qualify as 'two-dimensional . . . works of . . . art.'" *Id.* at 1012.

The Court focused on the language of Section 101 and the Copyright Act as a whole. Under Section 113(a), a copyright owner's exclusive right to reproduce a pictorial, graphic, or sculptural work "includes the right to reproduce the work in or on any kind of article, whether useful or otherwise." *Id.* at 1010. The Court explained that Section 101 is the "mirror image" of Section 113(a): "Whereas §113(a) protects a work of authorship first fixed in some tangible medium other than a useful article and subsequently applied to a useful article, §101 protects art first fixed in the medium of a useful article." *Id.* at 1011.

The Court found that it was irrelevant whether Varsity Brands' designs were physically separable from the uniforms: "The statutory text indicates that separability is a conceptual undertaking." *Id.* at 1014.

Likewise, the Court found it insignificant that imaginatively removing the designs from the uniforms and placing them in another medium, such as a canvas, would retain the outline of a cheerleading uniform. "Just as two-dimensional fine art corresponds to the shape of the canvas on which it is painted," the Court explained, "two-dimensional applied art correlates to the contours of the article on which it is applied." *Id.* at 1012. The Court compared the uniform designs to a design etched or painted on the surface of a guitar, which would maintain copyright protection if placed on album cover—even though it would still resemble the shape of a guitar. *Id.*

Star Athletica argued that Varsity Brands' surface designs themselves were utilitarian because plain white uniforms would be less appealing for cheerleaders. The Court disagreed. It explained that the focus of the separability inquiry is "on the extracted feature and not on any aspects of the useful article that remain after the imaginary extraction." *Id.* at 1013. Moreover, the Copyright Act does not protect only features that "have no effect whatsoever on a useful article's utilization function." Such an interpretation would deprive the *Mazer* statuette of protection, since "without the base, the 'lamp' would be just a shade, bulb, and wires." *Id.* at 1014.

Related Guidance

Counsel must recognize the limitation of the Court's holding. While Varsity Brands' surface decorations may be subject to copyright, the uniforms themselves are not. The Court explained that Varsity Brands has "no right to prohibit any person from manufacturing a cheerleading uniform of identical shape, cut, and dimensions." *Id.* at 1013.

As discussed above, Congress has not passed a law specifically directed at protecting fashion designs, and other areas of intellectual property, such as trade dress and design patents, have their limitations. While the full impact of *Varsity Brands* is not yet known, under some circumstances copyright may be the most effective means of protection and enforcement for designers in the United States.

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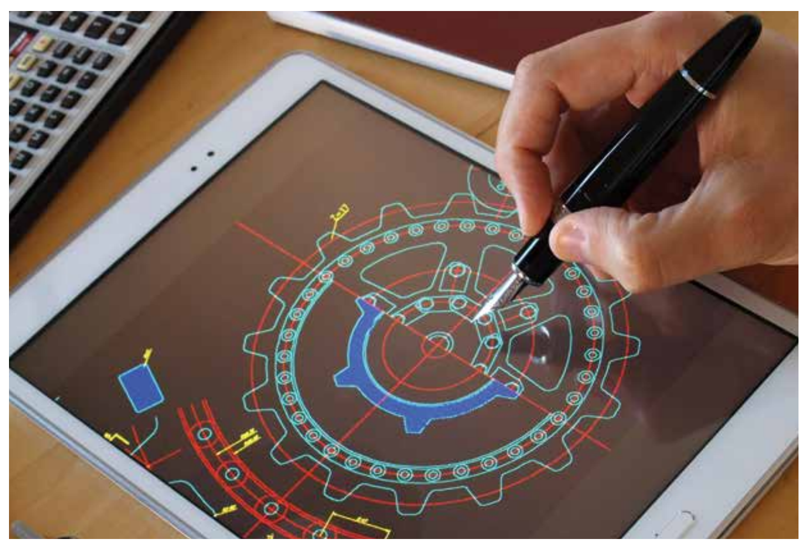
Drafting a Motion to Dismiss a Patent Infringement Complaint for **Failure to State a Claim under Rule 12(b)(6)**

THIS ARTICLE EXPLAINS THE STRATEGIC AND PRACTICAL considerations associated with filing a motion to dismiss claims of patent infringement under Rule 12(b)(6) of the Federal Rules of Civil Procedure and discusses the legal grounds that are commonly raised in such motions to dismiss, including grounds for dismissing claims of:

- Direct infringement
- Induced infringement
- Contributory infringement
- Willful infringement



Strategic and Practical Considerations in Determining Whether to File a Motion to Dismiss

Whether a viable legal basis exists to file a motion to dismiss a claim of patent infringement is addressed below under Grounds for Seeking Dismissal of Claims of Direct Infringement, Induced Infringement, Contributory Infringement, and Willful Infringement. However, even where there is a valid legal basis for filing a motion to dismiss, defendants should consider a number of other strategic and practical questions before deciding to move forward with a motion to dismiss.

Will the Plaintiff Be Able to Easily Overcome Deficiencies by Filing an Amended Complaint?

If you file a motion to dismiss that identifies a bona fide defect in a complaint, a plaintiff may simply respond by amending the complaint and correcting the defect.[1] Moreover, even if the court grants a motion to dismiss, it will generally also grant a plaintiff leave to amend the complaint and correct any defects absent a reason to withhold such leave.[2] Thus, not all defective complaints warrant a motion to dismiss. For example, a complaint may fail to allege that the accused product contains an element of a claim that is conventional in the art. Although such an omission would render a claim of infringement susceptible to a motion to dismiss, this defect could easily be corrected and litigation would proceed.

Will a Motion Force the Plaintiff to Narrow the Issues in the Litigation?

On the other hand, regardless of whether the plaintiff will ultimately be able to file an acceptable amended complaint, you may want to file a motion to dismiss if it will help to narrow or frame the issues in the litigation. In particular, you can use a motion to dismiss as a tool to obtain more detailed allegations from the plaintiff. For example, you may wish to challenge a claim of direct infringement to force the plaintiff to file an amended complaint that more specifically discloses a theory of infringement. Requiring such a disclosure often assists in narrowing the scope of discovery and provides the defendant more concrete parameters in searching for prior art. This has becoming an increasingly common ground for motions to dismiss following the abrogation of Form 18, which previously permitted complaints to contain only minimal allegations of infringement. See Failure to Adequately Allege Direct Infringement below under Grounds for Seeking Dismissal of Claims of Direct Infringement.

Will Claims Survive Even If the Motion Is Successful?

Another consideration that often causes defendants to forego filing a motion to dismiss is that the motion, even if successful, would not dispose of the case, limit the defendant's potential liability, or otherwise narrow the issues in the litigation. For example, you may choose to not to file a motion to dismiss an inadequately pled claim of contributory infringement if the plaintiff has properly stated claims of direct and induced infringement.

Would the Basis for Dismissing the Complaint Be More Effectively Raised at a Later Stage of the Case?

Under some circumstances, defendants may opt to forego filing a motion to dismiss where the grounds for dismissing the complaint would be better raised as a motion for judgment on the pleadings under Fed. R. Civ. P. 12(c) or an early motion for summary judgment under Rule 56 of the Federal Rules of Civil Procedure. Waiting to raise deficiencies in the plaintiff's claims may make sense where those deficiencies will be highlighted by further proceedings. For example, a defendant may wait before raising patent eligibility challenges under 35 U.S.C. § 101 until the plaintiff has served its initial infringement contentions and taken claim construction positions. Broad positions taken by a plaintiff on infringement and claim construction will frequently support an argument that the patent is directed to an abstract idea, lacks an inventive concept, and is therefore invalid under § 101. Also, if the construction of disputed claim terms would affect the outcome of the § 101 issue, a defendant will likely have no choice but to wait to seek dismissal of the claim terms until after claim construction proceedings are concluded.[3] In such a situation, you would bring that issue before the court in the form of a judgment on the pleadings or summary judgment motion rather than a motion to dismiss.

You may also wish to forego filing a motion to dismiss that will alert the plaintiff to potential flaws in its case and provide the plaintiff an opportunity to focus on and address those weaknesses. For example, a defendant may wish to raise strong non-infringement defenses by way of a motion for summary judgment rather than providing the plaintiff with the opportunity to develop alternative theories of infringement.

Will the Motion to Dismiss Reinforce a Helpful Litigation Theme?

In close cases, defendants may be persuaded to file a motion to dismiss if it will reinforce a helpful theme in the litigation. For example, if the motion will highlight for the court a fundamental and enduring deficiency in the plaintiff's case, the defendant may move forward with the motion even if the motion is unlikely to succeed. Similarly, a motion to dismiss may allow the defendant to highlight the plaintiff's lack of pre-suit diligence and lay the foundation for a later motion for fees under 35 U.S.C. § 285 by convincing the judge at an early stage that the plaintiff's lack of diligence was exceptional. Additionally, a motion to dismiss can send a message to a plaintiff that the defendant is prepared to vigorously litigate the case, which can sometimes improve your settlement position.

Will Filing a Motion to Dismiss Impact the Case Schedule in a Way That Is Beneficial?

You should also consider if a motion to dismiss may beneficially impact the deadlines in your case. First, a motion to dismiss constitutes a responsive pleading under Fed. R. Civ. P. 12. As such, even if the motion to dismiss is denied, you will not be required to file an answer to the complaint until 14 days after the denial. By delaying the answer deadline, you have additional time to develop your case strategy and the factual basis for your affirmative defenses and counterclaims. Second, a motion to dismiss often has the practical effect of delaying discovery. While it is rare for a court to formally stay a case

1. Fed. R. Civ. P. 15(a)(1)(B). 2. Foman v. Davis, 371 U.S. 178, 182, (1962); see also Fed. R. Civ. P. 15(a)(2).

3. Bancorp Servs., L.L.C. v. Sun Life Assur. Co. of Canada (U.S.), 687 F.3d 1266, 1273–74 (Fed. Cir. 2012).

pending resolution of a motion to dismiss, courts routinely wait to hold a Rule 16 of the Federal Rules of Civil Procedure scheduling conference (or to issue a scheduling order) until a pending motion to dismiss is resolved, providing you additional time to prepare your case.

Governing Standards for Motions to Dismiss

A motion to dismiss under Fed. R. Civ. P. 12(b)(6) will typically include a brief recitation of the governing legal standards. Because a Fed. R. Civ. P. 12(b)(6) motion raises a procedural issue that is not unique to patent law—the adequacy of the complaint under Rule 8 of the Federal Rules of Civil Procedure—the movant should cite precedent from the regional circuit in which the case is pending, as well as the Supreme Court's decisions in *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544 (2007) and *Ashcroft v. Iqbal*, 556 U.S. 662 (2009). Federal Circuit precedent, however, will still control any relevant issues of substantive patent law (e.g., the elements necessary to prove claims of infringement).

Grounds for Seeking Dismissal of Claims of Direct Infringement

A claim for direct infringement arises under 35 U.S.C. § 271(a). The standards for pleading a claim of direct patent infringement changed on December 1, 2015, when the sample complaint governing such claims (Form 18) was abrogated. Claims must now plead facts that render the claim plausible, rather than merely possible, as set forth in *Twombly* and *Iqbal*.[4] Due to this recent change in the law, the grounds for seeking the dismissal of claims of direct infringement are somewhat unsettled and vary from jurisdiction to jurisdiction (and even from judge to judge within the same jurisdiction). You should research the case law in your circuit to determine the current standards of pleading requirements.

Failure to Adequately Allege Direct Infringement

In order to directly infringe a patent, an accused product or process must practice (either literally or under the doctrine of equivalents) every limitation of an asserted patent claim. An increasingly common basis for seeking dismissal of a claim of direct infringement is that the complaint does not set forth a plausible factual basis for inferring that the accused product or process satisfies all of the claim limitations.

Until the recent abrogation of Form 18, a claim for direct infringement required only a conclusory allegation. For example, stating that the defendant "has infringed and is infringing . . . by making, selling, and using electric motors that embody the patented invention" was a sufficient allegation.

Related Content

For an overview of the key issues in the patent litigation process, see

> PATENT LITIGATION FUNDAMENTALS

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For guidance on drafting an answer to a district court complaint for direct infringement of a patent, see

> DRAFTING THE ANSWER TO A PATENT INFRINGEMENT COMPLAINT

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For a sample brief that accompanies a motion to dismiss a patent infringement lawsuit, see

> BRIEF IN SUPPORT OF DEFENDANT'S MOTION TO DISMISS (SECTION 101, PATENT ACTION) (D. DEL.)

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For information on responding to patent cases that are brought by non-practicing entities (NPEs), see

> PATENT LITIGATION STRATEGIES AGAINST NPES

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Plaintiffs were not required to allege any facts supporting the assertion that the accused product(s) embodied the patented invention.

Following the abrogation of Form 18, courts generally agree that a complaint must contain more than conclusory allegations of infringement. Courts, however, have disagreed over how much additional information is required.

At a minimum, a complaint must:

- Identify the accused product or process
- Identify at least one claim that is allegedly infringed
- Provide a description of the feature of the accused product or process that is alleged to infringe the asserted claim[5]

A complaint lacking this information will be vulnerable to a motion to dismiss. Certain courts have gone a step further and held that a plaintiff must also now provide factual allegations sufficient to plausibly infer that an accused product or process satisfies each and every limitation of at least one patent claim. These cases require a plaintiff to include facts in the complaint akin to the infringement contentions traditionally served later in litigation pursuant to local patent rules. You may seek to dismiss a complaint under this line of cases if it:

- Is silent on one or more claim limitation
- Contains only conclusory allegations that a limitation is satisfied without underlying facts (e.g., by parroting the claim language) –or–
- Contains factual allegations that affirmatively show a limitation is not satisfied[6]

Not all courts, however, have required element-by-element factual allegations.[7] This is an area of the law that is rapidly developing, with new decisions issued regularly. As such, you should be sure to refresh your legal research in the jurisdiction where your case is pending prior to filing a motion to dismiss claims of direct infringement.

Failure to Adequately Allege Joint Infringement

To infringe a method claim, all of the steps of the method must be performed by, or be attributable to, a single entity.[8] Where more than one actor is involved in practicing the steps, the actions of those actors may be attributed to a single defendant for the purpose of infringement where:

- One entity directs or controls the other's performance –or–
- The actors form a joint enterprise[9]

This form of direct infringement is called divided or joint infringement.

If a plaintiff alleges infringement of a method claim based on the actions of multiple actors, the plaintiff must include facts in the complaint that plausibly give rise to an inference of divided infringement.[10] To adequately allege that a defendant directs or controls the activities of a third party, for example, a plaintiff must allege facts that would establish vicarious liability, such as an agency relationship or a contract between the defendant and the third party to perform one or more steps of the method.[11] To plead a joint enterprise, the complaint must set forth a plausible factual basis for inferring:

- An agreement, express or implied, among the members of a group
- A common purpose to be carried out by the group
- A community of pecuniary interest (a common financial interest) in that purpose among the members –and–
- An equal right to a voice in the direction of the enterprise, which gives an equal right of control[12]

You may thus attack a claim of joint direct infringement at the motion to dismiss stage where the plaintiff fails to allege facts to create an inference that one participant in the joint infringement controls the performance of another or that the participants form a joint enterprise.

Grounds for Seeking Dismissal of Claims of Induced Infringement

Claims for induced infringement arise under 35 U.S.C. § 271(b). To state a claim for induced infringement, a plaintiff must allege facts sufficient to infer all of the following:

- A third party directly infringed the asserted patent
- The defendant had knowledge of the asserted patent
- The defendant had the specific intent to induce the third party to infringe the asserted patent –and–
- The defendant actually caused the third party to directly infringe the asserted patent[13]

Failure to Adequately Allege Direct Infringement

A claim of induced infringement can only arise where a third party has directly infringed a patent-in-suit.[14] As such, you may move to dismiss a claim for induced infringement where the plaintiff has failed to offer factual allegations sufficient to create an inference that a third party has directly infringed a patent.[15] For example, you may seek to dismiss an inducement claim where the plaintiff has failed to identify, at least by category, the party that allegedly engages in direct infringement (e.g., customers).

Failure to Allege Pre-suit Knowledge of Patent-in-Suit

As a general matter, the knowledge requirement of a claim for induced infringement is not a fertile basis for filing a motion to dismiss because service of the complaint itself is sufficient to provide a defendant with the necessary knowledge of the patent.[16] Courts, however, have been willing to limit claims for induced infringement to post-suit activity in response to a motion to dismiss on the grounds that the plaintiff failed to allege pre-suit knowledge of the patent.[17] You should research the case law in your jurisdiction to determine if you can make a

4. Bell Atlantic Corp. v. Twombly, 550 U.S. 544, 570 (2007); Ashcroft v. Iqbal, 556 U.S. 662, 678 (2009).

5. Scripps Research Inst. v. Illumina, Inc., 2016 U.S. Dist. LEXIS 161279, at *12 (S.D. Cal. Nov. 21, 2016). 6. Atlas IP LLC v. Pac. Gas & Elec. Co., 2016 U.S. Dist. LEXIS 60211, at *12–13 (N.D. Cal. Mar. 9, 2016); RainDance Technologies, Inc. v. 10X Genomics, Inc., 2016 U.S. Dist. LEXIS 33875, at *6 (D. Del. Mar. 4, 2016). 7. Avago Techs. Gen. IP (Singapore) PTE Ltd. v. Asustek Computer, Inc., 2016 U.S. Dist. LEXIS 55655, *13 (N.D. Cal. Apr. 25, 2016); Uniloc USA, Inc. v. Avaya Inc., 2016 U.S. Dist. LEXIS 181826, at *14–15 (E.D. Tex. May 13, 2016). 8. Akamai Techs., Inc. v. Limelight Networks, Inc. 797 F.3d 1020, 1022 (Fed. Cir. 2015). 9. Id. at 1022. 10. Lyda v. CBS Corp., 838 F.3d 1331, 1339 (Fed. Cir. 2016). 11. *Akamai*, 797 F.3d at 1023. 12. Id. at 1023. 13. DSU Med. Corp. v. JMS Co., 471 F.3d 1293, 1304 (Fed. Cir. 2006) (en banc). 14. Limelight Networks, Inc. v. Akamai Techs., Inc., 134 S. Ct. 2111, 2117 (2014). 15. Global Tech LED, LLC v. Every Watt Matters, LLC, 2016 U.S. Dist. LEXIS 122111, *10–11 (S.D. Fla. May 18, 2016). 16. Uniloc USA, Inc. v. Avaya, Inc., 2016 U.S. Dist. LEXIS 181826 (E.D. Tex. May 13, 2016). 17. Telecomm Innovations, LLC v. Ricoh Co., 966 F. Supp. 2d 390, 394 (D. Del. 2013).

partial motion to dismiss a claim of indirect infringement that does not allege pre-suit knowledge of the patent.

Failure to Adequately Allege Specific Intent

A claim of inducement requires an allegation of culpable conduct directed to encouraging another's infringement.[18] This requirement cannot be satisfied merely by alleging that a defendant had knowledge of the patent and the direct infringer's activities.[19] A defendant should typically consider a motion to dismiss due to the failure to adequately allege specific intent in two circumstances.

First, you may move to dismiss a claim of induced infringement where the complaint contains only conclusory assertions of intent without any supporting factual allegations. For example, merely alleging that the defendant acted knowingly, intentionally, or with specific intent to induce infringement is not likely to be insufficient.[20]

Second, you may file a motion to dismiss where the plaintiff relies on the existence of product instructions or marketing literature to allege specific intent but fails to explain how those materials reflect an intent to encourage infringement.[21] As the Federal Circuit has noted, to be a sufficient basis for a claim of inducement, such materials must "teach an infringing use of the device such that we are willing to infer from those instructions an affirmative intent to infringe the patent."[22] In other words, the mere fact that an allegedly infringing device comes with instructions does not give rise to a plausible claim of inducement against the supplier without an explanation of how those instructions demonstrate an intent to induce the user of the device to infringe. The strength of a motion to dismiss on this basis, however, may vary substantially based on the jurisdiction and judge hearing the motion. Some courts have held, for example, that a complaint is sufficient even where it contains only the unsupported assertion that product instructions "encourage use of [the accused] products in ways that directly infringe."[23]

Grounds for Seeking Dismissal of Claims of Contributory Infringement

To state a claim for contributory infringement, a plaintiff must allege facts sufficient to plausibly allow an inference of all of the following:

- The defendant supplies a component that is a material part of a patented invention (or supplies a "material or apparatus" used in practicing a patented process).
- The defendant knew the component was "especially made or especially adapted for use in an infringement."
- The component has no substantial noninfringing use.
- The component is ultimately used in a direct infringement of the patent by a third party.[24]

Failure to Identify a Component, Material, or Apparatus Supplied by the Defendant

To be liable for contributory infringement under § 271(c), you must supply a component of a patented invention or a material or apparatus used in performing a patented method. You may therefore file a motion to dismiss if the plaintiff has failed to identify the component, material, or apparatus allegedly supplied by the defendant.[25]

Failure to Adequately Allege Direct Infringement

As with induced infringement, a plaintiff asserting a claim of contributory infringement must allege facts sufficient to support an inference that a third party is directly infringing the patent-in-suit.[26] You may thus seek to dismiss a claim of contributory infringement where the complaint lacks factual allegations sufficient to plausibly infer direct infringement.[27] This ground for seeking dismissal of a claim for contributory infringement is likely to grow in popularity as courts adjust to the abrogation of Form 18 and the new requirement that plaintiffs must plausibly plead claims of direct infringement under the standards of *Iqbal* and *Twombly*.

Failure to Allege Specific Intent

As with claims of induced infringement, claims of contributory infringement require that the defendant act with specific intent (i.e., that the defendant knew that the combination for which its components were especially made was both patented and infringing).[28] As such, you may seek to dismiss a claim of contributory infringement where the plaintiff fails to allege a plausible factual basis for inferring that the defendant knew of the patent-in-suit and knew that the acts of a third party constituted infringement of the patent.[29]

Failure to Adequately Allege No Substantial Noninfringing Uses

To state a claim for contributory infringement, a plaintiff must also plead facts that allow an inference that the components sold or offered for sale have no substantial non-infringing uses.[30] An alternative use of the components is not substantial if it is "unusual, far-fetched, illusory, impractical, occasional, aberrant, or experimental."[31]

18. DSU Med. Corp., 471 F.3d at 1306. 19. Takeda Pharms. U.S.A., Inc. v. West-Ward Pharm. Corp., 785 F.3d 625, 631 (Fed. Cir. 2015). 20. Telebrands Corp. v. GMC Ware, Inc., 2016 U.S. Dist. LEXIS 178545, at *20–21 (C.D. Cal. Apr. 5, 2016). 21. Takeda Pharms. U.S.A., Inc. v. West-Ward Pharm. Corp., 188 F. Supp. 3d 367, 377–78 (D. Del. May 18, 2016). 22. Vita-Mix Corp. v. Basic Holding, Inc., 581 F.3d 1317, n.2 (Fed. Cir. 2009). 23. M2M Sols., LLC v. Telit Comms PLC, 2015 U.S. Dist. LEXIS 102349, at *12 (D. Del. Aug. 5, 2015). 24. 35 U.S.C. § 271(c); see also C.R. Bard, Inc. v. Advanced Cardiovascular Sys., 911 F.2d 670, 673 (Fed. Cir. 1990). 25. Cleveland Clinic Found. v. True Health Diagnostics, LLC, 2016 U.S. Dist. LEXIS 21907, at *22 (N.D. Ohio Feb. 23, 2016). 26. Paper Converting Mach. Co. v. Magna-Graphics Corp., 745 F.2d 11, 24 (Fed. Cir. 1984). 27. Goade v. Parker Compound Bows, Inc., 2016 U.S. Dist. LEXIS 68896, at *9 (M.D. Tenn. May 24, 2016). 28. Fujitsu Ltd. v. Netgear Inc., 620 F.3d 1321, 1326 (Fed. Cir. 2010). 29. Bonutti Skeletal Innovations LLC v. Globus Med., Inc., 2015 U.S. Dist. LEXIS 77492, at *31–32 (E.D. Pa. June 15, 2015).

Several courts have held that a claim of contributory infringement may be dismissed where the plaintiff makes only a conclusory allegation that a component has no substantial non-infringing uses.[32] Other courts, however, do not require additional facts to support a claim of contributory infringement beyond an allegation that there are no substantial non-infringing uses.[33]

Failure to Allege That the Component Is a Material Part of the Invention

To state a claim of contributory infringement, a plaintiff must also allege facts plausibly showing that the defendant's component is a material part of the invention. You may move to dismiss if a complaint is silent on this element or merely contains a conclusory allegation reciting the language of the statute.[34]

Grounds for Seeking Dismissal of Claims of Willful Infringement

Under 35 U.S.C. § 284, courts may award enhanced damages up to three times the actual damages awarded in a patent infringement case if there is a finding that the defendant willfully infringed the plaintiff's patent. Plaintiffs routinely include a request for enhanced damages for willful infringement under 35 U.S.C. § 284 in complaints. Although willful infringement is not a cause of action itself, you may nonetheless seek dismissal of a claim of willful infringement under Fed. R. Civ. P. 12(b)(6).

Failure to Allege Pre-suit Knowledge of Patent

A prerequisite for a claim of willful infringement is that the defendant knew of the patent-in-suit.[35] The requirement for knowledge of the patent-in-suit is not always satisfied by simply serving the complaint. "[A] willfulness claim asserted in the original complaint must necessarily be grounded exclusively in the accused infringer's pre-filing conduct. By contrast, when an accused infringer's post-filing conduct is reckless, a patentee can move for a preliminary injunction[.]"[36]Some courts have interpreted *Seagate* to require a plaintiff to file a preliminary injunction in order to claim willful infringement based only on post-filing conduct in an amended complaint.[37] Thus, you can move to dismiss a request for enhanced damages under 35 U.S.C. § 284 in an original complaint when the plaintiff fails to adequately allege

pre-suit knowledge of the patent-in-suit and fails to seek a preliminary injunction.[38]

Failure to Adequately Allege Willfulness

On June 13, 2016, the Supreme Court addressed the standards governing a claim for enhanced damages under 35 U.S.C. § 284 in Halo Elecs., Inc. v. Pulse Elecs., Inc., 136 S. Ct. 1923, 195 L. Ed. 2d 278 (2016). The Court held that "objective recklessness" is not a requirement for awarding such damages, thereby rejecting the test the Federal Circuit articulated in In re Seagate Technology, LLC, 497 F.3d 1360 (Fed. Cir. 2007). The Court also held, however, that enhanced damages should generally be reserved for egregious cases typified by willful misconduct. The Court noted that willful misconduct must be beyond typical infringement and has been described as conduct that is "wanton, malicious, bad-faith, deliberate, consciously wrongful, flagrant, or—indeed—characteristic of a pirate." *Halo Elecs.*, 136 S. Ct. at 1932.

To state a claim for willful infringement, a plaintiff must allege facts sufficient to infer willful misconduct that meets the standard articulated in *Halo*. As such, you may seek to dismiss a claim for enhanced damages where the complaint is lacking such factual allegations that the defendant's alleged infringement meets this standard.[39] L

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RESEARCH PATH: *Intellectual Property & Technology > Patents > Patent Litigation > Practice Notes*

30. In re Bill of Lading, 681 F.3d 1323, 1337 (Fed. Cir. 2012). 31. Vita-Mix Corp. v. Basic Holding, Inc., 581 F.3d 1317, 1327 (Fed. Cir. 2009). 32. Telebrands Corp. v. GMC Ware, Inc., 2016 U.S. Dist. LEXIS 178545, at *19 (C.D. Cal. Apr. 5, 2016); Windy City Innovations, LLC v. Microsoft Corp., 2016 U.S. Dist. LEXIS 79380, at *20 (N.D. Ill. June 17, 2016); Intellicheck Mobilisa, Inc. v. Wizz Sys., LLC, 2016 U.S. Dist. LEXIS 7290, at *15 (W.D. Wash. Jan. 20, 2016). 33. Iron Gate Sec., Inc. v. Lowe's Cos., Inc., 2016 U.S. Dist. LEXIS 34061, at *11 (S.D.N.Y. Mar. 16, 2016); Westmoreland Advanced Materials, Inc. v. Allied Mineral Prods., Inc., 2016 U.S. Dist. LEXIS 76801, at *10 (W.D. Penn. June 13, 2016); Uniloc USA, Inc. v. Avaya Inc., 2016 U.S. Dist. LEXIS 181826, at *20–21 (E.D. Tex. May 13, 2016). 34. Enthone Inc. v. BASF Corp., 126 F. Supp. 3d 281, 289 (N.D.N.Y. 2015); Cellular Communs. Equip. LLC v. HTC Corp., 2015 U.S. Dist. LEXIS 179461, at *30 (E.D. Tex. Mar. 27, 2015). 35. Gustafson, Inc. v. Intersystems Indus. Prods., Inc., 897 F.2d 508, 511 (Fed. Cir. 1990). 36. In re Seagate Tech., LLC, 497 F.3d 1360, 1374 (Fed. Cir. 2007). 37. McRO, Inc. v. Namco Bandai Games Am., Inc., 23 F. Supp. 3d 1113, 1123 (C.D. Cal. 2013). 38. Windy City Innovations, LLC v. Microsoft Corp., 193 F. Supp. 3d 1109, 1117 (N.D. CA 2016). 39. Jenkins v. LogicMark, LLC, 2017 U.S. Dist. LEXIS 10975, at *12–13 (E.D. Va. Jan. 25, 2017).

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Using Mediation to Resolve **Construction Disputes**

Construction projects often take years to complete, involve layers of contractors and subcontractors, and employ hundreds, if not thousands, of workers. Efficient conflict resolution is important in the construction industry because it helps maintain relationships between people and entities who must continue to work together on a project that may be midstream in its schedule when conflicts arise. In addition to maintaining a good relationship on a project under construction, the parties want to maintain their relationship for future projects.

DISPUTES ARE VERY COMMON ON CONSTRUCTION PROJECTS, and the parties often turn to mediation to minimize disputes and the costs, both financial and time, arising from litigation and arbitration. Mediation is also appealing because a construction dispute can be mediated while litigation or arbitration is ongoing or while the project is still being constructed.

Mediation Basics

Mediation is a private dispute resolution process in which the parties work with a mediator to negotiate a settlement to their dispute. The mediator is a neutral party who has no vested interest in the outcome and is trained to facilitate a settlement between the parties. In addition, for construction disputes the mediator usually has experience in the construction industry.

A mediator cannot bind the parties to any outcome. In mediation, the parties are the decision makers and only they can reach a mutually satisfactory agreement and find solutions that facilitate completion of a project still under construction or preserve relationships for future construction projects. This contrasts with litigation and arbitration, where control of the dispute is relinquished to a court or arbitrator that has no interest in facilitating timely completion of a project or preserving relationships.

RECOGNIZING THE EFFECTIVENESS OF MEDIATION IN RESOLVING CONSTRUCTION DISPUTES, MANY CONSTRUCTION INDUSTRY STANDARD CONTRACTS REQUIRE THAT THE PARTIES MAKE A GOOD FAITH ATTEMPT TO SETTLE THEIR DISPUTE THROUGH MEDIATION PRIOR TO INSTITUTING LITIGATION OR ARBITRATION.

Advantages of Mediation in a Construction Dispute

Mediation is faster and less expensive than litigation or arbitration. Mediation sessions usually take no more than a day or two, compared to a court trial or arbitration hearing that can take weeks. Mediations can be scheduled as soon as the parties are ready, while arbitration hearings and court trials often take years to be scheduled. This time advantage is particularly important when the mediation takes place while a project is still under construction because resolution of disputes clears the way for more cooperation between the project participants.

Recognizing the effectiveness of mediation in resolving construction disputes, many construction industry standard contracts require that the parties make a good faith attempt to settle their dispute through mediation prior to instituting litigation or arbitration. See AIA Document A201 (2017) General Conditions of the Contract for Construction, Section 15.3 "Mediation." Some of the organizations that administer arbitrations have rules that require or encourage the use of mediation while the arbitration proceedings continue. See American Arbitration Association Construction Industry Arbitration Rules and Mediation Procedures Rule 10 "Mediation," which requires mediation of all disputes in excess of $100,000. In addition, it is common for courts handling construction disputes to refer a case to court-administered mediation programs because many judges find the complexities of construction disputes amenable to mediation.

Examples of construction disputes that are most frequently mediated include:

- Contractor's defective work
- Architect's defective plans and specifications
- Delays in project completion and other schedule issues
- Payment issues
- Changes to the scope of work
- Differing site conditions
- Property damage to the project
- Disputes arising from termination of a contractor or subcontractor

This list is not exhaustive.

Notwithstanding its benefits, mediation is only effective if both parties want to settle the dispute. If one of the parties is only participating in the mediation because of contractual requirements, arbitration, or court rules and is not interested in settling the dispute, mediation will not be effective.

Additional Advantages of Mediation

Confidentiality

In general, mediations are private and confidential and (unless the parties agree otherwise) everything discussed during the mediation and any settlement offers that are exchanged cannot be used in court or in an arbitration if the parties do not settle their dispute. Further, since mediation is a facilitated settlement negotiation between the parties, mediation is covered by evidentiary rules protecting communications between parties regarding settlement.

At the beginning of the mediation, the parties typically sign a confidentiality agreement. If the mediation is conducted pursuant to a court-sponsored mediation program, it is likely that the court's rules will require execution of a confidentiality agreement, and the mediator will not be permitted to discuss the mediation with the court. The only communication the mediator may have with the court is to advise the court if the case was settled or not.

In addition, if the parties settle their dispute, they can write a confidentiality clause into the settlement agreement. In contrast, court decisions resolving construction disputes are public. This issue is particularly important to an owner of a project who makes a payment to a contractor and does not want other contractors on future projects to see the owner as an easy target. Similarly, a contractor making a settlement payment to a subcontractor does not want to appear to be an easy target for other subcontractors it frequently hires.

Limited Discovery

While mediation does not eliminate discovery if a dispute is in litigation or arbitration, it can reduce it. Limited discovery is needed for the parties to have a full grasp of the facts surrounding the dispute so they can better assess their chances of success in court or in arbitration. In addition, with some discovery the parties are better able to assess and clarify their positions and, possibly, will be more inclined to settle their case at the mediation. Court-sponsored mediation programs often have rules allowing the mediator to suggest that some limited discovery and exchange of documents occur prior to the first mediation session, to allow the parties to assess their positions better. Therefore, it is recommended that parties exchange project documentation before the mediation of a construction dispute.

Some attorneys are concerned that by agreeing to limited discovery before the mediation, they are allowing a fishing expedition by the other party. However, such fears are unfounded. Court rules allow liberal discovery. Anything that an attorney would produce in mediation would be provided under a court's discovery rules anyway.

Timing is crucial because if the mediation is scheduled too early in the dispute process, the parties may not have sufficient information to make a good business decision. However, waiting too long to mediate can result in entrenched positions making a dispute difficult to settle.

The Mediation Process

First, the parties must select a mediator. The different ways to select a mediator are explained below. After the parties agree on a mediator, a pre-mediation conference call is held by the mediator and counsel for all the parties. The mediator and the parties set a date for the mediation and the mediator will ask each party to submit a pre-mediation statement. The mediator and counsel also discuss who should attend the mediation.

Usually at the beginning of the mediation, the mediator conducts a joint session with all the parties present. During this joint session, the mediator will introduce the parties and their counsel and explain the mediation process, including the purpose of joint sessions and private caucuses. The mediator will also discuss the confidential nature of the mediation process and explain that any information given during a private caucus will not be disclosed to the other party without permission.

Next, the mediator asks each party to make a presentation to the mediator and the other party to the dispute. The presentation is usually made by counsel. Sometimes a party will make its own presentation in addition to the one made by its counsel. Venting by a party during opening statements is not unusual in construction mediation. If the parties are hostile to each other, the mediator may eliminate the joint session and start the mediation with private caucuses. This is particularly true when animosity is so high and tempers are flaring that joint sessions will not work.

Related Content

For a list of the fundamental provisions that should be included in a construction contract, see

> **DRAFTING AN OWNER-CONTRACTOR AGREEMENT**

RESEARCH PATH: *Real Estate > Construction > Owner and Contractor Agreement > Practice Notes > Owner-Contractor Agreement*

For an overview of the steps in the arbitration of a construction dispute under the American Arbitration Association rules, see

> **ARBITRATION OF CONSTRUCTION DISPUTES UNDER THE RULES OF AMERICAN ARBITRATION ASSOCIATION**

RESEARCH PATH: *Real Estate > Construction > Owner and Contractor Agreement > Practice Notes > Dispute Resolution*

For a discussion on the rules and procedures governing the arbitration of a construction dispute under the JAMS rules, see

> **ARBITRATION OF CONSTRUCTION DISPUTES UNDER JAMS**

RESEARCH PATH: *Real Estate > Construction > Owner and Contractor Agreement > Practice Notes > Dispute Resolution*

For information on alternative dispute resolution provisions in contracts, see

> **RESOLVING CONFLICT: DISPUTE RESOLUTION**

RESEARCH PATH: *Real Estate > Joint Ventures > Joint Venture Agreement > Practice Notes > Dispute Resolution*

After the joint session, the mediator conducts private caucuses. When conducting private caucuses, the mediator meets and discusses the case with each party in separate conference rooms. The mediator exchanges information and proposals that he or she has received from the other party, with the ultimate goal of narrowing the differences in proposals and settling the dispute.

Based upon approach and style, some mediators do not hold an initial joint session with the parties and start the mediation with private caucuses only. Such mediators hold joint sessions only when the parties are close to a settlement. However, most mediators believe the ability of the parties to talk to each other and express their position early in the mediation is important.

MANAGING EXPECTATIONS IS AN IMPORTANT PART OF PREPARING A CLIENT FOR MEDIATION. EXPERIENCED PARTICIPANTS ARE FAMILIAR WITH THE POSTURING OFTEN TAKEN BY OWNERS, CONTRACTORS, AND SUBCONTRACTORS DURING THE COURSE OF A PROJECT. IT IS NOT UNUSUAL FOR SUCH POSTURING TO ALSO TAKE PLACE DURING MEDIATION.

Choosing a Mediator

Construction is a complicated business because of the many participants on a project. Like many businesses, understanding how all the participants are supposed to interact and their dependencies on each other is very important. It is not possible to teach a mediator about the nuances of the construction business to enable the mediator to resolve a dispute effectively. Without this frame of reference, the mediator will not be able to properly evaluate the facts and suggest constructive solutions. Therefore, it is recommended that the mediator of a construction dispute have experience with the construction industry.

All mediators in construction disputes are trained to facilitate a settlement and help the parties reach a mutually satisfactory resolution. However, in many instances the mediator must take an evaluative approach, particularly when a party has an unreasonable interpretation of the facts or unrealistic expectations about a settlement outcome. The mediator needs to provide an opinion about the strengths or weaknesses of a party's case and legal arguments if the case is going to be settled. The mediator's opinion helps to manage that party's expectations about the outcome if the case is tried or arbitrated and can also help the party to understand what a reasonable and feasible settlement might look like.

In addition to possessing knowledge of the construction industry, the mediator must have traits that are important for all kinds of disputes, such as:

- The ability to listen
- Impartiality
- The ability to explore solutions
- Flexibility
- Persuasiveness
- Patience
- The ability to explore and explain complex issues
- The ability to manage parties and their emotions
- Comfortable with evaluating and discussing the parties' positions in caucus

Courts have embraced mediation to reduce their backlog of cases. Many courts have mediation programs with a roster of trained and experienced mediators that are available to parties. The court employee responsible for administering the mediation program will assign the case to a mediator who has expertise in construction disputes from the court's mediation panel.

If the parties do not want to use the court-appointed mediator, they may use a mediator not affiliated with the court's mediation program. However, the advantage of using a court-appointed mediator is that, depending on the court's rules, the mediator may provide the first few hours of mediation services for free and the mediator's hourly rate is often less than what a mediator might be paid outside the court's program.

If the dispute is not in litigation or arbitration, the parties' attorneys will usually suggest mediators that they have used before and who are experienced in the construction industry. Also, the American Arbitration Association, JAMS, and other dispute resolution entities maintain lists of mediators who have experience mediating construction disputes.

Preparation for the Mediation

Most mediators ask each party to provide a memorandum that sets forth their understanding of the facts and what they believe is not in dispute. The memorandum should also state the party's position on liability and damages and how the case might be settled, including at what dollar amount. This memorandum, sometimes referred to as a mediation statement, is confidential and is only for the mediator. It is not exchanged with the parties or the court or arbitrator. Usually the memorandum does not exceed ten pages and is submitted to the mediator between seven and ten days before the scheduled mediation date. Of course, depending on the nature of the case and the number of issues involved in the dispute, these limitations may vary.

In conjunction with their clients, the parties' attorneys must decide who should attend the mediation. In addition to their attorney, a representative of the party familiar with the facts in dispute and who has full settlement authority should attend. Sometimes this requires a party to send two or more employees

to the mediation, including project managers, project schedulers, accountants, and possibly experts.

Experts whom a party intends to use as testifying expert witnesses should not attend the mediation or review the other party's mediation statement. Courts have precluded experts from testifying at trial and stricken their expert reports on the ground that such experts participated in the confidential mediation process and that the information provided by the other party during the mediation may be inadvertently used during the expert's testimony or in the expert's report. To allow the expert to testify or their reports to be entered into evidence could prejudice the other party who made a disclosure during the confidential mediation process.

Counsel should be fully familiar with the facts in dispute and should bring any document that may support a client's position. Such preparation does not have to be as thorough and time consuming as preparation for a trial or arbitration hearing, but should be sufficient to explain the client's position to the mediator and the other party.

Managing expectations is an important part of preparing a client for mediation of a construction dispute. Experienced participants on construction projects are familiar with the posturing often taken by owners, contractors, and subcontractors during the course of a project. It is not unusual for such posturing to also take place during mediation. Particularly at the beginning of mediation, it is not unusual for a party to make an extreme offer to or demand of the other party. This posturing can also take the form of venting by the parties, despite efforts by the mediator to control it.

An attorney should prepare the client for these possibilities and explain that extreme early offers, demands, and venting are just part of the mediation process and do not mean the dispute will not settle later that day or the next day. It is not unusual for a party to storm out of a mediation session after hours of frustrating negotiations and claim that the other party is not negotiating in good faith. This type of contentious behavior is not infrequent in construction disputes, and often the dispute is amicably settled the next day or a few days later as the mediator shuttles settlement offers back and forth between the parties by phone.

Mediation Settlement Agreements

Particularly for a construction dispute, settlement terms often include more than a lump-sum dollar amount paid by a certain date. Payment schedules, agreements for work to be completed by a certain date, and other terms can be included in the agreement. These types of terms can too easily be forgotten between the conclusion of the mediation and drafting the settlement agreement, and it is recommended that, to the extent possible, the settlement agreement either be finalized and signed before the conclusion of mediation or at least written in the form of a term sheet signed by both parties.

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RESEARCH PATH: Real Estate > Construction > Owner and Contractor Agreement > Practice Notes > Dispute Resolution

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Credit Agreements in the Insurance Industry

This article explains how to modify a standard credit agreement to account for a borrower that is an insurance company or an insurance holding company. Examples illustrate the specific types of provisions that may be appropriate for such a borrower. The guidance includes drafting and negotiation points for both borrower's and lender's counsel.

IN STRUCTURING THESE TRANSACTIONS, LENDER'S COUNSEL should be aware that, as a general matter, unsecured loans made to an insurance company or an insurance holding company will be subordinated by law to insurance policy claims. In all U.S. jurisdictions insurance policy claims rank senior to unsecured bank debt and other general, unsecured creditor claims in a liquidation proceeding. Where the borrower is an insurance holding company that relies on its operating subsidiary for liquidity, bank debt would be structurally subordinated to policy claims at the subsidiary level. We would note also that when you are lending to such an insurance holding company, you should be mindful of regulatory restrictions on the subsidiaries' ability to distribute profits up to the borrower as a dividend.

Representations and Warranties

An insurance company or, to a lesser extent, an insurance holding company, is subject to a regime of state law rules and regulations not applicable to other borrowers. For this reason, a standard set of representations and warranties may be insufficient or inappropriate for this kind of borrower. Below are suggestions on how to revise or supplement these provisions in a manner appropriate to insurance borrowers.

Compliance with Laws

As lender's counsel, you should ensure that the representation on compliance with applicable laws covers insurance-specific, standard-setting bodies such as the National Association of Insurance Commissioners (NAIC) and, where applicable, supra-national bodies such as the European Union. This representation typically covers compliance with laws, requirements of law, or an equivalent term, the definition of which begins with a litany of types of legal mandates (e.g., federal, state, local, and foreign statutes, treaties, rules, guidelines, regulations, ordinances, codes, and administrative or judicial precedents). The overall term law or the equivalent will then be defined to mean these types of mandates

IN THE EVENT THAT THE BORROWER IS ITSELF AN INSURER, IT MIGHT NOT PRODUCE GAAP FINANCIALS AT ALL, AND THEREFORE SAP MIGHT BE THE ONLY AVAILABLE FINANCIALS ON WHICH TO GIVE REPRESENTATIONS.

promulgated by a defined governmental authority. Lender's counsel should make sure the NAIC and/or other appropriate bodies are included in this latter definition. For example:

> Any nation or government, any state or other political subdivision thereof, any agency, authority, instrumentality, regulatory body, court, central bank, or other entity exercising executive, legislative, judicial, taxing, regulatory, or administrative functions of or pertaining to government (including any supra-national body such as the European Union or the European Central Bank), any securities exchange, or any self-regulatory organization (including the National Association of Insurance Commissioners)

However, as counsel for the borrower, you might resist such provisions (which are not uncommon but not necessarily customary). The argument here is that pronouncements of such bodies do not have the force of law and are often aspirational in nature. Thus, borrower's counsel would argue that inclusion of such bodies in requirements of law may be overbroad and result in technical defaults.

Financial Statements and Accounting Standards

Lender's counsel should consider whether generally accepted accounting principles (GAAP) is the appropriate standard in the representation covering the financial statements previously delivered by the borrower. A borrower typically represents and warrants that its financial statements "were prepared in accordance with GAAP consistently applied throughout the period covered thereby, except as otherwise expressly noted therein." GAAP typically will still be appropriate where the borrower is an insurance holding company (as opposed to an operating insurer).

However, as lender's counsel, you should consider whether the representation, in the case of a holding company borrower, ought to cover not only GAAP financials of the borrower but also statutory accounting-based financials of the borrower's key insurance operating subsidiaries. In general, statutory accounting (SAP) is a distinct accounting regime for U.S. insurers promulgated by the NAIC. It differs from GAAP in material respects. SAP tends to focus primarily on an insurer's ability to pay policyholder obligations and related balance sheet items such as surplus and loss reserves. SAP by definition does not consolidate legal entities and measures performance and financial position only at a single entity.

In the event that the borrower is itself an insurer, it might not produce GAAP financials at all, and therefore SAP financials might be the only available financials on which to give representations. In that case, it is appropriate for the borrower to represent only that the financial statements "were prepared in accordance with SAP." The term SAP can be defined as:

> The statutory accounting practices prescribed or permitted by the insurance commissioner (or other similar authority) as of the date hereof in the jurisdiction of incorporation of such Subsidiary for the preparation of annual statements and other financial reports by insurance companies of the same type as such Subsidiary

Avoiding a Reserve Inadequacy MAE

Borrower's counsel might seek to allocate to the lender all or part of the risk associated with the adequacy of borrower's posted reserves. Generally, reserves refer to liabilities on the balance sheet, actuarially determined by the insurer itself, in respect of its insurance-related obligations under policies it has issued. There is always a risk that, even when reserves have been professionally calculated, the amount of reserves held on the balance at a given time are insufficient to absorb losses that occur (for instance, in the event of an unpredicted catastrophic event causing widespread property damage). When this happens, reserves may have to be strengthened (i.e., additional liabilities posted), surplus may otherwise be adversely affected, and/or a charge to earnings may be incurred. If such consequences are serious enough, they could rise to the level of a material adverse effect (MAE) for purposes of a representation, covenant, or condition, depending on how MAE is defined. This could result in an event of default even where the borrower has determined and is maintaining reserves in a manner well within industry standards.

A borrower might take the position that, as long as generally accepted actuarial standards have been applied in the determination of its reserves (which is a representation that should be unobjectionable to an insurer), and/or financial covenants are being observed, the borrower should not bear the sole risk of losses exceeding reserves. Accordingly, the lender should bear at least part of this risk by virtue of having loaned funds to an insurance company, whose business is by its nature dependent on future events. Such an allocation of risk might be drafted by including a proviso such as one of the following in the definition of material adverse effect:

> Provided that, so long as no violation of the covenants contained in Section [reference to financial covenant section of credit agreement] shall have occurred and be continuing as a result thereof, the occurrence of losses that give rise to or result in Excess Catastrophe Losses shall not be deemed to have a Material Adverse Effect.
>
> Provided, that solely for purposes of determining whether a Material Adverse Effect has occurred at a time prior to the Closing Date, and assuming the accuracy of the [representation that reserves have been determined in accordance with accepted professional standards], a Specified Reserve Increase shall not, by itself, be deemed to constitute a Material Adverse Effect; . . . A "Specified Reserve Increase" means an increase in statutory loss reserves, loss adjustment expense reserves or contingency reserves, which, together with all other such increases occurring within 30 days of each other, equals or exceeds $[xxx].

Fine-Tuning Financial and Negative Covenants

As with representations and warranties, financial and negative covenants should be fine-tuned for insurance companies and insurance holding companies. These borrowers may need certain carve-outs from the restrictions in credit agreements to allow them to operate—from a competitive and a regulatory standpoint. While lenders will generally agree to such allowances, they will impose additional financial covenant tests on these borrowers. Below are descriptions of these provisions and what borrower's and lender's counsel should look out for.

Financial Definitions

As with other borrowers, insurance companies are generally subject to financial covenants so lenders can monitor the borrower's ongoing ability to repay the loans. In fact, these tests are generally more important for insurance companies, given that these borrowers are granted more leeway in their negative covenants (see Allowances in Negative Covenants, below). Certain financial covenants are often used for insurance entities:

- A maximum leverage ratio (in this case, maximum ratio of adjusted consolidated indebtedness to adjusted total capitalization or tangible net worth of the loan parties) –and–
- A minimum tangible net worth (or similar measurement of owners' equity)

Borrower's counsel may seek to modify certain defined terms in order to make compliance with these tests less onerous. Lenders are often amenable to such changes, although negotiation is usually required on these points. Specifically, as borrower's counsel you should try to include in tangible net worth (or consolidated net worth) so-called hybrid-capital instruments. Generally, these are securities with both

Related Content

For guidance on preparing credit agreement representations and warranties, see

> DRAFTING REPRESENTATIONS AND WARRANTIES (CREDIT AGREEMENT)

RESEARCH PATH: *Finance > The Credit Agreement > Representations, Warranties and Covenants > Practice Notes > Representations and Warranties*

For an example of a standard representations and warranties section for a credit agreement, see

> REPRESENTATIONS AND WARRANTIES PROVISIONS (CREDIT AGREEMENT)

RESEARCH PATH: *Finance > The Credit Agreement > Representations, Warranties and Covenants > Forms > Representations and Warranties*

For a discussion of the standard representations and warranties found in loan agreements, see

> COMMONLY NEGOTIATED REPRESENTATIONS AND WARRANTIES (CREDIT AGREEMENT)

RESEARCH PATH: *Finance > The Credit Agreement > Representations, Warranties and Covenants > Practice Notes > Representations and Warranties*

For an explanation on why lenders often require negative covenants and related definitions in credit agreements, see

> NEGATIVE COVENANTS (CREDIT AGREEMENT)

RESEARCH PATH: *Finance > The Credit Agreement > Representations, Warranties and Covenants > Practice Notes > Affirmative, Negative and Financial Covenants* debt- and equity-like features that are treated as capital by rating agencies, regulators, or others. An example of such instruments is surplus notes, which are specifically recognized under state insurance laws and SAP as part of an insurer's surplus rather than as balance sheet liabilities. Historically, surplus notes have been a key way for mutual insurers (non-stock insurers whose policyholders are effectively the equity holders of the company) to raise surplus insofar as stock issuances are legally impossible. However, stock insurers can use surplus notes too, and they are a common part of insurance company capital structure because of their familiarity to regulators and their hybrid nature.

For that reason, insurers have a good argument for including surplus notes in tangible net worth. Doing so bolsters a borrower's balance sheet for purposes of meeting the minimum tangible net worth test on its own and in creating a more favorable leverage ratio (as tangible net worth is a component of the denominator of that test). You can include hybrid-capital instruments in net worth by defining consolidated tangible net worth as:

> The consolidated stockholders' equity (including Hybrid Capital) of the Company and its Subsidiaries less their consolidated intangible assets, all determined on a consolidated basis as of such date in accordance with GAAP

where hybrid capital is defined as:

> At any time, all subordinated securities, instruments, or other obligations issued by the Company to the extent that such securities, instruments, or other obligations (i) are accorded equity treatment by [rating agencies] at issuance and (ii) mature no earlier than the date which is six months after the Termination Date

As borrower's counsel, you should correspondingly exclude hybrid instruments from the adjusted consolidated total debt prong of the test. For example, the definition of consolidated total debt might specifically exclude hybrid capital in the example presented above. For example:

> "Consolidated Total Debt": at any date, the aggregate principal amount of all Indebtedness of the Company and its Subsidiaries at such date, determined on a consolidated basis in accordance with GAAP; . . . For the avoidance of doubt, Consolidated Total Debt shall not include Hybrid Capital.

Whether and to what extent such modifications are appropriate will hinge on the specific capital structure of the borrower and its regulatory regime. For instance, a borrower with little hybrid capital may be less insistent that such instruments be counted as equity for purposes of the credit agreement unless such borrower wants to maintain the flexibility of utilizing hybrid capital in the future.

Risk-Based Capital Financial Covenants

Often a lender may seek to impose additional financial covenants based on risk-based capital (RBC). RBC is a regulatory framework administered by the NAIC and adopted in all 50 states for most types of insurers. RBC measures the total capital of an insurer against certain benchmark thresholds of required capital, as determined by a company-specific analysis. Of the benchmarks, Authorized Control Level (ACL) is the absolute minimum amount of capital that an insurer must hold based on its particular risk profile, as determined from prescribed calculations. Other benchmarks are multiples of ACL. For instance, Company Action Level (CAL) is two times ACL. Certain remedies are available to the regulator in the event the insurer falls below CAL, and more severe remedies are available if capital falls below ACL. Similarly, a lender may wish to include a covenant based on maintaining some minimum RBC ratio. An example of a financial covenant based on RBC is:

> Minimum Risk-Based Capital: The Borrower will at all times cause each Significant Insurance Subsidiary to maintain a ratio of (a) Total Adjusted Capital (as defined in the Risk-Based Capital Act or in the rules and procedures prescribed from time to time by the NAIC with respect thereto) to (b) the Company Action Level RBC (as defined in the Risk-Based Capital Act or in the rules and procedures prescribed from time to time by the NAIC with respect thereto) of at least [xxx]%.

Finally, as borrower's counsel, you should ensure that the credit agreement makes clear that indebtedness does not include any liabilities incurred by the insurer under insurance or reinsurance contracts. Such savings clauses are typical and are necessary for financial covenant compliance, unless otherwise built into the ratios. For example, you can incorporate the following exception into the definition of indebtedness:

> For the avoidance of doubt, Indebtedness shall not include the obligations of any Insurance Subsidiary under any Primary Policy, Reinsurance Agreement, Retrocession Agreement, or Other Insurance Product which is entered into in the ordinary course of business.

Allowances in Negative Covenants

Insurance companies may also ask for industry-specific exemptions to the restrictions in their negative covenants. This flexibility could be critical from either a business or a regulatory standpoint—and in any event may be necessary to allow the insurance company to operate within the constraints of the credit agreement. A few significant carve-outs are described below.

Prohibition against Indebtedness

In its covenant not to incur additional indebtedness, the borrower may seek a basket for letters of credit that it procures in order to secure reinsurance obligations. Here is an example of such a basket, providing for a carve-out from the covenant against the incurrence of indebtedness:

> Indebtedness for letters of credit which have been issued on behalf of any Insurance Subsidiary to or for the benefit of reinsurance cedents or insurance clients in the ordinary course of business.

Alternatively, the definition of indebtedness could specifically exclude "issued, but undrawn, letters of credit which have been issued to reinsurance cedents in the ordinary course of business."

Generally, by way of background, insurance regulatory authorities, rating agency guidance, or market conditions might require a reinsurer to post collateral in support of its obligations to an insurer that obtained the reinsurance under a reinsurance arrangement that the reinsurer is providing. This insurer obtaining the reinsurance, called the ceding insurer or cedent, is exposed to the underlying policyholder. The pledged

Related Content

For information on balance sheet covenants and cash flow covenants, see

> FINANCIAL COVENANTS (CREDIT AGREEMENT)

RESEARCH PATH: Finance > The Credit Agreement > Representations, Warranties and Covenants > Practice Notes > Affirmative, Negative and Financial Covenants

For assistance in drafting a limitation on indebtedness negative covenant clause, see

> LIMITATION ON INDEBTEDNESS NEGATIVE COVENANT PROVISION (CREDIT AGREEMENT)

RESEARCH PATH: Finance > The Credit Agreement > Representations, Warranties and Covenants > Forms > Covenants

For detailed information on the different forms of conditions precedent utilized in closing and funding credit agreements, see

> DRAFTING AND NEGOTIATING CONDITIONS PRECEDENT (CREDIT AGREEMENT)

RESEARCH PATH: Finance > Closing and Post-Closing Mechanics > The Closing Process > Practice Notes > Closing Deliverables assets are intended to be recoverable by the ceding company in the event that the reinsurer defaults on its obligations. Therefore, a borrower that is a reinsurer subject to such collateral-posting requirements may be party to arrangements where it pledges assets in the ordinary course to secure obligations to counterparties (thus requiring this carve-out).

In addition, as a diligence matter, a lender should consider the borrower's exposures on collateralized insurance or reinsurance it has assumed and its methods of posting such collateral. In this regard, you should be aware of the regulations on credit for reinsurance. These are the rules governing under what circumstances a cedent can record its ceded reinsurance as a valid asset, which might require that the reinsurer be licensed or otherwise qualified and/or that the reinsurer post collateral at 100% or some lesser portion of the ceded liability. These regulations are complex and in recent years have been evolving in many jurisdictions, both in the United States and elsewhere, to reflect regulatory reforms on reciprocity between jurisdictions.

Covenant against New Investments

In the covenant not to make new investments, the borrower will want appropriate carve-outs for ordinary course investment portfolio activities. In general, an insurer's assets comprise investment assets held against policy obligations, making such a carve-out a reasonable request by the borrower and fairly customary. However, lender's counsel should seek to limit this exception to:

- Investments made pursuant to borrower's investment guidelines that lender will have seen and approved
- Investments in conformity with relevant insurance laws (which impose diversification, credit-quality, and similar requirements) –or–
- Investments below a certain dollar threshold

The extent and scope of any such exceptions are subject to negotiations based on the insurer's particular facts and circumstances. For example, a borrower that engages in active trading may require even more flexibility here.

Asset Dispositions

Borrower's counsel may seek to qualify any prohibitions on asset dispositions by carving out specific types of reinsurance transactions. Reinsurance of existing risks on the borrower's balance sheet is typically accompanied by a transfer of assets to the reinsurer to support such liabilities. Borrowers may engage in these transactions to meet certain financial objectives, such as risk management or improving surplus, and not primarily to divest such assets. Therefore, as borrower's counsel you should make sure these transactions are not restricted by the covenant against dispositions; lenders will be amenable to these as long as they are persuaded that these provisions are needed for the normal operation and capital management of the borrower. For example, if that covenant broadly prohibits asset dispositions, you can revise that definition by excluding these transactions as in the following parenthetical clause:

> Asset Disposition means any sale, transfer, or other disposition (excluding any loss portfolio transfer or any surplus relief transaction (within the meanings prescribed by SAP) through assumption, reinsurance, cancellation, and rewriting of insurance business or otherwise) of any asset of a Borrower or any Subsidiary in a single transaction or in a series of related transactions . . .

Events of Default

Regulated insurance companies are not eligible to be debtors under the Bankruptcy Code. Therefore, lender's counsel will want to make sure that the bankruptcy event of default picks up potential non-U.S. Bankruptcy Code proceedings, particularly liquidation and rehabilitation proceedings in a state court under state insurance law. Lender's counsel should ensure the bankruptcy events of default are drafted broadly enough to pick up such proceedings. For example, insolvency proceedings should include "liquidation, reorganization, rehabilitation, conservatorship, delinquency, or other relief under any federal, state, or foreign bankruptcy, insolvency, receivership, or similar law now or hereafter in effect."

THE TYPICAL ENFORCEABLE OBLIGATIONS REPRESENTATION AND STANDARD CONDITIONS IN A CREDIT AGREEMENT GENERALLY REQUIRE THE BORROWER TO CERTIFY THAT IT HAS RECEIVED ALL CONSENTS PRIOR TO BORROWING.

Miscellaneous Provisions

Lender's counsel should keep in mind two additional cautions: One relates to consents and approvals to make sure the borrower is legally allowed to borrow (and to pay back) the loans, and the other relates to possible obstacles against exercising remedies against these types of borrowers.

Conditions to Borrowing

Counsel for lenders should take into account any regulatory approvals that might be required in connection with the borrowing. Typically an insurer need not obtain approval of an insurance regulator prior to borrowing funds, but there can be exceptions. This is something that the lender and its counsel need to ascertain during legal due diligence. It could be the case that a particular insurer is under heightened regulatory scrutiny because of financial distress, and therefore the regulator does not permit any new borrowing without its consent. Some states have laws that limit the amount of secured borrowing an insurer can incur; under such laws, exceeding these thresholds might require prior regulatory approval or waiver.

The typical enforceable obligations representation and standard conditions in a credit agreement generally require the borrower to certify that it has received all consents prior to borrowing. In most cases lenders are satisfied with such protections. Here, however, lender's counsel should specifically attend to these requirements and be satisfied that they are met, given the heavily regulated nature of this industry.

Pledges

In a borrowing by an insurance holding company, in which the borrower is pledging its shares in downstream insurance companies as security for the borrowing, you should be mindful of regulatory requirements regarding acquisitions of control of insurers. It is customary for pledge and security agreements in connection with such transactions to require, as a condition to the lender's exercise of remedies, that any remedy involving a sale of the shares of the insurer shall have received prior approval from all applicable insurance regulators. This could present some significant challenges in exercising remedies against this equity and taking control of operating insurers. An example follows:

> Without limiting the generality of the foregoing, if an Event of Default shall have occurred and be continuing, the Secured Party may exercise (i) all the rights of a secured party under the UCC . . . ; provided that the right of the Secured Party to sell or otherwise dispose of an Equity Interest in any Regulated Subsidiary shall be subject to the Secured Party's or the relevant Pledgor's obtaining, to the extent necessary under applicable law, the prior approval of such sale or other disposition by the Governmental Authority having jurisdiction with respect to such Regulated Subsidiary.

As finance counsel, you should be aware of all of these issues in reviewing or drafting a credit agreement for an insurance company or insurance holding company. But given the complexity of the regulations underlying this industry, it is always a good idea to consult with a counsel experienced in these matters as early in the process as possible. L

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RESEARCH PATH: *Finance > Fundamentals of Financing Transactions > Credit Facility Basics > Practice Notes > Purpose and Types of Credit Facilities*

Technology Industry
Practice Guidance Q&A with Gregg A. Noel and Michael J. Mies

SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP

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Michael J. Mies

THE TECHNOLOGY INDUSTRY IS FOCUSED around companies that primarily sell technology or technology services. Major players in the technology industry include:

- Hardware companies, such as Apple, Dell, HP, and Lenovo, which generate revenue by building and selling physical products
- Software companies, such as Alphabet (Google), Adobe Systems, Microsoft, and Oracle, which generate revenue by developing and selling software
- Information technology (IT) services companies, such as IBM, which generate revenue by providing services related to either hardware or software
- Companies that provide critical components to the technology industry, such as Intel and Applied Materials, which generate revenue by providing software or hardware to other technology companies
- Peer-to-peer companies, such as Uber, Airbnb, Snapchat, Facebook, and Lyft, which generate revenue by connecting individuals or businesses together online to deal with each other directly
- Biotechnology and medical device companies, such as Amgen and Medtronic, which generate revenue by developing and selling products or services used in the medical industry

The technology industry is also often defined to include companies that rely on technological innovation to disrupt existing business models, such as Amazon and Tesla.

In addition to competing in the technology industry, many technology companies also impact other industries. For example, Apple has established a presence in media with iTunes and its Apple TV product. Alphabet is a pioneer in the car industry, launching a self-driving car project in 2014. Uber and Lyft's online services are similarly disrupting the transportation industry.

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

Securities offerings by technology companies, including private and public equity and debt offerings, are subject to the same general set of securities laws and regulations that govern securities offerings by companies in other industries. This includes the Securities Act of 1933, as amended (the Securities Act); the Securities Exchange Act of 1934, as amended (the Exchange Act); the Sarbanes-Oxley Act of 2002; the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010; the Trust Indenture Act of 1939, as amended; and state securities or blue sky laws.

In particular, the issuance of options, restricted shares, and other forms of equity incentives, on which many technology companies rely heavily to incentivize their employees, requires compliance with the Securities Act and state blue sky laws. For private technology companies, Rule 701 (17 C.F.R. § 230.701) under the Securities Act is an important exemption from the registration requirements of the Securities Act for issuances of equity to employees, officers, directors, consultants, and advisors.

Technology companies that qualify as emerging growth companies (principally, technology companies with less than $1 billion of revenues) under the Jumpstart Our Business Startups Act (the JOBS Act) may also benefit from accommodations that are designed to facilitate the initial public offering (IPO) process.

Non-securities related laws and regulations may also impact a securities offering by a technology company. For example, many technology companies are potentially disruptive of heavily regulated industries, such as Airbnb in the housing and rental industry, Uber and Lyft in the labor and transportation industry, and financial technologies (fintech) companies that use technology and innovation to compete against traditional financial institutions in the delivery of financial services. These technology companies will need to provide an overview of the laws and regulations applicable to their businesses in the offering document and also evaluate their compliance with these laws and regulations in the context of securities offerings and their disclosure obligations under the Securities Act. If a technology company is in the process of seeking a significant government approval, such as Food and Drug Administration (FDA) approval of a new drug in the case of a biotechnology company, the technology company will also need to consider the applicable approval process and related laws and regulations in determining what is material to an investor and needs to be disclosed under the Securities Act.

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

Similar to companies in other industries, technology companies may offer securities both on a registered basis as well as by private placement and may issue various types of securities (debt, equity, convertible, or hybrid securities). Based on recent market practice, private technology companies typically issue preferred equity or convertible debt, which converts to common equity upon an IPO. As technology companies mature, however, they are more likely to issue straight debt.

The process for an offering of securities by a technology company is generally the same as the process for offerings by companies in other industries. Whether a technology company is offering debt or equity securities will have an impact on the overall offering process and the extent of documentation required. In addition, whether the securities are offered publicly or privately will have an impact on the overall offering process, the extent of documentation required, and the investor base to which the securities may be offered and sold.

For venture financings (principally private acquisitions of preferred equity or convertible debt by a venture capital firm), counsel will often start with the model legal documents prepared by the National Venture Capital Association (NVCA). These forms are available at http://www.nvca.org and are designed to reduce the time and effort spent by investors, management teams, and attorneys on negotiating legal documentation. Venture capital firms are often unwilling to negotiate or deviate from the forms for standard provisions due to the number of financing rounds completed each year. Among the tailored provisions that are often heavily negotiated are liquidation preferences, forced conversion thresholds, governance provisions, potential vesting of founder stock, employee equity pool, and anti-dilution provisions, including ratchet provisions in connection with an IPO. IPO ratchet provisions are designed to protect pre-IPO investors by granting them more shares upon automatic conversion if the public offering price is below a certain threshold. These provisions can apply to one or more series of financings and may have different threshold IPO prices. If a venture capital investor does not receive an IPO ratchet provision in connection with its investment, it may negotiate for a different type of protection, such as a minimum IPO price below which its preferred equity or convertible debt will not convert to common equity.

While preferred equity and convertible debt typically convert automatically to common equity upon an IPO, private technology companies looking to consummate an IPO will still need to discuss their capitalization structure post-IPO with their advisors, as well as the underwriters and their counsel. In particular, a growing number of private technology companies have dual class stock structures with one class of super-voting shares designed to enable founders and other critical members of management to maintain control of the company post-IPO. While technology companies such as Square Inc., Facebook, Alibaba, LinkedIn, Yelp, Groupon, and FitBit have completed IPOs with dual class stock structures, this structure is subject to criticism from stockholder and corporate governance advocates and may impact pricing in an IPO. As a result,

underwriters may advise against a dual class structure.

In public offerings, the Securities Act requires that a company file a registration statement with the Securities and Exchange Commission (the SEC) before securities may be offered or sold. The registration statement contains a prospectus, exhibits of material documents, and other required information. The prospectus, which is distributed to investors, provides an overview of the company, including its products and services, financial statements, management, and other material information. The prospectus will also include a description of the terms of the securities offered and the use of proceeds of such offering.

In some private transactions exempt from registration under the Securities Act, companies provide investors with an offering circular, offering memorandum, or private placement memorandum. A private offering document is similar to a prospectus and typically includes much of the same information required by the SEC in a prospectus. However, the issuer is not required to publicly file a private offering document. Venture capital financings with institutional venture capital investors and accredited investors often do not involve such a circular.

In order to prepare the prospectus or private offering document, counsel will need to complete due diligence on the issuer. For technology companies, due diligence requests will likely cover intellectual property (IP) related matters in addition to traditional corporate requests, such as copies of material contracts, corporate records, and minutes. Depending on the scope and significance of the issuer's IP, counsel for the underwriters or initial purchasers may also request a separate IP due diligence call or updated patent searches. Counsel for the underwriters or initial purchasers may also request legal opinions covering certain statements in the prospectus or private offering document. If the technology company operates in a heavily regulated industry, counsel will also need to conduct due diligence on compliance with applicable rules and regulations, as well as risks associated with non-compliance.

What information must be made available to potential investors in connection with securities offerings by technology companies?

The SEC instructs issuers to file a registration statement with information about the company and to provide the prospectus to investors, unless an exemption is available. Issuers conducting private placements are exempt from making specific disclosures, but market practice is to comply closely with the SEC requirements for comparable public offerings.

The tension between what investors and the Securities Act require in terms of disclosure and the historical secrecy of the technology industry can result in disclosure issues for technology companies. Technology companies may not want to disclose much information about their technologies, products,

and engineers in a public registration statement or private offering document because they may be concerned about competitors using this information to duplicate technology or identify potential engineers to hire. This is especially an issue in venture financings as venture capital firms often refuse to sign non-disclosure agreements. To resolve this conflict, counsel for the issuer and the potential investor (or underwriter or initial purchaser) will need to weigh the value of the information to the potential investor against the competitive or market risk to the technology company. For sophisticated technology companies with highly confidential trade secrets (such as biotechnology and medical device companies), venture capital firms may be more willing to sign non-disclosure agreements or designate certain information as accessible only by the attorneys on the offering. For less technical information, counsel may be able to address the tension through qualitative or aggregate disclosure that meets the requirements of investors and the Securities Act, but is of minimal value to competitors.

Please describe the common risk factors that are specific or unique to issuers in this industry. Have there been any recent developments or changes that counsel should be aware of when preparing for these risk factors?

Risks Related to Competition and Growth

Because the technology industry is rapidly changing and highly competitive with the constant introduction of new products and services, there will be a focus on risks related to growth and competition. Technology companies should consider the risk that their products may become obsolete due to innovation by their competitors or market focus on an alternative platform or software. For example, peer-to-peer companies may want to highlight the risk of a decline in user growth or user engagement as a result of influential users endorsing an alternative product, a perceived decrease in quality, a negative reaction to new advertising methods, or other negative publicity.

Technology companies should also consider the risk that they could miss the applicable product cycle for a new product offering. For example, hardware and software companies may want to highlight the risk that bugs or compatibility issues delay the release of a new product, making it unavailable when purchases of that type of product peak.

Finally, technology companies should consider the risks associated with high levels of growth. For example, technology companies that have experienced or expect to experience rapid growth in headcount and operations may want to highlight the risk that they

Related Content

For general information on securities laws and regulations, see

> **U.S. SECURITIES LAWS: AN OVERVIEW**

RESEARCH PATH: *Capital Markets & Corporate Governance > Debt Securities Offerings > Rule 144A/Regulation S Debt Offerings > Practice Notes > The Offering Process*

For additional information about the typical process for securities offerings by all types of companies (including technology companies), see

> **UNDERSTANDING THE INITIAL PUBLIC OFFERING PROCESS**

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

For guidance on the registration statement review process with the U.S. Securities and Exchange Commission (SEC), see

> **UNDERSTANDING THE SEC REVIEW PROCESS**

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

For an overview of the periodic and current reporting obligations of companies that are subject to the requirements of Section 13 of the Securities Exchange Act of 1934, see

> **PERIODIC AND CURRENT REPORTING RESOURCE KIT**

RESEARCH PATH: *Capital Markets & Corporate Governance > Public Company Reporting > Current Reports on Form 8-K > Practice Notes > Resource Kits*

For a discussion on the corporate governance requirements applicable to corporations, see

> **INTRODUCTION TO CORPORATE GOVERNANCE REQUIREMENTS FOR PUBLIC COMPANIES**

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

> BECAUSE MANY TECHNOLOGY COMPANIES HAVE A LIMITED OPERATING HISTORY, THERE SHOULD BE A FOCUS ON RISKS RELATED TO THE COMPANY'S FUTURE FINANCIAL PERFORMANCE. FOR EXAMPLE, EARLY STAGE COMPANIES THAT GENERATE LIMITED OR VOLATILE REVENUE MAY WANT TO HIGHLIGHT THE RISK THAT THEIR OPERATING RESULTS MAY FLUCTUATE AND THAT THEY MAY BE UNABLE TO ACHIEVE OR SUBSEQUENTLY MAINTAIN PROFITABILITY.

may be unable to innovate or execute as quickly as a smaller organization and the risk that they are unable to effectively manage a larger organization.

Risks Related to Financial Results

Because many technology companies have a limited operating history, there should be a focus on risks related to the company's future financial performance. For example, early stage companies that generate limited or volatile revenue may want to highlight the risk that their operating results may fluctuate and that they may be unable to achieve or subsequently maintain profitability. Technology companies that operate in new or unproven markets may want to highlight the risk that the applicable market may not develop as expected.

Technology companies should also consider whether their financial performance presents any liquidity concerns. For example, a technology company that generates limited revenue may want to highlight its cash flow needs, including any debt service obligations, and the risk that it may be unable to generate sufficient cash flow to satisfy its obligations.

Risks Related to Innovation and Research and Development

Since technology companies often spend heavily on research and development, including to attract talented engineers, they should also consider the risks associated with those investments. Potential risks include dependence on key personnel, ability to attract and hire skilled personnel, and ability to integrate acquired products or services.

Risks Related to Governmental Action, Regulation, and Litigation

The operations of technology companies can involve numerous laws and regulations. As a result, technology companies should evaluate their risk factors in light of the relevant regulatory regimes. Counsel should pay special attention to risks or uncertainties associated with accounting, such as transfer pricing, international taxes, IP, and general regulatory compliance.

As a result of high profile data security breaches, there has also been increased focus on risks related to cybersecurity for any technology company that processes or stores customer data. Technology companies that have international operations or that expect to expand internationally may also want to highlight the risks associated with complying with foreign laws and foreign currency regulations, double taxation of international earnings, and potentially adverse tax consequences due to changes in tax laws.

Please provide the key discussion points that counsel should consider when preparing the business and management's discussion and analysis (MD&A) sections for issuers in this industry.

The MD&A section of a prospectus or private offering document is the management's analysis of its financial statements and prospects for the business. In addition to discussing historical results, technology companies should include a discussion of key factors that impact their business and could cause historical results to not be indicative of future results. For example, a technology company with limited revenue generation should consider including a discussion of other non-financial metrics that would help an investor evaluate its business and prospects for future revenue. For some technology companies, it may also be appropriate to include a detailed discussion of accounting policies with respect to revenue recognition and capitalization or expense of development costs. In addition to traditional financial metrics, many technology companies regularly report user metrics, such as daily active users, k-value (a measure of virality that quantifies the growth rate of websites, apps, or a customer base), portion of mobile traffic, and total addressable market (TAM). TAM is a term that typically refers to the revenue opportunity available for a product or service. TAM can be calculated either as a global total (representing the entire market that a technology company could hypothetically reach) or as a target market (representing the market that the technology company could reasonably serve based on certain constraints).

Some technology companies also quantify traffic acquisition costs (TAC), which consists of payments made by Internet companies to affiliates and online firms that direct consumer

and business traffic to their websites. TAC is a critical cost of revenue for Internet search firms such as Alphabet and Yahoo and is watched closely by investors and analysts. By quantifying TAC, technology companies are able to report revenues on both a gross basis and net basis that excludes TAC. Some technology companies also quantify TAC as a percentage of advertising and search revenue, which can be used to evaluate cost pressures on profitability.

User metrics (including daily active users, k-value, portion of mobile traffic, and TAM) and TAC are not considered non-GAAP financial measures for purposes of Regulation G or Item 10(e) of Regulation S-K. As a result, they are not required to be reconciled to the most directly comparable GAAP financial measure. Revenue excluding TAC (or revenue ex-TAC) would typically be considered a non-GAAP financial measure for purposes of Regulation G (17 C.F.R. §§ 244.100-102) or Item 10(e) (17 C.F.R. § 229.10) of Regulation S-K, however, and should be reconciled to revenue calculated in accordance with GAAP.

Is there any other additional or special disclosure that should be included in the prospectus or registration statement for issuers in this industry, either required by the SEC or from market practice?

In 2011 the SEC Division of Corporation Finance released CF Disclosure Guidance: Topic No. 2 – Cybersecurity (October 13, 2011), which is available at https:/twww.sec.gov/divisions/corpfin/guidance/cfguidance-topic2.htm. This guidance made it clear that material cybersecurity risks and incidents should be disclosed to investors. As a result, any technology company that experiences a data breach will need to evaluate whether that data breach is material and required to be disclosed. Whether or not a data breach is material and required to be disclosed is a judgment call that will need to be made based on the severity of the data breach and its potential impact on the issuer.

Technology companies that offer social media services should also consider the legal and reputational risks associated with their services in the context of a securities offering. For example, there are unique IP issues associated with social media sites, including policies on ownership and sourcing of IP generated by users, compliance with the Digital Millennium Copyright Act, inadvertent disclosure of confidential information, and trademark infringement via third-party registration of user names in social media. There can also be reputational risks associated with social media services. For example, a social media site could lose customers if it censors its users or if it cooperates with governmental requests for customer data.

The SEC has also considered requiring more specific, uniform IP disclosures. Currently, biotechnology and pharmaceutical companies provide more extensive disclosure of their IP than information technology and service companies. See Section IV.A.3. Technology and Intellectual Property Rights (Item 101(c)(1)(iv)) of the SEC's Concept Release: Business and Financial Disclosure Required by Regulation S-K (Release Nos. 33-10064, 34-77599; File No. S7-06-16).

In addition to the foregoing disclosure, technology companies (like all companies) should disclose any information that is reasonably likely to influence a buyer's decision to invest in the company. For companies that are subject to regulatory regimes, market practice is to disclose any issues or developments in obtaining required approvals. Moreover, technology companies should focus on IP rights, including exclusivity assurances and plans for development of inventions.

Please discuss any other special disclosure issues or advice applicable to issuers in this industry.

As discussed above, it is important to understand the laws and regulations governing technology companies in different sectors. For example, fin-tech companies are subject to numerous U.S. and foreign regulatory regimes, including those relating to anti-money laundering, consumer protection, privacy and protection of data, bank secrecy, and similar regulations. These regulatory regimes are typically jurisdiction specific and complex and affect disclosure under the Securities Act because a technology company's compliance or failure to comply is generally considered material information.

While not specific to the technology industry, it is more common for technology companies to issue a low-vote or no-vote class of common equity in their IPOs. Examples include Google, Facebook, Zynga, Groupon, and most recently, Snap, Inc. As such, these issuers would include risk factors and disclosure about the ability of the (typically) founders to continue to control the outcome of all matters submitted to shareholder vote. Moreover, as many technology companies are heavily associated with their founders (e.g., Elon Musk with Tesla), additional disclosure may be warranted regarding the issuer's reliance on such founder and his or her time commitment to the issuer.

What are the major regulatory trends affecting technology companies?

As technology companies transform the way people communicate, share information, and do business, there is friction with existing laws and regulations that have not caught up with existing technology. For example, Uber has been banned in certain cities and countries for not complying with laws on the carriage of passengers that were originally intended to apply to taxis. Some also argue that outdated tax laws and regulations have permitted many technology companies to use complicated tax strategies to avoid paying corporate taxes. Finally, as wage and hour lawsuits against technology companies increase, technology companies are focused on regulations related to employee classifications, with many technology companies advocating for a new classification (other than independent contractor or employee).

Since technology companies often operate worldwide, there are also regulatory compliance issues associated with complying with laws and regulations on a country-by-country basis, especially privacy and data security regulations. Different privacy and data security laws and regulations may apply depending on where data is stored or transferred. For example, complying with a request from the U.S. government for data that is hosted internationally can breach foreign data protection laws. As a result of high profile data security breaches, there is also increased focus on regulatory risks in the cybersecurity realm.

What are the major commercial trends affecting technology companies?

As discussed above, the technology industry is fast paced with constant innovation and short product cycles. As a result, technology companies are under pressure to constantly introduce new products and respond to changes in the industry. For example, Apple has historically introduced a redesigned iPhone every two years. Software and app developers are also constantly updating their products to introduce new features or improve compatibility with changes in related hardware or software. Technology companies that are unable to keep up with their competitors' innovation, or that miss the applicable product cycle for a new product, face the risk of becoming obsolete, which has continued to drive large investments in research and development, as well as acquisitions of smaller technology companies by larger technology companies.

Another trend in the technology industry is that technology companies are staying private longer. An increasing number of technology companies are reaching high valuations in private markets and choosing not to undertake IPOs. This trend has increased the number of private funding rounds that many technology companies complete (including potential down rounds where investors purchase securities at a lower valuation than the preceding round), increased private market activity by employees and investors, and increased focus on sale processes as a means of achieving liquidity. There are several reasons that technology companies may be deciding to stay private longer, including increased availability of private capital and a view that public markets prefer larger technology companies. The JOBS Act also increased the maximum number of stockholders a private company can have before it must disclose financial statements, which provides additional flexibility to private companies.

What practice points can you give to lawyers working with technology companies?

Since the technology industry is constantly evolving and expanding, it is important for lawyers working with technology companies to stay current on emerging legal issues and trends in the technology industry. For lawyers working with technology companies that are looking to disrupt other industries, it is also important to stay current on emerging legal issues and trends in those industries. Finally, it is important to understand your client's attitude toward risk as some technology companies will have a larger appetite for risk than others.

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RESEARCH PATH: Capital Markets & Corporate Governance > Industry Practice Guides > Technology > Practice Notes > Industry Practice Guides

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HEALTH REIMBURSEMENT ACCOUNTS: **NAVIGATING COMPLIANCE LANDMINES**

This article discusses how to design and operate compliant employer-sponsored health reimbursement accounts (HRAs) under the Internal Revenue Code (I.R.C.), with a particular focus on the Patient Protection and Affordable Care Act (ACA).

WITH CONTINUED INCREASES IN HEALTH CARE COSTS and the evolution of the post-ACA health care marketplace, HRAs are an increasingly common feature of employers' benefits packages for both employees and retirees. The increased prevalence of HRAs suggests that for many employers, the cost savings and flexibility that can be achieved through the use of HRAs outweigh the risks arising from the complex legal framework within which HRAs must be designed and administered. Although there are, in fact, many benefits to using HRAs, this is not an area in which employers should tread lightly. There are numerous compliance risks, pitfalls, and traps for the unwary associated with the design and administration of HRAs, particularly under the ACA and related guidance.

Introduction to HRAs

An HRA is a notional account that an employer credits with dollar amounts that may be used to pay or reimburse eligible health care expenses incurred by participants and their eligible dependents. No specific section of the I.R.C. created the concept of HRAs. Rather, Internal Revenue Service (IRS) guidance issued beginning in 2002 describes a particular type of health care expense reimbursement arrangement, referred to as an HRA, that can include a carryover feature, qualifies for tax-favored treatment under I.R.C. §§ 105 and 106, and is subject to the non-discrimination requirements under I.R.C. § 105(h).

HRAs are self-funded group health plans that are subject to the same mandates that apply to traditional major medical plans. However, due to the unique nature of HRAs, the impact of the group health plan mandates on HRAs and traditional major medical plans can be different.

Basic Requirements for Tax-Favored Treatment

All HRAs must meet certain basic requirements in order to qualify for tax-favored treatment under the I.R.C.

No employee contributions. HRAs cannot be funded either directly or indirectly by employee contributions. They can only be funded by employer contributions. See Rev. Rul. 2002-41, pt. II; Rev. Rul. 2005-24.

Not offered under a cafeteria plan. HRAs cannot be funded with pre-tax salary reduction contributions or otherwise under an I.R.C. § 125 cafeteria plan. Notice 2002-45, pt. IV.

Restrictions on eligible individuals. HRAs can only pay or reimburse eligible health care expenses incurred by:

- An employee or former employee such as a retiree (referred to in this article as a participant) –and–
- A participant's spouse, federal tax dependents, or children who are under age 27 as of the end of the taxable year (referred to in this article as eligible dependents)

Notice 2002-45, pt. III; Rev. Rul. 2006-36.

In order to be payable or reimbursable from an HRA on a tax-free basis, an eligible health care expense must be incurred by the participant or eligible dependent (1) after the establishment of the HRA and (2) while the participant or eligible dependent, as applicable, is covered by the HRA.

Restrictions on eligible expenses. Although employers have flexibility in designing the types of health care expenses that may be reimbursed under an HRA (e.g., only medical expenses and not dental or vision expenses, or vice versa), HRAs can only pay or reimburse qualified medical expenses as defined in I.R.C. § 213(d) that have not otherwise been (1) reimbursed, (2) covered by insurance, or (3) claimed as an itemized deduction on the participant's federal income tax return. Notice 2002-45, pt. II; Rev. Rul. 2002-41; see also IRS Publication 502.

Substantiation rules. The same claims substantiation and debit card rules that apply to health flexible spending accounts (health FSAs) also apply to HRAs. Notice 2006-69.

Treatment of unused amounts. Any amounts credited to an HRA that remain unused cannot be cashed out to the participant, and the participant cannot receive any other taxable or non-taxable benefit under the HRA other than the payment or reimbursement of eligible health care expenses. Rev. Rul. 2005-24. This restriction applies in all circumstances, including in the event of a participant's death, after which the only permissible uses of any remaining amounts credited to the HRA are to pay or reimburse eligible health care expenses incurred by the participant prior to the participant's death (or incurred by the participant's eligible dependents covered by the HRA at the time of the participant's death if the HRA design has a spend-down feature that permits such use after the participant's death).

Unused amounts remaining in an HRA at the end of a plan year can be carried over for use during future plan years. Notice 2002-45, pt. I. An HRA can be designed to permit continued access to unused amounts following an employee's termination of employment, subject to the opt-out requirements for integrated HRAs, described further below.

Coordination of HRA and health FSA coverage. If a participant is covered by an HRA and a health FSA, the IRS has established a default ordering rule which provides that amounts credited to the

Related Content

For assistance in establishing a compliant employer-sponsored health reimbursement account (HRA) benefit plan, see

> HEALTH REIMBURSEMENT ACCOUNT (HRA) IMPLEMENTATION CHECKLIST

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

For detailed information on cafeteria or section 125 employee welfare benefit program plans, see

> UNDERSTANDING I.R.C. § 125 CAFETERIA PLANS

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

For an overview on determining what employee benefit plans and programs are subject to regulation under the Employee Retirement Income Security Act of 1974 (ERISA), see

> IDENTIFYING ERISA EMPLOYEE BENEFIT PLANS

RESEARCH PATH: *Labor & Employment > Employee Benefits > ERISA > Practice Notes > ERISA*

For practical guidance on essential health benefits and excepted benefits under the Patient Protection and Affordable Care Act (ACA), see

> ANALYZING ACA ESSENTIAL HEALTH BENEFITS AND EXCEPTED BENEFITS

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

For a list of the provisions for establishing a health reimbursement account (HRA) and descriptions of the various elements that comprise a compliant HRA under federal law see

> HEALTH REIMBURSEMENT ACCOUNT (HRA) CLAUSES FOR EMPLOYEE BENEFIT WRAP PLAN

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

HRA must be used first before the health FSA can pay or reimburse eligible health care expenses. If an employer wants to reverse this default rule as a matter of plan design, an explicit provision to that effect is required in the HRA and health FSA plan documents. Notice 2002-45, pt. V.

Design Alternatives

Notwithstanding the restrictions imposed on HRAs by the ACA market reform provisions discussed in the next section, HRAs are still fairly flexible vehicles affording employers a number of different design choices, including those described below.

Crediting Options

Employers have considerable flexibility in determining how and when amounts are credited to participants' HRAs:

Amount. Unlike health FSAs and health savings accounts (HSAs), the I.R.C. does not impose any limit on the amount that can be credited to an HRA in any given year. However, employers typically choose a dollar limit that helps to control costs and aligns with their comprehensive benefit strategy.

Reward. Some employers link HRA credits to participation in a wellness or disease-management program, or to some other employee behavior or circumstance. With such a design, careful consideration must be given to the I.R.C. § 105(h) non-discrimination requirements, Health Insurance Portability and Accountability Act (HIPAA) non-discrimination requirements, and the prohibition against correlating HRA contributions with salary reductions under a cafeteria plan.

Frequency. An employer can credit amounts to participants' HRAs at whatever interval it deems appropriate (e.g., on a monthly, annual, or other periodic basis, or perhaps even on an ad hoc basis if permitted by the written terms of the HRA and administered in a non-discriminatory manner). The uniform coverage rule that applies to health FSAs does not apply to HRAs, so the full amount to be credited to an HRA for a period of coverage does not have to be available on the first day of that period of coverage.

Access Options

Employers also have a few different design choices when it comes to how and when participants can access amounts credited to their HRAs:

- **While employed.** Many employers design their HRAs to be used by employees while they are employed. Amounts are credited to participants' HRAs during the course of their employment, and those amounts are available to pay or reimburse eligible health care expenses incurred by participants and their eligible dependents while the participants remain employed. Due to the ACA group health plan market reform considerations, these types of HRAs must be integrated with other group major medical plan coverage.
- **After termination of employment.** Other employers design their HRAs to be used by participants and their eligible dependents after termination of employment (e.g., by retirees who have satisfied minimum age and service requirements set by the employer). Amounts are credited to participants' HRAs during the course of employment and/or after termination of employment, but those amounts are not available to pay or reimburse eligible health care expenses incurred by participants and their eligible dependents until after participants' termination of employment. Because these types of HRAs provide coverage only to participants who are former employees and their eligible dependents, they are considered retiree-only HRAs and can be provided on a stand-alone basis (i.e., they do not have to be integrated with other group major medical plan coverage).

HDHP/HSA Coordination Options

Employers who sponsor a high-deductible health plan (HDHP) intended to permit HDHP participants to contribute to an HSA are limited with respect to the HRA coverage they can offer. General purpose HRAs that can be used to pay or reimburse HDHP participants' out-of-pocket major medical expenses even before the participants satisfy their HDHP deductibles are considered disqualifying non-HDHP coverage that makes the participants ineligible to contribute to an HSA. HDHP/HSA Designs are discussed in detail in the full article, *Establishing Compliant Health Reimbursement Accounts (HRAs)* in Lexis Practice Advisor.

ACA Group Market Reform Restrictions

Because HRAs are group health plans, they must comply with the ACA's group market reform provisions, such as the prohibition on lifetime and annual limits on the dollar value of essential health benefits, 100% first dollar coverage of preventive health services, the adult child coverage mandate, and the prohibition on rescissions, among others. Notice 2013-54 , pt. II.A.

An HRA may be able to avoid some or all of these requirements if (1) it is considered a grandfathered health plan under the ACA; (2) it is a retiree-only plan; or (3) it provides only excepted benefits (as defined under the Employee Retirement Income Security Act of 1974 (ERISA) § 733(c)(2) (29 U.S.C. §1191b(c)(2)); I.R.C. § 9832(c)(2)(A); 42 U.S.C. 300gg-91(c)(2)), such as limited-scope dental and/or vision benefits. If an HRA does not qualify for one of these exceptions, then it is subject to all of the ACA's group market reform provisions, but generally will not be able to satisfy these requirements.

As a result, a general purpose HRA that pays or reimburses expenses incurred by participants who are current employees can no longer be structured as a stand-alone plan. Instead, employers are now generally required to structure their general purpose HRAs for participants who are current employees as being part of, or integrated with, other group major medical plan coverage to rely on the other medical plan's compliance with the ACA's group market reform provisions. Failing to comply with the ACA's group market reform provisions can result in liability for a $100 per day excise tax per violation per person under I.R.C. § 4980D(b) , as well as Department of Labor (DOL) enforcement actions and participant lawsuits.

Integrated HRAs

Employers can choose one of two integration methods when designing a general purpose HRA that pays or reimburses expenses incurred by participants who are current employees, one in which minimum value major medical plan coverage is not required for the HRA to be considered integrated, and one in which minimum value major medical plan coverage is required. Note that such integration does not require the HRA and the group major medical plan coverage with which it is integrated to share the same plan sponsor, to have the same plan documents or governing instruments, or to file a single Form 5500. 26 C.F.R. § 54.9815-2711(d)(2) ; Notice 2013-54 , pt. III.A.1.

Integrated HRA—Minimum Value Not Required

An HRA is integrated with other group major medical plan coverage under this method if all of the following requirements are met:

- The plan sponsor offers a group health plan (other than the HRA) to employees that does not consist solely of excepted benefits.
- The employees receiving the HRA are actually enrolled in a group health plan (other than the HRA) that does not consist solely of excepted benefits (referred to here as non-HRA group coverage), regardless of whether the plan is offered by the same plan sponsor.
- The HRA is available only to employees who are enrolled in non-HRA group coverage, regardless of whether the non-HRA group coverage is offered by the plan sponsor of the HRA (e.g., the HRA may be offered only to employees who do not enroll in the HRA sponsor's group major medical plan but are enrolled in other non-HRA group coverage, such as a group major medical plan maintained by the employer of the employee's spouse).
- The benefits under the HRA are limited to reimbursement of one or more of the following:
  - Co-payments, co-insurance, deductibles, and premiums under the non-HRA group coverage –or–
  - Medical care (as defined under I.R.C. § 213(d) that does not constitute essential health benefits
- Under the terms of the HRA:
  - Participants are permitted to permanently opt out of and waive future reimbursements from the HRA at least annually –and–
  - Upon termination of employment, either (1) the remaining amounts credited to the HRA are forfeited, or (2) the participant is permitted to permanently opt out of and waive future reimbursements from the HRA

26 C.F.R. § 54.9815-2711(d)(2)(i).

Integrated HRA—Minimum Value Required

An HRA is integrated with other major medical plan coverage under this method if all of the following requirements are met:

- The plan sponsor offers a group major medical plan (other than the HRA) to employees that provides minimum value.
- The employees receiving the HRA are actually enrolled in a group major medical plan (other than the HRA) that provides minimum value (referred to here as non-HRA MV group coverage), regardless of whether the plan is offered by the plan sponsor of the HRA.
- The HRA is available only to employees who are enrolled in non-HRA MV group coverage, regardless of whether the non-HRA MV group coverage is offered by the plan sponsor of the HRA (e.g., the HRA may be offered only to employees who do not enroll in the HRA sponsor's group major medical plan but are enrolled in other non-HRA MV group coverage, such as a group major medical plan maintained by the employer of the employee's spouse).
- Under the terms of the HRA:
  - Participants are permitted to permanently opt out of and waive future reimbursements from the HRA at least annually –and–
  - Upon termination of employment, either (1) the remaining amounts credited to the HRA are forfeited, or (2) the participant is permitted to permanently opt out of and waive future reimbursements from the HRA

26 C.F.R. § 54.9815-2711(d)(2)(ii).

Forfeiture and Reinstatement Provisions for Integrated HRAs

Under both integration methods, forfeiture or waiver occurs even if the forfeited or waived amounts may be reinstated upon a fixed date, a participant's death, or the earlier of the two events (referred to as the reinstatement event). For this purpose, coverage under an HRA is considered forfeited or waived prior to a reinstatement event only if the participant's election to forfeit or waive is irrevocable. An effective irrevocable election means that, beginning on the effective date of the election and through the date of the reinstatement event, the participant and the participant's eligible dependents have no access to amounts credited to the HRA. Further, upon and after reinstatement, the reinstated amounts under the HRA may not be used to pay or reimburse eligible health care expenses that were incurred during the period after forfeiture or waiver and prior to reinstatement. 26 C.F.R. § 54.9815-2711(d)(3).

Opt-In/Opt-Out and/or Waiver Procedures for Integrated HRAs

To comply with the final requirement listed for both of these integration methods (and to facilitate HRA participants' management of their HSA eligibility and ACA marketplace subsidy eligibility), an employer may need to develop an opt-in/opt-out and/or waiver procedure taking the following considerations into account:

- **Timing:**
  - For current employees, the opt-out/waiver opportunity that must be provided at least annually is probably best accomplished as part of the employer's regular annual enrollment process each year during which employees have the opportunity to elect to decline HRA coverage for the next plan year.
  - For former employees, if the employee's HRA balance is not automatically forfeited upon termination of employment as a matter of HRA plan design, then when an employee terminates employment, the employer must provide the terminating employee the opportunity to elect to opt out of or waive post-termination HRA coverage. If desired, an employer could also provide an annual election opportunity with respect to retiree HRA coverage whereby retirees could elect into or out of retiree HRA coverage on a plan year-by-plan year basis.

A GROUP HEALTH PLAN, INCLUDING AN HRA, USED TO PURCHASE COVERAGE ON THE INDIVIDUAL MARKET IS NOT INTEGRATED WITH THAT INDIVIDUAL MARKET COVERAGE. THIS MEANS THAT EMPLOYERS CAN NO LONGER PAY INDIVIDUAL MEDICAL PLAN PREMIUMS ON BEHALF OF CURRENT EMPLOYEES OR DIRECTLY REIMBURSE CURRENT EMPLOYEES FOR THE COST OF INDIVIDUAL MEDICAL PLAN PREMIUMS...

- **Default rule (opt in or opt out).** When permitting election opportunities for HRA coverage, an employer will need to specify what the default rules are for participants who do not make an election. For example:
  - During annual enrollment processes for both current employees and retirees, will current HRA coverage status continue into the next plan year in the absence of a participant's affirmative election (i.e., an evergreen election)? Or will participants have to proactively elect HRA coverage for the next plan year if they want to keep such coverage in place?
  - At termination of employment, will HRA coverage continue for former employees unless they elect otherwise (i.e., opt-out election)? Or must a former employee proactively elect post-termination HRA coverage in order to have such coverage (i.e., opt-in election)?

Notice 2013-54, pt. III.A.1, Q&A-4.

No Integration with Individual Market Coverage for Most HRAs and Employer Payment Plans

A group health plan, including an HRA, used to purchase coverage on the individual market is not integrated with that individual market coverage. This means that employers can no longer pay individual medical plan premiums on behalf of current employees or directly reimburse current employees for the cost of individual medical plan premiums, either on a tax-free or taxable basis. Such "employer payment plans" are essentially HRAs that are not compliant with the ACA's group market reform requirements and which expose the employer to excise tax liability, audit risk, and litigation risk. 26 C.F.R. § 54.9815-2711(d)(4); DOL EBSA, FAQs About Affordable Care Act Implementation (Part XI) (Jan. 24, 2013), Q2.

Employers who want to pay for or reimburse individual medical plan premiums now only have the following options available to them:

- Pay or reimburse individual medical plan premiums for former employees only under a retiree-only HRA
- Pay or reimburse individual dental and/or vision plan premiums only for current and/or former employees under a limited-purpose HRA
- Provide additional taxable cash compensation to current employees with the intention that such amounts will be used to pay individual medical plan premiums, but without requiring or verifying that such amounts are in fact used in that way –or–
- If eligible, establish a qualified small employer HRA (described below)

Qualified Small Employer HRAs

Recent legislation permits small employers to provide non-integrated, stand-alone HRAs to their active employees that can be used to pay or reimburse individual medical plan premiums without running afoul of the ACA's group market reform requirements. Such plans are referred to as qualified small employer HRAs and must meet all of the following requirements:

- Be maintained by an employer that:
  - Is not an applicable large employer, as defined in I.R.C. § 4980H(c)(2) (i.e., an employer that employs fewer than 50 full-time plus full-time equivalent employees) –and–
  - Does not offer a group health plan to any of its employees
- Be provided on the same terms to all employees of the employer, subject to certain permissibly excluded classes of employees (e.g., part-time or seasonal workers)
- Be funded solely by the employer (and without salary reduction contributions)
- Provide for the payment for, or reimbursement of, expenses for medical care (as defined in I.R.C. § 213(d)) incurred by an eligible employee or the eligible employee's family members
- Limit the amount of payments and reimbursements to $4,950 (employee only) or $10,000 (employee plus eligible family members) per year, prorated for partial-year coverage and subject to annual cost-of-living increases –and–
- Furnish a notice to employees at least 90 days before the beginning of the plan year and upon eligibility regarding the amount of the benefit, marketplace reporting requirements, and potential adverse tax effects for employees who do not have minimum essential coverage

AN EMPLOYER SHOULD CAREFULLY CONSIDER ITS HRA DESIGN IF THE EMPLOYER'S GROUP MAJOR MEDICAL PLAN DOES NOT COVER ALL CATEGORIES OF ESSENTIAL HEALTH BENEFITS.

Qualified small employer HRAs are not considered to be a group health plan for almost all purposes under the I.R.C., ERISA, and the Public Health Service Act (PHSA). Amounts provided under a qualified small employer HRA cannot be excluded from an employee's income unless the employee has some other minimum essential coverage. 21st Century Cures Act (Pub. L. No. 114-255), § 18001. For more information, see DOL, FAQs About Affordable Care Act Implementation Part 35 .

Spend Down Available

Unused amounts credited to an HRA while the HRA is integrated with other group major medical plan coverage may be used to pay or reimburse eligible health care expenses in accordance with the terms of the HRA after a participant ceases to be covered by other integrated group major medical plan coverage without causing the HRA to violate the ACA's group market reform requirements. Notice 2013-54 , pt. III.A.1, Q&A-5. An HRA that pays or reimburses eligible health care expenses incurred by participants who are current employees, however, cannot be used to pay or reimburse individual medical plan premiums after the participant ceases to be covered by the other group major medical plan coverage with which the HRA had been integrated. Notice 2015-87, pt. II.A, Q&A-2.

Essential Health Benefits Considerations

An employer should carefully consider its HRA design if the employer's group major medical plan does not cover all categories of essential health benefits. In general, if the group major medical plan with which an HRA is integrated does not cover a category of essential health benefits, but the HRA is available to pay for or reimburse that category of essential health benefits up to the HRA's maximum benefit, then that HRA imposes an annual limit in violation of the ACA's annual dollar limit prohibition. Note that this potential mismatch in plan design between essential health benefits covered by the group major medical plan and essential health benefits payable from the HRA can only occur if the group major medical plan is either grandfathered, self-funded, or fully insured in the large group market.

The IRS has provided relief from this mismatch problem for group major medical plans that provide minimum value. Specifically, an HRA integrated with a group major medical plan that provides minimum value will not be treated as imposing an annual limit in violation of the ACA's annual dollar limit prohibition, even if that group major medical plan does not cover a category of essential health benefits and the HRA is available to pay for or reimburse that category of essential health benefits up to the HRA's maximum benefit. Notice 2013-54 , pt. III.A.1, Q&A-6.

Coverage of Eligible Dependents

An HRA is permitted to be integrated with the employer's other group major medical plan coverage only as to the individuals who are enrolled in both the HRA and the employer's other group major medical plan. If an employee's eligible dependents are not enrolled in the employer's group major medical plan coverage, any coverage of these eligible dependents provided under the HRA cannot be integrated with the coverage under the employer's group major medical plan, and the HRA coverage generally would fail to meet the ACA's group market reform provisions.

Common HRA Pitfalls and Periodic HRA Compliance Reviews

Some common pitfalls in designing and administering compliant HRAs include the following:

- Permitting employee contributions to fund an HRA, including inadvertently structuring HRA credits in such a way as to create indirect employee funding of the HRA
- Failing to ensure that the HRA only pays or reimburses eligible health care expenses described in I.R.C. § 213(d), including failure to implement claims substantiation and debit card rules
- Providing a cash-out of unused amounts to participants
- Processing claims against a participant's health FSA balance before amounts credited to the participant's HRA are exhausted without having explicit plan provisions that reverse the default rule to require the health FSA amounts to be used first
- Not including sufficient detail in applicable plan documents and SPDs regarding plan design elements, such as how much is credited to the HRA, when those credits occur, who eligible dependents are under the HRA, and what types of expenses the HRA pays or reimburses
- Allowing an individual to be enrolled in both an HDHP and a general purpose HRA and also facilitating HSA contributions by that same individual
- Offering a stand-alone, non-integrated, general purpose HRA to current employees in violation of the ACA's group market reform provisions
- Providing payment or reimbursement of individual-policy medical insurance premiums for current employees
- Failing to restrict HRA reimbursements to expenses incurred by current employees' dependents who are enrolled in the major medical plan with which the HRA is integrated
- Failing to recognize or communicate when general purpose HRA coverage makes a former employee ineligible for premium tax credits or cost sharing reductions to help pay for individual medical insurance coverage through an ACA marketplace.

Given the complexities and evolving landscape of legal compliance obligations and available guidance, it is extremely important to thoroughly analyze existing and proposed HRA designs, and to periodically review existing HRA plans, to ensure compliance with all applicable requirements and to mitigate against litigation, excise tax, audit, and/or other enforcement action risks.

This article is an abridged version of *Establishing Compliant Health Reimbursement Accounts (HRAs)*. The full article provides enhanced discussion and additional topical coverage on Medicare coverage considerations, the impact other aspects of the ACA have on HRAs, and compliance under ERISA, HIPAA, COBRA, and other laws. L

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

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Public Company Reporting and Corporate Governance

THIS ARTICLE DISCUSSES RECENT DEVELOPMENTS RELATING to U.S. public company reporting and corporate governance and the outlook going forward. The U.S. election season and the change in administration have resulted in a period of more limited activity by the Securities and Exchange Commission (SEC), which operated with only three commissioners for all of 2016 and only two (less than a quorum) from January through early May of 2017. However, the SEC staff has remained active, and there have been continuing developments in the roll-out (and potential roll-back) of disclosure and governance regulations called for by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank or the Dodd-Frank Act) (111 P.L. 203, 124 Stat. 1376).

Intensified Scrutiny of Non-GAAP Financial Measures by SEC Staff

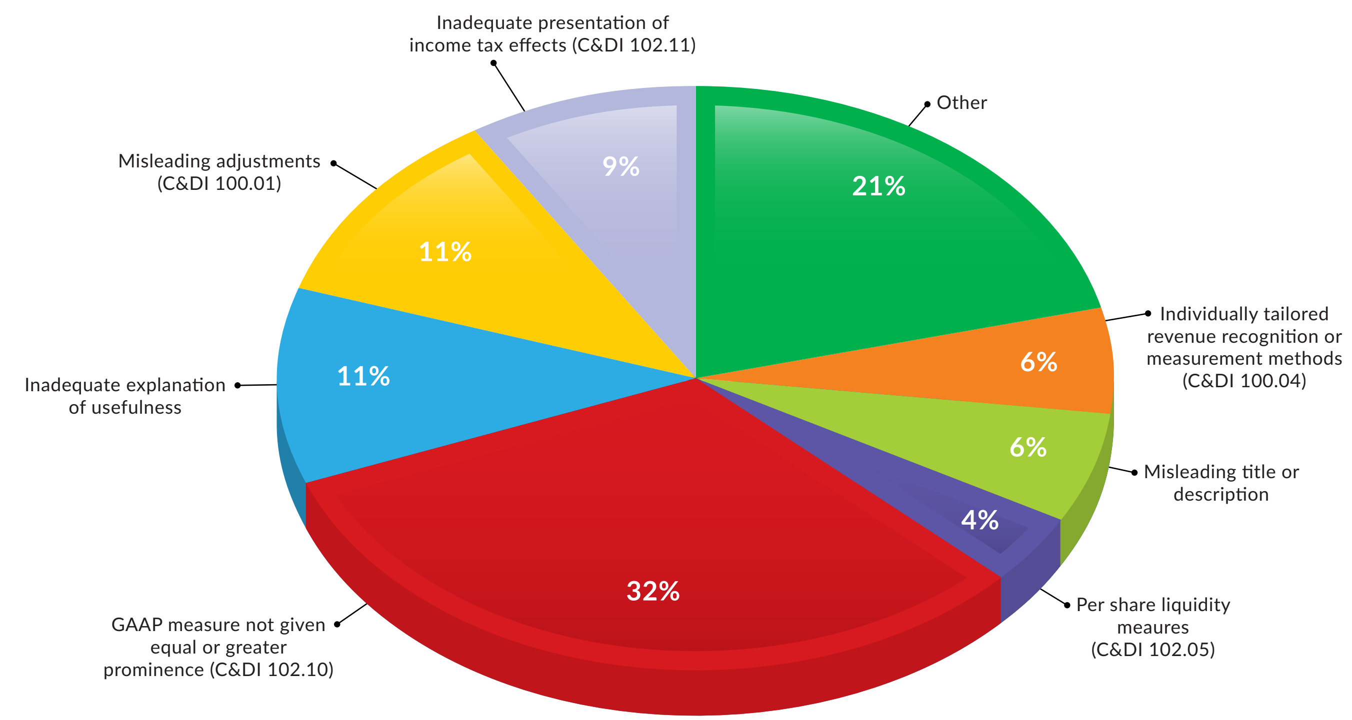
In May 2016, the SEC's Division of Corporation Finance issued new guidance in the form of Compliance and Disclosure Interpretations (C&DIs) identifying a number of potentially problematic uses of non-generally accepted accounting principles (non-GAAP) financial measures. This 2016 guidance represented a more restrictive stance by the staff, particularly compared to 2010 staff guidance that was widely viewed as emphasizing flexibility. The 2016 guidance was accompanied by public statements by SEC staff members of their intent to increase scrutiny of non-GAAP usage in SEC filings.

As of April 14, 2017, the SEC staff had publicly released more than 500 comments to nearly 250 companies challenging the calculation and presentation of non-GAAP financial measures in filings made subsequent to this guidance. Based on an analysis of these comments, the following have been the most common areas of SEC staff focus during this period, in descending order of frequency:

- GAAP measure not given equal or greater prominence (C&DI 102.10)
- Inadequate explanation of usefulness of non-GAAP measure
- Misleading adjustments, such as exclusion of normal recurring cash expense (C&DI 100.01)
- Inadequate presentation of income tax effects of non-GAAP measure (C&DI 102.11)
- Individually tailored revenue recognition or measurement methods (C&DI 100.04)
- Misleading title or description of non-GAAP measure
- Use of per share liquidity measures (C&DI 102.05)

As indicated previously, five of these top seven areas relate specifically to concerns addressed by the May 2016 guidance, with the comments usually citing the relevant C&DI, while the other two reflect continued focus on issues (explanation of usefulness and misleading titles) that have long been the subject of staff comment. This demonstrates that the staff's efforts to monitor and enforce compliance are expanding, rather than replacing, its traditional areas of focus regarding non-GAAP measures.

The following chart shows the frequency with which each of these areas was raised in staff comments, as a percentage of total non-GAAP comments during this period. The nature of the comments received in each area is discussed in further detail below.



Comments released through April 14, 2017, for filings made after May 17, 2016

GAAP Measure Not Given Equal or Greater Prominence

The non-GAAP rules for SEC filings and earnings releases furnished on Form 8-K are included in Item 10(e) (17 C.F.R. § 229.10) of Regulation S-K. Regulation G (17 C.F.R. § 244.100 – 102) contains non-GAAP rules applicable to all public disclosures. The rule sets are largely similar, with one key difference being that Item 10(e) requires the GAAP measure to be given "equal or greater prominence" to the non-GAAP measure.

The SEC staff has shown great interest in policing compliance with the "equal or greater prominence" requirement applicable to SEC filings and earnings releases furnished on Form 8-K. This area, including the staff's strict interpretation set out in C&DI 102.10, represents by far the largest proportion (approximately a third) of the non-GAAP comments on filings since May 2016. Comments in this area fall into three main subcategories:

- **Comparable GAAP measure omitted or given less prominence.** A number of the comments have focused on issuers' failure to present the most comparable GAAP measure prior to the non-GAAP measure (or, in some cases, at all) when discussing a non-GAAP measure in narrative or tabular format. The comments make clear that all discussions or presentations (including tabular reconciliations) of non-GAAP measures should be preceded by the comparable GAAP measure. Some comments objected to an unequal emphasis in the presentation of non-GAAP measures as compared to the corresponding GAAP measures (such as having three bullet points and one chart for the non-GAAP measures, but only one bullet point and no chart for the comparable GAAP measures).

- **Full non-GAAP income statement.** In C&DI 102.10, the SEC staff clarified that "[p]resenting a full income statement of non-GAAP measures or presenting a full non-GAAP income statement when reconciling non-GAAP measures to the most directly comparable GAAP measures" would be an example of giving undue prominence to non-GAAP measures. A number of comments have reminded issuers of this position and the need to revise their reconciliations so as not to provide what appears to be a full non-GAAP income statement.
- **Excluding a quantitative forward-looking reconciliation.** Under the rules, when presenting a forward-looking non-GAAP financial measure, issuers must include, "to the extent available without unreasonable efforts," a reconciliation of the measure to the most directly comparable GAAP measure. C&DI 102.10 and the staff's numerous comments on this point have made clear that if an issuer excludes a quantitative forward-looking reconciliation, the issuer must disclose reliance on the "unreasonable efforts" exception, along with identification of the information that is unavailable.

The SEC scrutiny in this area has extended, in some cases, to enforcement investigation or actions. For example, in January 2017, the SEC announced that MDC Partners agreed to pay a $1.5 million fine to settle charges relating to, among other things, improper use of non-GAAP measures, including failing to give GAAP measures equal or greater prominence.

Inadequate Explanation of Usefulness of Non-GAAP Financial Measures

Although the SEC staff did not issue new guidance as to Item 10(e)(1)(i)(C) of Regulation S-K, it has continued to focus on issuers' disclosure of how their non-GAAP financial measures provide useful information to investors regarding the issuer's financial condition and results of operation. Specifically, the staff frequently makes the following points in commenting on the usefulness disclosure, particularly in the case of unorthodox non-GAAP measures:

- The staff commonly responds to generic-sounding disclosure by asking for a "more substantive" description of the usefulness. For example, the staff did not deem it sufficient for a company to describe a measure as "useful to investors in understanding our capital requirements," as this does not say how it is useful.
- The disclosure must be specific to each non-GAAP measure, explaining the particular reasons why it is useful to investors, as opposed to a general blanket statement asserting the usefulness of a variety of different types of measures.
- Merely stating how management uses a measure does not satisfy the requirement to disclose how it is useful to investors.
- The staff has stated that it is not appropriate for the usefulness disclosure to suggest that the non-GAAP measure is "better, more meaningful or superior" to the GAAP measure.
- Disclosure need not be expansive and, in fact, the staff commonly notes that disclosure should be "concise," as well as "substantive."

Potentially Misleading Adjustments

The non-GAAP rules do not prohibit the exclusion of recurring items from non-GAAP measures, but rather just prohibit the identification of an excluded recurring item as "non-recurring, infrequent or unusual." C&DI 100.01, however, imposes an additional restraint, providing that "[c]ertain adjustments may violate Rule 100(b) of Regulation G because they cause the presentation of the non-GAAP measure to be misleading," including "presenting a performance measure that excludes normal, recurring, cash operating expenses." The SEC staff has issued a number of comments questioning issuers' adjustments and requesting explanations as to why such adjustments are not "normal, recurring, cash operating expenses." Particular areas of focus include litigation expenses, lease/rent expense, restructurings charges, and acquisition and integration costs, particularly where an issuer has included such charges over several years.

Inadequate Presentation of Income Tax Effects

C&DI 102.11 provides that an issuer "should provide income tax effects on its non-GAAP measures depending on the nature of the measures" and that "income taxes should be shown as a separate adjustment and clearly explained." Most of the comments based on this C&DI asked issuers to present the income tax effects as a separate adjustment rather than presenting the measure "net of tax" and to explain clearly how the income tax effect was calculated.

Use of Individually Tailored Revenue Recognition or Measurement Methods

C&DI 100.04 provides that a non-GAAP measure that individually tailors revenue recognition or measurement methods could be misleading in violation of Rule 100(b) of Regulation G. SEC staff objections to individually tailored recognition or measurement methods have further clarified that use of individually tailored accounting principles (such as deferring revenue and costs, adjusting weighted-average common shares, and adjusting assets for proportionate economic ownership) and individually tailored expense recognition methods (such as removing only portions of depreciation expense) may also be misleading.

Use of a Per Share Non-GAAP Financial Measure as a Liquidity Measure

A number of the comments have reiterated the rules' prohibition of per share presentations of liquidity measures. C&DI 102.05 and the related comments make clear that the SEC staff looks at the substance of the per share non-GAAP measure in this regard, rather than how it is characterized. In particular, such per share data is prohibited if the measure can be used as a liquidity measure, even if management characterizes it as a performance measure. The SEC staff's approach here is an expansion of its preexisting view (including in C&DI 103.02 issued in 2010) that earnings before interest and taxes (EBIT) and earnings before interest, taxes, depreciation, and amortization (EBITDA) cannot be presented on a per share basis, even if they are characterized as performance measures

The staff has engaged in a dialogue with a number of issuers as to whether and how certain measures comply with C&DI 102.05. Guidance in this area may continue to evolve given the staff's statement in a January 2017 letter to Allergan plc that the staff would, in light of the discussion about the matter, "evaluate the industry practices . . . and consider whether additional comprehensive non-GAAP staff guidance is appropriate."

Misleading Titles or Descriptions

Item 10(e)(1)(ii)(E) of Regulation S-K has been, and continues to be, a focus of SEC staff comments. Item 10(e)(1)(ii)(E) provides that issuers cannot "[u]se titles or descriptions of non-GAAP financial measures that are the same as, or confusingly similar to, titles or descriptions used for GAAP financial measures." A number of the staff comments relating to this requirement ask issuers to revise the title of a non-GAAP cash flow measure (such as "cash flow from core operations" or free cash flow that has been adjusted) to prevent confusion with GAAP cash flow. Additionally, the SEC staff has objected to the use of certain titles that it deems confusingly similar to GAAP titles, such as "operating," "comparable," "underlying," and "core," when referring to non-GAAP measures.

In preparing disclosure, companies should be mindful of these areas of staff focus. The staff's continued scrutiny of non-GAAP financial measures—in particular the "equal or greater prominence" requirement—is expected to continue and may involve challenges to practices and presentations that were not viewed as problematic prior to the May 2016 guidance.

The Status of the SEC's Dodd-Frank To-Do List on Disclosure and Governance

Seven years ago, the Dodd-Frank Act was enacted into law, handing the SEC and many other agencies a long list of regulatory mandates. In the SEC's case, this includes a number of directives relating to public company disclosure and governance. The SEC promptly completed some of these regulations, which have already become familiar parts of the compliance landscape, such as mandatory say-on-pay votes for proxy filers. Other mandates have had a rockier path, but at this point have resulted in final rules with developing market practices; for example, although the SEC's mandatory proxy access rule was judicially vacated, private adoption through the shareholder proposal process has led to proxy access becoming a common feature for large and mid-cap companies.

Related Content

For an overview of and a timeline showing the progress of regulatory implementation of the Dodd-Frank Act, see

> THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT: ROAD MAP TO KEY PROVISIONS

RESEARCH PATH: *Capital Markets & Corporate Governance > Public Company Reporting > Other Reporting Obligations > Practice Notes > Other Reporting Obligations*

For guidance on the regulation and disclosure requirements for non-GAAP measures, see

> UNDERSTANDING SEC REGULATION OF NON-GAAP FINANCIAL MATTER

RESEARCH PATH: *Capital Markets & Corporate Governance > Financial Disclosure Issues for Public Companies > Disclosing Non-GAAP Information > Practice Notes > Non-GAAP Financial Information*

For a discussion on the pay ratio rule, see

> UNDERSTANDING PAY RATIO DISCLOSURE

RESEARCH PATH: *Capital Markets & Corporate Governance > Executive Compensation > Disclosure Requirements > Practice Notes > Compensation Disclosure in the Proxy Statement*

For additional information on the Dodd-Frank Act executive compensation provisions in general, see

> DODD-FRANK ACT – EXECUTIVE COMPENSATION PROVISIONS

RESEARCH PATH: *Capital Markets & Corporate Governance > Executive Compensation > Disclosure Requirements > Practice Notes*

A number of Dodd-Frank provisions relating to disclosure and governance, however, have not yet developed into final rules or have otherwise been delayed or halted. Below is a discussion of the status of several of these provisions.

CEO Pay Ratio Rule: Rule Adopted, Effective for 2018 Proxy Season, But Delay Possible

Section 953(b) of the Dodd-Frank Act directed the SEC to require disclosure of:

- The median of the annual total compensation of all employees of the issuer, except the issuer's chief executive officer (CEO) (or the equivalent)
- The annual total compensation of the issuer's CEO (or the equivalent)
- The ratio of those amounts

The final SEC rule, which was adopted in August 2015 by a 3-2 vote, provides that disclosure will be required with respect to the first fiscal year beginning on or after January 1, 2017; accordingly, the rule will not be effective until the 2018 proxy season.

The path to effectiveness for the rule may not be a smooth one. In February 2017, Acting SEC Chairman Michael S. Piwowar, noting reports of unanticipated compliance difficulties, issued a statement requesting public comment on these challenges and whether relief is needed. He also directed the SEC staff to reconsider the implementation of the rule based on any comments submitted. The comment period ended in March 2017. In addition, the pay ratio disclosure is among the Dodd-Frank provisions targeted for repeal by various legislative efforts, including the Financial Choice Act first introduced in the House of Representatives (the House) in 2016.

One of the biggest challenges that arose as companies began considering how to calculate and present their ratio was how to identify the median employee. The final rule allows significant flexibility, so long as material assumptions, adjustments, or estimates are disclosed. In October 2016, the staff posted new guidance on the SEC website relating to the determination of the median employee. This guidance (C&DIs 128C.01-.05) continued to emphasize flexibility, making clear that the "consistently applied compensation measure" used to identify the median employee may cover less than an annual period, may cover a time period that does not include the date on which the employee population was determined, and may generally consist of annual total compensation from the registrant's prior fiscal year.

The October 2016 guidance also includes examples of measures that would generally not be permissible because they do not reasonably reflect the annual compensation of employees, including the use of cash compensation when employees widely receive equity awards, hourly or other rates of pay without factoring in time worked, and Social Security taxes unless all employees earn less than the Social Security wage base.

Even though the new disclosure will not be required until the 2018 proxy season at the earliest, companies may find it helpful to conduct dry runs of the calculation based on past compensation data in order to develop an appropriate methodology; identify and resolve interpretive, practical, or disclosure issues; and ensure that systems are in place to capture information necessary to support the chosen methodology.

Pay-versus-Performance Disclosure: Rule Proposed

Dodd Frank Section 953(a) directed the SEC to adopt rules requiring annual meeting proxy statements to show the relationship between executive compensation "actually paid" and the financial performance of the issuer, taking into account stock price and dividends. In April 2015, the SEC published its proposed rule by a 3-2 vote. No final rule has been adopted.

The proposed rule would require covered issuers to disclose the following in a new table for each of the most recent five years (subject to transition for the period after adoption):

- The total compensation as reported in the Summary Compensation Table for the CEO and the average for the other named executive officers (NEOs)
- The actual pay (described below) for the CEO and the average for the other NEOs
- The issuer's and its peers' cumulative total shareholder return, or TSR (i.e., the change in stock price over the period assuming reinvestment of dividends) since the start of the five-year period

The rule would also require a clear description, through text, graphics, or a combination of the two, of the relationship of actual pay to TSR and of the company's TSR to that of its peers.

"Actual" pay is a new concept that was not defined in the statute and did not exist otherwise in SEC rules. The definition that the SEC proposed would start with the total reported compensation and make the following adjustments:

- Equity awards would be considered actually paid on the date of vesting and at fair value (as calculated for accounting purposes) on that date, rather than fair value on the grant date.
- Change in pension value would consist of an actuarially determined service cost for the year and would exclude the portion of the change that results from interest rate changes, the executive's age, and other actuarial inputs and assumptions regarding benefits accrued in previous years. The SEC states that this should reduce volatility of the measure.

In the proposing release, the SEC states that it is aware of the various concepts of "realized" and "realizable" pay that have been increasingly used in proxy statement in recent years, but that it is not aware that there has been broad agreement on any particular formula. Companies could supplement the required disclosure with other appropriate measures that they think provide useful information on pay-for-performance alignment, "provided that the supplemental disclosure is not misleading and not presented more prominently than the required disclosure."

Related Content

For questions and answers to the key provisions of the final and proposed rules regarding executive compensation in Dodd-Frank, see

> **Q&A: KEY PROVISIONS OF EXECUTIVE COMPENSATION UNDER DODD-FRANK**

RESEARCH PATH: *Capital Markets & Corporate Governance > Executive Compensation > Disclosure Requirements > Practice Notes > Compensation Disclosure in the Proxy Statement*

For more information on the SEC's proposed pay-versus-performance rule, see

> **PAY-FOR-PERFORMANCE**

RESEARCH PATH: *Capital Markets & Corporate Governance > Executive Compensation > Disclosure Requirements > Practice Notes > Compensation Disclosure in the Proxy Statement*

For additional information on clawbacks, see

> **APPLYING INCENTIVE COMPENSATION – CLAWBACK PROVISIONS**

RESEARCH PATH: *Capital Markets & Corporate Governance > Corporate Governance and Compliance Requirements for Public Companies > Compliance Controls > Practice Notes > Financial Reporting Controls*

For additional information, see

> **DODD-FRANK ACT – PROPOSED EXECUTIVE COMPENSATION RULEMAKING**

RESEARCH PATH: *Capital Markets & Corporate Governance > Executive Compensation > Disclosure Requirements > Practice Notes*

As noted above, two Commissioners opposed issuance of the proposed rule. These Commissioners expressed concerns over the focus on TSR and whether it incentivizes short-term thinking to the detriment of companies and investors.

Clawback Requirements: Rule Proposed

Dodd-Frank Section 954 directed the SEC to require listed companies to adopt policies providing for the recapture (or clawback) of excess incentive compensation paid to an executive officer based on erroneous financial statements. In July 2015, the SEC published its proposed rule by a 3-2 vote. No final rule has been adopted.

In recent years, clawback policies have become more prevalent as a means of protecting companies and their shareholders in cases of fraud or misconduct. The Sarbanes-Oxley Act, adopted in 2002, permitted companies to recapture compensation paid to the CEO and the chief financial officer (CFO) of a public company when there is a restated financial statement due to misconduct. The increased focus on risk management following the 2008 financial crisis also contributed to the proliferation of clawback policies, particularly at financial institutions.

The SEC's proposed rule would prohibit stock exchanges from listing companies that did not have compliant written clawback policies. Such a policy would need to provide that, in the event the issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer with any financial reporting requirement under the securities laws, the issuer will recover from its current and former executive officers the amount of erroneously awarded incentive-based compensation received during the three completed fiscal years immediately preceding the date the restatement is required. Clawbacks would be on a no-fault basis, without regard to any misconduct or responsibility of the executive for the erroneous financial statements.

The definition of executive officer is modeled on the definition of officer under Rule 16a-1(f) (17 C.F.R. § 240.16a-1) for purposes of Section 16 reporting and short-swing profit liability under the Securities Exchange Act of 1934, as amended (Exchange Act). The policy must cover former officers, but mandatory clawback would only apply to compensation earned at least in part during a period that an executive officer served in that capacity.

The rule would apply only to incentive-based compensation, and only to the extent that the amount awarded would have been lower under the financial measure as restated. It would not include, for example, salary, discretionary bonuses, or bonuses based solely on satisfying one or more subjective, strategic, or operational measures.

Listed issuers would be required to claw back excess covered compensation unless the direct expense paid to a third party to assist in enforcing the policy would exceed the amount to be recovered (or in the case of a foreign private issuer, if recovery would violate home country law).

The Financial Choice Act, which was first introduced in the House in 2016 and contemplates the repeal or limitation of numerous Dodd-Frank provisions, would limit the scope of the clawback requirement to those executives who had control or authority over the company's financial reporting.

THE FINANCIAL CHOICE ACT . . . WOULD LIMIT THE SCOPE OF THE CLAWBACK REQUIREMENT TO THOSE EXECUTIVES WHO HAD CONTROL OR AUTHORITY OVER THE COMPANY'S FINANCIAL REPORTING.

Hedging Policies: Rule Proposed

The Dodd-Frank provision on hedging policies was among the least controversial, particularly because it did not seem to require significant disclosure beyond what SEC rules already required. Section 955 of the Dodd-Frank Act directs the SEC to require disclosure as to whether employees or directors are permitted to hedge equity securities of the issuer. The SEC published its proposed rule in February 2015. The proposal was approved unanimously by the SEC in private session, but two Commissioners issued a separate joint statement expressing concerns over the broad scope of the proposal (in particular, its application to all employees and to smaller reporting companies, emerging growth companies, and closed-end funds). No final rule has been adopted.

The proposed rule would not require any company to prohibit hedging transactions or to otherwise adopt hedging policies and would not require disclosure of any particular hedging transactions.

Existing SEC rules already address concerns over insider hedging in various ways. For example, existing Item 402(b)(2)(xiii) (17 C.F.R. § 229.402) of Regulation S-K contemplates that the Compensation and Disclosure Analysis would include disclosure of any issuer anti-hedging policies, and many hedging arrangements by executive officers would require reporting and expose executives to potential short-swing liability under Section 16 of the Exchange Act.

Resource Extraction and Conflict Minerals

The years since the adoption of Dodd-Frank have not been kind to two socially motivated disclosure requirements that were included in the SEC's mandate: resource extraction and use of conflict minerals. After years of legal analysis and interpretation, rulemaking, and judicial arguments, the most potent aspects of the disclosure rules are not in effect, and both of these topics are among those targeted for repeal by the Financial Choice Act.

In February 2017, the president signed into law a legislative resolution that disapproves the updated SEC resource extraction rule adopted in 2016 and provides that it has no force and effect. Portions of the conflict mineral rule, as adopted by the SEC, were invalidated by the Court of Appeals for the District of Columbia Circuit in Nat'l Ass'n of Mfrs. v. SEC, 800 F.3d 518 (D.C. Cir. Aug. 18, 2015), and subsequently the SEC staff issued a statement on future enforcement of the remaining parts of the conflict mineral rule.

Market Outlook

There is significant doubt as to whether the Dodd-Frank disclosure-related rules will ever be finalized and come into effect and, if so, in what form. The rule proposals and adoptions in this area were among the small minority of SEC actions that were opposed by some of the Commissioners, and that was before the U.S. executive and legislative branches came under the control of Republicans vowing to pull back on a perceived over-regulation of U.S. businesses. As noted in the discussion above, many of the rule proposals and adoptions were approved by the SEC by a 3-2 vote; of the two Commissioners who remain in office, Commissioner Kara M. Stein voted in favor of all and Commissioner Piwowar voted against all.

Issuers and their counsel should, nevertheless, keep apprised of developments and give appropriate consideration to how they would implement these requirements if and when they come into effect. The supporters of these disclosures are as fervent as their opponents, and it is impossible to predict how these rules will fare in the multiple complex negotiations that are sure to come.

The SEC staff's non-GAAP focus, however, has not been the subject of significant controversy, and there is no reason to believe that it will abate, particularly as it is about the monitoring of compliance with existing rules and guidance, rather than expansion of regulation. Absent any revised guidance or new statements as to SEC staff focus, issuers and their counsel should continue to draft and review financial disclosure with an understanding of the staff's concerns and interpretations on usage of non-GAAP measures. L

Assistance provided by Bob Buckholz, Cathy Clarkin, Scott Miller, Sarah Wilson, June Hu, and Grace Chung, Sullivan & Cromwell LLP.

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RESEARCH PATH: Capital Markets & Corporate Governance > Market Trends > Corporate Governance & Continuous Disclosure > Practice Notes > Recent Trends in Corporate Governance & Continuous Disclosure

Timothy Murray MURRAY HOGUE AND LANNIS

Contract Drafting Advice: The "Battle of the Forms" Demystified

SECTION 2-207 OF THE UNIFORM COMMERCIAL CODE (UCC) was supposed to resolve these questions: (1) Is a contract formed when parties exchange forms that contain non-matching terms and the parties don't sign off on a single document? (2) If so, what are the terms of that contract? These questions are of monumental importance to American commerce given the widespread practice of contracting for the sale of goods via the exchange of preprinted forms, but the answers provided by § 2-207 are anything but satisfying, to put it charitably.

Section 2-207 has been called "a defiant, lurking demon patiently waiting to condemn its interpreters to the depths of despair";[1] "incomprehensible";[2] and "a complete disaster" that was the product of "a miserable, bungled, patched-up job . . . ."[3] Its intentions were grand but it was poorly drafted, and it has cut a swath of confusion that has confounded the commercial bar for more than half a century.

In the 1990s, as part of the well-known effort to revise UCC Article 2, the UCC's permanent editorial board proposed an amended § 2-207 based on the ideas of my *Corbin on Contracts Desk Edition* co-author, Professor John E. Murray, Jr.[4] That would have been a marked improvement, but the revised Article 2—including the much-improved § 2-207—died on the vine.

A sea of ink has been spilled to describe this mess, but a short article that presents the battle of the forms in a nutshell might help untangle § 2-207's daunting convolutions for the practitioner who doesn't have time to read a treatise about it.

But be forewarned, the following is not for the faint-hearted—the subject is jaw-droppingly confusing.

An All-Too Common Scenario

Consider a common sale of goods transaction. The parties agree on the essential business terms (the identity of the product being bought and sold, quantity, price, and delivery terms). The buyer sends the seller a purchase order form with this critical commercial information on it, but on the back of that form are preprinted, standardized terms and conditions—sometimes called "boilerplate," or more pejoratively, "legalese." These terms are drafted by the buyer's lawyers but they're not specific to the transaction. They're presented in print so small, it is painful to read them.

The seller receives the buyer's form and responds by sending back its acknowledgment form that promises to ship the product referenced in the purchase order. But on the back of that form are the seller's own preprinted, standardized terms and conditions, which are very different from the buyer's. Among other things, the seller's terms exclude consequential and incidental damages, disclaim implied warranties, set forth a limited 90-day warranty, promise to repair or replace any defective part of the product as the "sole and exclusive remedy," and require that all disputes between the parties be resolved in arbitration in the county of the seller's principal place of business. The buyer's purchase order was silent on each of these terms.

Even though the parties have not signed off on a single document, the seller ships, and the buyer accepts the goods. Nobody bothers to read the other party's standardized terms, much less tries to figure whose boilerplate governs the transaction—until there's a problem with the product.

And this is perhaps the most remarkable thing about the battle of the forms; for contracts formed via the exchange of standardized, preprinted forms, the contract cannot consist of both parties' boilerplates. The fact is, a staggering percentage of carefully drafted terms and conditions will have no contractual significance—yet this doesn't seem to be a concern to a lot of businesspeople or their attorneys.

Common Law

Under the common law, in order to form a contract, the terms of the acceptance had to match the terms of the offer exactly—this was called the matching acceptance or mirror image rule. If the terms of the response to the offer deviated from the offer in any manner, the response was not an acceptance but a rejection of the offer and a counteroffer that created a brand new power of acceptance in the original offeror.[5]

It must be emphasized that to form a contract under the common law, all of the terms of the offer and acceptance had to match: (1) the terms that the parties consciously considered—subject matter, quantity, price, and delivery terms (Professor Karl Llewellyn, chief architect of the UCC, principal draftsman of Article 2, and devoted protégé of Professor Corbin, famously called these "dickered terms"[6]) and (2) the so-called boilerplate terms typically found in the fine print of preprinted, standardized forms that are very often ignored by the parties—such as disclaimer of implied warranties, limitations and exclusions of the default remedies provided by law, choice of law, choice of forum, and mandatory arbitration clauses. Boilerplate terms often aren't pertinent unless a problem arises with the goods that are the subject of the deal.

In a battle of the forms scenario involving the sale of goods at common law, where the parties exchanged forms that did not match exactly, no contract was formed. Nevertheless, if the

Related Content

For more information on the daunting challenges in contract law when the parties exchange unsigned forms, see

> UNDERSTANDING THE BATTLE OF THE FORMS

RESEARCH PATH: *Commercial Transactions > Supply of Goods and Services > Contract Formation, Breach, and Remedies under the UCC > Practice Notes > Contract Formation*

For detailed guidance on drafting enforceable contracts, see

> CONTRACT DRAFTING LANDMINES

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

Additional LexisNexis Content

For an extensive discussion on the battle of the forms in contract formation, see

1-2 MURRAY ON CONTRACTS §§ 50, 51 (2011)

For a detailed overview on UCC § 2-207, see

1-3 CORBIN ON CONTRACTS §§ 3.37, 3.37A (2017)

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1. Reaction Molding Techs v. General Elec. Co., 585 F. Supp. 1097, 1104 (E. D. Pa. 1984). 2.. D. Keating, *Exploring the Battle of the Forms in Action*, 98 Mich. L. Rev. 2678, 2679 (2000). 3. Prof. Grant Gilmore, quoted in J. Murray, *The Chaos of the "Battle of the Forms": Solutions*, 39 Vand. L. Rev. 1307, 1309 (1986). 4. See W. David Slawson, *Binding Promises* at 198, n. 44 (1996).

5. United States v. Marietta Mfg. Co., 339 F. Supp. 18 (S.D. W. Va. 1972). 6. The dickered terms concept is central to understanding the battle of the forms. Llewelyn wrote:

> Instead of thinking about "assent" to boiler-plate clauses, we can recognize that so far as concerns the specific, there is no assent at all. What has in fact been assented to, specifically, are the few dickered terms, and the broad type of the transaction, and but one thing more. That one thing more is a blanket assent (not a specific assent) to any not unreasonable or indecent terms the seller may have on his form, which do not alter or eviscerate the reasonable meaning of the dickered terms. The fine print which has not been read has no business to [undercut] the reasonable meaning of those dickered terms which constitute the dominant and only real expression of agreement.

K. Llewellyn, *The Common Law Tradition: Deciding Appeals* 370 (1960). Prof. Llewellyn wrote that "any contract with boiler-plate results in two . . . contracts: the *dickered* deal, and the collateral one of *supplementary* boiler-plate." K. Llewellyn, *The Common Law Tradition: Deciding Appeals* 371 (1960). One court explained:

> Usually, the parties "concentrate[] exclusively on the 'dickered' terms of the deal, i.e., those terms which they consciously adverted, such as the description of the goods, the quantity, the price and other terms which the decent merchant consciously would consider."

Hunger U.S. Special Hydraulics Cylinders Corp. v. Hardie-Tynes Mfg. Co., 41 U.C.C. Rep. Serv. 2d (Callaghan) 165, 2000 Colo. J. C.A.R. 645 (10th Cir. 2000). *See also*, Alliance Wall Corp. v. Ampat Midwest Corp., 17 Ohio App. 3d 59, 477 N.E.2d 1206, 17 Ohio B. Rep. 114, 41 U.C.C. Rep. Serv. (Callaghan) 377 (Ohio Ct. App., 1984). 7. One court explained:

> Prior to adoption of the Uniform Commercial Code (UCC), the common law "mirror image rule" held that an acceptance that did not precisely parrot the terms set out in the offer was never an acceptance but a mere counteroffer. . . . This rigid requirement led to an unfortunate practice whereby commercial dealings too often degenerated into a "battle of the forms" in which the merchant sending the last written communication before performance would reap the spoils of the battle by having the "last shot" at inserting favorable boilerplate terms.

Superior Boiler Works v. R.J. Sanders, Inc, 711 A.2d 628, 633, 36 U.C.C. Rep. Serv. 2d (Callaghan) 1031 (R.I. 1998). *See also*, VLM Food Trading Int'l, Inc. v. Ill. Trading Co., 811 F.3d 247 (7th Cir. 2016) (common law resolved the battle of the forms by applying the last shot rule).

parties were in agreement on the dickered terms, they typically proceeded to perform the transaction anyway, often blissfully unaware that the exchange of forms did not create a contract. When the goods were shipped and accepted, the parties had a contract—after all, the goods weren't shipped as a gift.

But what were the terms of that contract? Under the common law, the party that sent the last form was deemed to have made an offer, based on the terms of the document it sent, that was accepted by the other party's performance.

For example, if the buyer's purchase order constituted the offer (as was usually, but certainly not always, the case), the seller's acknowledgment form constituted a rejection and a counteroffer. But if the seller proceeded to ship and the buyer accepted the goods—which was common—the buyer was deemed to have accepted both the goods and the seller's counteroffer since the seller fired the last shot. Not surprisingly, this was called the last shot rule.[7]

The problem? The contract based on the seller's boilerplate had no relation to the parties' intentions. The law "accorded undue advantages based on [the] fortuitous position[ ]" of the sender of the documents.[8] Whoever was last, was first—happenstance selected the winner, a result that was as unjust as it was arbitrary. If the goal of contract law is to give effect to the intentions of the parties, this didn't accomplish that.

The U.C.C.

The drafters of the UCC devised § 2-207 to rectify the common law's failures, but they might have made matters worse. Section 2-207 sought to answer two questions: (1) Have the parties formed a contract? (2) And if so, what are its terms?

To understand § 2-207, it is necessary to resist the temptation to consider its subsections in the order they appear. Here is the lurking demon in its entirety:

> (1) A definite and seasonable expression of acceptance or a written confirmation which is sent within a reasonable time operates as an acceptance even though it states terms additional to or different from those offered or agreed upon, unless acceptance is expressly made conditional on assent to the additional or different terms.
>
> (2) The additional terms are to be construed as proposals for addition to the contract. Between merchants such terms become part of the contract unless:
>
> (a) the offer expressly limits acceptance to the terms of the offer;
>
> (b) they materially alter it; or
>
> (c) notification of objection to them has already been given or is given within a reasonable time after notice of them is received.
>
> (3) Conduct by both parties which recognizes the existence of a contract is sufficient to establish a contract for sale although the writings of the parties do not otherwise establish a contract. In such case the terms of the particular contract consist of those terms on which the writings of the parties agree, together with any supplementary terms incorporated under any other provisions of this Act.

A Contract Can Be Formed Via the Exchange of Non-Matching Forms

Contract Formation

The great innovation of § 2-207 was "to reform the common law mirror-image rule and reject the last-shot doctrine which accorded undue advantage to the mere order in which forms were sent."[9] The first part of § 2-207 (1)—the words before the comma—announces that the mirror image rule will no longer prevent contract formation:

> (1) **A definite and seasonable expression of acceptance or a written confirmation which is sent within a reasonable time operates as an acceptance even though it states terms additional to or different from those offered or agreed upon,** unless acceptance is expressly made conditional on assent to the additional or different terms.

U.C.C. § 2-207(1) (emphasis added).

Contracts can now be created via the exchange of non-matching forms. A lot of responses that used to be counteroffers under the common law are now acceptances under the UCC.[10] The new law merely recognized the reality that parties intend to enter into contracts even though the forms they exchange are not the mirror image of each other.

The words of § 2-207 before the comma presuppose that an offer has been made—not an invitation to make an offer, but a bona fide offer that created a power of acceptance in the offeree. That is, the offeror has "communicate[d] a manifestation of willingness to enter into a bargain that would justify another person in understanding that his or her assent to that bargain was invited and would form a contract." *Corbin on Contracts* § 1.11 (2017). Either the buyer or the seller can be the offeror, but there must be an offer to trigger § 2-207.

"Mirror image" rule destroyed—but the dickered terms still have to match. Courts construe the language of § 2-207(1) before the comma (quoted above) to mean that the mirror

8. Daitom, Inc. v. Pennwalt Corp., 741 F.2d 1569, 1580, 39 U.C.C. Rep. Serv. (Callaghan) 1203 (10th Cir. 1984). 9. Richardson v. Union Carbide Indus. Gases, Inc., 790 A.2d 962, 968, 347 N.J. Super. 524, 534, 47 U.C.C. Rep. Serv. 2d (Callaghan) 119 (App. Div. 2002). 10. *See, e.g.*, Transwestern Pipeline Co. v. Monsanto Co., 46 Cal. App. 4th 502, 53 Cal. Rptr. 2d 887, 96 Cal. Daily Op. Service 4354, 96 Daily Journal DAR 7002, 29 U.C.C. Rep. Serv. 2d (Callaghan) 1178 (Cal. App. 2d Dist. 1996).

image rule does not apply to different or additional boilerplate terms. But courts usually hold that the mirror image rule still applies to the dickered terms of the transaction, as described by Prof. Llewellyn (that is, the essential business terms—the description of the product, quantity, price, payment, and delivery terms). A response to an offer that alters the dickered terms in a significant way does not constitute "[a] definite and seasonable expression of acceptance" under § 2-207 (1), and a contract is not formed.[11]

But where the dickered terms largely match, even if the response to the offer includes additional or different *boilerplate* terms, there *is* "[a] definite and seasonable expression of acceptance"—and a contract has been formed.

What Are the Terms?

If the parties have exchanged forms containing non-matching boilerplate terms and a legally binding contract is formed under § 2-207 (1), what are the terms of the contract? The answer lies in § 2-207(2) (that subsection only applies if a contract is formed under 2-207(1)).[12] That subsection provides:

> (2) The additional terms are to be construed as proposals for addition to the contract. Between merchants such terms become part of the contract unless:
>
> (a) the offer expressly limits acceptance to the terms of the offer;
>
> (b) they materially alter it; or
>
> (c) notification of objection to them has already been given or is given within a reasonable time after notice of them is received.

The Knockout View

Immediately, there is a significant problem with the words of § 2-207(2). Notice that § 2-207(1) recognizes that the forms exchanged can create a contract notwithstanding "different" or "additional" terms. But the language of § 2-207(2) only bothers to tell the reader how to treat "additional" terms—"different" terms are not mentioned in this subsection, and the text of the statute does not instruct the reader how to treat them.

The official comments to § 2-207 lend some support for the view that § 2-207(2) was intended to address both "additional" and "different" terms, but most courts have refused to read "different" into § 2-207(2).

To deal with this problem, apparently a majority of jurisdictions[13] have followed the so-called knockout view. This view holds that expressly different terms are knocked out—excised—and any remaining gaps are filled by the UCC's default terms.[14]

It must be underscored that the knockout view only applies where there are expressly conflicting terms. If an offer is silent as to a term but the document responding to the offer addresses it, the new term in the responding document is an "additional" term, and § 2-207(2) will become operative (in other words, the knockout rule does not apply to that term).

What Happens to "Additional Terms"?

The answer to this question depends on whether or not the parties are merchants.

Non-merchants. The first sentence of § 2-207(2) states that "[t]he additional terms are to be construed as proposals for addition to the contract." If the parties are not merchants, then, presumably, like any other "proposal," the offeror would have to agree to such a term to make it part of the contract.

Merchants. The second sentence deals with the situation involving merchants—meaning, "virtually anyone in business."[15] Section 2-207(2) states: "Between merchants such terms become part of the contract unless" one of the three enumerated exceptions in § 2-207(2) applies.

Offeror Can Limit Acceptance to Terms of the Offer

§2-207(2)(a) and (c) allows the offeror—the so-called master of the offer—to expressly limit acceptance to the terms of the offer in two ways:

> (2) . . . Between merchants such [additional] terms become part of the contract unless:
>
> (a) the offer expressly limits acceptance to the terms of the offer;
>
> . . . .
>
> (c) notification of objection to them has already been given or is given within a reasonable time after notice of them is received.

"If the offeror expressly limits acceptance to the terms of the offer," in either of the ways spelled out in §2-207(2)(a) and (c), "any additional term, material or immaterial, cannot become part of the contract."[16]

Thus, if the offeror tracks the safe-harbor language of §2-207(2)(a) and (c) in its offer—or sends an objection "within a reasonable time" as permitted by §2-207(2)(c)—

11. ". . . generally courts have found that no contract is formed pursuant to the exchange of forms if the dickered terms of the offer and purported acceptance do not match in ways that matter to the parties." T. Davis, *U.C.C. Section 2-207: When Does An Additional Terms Materially A Contract?*, 65 Cath. U.L. Rev. 489, 498 (2016). Professor John Murray explained: "It would not be reasonable to assume a 'definite expression of acceptance' if the variant term in the response to the offer is a 'dickered' terms such as a different price or product or quantity or another term which differed from a term in the offer that should have been reasonably understood as important to the offeror." J. Murray, *Murray on Contracts* § 51 (2011). 12. Corus Am., Inc. v. Int'l Safety Access Corp., 2009 U.S. Dist. LEXIS 118838, at *14 (N.D. Ill. Dec. 22, 2009). 13. General Steel Corp. v. Collins, 196 S.W.3d 18, 60 U.C.C. Rep. Serv. 2d (Callaghan) 1 (Ky. Ct. App. 2006); H. Hamoudi, *The American Commercial Religion*, 10 DePaul Bus. & Comm. L.J. 107 (2012). 14. Examples of cases that have applied this rule: Daitom, Inc. v. Pennwalt Corp., 741 F.2d 1569, 39 U.C.C. Rep. Serv. (Callaghan) 1203 (10th Cir. 1984); Memphis-Shelby County Airport Auth. v. Ill. Valley Paving Co., 2006 U.S. Dist. LEXIS 79970 (W.D. Tenn. Nov. 1, 2006); Northrop Corp. v. Litronic Indus., 29 F.3d 1173, 24 U.C.C. Rep. Serv. 2d (Callaghan) 407 (7th Cir. 1994). 15. As used in 2-207, the term "merchant" "has a broad meaning referring to virtually anyone in business." J. Murray, *Murray on Contracts* § 51 (2011). *See* § 2-104(1) and Comment 2 to that section. 16. J. Murray, *Murray on Contracts § 51* (5th ed. 2011).

the offeror prevents additional terms in the offeree's response from becoming part of the contract.

If the Offeror Fails to Limit Acceptance to the Terms of the Offer, § 2-207(2)(b) Applies

If the offeror fails to expressly limit acceptance to the terms of the offer and does not object to additional terms—that is, if the offeror fails to avail itself of § 2-207(2)(a) or (c)—any additional term automatically becomes part of the contract between merchants unless the term "materially alters" the offer under § 2-207(2)(b):

> (2) . . . . Between merchants such [additional] terms become part of the contract unless:
>
> . . . .
>
> (b) they materially alter it;

The issue of whether an additional term is a material alteration under § 2-207(2)(b) has become a significant source of litigation. As suggested above, it is a controversy that the offeror can avoid by tracking the language of §2-207(2)(a) or (c) in its offer or notification of objection.

An additional term is a material alteration if it "result[s] in surprise or hardship if incorporated without express awareness by the other party." UCC § 2-207, Comment 4. Comment 5 to § 2-207 characterizes it as "unreasonable surprise." One commentator explained: "Courts impose the burden of establishing a material alteration on the non-assenting party who is objecting to the inclusion of the additional term. To satisfy its burden, most jurisdictions require the non-assenting party to prove that incorporating an additional term into the parties' agreement will result in surprise or hardship to the non-assenting party."[17]

But "what is or is not a material alteration is dependent upon a number of factors and variables, including the value of the transaction, the quantity involved in the transaction, the relationship of the parties to each other, the custom and usage of trade, and the course of dealing and course of performance between the parties. Only by considering all of the above factors can a court make a determination whether a term is truly a material alteration."[18]

The official comments to § 2-207 provide examples of material and immaterial alterations, but courts do not always feel obliged to follow their lead. Courts often opt for a fact-based analysis of each term. A survey of the cases decided over the course of a decade found that most cases hold that arbitration provisions do not materially alter the agreement; cases are split as to whether a disclaimer-of-warranty clause constitutes a material alteration; forum selection clauses usually constitute material alterations; cases are split over whether a limited remedy or a disclaimer of consequential damages constitute a material alteration; interest clauses do not constitute a material alteration; and attorney's fees provisions rarely constitute a material alteration.[19]

Offerees Can Still Make Counteroffers under § 2-207, but the Common Law Last Shot Rule No Longer Applies

Despite the above, offerees can still make counteroffers under § 2-207. A contract is not formed via the exchange of forms if the offeree responds to the offer by making a counteroffer using the magic words of § 2-207(1)—the words after the comma. This portion of the paragraph recognizes that offerees can make counteroffers when "acceptance is expressly made conditional on assent to the additional or different terms."

§ 2-207(1) states:

> A definite and seasonable expression of acceptance or a written confirmation which is sent within a reasonable time operates as an acceptance even though it states terms additional to or different from those offered or agreed upon, ***unless acceptance is expressly made conditional on assent to the additional or different terms.***

U.C.C. § 2-207(1) (emphasis added).

When an offeree (in the typical scenario, the seller) parrots this safe harbor language of § 2-207(1) (after the comma) in its acknowledgement form or other document sent in response to the offer, the response is deemed to be a counteroffer that both rejects the offer and creates a new power of acceptance in the original offeror (typically, the buyer). In that case, no contract is formed via the exchange of forms.[20]

Recall that in this very scenario at common law, where the parties proceeded to perform even though their exchange of forms did not result in a contract, the last shot principle dictated that the terms of the contract were those of whichever party sent the last form (usually the seller). But to allow that result under the UCC would embrace the very thing § 2-207 was designed to avoid.

In recognition of this, courts hold that the acceptance of the goods in response to a UCC § 2-207 counteroffer does not constitute an acceptance of the offeree's terms. The offeror is only bound to those terms if it expressly assents to them,[21]

17. T. Davis, *U.C.C. SECTION 2-207: WHEN DOES AN ADDITIONAL TERM MATERIALLY ALTER A CONTRACT?*, 65 Cath. U.L. Rev. 489, 503 (2016). **18.** C. Stephens, *Escape from the Battle of the Forms: Keep it Simple, Stupid*, 11 Lewis & Clark L. Rev. 233, 248 (2007). **19.** T. Davis, *U.C.C. SECTION 2-207: WHEN DOES AN ADDITIONAL TERM MATERIALLY ALTER A CONTRACT?*, 65 Cath. U.L. Rev. 489 (2016). **20.** Mark Andy, Inc. v. Heat Techs., 2015 U.S. Dist. LEXIS 44008 (E.D. Mo. Apr. 3, 2015) ("Here, Mark Andy's Purchase Order [in response to Heat Technologies' offer] tracks the statutory language and states that 'acceptance of this Order is expressly made conditional on assent to the terms, provisions and conditions of this Order . . . ' Accordingly, it was not a valid acceptance of Heat Technologies' offer." Rather, it was a counteroffer, but because it expressly conditioned its acceptance on Heat Technologies' assent to the proposed terms in the Purchase Order, a contract on Mark Andy's terms resulted only if Heat Technologies assented. The court explained: "Mere performance does not constitute acceptance of all the terms in the counter-offer.")

which is most unlikely. So what are the terms of the contract if the parties proceed to perform anyway, as they typically do?

If the Parties Perform, There is a Contract by Conduct

If the parties fail to form a contract via the exchange of forms (as occurs when the offeree makes a counteroffer under § 2-207 (1)), and if the parties nevertheless perform—the seller ships and the buyer accepts the goods—the parties have a contract by conduct under § 2-207 (3).

> (3) ***Conduct by both parties which recognizes the existence of a contract is sufficient to establish a contract for sale although the writings of the parties do not otherwise establish a contract.*** In such case the terms of the particular contract consist of those terms on which the writings of the parties agree, together with any supplementary terms incorporated under any other provisions of this Act.

U.C.C. § 2-207(3) (emphasis added).

What are the Terms of this Contract by Conduct?

To ascertain the terms of a § 2-207(3) contract by conduct, the UCC instructs us to look to the forms the parties exchanged—the same forms that otherwise have no legally operative effect:

> (3) Conduct by both parties which recognizes the existence of a contract is sufficient to establish a contract for sale although the writings of the parties do not otherwise establish a contract. In such case ***the terms of the particular contract consist of those terms on which the writings of the parties agree, together with any supplementary terms incorporated under any other provisions of this Act.***

U.C.C. § 2-207(3) (emphasis added).

The terms of the forms exchanged that match are, of course, the dickered terms (e.g., subject matter, quantity, price, and time of delivery). Non-matching terms are excised. These typically include disclaimer of implied warranties, limitations and substitutions of the default remedies provided by law, choice of law, choice of forum, and mandatory arbitration clauses.

The remaining gaps are supplemented by implied or default terms under the UCC. Thus, implied warranties, the entire panoply of remedies allowed by Article 2, and adjudication of disputes in a court of law—terms either expressly stated or impliedly assumed by Article 2—are inserted in the gaps left after non-matching boilerplate terms are excised.[22] These default terms largely favor buyers.

Confirmations

If you aren't sufficiently confused by now, note that § 2-207 treats written confirmations of oral or informal contracts as acceptances (more accurately, § 2-207(1) pretends that a confirmation constitutes an acceptance) even though the confirmation contains non-dickered terms different from or additional to the terms of the prior oral contract.[23]

The popular phrase "battle of the forms" is misleading. Section 2-207 applies to transactions involving a single confirmation, as well as where both parties send conflicting confirmations.[24]

Section 2-207 Has Not Been Applied to Common Law Cases

Unlike much of the UCC, the principles established by § 2-207 have not found their way into the common law. While the comments to the *Restatement (Second) of Contracts* mentions § 2-207, the *Restatement* continues to embrace the common law's mirror image rule—with all its flaws—for contracts not involving the sale of goods. See Restatement (Second) Contract § 59 ("A reply to an offer which purports to accept it but is conditional on the offeror's assent to terms additional to or different from those offered is not an acceptance but is a counter-offer.") Given the pathologies of § 2-207, that may be for the best. L

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RESEARCH PATH: *Commercial Transactions > Supply of Goods and Services > Contract Formation, Breach, and Remedies under the UCC > Articles > Battle of the Forms*

21. *Id.*; C. Itoh & Co. v. Jordan Int'l Co., 552 F.2d 1228, 21 U.C.C. Rep. Serv. (Callaghan) 353 (7th Cir. 1977); Man Ferrostaal Inc. v. Winner Steel Servs., 2007 U.S. Dist. LEXIS 89109 (W.D. Pa. Nov. 19, 2007). 22. *See* Sanmina-Sci Corp. v. Pace U.S., 2015 Cal. App. Unpub. LEXIS 4765 (Cal. App. 6th Dist. July 7, 2015) (2-207(3) limits the contract to the terms on which their writings expressly agree, along with gap-filler provisions from the Commercial Code). 23. One court explained:

> Section 2.207 is addressed to two situations. The first is where an offer is made and a written acceptance is sent in return, but the acceptance purports to add additional terms to the contract. . . . The second situation to which section 2.207 applies is where an agreement has already been reached by the parties, either orally or through informal correspondence, and is later followed by a formal written confirmation containing both terms already agreed upon and additional terms not previously discussed. . . . This "written confirmation" refers to the writing necessary to make enforceable a contract that would otherwise be unenforceable under the U.C.C.'s statute-of-frauds provision.

Int'l Metal Sales, Inc. v. Global Steel Corp., 2010 Tex. App. LEXIS 2201, at *30 (Tex. App. Austin Mar. 24, 2010) (invoice sent after oral agreement is not a confirmation). 24. *See* Dorton v. Collins & Aikman Corp., 453 F.2d 1161 (6th Cir. 1972).

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JOSEPH MARGER IS A PARTNER IN Reed Smith's Real Estate group. He has substantial experience in all aspects of the sale and acquisition of real estate, both single-asset and portfolio transactions, including industrial and commercial single-user facilities, shopping centers, hotels, office buildings, and multi-family residential properties. He is equally experienced in real estate finance, including sale-leaseback and build-to-suit financing transactions, traditional loan documentation for borrowers and institutional lenders for construction and development, and stabilized assets, including securitized transactions. In addition, Joseph has extensive experience in the representation of landlords and tenants in negotiating and drafting significant commercial office leases, bank branch leases, and retail and restaurant leases in New York City and across the country and in structuring transactions and drafting partnership and limited liability company agreements involving pension funds, developers, investment banks, private equity funds, and individual investors.

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LEAH SAMIT ROBINSON RECENTLY joined Mayer Brown LLP to build and lead its State and Local Tax Group. She advises public and private business entities on state and local tax planning, controversy, and litigation. Leah provides national and state tax strategy and audit assistance for clients on a full range of tax matters, including nexus, combination and apportionment, and net operating loss issues. She is particularly well known for her advocacy in New York City and New York State, as well as for advising on the impact of the massive New York tax reform undertaken in 2014 and 2015. She has been appointed to the New York City Department of Finance Commissioner's Advisory Board each year since 2014, as well as to the city's Pass-Through Taxation Working Group (also since 2014), a think tank formed by the Department of Finance to assist with bringing reform to the city's Unincorporated Business Tax.

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