The LEXIS PRACTICE ADVISOR Journal™
DECEMBER 2017
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LIFE SCIENCES PATENTS: STRATEGIES FOR OVERCOMING EARLY LITIGATION CHALLENGES TO PATENT ELIGIBILITY

Avoiding Accidental Contracting

What Employers Should Know when Considering Using Payroll Cards to Pay Employees' Wages

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The
LEXIS PRACTICE ADVISOR Journal™

DECEMBER 2017 (Volume 2, Issue 5)

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

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

LETTER FROM THE EDITOR

Eric Bourget, Editor-in-Chief

THIS EDITION OF THE LEXIS PRACTICE Advisor marks the last edition in 2017. Hopefully everyone is on the verge of wrapping up any loose ends whether that means concluding a negotiation, closing a large transaction, filing a last-minute motion, winning a trial, or securing a new client. This edition focuses on several trending topics and practice areas that have been prevalent throughout 2017.

Life sciences is a burgeoning field that is intertwined with Intellectual Property law but also has implications in other practice areas like Corporate M&A. This issue features strategies for overcoming early litigation challenges to patent eligibility in the life sciences area. The article outlines methods the patentee may consider when facing patent eligibility challenges early in litigation. When such challenges arise in the life sciences arena, the claims commonly in focus are those directed to methods or tools for analysis of biological samples, compositions of matter based on naturally occurring materials, or methods of treatment using compositions asserted to be naturally occurring.

This issue also provides coverage on an issue that everyone has witnessed driving by shopping malls, shopping centers, and empty storefronts, which has had a tremendous impact on real estate and corporate legal professionals. A major evolution is occurring in commercial real estate due to the increase in e-commerce over brick-and-mortar retail. This phenomenon has created demand for attorneys who have retail leasing expertise with an emphasis on lease exit strategies. This article addresses several exit strategies such as co-tenancy, space sharing, subletting, and the legal implications of these changing uses.

Another recurring issue for employers is addressed in this edition—workplace violence, a safety issue that often surfaced in news stories and impacted many companies this year. This article offers guidance to assist with designing and implementing policies and practices that address and deter workplace violence, a task that often falls on general counsel or human resource professionals.

In addition, this edition provides guidance for employers and corporations when considering an increasingly popular method of paying wages—the use of payroll cards. Although these cards can reduce administrative costs associated with processing and distributing checks, there are other potential inconveniences and fees to consider.

One area of law that experienced significant changes and was frequently in the news in 2017 is immigration law. This edition includes an article that covers the primary immigration actions of the current administration impacting U.S. employers. The article examines multiple travel bans, H-1B and L-1 visa reform, the Reforming American Immigration for a Strong Economy Act (RAISE Act), extreme vetting and enhanced scrutiny of travelers, and Deferred Action for Childhood Arrivals (DACA) developments, in addition to the president's continuing immigration priorities.

Our drafting advice section addresses an issue that results in a significant amount of litigation each year—the accidental formation of a contract during negotiations. Accidental formation is something that every practitioner should be wary of when representing a client through any contract negotiation, and practitioners should take steps to ensure that accidental negotiation does not occur. This drafting guidance offers valuable tips for avoiding these disputes.

We hope that you had a healthy, happy, and productive 2017 and thank you for your continued readership of The Lexis Practice Advisor Journal. We look forward to providing you with even more practice insights, trends, and guidance next year.

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.

D.C. COURT ORDERS EEOC TO RECONSIDER WORKPLACE WELLNESS RULES

IN AN ACTION BROUGHT BY THE AMERICAN ASSOCIATION of Retired Persons (AARP), the U.S. District Court for the District of Columbia has ordered the U.S. Equal Employment Opportunity Commission (EEOC) to reconsider two regulations related to employer-sponsored wellness programs. AARP v. U.S. Equal Employment Opportunity Comm'n, 2017 U.S. Dist. LEXIS 133650 (D.D.C. Aug. 22, 2017).

U.S. Judge John Bates found that the EEOC failed to adequately explain the reasoning behind the rules, which allow employers to require disclosure of health information in order to be eligible to benefit from financial incentives tied to participation in employer-sponsored wellness programs. 81 Fed. Reg. 31,126; 81 Fed. Reg. 31,143.

The AARP challenged the regulations in a suit filed on behalf of its members, contending that they are inconsistent with requirements in the Americans with Disabilities Act (ADA) and the Genetic Information Nondiscrimination Act (GINA) that disclosure of health information to an employer must be voluntary. The AARP argued that employees who would not otherwise disclose health information would be forced to do so in order to obtain reductions in health coverage costs of up to 30% as permitted by the regulations, thereby rendering the disclosure involuntary.

The EEOC moved for dismissal of the action, contending that the AARP lacked standing; the AARP moved for summary judgment.

Judge Bates granted the AARP's motion, finding that the EEOC failed to justify its adoption of the 30% incentive figure.

"EEOC has failed to adequately explain its decision to construe the term 'voluntary' in the ADA and GINA to permit the 30% incentive level adopted in both the ADA rule and the GINA rule," the judge said. "Neither the final rules nor the administrative record contain any concrete data, studies, or analysis that would support any particular incentive level as the threshold past which an incentive becomes involuntary in violation of the ADA and GINA. To be clear, this would likely be a different case if the administrative record had contained support for and an explanation of the agency's decision, given the deference courts must give in this context. But 'deference' does not mean that courts act as a rubber stamp for agency policies."

However, the judge declined to vacate the rules, finding that to do so would likely cause "widespread disruption and confusion." Instead, he remanded the rules to the EEOC for reconsideration "in a timely manner." The EEOC has since indicated in a status report to Judge Bates that it will issue a notice of proposed rulemaking by August 2018 and a final rule by October 2019.

- Lexis Practice Advisor Journal Staff

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

THIRD CIRCUIT FINDS SHORT WORK BREAKS COMPENSABLE UNDER FLSA

THE FAIR LABOR STANDARDS ACT (FLSA) REQUIRES employers to compensate employees for all rest breaks of 20 minutes or less, the U.S. Court of Appeals for the Third Circuit ruled.

The court affirmed a ruling by the U.S. District Court for the Eastern District of Pennsylvania entering partial summary judgment for the U.S. Department of Labor (DOL) in a suit against Progressive Business Publications. Sec'y, U.S. Depart. of Labor v. Am. Future Sys. Inc., 2017 U.S. App. LEXIS 19991 (3rd Cir. Oct. 13, 2017).

Progressive produces business publications that are sold by its office-based sales representatives. Members of the sales force are paid an hourly wage and receive bonuses based on the number of sales per hour while they are logged into their computers.

In 2009 Progressive eliminated its policy of providing two paid 15-minute breaks for its employees, instead allowing them to log off their computers at any time but paying them only for the time they spent logged in. The company positioned the new policy as creating more flexibility for employees by allowing them to take breaks at any time for any duration.

In addition, under the new policy sales representatives were required to estimate their hours for each upcoming two-week period and were subject to discipline, including termination, for not meeting the estimated hours.

The DOL filed suit, alleging that Progressive violated the FLSA by failing to pay the federal minimum wage to its sales representatives. The DOL sought unpaid compensation, liquidated damages, and a permanent injunction against future violations.

The district court entered partial summary judgment for the DOL, citing its Wage and Hour Division's (WHD) interpretation of the FLSA as requiring compensation for "rest periods of short duration" and defining those rest periods as "running from 5 minutes to about 20 minutes." 29 C.F.R. § 785.18. Progressive appealed.

Affirming the district court, the Third Circuit rejected Progressive's argument that its policy is a "flexible time" policy, not a break policy, and that therefore the FLSA does not require it to compensate employees for times when they are logged off. The protections provided by the FLSA "cannot be negated by employers' characterizations that deprive employees of rights they are entitled to under the FLSA," the court said. "The 'log off' times are clearly 'breaks' to which the FLSA applies."

Further, the appeals court said, the WHD's interpretation is reasonable, given the language and purpose of the FLSA.

"As the District Court explained, it is readily apparent that by safeguarding employees from having their wages withheld when they take breaks of twenty minutes or less 'to visit the bathroom, stretch their legs, get a cup of coffee, or simply clear their head after a difficult stretch of work, the regulation undoubtedly protects employee health and general well-being by not dissuading employees from taking such breaks when they are needed,'" the court concluded.

- Lexis Practice Advisor Journal Staff

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

CONGRESS VACATES CONSUMER FINANCIAL PROTECTION BUREAU'S ARBITRATION RULE

PRESIDENT DONALD J. TRUMP HAS SIGNED A CONGRESSIONAL resolution overtuning a Consumer Financial Protection Bureau (CFPB) rule that would have barred financial companies from conditioning the opening of consumer credit accounts on an agreement to resolve disputes via arbitration, not by litigation, including class actions.

The vote was largely on party lines. The House of Representatives voted 231-190 to vacate the rule, with one Republican voting no; the Senate vote was 51-50, with Vice President Mike Pence breaking a 50-50 tie. All 48 Democrats were joined by two Republican senators in voting no.

After the vote, President Trump voiced support for Congress' action, saying, "By repealing this rule, Congress is standing up for everyday consumers and community banks and credit unions, instead of the trial lawyers, who would have benefited the most from the CFPB's uninformed and ineffective policy."

CFPB Director Richard Cordray said in a statement that the Congressional action "robs consumers of their most effective legal tool against corporate wrongdoing. As a result, companies like Wells Fargo and Equifax remain free to break the law without fear of legal blowback from their customers."

The rule (12 C.F.R. pt. 1040), promulgated in July pursuant to Section 1028(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, was scheduled to take effect on September 18, with mandatory compliance for pre-dispute arbitration agreements entered into on or after March 19, 2018.

The U.S. Chamber of Commerce and a number of financial institutions and organizations filed suit for injunctive relief against the rule in the U.S. District Court for the Northern District of Texas in September (Chamber of Commerce of the United States of America, et al. v. Consumer Financial Protection Bureau, et al., No. 3:17-cv-02670-D (N.D. Tex.)).

- Lexis Practice Advisor Journal Staff

RESEARCH PATH: *Finance > Financial Services Regulation > Consumer Financial Regulation > Articles*

AGENCIES EASE POST-HURRICANE APPRAISAL REQUIREMENTS

IN RESPONSE TO WIDESPREAD DAMAGE CAUSED BY Hurricanes Harvey, Irma, and Maria, the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the National Credit Union Administration announced that they will not require financial institutions to obtain appraisals for affected transactions if (1) the properties involved are located in areas declared major disasters, (2) there are binding commitments to fund the transactions within 36 months of the date the areas were declared major disasters, and (3) the value of the real properties supports the institutions' decisions to enter into the transactions.

The exceptions apply to transactions in areas of Florida, Georgia, Puerto Rico, Texas, and the U.S. Virgin Islands and expire three years after the date the president declared each area a major disaster. The exceptions are being made under the Financial Institutions Reform, Recovery, and Enforcement Act and its implementing regulations.

Financial institutions that use the appraisal exception must maintain information estimating the collateral's value that sufficiently supports their credit decision to enter into the transaction. The agencies will monitor institutions' real estate lending practices to ensure the transactions are being originated in a safe and sound banking manner.

-Pratt's Bank Law & Regulatory Report, Volume 51, No. 10

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

TREASURY OUTLINES WAYS TO STREAMLINE CAPITAL MARKETS REGULATION

A RECENTLY RELEASED U.S. DEPARTMENT OF THE Treasury (Treasury) report found that there are "significant reforms that can be undertaken to promote growth and vibrant financial markets while maintaining strong investor protections."

The report details how to streamline and reform the U.S. regulatory system for the capital markets. It is the second of four Treasury will issue in response to President Donald J. Trump's Executive Order 13772, which called on Treasury to identify laws and regulations that are inconsistent with a set of core principles of financial regulation.

"The U.S. has experienced slow economic growth for far too long. In this report, we examined the capital markets system to identify regulations that are standing in the way of economic growth and capital formation," said Treasury Secretary Steven T. Mnuchin. "By streamlining the regulatory system, we can make the U.S. capital markets a true source of economic growth which will harness American ingenuity and allow small businesses to grow."

Treasury found that the federal financial regulatory framework and processes could be improved by:

- Evaluating the regulatory overlaps and opportunities for harmonization of Securities and Exchange Commission and Commodity Futures Trading Commission regulations
- Incorporating more robust economic analysis and public input into the rulemaking process in order to make it more transparent
- Opening private markets to more investors through proposals to facilitate pooled investments in private or less liquid offerings and revisit the accredited investor definition
- Limiting the imposition of new regulations through informal guidance, no-action letters, or interpretation, instead of through notice and comment rulemaking
- Reviewing the roles, responsibilities, and capabilities of self-regulatory organizations and making recommendations for improvements

The report also recommends examining the impact of Basel III capital standards on secondary market activity in securitized products.

The Treasury report went on to say that "Dodd-Frank and various rulemakings implemented to address pre-crisis structural weaknesses in the securitization market may have gone too far toward discouraging securitization. By imposing excessive capital, liquidity, disclosure, and risk retention requirements on securitizers, recent financial regulation has created significant disincentives to securitization. While some changes are helpful in promoting market discipline, others unduly constrain market activity and limit securitization's useful role as a funding and risk transfer mechanism for lending."

-Pratt's Bank Law & Regulatory Report, Volume 51, No. 10

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

G-7 RELEASES CYBERSECURITY REPORT

THE FINANCE MINISTERS AND CENTRAL BANK governors of the G-7 countries released the *Fundamental Elements for Effective Assessment of Cybersecurity for the Financial Sector*. The new report advances the work of last year's report, *G-7 Fundamental Elements of Cybersecurity for the Financial Sector*.

The U.S. Department of the Treasury (Treasury) and the Board of Governors of the Federal Reserve System welcomed the "continued efforts by the G-7 to promote effective practices for cybersecurity and drive greater consistency across the international financial sector."

"A secure, safe, and strong financial sector is essential to promote real growth within the U.S. economy and across the world. Cybersecurity, particularly in the financial sector, is a top priority for the United States, and we are pleased to work with the members of the G-7 to advance a common approach that enhances resiliency," said Treasury Secretary Steven T. Mnuchin. "Technology has become the global engine driving innovation and economic growth, and it provides a channel for the financial sector to engage customers and counterparties. However, this trend brings increased cyber risk, which is real, dynamic, and evolving."

"The new Elements, though non-binding and non-prescriptive, provide tools for institutions to evaluate the performance and assessment of cybersecurity practices," Treasury said. "Additionally, they detail a set of outcomes which demonstrate sound cybersecurity and process components for organizations to use when evaluating their cybersecurity."

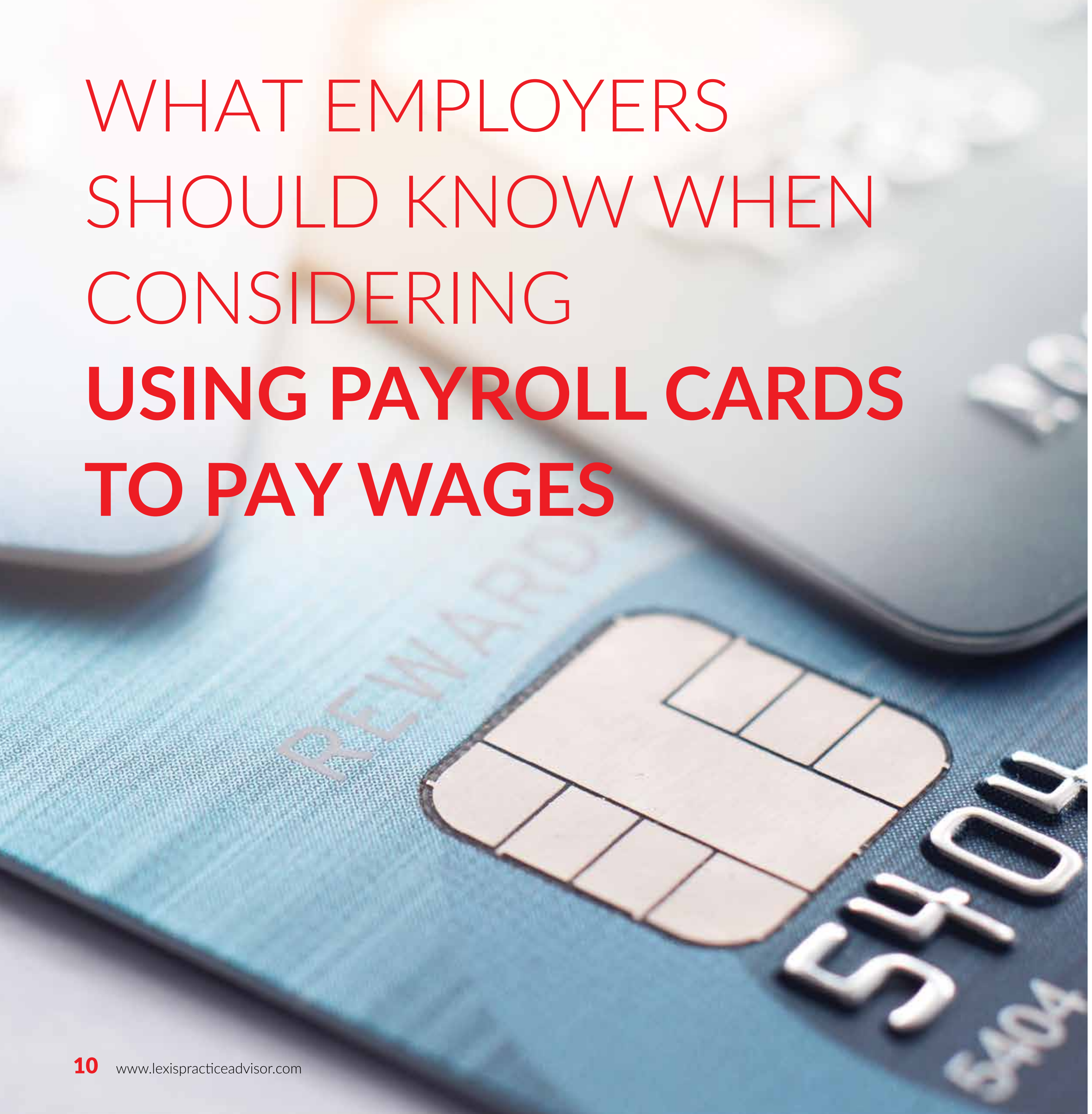
The Treasury and the Bank of England co-chair the G-7 Cyber Expert Group, established in 2015.

-Pratt's Bank Law & Regulatory Report, Volume 51, No. 10

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

Kevin E. Vance and Julian A. Jackson-Fannin
DUANE MORRIS LLP

WHAT EMPLOYERS SHOULD KNOW WHEN CONSIDERING **USING PAYROLL CARDS TO PAY WAGES**



This article outlines key considerations when advising employers on the use of payroll card programs as an alternative method of paying employees.

What Are Payroll Cards?

Payroll cards—also known as payroll debit cards or paycards—are similar to bank debit cards. They are an increasingly popular method for employers to pay wages because they reduce the administrative costs associated with the processing and distribution of live, paper paychecks. Payroll cards can also be attractive to employees, as payroll cards eliminate the hassle and monetary cost sometimes associated with cashing live paychecks.

In a typical payroll card program, the employer chooses a bank or financial institution to issue the cards. Employees who opt for this method of payment establish payroll card accounts with that financial institution. Employers add wages to the payroll cards each pay period. Employees may then use the payroll cards for ATM withdrawals, bank teller withdrawals, debit card purchases, and cash back withdrawals.

As with other accounts, banks sometimes charge fees for the maintenance and use of payroll card accounts. These fees have been the subject of a few recent wage and hour cases and pose some risks for employers who wish to use payroll cards.

Case Law

For example, in Holak v. Kmart Corp., 2012 U.S. Dist. LEXIS 176331, at *4–5 (E.D. Cal. Dec. 12, 2012), plaintiff Amie Holak sought to bring a class action suit against Kmart Corp. alleging, among other things, that:

- She and other putative class members were required to participate in a payroll debit card program if they did not elect to participate in direct deposit.
- Kmart charged unauthorized transaction fees for the use of payroll debit cards and deducted the fees from their wages.
- She and other putative class members could not withdraw all of their wages in a single transaction and incurred transaction fees with every ATM withdrawal after the first one in a given pay period.

Holak and other putative class members claimed Kmart violated Cal. Lab. Code §§ 212 and 221 by taking unlawful wage deductions and unlawfully discounting their wages. Holak, 2012 U.S. Dist. LEXIS 176331, at *11. Kmart successfully moved to dismiss Holak's claims on the grounds that:

- Participation in the payroll debit card program was optional
- The terms and conditions, including the fee schedule, of the program were provided to participants –and–
- The payroll card program provided two ways for participants to withdraw their entire paycheck on demand without paying any fees

Id. at *16–20. Although Kmart successfully defended the use of its payroll debit card program, this case illustrates the need for employers to consider all aspects, including the assessment and disclosure of transaction fees, when deciding to implement a payroll card program.

> WHEN ADVISING EMPLOYERS ON A PARTICULAR PAYROLL CARD PROGRAM, YOU SHOULD PAY SPECIAL ATTENTION TO THE FEE SCHEDULE THAT THE CARD ISSUE PROVIDES, AS MANY FEES ARE NOT ALWAYS OBVIOUS.

Likewise, in Ortiz v. Randstad North America, L.P., 2015 U.S. Dist. LEXIS 30660, at *6 (N.D. Cal. Mar. 12, 2015), plaintiff Adan Ortiz alleged Randstad owed him the full amount of his minimum wage because its payroll debit card program—which allowed for the imposition of transaction fees—did not comply with Cal. Lab. Code § 212. Randstad successfully moved for summary judgment relying on evidence that:

- Its payroll debit card program allowed participants to obtain their wages at a number of locations, including VISA-issuing banks.
- Randstad provided details, including when and how fees were imposed, in a welcome kit to the participants in the payroll debit card program.
- Participants in the payroll debit card program received an itemized wage statement in the form of a pay stub.
- Participants could make one transaction per pay period without incurring a transaction fee.

Ortiz, 2015 U.S. Dist. LEXIS 30660, at *8–10, 13. In addition, Randstad introduced evidence showing that Ortiz had used his payroll debit card on "hundreds of occasions" to obtain his wages without incurring any transaction fees. *Id.* at *10, 13.

Best Practices – Fee Disclosures

As noted from the cases above, fee disclosures are critical to minimizing the risks involved in implementing and maintaining payroll card programs. When advising employers on a particular payroll card program, you should pay special attention to the fee schedule that the card issue provides, as many fees are not always obvious. This is especially true concerning:

- Balance inquiry fees
- Fees for adding money to the card or loading fees
- Out-of-network ATM fees
- Fees based on caps on the number of uses of in-network ATMs
- Overdraft or denied transaction fees –and–
- Other miscellaneous fees such as fees for:
  - Online purchases
  - Receiving paper statements
  - Using a check instead of the card to obtain wages
  - Inactive cards –or–
  - Replacement cards

You can best handle these risks by ensuring the contract you negotiate with the card issuer specifically identifies all of the types of fees that the card issuer may charge. Also, to further minimize the risks that transaction fees pose, you should ensure that the card issuer cannot add or increase fees without prior written approval from the employer.

The use of payroll cards is governed by a patchwork system of federal and state laws. More states are introducing new regulations each year.

Federal Restrictions on the Use of Payroll Cards

The Fair Labor Standards Act (FLSA)

The FLSA requires employers to pay minimum wages and overtime wages to certain types of employees. See 29 U.S.C. § 201 et seq. The FLSA is silent on how employers must pay wages other than to say that wages must be paid "finally and unconditionally or 'free and clear.'" 29 C.F.R. § 531.35. Wages are not paid "free and clear" if the employee is required to "kick back" a portion of the wages to the employer. *Id.*

The FLSA does not specify whether wages should or may be paid pursuant to check, direct deposit, or payroll card. However, any mechanism that requires the employee to bear administrative costs associated with the processing of payments may violate the FLSA if the imposition of fees results in the employee being paid less than the minimum wage for all hours worked or less than the full amount of overtime wages due.

Regulation E of the Electronic Funds Transfer Act (EFTA)

The EFTA is a 1978 federal law that governs electronic banking transactions. See 15 U.S.C. §§ 1693-1693r. In 2006, Regulation E, which implements the EFTA, was amended to apply to "payroll card account[s]." See 12 C.F.R. §§ 205.1-205.20.

In 2013, the Consumer Financial Protection Bureau (CFPB) issued guidance explaining Regulation E's application to payroll cards. See CFPB Bulletin 2013-10. As explained by the CFPB, Regulation E covers payroll card accounts if they are "operated or managed by the employer, a third-party payroll processor, a depository institution or any other person." *Id.*; see also 12 C.F.R. § 1005.2(b)(2).

Regulation E prohibits employers from requiring that employees accept payment by payroll cards issued by a financial institution that the employer selected. See 15 U.S.C. § 1693k(2); 12 C.F.R. § 1005.10(e)(2) and comment 10(e)(2)-1. However, Regulation E does permit employers to offer employees the choice between payment by payroll card and payment by some other means. *Id.* Therefore, an employer payroll card program run by a financial institution of the employer's choosing is lawful so long as the employer provides employees the choice of accepting payment of wages by other means, such as a physical paycheck.

Regulation E provides various protections for those employees who receive wages on a payroll card including, but not limited to:

- Requiring that the financial institution make certain disclosures to payroll card users, including disclosures about fees
- Requiring that employees have access to information about payroll card balance and account history –and–
- Mandating that financial institutions provide Federal Deposit Insurance Corporation (FDIC) protection to payroll cards, as well as protection from fraudulent charges

12 C.F.R. §§ 1005.7, 1005.9(b), 1005.18(b), (c).

The 2013 CFPB guidance noted that while the EFTA and Regulation E preempt state laws that conflict with the EFTA and Regulation E, nothing prohibits states from enacting laws or regulations that offer more protection to employees than the protections provided by the EFTA and Regulation E. See CFPB Bulletin 2013-10.

Final Regulations Issued under Regulation E and Z of the Truth in Lending Act (TILA)

In 2016, the CFPB released comprehensive final regulations under Regulation E as well as Regulation Z of the TILA. (Due to various concerns regarding overall implementation and compliance, the CFPB's final regulations will not go into effect until April 1, 2018. See 81 F.R. § 83934.) The TILA covers the advancement of credit—including overdraft protection—on payroll cards and serves to "promote the informed use of consumer credit by requiring disclosures about its terms and costs." 12 C.F.R. § 226.1 et seq.; 12 C.F.R. §§ 1005 and 1026. While the primary focus of these final regulations is on financial institutions that issue payroll cards, the CFPB also clarified certain aspects of the use of payroll cards in general and imposed additional requirements on employers maintaining payroll card programs in two central areas: (1) transparency and disclosure and (2) consumer protections.

Covered Payroll Card Accounts

First, the CFPB clarified that the final regulations only apply to payroll card accounts where an employees' wages are regularly deposited. The final regulations exclude payroll card accounts where an employer deposits funds on an inconsistent basis or where the funds are not considered the employees' primary source of compensation (e.g., emergency pay advances, bonus payments, travel or transit reimbursements, or payments related to flexible spending or health savings account reimbursements).

Hybrid Prepaid Credit Cards

The CFPB also included a new category of payroll cards in the final regulations called "hybrid-prepaid credit cards," which can be subject to Regulation Z compliance under certain circumstances. For example, if the payroll card has a separate credit feature that allows an employee to access credit from a credit account or credit subaccount separate and apart from the payroll card account, the payroll card may be subject to Regulation Z. Additionally, if the payroll card's credit feature is offered by the issuing financial institution or an affiliated business and the employee can use the payroll card's credit feature to complete transactions or if the payroll card offers overdraft protection, it will most likely be subject to Regulation Z compliance. See 12 C.F.R. § 1026.61.

Disclosure Requirements

The final regulations also require a heightened level of disclosure by employers to employees who elect to use payroll cards by requiring employers to provide short-form and long-form disclosures. 81 F.R. §§ 84007-84009; see also 12 C.F.R. §§ 1005.18 and 1005.19. In addition, employers must notify employees of any changes in the terms or conditions of the payroll card program and must inform employees of the issuing financial institution's name, website, and telephone number. See 81 F.R. § 84004; 12 C.F.R. §§ 1005.8, 1005.18(f) and (h).

STATE LAW GENERALLY GOVERNS HOW EMPLOYERS MUST PAY WAGES BECAUSE THE FLSA IS SILENT ON THIS ISSUE. . . . GENERALLY SPEAKING, STATE LAW REGULATIONS OF PAYROLL CARDS ARE SIMILAR TO STATE LAWS REGARDING PAYMENT BY DIRECT DEPOSIT.

Short-Form Disclosure

Employers must provide the short-form disclosure prior to any transactions occurring on the payroll card; this includes any payroll deposits made by the employer. To ensure strict compliance, employers should provide the short-form disclosure in writing prior to an employee's election to participate in the payroll card program. 12 C.F.R. § 1005.18(b); 81 F.R. § 84019.

The short-form disclosure must contain the following information:

- It must contain a statement that the employee can refrain from participating in the employer's payroll card program.
- The statement must indicate and list the employee's payment options and set forth how the employee should inform the employer of their chosen payment method.
- The disclosure must list the number of fee types as well as the particular fees associated with the use of the payroll card, even if they are not offered by the employer's particular payroll card program, including any fees associated with purchases, inactivity, customer service, and ATM usage. Fees must be listed even if they result in $0.00 being charged to the employee.
- The disclosure must also have a statement regarding overdraft and credit extension features, card registration, and government insurance coverage.
- The disclosure must list the CFPB's website and include instructions as to how an employee can obtain general information about payroll card accounts and where to find the long-form disclosure. See 12 C.F.R. §§ 1005.18 and 1005.19.

Long-Form Disclosure

Employers also must provide the long-form disclosure prior to any transactions occurring on the payroll card, including any payroll deposits made by the employer. The timing for the disclosure of the long-form mirrors the timing requirement for the short-form disclosure. As such, employers should provide the long-form disclosure in writing prior to an employee's election to participate in the payroll card program and at the same time they provide the short-form disclosure. 12 C.F.R. § 1005.18(b); 81 F.R. § 84019.

In addition to reiterating the information required in the short-form disclosure (see the subsection above on the short-form disclosure), the long-form disclosure must also include the following:

- The title of the payroll card program
- A comprehensive list of all fees and fee types associated with the payroll card program
- The issuing financial institution's name and contact information –and–
- Instructions on how employees can submit a complaint to the CFPB regarding a payroll card account

See 12 C.F.R. §§ 1005.18(b)(4).

Common Requirements under State Wage and Hour Laws

State law generally governs how employers must pay wages because the FLSA is silent on this issue. No states have passed legislation outlawing wage payment by payroll cards. More than 20 states have enacted laws regulating the use of payroll cards. Generally speaking, state law regulations of payroll cards are similar to state laws regarding payment by direct deposit. These laws supplement and in some cases offer greater protection than Regulation E. For example, most states (including, among others, New Jersey, N.J. Admin. Code § 12:55-2.4(i)(1); Vermont, 21 Vt. Stat. Ann. § 342(c)(2)(C); and West Virginia, W. Va. Code § 21-5-3(b)(3)) allow employers to pay wages via payroll cards only if employees first consent, usually in writing. And some states (e.g., Maryland, Md. Code Ann. Lab & Empl. § 3-502(e)(2)(ii); Tennessee, Tenn. Code Ann. § 50-2-103(e)(D)(2); New Hampshire, N.H. Rev. Stat. Ann. § 275:43(II); and Nevada, Nev. Admin. Code § 608.135(2)(b)) mandate that employers disclose to employees any fees associated with payroll card accounts.

Consider State Breach of Contract Claims for Unpaid Wages

The FLSA regulates only overtime wages and minimum wages. It does not, for example, require that employers pay employees' agreed-upon straight time wages. However, employees sometimes bring state law breach of contract claims for unpaid wages if payroll card fees have the effect of reducing the hourly wage earned by employees. To combat this risk, you should advise employers to ensure that employees have the right to access and withdraw—at least once per pay period—the total amount of wages deposited into their payroll card account without incurring any fees.

Payroll Card Laws Enacted in 2016

New York's Payroll Debit Card Regulations

The New York State Department of Labor issued regulations governing the method of payment to employees, including comprehensive rules for the payment of wages by payroll debit card. These regulations were supposed to take effect on March 7, 2017. However, on February 16, 2017, the New York Industrial Board of Appeals issued an opinion and order revoking the regulations, finding that the New York Commissioner of Labor had exceeded her authority in promulgating them.

Connecticut's Payroll Card Statute

On October 1, 2016, Connecticut joined the growing number of states allowing employers to pay employees using payroll cards, provided certain conditions are met. For an employer to use payroll cards in Connecticut, an employee must "voluntarily and expressly" authorize, in writing or electronically, that he or she wishes to be paid with a card "without any intimidation, coercion, or fear of discharge or reprisal from the employer." No employer can require payment through a card as a condition of employment or for receiving any benefits or other type of remuneration. Conn. Gen. Stat. § 31-71k(b)(2).

Additional conditions that must be satisfied according to the statute include, but are not limited to:

- Employers must give employees the option to be paid by check or through direct deposit.
- The payroll card must be associated with an ATM network that ensures the availability of a substantial number of in-network ATMs in the state.
- Employees must be able to make at least three free withdrawals per pay period.
- None of the employer's costs for using payroll cards can be passed on to employees.

Conn. Gen. Stat. § 31-71k, as amended by 2016 Ct. P.A. 16-125.

Pennsylvania's Payroll Card Statute

On November 4, 2016, Pennsylvania enacted 2016 Pa. Laws 161; 2015 Pa. SB 1265 (codified at 7 Pa. Stat. Ann. § 6122.1) (effective May 5, 2017), which amends Pennsylvania's Banking Code and governs the payment of wages through the use of payroll card accounts.

An employer must receive an employee's written authorization to pay him or her by payroll card. 7 Pa. Stat. Ann. § 6122.1(1). See also 12 C.F.R. § 1005.10(b). Prior to obtaining this authorization, an employer is required to comply with stringent notice requirements, in writing or electronically. Specifically, the employer must give notice of:

- All of the employee's wage payment options
- The terms and conditions of the payroll card account option, including any fees the employee may be subjected to by the card issuer
- Notice that third parties may also assess fees in addition to those of the card issuer –and–
- The methods for payment available to the employee for accessing wages without incurring fees

7 Pa. Stat. Ann. § 6122.1(4).

Related Content

For more information on the Fair Labor Standards Act's (FLSA) minimum wage requirements and state law exceptions, see

> NAVIGATING THE FLSA'S MINIMUM WAGE REQUIREMENTS

RESEARCH PATH: *Labor and Employment > Wage and Hour > Compensation > Practice Notes*

For an explanation on the FLSA's overtime requirement and how to calculate the regular rate of pay and overtime rates of hourly employees., see

> COMPLYING WITH THE FLSA'S OVERTIME REQUIREMENTS FOR HOURLY NON-EXEMPT EMPLOYEES

RESEARCH PATH: *Labor and Employment > Wage and Hour > Compensation > Practice Notes*

For an analysis of state method of pay laws—including information on state payroll card laws—see the Pay Timing, Frequency, Methods, and Deductions column of

> WAGE AND HOUR STATE PRACTICE NOTES CHART

RESEARCH PATH: *Labor & Employment > Employment Litigation > Class and Collective Actions > Practice Notes*

For guidance regarding federal law and the timing and frequency of pay, see

> UNDERSTANDING FEDERAL LAW ON TIMING AND FREQUENCY OF PAY

RESEARCH PATH: *Labor and Employment > Wage and Hour > Compensation > Practice Notes*

For a summary of laws governing private employers' use of direct deposit and payroll cards to pay their employees' wages, see

> DIRECT DEPOSIT AND PAYROLL CARD STATE LAWS CHART

RESEARCH PATH: *Labor and Employment > Jurisdictional Considerations > State Charts & Surveys > Practice Notes*

Employers may not make the payment of wages or other compensation by payroll card a condition of employment or other form of remuneration. 7 Pa. Stat. Ann. § 6122.1(3). When an employee makes a request to change the payment method from a payroll card to another payment method (e.g., check, direct deposit, etc.), the employer must honor the employee's request as soon

as possible, but no later than the first payday after 14 days from the employer receiving the employee's request and any necessary information. 7 Pa. Stat. Ann. § 6122.1(9).

Employees must have the right to make at least one withdrawal from a payroll card account up to the full amount of wages for each pay period free of charge. 7 Pa. Stat. Ann. § 6122.1(5). Employees must also have the opportunity to obtain the balance on their payroll card accounts through an automated telephone system or other electronic means without charge. 7 Pa. Stat. Ann. § 6122.1(6). There also may not be fees for:

- Applying or participating in the payroll card program
- The issuance of an initial payroll card
- The issuance of one replacement card per year upon the employee's request
- Transfer of wages and other compensation from the employer to the payroll card account
- Purchase transactions at the point of sale –and–
- Nonuse or inactivity of the payroll card account for a period of less than 12 months

7 Pa. Stat. Ann. § 6122.1(7). Funds in a payroll card account do not expire. 7 Pa. Stat. Ann. § 6122.1(8).

Pros and Cons of Using Payroll Cards

Advantages

Payroll cards can benefit both employers and their employees, as they cut down on the administrative cost and hassle of dealing with live, physical paychecks. The reduction in paper also benefits the environment.

For years employers have sought alternatives to live paychecks because producing them can be expensive. Direct deposit of paychecks is popular, but many states (e.g., Florida, Fla. Stat. § 532.04(2) and Montana, Mont. Code Ann. § 39-3-204(2)) prohibit employers from requiring direct deposit. The U.S. Department of Labor also takes the position that employers cannot exclusively pay wages through direct deposit. See U.S. Dept. of Labor Field Operations Handbook § 30c00. Using payroll cards can be another attractive way for employers to minimize payroll processing costs, particularly with respect to low-wage earners.

Also, some employees may lack the finances or credit necessary to open bank accounts to be paid by direct deposit. These employees are typically paid by live paycheck. To cash their paychecks, some employees must wait in line and pay fees at check cashing businesses. Payroll cards may be an attractive alternative payment option for these employees.

Additionally, payroll cards are usually insured by the FDIC and offer fraud protection, which provides employees with security that is absent from a live paycheck.

Disadvantages

The primary drawback to employers in using payroll cards is the relative infancy of this wage payment method. With states issuing new laws each year, it is possible that employers may unintentionally run afoul of some technical requirements and thus expose themselves to liability.

As stated above, payroll cards are an attractive option to employees who lack bank accounts for direct deposit payments. However, those employees with such bank accounts may prefer direct deposit and may find payroll cards to be cumbersome.

Best Practices for Establishing and Maintaining Payroll Card Programs

Establishing Payroll Card Programs

At the outset, you should know whether the employer's employees are located in a state (or states) with particular payroll card regulations and tailor their payroll card programs accordingly. You should also advise the employer to partner with an experienced payroll card vendor that is familiar with the laws in all states in which the employer operates. In general, when developing a payroll card program, you should advise the employer to strive for a program that includes:

- Offering employees the choice between being paid by payroll cards, direct deposit, or live paycheck
- Requiring employees to sign consent forms stating that the employee's choice to be paid via payroll card is voluntary and not a condition of employment
- Permitting employees to cancel participation in the payroll card program immediately, and at any time
- Offering a payroll card program that permits employees to withdraw, by a proximately located ATM or bank teller transaction, the full amount of their pay each pay period, with no fees charged for the withdrawal
- Offering a name brand of payroll cards, such as Visa, MasterCard, or Discover, issued by a reputable bank with a widely available, surcharge-free ATM network
- Providing employees with training and easy-to-understand information on payroll card program usage
- Ensuring that the payroll card program provides employees with a cost-free means to check their balance and account history –and–
- Ensuring that employees' payroll card accounts are protected by DIC deposit insurance

When establishing a payroll card program and selecting a vendor, such as a bank or other financial institution, you must take special care to research and investigate the employer's options. You must have confidence that the vendor can provide competent, legally compliant services in those states in which the employer does business. Some vendors may offer monetary incentives to employees that may appear attractive. But you must keep the employer's focus on the quality of the program as a whole and not on the quality of the incentives that the vendor offers.

Maintaining Payroll Card Programs

The work does not stop when the employer implements the payroll card program. After the employer implements a payroll card program, you should review and audit the program at regular intervals to assess performance. You should assess, among other things, employee comments and complaints about the program and whether the program has resulted in savings to the company. If employee participation is low, or if there are questions about employee satisfaction, you and an employer representative should meet with employees to identify and address concerns. It may be advisable to adjust or change the program, based on employee comments and feedback. In addition, because this area of the law is evolving, you should keep tabs on any developments or changes to ensure that the program remains in compliance. L

Kevin E. Vance *is a partner with Duane Morris, LLP. His practice focusses on labor and employment litigation and other types of business litigation. Mr. Vance counsels businesses on a wide variety of labor and employment matters and drafts employee handbooks, employment agreements, releases, settlement agreements, and opinion letters. Mr. Vance also represents businesses in ERISA litigation matters and ADA public accommodation lawsuits. In addition to litigation in state and federal courts, he represents businesses before the Equal Employment Opportunity Commission, the National Labor Relations Board, the U.S. Department of Labor, and various state and local agencies. He is a frequent lecturer on labor and employment law topics.* ***Julian A. Jackson-Fannin*** *is an associate in the firm's Trial Practice Group. Mr. Jackson-Fannin's experience includes commercial, construction defect, and employment litigation. Prior to joining Duane Morris, Mr. Jackson-Fannin served as a law clerk to the Honorable Donald L. Graham of the U.S. District Court for the Southern District of Florida.*

RESEARCH PATH: *Labor & Employment > Wage and Hour > Compensation > Practice Notes*

Timothy Murray MURRAY, HOGUE & LANNIS

DRAFTING ADVICE: AVOIDING ACCIDENTAL CONTRACTING

THERE IS A STAGGERING AMOUNT OF LITIGATION involving disputes over whether a binding contract was formed during contract negotiations. In a typical case of this kind, the parties agree on many issues while negotiating a deal, but they intend to execute a formal document and never get around to doing it before their relationship unravels for one reason or another. Litigation erupts. One party claims there is a binding contract and that the failure to execute that final document doesn't matter. The other party claims he or she didn't intend to reach a final agreement. In the contract law milieu, there are few scenarios more common—or more damaging to the careers of the parties accused of entering into accidental contracts.

Contract formation does not always follow the same trajectory, and sometimes it ends with a document that, at first blush, looks preliminary in nature—perhaps not like a contract at all. Documents that typically are not intended to reach the parties' ultimate contractual objective—including proposals, term sheets, memoranda of understanding, and letters of intent—can, in fact, be legally operative contracts that do just that.[1] Accidental contracting often arises in connection with these so-called preliminary agreements. The first important suggestion is to disregard the labels slapped on a document. Whether it is called a letter of intent, a term sheet, or, for that matter, a ham sandwich, it can still be a binding agreement on the parties' ultimate contractual objective. Courts decide the legal effect of such documents based on "the keystone of all contract law," the parties' intent.[2]

The legal concepts discussed in this short article are the kinds of things we learned in first year contract law class, so why does this issue crop up in case after case after case? It crops up because, too often, parties mistake their subjective intentions with the kind of intentions the law cares about. Contract law gives effect to the parties' outward and objective manifestations of assent, not their subjective intentions. As with most contract law disputes, accidental contracting can almost always be avoided by careful drafting. If the parties desire to delay contract formation until a final document is executed, that intention ought to be plainly manifested in writing.

To discern whether a preliminary agreement reaches the parties' ultimate contractual objective, two overriding questions are paramount:

- Have the parties agreed on all essential terms of the transaction with sufficient clarity to allow a court to enforce the agreement in the event of a breach?
- Does a party know or have reason to know that another party to the proposed transaction desires to delay contract formation until something else happens?

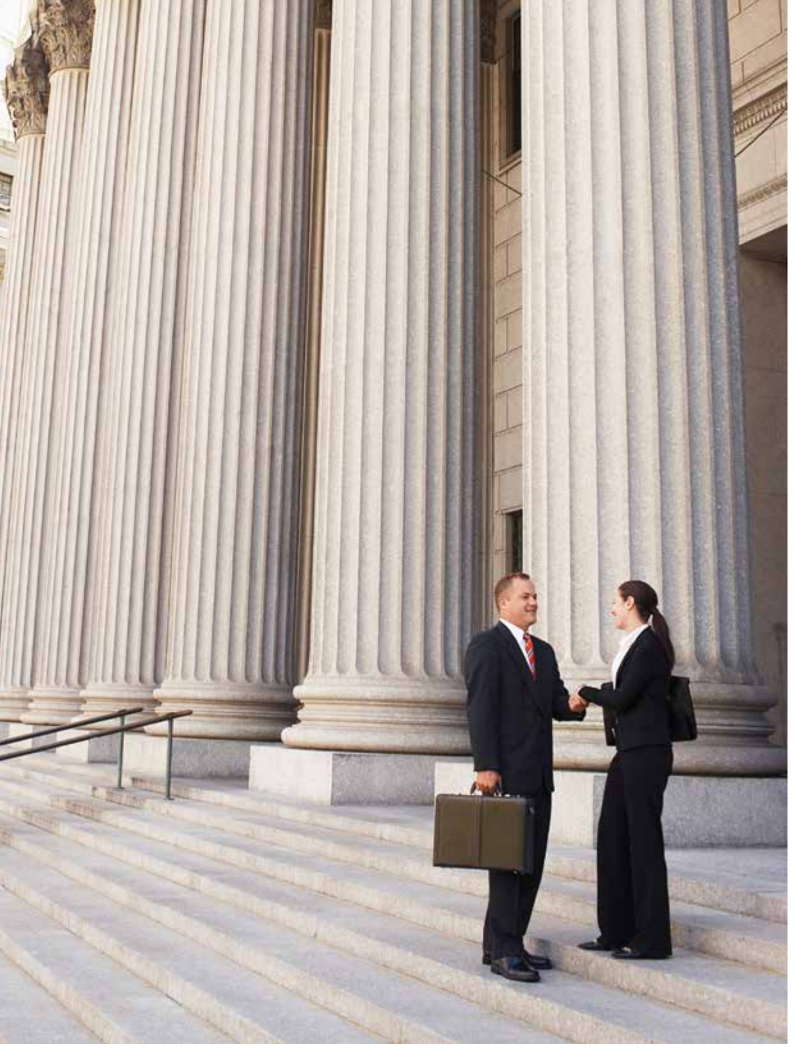
Have the Parties Agreed on All Essential Terms of the Transaction with Sufficient Clarity to Allow a Court to Enforce the Agreement in the Event of a Breach?

Every contract needs to have agreement on certain terms in order to be an enforceable contract, and the terms vary depending on the type of contract. For example, for the sale of goods, the description of the product and the quantity are essential terms (though for requirements or output contracts, quantity is determined based on the buyer's requirements or the seller's output). Beyond that, parties are free to designate terms they deem essential. If a party manifests an intention not to be bound in the absence of agreement on a particular term—even if that term typically would not be considered essential—no deal is possible absent agreement on that term. In a case involving the question of whether a settlement agreement was enforceable, the court defined the essential terms in accordance with the parties' intentions, based on the terms they actually negotiated.[3]

It is very common for the parties to expressly leave open one or more essential terms to be agreed upon later—this is the classic agreement to agree, a legal conclusion that means there is no binding agreement because the agreement lacks enough terms for a court to know whether a breach has occurred or to be able to enforce the contract in the event of a breach. Where the parties have not come to agreement on an essential term, there can be no contract—and there is little danger of accidental contracting.

But doesn't the law routinely imply terms the parties have left open in order to make an agreement a binding contract? Yes, but the law won't imply essential terms—terms specific to the deal that the parties must agree upon in order for a court to be able to enforce it, such as description of the product and quantity in a contract for the sale of goods. Nor will a court imply a term that the parties intend to agree upon but just haven't gotten around to yet (example: parties don't have to agree on price for the sale of goods but almost always do). But where the parties have agreed on essential terms, are not still haggling over one or more terms important to one of the parties, and intend to have a contract, courts imply default terms for the ones the parties have left open. For example, in connection with a transaction for the sale of goods governed by the Uniform Commercial Code (U.C.C.), if the parties have left open the remedies to be provided, the default remedies set forth in the U.C.C. will be implied, and contract formation will not be withheld in the absence of express agreement on those terms. (Tip: if you are the buyer, silence is typically better than negotiating remedies provisions; the U.C.C. remedies favor buyers.)

1. "Because of their susceptibility to unexpected interpretations, it is easy to understand why letters of intent have been characterized by at least one practitioner as 'an invention of the devil.'" Quake Construction, Inc. v. American Airlines, Inc., 565 N.E.2d 990, 1009, (Ill. 2990) (Stamos, J., concurring). 2. Great Circle Lines, Ltd. v. Matheson & Co., 681 F.2d 121, 126 (2d Cir. 1982). See also, Am. Eagle Outfitters v. Lyle & Scott Ltd., 584 F.3d 575 (3d Cir. 2009). 3. Keumurian v. Equifax Info. Servs., LLC, 2016 U.S. Dist. LEXIS 149104, at *9 (D. Mass. Oct. 27, 2016).



Related Content

For a discussion of pitfalls to avoid in agreements for the sale of goods, see

> SALE OF GOODS AGREEMENTS: AVOIDING COMMON PITFALLS

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

For an overview of contract formation under the UCC, see

> CONTRACT TERMS AND THE UCC

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

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*

Does a Party Know or Have Reason to Know That Another Party to the Proposed Transaction Desires to Delay Contract Formation Until Something Else Happens?

If either party knows or has reason to know that the other party does not intend to have an enforceable contract until something else happens, "the preliminary negotiations and agreements do not constitute a contract."[4] The something else can be practically anything—including the execution of a more formal written memorial of the deal, approval by a party's home office, or agreement on one or more issues that have not been resolved.

It is often the case that the parties reach agreement on all essential terms but also contemplate that they will execute one or more additional documents as part of their deal. This is where accidental contracting often occurs.

If a party makes clear during negotiations that there will not be a legally operative contract unless and until the parties execute a formal memorial of the deal, that is the end of the inquiry—there is no contract absent that document. Those are the easy cases.

But it is very common for parties to mutually agree that they will execute a more formal agreement. (A common example: a settlement agreement reached on the courthouse steps the day of the trial. In connection with that settlement, the parties' attorneys typically agree that one of them will later draft a formal settlement agreement.) Generally, in most jurisdictions, even though the parties intend to execute a formal written document, if they have agreed on all the essential terms with sufficient certainty that the agreement may be enforced, and if neither party knows or has reason to know that the other intends to condition contract formation on the execution of a formal written memorial, courts generally find that a binding contract has been entered into.[5] A subsequent failure to come to terms on a formal agreement cannot undo their prior, less formal agreement.[6]

This is a question of the parties' intent. The greater the complexity of the deal, the more likely it is that the parties intend to execute a formal written memorial of their transaction.[7] But many significant

4. Restatement (Second) Contracts § 27, comment b. 5. Restatement (Second) of Contracts § 27 states: "Manifestations of assent that are in themselves sufficient to conclude a contract will not be prevented from so operating by the fact that the parties also manifest an intention to prepare and adopt a written memorial thereof; but the circumstances may show that the agreements are preliminary negotiations." 6. Foster v. United Home Improv. Co., 428 N.E.2d 1351 (Ind. Ct. App. 1981); Camargo v. Alick Smith Gen. Contr., Inc., 2016 U.S. Dist. LEXIS 153157 (E.D. Pa. Nov. 4, 2016); Keumurian v. Equifax Info. Servs., LLC, 2016 U.S. Dist. LEXIS 149104 (D. Mass. Oct. 27, 2016). 7. Skycom Corp. v. Telstar Corp., 813 F.2d 810, 815–816 (7th Cir. 1987).

GIVEN THE DIFFICULTY IN DISCERNING WHETHER THE PARTIES HAVE REACHED A FINAL AGREEMENT, IF A PARTY DESIRES TO POSTPONE FORMING A FINAL CONTRACT UNTIL A MORE FORMAL DOCUMENT IS EXECUTED, HE OR SHE SHOULD STATE THIS INTENTION IN WRITING WITH CLARITY.

transactions are concluded in the absence of a final, formal document. There is no bright line.

Sometimes, one of the parties misconstrues the parties' mutual intention to execute a more formal agreement to mean there can be no contract without one. The difference can be subtle, and it is a recipe for accidental contracting. In many situations, it is not easy to tell the difference between an enforceable agreement and an unenforceable agreement to agree. In *Gurley v. King*,[8] the plaintiff, a recording artist, signed a memorandum of agreement with a manager stating that the artist "will sign an exclusive management contract with [the manager] for three years" to begin when his contract with his current management company ends, or earlier if the manager could arrange it. The manager would receive a 15% commission on the artist's gross income. The memorandum concluded, "The details of the agreement will be worked out later but basically will follow the same arrangement currently in place with [the artist's current manager]." When the artist refused to honor the agreement, the manager sued. The court noted it is possible for parties to make an enforceable contract binding themselves to execute a subsequent final agreement, but only if the initial agreement expresses all essential terms to be incorporated in the final document, which would be a mere memorial of the agreement already reached. The question of whether the parties had a binding agreement was a question of fact to be resolved by the trier of fact.

The U.S. Court of Appeals for the Ninth Circuit's opinion in *Facebook, Inc. v. Pac. Northwest Software, Inc.*,[9] presents a striking example of some of the concepts at issue. Identical twins Cameron and Tyler Winklevoss, along with Divya Narendra (collectively, the Winklevosses) claimed that Mark Zuckerberg stole the idea for Facebook from them. They sued Facebook, and Facebook countersued them, and eventually the parties mediated their dispute in 2008 and appeared to enter into a settlement agreement. Specifically, the Winklevoss' competing social networking site, ConnectU, Facebook, and the Winklevosses signed a handwritten, one-and-a-third-page Term Sheet & Settlement Agreement in which the Winklevosses agreed to give up ConnectU in exchange for cash and a percentage of Facebook's common stock. The settlement agreement also stated: "Facebook will determine the form & documentation of the acquisition of ConnectU's shares [ ] consistent with a stock and cash for stock acquisition." The settlement agreement also purported to end all disputes between the parties. The parties agreed to grant each other "mutual releases as broad as possible," and the Winklevosses represented and warranted that "[t]hey have no further right to assert against Facebook " and "no further claims against Facebook & its related parties." The parties stipulated that the settlement agreement was binding.

The parties could not agree on the form of the final deal documents. Facebook moved to enforce the settlement agreement and asked a district court to order ConnectU and the Winklevosses to sign more than 130 pages of documents, including a stock purchase agreement and a mutual release agreement. Facebook's transactional attorneys claimed that the terms in these documents were "required to finalize" the settlement agreement, and Facebook's expert opined that they were "typical of acquisition documents."

The district court enforced the settlement but refused to require that the stack of documents drafted by Facebook's lawyers be executed. The Ninth Circuit affirmed. It rejected the Winklevosses' argument that because the parties had not come to agreement on the terms that Facebook claimed were required to complete the transaction, there was no legally operative settlement agreement. The court explained that, in fact, the agreement is enforceable so long as its terms are sufficiently definite for a court to determine whether a breach has occurred and order damages or specific performance. "This is not a very demanding test, and the Settlement Agreement easily passes it: The parties agreed that Facebook would swallow up ConnectU, the Winklevosses would get cash and a small piece of Facebook, and both sides would stop fighting and get on with their lives," the court said.

What about the fact that the parties had not yet agreed on some important terms—terms that may affect the value of the bargain? The court explained that the settlement agreement itself specified how to fill in the material terms that the Winklevosses claimed were missing from the deal: "Facebook will determine the form & documentation of the acquisition of ConnectU's shares [ ] consistent

8. 183 S.W.3d 30, (Tenn. Ct. App. 2005). 9. 2011 U.S. App. LEXIS 10430 (9th Cir. April 11, 2011).

with a stock and cash for stock acquisition." That clause, the court explained, "leaves no doubt that the Winklevosses and Facebook meant to bind themselves and each other, even though everyone understood that some material aspects of the deal would be papered later."

"The Winklevosses' contractual delegation is valid," the court concluded, "because the Settlement Agreement obligates Facebook to draw up documents 'consistent with a stock and cash for stock acquisition.' And, if Facebook should draft terms that are unfair or oppressive, or that deprive the Winklevosses of the benefit of their bargain, the district court could reject them as a breach of the implied covenant of good faith and fair dealing. . . . The district court got it exactly right when it found the Settlement Agreement enforceable but refused to add the stack of documents drafted by Facebook's deal lawyers." The court added: "At some point, litigation must come to an end. That point has now been reached."[10]

Avoid Accidental Contracting with Clarity in Drafting

Given the difficulty in discerning whether the parties have reached a final agreement, if a party desires to postpone forming a final contract until a more formal document is executed, he or she should state this intention in writing with clarity. A letter of intent or other preliminary agreement should state that there can be no contract on the ultimate contractual objective until the parties have entered into a subsequent, final, formal statement of their deal. It could include language such as the following:

> Notwithstanding completed negotiations on every material or essential aspect of the agreement, and regardless of any informal public or private statements emanating from any representative of the buyer or seller, the parties hereby emphasize their intention that neither party will be legally bound to any contract for the purchase and sale of the stock or assets of the Acme Corporation, or be subject to any other liability whatsoever on any legal theory concerning such a purchase and sale, until a subsequent, final document evidencing the complete and exclusive contract of the parties is signed by the presidents of both the buyer and seller as well as the chair of the boards of the buyer and seller.

No one has ever heard a judge complain that a writing is too clear for him or her. Given the sometimes enormous risks posed by accidental contracting, and considering how frequently the issue arises, clients ought to be counseled to include such statements in their communications as a matter of course.

__Timothy Murray__, a partner in the Pittsburgh, PA law firm Murray, Hogue & Lannis, is coauthor of the **Corbin on Contracts Desk Edition** *(2017) and writes the biannual supplements to Corbin on Contracts.*

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

10. When the Winkelevoss brothers announced they planned to appeal to the Supreme Court, an authority even higher than the Ninth Circuit Court of Appeals—the Hollywood Reporter—succinctly called for an end to the haggling: *"Give it a rest, please."* Eriq Gardner, *The Winkevoss Twins Should End Their Hopeless Facebook Lawsuit*, Hollywood Reporter (May 17, 2011), http://www.hollywoodreporter.com/thr-esq/winklevoss-twins-should-end-hopeless-189033.

Joshua Davidson BAKER BOTTS L.L.P.

Top 10 Practice Tips: Master Limited Partnerships

If you are internal counsel to a publicly traded corporation that has decided to form a master limited partnership (MLP) and would like to become better educated about MLPs before starting the IPO process, below are 10 practice tips for you.

1 Obtain a basic understanding of the tax qualifying income rules.

MLPs have a special tax status. Unlike corporations, they are not taxed at the entity level and unitholders are taxed on their allocated share of income, not on their distributions. This is only the case, however, if the MLP satisfies certain complex qualifying income rules. Ninety percent of the MLP's income must be from certain activities related to natural resources or other qualifying sources. If the MLP fails that test in any one year, it will become taxable as a corporation. Although specialist tax counsel handles the qualifying income analysis, you should be aware of the following:

- Equity investors care very much about the qualifying status of MPLs and so outside counsel will be required to give what is known as a will opinion on qualifying income for each equity raise.
- In order to give this opinion, outside counsel will perform detailed diligence on the sources of income and require certifications from management.
- When the company makes an acquisition, it will need to carefully investigate the qualifying nature of the acquired company's income.
- How customer contracts are structured (e.g., lease vs. services agreement) or whether the MLP's customer is an end user of the product can affect whether the revenue from that contract is qualifying.

2 Read an MLP partnership agreement.

Unlike a corporation, a Delaware limited partnership is a creation of contract and a court will look to the words of the partnership agreement to determine the rights of the parties. MLP agreements generally contain very similar provisions. The key provisions deal with:

- The replacement of default fiduciary duties with contractual duties
- Methods of resolving conflicts of interest
- Cash distribution policy
- Governance
- Indemnification
- Unitholder voting rights
- Tax allocations
- Dissolution

The agreement runs close to 100 pages, which demonstrates how many aspects of the MLP are governed by contract.

3 Understand the fiduciary duty provisions of the partnership agreement.

When the general partner or its officers and directors are acting on behalf of the partnership, they must act in good faith, meaning that they must subjectively believe that their decision is in, or not opposed to, the best interest of the MLP (or in some cases, simply not adverse to the MLP). In any case, the actor is presumed to have acted with the requisite standard and a plaintiff will have the difficult burden of showing otherwise. When the general partner or the parent acts in its own capacity, it owes no fiduciary duty to the MLP.

4 Appreciate how MLP boards operate differently from corporate boards.

An MLP is governed by its general partner, which will be a subsidiary of the parent corporation. The board sits at the general partner level and therefore its directors (who manage the MLP) are appointed by the parent corporation (as the sole shareholder of the general partner) and are not elected by the public unitholders of the MLP. An MLP board is not required to have a majority of independent directors, and typically a majority of directors are officers of the parent. MLPs are also not required to have a governance or compensation committee but are required to have a standard audit committee of three independent directors.

5 Figure out the relationship between officers of the parent and the general partner.

The general partner will have officers, who are frequently also officers of the parent corporation. Key issues to consider are:

- Whether any officers of the general partner should not be officers or employees of the parent
- How to allocate a shared officer's or employee's time between the MLP and the parent
- How much authority to delegate to officers
- Whether to compensate the officers of the general partner with restricted or phantom units under the MLP's long-term incentive plan

6 Learn the dropdown process.

The MLP's principal source of acquisitions is likely to be the parent corporation. When an MLP buys assets from its parent in exchange for cash or units, it is called a dropdown. Because the parent controls the MLP and therefore sits on both sides of the transaction, a conflicts committee of at least two independent directors is usually empowered to evaluate and negotiate the dropdown with the parent. Approval by an appropriately constituted conflicts committee doing its job properly will cleanse any conflict of interest and place a high bar for a plaintiff seeking to challenge the dropdown. Key points to keep in mind:

- In addition to meeting Securities and Exchange Commission (SEC) or exchange independence requirements, conflicts committee members may not own an interest or may own only a minimal interest in the general partner or the parent.
- The committee will retain its own financial and legal advisors, who must be independent of the parent and the MLP, and will obtain a fairness opinion from its financial advisor.
- It is important that you not dictate advisors for the committee, though you can recommend lawyers and bankers experienced in the field and advise whether any are conflicted.
- The committee and its advisors will conduct a thorough examination of the acquired assets and should not be pressured to complete this work in a short time frame.
- The committee will operate autonomously without your participation once it has been charged.
- You should advise your management that the committee must retain the power to say no to the transaction and will likely try to negotiate a better deal for the MLP.

7 Understand the cash distribution policy.

One of the key selling points in the marketing of MLPs is that they generally distribute all of their available cash except for reserves necessary in the business. Acquisitions and capital projects are very often funded with external capital. The typical MLP has three types of limited partner interests at IPO, each with its own cash distribution priorities: common units, subordinated units, and incentive distribution rights. You should become familiar with concepts such as subordination period, high splits, distribution coverage ratio, operating surplus, and adjusted operating surplus.

Related Content

For information on the taxation of master limited partnerships, see

> TAXATION OF PUBLICLY TRADED PARTNERSHIPS

RESEARCH PATH: *Capital Markets & Corporate Governance > Beneficial Ownership: Reporting, Compliance and Tax Matters > Tax Consequences > Practice Notes*

For an overview on the disclosure requirements for master limited partnerships in the oil and gas industry, see

> OIL AND GAS INDUSTRY PRACTICE GUIDE

RESEARCH PATH: *Capital Markets & Corporate Governance > Industry Practice Guides > Oil & Gas > Practice Notes*

8 Appreciate different treatment under federal securities laws.

MLPs are subject to all federal securities laws, except that there are no annual proxy statements for the election of directors since the directors are appointed by the owner of the general partner. Proxy statements are required to the same extent as corporations for actions requiring unitholder votes, such as the approval of new stock incentive plans or material corporate transactions. Furthermore, limited partnerships are ineligible issuers for anything other than firm commitment underwritings, which means that an MLP that is a well-known seasoned issuer (WKSI) cannot use a WKSI shelf registration statement for at-the-market programs or resale shelves that contemplate a plan of distribution other than a firm commitment underwriting.

9 Be aware that other regulatory authorities treat MLPs differently.

Three principal differences to be aware of are:

- There are significant restrictions on the ability of limited partnerships to sell securities into European countries and Canada, which (along with adverse tax considerations) make marketing into those countries unusual.
- The Financial Industry Regulatory Authority (FINRA), which regulates the compensation of underwriters in securities offerings, regulates MLPs differently than it does corporations. FINRA considers MLPs to be direct participation programs. This is mostly of concern to underwriters' counsel, but your securities counsel should be aware of this different regulatory scheme as well.
- MLPs are not subject to New York Stock Exchange and NASDAQ Stock Market rules limiting the ability of a listed company to issue more than 20% of its outstanding publicly traded equity in a transaction not involving a public offering. This is of significant benefit to MLPs, which often do large private investments in public equity offerings.

10 Understand the ways in which MLP financial information can be presented differently.

MLPs follow generally accepted accounting principles (GAAP) and Regulation S-X (17 C.F.R. § 210.1-01 – § 210.12-29), but there are a few noteworthy differences. First of all, because dropdowns are transactions between entities under common control, MLPs will often be required to recast their quarterly and annual historical financial results to reflect the acquisition as if made at the beginning of the period. Secondly, MLPs very often use a non-GAAP measure called cash available for distribution. As MLPs are cash distribution vehicles, a great deal of attention is paid to this metric by investors. Getting the SEC comfortable with your non-GAAP presentations can require some work. Third, because MLPs are so acquisitive, and because they often acquire partial interests in entities, you will be required to become familiar with the nuances of acquisition and joint venture accounting (Regulations S-X 3-05 (17 C.F.R. § 210.3-05) and 3-09 (17 C.F.R. § 210.3-09)). L

***Joshua Davidson** is a partner in Baker Botts' Houston office and handles a wide range of corporate and securities work. He is nationally recognized for his experience in transactions involving MLPs, YieldCos, and royalty trusts. Mr. Davidson is head of the firm's Capital Markets and MLP/YieldCo Practice and has concentrated on MLPs for almost 25 years. He has participated in hundreds of equity and debt public offerings and private placements of MLPs and other alternative entities, including more than 60 initial public offerings. Mr. Davidson works with companies in the pipeline, midstream, oil and gas, renewable energy, shipping, refining, coal, propane, and heating oil industries.*

RESEARCH PATH: *Capital Markets & Corporate Governance > IPOs > Resource Kits*

S.H. Spencer Compton and Diane Schottenstein

The Impact of E-commerce on Retail Leases and Lease Exit Strategies

EVERY REAL ESTATE INDUSTRY HEADLINE TODAY SEEMS to trumpet the decline of retail leasing and the advent of e-commerce: the so-called "Amazon Effect."[1] One recent article recounts the impact of Amazon on traditional retailers such as Walmart and concludes that:

> It is apparent the Amazon Effect has left America with far more storefronts than needed. Stand-alone stores are being shuttered, with no alternative use for most buildings. Malls and shopping centers go begging as traffic drops, tenants leave, lease rates collapse and the facilities end up wholly or nearly empty. This may mean you don't want to invest in retail real estate REITs. But it also may mean that neighborhoods, and sometimes entire towns, will be impacted as these empty buildings reduce interest in housing and push down residential prices.[2]

Amazon has changed the way consumers shop. Shopping center owners have reacted by repositioning their properties in a variety of ways. Some traditional malls are being used as back offices[3] or medical facilities.[4] Other large mall operators have upgraded their properties to create experiential retail spaces with attractive entertainment options such as restaurants, meeting spaces, theaters, and skating rinks.[5] Some landlords are now more willing to have short-term tenants such as pop-up stores than they might have been in the past.[6]

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1. Matthew Flamm, *Amazon and High Rents Are Killing New York City Retailers*, Crain's New York Business, Jan. 23, 2017, http://www.crainsnewyork.com/article/20170123/RETAIL_APPAREL/170129978/amazon-and-high-rents-are-killing-new-york-city-retailers-like-laytners-linen-home-leaving-industry-watchers-to-wonder-when-the-carnage-will-end; Derek Thompson, *What in the World Is Causing the Retail Meltdown of 2017?*, The Atlantic, April 10, 2017, https://www.theatlantic.com/business/archive/2017/04/retail-meltdown-of-2017/522384/?utm_source=Sailthru&utm_medium=email&utm_campaign=Newsletter+Weekly+Roundup%3A+Retail+Dive+04-15-2017&utm_term=Retail+Dive+Weekender&utm_source=ActiveCampaign&utm_medium=email&utm_content=The+Amazon%2FMaersk+Connection&utm_campaign=May+2017+Monthly. 2. Adam Hartung, *How the 'Amazon Effect' Will Change Your Life and Investments*, Forbes, Feb. 28, 2017, http://www.forbes.com/sites/adamhartung/2017/02/28/how-the-amazon-effect-will-change-your-life-and-investments/. 3. Esther Fung, *Retailers' Call Centers Bring Life to Dead Mall Space*, Fox Business, April 25, 2017, http://www.foxbusiness.com/features/2017/04/25/retailers-call-centers-bring-life-to-dead-mall-space.html; Ashlee Kieler, *Deserted Malls Find New Use As Retail Call Centers*, Consumerist, April 25, 2017, https://consumerist.com/2017/04/25/deserted-malls-find-new-use-as-retail-call-centers/. 4. Esther Fung, *Mall Landlords Lure Medical Providers As Retailers Bolt*, The Wall Street Journal, March 28, 2017, https://www.wsj.com/articles/mall-landlords-lure-medical-providers-as-retailers-bolt-1490698804. 5. Sarah Halzack, *How Malls Are Reinventing Themselves for the E-Commerce Era*, The Washington Post, Dec. 19, 2014, https://www.washingtonpost.com/news/business/wp/2014/12/19/how-malls-are-reinventing-themselves-for-the-e-commerce-era/?utm_term=.3d41ea0e8ab5; Phil Wahba, *Simon Property Group Fights to Reinvent the Shopping Mall*, Fortune, Dec. 2, 2016, http://fortune.com/simon-mall-landlord-real-estate/; Roberto Fantoni, Fernanda Hoefel, and Marina Mazzarolo, *The Future of the Shopping Mall*, McKinsey & Company, November 2014, https://www.mckinsey.com/business-functions/marketing-and-sales/our-insights/the-future-of-the-shopping-mall; Neil Nisperos, *How Malls Are Reinventing Themselves: Not Just Shopping, But Places to Have Fun*, The Press Enterprise, April 9, 2017, http://www.pe.com/2017/04/02/how-malls-are-reinventing-themselves-not-just-shopping-but-places-to-have-fun/. 6. Esther Fung, *Mall Owners Warm Up to 'Pop-Up Stores'*, The Wall Street Journal,, Aug. 16, 2016, https://www.wsj.com/articles/mall-owners-warm-up-to-pop-up-stores-1471366058.

Ironically, Amazon has purchased the site of the former Randall Park Mall in Ohio (briefly the largest mall in the world when it opened in 1976) to use as a fulfillment center. On a cheerful note, Amazon intends to hire as many as 100,000 full-time and 30,000 part-time employees in the United States by mid-2018.[7]

Will e-commerce and changing consumer patterns result in a permanent negative impact on the retail market? Can failing retail centers be rehabilitated, or are there too many brick and mortar stores chasing too few live retail customers? Whatever the answers to these questions may be, economic downturns in the past have taught us that a tenant should consider a lease exit strategy when entering into a lease. Although most leases contain assignment and subletting provisions, if they are not carefully crafted they may not result in a satisfactory lease exit strategy. Provisions such as terminations rights, gross sale thresholds, and co-tenancy requirements should be considered and negotiated before the lease is executed.

Keep in mind that time-honored leverage factors (business track record, size of premises, balance sheet / desirability of tenant, desirability of premises, etc.) will always control all negotiations.

Termination Rights

Unless the tenant is a government agency, the landlord is unlikely to agree to a blanket termination right. After all, any bank evaluating a loan to that the landlord will assume the lease will be terminated and give it minimal value in assessing the property's income stream. However, a lease with a termination right narrowly tied to a particular event (such as the death of a key operator or the merger or acquisition of the business in a larger corporate transaction) will receive a higher valuation. This calculus is highly fact-specific and should be carefully considered.

The tenant might also request a termination right if the landlord becomes insolvent. Although a subordination, non-disturbance, and attornment agreement (SNDA) may give the tenant some comfort where the landlord is foreclosed upon, the SNDA will probably not require the bank to fulfill certain landlord obligations, including those relating to unpaid work allowances. The tenant may want the SNDA to provide it with a rent credit equal to any such unpaid allowance. A powerful tenant could require escrowed funds to cover the same.

Gross Sales Thresholds

Under certain circumstances, a landlord might agree to a termination right where a specified sales point is not achieved by a certain date. This makes sense both for a tenant concerned about the viability of a location and for a landlord who seeks to share in a tenant's sales through percentage rent. The landlord will require prior notice of a termination election and recoupment of costs such as improvement allowances and brokerage. No termination right would be available to a tenant who failed to operate at full capacity; otherwise an intentional slowing down or going dark could trigger a termination right.

Co-tenancy Requirements

A co-tenancy provision requires the landlord to have certain occupants open and operating at its mall as of the tenant's lease commencement date and throughout the term. For example, a high-end fashion retailer may require that its lease not commence until specified other high-end retailers are open and operating. Today it is customary for a space lease in a new mall to require that the anchor stores and a negotiated percentage of retail stores be open and operating as of the commencement date. Sometimes a lease will commence but only percentage rent will be payable, with base rent not due until the co-tenancy threshold has been met. The agreed rationale is that sufficient foot traffic (e.g., customers) at a mall is necessary to justify rent payments for a tenant.

Similarly, a co-tenancy requirement can apply throughout the life of a lease. A mall tenant pays rent based upon an agreed set of circumstances. If a key anchor tenant goes dark, there will be less foot traffic and the location will become less valuable. To protect itself, the landlord will often negotiate for time and flexibility in order to get a replacement anchor tenant (or percentage of other tenants, as the case may be) before a termination right is triggered. Since department stores are on the decline, a landlord may negotiate that an anchor department store can be replaced by two or more smaller stores or other draws to the mall such as a destination restaurant. When negotiating the lease provision relating to a hypothetical anchor replacement, the retail tenant must determine if the new tenant will generate the right kind of foot traffic for its business. The landlord, too, needs to be careful in the drafting or it may be left with no viable replacement. For example, if the lease provides that a departing Barnes & Noble must be replaced with an equivalent national bookseller, such a retailer will be difficult to find. Likewise, a replacement tenant provision that is too narrowly drawn can backfire on the landlord: where a provision requires a national food retailer, a strong regional food store such as B.J.'s Warehouse will not qualify as a replacement. To ease the landlord's anchor replacement process, a reduced rent period can be the tenant's remedy before its actual termination right is triggered. Some

7. Rich Bockmann, *Will Dead Malls Be the Next Logistics Hubs?*, The Real Deal, Aug. 8, 2017 https://therealdeal.com/2017/08/08/will-dead-malls-be-the-next-logistics-hubs/.

landlords will require a tenant to demonstrate economic harm before a co-tenancy termination right can be exercised.

Subletting and Assignment

Assignment and subletting rights can be reliable exit mechanisms, but the devil is in the details. In an economic downturn, it is likely that the tenant is competing to sublet with several other tenants and may not be able to obtain a suitable sublessee to pay all the rent. Generally, the landlord will not release the tenant from its lease obligations. Besides the actual assignment and subletting provision, the provisions relating to use, trade names signage, and alterations can also create hurdles to subletting or assigning.

In any event, the tenant will want as broad assignment and subletting rights as possible. If the lease imposes no restriction at all, then the tenant has an unlimited right to assign or sublet because the law generally does not favor restrictions on the alienability of real property. However, in New York, if the lease just requires the landlord's consent, the courts have ruled that the landlord may refuse consent arbitrarily and for any reason or no reason at all, and it may even extract a payment as a condition for the consent. There is no inferred landlord obligation to act reasonably unless the lease specifically so requires.[8]

The tenant will want the landlord to agree not to unreasonably withhold, delay, or condition consent to an assignment or sublet. As expected, there are hundreds of cases interpreting what constitutes reasonable behavior in different circumstances, so a trier of fact is the ultimate arbiter of what is reasonable. In American Book Co. v. Yeshiva University Development Foundation, 297 N.Y.S. 2d 156, 160 (Sup. Ct. 1969), the court set out four factors that are reasonable for a landlord to consider in determining whether to agree to an assignment or sublet: (1) financial qualification of the proposed subtenant, (2) the identity or business character of the subtenant (i.e., its suitability for the particular premises), (3) the proposed use, and (4) the nature of the occupancy. We shall consider each factor below.

Financial qualification is the most objective criteria. A landlord is entitled to satisfy itself that the proposed subtenant has the economic ability to fulfill its obligations to pay rent and to perform the lease obligations. This can require an evaluation of net worth and liquidity. Reviewing the subtenant's identity / business character, considering whether the proposed subtenant has relevant business experience or is a current

8. See Mann Theatres Corp. v. Mid-Island Shopping Plaza Co., 464 N.Y.S.2d 793 (App. Div.1983) aff'd, 468 N.E.2d 51 (N.Y. 1984).

tenant of the landlord, has been found to be reasonable. For use: is the proposed use prohibited by other tenants' exclusive rights? Will such use overburden the premises or parking?

What factors might a court deem unreasonable? Unreasonable grounds for denying consent include considerations of mere taste and personal idiosyncrasies of the landlord. In Am. Book Co. v. Yeshiva Univ. Dev. Found., Inc., 297 N.Y.S.2d 156 (Sup Ct. 1969), the court found that the landlord could not withhold consent based on a philosophical and ideological objection to the proposed tenant's business.

To avoid uncertainty as to what is a reasonable withholding of consent, some leases specify permissible factors that the landlord may consider in deciding whether or not to refuse consent to an assignment or sublet. These lists can be long and detailed. For example, a landlord may require a particular net worth threshold, restrict assignments to government offices such as the department of motor vehicles, or reject any proposed subtenant that had previously negotiated for space directly with the landlord in the last six months.

Additionally, a landlord usually requires that a tenant reimburse the landlord's expenses in connection with an assignment or sublet and pay any sublease profit to the landlord. In any such provision, the tenant should be sure that profit is defined as net profit so that brokerage, alterations, marketing, legal, free rent, and other expenses incurred in connection with the sublet are offset against the income. Further, the tenant's profit participation payments to the landlord should be due only to the extent the tenant actually receives them. If there are installment payments and the subtenant or assignee defaults, the tenant should be able to stop paying and perhaps be entitled to claw back any payments already made.

Process and timing of a consent request can be critical. The lease will often require a fully executed assignment or sublease to be submitted to the landlord for review. Try to have the lease provide that a signed term sheet will suffice to initiate the consent review period instead of waiting for a final fully executed sublease that ultimately may not be approved. Similarly, notwithstanding landlord pushback, try to have the lease provide a time certain by which the landlord must respond to an assignment or sublet consent request. Failure to so timely respond will be deemed consent granted. Remember, delay can foil a deal.

Even if there is a broad assignment or subletting right, a retail tenant can be thwarted by a narrowly drawn use clause that can block an otherwise satisfactory exit transaction. It is typical for a retail lease to specify a limited use for the property. However, if a tenant can only sublet to a store with the same use, and all stores with that use are under economic pressure, the tenant could be effectively left with no exit. Tenants should try to negotiate a broader use provision in the event of an assignment or sublet even though the landlord may resist, claiming that it knows best what retailers should be in its mall.

A lease provision requiring the tenant to operate its business under a specified trade name only can also hinder assignment or subletting. Such a requirement may block a satisfactory exit plan unless the tenant sells its business to an entity who will continue to operate it under the same trade name.

Keep in mind that landlords typically reserve certain rights relating to exterior and interior signage and alterations. Similarly, some leases provide that renewal rights and expansion options do not accrue to a sublessee or assignee. Such restrictions might make the tenant's space less palatable to a replacement tenant.

Other Solutions

If a tenant is not strapped for cash but is unhappy with a particular location, it could offer to buy out its lease. The buyout price would be determined by negotiation and would turn on several factors, including the landlord's ability to find another tenant, the remaining term of the lease, and the landlord's unamortized construction and brokerage costs.

Sometimes a struggling tenant will ask for a temporary rent reduction or decrease in percentage rent. The landlord might consider such a request given the totality of the circumstances but might couple it with a termination option if the landlord finds another tenant. The landlord would likely not allow the tenant to sublet at the reduced rent without the profit going to the landlord notwithstanding any rent concession.

A tenant should review the lease and current circumstances for a landlord default that could allow the tenant to terminate the lease. For example, if the landlord is not providing all services required under the lease, the tenant might have the right to terminate the lease. Note that it is just as likely that an attempt to terminate the lease for a landlord default will end up in litigation, absent a clear right or egregious lease violation.

The Lender's Role

A behind-the-scenes party in a lease exit negotiation can be the landlord's lender. Applicable loan documents may require that certain debt service covenants be met. Similarly, there may be certain reserve requirements in connection with brokerage commissions and tenant improvements that can hinder the landlord's flexibility. Likewise, a lender may have approval rights over any lease modification. The tenant should evaluate the lender's role before embarking on any lease exit strategies.

Conclusion

Although the Amazon Effect has changed the course of retail leasing, other events over the years have disrupted retail markets: economic downturns, fads, and even inventory shortages. Both retail tenants and landlords need to be optimistic and nimble to succeed in their businesses. In the past, many lease terminations occurred because shoppers did not want to buy what the retail tenant was selling. Today, many lease terminations occur because shoppers don't need to leave their homes to buy almost anything. Given the magnitude of both a landlord's and a tenant's investment in a retail store at a time of such uncertainty, both sides should be creative and accommodating when faced with failing results. Pre-negotiated, creative, and even-handed lease termination provisions can save both sides a lot of pain and expense. L

***S. H. Spencer Compton** has been a vice president and special counsel at the New York office of First American Title Insurance Company since 2001. Prior to that, he was a real estate attorney in New York City, with an emphasis on commercial leasing and real estate financing transactions. **Diane Schottenstein** is a real estate attorney practicing in Manhattan for over twenty years. She has experience in office and retail leasing, financing, and the acquisition and sale of residential and commercial real estate.*

RESEARCH PATH: *Real Estate > Commercial Leasing > Lease Agreement > Articles*

ALTHOUGH THE AMAZON EFFECT HAS CHANGED THE COURSE OF RETAIL LEASING, OTHER EVENTS OVER THE YEARS HAVE DISRUPTED RETAIL MARKETS: ECONOMIC DOWNTURNS, FADS, AND EVEN INVENTORY SHORTAGES.

Related Content

For a discussion on the attorney's role in identifying retail leasing concerns from both the landlord and the tenant perspective, see

> ATTORNEY'S ROLE IN THE RETAIL LEASING PROCESS

RESEARCH PATH: *Real Estate > Commercial Leasing > Lease Agreement > Practice Notes*

For a list of key retail lease provisions and practical tips for drafting and negotiating a retail lease, see

> DRAFTING, REVIEWING, AND NEGOTIATING A RETAIL LEASE AGREEMENT

RESEARCH PATH: *Real Estate > Commercial Leasing > Lease Agreement > Practice Notes*

For a sample lease agreement for a retrial space, see

> RETAIL LEASE AGREEMENT

RESEARCH PATH: *Real Estate > Commercial Leasing > Lease Agreement > Forms*

For an overview on the key components of a sublease agreement and what each of the parties to the sublease agreement must be aware of during the drafting and negotiation process, see

> KEY ISSUES IN DRAFTING AND NEGOTIATING SUBLEASE AGREEMENTS

RESEARCH PATH: *Real Estate > Commercial Leasing > Assignment and Subleasing > Practice Notes*

For a proposed sublease agreement that includes practical guidance and drafting notes, see

> SUBLEASE AGREEMENT

RESEARCH PATH: *Real Estate > Commercial Leasing > Assignment and Subleasing > Forms*

For information on the issues for a tenant and a landlord to consider when agreeing to an early lease termination and drafting the associated surrender agreement, see

> TERMINATING THE LEASE BY SURRENDER AGREEMENT

RESEARCH PATH: *Real Estate > Commercial Leasing > Surrender of Lease > Practice Notes*

Elizabeth Espín Stern and Maximillian Del Rey
MAYER BROWN LLP

The Changing Immigration Laws under the Trump Administration: **A New Era for U.S. Immigration**

Introduction

By all accounts, immigration was among the most debated issues of the 2016 presidential election. According to the Pew Research Center, 70% of registered voters listed immigration as "very important" to their vote in 2016. From the inception of his presidency, Donald Trump has made clear that the issue remains at the core of the administration's America First policy. As the president said in his inaugural speech:

> From this moment on, it's going to be America First. Every decision on trade, on taxes, on immigration, on foreign affairs, will be made to benefit American workers and American families. We must protect our borders from the ravages of other countries making our products, stealing our companies, and destroying our jobs. Protection will lead to great prosperity and strength. (Donald J. Trump, Inaugural Address (Jan. 20, 2017)).

This article describes the primary immigration actions of the administration that impact employers in the United States. This article will examine (1) President Trump's multiple travel bans, (2) H-1B and L-1 visa reform, (3) the Reforming American Immigration for a Strong Economy Act (RAISE Act), (4) extreme vetting and enhanced scrutiny of travelers, (5) Deferred Action for Childhood Arrivals (DACA) developments, and (6) the president's continuing immigration priorities.

Travel Bans

During the 2016 presidential campaign, then-presidential candidate Trump called for a "total and complete shutdown of Muslims entering the United States"[1] until U.S. authorities "can figure out what's going on." Following President Trump's inauguration on January 20, 2017, the administration moved quickly to enact travel restrictions and other policies in line with his campaign promises.

Travel Ban 1.0 (E.O. 13769)

On January, 27, 2017, President Trump issued an executive order titled "Protecting the Nation from Foreign Terrorist Entry into the United States." 5 Exec. Order No. 13,769, 82 Fed. Reg. 8977 (Jan. 27, 2017) (EO-1). EO-1 included, among other things, a 90-day travel restriction on foreign nationals from seven countries (Iran, Iraq, Libya, Somalia, Sudan, Syria, and Yemen), a 120-day restriction on refugee admissions, an indefinite restriction on Syrian refugee admissions.

The U.S. Department of Homeland Security (DHS) immediately took enforcement steps, including detention of individuals from the affected countries upon their arrival in the United States at multiple airports across the nation and refusal of admission to approved refugees, non-immigrant (temporary) visa holders, and immigrant visa (green card) holders who were U.S. permanent residents. In many cases, officials removed these individuals to their countries of origin. While the executive order did not expressly define what it meant to be "from" one of these affected countries, DHS has said that this means nationals and citizens of the affected countries. See FAQ on Protecting the Nation from Terrorist Foreign Entry into the United States (July 21, 2017).[2]

On the same day, the U.S. Department of State issued an "Urgent Notice," advising that visa issuance for affected individuals had been suspended, effective immediately until further notification, and instructing those scheduled for visa interviews to not attend their visa appointments.

Challenging EO-1

In response to these government actions, multiple court actions were filed on January 28, 2017, through February 3, 2017, challenging the legality of the order and requesting emergency stays of the travel restrictions. These actions resulted in some temporary restraining orders prohibiting the detention and removal of foreign travelers with valid and non-immigrant visas. The administration clarified during this period that neither lawful permanent residents nor holders of third-country passports were covered by the executive order's 90-day travel restriction.

While the travel ban remained the subject of litigation, President Trump issued a second executive order to replace EO-1.

Travel Ban 2.0 (E.O. 13780)

President Trump signed a new executive order on March 6, 2017, restricting travel to the United States by certain individuals from six countries—Iran, Libya, Somalia, Sudan, Syria, and Yemen—for 90 days and placed a moratorium on worldwide refugee admissions for 120 days. 6 Exec. Order No. 13,780, 82 Fed. Reg. 13209 (Mar. 6, 2017) (EO-2). EO-2, titled "Protecting the Nation from Foreign Terrorist Entry into the United States," replaced and revoked EO-1, which was signed on January 27, 2017.

In contrast to the prior executive order, EO-2 included the following specific provisions relevant to the travel ban. Iraq was omitted from the six countries whose nationals would be subject to the 90-day travel ban. The 90-day ban was slated to take effect from March 16 through June 14, 2017. The travel ban expressly did not apply to U.S. citizens, lawful permanent residents, dual nationals, asylees, refugees previously admitted, government officials, and individuals with valid travel documents. The new order stated that the travel ban would apply to individuals from the six designated countries only if they (1) were outside the United States on March 16, 2017, (2) did not have a valid visa when EO-1 took effect, and (3) did not have a valid visa on March 16, 2017.

Additionally, officers could decide on a case-by-case basis to authorize issuance of a visa or permit entry of an individual to the United States who would be otherwise barred by the new executive order.

Challenging EO-2

Attorneys general for the states of Hawaii, New York, and Washington immediately announced challenges to President Trump's EO-2. The U.S. District Court for the District of Hawaii issued a nationwide order on March 15, 2017, blocking implementation of EO-2, which was scheduled to commence March 16. Among other injuries alleged by the plaintiffs, the court noted that the plaintiffs were "likely to succeed" on their allegation that the EO-2 violated the Establishment Clause of the First Amendment. Hawai'i v. Trump, 241 F. Supp. 3d 1119, 1140 (D. Haw. 2017). The U.S. District Court for the District of Maryland issued a similar decision, partially blocking implementation of EO-2 by enjoining, nationwide, Section 2(c) of EO-2. Section 2(c) would temporarily suspend for 90 days entry into the United States of certain nationals of the aforementioned six countries. Int'l Refugee Assistance Project v. Trump, 241 F. Supp. 3d 539, 560 (D. Md. 2017).

On May 25, 2017, a divided U.S. Court of Appeals for the Fourth Circuit, sitting en banc, substantially upheld the nationwide preliminary injunction against Section 2(c) of EO-2 issued by the District Court of Maryland. Int'l Refugee Assistance Project v. Trump, 857 F.3d 554 (4th Cir. 2017). On June 26, 2017, the U.S. Supreme Court announced that it would hear the

1. https://www.washingtonpost.com/news/post-politics/wp/2015/12/07/donald-trump-calls-for-total-and-complete-shutdown-of-muslims-entering-the-united-states/?utm_term=.5860d7783a80

2. https://www.dhs.gov/news/2017/06/29/frequently-asked-questions-protecting-nation-foreign-terrorist-entry-united-states.

U.S. government's appeal from lower court orders enjoining EO-2. The Court granted the government's application to stay the injunctions "with respect to foreign nationals who lack any bona fide relationship with a person or entity in the United States," thus allowing the travel ban to proceed with respect to such individuals. However, the Court left in place the injunction barring implementation of EO-2 as it related to individuals who have a "bona fide relationship" with any individual or entity in the United States; as a result, EO-2 remained inoperative for the significant majority of affected individuals. The Supreme Court declined to define a "bona fide" relationship, leaving it subject to interpretation. Trump v. Int'l Refugee Assistance Project, 137 S. Ct. 2080 (2017).

On October 10, 2017, the Supreme Court dismissed as moot an appeal to hear EO-1, as the relevant provisions of EO-1 had expired. Trump v. Int'l Refugee Assistance Project, 2017 U.S. LEXIS 6265 (Oct. 10, 2017). On October 24, 2017, challenges to EO-2 were also dismissed because the March order had expired. Trump v. Hawai'i, 2017 U.S. LEXIS 6367 (Oct. 24, 2017).

Travel Ban 3.0

On September 24, 2017, President Trump issued a "Presidential Proclamation Enhancing Vetting Capabilities and Processes for Detecting Attempted Entry Into the United States by Terrorists or Other Public-Safety Threats" (EO-3). The proclamation imposed nationality-based travel restrictions as a result of the worldwide review conducted by the Secretary of Homeland Security, in consultation with the Secretary of State and the Director of National Security, pursuant to Section 2(b) of EO-2. The new country-specific restrictions would affect travel to the United States by nationals of Chad, Iran, Libya, North Korea, Somalia, Syria, Venezuela, and Yemen. Sudan, which had been included in EO-1 and EO-2, was removed from the list of restricted countries. The restrictions and limitations contained in the proclamation were slated to take effect on October 18, 2017.

Unlike EO-1 and EO-2, the presidential proclamation incorporated an approach that, as noted in EO-3, was designed to be "tailored, as appropriate, given the unique conditions in and deficiencies of each country, as well as other country-specific considerations." The below chart summarizes these restrictions:

COUNTRY NATIONALS	RESTRICTION
CHAD	Entry into the United States as immigrants and as business visitors (B-1) or tourists (B-2) is suspended indefinitely.
IRAN	Entry into the United States as immigrants and as non-immigrants is suspended indefinitely, except for students (F and M) and exchange visitors (J). Students and exchange visitors will be subject to enhanced screening and vetting requirements.
LIBYA	Entry into the United States as immigrants and as business visitors (B-1) or tourists (B-2) is suspended indefinitely.
NORTH KOREA	Entry into the United States as immigrants and as non-immigrants is suspended indefinitely.
SOMALIA	Entry into the United States as immigrants is suspended indefinitely. Non-immigrants will be subject to enhanced screening and vetting requirements.
SYRIA	Entry into the United States as immigrants and as non-immigrants is suspended indefinitely.
VENEZUELA	Entry into the United States of certain Venezuelan government officials and their immediate family members as business visitors (B-1) or tourists (B-2) is suspended indefinitely.
YEMEN	Entry into the United States as immigrants and as business visitors (B-1) or tourists (B-2) is suspended indefinitely.

On October 17, 2017, U.S. district courts in Hawaii and Maryland enjoined EO-3 from taking effect on the following day. While the Supreme Court has dismissed both appeals from EO-1 and EO-2 because of mootness concerns, we do not know whether EO-3 will ultimately lead to a Supreme Court appeal.

Guidance for Employers

Although the latest travel ban has been enjoined, travelers can expect more scrutiny of their visa applications and more intense port of entry questioning. Accordingly, employers should:

- Provide clear and direct communications to their work corps, referring them to reliable sources for the specific parameters of the current vetting procedures.
- Make an employer hotline, such as an e-hotline, available for any urgent questions and ensure that travel reimbursement and authorization sources are linked into the hotline.
- Provide guidance to employees on port admission and customs clearance processes, including ensuring that they carry full paperwork on their visa status or, if they are business travelers, the propriety of their activity (e.g., a conference itinerary) and indication of its short-term duration (a round-trip ticket and employment/payroll obligations in the home country).
- Advise employees that because devices such as mobile phones, laptop computers, and tablets can be checked for social media activity and other data, archiving confidential data in advance of travel is wise
- Ensure that their leadership in human Resources (HR), global mobility, legal, and security stay informed on further restrictions and port practice developments.

H-1B and L-1 Visa Reform

During the 2016 presidential election, President Trump had also repeatedly campaigned for H-1B and other visa reforms. The administration has announced and carried out changes to two primary categories to date, the H-1B and L-1 visa programs.

- The H-1B visa program allows U.S. employers to sponsor foreign workers in specialty occupations requiring attainment of a bachelor's degree in the specific specialty or an equivalent combination of education, experience, and training. The H-1B program is limited to 65,000 new H-1B visas per year, with an additional allotment of 20,000 for individuals who have earned a U.S. advanced degree (master's or higher). New H-1B visa petitions are generally accepted six months in advance of the federal fiscal year—on about April 1 of each year.
- The L-1 visa program allows multinational employers to transfer executives and managers, L-1A, or individuals with specialized or advanced knowledge of the enterprise, L-1B, to related U.S. offices to contribute the fruits of their experience with the global enterprise. Qualifying employees must have at least one year of experience working for the global enterprise outside of the United States, with the one year of experience having been fulfilled during the three years preceding the requested L-1 period of admission. The foreign arm of the company at which they worked may be either a parent, subsidiary, affiliate, or branch, or in the case of a 50-50 joint venture, the transfer may occur between the joint venture and either partner.

January 23, 2017, Leaked Draft Executive Order (H-1B)

On January 23, 2017, a leaked draft of an executive order outlined sweeping reform for H-1B visas, including a merit-based process for selection of H-1B workers. As a result of the leak, many employers—including large IT and sourcing companies—became more selective in cases they agreed to file during the H-1B lottery. The administration never issued this order, however, and the FY 2018 H-1B lottery was administered precisely as in other years, according to a random selection of petitions filed within the first five working days of April 2017.

Pre-lottery Suspension of Premium Processing

On March 3, 2017, U.S. Citizenship and Immigration Services (USCIS), which reviews and adjudicates Form I-129 petitions, suspended premium processing for all H-1B petitions starting April 3, 2017. Employers rushed to file extensions by April 3 to avoid gaps in travel authorization or driver's licenses (as many states require proof of U.S. work authorization to issue license renewals) and stem anxiety of employees. On July 24, 2017, the agency lifted the suspension for certain H-1B cap-exempt petitions and on September 18, 2017, reinstated premium processing for H-1B visa petitions subject to the cap. USCIS resumed premium processing on October 3, 2017, for all H-1B "specialty occupation petitions, including initial filings, H-1B amendment, change-of-employer, and extension petitions."

THE EMPHASIS ON POTENTIAL WAGE DISPARITIES, MISREPRESENTED JOB DUTIES OR LOCATIONS, AND EXPERIENCE SHORTFALLS SIGNIFY A NOTABLE DEPARTURE FROM THE MORE STRAIGHTFORWARD AUDITS USCIS CONDUCTED IN THE PAST.

Changing Standard for H-1B Qualification for Entry-Level Positions

Further contributing to the confusion, in "Rescission of the December 22, 2000 'Guidance memo on H1B computer related positions,'" PM-602-0142, Mar. 31, 2017, (Policy Memorandum)—issued on the eve of the annual H-1B visa filing period, USCIS reversed a previously issued policy memorandum classifying all computer programming positions as specialty positions. The Policy Memorandum placed the burden on employers to prove that positions qualify for H-1B specialty occupation classification. The agency based its policy reversal largely on the fact that entry-level programmer positions do not consistently require attainment of a bachelor's degree or equivalent, which is a prerequisite for H-1B classification as a "specialty occupation."

While the policy expressly dealt with entry-level computer programmers, USCIS emphasized three points that heralded broader application of a more demanding standard for any occupation: (1) if a bachelor's degree in a precisely relevant specialty field is not the standard minimum for entry into the occupation, USCIS will not consider the occupation generally to meet the H-1B standards; (2) when an occupation does not generally qualify for H-1B classification, the employer must provide evidence to distinguish how its particular position meets the criteria for classification as a specialty occupation; and (3) if the wage level designation for the position is entry level, USCIS may consider this factor to signal that the position does not qualify as an H-1B specialty occupation. See USCIS, PM-602-0142 (Mar. 31, 2017).

USCIS Launches "American Workers First" Anti-Fraud Measures on the Day That the FY 2018 H-1B Filing Period Opens

USCIS announced five indicators of fraud and abuse, each of which supports its stated mandate to protect U.S. workers by preventing all employers from abusing the H-1B program by "decreasing wages and job opportunities [for Americans] as they import more foreign workers."[3] The indicators cited by USCIS include (1) the H-1B worker will not be paid the wage certified in the Labor Condition Application (LCA); (2) there is a wage disparity between the H-1B worker and other workers performing the same or similar duties, (3) the H-1B worker is not performing the duties specified in the H-1B petition, (4) the H-1B worker has less experience than U.S. workers in similar positions in the same company, and (5) the H-1B worker is not working in the intended location as certified on the LCA. The emphasis on potential wage disparities, misrepresented job duties or locations, and experience shortfalls signify a notable departure from the more straightforward audits USCIS conducted in the past.

Buy American and Hire American Executive Order

Following a series of reforms to the H-1B process, on April 18, 2017, President Trump signed the "Buy American and Hire American" Executive Order 13788 (E.O. 13788). E.O. 13788 addressed two aspects of the administration's policy: protection of U.S. jobs and preference for U.S.-manufactured products or goods.

> In order to create higher wages and employment rates for workers in the United States, and to protect their economic interests, it shall be the policy of the executive branch to rigorously enforce and administer the laws governing entry into the United States of workers from abroad, including section 212(a)(5) of the Immigration and Nationality Act (8 U.S.C. 1182(a)(5)).

E.O. 13788.

Hire American

With regard to U.S. jobs, E.O. 13788 directs the U.S. Departments of Labor, Justice, Homeland Security, and State to review employment-based foreign worker programs to "[e]nsure the integrity of the Immigration System in Order to 'Hire American'" and ensure that U.S. workers are provided with adequate protections from lower-cost foreign labor. E.O. 13788 calls for increased scrutiny and reform of existing non-immigrant worker programs, particularly the H-1B program.

E.O. 13788 directs the interagency group to do the following: (1) propose new rules and guidance as soon as practicable, and (2) review and reform the H-1B visa program to ensure that "H-1B visas are awarded to the most-skilled or highest-paid petition beneficiaries." The reforms herald adoption of merit-based allocation of annual visas to heighten wage and skills levels of H-1B workers.

3. See USCIS, *Combating Fraud and Abuse in the H-1B Program* (Apr. 3, 2017), https://www.uscis.gov/working-united-states/temporary-workers/h-1b-specialty-occupations-and-fashion-models/combating-fraud-and-abuse-h-1b-visa-program.

H-1B Impact to Date

The H-1B pool of filings decreased by 15% from the past two years, which seems to show that employers were more selective in their submission of petitions during the cap season. The government, in turn, has increased scrutiny over H-1B adjudications. Reports indicate a 45% increase in H-1B Requests for Evidence (RFEs) as compared to 2016. In particular, USCIS introduced aggressive H-1B RFEs questioning the sufficiency of H-1B petitions submitted with Level 1 wages and increased H-1B RFEs questioning relevancy of the degree to the specialty occupation (e.g., engineering or business for IT).

New USCIS Director's First Policy Memorandum Reverses Longstanding Policy to Defer to Previously Approved H-1B and L-1 Petitions

On October 23, 2017, USCIS released its first policy memorandum[4] under newly appointed Director L. Francis Cissna, by which USCIS eliminated a longstanding policy of deference in non-immigrant extension petitions. In 2004 and 2015 memoranda, USCIS had instructed reviewing officers to give deference to the findings of a previously approved petition as long as the key elements were unchanged and there was no evidence of a material error or fraud related to the prior determination. The updated policy guidance rescinds the previous policy.

In the announcement of the revised policy, the USCIS director noted that "USCIS officers are at the front lines of the administration's efforts to enhance the integrity of the immigration system. This updated guidance provides clear direction to help advance policies that protect the interests of U.S. workers."

Findings of DHS Report in USCIS Site Visits

On October 20, 2017, the DHS Office of Inspector General (OIG) submitted a report[5] summarizing its audit of USCIS's Administrative Site Visit and Verification Program (ASVVP), concluding that "USCIS site visits provide minimal assurance that H-1B visa participants are compliant and not engaged in fraudulent activity."

The report concluded that USCIS's ASVVP program had multiple shortfalls related to the limited number of site visits conducted, a lack of training, and a failure by inspectors to take proper action in instances where non-compliance is detected. The report further outlined a lack of agency tracking of visits, associated costs, and outcomes.

Among the DHS OIG recommendations, which USCIS "concurred with . . . and has begun corrective actions to address," are that USCIS should:

- Enhance tracking of H-1B site visit activity, including tracking of targeted site visits and program costs, as well as analysis of adjudicative actions resulting from the site visits. The report said that USCIS should then leverage this data to develop performance measures to assess the effectiveness of ASVVP and assist with oversight improvements.
- Further identify data and assessments obtained through ASVVP post-adjudication and implement measures to systematically share this information with external stakeholders.
- Assess ASVVP to determine the best allocation of resources, including adjustments to the number of site visits per year, random sampling procedures, and the time and effort spent on each site visit. To ensure consistent approaches and documentation for site visits, the report recommended that the assessment also should identify policies, procedures, and training requiring an update. The report further recommended developing a career path for site visit officers who wish to remain in investigatory positions.
- Develop comprehensive policies across USCIS to ensure adjudicative action is prioritized on fraudulent or noncompliant immigration benefits identified by the H-1B ASVVP and targeted site visits.

Site visits will be prioritized, with a more results-oriented and data-driven approach in the ASVVP program.

4. https://www.uscis.gov/sites/default/files/USCIS/Laws/Memoranda/2017/2017-10-23Rescission-of-Deference-PM6020151.pdf 5. https://www.oig.dhs.gov/sites/default/files/assets/2017/OIG-18-03-Oct17.pdf

Guidance for Employers in View of These Developments

With the addition of a seasoned agency veteran, USCIS is poised to take multifaceted action to enforce its goals—eradication of fraud and abuse in the H-1B visa program. In light of this, employers should review each aspect of their visa programs: candidate selection, execution of visa filings, maintenance of compliance records, and monitoring of ongoing compliance. Key actions for employers to take include the following:

- Undertake a close review of how candidates are selected and the standards that the company requires to qualify for a visa. In the H-1B area, USCIS will consider low-wage or entry-level skill positions to be an indicator that the employer is abusing the system.
- Ensure that legal, HR, and global mobility all have a line of sight into the use of visas, and create escalation protocols that allow legal to monitor compliance.
- Consider adopting an integrity policy to demonstrate the company's commitment to appropriate use of the visa categories.
- If the company is placing its visa holders at customer sites, ensure that the direct management, supervision, and control of the workers is exclusively the domain of the company, not the customer. An audit trail that confirms this point is essential, and affirmation of that personnel authority and supervision should be maintained in the filing.
- When a material change occurs, include any site change outside of normal commuting distance in the H-1B arena, adhering to the amendment requirements in the regulations for each category. When in doubt, employers should consult with the company's experts on global mobility and outside counsel.
- When relying on third-party staffing of functions such as IT, use suppliers that are reliable and willing to certify their compliance with immigration and employment regulations. Employers should ensure that service agreements include the supplier's affirmation that it will only use subcontractors that are approved by the company and that supply similar certifications.

The RAISE Act and Its Effect on Employers

On August 2, 2017, President Trump announced his strong endorsement of the RAISE Act, 115 S. 1720, a bill introduced by Senators Tom Cotton (R-AR) and David Perdue (R-GA) that would slash annual overall immigration by half over 10 years. The RAISE Act seeks to implement extensive reform to the U.S. immigrant visa system, including replacing the current classification-based system with a merit-based points system.

Specifically, the RAISE Act would:

- Replace the employment-based immigrant visa system of the past 27 years with a merit-based selection process under which prospective immigrants would earn points based on education, English-language ability, high-paying job offers, age, extraordinary achievement, and high-value investment.
- Retain immigration preferences for the spouses and minor children of U.S. citizens and legal permanent residents while eliminating preferences for certain categories of extended and adult family members.
- Eliminate the Diversity Visa lottery program, which currently provides 50,000 green cards annually to citizens of countries historically underrepresented in the annual flow of immigrants to the United States.
- Place an annual limit of 50,000 on the number of refugees eligible to become permanent residents.

Due to the inherent unpredictability of selection, employers that wait to sponsor employees for permanent residency could lose valuable talent. The RAISE Act's points-based system would set a 30-point minimum threshold for qualification for an immigrant visa, and USCIS would offer immigrant visas twice yearly to the highest-scoring applicants. While specific details regarding visa application procedures remain unsettled, the legislation states that applicants not selected after 12 months would be required to reapply.

Potential Changes to the Annual H-1B Process

The RAISE Act provides an illuminating preview of how the Trump administration is likely to change the annual H-1B selection process. The Trump administration has emphasized a points-based system as a method of ensuring that the United States welcomes only the "best and brightest" foreign workers, and the RAISE Act's immigrant visa system accordingly could be adapted by the administration in furtherance of H-1B specialty occupation visa reform. In that instance, points-based selection would replace the current annual H-1B visa lottery, during which H-1B petitions are selected at random for processing. The RAISE Act echoes the "Buy American and Hire American" executive order, by which the president gave direction to his cabinet to "suggest reforms to help ensure that H-1B visas are awarded to the most-skilled or highest-paid petition beneficiaries."

Looking Ahead

Should the RAISE Act or a similar measure gain traction in Congress, employers may wish to consider sponsoring employees for immigrant visas before change takes effect. Early sponsorship would ensure that the applicants have the best possible opportunities for selection for an immigrant visa in the event of oversubscription, which is highly likely. In addition, however, it will be important for employers to evaluate the impact of a points-based system on their recruitment and retention objectives and make their voice heard in the legislative debate.

Extreme Vetting and Enhanced Scrutiny of Travelers

In the first year of his term, President Trump and his administration took a number of steps to further his campaign promise to tighten U.S. border security. These efforts have included the travel bans discussed above, as well as extreme vetting measures designed to heighten scrutiny of U.S. visa applicants and inbound travelers.

Beginning February 2017, DHS, and in particular, Customs and Border Protection (CBP), began actively enforcing search policies that extend to "virtual briefcases"—including, but not limited to, electronic data contained on personal devices such as mobile phones, laptop computers, and tablets. The nature of these searches, including the fact that they are normally conducted without a search warrant or any other indication of suspicion, has raised concerns by members of Congress[6] and garnered media attention for their intrusiveness to travelers seeking to enter the United States. In the past, these types of searches, however, have been deemed generally permissible by the U.S. Supreme Court and were examined in detail in a 2009 Privacy Impact Assessment (PIA) prepared by DHS.[7]

The PIA states that border officers may conduct searches of electronic devices as part of agency goals to interdict and investigate violations of federal law as well as to prevent the admission of contraband or inadmissible persons into the United States. During the inspection process, travelers are subject to an examination to determine their admissibility into the United States and an examination of their belongings for evidence of contraband or criminal activity, without a warrant and without suspicion.

On March, 20, 2017, DHS announced that a new ban on certain types of electronics on international inbound flights to the United States would go into effect on March 21, 2017. The restrictions targeted flights leaving from majority-Muslim countries. Restricted items include electronics that are bigger than standard mobile telephones, including laptop computers, tablets, cameras, travel printers, and gaming devices. These restrictions were lifted by July 19, 2017, but the agency continues to exercise its practice of searching electronic devices under the PIA analysis.

DACA Developments

On September 5, 2017, the Trump administration announced the end of DACA. The DACA program has provided work and temporary residency authorization for nearly 800,000 beneficiaries who were brought with their families to the United States as children and meet several guidelines. DACA has allowed these young people—known as the Dreamers—to work and study in the United States free from the threat of deportation. It has been reported that over 97% of the beneficiaries are in the U.S. workforce or in school.

Related Content

For more information on the Deferred Action for Childhood Arrivals program, see

> **DEFERRED ACTION FOR CHILDHOOD ARRIVALS (DACA): THE RESCISSION OF DACA AND THE IMPACT ON EMPLOYERS**

RESEARCH PATH: *Labor & Employment > Business Immigration > Employment Eligibility Verification > Practice Notes*

For guidance on issues that immigration counsel must thoroughly review and examine before mergers or acquisitions occur, see

> **IMMIGRATION LAW CONSIDERATIONS IN BUSINESS TRANSACTIONS**

RESEARCH PATH: *Labor & Employment > Business Immigration > Employment Eligibility Verification > Practice Notes*

For a discussion on the key topics and best practices for an employer to consider when developing an immigration sponsorship policy, see

> **BUSINESS IMMIGRATION SPONSORSHIP: KEY CONSIDERATIONS**

RESEARCH PATH: *Labor & Employment > Business Immigration > Visas > Practice Notes*

For an overview of the main issues relating to H-1B Visas, see

> **H-1B VISAS: SPECIALTY OCCUPATION NONIMMIGRANT VISAS**

RESEARCH PATH: *Labor & Employment > Business Immigration > Visas > Practice Notes*

6. https://www.law360.com/immigration/articles/894172/senator-questions-border-electronics-searches?nl_pk=41764bf1-52dd-4391-970f-9928fc17040e&utm_source=newsletter&utm_medium=email&utm_campaign=immigration. 7. https://www.dhs.gov/sites/default/files/publications/privacy_pia_cbp_laptop.pdf.

According to the announcement, DACA would remain in place for nearly six months, until March 5, 2018. DHS would process initial requests for DACA and work authorization received on or before September 5, 2017, but would not accept new initial requests for DACA benefits after September 5, 2017. DHS would process applications for extension of DACA benefits from current beneficiaries whose benefits will expire on or before March 5, 2018, that had been accepted by DHS as of October 5, 2017. Thus, a current beneficiary whose DACA benefits will expire March 6, 2018, or later is ineligible to file for an extension.

DACA recipients with current work authorization will remain authorized to work until the expiration date on the employment authorization document (EAD) unless their status is revoked. Lastly, DHS will not approve any new applications for advance parole, although it will generally honor the validity period for previously approved applications for advance parole. Pending applications for advance parole will be administratively closed, and the fees will be refunded.

The six-month extension of the program is designed to give Congress an opportunity to pass legislation to protect DACA beneficiaries, putting the issue of protecting individuals brought to the United States as children back in the hands of Congress. Senator Susan Collins (R-ME) said she believes there is "widespread bipartisan support for legislation that would provide some measure of protection to children who are brought to this country through no decision of their own." If Congress is unable to pass a bill, President Trump has promised to "revisit this issue."

How Employers Should Respond

- Do not refuse to hire an applicant solely because they present a valid EAD that will expire in the future.
- Do not review I-9 records to validate which employees are DACA beneficiaries.
- In determining the length of approved work authorization, employers should rely exclusively on their I-9 records.
- Employers should make sure their I-9 recordkeeping is up-to-date and that they are properly reviewing their Section 3 reverification obligations.
- Be aware that each DACA case is distinct based on individual circumstances.

Immigration Policy Priorities

On October, 8, 2017, the Trump administration published a list of three immigration policy objectives to (1) ensure safe and lawful admissions, (2) defend the safety and security of the United States, and (3) protect American workers. The administration indicated in its statement that it is

TWO ASPECTS OF [TRUMP ADMINISTRATION] POLICY OBJECTIVES MERIT CLOSE EVALUATION BY EMPLOYERS: AN EMPHASIS ON HEIGHTENED VISA FRAUD DETECTION CAPABILITIES AND THE DEVELOPMENT OF A POINTS-BASED SYSTEM TO MEASURE ELIGIBILITY OF FOREIGN NATIONALS FOR U.S. PERMANENT RESIDENCE.

"ready to work with Congress" to meet these immigration policy priorities.

The three main policy objectives—border security, interior enforcement, and a merit-based immigration system—align with earlier White House pronouncements, including the "Buy American, and Hire American" executive order and the statements accompanying its multiple travel bans. Two aspects of these policy objectives merit close evaluation by employers: an emphasis on heightened visa fraud detection capabilities and the development of a points-based system to measure eligibility of foreign nationals for U.S. permanent residence.

Measures to Enhance Visa Fraud Detection

The Trump administration's policy priorities identify multiple avenues of enhancing enforcement of U.S. immigration laws, including expansion of the Department of State's authority to collect and use fraud prevention and detection fees to combat visa fraud and enhanced funding of the Visa Security Program, especially at high-risk consular posts. In particular, the administration proposes strengthening the ability of the Department of State to detect and prevent fraud in the following ways:

- Expand the Department of State's authority to use fraud prevention and detection fees for programs and activities to combat all classes of visa fraud within the United States and abroad.
- Ensure funding for the Visa Security Program and facilitate its expansion to all high-risk posts.
- Grant the Department of State the authority to apply the Passport Security Surcharge to the costs of protecting U.S. citizens and their interests overseas and to include those costs when adjusting the surcharge.
- Strengthen laws prohibiting civil and criminal immigration fraud and encourage the use of advanced analytics to proactively detect fraud in immigration benefit applications.

The prioritization of visa fraud detection is a critical point for employers and their foreign national populations, as employers and employees should expect longer queues and increased security checks for visa benefits. The Trump administration's prioritization of visa fraud detection and prevention aligns with recent changes announced by the administration, including the phase-in of in-person interviews for all employment-based applicants for permanent residence, including dependent family members, effective on October 1, 2017, for applications filed on or after March 6, 2017. Visa applicants may also find that consular officers will question their eligibility for a visa benefit even when an underlying visa petition has already been granted by DHS (e.g., for H-1B benefits).

Development of a Points-Based Immigration System

The Trump administration's prioritization of a points-based immigration system for employers aligns with the president's endorsement of the RAISE Act. Despite President Trump's support, implementation of a points-based immigration system would require congressional action and is unlikely to affect petitions and related submission filed under current US immigration laws.

Conclusion

Employers should expect the Trump administration to aggressively pursue its stated platform of immigration priorities, which include enacting policy and regulation to support the "Hire American" and extreme vetting proclamations of President Trump. In this environment, employers should closely review their visa programs to ensure that they are in compliance with changing standards and work to establish leadership for and a broad-based culture of compliance in this area. A focused assessment of potential alternative visa options and when and how employers sponsor candidates for permanent residency can help advance staffing goals. In addition, employers should evaluate the strength of their I-9 and E-Verify employment verification programs. In the merger and acquisition context, diligence over visa and I-9 issues is more important than ever. Similarly, employer diligence over the vendors they use, particularly for IT functions where H-1B and L-1 usage may be high, should be integrated into procurement contracts and vendor resource programs. As a final matter, keeping an open line of communication, with informed messaging being sent to the work corps, is essential. L

Elizabeth Espín Stern *is a partner in Mayer Brown's Washington, D.C. office, where she leads the firm's Global Mobility & Migration group.* ***Maximillian Del Rey*** *is an associate with the group in the firm's Employment & Benefits practice and is also located in Washington, D.C.*

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Recent Trends in Media Industry Mergers and Acquisitions

Q&A with Meredith Senter and Erin Kim

LERMAN SENTER PLLC

Meredith S. Senter, Jr.

Erin E. Kim

This expert interview provides an overview of current market trends in the media industry and outlines the important aspects of this segment that make mergers and acquisitions in the industry unique.

What Does the Current Market Look Like in the Media Industry?

Mergers and acquisitions in the U.S. media industry have been on the rise. Television M&A is returning after a hiatus due to quiet period restrictions related to the incentive auction held by the Federal Communications Commission (FCC). In the incentive auction that ended in April 2017 the FCC auctioned off television station spectrum for wireless use. Stations that waited out the prohibition on transfers during the incentive auction are now doing deals, as are stations that hoped to sell in the auction, but did not. We are also seeing deals involving the sale of the residual assets of television stations sold in the auction.

On the radio side, the Entercom-CBS Radio merger is the largest transaction in several years and will result in additional activity due to required divestitures. The two largest radio companies are operating on extraordinary debt loads that will need to be addressed at some point. We are also seeing smaller strategic radio transactions, in particular for key single stations and FM translators being acquired to improve a station's signal.

There is also significant M&A activity involving program networks, cable operators, and other distributors.

Are There Any Prevailing Trends That You Are Seeing?

Consolidation spree. Four major mergers are currently pending—AT&T-Time Warner, Sinclair-Tribune, Discovery-Scripps, plus the already mentioned Entercom-CBS Radio merger—with speculation about many others. These companies are reacting to an industry transformation marked by changing consumer viewing and listening habits and shifting revenue streams.

Scale as driver. Scale not only serves as a tool for reducing operating costs, but also protects leverage in negotiations over program rights and retransmission rights. There are also technology-oriented reasons for scale. For example, television companies want a nationwide footprint to be positioned to take advantage of technical developments associated with ATSC 3.0, which is a new TV broadcast standard. Other entities are vertically integrating to secure content (e.g., AT&T's proposed acquisition of Time Warner as a specific play for content) or to secure control of the distribution platform for their content (e.g., NBCUniversal's acquisition of a low-power television station and lease of spectrum rights to serve as the NBC network affiliate in the Boston market, replacing a longstanding independently owned NBC affiliate).

Regulatory regime change and easing. The regulatory environment is encouraging, given the change in FCC leadership earlier this year. Immediately after Ajit Pai became chairman, the FCC lifted limits imposed by the prior administration on transactions involving services and sales agreements between television stations in the same market. The FCC then rescinded the prior administration's elimination of the UHF discount, which enables television groups to own more television stations before tripping the national television ownership cap. Currently pending before the FCC are petitions for reconsideration of the prior administration's 2016 broadcast ownership order. The FCC is expected to address these petitions and may review and potentially rescind longstanding ownership restrictions. The ownership restrictions rumored to be under review include:

- The newspaper/broadcast cross-ownership rule, 47 C.F.R § 73.3555(d), which prohibits common ownership of a newspaper and television or radio station in the same market
- The local television ownership cap, 47 C.F.R § 73.3555(b), which prohibits ownership of two of the top four television stations in a market –and–
- The radio subcaps, 47 C.F.R § 73.3555(a), which restrict the number of AM and FM stations a company can own in a single market

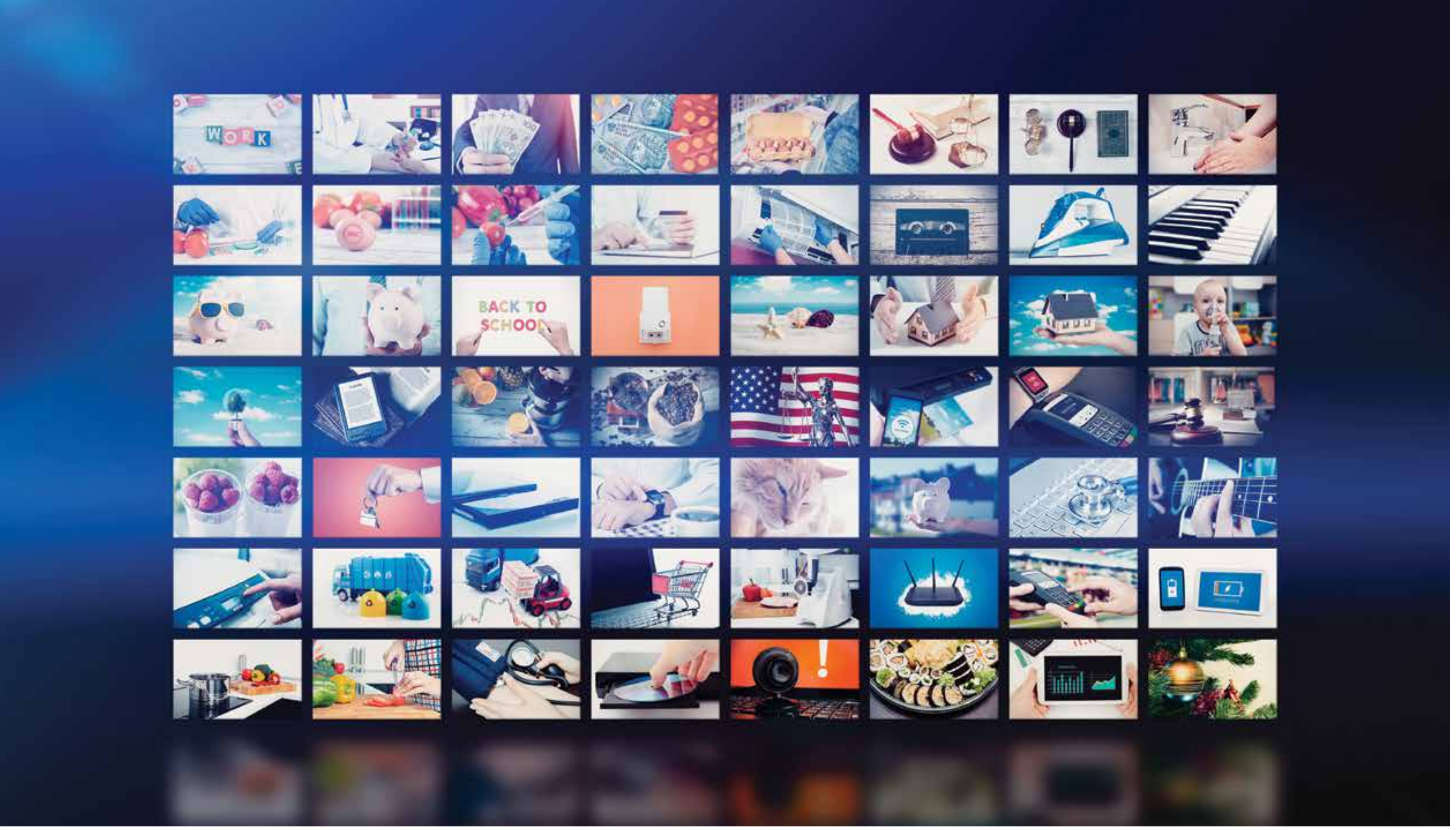
What Are the Key Regulatory Issues in Media Transactions?

There are unique procedural and substantive regulatory issues in the media space that practitioners deal with every day. Because we are in a regulated industry, FCC licenses are very important. Without a license, radio and television stations would not be able to broadcast a signal to listeners and viewers. Other media companies may hold FCC licenses to transmit or receive programming or authorizations to provide telecommunications services. For example, many cable operators use terrestrial microwave frequencies and satellite earth stations to distribute programming, direct-broadcast satellite providers use satellites to deliver programming to subscribers' individual satellite dishes, and program networks use earth stations and satellites to deliver their programming to distributors. All of these activities require licenses from the FCC. Under the Communications Act of 1934, as amended, 47 U.S.C. § 214(a) and § 310(d), the FCC must consent to the transfer of its licenses in a merger or acquisition, and therefore the FCC must consent to the merger or acquisition before a deal can close.

The need for FCC consent introduces regulatory uncertainty into media company transactions. The FCC is required to give public notice and opportunity to comment as part of its review. Absent any objections or challenges, the FCC review process takes six to eight weeks. However, if there is any challenge, the process can take several months or more, even for a typical transaction, regardless of the merit of the challenge. The process takes significantly longer for transactions that are determined to have a significant impact on the public interest or raise complex issues, which is basically any high-profile transaction. These major transactions are sometimes separately docketed and managed by the FCC's Transaction Team and often require review by the Department of Justice (DOJ) or the Federal Trade Commission (FTC) under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, 15 U.S.C. § 18a, (HSR review) as well. Many of these high-profile transactions are opposed by public interest organizations, others in the media industry, and even individual listeners and viewers. The Sinclair-Tribune merger is in the middle of the FCC review process now and has been opposed by individuals and a number of groups—including cable and satellite operators, trade associations, mobile phone companies, independent programmers, and public interest organizations. The recent AT&T-DirecTV, Charter-Time Warner Cable-Bright House and Altice-Cablevision transactions were also all opposed, just to name a few.

What Are Some Common Deal Structuring Issues That You Encounter?

Regulatory risk allocation. As mentioned, regulatory uncertainty is a major recurring issue in media transactions. A seller wants certainty and swiftness of closing, and a buyer wants to know that the deal will be approved. Thus, parties regularly negotiate the extent to which FCC and/or DOJ/FTC consent will be pursued and the relative burdens of doing so. The parties also negotiate protections and risk allocation. The provisions that are commonly negotiated include (1) outside dates for the transaction; (2) the conditions or requirements imposed by regulatory agencies that the buyer or seller must accept (including required divestitures); and (3) in some cases, breakup fees where the regulatory approval is not obtained. A well-known example is the breakup fee resulting from the abandoned AT&T/T-Mobile merger. AT&T paid T-Mobile a $4 billion fee of cash and spectrum rights after facing opposition



to the transaction from the FCC and the DOJ. There is also a breakup fee of $500 million in the currently pending AT&T-Time Warner merger.

Divestitures and alternative transactions. In addition, media transactions may need to be structured to comply with applicable FCC media ownership restrictions, as well as any divestiture or conduct remedies imposed by the DOJ. Required divestitures are a common issue for larger transactions. To allow the larger transaction to proceed with the divestitures pending, the FCC has permitted short-term waivers of its rules and the formation of divestiture trusts to hold stations pending sales to third parties. The FCC allows parties to select the stations to be divested, as only the total number of stations is considered for compliance with the FCC's media ownership rules. The DOJ, however, considers other factors such as the format, target audience, and relative competitiveness of the station in the market and may require specific stations to be divested. If timing is a concern for a deal, parties may utilize a local marketing agreement or time brokerage agreement, allowing the buyer to program the station or stations pending the closing. Stations also engage in many types of arrangements that may not involve an outright transfer or sale, such as joint selling agreements, news sharing agreements, shared services agreements, and others. All of these are options that the parties must consider when structuring transactions.

Is There a Particular Aspect of This Industry's M&A Activity That a Typical M&A Practitioner Would Be Unaware of or Would Be Surprised to Learn?

Limits on FCC review. Those outside the industry may not be aware that the FCC does not have automatic authority to review mergers and acquisitions involving cable and program networks. The FCC's jurisdiction is limited to FCC licensees, and for many of these companies, their FCC licenses cover operations that are not critical to the core business or can be easily replicated with alternate services. These companies are starting to get around FCC review by surrendering their FCC licenses and pursuing alternatives for the licensed operations. A recent example is the AT&T-Time Warner merger. Time Warner divested its Atlanta television station and surrendered the wireless and earth station licenses used by HBO, CNN, and other networks in order to avoid FCC review of the merger.

Potential delays with multiple agency reviews. There is a substantive aspect of the FCC's transactional review that those outside the industry may be interested to learn about. The FCC reviews deals under a public interest standard, and its deadlines are aspirational, not binding. Unlike other merger review regimes, such as the DOJ's and FTC's HSR review—which aligns to official, published analytical guidelines—the FCC's review methodology is less proscriptive and typically broader. In addition, because affirmative consent from the FCC is required prior to closing, the FCC almost always acts after the DOJ or FTC and after national security agencies in transactions involving a significant foreign investment. By acting last, the FCC de facto extends the review periods for the other agencies as they know the deal will not close until after the FCC acts even if their proscribed time periods (e.g., expiration of the HSR review waiting period) have passed.

Post-closing risk of FCC rescission. Many M&A deals include regulatory approvals as conditions to closing. However, practitioners may be surprised to learn that FCC consent might not—technically—be final. Although many transactions proceed to closing upon an initial consent, the FCC has the authority to subsequently rescind its consent. Rescission can occur following a successful petition for reconsideration (which can be filed by any interested person), or even on sua sponte motion by the FCC. This is obviously a concern for buyers who have paid the purchase price only to find their FCC licenses at risk and potentially facing the need to engage in costly long-term litigation following the closing. That said, in large, public company transactions, buyers tend to proceed to closing prior to finality notwithstanding this risk. As a business matter, it is impractical to delay the closing and wait out the long appeals process. In private transactions, buyers take one of three approaches in the acquisition agreement:

1. Require an FCC final order as a condition to the buyer's obligation to close (which provides finality but adds uncertainty to closing timing)
2. Close on initial grant unless there is a challenge lodged against the transaction (the middle ground approach) -or-
3. Assume the risk and close on an initial grant

With the second and third approaches, buyers may also require a rescission or unwind agreement that spells out what the parties must do to defend the transaction following the closing and what happens if the FCC rescinds the grant. Fortunately, examples of an FCC rescission following an initial grant are rare; however, post-closing litigation should be expected where a transaction is challenged. L

__Meredith Senter__, a member of Lerman Senter PLLC, has specialized in the representation of clients in the broadcast, cable, and telecommunications industries since 1980. He has represented clients, from individuals to CBS Corporation, in the purchase or sale of numerous radio and television stations and has served as the lead attorney on transactions ranging in size from under $1 million to over $1.4 billion. Meredith counsels radio and television groups, wireless telecommunications companies, cable program services, and banks and investment companies that lend to or invest in telecommunications companies. In addition to advising clients on day-to-day regulatory matters, he assists them in structuring acquisitions and investments in compliance with complex FCC ownership and attribution regulations, often working with other law firms and in-house counsel. __Erin E. Kim__ is a member of Lerman Senter PLLC specializing in assisting broadcast and mass media clients with transactional and regulatory matters. Her clients include large, publicly traded mass media companies and small local broadcasters. She has substantial experience handling all aspects of complex broadcast transactions.

RESEARCH PATH: Corporate and M&A > M&A by Industry > Media & Telecom M&A > Practice Notes

Related Content

For an overview of considerations relevant to M&A transactions in the media industry, see

> **MEDIA M&A TRANSACTIONS**

RESEARCH PATH: *Corporate and M&A > M&A by Industry > Media & Telecom M&A > Practice Notes*

For a discussion of due diligence factors to consider in a telecom M&A deal, see

> **TELECOM M&A TRANSACTIONS**

RESEARCH PATH: *Corporate and M&A > M&A by Industry > Media and Telecom M&A > Practice Notes*

To learn about the consequences of terminating an M&A deal, see

> **CONSEQUENCES OF TERMINATION IN M&A DEALS**

RESEARCH PATH: *Corporate and M&A > M&A Provisions > Termination > Practice Notes*

For a discussion on drafting break-up fee provisions in an M&A agreement, see

> **BREAK-UP FEE PROVISIONS**

RESEARCH PATH: *Corporate and M&A > M&A Provisions > Break-up Fee/ Termination Fee > Practice Notes*


Michael Furrow and Shannon Clark
FITZPATRICK, CELLA, HARPER & SCINTO

LIFE SCIENCES: STRATEGIES FOR OVERCOMING EARLY LITIGATION CHALLENGES TO PATENT ELIGIBILITY

Introduction

Section 101 of the Patent Act provides: "Whoever invents or discovers any new and useful process, machine, manufacture, or composition of matter, or any new and useful improvement thereof, may obtain a patent therefor, subject to the conditions and requirements of this title." 35 U.S.C. § 101. The Supreme Court has held that this section contains an important implicit exception for laws of nature, natural phenomena, and abstract ideas. Alice Corp. Pty. Ltd. v. CLS Bank Int'l, 134 S. Ct. 2347, 2354 (2014); see also Mayo Collaborative Servs. v. Prometheus Labs., Inc., 566 U.S. 66, 70 (2012).

The U.S. Court of Appeals for the Federal Circuit has expressed that patent eligibility is a threshold issue of law that may be amenable to resolution through an early dispositive motion, thereby minimizing unnecessary burdens on the parties and the court. See, e.g., Ariosa Diagnostics, Inc. v. Sequenom, Inc., 788 F.3d 1371, 1373–75 (Fed. Cir. 2015); Ultramercial, Inc. v. Hulu, LLC, 772 F.3d 709, 717–19 (Fed. Cir. 2014); OIP Techs., Inc. v. Amazon.com, Inc., 788 F.3d 1359, 1364 (Fed. Cir. 2015) (Mayer, J., concurring).

This article considers strategies that you as the patentee may utilize when facing patent eligibility challenges early in litigation. Although much of the content is generalizable, special attention is given to inventions in the life sciences. When § 101 challenges arise in the life sciences arena, the claims commonly in focus are those directed to methods or tools for analysis of biological samples, compositions of matter based on naturally occurring materials, or methods of treatment using compositions that are asserted to be naturally occurring.

Two-Step *Alice* Framework

Following the Supreme Court's decision in *Alice Corp.*, there has been a significant increase in the number of patents challenged under § 101. Courts follow a two-step framework when "distinguishing patents that claim laws of nature, natural phenomena, and abstract ideas from those claiming patent-eligible applications of those concepts." 134 S. Ct. at 2355 (citing Mayo, 566 U.S. at 77–80). At step one, courts must determine "whether the claims are directed to one of those patent-ineligible concepts." *Id.* If they are, courts must consider the elements of each claim both individually and "as an ordered combination" to determine whether additional elements transform an abstract idea into a patent-eligible invention. *Id.* This second step is equated with "a search for an 'inventive concept'—i.e., an element or combination of elements that is 'sufficient to ensure that the patent in practice amounts to significantly more than a patent upon the [ineligible concept] itself.'" *Id.* (citing Mayo, 566 U.S. at 72–73).

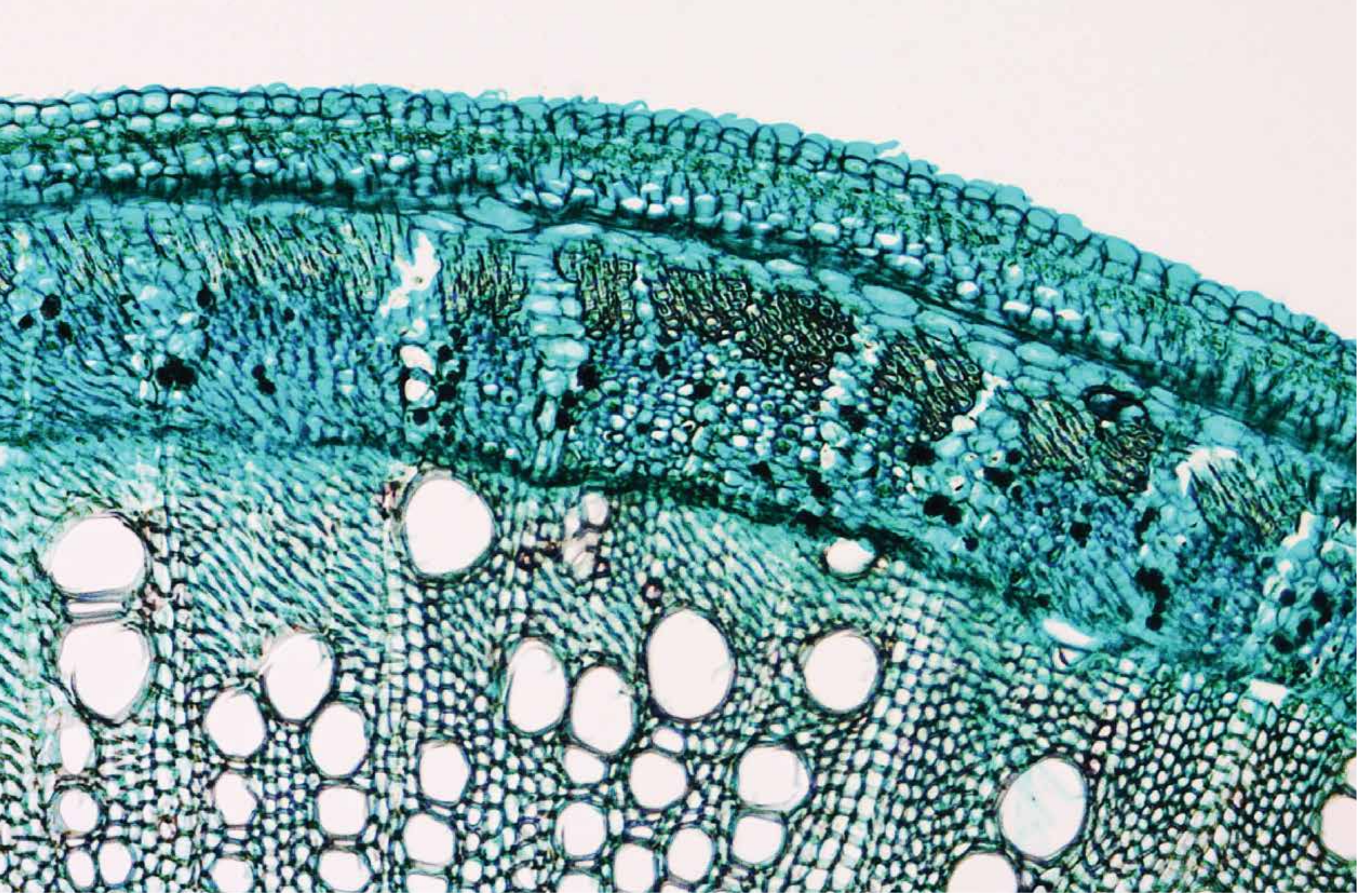
Practical Considerations for Preparing for and Responding to a Motion to Dismiss

FRCP 12(b)(6) and 12(c) Standards

Federal Rule of Civil Procedure 12(b)(6) governs a motion to dismiss a complaint for failure to state a claim upon which relief can be granted. The purpose of such a motion is to test the sufficiency of the complaint, not to resolve disputed facts or decide the merits of the case. See, e.g., Swierkiewicz v. Sorema N. A., 534 U.S. 506, 511 (2002); Bell Atlantic Corp. v. Twombly, 550 U.S. 544, 563 n.8 (2007). A motion to dismiss may be granted if, after accepting all well-pleaded allegations in the complaint as true and viewing them in the light most favorable to the plaintiff, the plaintiff is not entitled to relief. See, e.g., Maio v. Aetna, Inc., 221 F.3d 472, 481–82 (3d Cir. 2000) (citation omitted) Content Extraction & Transmission LLC v. Wells Fargo Bank, Nat'l Ass'n, 776 F.3d 1343, 1349 (Fed. Cir. 2014).

Rule 12(c) of the Federal Rules of Civil Procedure permits a party to move for the dismissal of a suit "[a]fter the pleadings are closed . . . but early enough not to delay trial." Fed. R. Civ. P. 12(c). A Rule 12(c) motion for judgment on the pleadings is "functionally identical" to a Rule 12(b)(6) motion to dismiss for failure to state a claim. Cave Consulting Grp., Inc. v. Truven Health Analytics, Inc., No. 15-cv-02177-SI, 2016 U.S. Dist. LEXIS 8395 (N.D. Cal. Jan. 25, 2016) (citing Dworkin v. Hustler Magazine, Inc., 867 F.2d 1188, 1192 (9th Cir. 1989)); Affinity Labs of Texas, LLC v. Amazon.Com, Inc., 2015 U.S. Dist. LEXIS 77411 (W.D. Tx. June 12, 2015) (citing Doe v. MySpace, Inc., 528 F.3d 413, 418 (5th Cir. 2008)). Courts must accept all factual allegations in the complaint as true and construe them in the light most favorable to the non-moving party. See, e.g., Allergan, Inc. v. Athena Cosmetics, Inc., 640 F.3d 1377, 1380 (Fed. Cir. 2011); Johnson v. Rowley, 569 F.3d 40, 43-44 (2d Cir. 2009). The motion may be granted if the moving party establishes that no material issue of fact remains to be resolved, and the party is entitled to judgment as a matter of law. See, e.g., Mele v. Fed. Reserve Bank of N.Y., 359 F.3d 251, 253 (3d Cir. 2004); Colony Ins. Co. v. Burke, 698 F.3d 1222, 1228 (10th Cir. 2012).

Although the focus of this article is on eligibility challenges by motion under Rules 12(b)(6) or (c), Rule 12(d) states that "[i]f, on a motion under Rule 12(b)(6) or 12(c), matters outside the pleadings are presented to and not excluded by the court, the motion must be treated as one for summary judgment." Thus, the Fed. R. Civ. P. 56 standard may (albeit rarely) become pertinent. Summary judgment is appropriate if the evidence shows that there is no genuine dispute as to any material fact and the moving party is entitled to judgment as a matter of law. Fed. R. Civ. P. 56(a); Celotex Corp. v. Catrett, 477 U.S. 317, 322 (1986). In determining whether a genuine dispute as to a material fact exists, the courts must view the evidence in the light most favorable to the non-moving party and draw all justifiable inferences in its favor. Anderson v. Liberty Lobby, Inc., 477 U.S. 242,



255 (1986). Nonetheless, the party opposing summary judgment may not rely on mere conclusory allegations nor speculation, but instead must offer evidence in support of its factual assertions. See, e.g., D'Amico v. City of New York, 132 F.3d 145, 149 (2d Cir. 1998); Thornhill Publ'g Co., Inc. v. GTE Corp., 594 F.2d 730, 738 (9th Cir. 1979).

What Is the Burden of Proof?

There is mixed guidance on whether a § 101 challenge must satisfy the clear and convincing invalidity standard of 35 U.S.C. § 252. Some courts adhere to this standard when adjudicating a § 101 challenge. See, e.g., Endo Pharms. Inc. v. Actavis Inc., 2015 U.S. Dist. LEXIS 127104 (D. Del. Sept. 23, 2015) (citations omitted); Affinity Labs of Texas, LLC v. DirecTV, LLC, 109 F.Supp.3d 916, 932–33 (W.D. Tex. 2015); Ultramercial, Inc. v. Hulu, LLC, 772 F.3d 709, 720 (Fed. Cir. 2014) (Mayer, J., concurring) (citation omitted). That said, because in early eligibility challenges all facts alleged by the patentee are taken as true, and disposition is an issue of law, many courts believe it makes little sense to consider an evidentiary standard. See, e.g., Mimedx Group, Inc. v. Nutech Med., Inc., 2015 U.S. Dist. LEXIS 158867 (N.D. Ala. Nov. 24, 2015); Esoterix Genetic Labs. v. Qiagen Inc., 133 F.Supp.3d 349 (D. Mass. 2015); Exergen Corp. v. Brooklands Inc., 125 F.Supp.3d 312 (D. Mass. 2015). See also Microsoft Corp. v. 141 Ltd. P'ship, 131 S.Ct. at 2253 (clear and convincing standard applies only to questions of fact) (Breyer, J., concurring).

Draft the Complaint with Eligibility in Mind

In evaluating the sufficiency of a complaint, generally (with limited exceptions, discussed below), courts may consider the complaint, documents attached to the complaint, and documents referenced by the complaint. See, e.g., OIP Techs., Inc. v. Amazon.com, Inc., 788 F.3d 1359, 1363 (Fed. Cir. 2015); Lone Star Fund V (U.S.) L.P. v. Barclays Bank PLC, 594 F.3d 383, 387 (5th Cir. 2010). Thus, you should consider incorporating factual allegations pertinent to *Alice* steps 1 and 2, with supporting citations, into the complaint to aid in responding to any potential eligibility arguments. See, e.g., Xlear, Inc. v. STS Health, Ltd. Liab. Co., 2015 U.S. Dist. LEXIS 167707, at *4–5 (D. Utah Dec. 14, 2015).

Identify and Explain the Materiality of Disputed Facts

As with any opposition to a motion to dismiss, you cannot rely on bare assertions that dispositive facts are in dispute, precluding resolution. As the patentee, you must explain how any purported factual disputes bear on resolution of the two steps in the eligibility inquiry. See, e.g., Genetic Techs. Ltd. v. Lab. Corp. of Am. Holdings, 2014 U.S. Dist. LEXIS 122780, at *15 (D. Del. Sep. 3, 2014). Persuasively identifying and supporting such disputes—for example concerning whether a person of ordinary skill in the art would view the limitations in the challenged claims as well-understood, routine, or conventional (see later discussion)—is the goal of any opposition to an early dispositive motion. See, e.g., Athena Diagnostics, Inc. v. Mayo Collaborative Servs., LLC, 2016 U.S. Dist. LEXIS 114259 (D. Mass. Aug. 25, 2016); Classen Immunotherapies, Inc. v. Biogen Idec, 2012 U.S. Dist. LEXIS 112280 (D. Md. Aug. 9, 2012).

Identify and Explain the Relevance of Non-trivial Questions of Claim Interpretation

If you can identify disputes concerning claim meaning that are material to the eligibility determination, the court may deny the motion or hold off on any determination until after the claim construction record has been fleshed out. The Federal Circuit has recognized that "it will ordinarily be desirable—and often necessary—to resolve claim construction disputes prior to a § 101 analysis, for the determination of patent eligibility requires a full understanding of the basic character of the claimed subject matter." Bancorp Servs., L.L.C. v. Sun Life Assur. Co. of Canada (U.S.), 687 F.3d 1266, 1273–74 (Fed. Cir. 2012). In practice, however, this can present a high bar. The court may be willing to take on a discrete legal question of construction, or simply express that its understanding of the claims is "sufficient" based upon the briefing for the purposes of the motion. Boehringer Ingelheim Pharms., Inc. v. HEC Pharm Co., Ltd., 2016 U.S. Dist. LEXIS 169812 (D. N.J. Dec. 7, 2016). Or parties bringing a § 101 challenge may argue that the dispute over meaning of claim language is immaterial, because the outcome would be the same under either party's construction. See, e.g., Genetic Techs. Ltd. v. Lab. Corp. of Am. Holdings, 2014 U.S. Dist. LEXIS 122780 (D. Del. Sept. 3, 2014); Cleveland Clinic Found. v. True Health Diagnostics, LLC, 2016 U.S. Dist. LEXIS 21907, at *6-7 (N.D. Ohio Feb. 23, 2016). Thus, as is true with any disputed facts, you must explain out how the § 101 analysis would materially change if certain terms are accorded your proposed construction rather than the challenger's, and you should articulate how the issues of construction are too complex or numerous to be fairly resolved at a preliminary stage of litigation. See CyberFone Sys., LLC v. CNN Interactive Grp., Inc., 558 Fed.Appx. 988, 992 n.1 (Fed. Cir. 2014); Bancorp Servs. L.L.C. v. Sun Life Assurance Co. of Canada, 687 F.3d 1266, 1273 (Fed. Cir. 2012); Genetic Veterinary Sci. v. Canine EIC Genetics, LLC, 101 F.Supp.3d. 833, 842–43 n. 3 (D. Minn. 2015).

If Appropriate, Supplement the Record

You should also consider whether judicial notice could be employed to supplement the record. Judicial notice may be taken of facts that are "generally known" or "can be accurately and readily determined from sources whose accuracy cannot reasonably be questioned." Fed. R. Evid. 201. But where the movant reasonably disputes the accuracy or meaning of a factual assertion within a document, notice is generally denied. For example, although documents containing a patent's prosecution history and prior art references are publicly available, they may be inappropriate for judicial notice when the accuracy of factual statements within those documents may be disputed. See, e.g., ContourMed v. Am. Breast Care L.P., 2016 U.S. Dist. LEXIS 34408 (S.D. Tex. Mar. 17, 2016). Nevertheless, not every helpful fact will be subject to any reasonable dispute. For example, courts have taken notice of teachings in the art when well known to the relevant scientific community. See Ameritox, Ltd. v. Millennium Health, LLC, 88 F. Supp. 3d 885, 892 (W.D. Wis. 2015); Affinity Labs of Texas, LLC v. Amazon.com Inc., 838 F.3d 1266, 1270 (Fed. Cir. 2016).

Additionally, in rare circumstances as discussed above, courts may be willing to treat the motion as a summary judgment motion and consider evidence the patentee attaches to its response, particularly where the movant has itself gone beyond the record. Such instances tend to permit greater opportunity to supplement the record by, for example, attaching an expert declaration or exhibits explaining the features and advantages of the invention. See, e.g., Rutgers v. Qiagen N.V., 2016 U.S. Dist. LEXIS 24736 (D. N.J. Feb. 29, 2016).

Life Sciences Claims That Have Been the Subject of an Eligibility Challenge

As stated in the introduction, eligibility challenges to life sciences patents commonly involve claims directed to methods or tools for analysis of biological conditions, and applications thereof. For example:

- "A method of assessing a test subject's risk of having [a disease], comprising comparing levels of [an enzyme] in a bodily sample from the test subject with levels of [the enzyme] in comparable bodily samples from control subjects diagnosed as not having the disease . . . wherein the [relative] levels of [the enzyme] is indicative of the extent of the test subject's risk of having [the disease]," The Cleveland Clinic v. True Health Diagnostics LLC, 859 F.3d 1352 (Fed. Cir. June 2017) (ineligible); see also Genetic Veterinary Sci., 101 F.Supp.3d. 833 (Ineligible: "A method for determining whether a dog has or is predisposed to develop [condition] . . . .").
- "A method for detecting [a naturally occurring nucleic acid] . . . which method comprises amplifying [the nucleic acid] from the serum or plasma sample and detecting the [nucleic acid] in the sample," Ariosa Diagnostics, 788 F.3d 1371 (ineligible).
- "A method of detecting human body temperature comprising: measuring temperature of a region of skin of the forehead; and processing the measured temperature to provide a body temperature approximation based on heat flow from an internal body temperature to ambient temperature," Exergen Corp. v. Thermomedics, Inc., 132 F.Supp.3d 200 (D. Mass. 2015) (ineligible).

Compositions of matter have also been challenged as being the same as naturally occurring materials. For example:

YOU SHOULD FOCUS ON CLEARLY ILLUSTRATING HOW AND WHY THE CLAIMS UNDER REVIEW DO NOT PREEMPT THE PUBLIC USE OF A LAW OF NATURE, NATURAL PHENOMENON, OR ABSTRACT IDEA.

- "A pair of single-stranded DNA primers for determination of a nucleotide sequence of a BRCA1 gene by a polymerase chain reaction, the sequence of said primers being derived from human chromosome 17q, wherein the use of said primers in a polymerase chain reaction results in the synthesis of DNA having all or part of the sequence of the BRCA1 gene," *In re* BRCA1– & BRCA2–Based Hereditary Cancer Test Patent Litig., 774 F.3d 755 (Fed. Cir. 2014) (ineligible); see also, Roche Molecular Sys, Inc. v. Cepheid, 2017 U.S. Dist. LEXIS 113280 (N.D. Cal. Jan. 17, 2017) (Ineligible: DNA primers used to detect mycobacterium tuberculosis found to be structurally and functionally identical to naturally occurring DNA sequences).

Also, claims to methods of treatment using compositions that are asserted to be naturally occurring materials may be attacked. For example:

- "A method of cleaning the nasopharynx in a human in need of said method which comprises nasally administering an effective amount of xylitol/xylose in solution," Xlear, Inc. v. STS Health, LLC, 2015 U.S. Dist. LEXIS 167707 (D. Utah Dec. 14, 2015) (12(b)(6) motion based on ineligibility denied).
- "A method of treating a lung cancer comprising administering a composition comprising a human or humanized anti-PD-1 monoclonal antibody to a human with the lung cancer, wherein the administration of the composition treats the lung cancer in the human." Bristol-Myers Squibb Co. v. Merck & Co., Inc., 2016 U.S. Dist. LEXIS 34292 (D. Del. Mar. 17, 2016) (12(b)(6) motion based on ineligibility denied).

Of course, this list simply identifies targets that may be more likely to be challenged and is not meant to be exclusive.

Strategy Considerations for Identifying Material Disputed Facts Concerning Eligibility

Keep the Normative Point Central: The Public Here Is Not Foreclosed from Using a Law of Nature, Natural Phenomenon, or Abstract Idea

The overarching concern behind the implicit exception to § 101 is one of preemption: the exception encompasses the "basic tools of scientific and technological work" and recognizes that authorizing "monopolization of those tools through the grant of a patent might tend to impede innovation more than it would tend to promote it." Mayo, 132 S. Ct. at 1293 (citing Gottschalk v. Benson, 409 U.S. 63, 67 (1972)). Thus, you should focus on clearly illustrating how and why the claims under review do not preempt the public use of a law of nature, natural phenomenon, or abstract idea. See, e.g., Rapid Litigation Mgmt. Ltd. v. CellzDirect, Inc., 827 F.3d 1042, 1052 (Fed. Cir. 2016); Rutgers v. Qiagen N.V., 2016 U.S. Dist. LEXIS 24736 (D. N.J. Feb. 29, 2016) (inventions limited to specific application of a diagnosis of a specific infection involving only specific antigens and causing a specific response where alternatives existed for each); Ameritox, Ltd., 88 F. Supp. 3d at 916-917 (holding that some claims do not preempt a natural law while others do).

Strategy Considerations in Addressing *Alice* Step 1

The goal of the party seeking early resolution will be to characterize your method claims as nothing more than the observation, identification, or analysis of a natural phenomenon, and your composition claims as not materially distinct from naturally occurring material. For example:

- A claim reciting methods for detecting a coding region of DNA based on its relationship to non-coding regions amounted to nothing more than identifying "information about a patient's natural genetic makeup," Genetic Techs., Ltd. v. Merial L.L.C., 818 F.3d 1369, 1373–74 (Fed. Cir. 2016)
- Claims directed to identifying the presence of cell-free fetal DNA (cffDNA) in a patient's bloodstream were claiming nothing more than the natural existence and location of cffDNA, Ariosa Diagnostics, Inc. v. Sequenom, Inc., 788 F.3d 1371, 1373–74 (Fed. Cir. 2015)
- Claims reciting methods for screening human germline for an altered BRCA1 gene by comparing the target DNA sequence with wild-type sequence were nothing more than abstract mental process, BRCA1 & 2, 774 F.3d at 761–62
- Claims directed to DNA primers used to detect mycobacterium tuberculosis found to be structurally and functionally identical to naturally occurring DNA sequences, Roche Molecular Sys. v. Cepheid, 2017 U.S. Dist. LEXIS 113280 (N.D. Cal. Jan. 17, 2017)

Focus on Elements That Take the Claims Beyond Excepted Subject Matter, Even if the Elements Themselves Are Well-Known

Movants will invariably focus on certain aspects or perceived phenomena involved in your claim to characterize the claim as being directed to one of the excepted ineligible concepts. In so doing, movants often describe claims at such a high level of abstraction or through such a narrow lens that some courts have referred to the general approach as "reductionist simplicity." See Verint Syst. Inc. v. Red Box Records Ltd., 226 F. Supp. 3d 190 (S.D. N.Y. Dec. 7, 2016). The Supreme Court has acknowledged that "[a]t some level, 'all inventions . . . embody, use, reflect, rest upon, or apply laws of nature, natural phenomena, or abstract ideas.'" Alice, 134 S. Ct. at 2354 (citing Mayo, 566 U.S. at 1293). Thus, you will invariably have to explain how the challenged claim, when considered in its entirety, at most simply involves the allegedly ineligible subject matter and is not directed to it. See Enfish, LLC v. Microsoft Corp., 822 F.3d 1327, 1335 (Fed. Cir. 2016); Rapid Litigation Mgmt., 827 F.3d at 1049. "Patenting the concept of lift is inappropriate under § 101. Patenting a particular airplane wing is not." Femto-Sec Tech., Inc. v. Lensar, Inc., No. 15-cv-1689, 2016 U.S. Dist. LEXIS 189327 (C.D. Cal. June 8, 2016). For the purposes of Alice step 1, it should not matter if the elements that distinguish the subject matter from any ineligible aspect were themselves inventive or well-known.

For example, in *Rapid Litigation Management Ltd. v. CellzDirect, Inc.*, the claim concerned a method for producing "a preparation of multi-cryopreserved cells." 827 F.3d at 1048. The movant focused on the cells' capability of surviving multiple freeze-thaw cycles, to identify what it called a "natural law." *Id.* The patentee explained that the claims are not directed to that feature of the cells, but rather a "constructive process" comprising concrete steps for preserving the cells. *Id.* ("Indeed, the claims recite a '*method of producing* a desired preparation of multi-cryopreserved hepatocytes.'").

In *Baxter International, Inc. v. CareFusion Corp.*, CareFusion argued that the claims at issue were directed to the abstract idea of calculating the remaining time on a battery, using well-known voltage and current measurements. 2016 U.S. Dist. LEXIS 63581, at *24 (N.D. Ill. May 13, 2016). In response, Baxter explained how CareFusion ignored components including medical infusion pump, battery, alarm, display and electrical circuits. Id. at 25. CareFusion's argument that the step 1 analysis should focus on alleged "novel" features (arguing that all of the tangible components of the claims were well-known) was rejected as irrelevant to the Step 1 inquiry. *Id.* at 28.

In *Viveve, Inc. v. Thermagen, LLC*, the challenged claims concerned methods for heating tissue and remodeling it once heated. 2017 U.S. Dist. LEXIS 60478, at *2 (E.D. Tex. Apr. 20, 2017). The movant focused on the natural phenomenon of collagen becoming malleable once heated. *Id.* at 3. The patentee, however, identified two steps that a physician must carry out: (1) heating the target tissue and (2) remodeling the therapeutic zone. *Id.* at 9. "This type of constructive process, carried out by an artisan to achieve a new and useful end,

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is precisely the type of claim that is eligible for patenting." *Id.* at 14 (citing Rapid Litigation Mgmt., 827 F.3d at 1048).

In *Rutgers v. Qiagen N.V.*, the challenged claims were to methods for detecting whether patients had been exposed to *Mycobacterium tuberculosis*. 2016 U.S. Dist. LEXIS 24736, at *1 (D. N.J. Feb. 29, 2016). The patentee plausibly argued that the "polypeptides or antigenic segments thereof in the compositions or methods" had "no naturally-occurring counterpart" and were "functionally distinct" from naturally occurring polypeptide antigens. *Id.* at 9.

Challenge the Movant's Alleged Identification of Ineligible Subject Matter

You should also consider whether the movant actually even identified ineligible subject matter—sometimes there is no plausible way to reduce the claim that far. For example, a movant was unsuccessful in claiming that ultrashort pulse laser beams were naturally occurring phenomena. Femto-Sec Tech., Inc. v. Lensar, Inc., 2016 U.S. Dist. LEXIS 189327 (C.D. Cal. June 8, 2016). In another example, a court rejected the articulation of an alleged natural phenomenon underlying a claim as "heat denature[ing] collagen and caus[ing] remodeling" because the "remodeling is a process comprising a doctor's application" of certain specific steps. Viveve, 2017 U.S. Dist. LEXIS 60478, at *9.

Strategy Considerations in Addressing *Alice* Step 2

With respect to *Alice* step 2, the party seeking early resolution will characterize any additional claim terms beyond those pertaining to excepted subject matter as conventional and assert that they have been applied in a routine manner. See, for example, Mayo at 87 (steps of administering the drug, measuring metabolite levels, and adjusting dosage were well known; the only new knowledge was of the natural phenomenon); Ariosa, 788 F.3d at 1377 (method claimed amounted to "a general instruction to doctors to apply routine, conventional techniques"); Genetic Techs. Ltd. v. Merial L.L.C., 818 F.3d 1369, 1377-1380 (Fed. Cir. 2016) (steps conventional, just applied to newly discovered law of nature).

Focus on the Combination of Elements That Is Unconventional

In an approach akin to the reductionism discussed in connection with *Alice* step 1, movants will often pull out each claim limitation separately and explain how they were well known and conventional. Patentees should bring the focus onto the claim as a whole and an evaluation of whether the claimed combination of elements was routine.

For example, in *Rapid Litigation Management Ltd. v. CellzDirect, Inc.*, although the "individual steps of freezing and thawing were well known, but a process of preserving hepatocytes by repeating those steps was itself far from routine and conventional." 827 F.3d at 1051.

In *Ameritox v. Millennium Health*, claim terms that "direct medical professionals to measure the level of a drug metabolite, to normalize data via a creatinine ratio, and then compare that value against the creatinine ratios of a population of individuals" were individually well known and routine, but the inventors' coupling of a normalization step and comparative step was unconventional. 88 F.Supp.3d at 911.

In *Idexx Laboratories, Inc. v. Charles River Laboratories, Inc.*, blood collection cards, analysis of samples for a biological marker, and use of immunoassay were all well known, but the "ordered combination of limitations . . . describe a specific, novel implementation." 2016 U.S. Dist. LEXIS 87888, at *15 (D. Del. July 1, 2016).

Identify Problems in the Art and the Improvements the Invention Provides

Patentees should also identify the problems that existed in the art and how the invention—the claim as a whole—solved those problems or improved upon what was known and available. See DDR, 773 F.3d at 1257; Cal. Inst. of Tech. v. Hughes Communs., Inc., 59 F.Supp.3d 974, 1000 (C.D. Cal. 2014); cf. Alice, 134 S. Ct. at 2359 ("The method claims do not . . . purport to improve the functioning of the computer itself.").

For example, in *Ameritox v. Millennium Health*, Ameritox explained how prior protocols were restricted and could only test for the "presence or absence of a drug metabolite in urine," which presented a "major difficulty" because of large variance in metabolite concentrations in urine. It was through the inventors' ingenuity that more accurate evaluation became available. 88 F.Supp.3d at 912.

In *Idexx Laboratories, Inc. v. Charles River Laboratories, Inc.*, the method provided clear advances over the prior art including "permit[ting] one to monitor the health of rodent populations without euthanizing animals, waiting for blood to clot in a centrifuge, or shipping blood serum overnight in a refrigerated container." 2016 U.S. Dist. LEXIS 87888, at *14 (D. Del. July 1, 2016).

In *Rutgers v. Qiagen N.V.*, the patentee plausibly alleged that the claimed single-visit *in vitro* objective blood tests for exposure to *Mycobacterium tuberculosis* provided great improvements over prior multiple-visit *in vivo* skin tests, in which tuberculosis antigens were injected into patients' arms, the site was inspected for irritation days later, and a subjective evaluation was made. 2016 U.S. Dist. LEXIS 24736, at *3-4 (D.N.J. Feb. 29, 2016).

In *Viveve, Inc. v. Thermagen, LLC*, the claims to heating and remodeling tissue provided improvements over the "only known methods for tightening the relevant tissue [which] required invasive surgical procedures which carried with them the risk of scarring." 2017 U.S. Dist. LEXIS 60478, at *15 (E.D. Tex. Apr. 20, 2017).

Conclusion

If you plan to assert a patent with claims that may invite a § 101 eligibility challenge, your defensive strategy begins with including factual allegations and supporting citations pertinent to the inquiries in *Alice* steps 1 and 2 in the complaint. If an early challenge does arise, identify material factual disputes and claim construction issues that warrant development of a full record. To do so, consider challenging the movant's alleged identification of excepted subject matter, and explain how the claim, when considered as a whole, is not in fact directed to that subject matter, but merely involves it. Also, explain how the claimed combination of elements is unconventional and provides improvements over the art. And keep the policy consideration central: the public is not foreclosed from using the alleged excepted subject matter because of the claim.

__Michael Enzo Furrow__ is a partner with Fitzpatrick, Cella, Harper & Scinto. His experience with and understanding of the challenges innate to discovery in the pharmaceutical and biotechnology fields fuel his passion to enforce and defend life sciences patents. He has represented innovators across these industries in high-stakes patent disputes both in Federal Court and before the U.S. Patent and Trademark Office, concerning drugs or biologics for treating HIV/AIDS, Alzheimer's disease, breast cancer, prostate cancer, bacterial infection, epilepsy, and various endocrine, vascular and gastrointestinal diseases, as well as genetically modified animals. __Shannon Clark__ is an associate with Fitzpatrick, Cella, Harper & Scinto.

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Elizabeth Harlan ASTRACHAN GUNST THOMAS, P.C.

Strategies for Creating and Implementing a Zero-Tolerance **Workplace Violence Policy**

According to the Occupational Safety and Health Administration (OSHA), approximately two million workers a year are affected by some form of workplace violence. The National Crime Victimization Survey reports more than a million workdays are lost each year as a result of workplace assaults. Employers are subject to multimillion dollar judgments when incidents take place on their watch, especially if they are aware of threats and fail to act.

THE RESPONSIBILITY TO DESIGN AND IMPLEMENT POLICIES and practices that address and deter workplace violence often falls on general counsel or human resource professionals. While there is certainly no one-size-fits-all approach to these issues, this article provides practical suggestions to those professionals who are undertaking the task of crafting and implementing a proactive zero-tolerance approach to workplace violence.

The Definition of Workplace Violence

The type of workplace violence most people immediately think of—active shooter homicides—is devastating to an employer, its employees and their families, its clients, and even to an industry. In 2015 (the most recent year for which statistics are reported by the U.S. Bureau of Labor Statistics) there were 417 workplace homicides in the United States. This represents a 2% increase in workplace homicides from 2014 and a 15% increase in workplace shootings. Active shooter incidents are becoming more common and deserve significant attention from every employer, but it is also important to understand that the concept of workplace violence encompasses much more than homicides.

Private companies adopt their own definitions of workplace violence. If your company does not already use a particular definition, or it wants to reconsider that definition, there are several examples of conduct rules and workplace violence policies available on the internet that can be used as a starting point.

OSHA defines workplace violence as "any act or threat of physical violence, harassment, intimidation, or other threatening disruptive behavior that occurs at the work site." Importantly, this definition includes verbal threats and intimidation—not just physical violence and threats of physical violence.

The National Institute for Occupational Safety and Health defines workplace violence as "violent acts (including physical assaults and threats of assaults) directed toward persons at work or on duty." This is a much narrower definition.

State regulators also vary in their definitions. For example, Maryland Occupational Safety and Health (Maryland's state OSHA entity) employs a much broader definition. It defines workplace violence as "a wide range of acts that include all violent behaviors and threats of violence, as well as any conduct that can result in injury, property damage, induce a sense of fear, or otherwise impede the normal course of work."

Before adopting a definition, think carefully about what behavior your company is willing to consistently police—from the top down. If you are not willing to enforce the definition as applied to your senior vice presidents or your chief executive officer, do not adopt it. Disparate treatment under the policy will destroy its efficacy and could lead to lawsuits.

Types of violence that you may want to include within the scope of a workplace violence policy include:

- Homicide
- Brandishing or using a weapon
- Physical assault
- Damaging, destroying, or sabotaging property
- Intimidating others
- Scaring others
- Harassing, stalking, or giving undue unwanted attention to another
- Shaking fists, kicking, punching a wall, or screaming at others
- Verbal abuse including offensive, profane, and vulgar language
- Threats, whether made in person or through letters, texts, phone, or email

Adopting a broad (but not too broad) definition for workplace violence is important because a consistently enforced policy can help nip bigger problems in the bud. For example, actively addressing threatening language may stave off a future physical attack, and a broad zero-tolerance policy can provide a viable mechanism for discussing and stopping intimidating, abusive verbal behavior in the workplace. This effort can be central to retaining talent. Because current employment laws within the United States do not address workplace bullying, unlike the laws of many other countries, an employer's workplace violence policy or conduct rules may provide the only clear pathway by which an employer or an employee can approach and proactively address verbally abusive, intimidating, or manipulative behaviors.

Related Content

For a discussion of issues related to workplace bullying, see

> COMBATING BULLYING IN THE WORKPLACE

RESEARCH PATH: *Labor & Employment > Workplace Safety and Health > Policies and Procedures > Practice Notes*

For advice on drafting a workplace violence policy, see

> DRAFTING WORKPLACE VIOLENCE POLICIES

RESEARCH PATH: *Labor & Employment > Workplace Safety and Health > Policies and Procedures > Practice Notes*

For an example of a policy against workplace violence, see

> WORKPLACE VIOLENCE POLICY

RESEARCH PATH: *Labor & Employment > Workplace Safety and Health > Policies and Procedures > Forms*

Categories of Workplace Violence

There are four categories of workplace violence that are typically recognized:

- Intimate partner violence
- Employee harms employee
- Client or customer harms employee
- Stranger harms employee

Special attention is placed here on intimate partner violence and employee-on-employee violence, as these are two types of violence that exhibit recognizable warning signs within the workplace.

Intimate Partner Violence

Intimate partner violence encompasses any violence by an intimate partner (husband, wife, former boyfriend, etc.) that makes its way into the workplace. The Centers for Disease Control reports that one in every four women and one in every ten men will experience domestic violence in their lifetime. That violence does not stay within the confines of the home. When a battered woman leaves her husband, for example, the husband may not know her new address, but he might know where she works. A 1998 study by the Family Violence Prevention Fund determined that 74% of employed battered women are harassed at work. The U.S. Bureau of Labor Statistics reports that in 2015, 43% of women employees killed in the workplace were killed by an intimate partner—as compared to only 2% of men.

An employer can make all the difference for someone facing domestic violence. Be attentive and aware. Here are some signs that could suggest that one of your employees may be experiencing abuse:

- Repeated physical injuries (often attributed to clumsiness, falls, accidents)
- Isolation (not talking to coworkers, eating alone)
- Emotional distress (crying at work)
- Ongoing despondence or depression
- Distraction
- Changes in quality of work
- Many personal phone calls (employee may be visibly shaken afterward)
- Absenteeism (arriving late, leaving early, doctor appointments, court appearances)

If you see these types of signs, or for any other reason suspect an employee is suffering abuse, reach out to the person. Often victims of domestic violence want someone to notice. Instead, people often decide the situation is none of their business or that it is best not to get involved. If the suspected abuse is affecting the employee's work, that is a perfect reason to open a dialogue. If the person denies the abuse, let him or her know that your door remains open.

Determine who the local service providers are for domestic violence so that you are ready to provide a resource when this type of conversation arises.

If the employee embraces your offer to help, here are some ideas that can help keep the employee safe at work:

- Temporary changes in the employee's work schedule or location
- Creative use of applicable leave policies
- Screening the employee's calls for them or changing their work number
- Changing the employee's work email address
- Providing security escorts to and from transportation (their car, the subway, etc.)

Intimate partner violence in the workplace has resulted in an untold number of lawsuits against employers. For example, when an Old Navy employee was shot and killed at work by her boyfriend in Chicago, Old Navy was sued on a premises liability theory for not providing sufficient security measures. Later, the complaint was amended to include allegations that the store manager knew the boyfriend had threatened the employee and did nothing about it.

In another suit, Gantt v. Security, USA, Inc., 356 F.3d 547 (4th Cir. 2004), Dominique Gantt, a security guard, sued her employer in federal court in Maryland, asserting claims for intentional infliction of emotional distress and sexual harassment arising out of the employer's alleged failure to protect her from a sexual assault in the workplace.

Gantt secured a protective order against her former boyfriend that prohibited him from calling her at work and stated that she should not be stationed at outside posts where she would be vulnerable to attack. She brought a copy of the protective order to her supervisor. Despite the clear mandates of the protective order, the supervisor repeatedly put calls through to Gantt from the ex-boyfriend. This same supervisor also stationed Gantt at an outside post, from which Gantt was abducted and raped by the ex-boyfriend.

The employer argued that Maryland's workers' compensation statute provided the only remedy for Gantt's injuries. The trial court granted the employer's motion for summary judgment. The U.S. Court of Appeals for the Fourth Circuit rejected that contention, determining that at least a portion of the factual scenario fell within the "deliberate intent to injure" exception to workers' compensation exclusivity. Accordingly, Gantt was permitted to pursue a claim for damages against her employer. A jury awarded her $2.25 million after one day of deliberation.

Be aware of intimate partner violence in the workplace and do what you can to protect your employees.

Employee-on-Employee Violence

According to the U.S. Secret Service, perpetrators of violence often choose a target in advance and make threats, not to the target, but to third parties. This phenomenon is central to prevention efforts. Employees must be trained to understand that when they hear threats, which most often will not be directed at them, they need to report the threats to a designated person. These types of communications cannot be ignored, as they may be the best chance to save a life.

The following are behaviors to look for in your employees or coworkers that often serve as warning signs for future violent behavior:

- Attendance problems
- Decreased productivity
- Inconsistent work patterns
- Inappropriate reactions
- Overreaching and criticism
- Mood swings
- Concentration problems
- Threats
- Throwing objects
- References to weaponry
- Unshakeable depression
- Disregard for personal safety
- Disregard for personal appearance

Train your employees to be conscious of the fact that people tend to ignore warning signs because they do not want to get involved or they think it is none of their business. Create an environment in which employees know to whom they should report their concerns and feel free to do so. Establishing this sort of culture requires complete buy-in from top management. This means that members of top management should be present at trainings and should stress to all employees that reporting threats of violent behavior is encouraged and expected and will not result in any sort of retaliation by the employer.

If warnings are conveyed to the appropriate people in a timely manner, both liability and harm may be avoided. For example, in Raymond DuPont v. Aavid Thermal Technologies, Inc., 147 N.H. 706 (2002), one employee, Robert Hilliard, shot and killed another employee, Raymond DuPont, and then shot himself. The warning signs were ignored. It was alleged that one coworker knew Hilliard was addicted to pain medication, was violent and aggressive, and had threatened DuPont, and a second employee knew Hilliard was abusing pain medication, was coming to work to confront DuPont, and was armed. Neither of these employees reported this information to anyone. When Hilliard appeared at work on his day off, two supervisors watched him accuse DuPont of having an affair with his girlfriend. Instead of calling security, the supervisors asked the two men to step outside. At that point, one of the coworkers finally informed a supervisor about the loaded handgun Hilliard was carrying. With that knowledge, the supervisors asked DuPont to return to work, but when Hilliard asked for a few more minutes outside with DuPont, the supervisors allowed it. Hilliard then shot DuPont and himself.

A New Hampshire court determined that the employer had a duty to protect DuPont because of the conduct of its supervisors. Relying on the Restatement (Second) of Torts, the court reasoned that an employer has a duty to protect an employee who, while acting within the scope of employment, comes into a position of imminent danger of serious harm and this is known to the employer or a person who has management duties. The employer failed to exercise reasonable care to avert the threatened harm, the court found.

Rather than turning a blind eye to threatening behavior and claiming ignorance if an incident occurs, the better course of action is to proactively encourage reporting, create a plan to protect your employees, and promptly address safety concerns.

Steps to Create a Zero-Tolerance Workplace Violence Plan

Here are some suggestions for putting a zero-tolerance workplace violence plan in place.

Create a Threat Assessment Team

No single person should be tasked with coming up with a definition of workplace violence, evaluating the workplace, and making all of the decisions necessary to keep employees safe. Instead, whenever possible, a team should be consulted. That team should ideally include:

- Managers
- Human resources
- Legal
- IT
- Employees

The threat assessment team should participate in an initial evaluation of the workplace for safety concerns (discussed below), meet periodically to update any evacuation plan and ensure that contact lists are current, and when time and circumstances permit, meet to discuss the best steps to take in response to individual instances of workplace violence.

Conduct a Worksite Analysis

It is a good idea to develop a relationship with local police and fire departments. Some departments will come to a workplace and conduct a free safety analysis. Invite local police and fire personnel to your company picnic, make them feel like part of your team, and cultivate real ties to these first responders. If you have multiple buildings, be sure the police and fire department personnel know the name and location for each building. During the 2013 Navy Yard shooting in Washington, D.C., precious time was lost while first responders tried to locate Building 197.

State and federal OSHA may also be willing to analyze the safety of your workplace. Reach out to them and ask. Private security companies can also be hired to conduct an analysis.

A physical analysis of a worksite will typically involve a review of issues such as who can access which parts of the building and how (security cards, codes, scans, etc.), whether portions of the building can be locked down, whether there is adequate lighting, whether individuals are protected when they work alone, the need for alarms and panic buttons, ideal hiding places in the event of an active shooter, and alternative exits, just to name a few.

An evacuation plan should be created, with rendezvous points and designated people to make sure everyone has arrived. When practicing for an active shooter scenario, employees should be instructed to silence their cell phones.

The threat assessment team should maintain a current contact list with phone numbers and names for each employee—such as a spouse or a good friend who can be called if something happens to an employee.

Once an evacuation plan is designed, practice it periodically without warning.

One point to keep in mind is that many people cannot recognize the sound of gunfire. Think about creative ways to address this concern, such as inviting a police officer to describe the sound or play a recording.

Create a Documentation System

The threat assessment team should designate someone to maintain records related to workplace violence. Among the items to include are:

- Records required by federal and state OSHA
- Incidents of verbal abuse, physical attacks, or aggressive behavior
- Details of investigations performed
- Information regarding any employee's history of violent behavior
- Minutes from meetings of the threat assessment team
- Documentation related to the hazard analysis
- Notes from any meeting with an employee regarding workplace violence
- Documentation of any corrective action taken or warnings given
- Documentation of all trainings performed and sign-in sheets from those trainings

Conduct Trainings

It is imperative that all managers and employees attend trainings related to recognizing the warning signs for intimate partner violence and employee-on-employee violence. Only with the full support of management will employees feel safe to report their concerns. General safety training, directed at preventing clients, customers, or strangers from harming employees is also very useful. For example, if certain doors to the outside are repeatedly propped open while people smoke, that creates a vulnerability that endangers everyone. Training can highlight the dangers of such conduct. Trainings can also incorporate visits from the local police or fire departments and provide a time to run evacuation drills.

As part of the training, make sure that everyone knows where the closest hospital or emergency room is located and that everyone has a phone number for every other employee and the best number for first responders. In addition, everyone should understand the capabilities of your phone system when the internet is down or power has been disconnected. Can you still dial 911? How?

It is also a good idea to locate counselors who are trained to provide aftercare for all employees who want it. It is best to be ready rather than searching for counselors in the aftermath of a tragic or frightening workplace event.

Screen Applicants for Violent Behavior

Screenings must be done in accordance with federal, state, and local law, but they typically can be performed after a first interview has been conducted and a contingent offer has been made. In each instance, an individualized assessment should be conducted that considers the job duties the person will perform and, where applicable, the offense the applicant committed, when that offense was committed, and any potential inaccuracies in the criminal history. An employer must be consistent about how it relies upon the information gathered. While background checks must be performed carefully, they are one of the best procedures an employer can utilize to predict future behavior and can help avoid a negligent hiring claim.

Create a Forum for Complaints

Workplace violence often arises when individuals do not believe they are being heard. One way to help avoid an escalation of frustration is by providing a regular forum for employees to voice complaints and concerns. This could be a monthly or quarterly meeting or an open door policy.

Be Mindful of Stressors

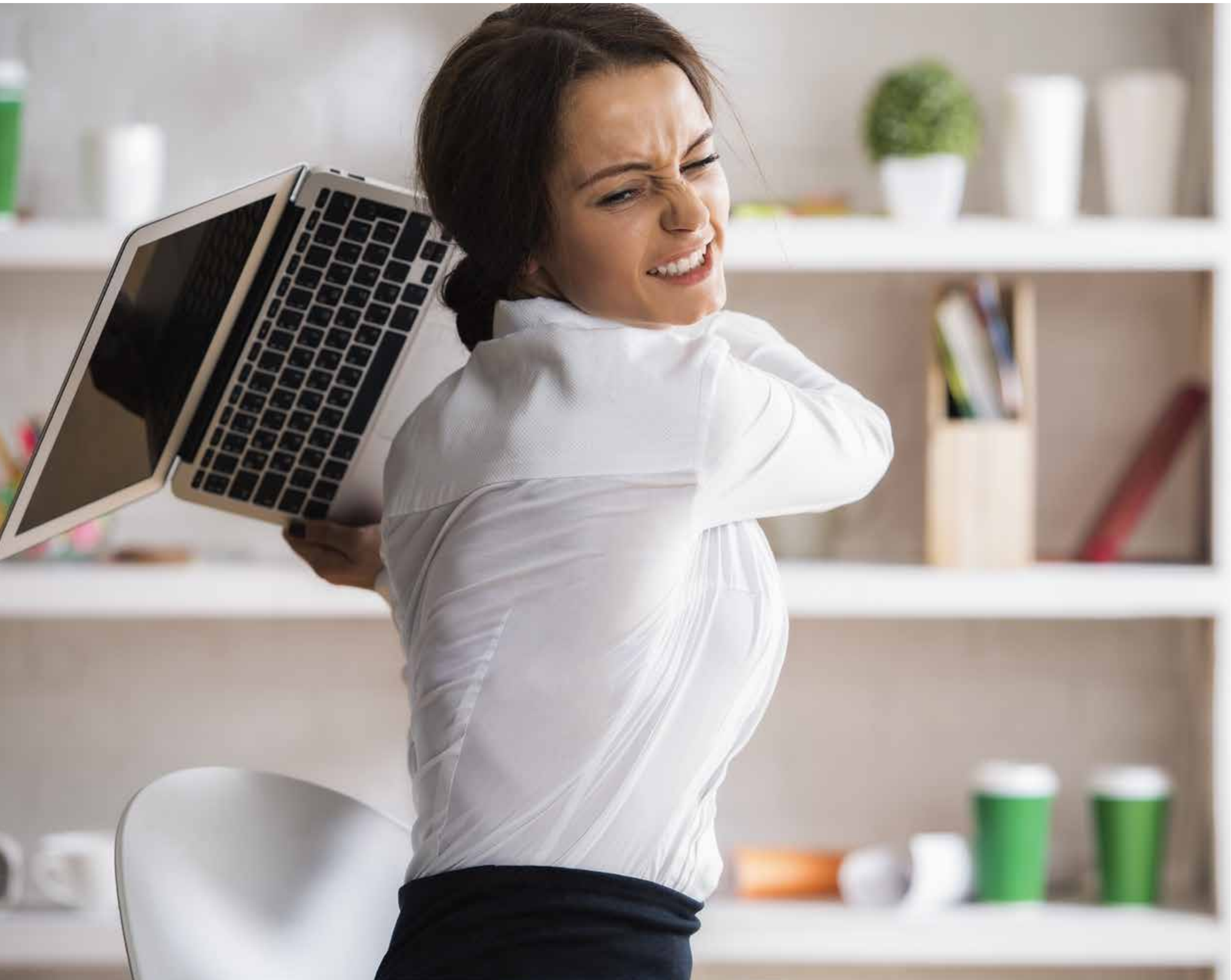
The threat assessment team needs to always remain aware of stressors on the workforce. Layoffs, mergers, increased or decreased workloads, new management, a sale of the company, or even new technology can create stress that may well set someone off. Be aware and be ready to discuss these issues with employees. If you need extra security, be ready to hire a security company.

Adopt a Written Zero-Tolerance Workplace Violence Policy and Enforce It

The threat assessment team, in conjunction with outside counsel if necessary, should carefully consider the types of workplace violence that the employer will not tolerate. Zero-tolerance does not mean that every person who runs afoul of the policy must be fired, but it does mean that every instance of workplace violence must be documented and investigated. As mentioned above, be sure to adopt a description of workplace violence that your company can and will consistently enforce. For example, if your company is not going to investigate every instance of verbal abuse by a member of management, think carefully about including language such as "verbal abuse including offensive, profane, and vulgar language."

Policy language should encourage reporting, should identify to whom reports should be made, and should make clear that no retaliation for reporting violations will be tolerated.

Once a written zero-tolerance workplace violence policy is in place, enforce it. Investigate complaints and be consistent about discipline. If someone threatens violence, assemble the threat assessment team, if there is time, to discuss whether to terminate the individual or place him or her on leave. Keep in mind that the more time that passes between the threat and the employer's response, the more questions can be raised about pretextual reasons for any decision that is made. Be decisive, but not hasty. The advice of counsel is generally recommended when termination is being considered.



WHEN INVESTIGATING VIOLATIONS OF A WORKPLACE VIOLENCE POLICY, BE MINDFUL NOT TO MAKE PUBLIC STATEMENTS THAT COULD BE CONSTRUED AS DEFAMATORY OR THAT PLACE AN EMPLOYEE IN A FALSE LIGHT. ALSO CONSIDER YOUR STATE'S PRIVACY LAWS.

One issue that may arise repeatedly is the effect of the Americans with Disabilities Act (ADA) on the ability to discipline or terminate employees under the policy. If the individual who violated the workplace violence policy is covered by the protections of the ADA, one question that may arise is whether the behavior for which he or she is being disciplined is caused by that disability. For example, if the person is blind and is being disciplined for threatening to kill a coworker, the behavior most likely is not caused by the disability. That person should receive whatever discipline any other employee would receive. On the other hand, if the employee has Tourette Syndrome and yells out threatening words to coworkers and customers, the question becomes whether the conduct at issue—verbally threatening coworkers or customers—is job-related and consistent with business necessity and whether other employees are held to the same standard.

The various subtleties of how courts have interpreted the ADA are beyond the scope of this article, but generally speaking, the Equal Employment Opportunity Commission has maintained that "certain conduct standards that exist in all workplaces and cover all types of jobs will always meet" the "job-related and consistent with business necessity" standard "such as prohibitions on violence, threats of violence, stealing, or destruction of property." There is also relatively consistent agreement among courts that workplace violence rules can be enforced without violating the ADA.

The question gets a bit trickier if the employee has not threatened violence but has violated the policy in another manner, such as swearing at someone in the workplace. Generally speaking, if the behavior interferes with the ability of the person or others to perform an important aspect of their job, discipline of some sort or an accommodation that helps keep the situation from reoccurring may be in order.

Keep in mind that it is much simpler for an employer to terminate an employee for violating a workplace violence policy than to rely on a direct threat theory available under the ADA. Again, the details of the direct threat theory go beyond the scope of this article, but suffice it to say that to prevail on a direct threat theory, the employer must conduct an individualized assessment of the employee's ability to safely perform the essential functions of the job. That assessment must be based on a reasonable medical judgment that relies on the most current medical knowledge and/or the best available objective evidence. Rather than engaging in a medical examination and relying on the experts necessary to establish a direct threat, it is simpler to adopt a zero-tolerance workplace violence policy and consistently enforce it.

When investigating violations of a workplace violence policy, be mindful not to make public statements that could be construed as defamatory or that place an employee in a false light. Also consider your state's privacy laws. If you are reviewing an employee's work email as part of an investigation, be sure that you have a policy in place that clearly informs the employee that he or she has no expectation of privacy in any email sent or received using the employer's email address, electronic equipment, or server. This will help avoid an intrusion-upon-seclusion claim.

Planning Tips

There are few policies an employer can adopt that are more useful than a workplace violence policy. Go forth. Be proactive. Get a plan in place before something happens, practice it, and keep all relevant information up to date. Your time and effort will help avoid lawsuits and multimillion dollar judgments, but more importantly, it may save lives. L

***Elizabeth Harlan** is a principal at Astrachan Gunst Thomas, P.C. in Baltimore, Maryland. Her practice includes advising creative businesses such as advertising agencies, computer software companies, cybersecurity companies, and architectural firms on employment matters. She also litigates cases in federal and state court.*

RESEARCH PATH: *Labor & Employment > Employment Policies > Safety and Health > Articles*

Clean & Renewable Energy Industry Practice Guide

Q&A with Scott Anthony, Eric Blanchard, and Matthew Gehl

COVINGTON & BURLING LLP

Scott Anthony

Eric Blanchard

Matthew Gehl

The clean and renewable energy industry focuses on alternative energy solutions to traditional fossil fuels, which currently dominate the supply of energy across the world. Unlike traditional fossil fuels, which are potentially finite in availability and can generate relatively high levels of pollution, clean and renewable energy sources generally do not face comparable availability concerns and can supply energy with a smaller footprint on the environment.

Please describe the clean & renewable energy industry and briefly discuss various types of companies and major players.

The major clean and renewable energy sources include biomass, solar, and wind power, among others.

Biomass

Biomass energy is organic material from which energy can be obtained and includes sources ranging from wood to waste-to-energy to landfill gas. This energy can be obtained both by burning the biomass directly (e.g., wood and manure) as well as converting the biomass to a different form of usable energy, such as ethanol, which can be added to gasoline to power automobiles. Major producers of biomass and biofuels include Green Plains Inc., an ethanol manufacturer who went public in 2007; BioAmber Inc., which sells a biologically produced, chemically identical replacement for petroleum-derived succinic acid, and which completed its initial public offering (IPO) in 2013; and FutureFuel Corp., a company that produces and sells biodiesel, a renewable energy fuel, and went public in London in 2007 before its later U.S. listing. Renewable Energy Group, Inc. is another major player, operating a network of 10 biomass-based diesel plants.

Solar

Solar energy is generated by converting sunlight into electricity. This occurs by a variety of mechanisms, including the use of photovoltaic panels or cells to convert sunlight into electricity and thermal collectors to gather heat from the sun. Solar energy is currently the most active segment of the clean and renewable energy industry, with companies such as Yingli Solar and Trina Solar focusing on the manufacture of solar panels. In addition, companies including SunPower, First Solar, SunRun, and SolarCity not only manufacture solar panels and systems, but also offer installation packages on a variety of levels spanning from utilities to residential. These companies may allow consumers to purchase a solar system outright, to lease a solar system, or to have a solar system installed and pay for the power produced.

Wind

Wind energy is typically generated by building wind turbines to harness and generate electricity. The energy harnessed by the turbine can be used either locally or as part of a larger wind farm that is connected directly to provide power to an electrical grid. More so than most sources of clean and renewable energy, the production of wind turbines requires a substantial initial capital outlay, thus leaning more heavily on the project finance markets than traditional equity or debt capital markets for capital raises. There are relatively few companies that are publicly listed on a major U.S. exchange that are purely focused on wind energy. General Electric is a major player in this space, and a handful of others trade over the counter, including Nordex, Siemens, and Vestas. Other participants include wind farm developers, many of which take the form of yieldcos (i.e., companies that seek to generate cash flows from a group of assets and then pay it back to investors as dividends), including Hannon Armstrong Sustainable Infrastructure, Pattern Energy Group, and Brookfield Renewable Energy Partners.

Investments

Clean and renewable energy companies focus on developing and commercializing one or more alternative forms of clean and/or renewable energy. As noted above, however, companies specializing in different types of clean or renewable energy may approach capital-raising differently. Companies developing biomass or, more recently, solar energy have tapped the U.S. equity capital markets to raise money. On the other hand, because of the substantial capital required at the outset, companies hoping to fund the construction of wind turbines or other types of production facilities have gravitated to the project finance space as a way to raise the necessary funds. In addition, earlier stage and/or private clean energy companies have had access to a growing pool of venture capital and seed funding. According to CB Insights, a data analyzing service, global investments in the clean energy financing market were $3.2 billion, $3.7 billion, and $3.8 billion for 2013, 2014, and 2015, respectively. Although a strong fourth quarter helped to stabilize investments for the year, funding in 2016 constituted a drop-off to this growth trend. Roughly half of this financing has come at the seed/angel stage, together with Series A through D financing rounds (discussed later under Startup Financing). Major financing rounds from 2016 have included $1 billion in Series A to WM Motors (Chinese electric vehicle), $120 million Series A to Chehejia (Chinese electric vehicle), $200 million to United Wind (U.S. wind), and $169 million to SITAC RE (Indian wind).

What are the relevant statutes and regulations governing securities offerings by clean & renewable energy companies?

Securities offerings are governed by a comprehensive set of laws and regulations that are applicable across industries. At the federal level, the two fundamental statutes that comprise the framework for securities regulation are the Securities Act of 1933, as amended (the Securities Act, 48 Stat. 74), and the Securities Exchange Act of 1934, as amended (the Exchange Act, 48 Stat. 881). Both statutes establish a disclosure-based regime designed to provide investors with enough information to make an informed decision about whether to purchase or sell a company's securities.

Securities Act

The Securities Act was designed to regulate the offer and sale of securities by (1) requiring companies to provide material financial and other information concerning the securities being offered for sale and (2) imposing liabilty for fraud, deceit, or other misrepresentation in the sale of securities. In order to achieve these two objectives, the Securities Act requires that every offer and sale of securities in the United States be registered with the Securities and Exchange Commission (SEC), unless an exemption from registration is available.

Registered Offerings

In general, offers may not be made until an issuer files a registration statement with the SEC. The registration statement, which includes a prospectus that must be delivered to investors, discloses certain qualitative and quantitative information about the issuer (including its business and financial operations) and the securities being offered for sale. Before a sale can be consummated, an issuer's registration statement must be declared effective by the SEC, typically following a review of the registration statement by the SEC staff, unless the issuer is a well-known seasoned issuer who qualifies to file an automatically effective registration statement.

The Securities Act imposes statutory liability for any material omissions or misstatements in the registration statement and prospectus, as well as any other documents furnished to a purchaser of securities under the Securities Act.

Private Placements

However, not all securities offerings must be registered with the SEC. There are various safe harbors and exemptions from registration that include, among others:

- Private offerings to a limited number of persons or institutions
- Offerings of limited size
- Offerings involving securities of municipal, state, and federal governments

The private placement exemption is widely relied on by issuers, with a number of safe harbors that help to facilitate capital raising. Among the most commonly utilized, Regulation D of the Securities Act contains safe harbors that allow issuers to raise up to $5 million (Rule 504 (17 C.F.R. § 230.504)), or an unlimited amount subject to limitations on the type of permitted investor (Rule 506 (17 C.F.R. § 230.506)). Rule 144A (17 C.F.R. § 230.144a) permits resales of certain qualified securities to sophisticated, large institutional investors and is frequently used for debt financing and offerings of other securities that are not listed on a national securities exchange. Regulation S (17 C.F.R. §§ 230.901–905) is a safe harbor utilized for offerings made exclusively outside of the United States.

Exchange Act

The Exchange Act was created to govern securities transactions on the secondary market and requires that companies with a security listed on a U.S. stock exchange, meeting certain asset amount and shareholder number requirements or making public offerings of securities in the United States, register such securities and file certain periodic and other reports with the SEC. These reports contain information similar to the information required in a registration statement under the Securities Act. In addition, the Exchange Act provides for the direct regulation of markets on which securities are sold (i.e., stock exchanges) and the participants in those markets.

A foreign clean and renewable energy company may qualify as a foreign private issuer (FPI) as defined in Rule 405 (17 C.F.R. § 230.405) under the Securities Act and Rule 3b-4 (17 C.F.R. § 240.3b-4) under the Exchange Act. A foreign company will qualify as an FPI if 50% or less of its outstanding voting securities are held by U.S. residents and none of the following three circumstances applies: (1) the majority of its executive officers or directors are U.S. citizens or residents, (2) more than 50% of its assets are located in the United States or (3) its business is administered principally in the United States. FPIs are entitled to reduced regulatory and reporting requirements under both the Securities Act and the Exchange Act.

Additional Statutes and Regulations

In addition to the Securities Act and the Exchange Act, there are several other federal statutes that regulate various aspects of public company conduct, market conduct, and securities offerings. These include:

- The Trust Indenture Act of 1939, which prohibits public offerings of debt securities unless there is an indenture that complies with the requirements of such act and provides for the appointment of a trustee to protect the rights of security-holders
- The Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley), which mandated a number of reforms to enhance financial disclosures and combat corporate and accounting fraud
- The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, which was designed to improve accountability and transparency in the financial system
- The Jumpstart Our Business Startups Act of 2012, which aimed to help businesses raise funds in the public capital markets by easing registration requirements for emerging growth companies (generally, companies with less than $1 billion during its most recent fiscal year)
  - Benefits afforded to emerging growth companies in the public offering process include, among others:
    - The ability to confidentially submit registration statements to the SEC for review
    - Two years of required audited financial statements rather than three
    - Significantly reduced executive compensation disclosure
    - Relief from certain Sarbanes-Oxley requirements
    - The ability to test the waters with investors before an offering

The SEC and the Financial Industry Regulatory Authority (FINRA) are the principal regulatory agencies that oversee the capital markets and capital formation activities in the United States. The national securities exchanges, such as the New York Stock Exchange (NYSE) and the NASDAQ Stock Market (NASDAQ), also perform oversight functions and impose a number of regulations that can impact capital raising.

In addition to the federal securities laws, each state has its own set of securities laws that are commonly referred to as blue sky laws. Securities offerings are subject to blue sky laws, although the National Securities Markets Improvement Act of 1996 has largely preempted many state securities laws.

What are other key laws and regulations that a securities lawyer working with a clean & renewable energy company needs to be aware of?

Lawyers working with clean and renewable energy companies should be aware of the major federal laws and regulations that govern the industry, including rules and regulations promulgated by the U.S. Energy Department and the Environmental Protection Agency (EPA). These laws and regulations provide for certain

quality and safety standards, in addition to regulating land use, the disposal of hazardous waste and materials used in the production of certain alternative energy sources, and the creation of certain tax and other incentive programs to promote the development and commercialization of clean and renewable energy. Applicable regulations include:

- The Biomass Research and Development Act of 2000
  - Part of the Agricultural Risk Protection Act of 2000, this act authorizes research to promote the conversion of biomass into bio-based industrial products. Under this act, the Biomass Research and Development Board and Technical Advisory Committee was created to coordinate with other federal programs and to promote the use of bio-based industrial products.
- The Farm Security and Rural Investment Act of 2002
  - This act was the first farm bill to contain an energy title and includes provisions that are designed to increase the federal government's purchase and use of bio-based products.
- The American Jobs Creation Act of 2004
  - This act includes the Volumetric Ethanol Excise Tax and serves as an incentive to the petroleum industry to blend ethanol into gasoline. It also helps to make ethanol more affordable for consumers.
- The Energy Policy Act of 2005
  - The Energy Policy Act of 2005 was the first major energy legislation passed since the Energy Policy Act of 1992 and includes a variety of incentives and programs to encourage the development and production of alternative fuels. For example, this act created the Renewable Fuels Standard, which requires that a certain amount of renewable fuels are blended with gasoline each year.
- The Energy Independence and Security Act of 2007
  - This act was designed to improve vehicle fuel economy and reduce U.S. dependence on oil. In addition, it increases the Renewable Fuels Standard created by the Energy Policy Act of 2005.
- The Food, Conservation and Energy Act of 2008
  - This act created the Biomass Crop Assistance Program, which is intended to encourage the production of feedstocks for cellulosic ethanol by providing multi-year contracts to growers of dedicated energy crops and creating incentives for the production, storage, and transportation of biomass and bioenergy facilities.

In addition to the foregoing list, internal and, more so, external counsel should track developing legislation and potential changes in regulations. Regulations affecting the clean energy sector are constantly evolving. New regulations are being considered and old regulations may be eliminated. In addition to tracking developments, companies should consider being involved in shaping the legislation through industry trade groups and other lobbying efforts. Tax credits, emissions standards, regulations regarding connecting to the power grid, and other matters are likely to be the subject of legislation. That provides industry the opportunity to influence the rules under which it will operate. There are plenty of organizations that allow smaller companies to participate in the process without spending significant amounts of precious capital.

What are the major regulatory trends affecting clean & renewable energy companies?

The new U.S. administration may inject regulatory uncertainty within the industry. Many clean and renewable energy companies are closely watching for how President Trump's administration will roll back or revise President Obama's clean power plan (CPP). In August 2015, President Obama and the EPA announced the CPP, which created the first-ever national standards to address carbon pollution from power plants. The plan established state-specific standards for carbon dioxide emissions from coal-burning power plants. While states were free to experiment with the means used to meet such standards, they were required to submit detailed emissions reduction plans. Almost immediately after the plan was finalized, opponents initiated challenges to it in court, arguing that the new policy exceeded the legislative authority granted in the 1990 Clean Air Act. While litigation is ongoing in the U.S. Court of Appeals for the District of Columbia Circuit, the new Trump administration is presenting a more direct path toward terminating the plan. Scott Pruitt, the new administration's head of the EPA, has publicly criticized the CPP on both policy and constitutional grounds. In addition, on March 27, 2017, Trump signed an executive order directing the EPA to review the CPP, which is widely expected to roll back the CPP. The Trump administration is also expected to roll back or revise other rules and regulations enacted during the Obama administration aimed at reducing carbon emissions.

Conversely, the Chinese national energy agency recently announced its intention to spend more than $360 billion on renewable energy through 2020. As U.S. government support for renewable energy initiatives declines, companies may want to consider additional disclosure relating to the potential resulting competitive disadvantages.

A recent development that may assist clean and renewable energy companies in their capital-raising efforts is the 2015 adoption of amendments to Regulation A (informally known as Regulation A+), which update and expand exemptions from SEC registration for issuances of securities of up to $50 million in a 12-month period. The clean and renewable energy industry has struggled to raise public equity capital in recent years due to political and regulatory uncertainty, a number of high-profile bankruptcies, and what is often a lengthy path to profitability. As such, the implementation of Regulation A+ provides another avenue for companies to raise much-needed equity capital without undergoing the lengthy process of SEC registration and becoming a public company.

Regulation A+ creates two tiers of exempt offerings. Tier 1, for offerings of up to $20 million in a 12-month period, and Tier 2, for offerings of up to $50 million in a 12-month period. Tier 1 issuers are subject to state blue sky registration and qualification requirements but are subject to minimal continuing reporting obligations. Tier 2 issuers are exempt from state blue sky registration and qualification requirements but are subject to ongoing periodic reporting requirements. The process involved in a Regulation A+ offering is fairly similar to a traditional public offering. For instance, issuers must still prepare and file an offering document with the SEC (Form 1-A), subject to SEC review and comment, including an offering circular used to market to investors. However, the reporting obligations for both the offering document and on an ongoing periodic basis are reduced compared to a traditional public offering.

More broadly, the SEC has emphasized creating more streamlined paths for smaller companies to raise capital. In addition to Regulation A+, the SEC has recently adopted Regulation Crowdfunding, which permits issuers to raise up to $1 million in a 12-month period, adopted amendments that update intrastate offering exemptions to create additional flexibility for companies to use web-based platforms, and amended Rule 504 of Regulation D to increase the aggregate offering limit in any 12-month period from $1 million to $5 million. These programs may assist clean and renewable energy companies to raise capital without relying on the traditional avenue of venture-capital-backed private financing rounds followed by a traditional IPO, which has become an increasingly challenging avenue of capital formation in the wake of Solyndra's collapse in 2011.

In addition, in recent years, clean and renewable energy companies have increasingly turned to creative, non-traditional ways of accessing the capital markets. For example, SolarCity has issued solar bonds to raise corporate debt for the company, but has done so by offering the bonds, backed by the company's solar panel systems, directly to retail investors in registered offerings. Many clean tech companies have also turned to state and local infrastructure finance agencies to fund clean tech projects now that most of the 2009 subsidies are gone. These agencies can create state clean energy funds to invest in clean energy, or even state green banks, which combine public and private sector funds to finance affordable and long-term loans to clean and renewable energy ventures. Green banks, or green investments banks, are public or quasi-public entities established specifically to facilitate private investment into clean energy infrastructure.

What are the major commercial trends affecting clean & renewable energy companies?

As discussed above, early stage and/or private clean energy companies have had access to a growing pool of venture capital and seed funding. In 2016, however, global funding for early stage private clean energy companies dropped off to a certain degree. Although a strong fourth quarter helped to stabilize investments for the year, funding in 2016 constituted a drop-off to the recent funding growth trend.

In addition, the number of exits by clean energy companies, which include IPOs and acquisitions, were also projected to drop in 2016. Although there have been approximately 30 clean energy-related IPOs since 2012, activity in this space has fallen off somewhat recently. After 127, 211, and 219 exits in 2013, 2014, and 2015, respectively, only 178 exits were projected for 2016 as of the third quarter, representing a decline of 20%.

Much of the weakness in 2016 resulted from the uncertain regulatory environment for clean energy companies as a result of challenges to President Obama's 2015 enactment of the CPP, which aimed to set limits on carbon dioxide pollution. The CPP was litigated, as discussed above, and in February 2016, the U.S. Supreme Court ordered a stay of the enforcement of the CPP until a formal judicial review could occur. In September 2016, the U.S. Court of Appeals for the District of Columbia Circuit heard arguments challenging the constitutionality of the CPP. No decision has yet been announced, creating a level of uncertainty for clean energy companies. In addition, on March 27, 2017, President Trump issued an executive order directing the EPA to review the CPP, which is widely expected to lead to rolling back or revising the CPP.

Funding by sector can be extremely variable by year. For example, in the aftermath of Solyndra's collapse in 2011, funding to solar companies fell by 50% from 2012 to 2013. In 2014, however, funding to solar companies rose again before dropping off in 2015. On the other hand, the wind sector has been a relatively stable growth sector, posting three consecutive years of growth from 2012 to 2015 and seeing funding increase tenfold over that timeframe. Funding to wind companies, particularly early-stage funding, continued at a steady pace in the early part of 2016.

What practice points can you give to lawyers working with clean & renewable energy companies in connection with capital raising activities?

Clean and renewable energy companies face the typical host of issues in connection with seeking and obtaining equity and debt financing from public and private sources. The following identifies and discusses a number of items that counsel should consider.

Regulated Nature of Business

The regulated nature of clean and renewable energy businesses often adds a layer of complexity to the due diligence process. Consequently, the time allotted for due diligence should be extended to match the level of familiarity of the investor with the particular clean and renewable energy segment. As an example, for a business that will be impacted by production tax credits (PTC), investors will want to be familiar with the current and expected status of the PTC. For companies that monetize Renewable Identification Number Credits or Solar Renewable Energy Credits, the status and operation of those markets will be important in addition to the core business of the company. Companies raising capital should be ready to educate potential investors on the regulatory environment as part of the due diligence process. Knowledge of the existing regulations is important, but so is an understanding of where the regulatory environment is likely to go in the future. Investors are investing in the current regulatory environment but will still be invested in the future if it changes and are likely to be more comfortable investing in a company that understands the current as well as the expected future environment. As companies develop past the initial stages, their technology advances, and the business model crystalizes, there is typically more due diligence on those matters. The complexity of the technology and business model will affect the speed at which investors get comfortable supporting the company, and any capital raising plan should plan for an appropriate length of time.

Companies should also understand whether there are likely to be any restrictions on foreign investment in their company. The Committee on Foreign Investment in the United States (CFIUS) oversees investments in U.S. assets that could affect national security. An investment from a non-U.S. party could be subject to review by CFIUS to the extent a company's technology connects to national, state, or local electricity grids; supplies the defense industry; or has government contracts, among other factors. While review itself is not fatal (the committee allows the vast majority of transactions to proceed), review will take time and so counsel should be alert to the issue and plan accordingly.

Internal Housekeeping

Companies typically raise money when they need it, so the timeline to close on any new funding matters. The typical process of business due diligence, technical due diligence, and legal confirmatory due diligence can be stalled at any point. Being prepared internally for the process can make the last part, the legal due diligence, go more smoothly. This entails collecting documents likely to be requested in a due diligence process, reviewing them, and organizing them. The internal team should be looking to identify the same items as would external counsel. Among other items, the process is designed to confirm the capitalization, confirm ownership of the intellectual property, identify any third-party consents, and identify any activities that might give rise to liability (e.g., indemnities to third parties, arrangements with distributors and agents operating internationally, exclusivity, rights of first negotiation, non-competition, and most favored customer arrangements). Internal counsel should also be prepared to address the status of any existing, pending, or threatened litigation or investigations.

Shareholder Approval

For both public and private companies, counsel must identify whether shareholder approval is required and obtain such approval and any other required third-party approvals early in the process. For a private company financing, a new series of preferred stock financing will typically require approval by the shareholders as a group, but also approval of individual series of investors. It is important to understand the required vote and the parties that will control or influence the vote. Early identification of the existence of investors with veto or blocking rights, by virtue of the number and type of shares held or contractual rights, will allow the internal team to ensure such investor is in favor of the financing and its terms. This can be important when the economic terms are not favorable to the company's prior investors (either because it is a down round or the new investor demanded preferential rights). In addition to required votes, many investors in private companies will have the right to participate in any new round of financing. While that may seem like a good problem (if current investors want to participate), it can be difficult if a new investor is demanding a fixed percentage of the company following its investment and additional investment by others would dilute that interest.

In-house counsel must have a good understanding of the various regulatory regimes that impact the company's business. Outside counsel can be relied upon for advice, but as the first line of inquiry from the internal client, internal counsel should have a broad overview and understanding of the various regulatory schemes within which the company operates. In addition to understanding the regulatory environment, understanding (to the extent possible) how other companies in the same market segment comply with their regulatory requirements can also be helpful. Sharing practices can allow in-house compliance and legal counsel to benefit from an additional thought process on how to deal with an issue or circumstance faced by the industry as a whole.

Accessing the Public Markets

Companies accessing capital from the public markets should prepare well in advance of when the capital will actually be needed. Companies may want to time the market to take advantage of interest rates, interest in particular industry sectors, or regulatory developments. Each time securities are offered, there is a due diligence process and a disclosure process. Compared to an IPO, the process in subsequent offerings is typically faster because it builds on what was previously done. However, for companies that expect to be in the market and their counsel, it is a good idea to maintain updated data room files in an organized fashion where new documents are easily identifiable. It is also a good idea to have established internal sign-off procedures to ensure material information is communicated to the deal teams and that representations and warranties can be provided to underwriters, lenders, and other relevant parties. Companies that are consistently in the market should create an internal team, create the appropriate processes and procedures, and keep materials organized so that the legal process does not interfere with the fundraising. It is also common for a company to use the same counsel for itself on each financing and to also designate underwriters' counsel. Using the same external teams will also reduce the transaction time and expense as the teams build up the institutional knowledge and are not starting from the beginning for each transaction.

***Scott A. Anthony** is a partner in Covington's Silicon Valley office. He advises public and private companies, investment funds, and entrepreneurs on mergers and acquisitions, venture capital investments, strategic investments, joint ventures, and other transactional matters. His clients include internet, social networking, online gaming, clean technology, software, networking and communications, semiconductor, energy storage, and life sciences companies.*

***Eric Blanchard** is a partner resident in the firm's New York office and is a Vice Chair of the Securities & Capital Markets practice group. Mr. Blanchard's practice focuses on domestic and international capital markets transactions, as well as governance, securities law reporting, and compliance. Mr. Blanchard has worked on securities offerings involving issuers from a variety of industries, from life sciences and technology to retail and consumer goods. In addition, Mr. Blanchard has represented both issuers and shareholders in proxy contests and shareholder activism matters.*

***Matthew Gehl** is special counsel in the firm's New York office and a member of the Corporate Practice Group. He practices corporate and securities law, with a focus on the representation of underwriters and issuers in equity and debt capital markets transactions. He also advises clients on disclosure and other securities laws issues, corporate governance matters, and other general corporate matters.*

RESEARCH PATH: Capital Markets & Corporate Governance > Industry Practice Guides > Clean & Renewable Energy > Practice Notes


Patrick Dolan and Ramy Ibrahim NORTON ROSE FULBRIGHT US LLP

Industry Insights: Aircraft Lease Securitizations

THE AIRCRAFT LEASE SECURITIZATION MARKET IS EVOLVING as evidenced by an increase in these transactions over the last few years. Indications are that 2017 may surpass 2016 in total number of aircraft lease securitizations. Three potentially significant issues for the aircraft lease securitization market during 2017 and in 2018 are (1) the applicability of the U.S. risk retention rule (Risk Retention Rule; see 79 FR 77602) to aircraft lease securitizations, (2) the U.S. Commodity Futures Trading Commission's rules regarding margin requirements for uncleared swaps, and (3) compliance with the Volcker Rule.

This article explains the structure of aircraft lease securitizations and certain bankruptcy and rating agency issues that must be considered in structuring these transactions, the benefits of using the debt capital markets for aviation financing, and the issues for the aircraft lease securitization market during 2017 and in 2018.

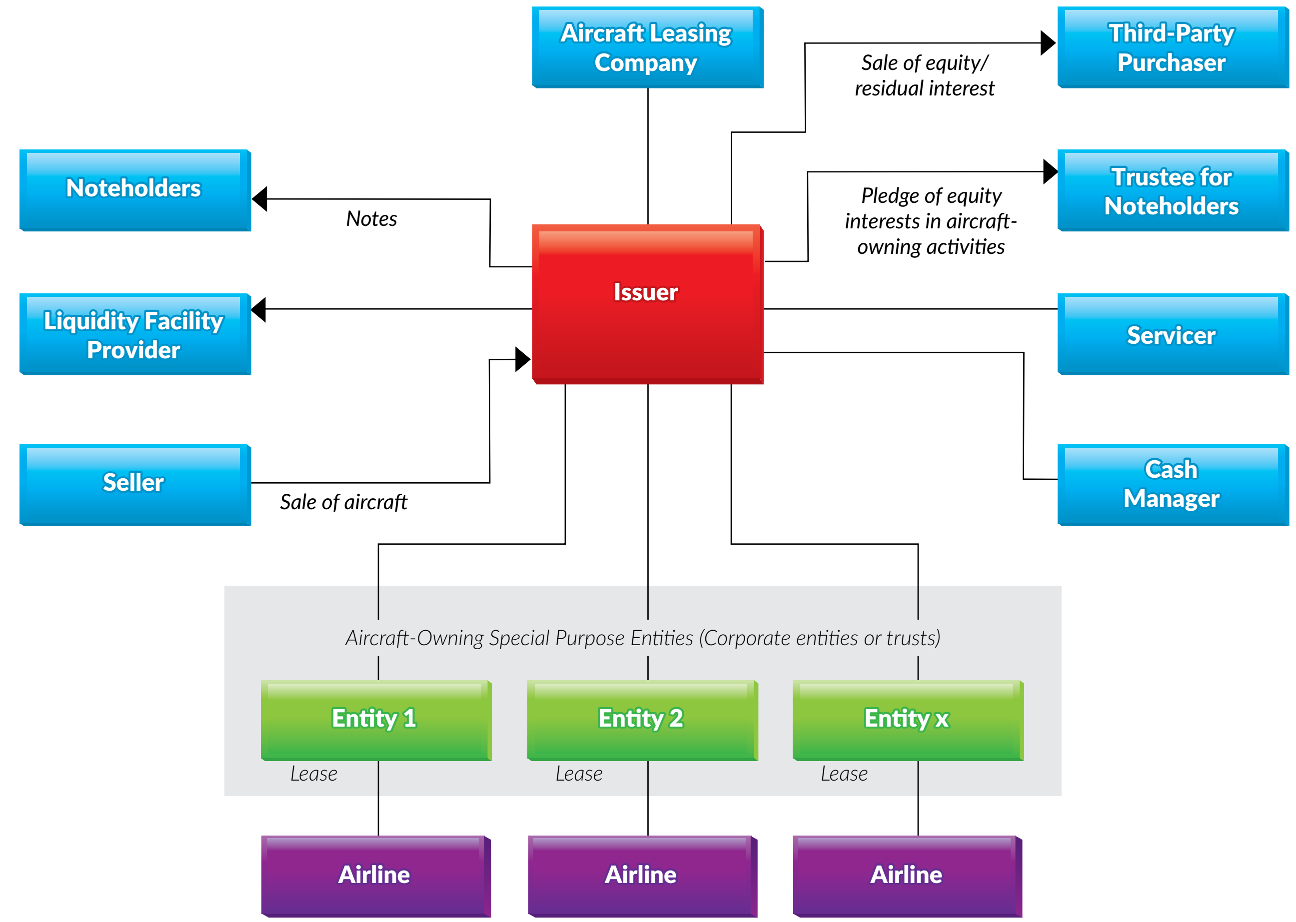
Introduction

Aircraft lease securitizations generally come in two types: aircraft lease portfolio securitizations and enhanced equipment trust certificate (EETC) securitizations.

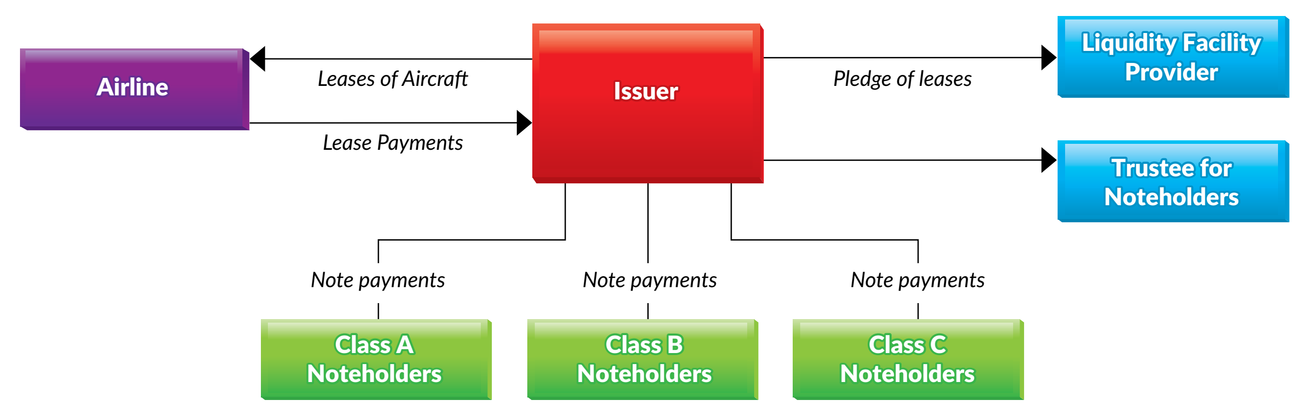
- **Asset-backed aircraft lease securitizations.** In the typical aircraft lease portfolio securitization, the issuing special purpose subsidiary of the sponsor, which is a newly formed bankruptcy-remote entity, owns the equity in various special purpose entities (SPEs), each of which owns an airplane that is leased to an airline. Normally, the lessees or airlines are located in the United States and around the world. Thus, unlike an EETC aircraft lease securitization (discussed below), the aircraft lease portfolio securitizations rely in part on diversification of credit risk. Similarly, re-marketing or re-leasing of aircraft plays a bigger role in aircraft lease portfolio securitizations, so the quality of the servicer is more important.
- **EETC aircraft lease securitizations.** In the typical EETC aircraft lease securitization, the issuing entity (issuer-lessor), which is a newly formed, bankruptcy-remote SPE and a subsidiary of the sponsor airline, owns a portfolio of aircraft and leases the aircraft to the sponsor airline. As a result, the transaction looks more like a corporate bond offering by the sponsor airline, but the sponsor airline is able to obtain a better rating on the EETCs than it could on its corporate bonds because of the securitization features.

Transaction Structure

The diagram below shows the structure of a typical aircraft lease portfolio securitization:



The diagram below shows the structure of a typical EETC aircraft lease securitization:



Key Features of the Transaction Structures

In both aircraft lease portfolio securitizations and EETC aircraft lease securitizations, there is a liquidity facility provided by a highly rated bank to ensure the payment of interest during an aircraft remarketing period (up to 18 months) following a default by an airline lessee. In EETC aircraft lease securitizations involving U.S. airlines, the lessor would typically rely on Section 1110 of the U.S. Bankruptcy Code, 11 U.S.C. § 1110, to repossess an aircraft from a bankrupt lessee. Section 1110 permits a lessor to repossess an aircraft if the bankrupt lessee does not elect to assume the lease and cure all defaults within 60 days of the bankruptcy filing.

In both types of securitizations, the lessor will typically grant possessory and security rights to a security or indenture trustee, which will represent and act on behalf of the noteholders. Following a default, the trustee will have the ability to enforce legal and contractual remedies against such rights in accordance with the relevant law and security agreement. The types of rights pledged to the trustee often include:

- Lessor rights under the lease, to receive rental payments directly and perform other acts reserved for the lessor
- Ownership rights in the aircraft, to enforce a deregistration power of attorney to take possession of and re-market or re-lease the aircraft
- Rights to any proceeds from the aircraft's insurance policy, to collect such proceeds and distribute to the noteholders in an event of loss –and–
- Membership rights in the lessor itself, to take control of the lessor and act in its stead

This trustee arrangement allows for trustee companies experienced in aircraft lease securitizations to centralize the decision-making process for several noteholders and to protect the rights and interests of those noteholders without requiring them to develop industry expertise.

In an EETC aircraft lease securitization or an aircraft lease portfolio securitization involving the bankruptcy of a foreign airline, Section 1110 of the U.S. Bankruptcy Code would not be available. Instead, the lessor would have to rely on the 2001 Cape Town Convention and its Aircraft Equipment Protocol (collectively, the Cape Town Convention) discussed later under Insolvency Issues. Finally, prior to the 2008 credit crisis, monoline insurance companies often provided bond insurance for bonds issued in aircraft lease securitizations. Since the credit crisis, however, aircraft lease securitizations no longer have this feature but rather rely on, among other things, over-collateralization.

The sponsor or an affiliate of the sponsor is normally the servicer in an aircraft lease securitization. In an aircraft lease portfolio securitization, it is not unusual to have two issuers of the bonds, a Delaware issuer and a Cayman Island issuer, and local law mortgages are not filed against the aircraft. Aircraft lease securitizations also often have many of the following features:

- A maintenance reserve account that is funded at closing and replenished during the course of the transaction
- Performance triggers such as aircraft utilization rate, loan-to-value ratio, and debt service coverage ratio (a default of either could result in a cash sweep and/or a cash trap)
- A feature that permits the sponsor to sell a limited percentage (e.g., 10%) of the portfolio at purchase prices below the allocable debt amount for such sold aircraft
- Concentration limits on, among other things, aircraft model, engine model, and jurisdiction of lessees
- A provision allowing for substitution of aircraft subject to certain conditions, for example:
  - No event of default or rapid amortization event has occurred.
  - The substitution occurs prior to specified anniversary of the closing date (e.g., the seventh anniversary).
  - The substitution will not result in a concentration test default.
  - The additional aircraft has a value at least equal to the disposed aircraft.
  - The value of all additional aircraft does not exceed a specified percentage of the initial value of the portfolio at closing.
- A provision requiring each lease to meet certain criteria (e.g., minimum term, lessees' credit rating, etc.)
- A provision requiring the issuer to enter into an interest-rate-protecting hedging agreement shortly after the funds are drawn
- A provision allowing the issuer to use a portion of the lease security deposits for working capital subject to certain conditions

While in theory it is possible to have an EETC aircraft lease securitization involving a non-U.S. airline as the sponsor, these transactions are not common. A feature found in recent aircraft lease portfolio securitizations is the sale of the residual or equity interest in the transaction to third-party investors. Previously, this interest was retained by the sponsor.

Insolvency Issues

As noted above, in an aircraft lease portfolio securitization most of the lessees are airlines located outside the United States and Section 1110 of the U.S. Bankruptcy Code is not available to the issuer in the securitization. The Cape Town Convention permits countries to select one of two options for dealing with airlines in bankruptcy:

- **Alternative A.** Alternative A provides that upon the occurrence of an insolvency-related event, the bankrupt debtor must give possession of an aircraft to the related creditor no later than the earlier of (1) the end of the "waiting period" and (2) the date on which the creditor would be entitled to possession of the aircraft if the Cape Town Convention did not apply. The waiting period is defined in the Cape Town Convention as the period specified in a declaration of the ratifying state/jurisdiction, which is the primary insolvency jurisdiction. States interested in achieving efficient pricing for financings and securitizations of aircraft have typically adopted a waiting period of 60 days (some states, like Brazil, have adopted a shorter period of 30 days).
- **Alternative B.** Alternative B has no outside time limit for the bankrupt airline to decide whether to assume or reject an airplane lease.

In non-Cape Town Convention countries, investors must determine whether there are protections in the jurisdiction of the lessee for creditors in an airline bankruptcy similar to those contained in Section 1110 of the U.S. Bankruptcy Code.

Rating Agency Considerations

Some of the factors that a rating agency will consider in rating an aircraft lease securitization include:

- Lessee credit quality
- Country risk
- Lessee concentration
- Country concentration
- The age of the aircraft and the mix of narrow-body planes versus wide-body planes in the portfolio (wide-body planes are generally more difficult to re-market)
- The initial leases' remaining lease terms
- Whether the transaction has performance triggers (e.g., aircraft utilization rate, debt service coverage ratio, etc.) and a liquidity facility to cover interest payments during the re-marketing/re-leasing of planes.

The rating agencies will typically require satisfactory appraisals of the aircraft prior to closing and may also require a maintenance appraisal showing projected maintenance expenses for the aircraft portfolio being securitized

The rating agencies will also consider the following factors:

- The loan-to-value ratio of the rated classes of bonds
- Whether the models of aircraft in the transaction are still in production
- The servicer's capabilities for servicing the aircraft (i.e., aircraft sales, re-leasing / re-marketing of aircraft, etc.)
- Whether the lessees are domiciled in highly-rated countries
- Whether the maintenance reserve has a forward-looking feature
- Whether any aircraft in the portfolio is owned by an existing entity as opposed to a newly-formed bankruptcy remote special purpose entity (the concern being whether there are any existing liabilities)

Benefits of Using the Debt Capital Markets in Aviation Finance

There are several benefits to sponsors in accessing the U.S. debt capital markets by means of an EETC aircraft lease securitization or aircraft portfolio lease securitization. First, the capital markets should generally be able to provide cheaper financing than the bank financing market and accommodate larger transactions. By using securitization structures, non-investment grade airlines or aircraft lessors are able to issue investment grade debt. Also, by accessing the capital markets, the sponsor airlines or aircraft lessors are able to gain exposure to new lenders and investors. Finally, the negative covenants in an aircraft securitization are generally less restrictive than those in a typical bank financing. This is in part because in a Rule 144A offering, which is how most aircraft securitizations access the U.S. capital markets, investors normally hold their securities in uncertificated form through the Depository Trust Company, and this makes it difficult to obtain an amendment or waiver of the transaction documents after closing so the covenants have to be drafted so as to allow for flexibility.

Risk Retention Rule

The Risk Retention Rule requires that the sponsor of any securitization transaction retain an economic interest in the credit risk of the securitized assets. The sponsor is the party that initiates a securitization transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity. A securitization transaction is a transaction involving the offer and sale of asset-backed securities (defined below in Defined Terms) by an issuing entity. The sponsor of a securitization transaction must retain an eligible vertical interest or eligible horizontal residual interest, or any combination thereof as follows:

1. If the sponsor retains only an eligible vertical interest, the sponsor must retain an eligible vertical interest of not less than 5%.
2. If the sponsor retains only an eligible horizontal residual interest, the amount of the interest must equal at least 5% of the fair value of all asset-backed security interests (defined below in Defined Terms) in the issuing entity issued as part of the securitization transaction, determined using a fair value measurement framework under U.S. generally accepted accounting principles.
3. If the sponsor retains both an eligible vertical interest and an eligible horizontal residual interest as its required risk retention, the fair value of the eligible horizontal residual interest and the eligible vertical interest must be at least 5%.

The percentage of the eligible vertical interest, the eligible horizontal residual interest, or combination thereof retained by the sponsor must be determined as of the closing date of the securitization transaction. In lieu of retaining all or any part of an eligible horizontal residual interest, the sponsor may, at closing of the securitization transaction, cause to be established and funded in cash, an eligible horizontal cash reserve account in the amount equal to the fair value of such eligible horizontal residual interest or part thereof, subject to certain specified conditions. The Risk Retention Rule contains specific provisions for alternative modes of risk retention for certain asset types (e.g., commercial mortgage-backed securitizations, credit card securitizations, asset-backed commercial paper, etc.).

Defined Terms

"Asset-backed security" is defined by incorporation of the definition of asset-backed security in the U.S. Securities and Exchange Act of 1934 (Exchange Act) and reads in relevant part as follows:

> a fixed-income or other security collateralized by any type of **self-liquidating** financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that **depend primarily** on cash flow from the asset . . . [emphasis added]. See 15 U.S.C. § 78c(a)(79).

"Asset-backed security interest" is defined in the Risk Retention Rule, in relevant part, as:

> [a]ny type of interest or obligation issued by an issuing entity, whether or not in certificated form, including a security, obligation, beneficial interest, or residual interest . . . payments on which are primarily dependent on the cash flows of the collateral owned or held by the issuing entity....

Related Content

For more information about offerings of investment grade asset-backed securities, see

> LEARNING THE BASIC LEGAL FRAMEWORK OF A SECURITIZATION TRANSACTION

RESEARCH PATH: *Finance > Structured Finance and Securitization > Securitization > Practice Notes*

For a primer on securitization, see

> INTRODUCTION TO SECURITIZATION

RESEARCH PATH: *Finance > Structured Finance and Securitization > Securitization > Practice Notes*

For a discussion on the roles that transaction parties play in packaging and servicing the underlying financial assets supporting asset-backed securities, see

> UNDERSTANDING THE MAJOR PARTIES AND DOCUMENTS IN A SECURITIZATION TRANSACTION

RESEARCH PATH: *Finance > Structured Finance and Securitization > Securitization > Practice Notes*

For guidance on the requirements that an issuer of a securitization transaction must meet in order to achieve bankruptcy remoteness, see

> ACHIEVING BANKRUPTCY REMOTENESS IN SECURITIZATIONS

RESEARCH PATH: *Finance > Structured Finance and Securitization > Securitization > Practice Notes*

For more information on margin requirements for uncleared swaps, see

> MARGIN REQUIREMENTS FOR SWAPS AND SECURITY-BASED SWAPS

RESEARCH PATH: *Finance > Financial Derivatives > Understanding Financial Derivatives > Practice Notes*

Additional questions regarding risk retention requirements are included in the full practice note in Lexis Practice Advisor.

Majority-Owned Affiliates

In the event the Risk Retention Rule does apply to a transaction, it provides that the required 5% retained interest may be held by a "majority-owned affiliate" (MOA) of the sponsor. A MOA of a person is an entity (other than the issuing entity) that directly or indirectly majority controls, is majority controlled by, or is under common majority control with, such person.

"Majority control" is defined to mean ownership of more than 50% of the equity of an entity, or ownership of any other controlling financial interest in the entity, as determined under generally accepted accounting principles.

The securitization industry appears to have settled on an 80-20 rule for MOAs that hold a vertical risk retention interest: up to 80% of the economic interest in the MOA may be sold to third parties so long as the sponsor retains 20% of the economic interest in and a majority of the voting control of the MOA. Apparently, at least one of the leading U.S. accounting firms is in agreement with this approach. The MOA-vertical retained interest approach is used in the collateralized loan obligation sector, but apparently has not been used in other sectors of the securitization market, although there is no reason why it cannot be used in other sectors. This 80-20 approach has apparently not been used in the context of an MOA holding an eligible horizontal residual interest. It is worth noting that the staff of the Securities and Exchange Commission (SEC) has suggested, in informal conversations, that the farther one moves away from the sponsor holding a majority economic interest in the MOA, the more one needs to be cognizant of the anti-hedging provisions in Section 12(b) of the Risk Retention Rule.

Full recourse financing of the risk retention interest by a sponsor or an MOA is permitted under the Risk Retention Rule. There is a question, however, as to what full recourse financing means. For example, if the MOA has no assets other than the retained interest, then the full recourse financing requirement probably is not satisfied. Rather, the MOA would have to pledge other assets or obtain a parent guaranty. However, one can make the case that in the context of a vertical retained interest (i.e., 5% of each class), 5% of the most senior class of classes will likely constitute most of the retained interest and in that situation, the parent guaranty could be limited (e.g., 5%).

Sukuk Tranches

Saudi Arabia recently decided to comply with the Risk Retention Rule in a sukuk bond offering of about $10 billion. This was apparently the first time a sukuk bond offering had complied with the Risk Retention Rule. In the offering memorandum, Saudi Arabia disclosed that it did not intend for its sukuk offering to be a securitization but as a precaution, it decided to comply with the Risk Retention Rule and retain a 5% eligible vertical interest. To comply with Shari'a law, the transaction used a murabaha or commodities purchase agreement involving a deferred purchase price structure where the deferred purchase price payments match the payments due on the related bonds offered to investors. The lawyers for Saudi Arabia apparently spoke to the SEC staff about the applicability of the Risk Retention Rule to the transaction. The staff may not have agreed that the murabaha or commodities purchase structure used in the transaction to comply with Shari'a law was not a self-liquidating financial asset.

The possibility of a sukuk tranche in an aircraft lease securitization also raises potential Risk Retention Rule issues. There are generally four common structures used in sukuk bond offerings (and there are variations of each of these structures) in order to make the transaction compliant with Shari'a law. The structure that poses the most challenges for purposes of the Risk Retention Rule involves the use of a commodities purchase arrangement involving deferred purchase price payments, or a murabaha structure, where the deferred purchase payments match the payments due on the related aircraft securitization bonds. While the structure is used to make the transaction compliant with Shari'a law, it is possible to view the deferred purchase price arrangement or a murabaha structure as a self-liquidating financial asset for purposes of the definition of asset-backed security under the Risk Retention Rule. A strong counterargument is that in a murabaha structure, there is no third-party credit risk being transferred. This is, however, a policy argument rather than an argument based on the text of the Risk Retention Rule.

Another argument for the proposition that the Risk Retention Rule should not apply to sukuk offerings is based on an SEC staff compliance and disclosure phone interpretation issued September 6, 2016, regarding funding agreement-backed notes (see SEC Staff Compliance & Disclosure Interpretation (CD&I) Section 301, September 6, 2016). The phone interpretation involved the following facts:

- An insurance company creates a special purpose vehicle to issue a single series of notes.
- The insurance company enters into a funding agreement with the special purpose vehicle.
- Principal and interest payments on the notes consist exclusively of cash flows from the funding agreement.
- The funding agreement is an insurance product and the direct liability of the insurance company.
- Payments on the funding agreement are backed by the general account of the insurance company.
- The terms of the notes exactly match the terms of the underlying funding agreement.
- There are no other credit enhancements for the notes and only a nominal residual interest in the special purpose vehicle is created for purposes of complying with formation requirements of local law.
- Only one series of notes is created with the backing of a particular funding agreement.
- While the special purpose vehicle may issue multiple series of notes, each series will be backed by one distinct funding agreement.
- Amounts paid by the insurance company to the special purpose vehicle under the funding agreement are used solely for making payments due under the notes.
- Any fees and expenses payable by the special purpose vehicle are reimbursed through a separate agreement with the insurance company.

The question presented to the staff was whether such funding agreement-backed notes would be an asset-backed security as defined in 15 U.S.C. § 78c(a)(79). The staff responded that they would not because they did not consider the funding agreement to be a separate financial asset servicing payments on the notes. Rather, an assessment of the cash flows servicing the payments on the notes requires looking through the funding agreement to the general account of the insurance company because (1) the structure of the funding agreement-backed notes is meant to replicate payments made by the insurance company under the funding agreement, (2) the funding agreement is a direct liability of the insurance company, and (3) payments on the funding agreement-backed notes are based solely on the ability of the insurance company to make payments on the funding agreement. Some have argued that the foregoing SEC staff phone interpretation provides a basis for arguing certain sukuk structures should not be subject to the Risk Retention Rule. It should be noted that SEC staff phone interpretations are not binding and therefore do not have precedential value.

Potential Remedies

It is not clear what remedies the U.S. government or private parties may pursue for violations of the Risk Retention Rule since the rule does not address this issue. The applicable U.S. governmental agencies charged with jointly administering the rule (the U.S. Office of the Comptroller of the Currency (OCC), the U.S. Federal Reserve System, the U.S. Federal Deposit Insurance Corporation (FDIC), and the SEC), however, will have the power to seek and impose penalties against sponsors who violate the Risk Retention Rule. The rule provides that the rule and any related regulations shall be enforced by the appropriate federal banking agency, with respect to any securitizer that is an insured depository institution, and the SEC with respect to any securitizer that is not an insured depository institution. Private rights of action for violations of the rule could include disclosure-based litigation claims against issuers and underwriters and rescission claims by investors.

The stakes for noncompliance with the Risk Retention Rule are potentially significant.

Margin Requirements for Uncleared Swaps

Another potential issue facing the aircraft lease securitization market is the Commodity Futures Trading Commission (CFTC) swaps margin requirements for uncleared swaps that went into effect on March 1, 2017. Pursuant to the Commodity Exchange Act, the CFTC is required to promulgate margin requirements for uncleared swaps applicable to each swaps dealer for which there is no prudential regulator (i.e., the swaps dealer is not regulated by the Board of Governors of the Federal Reserve System, the OCC, the FDIC, the Farm Credit Administration, or the Federal Housing Finance Agency)[1]. The CFTC published final margin requirements for swaps dealers in January 2016. As part of the final margin requirements, the CFTC issued Regulation 23.153, which requires swaps dealers to collect and post variation margin with each counterparty that is a swaps dealer, major swap participant, or a financial end user. On February 13, 2017, the CFTC extended the compliance date for variation margin requirements from March 1, 2017 to September 1, 2017.

An aircraft lease securitization warehouse facility where the borrower is an SPE that purchases receivables, loans, or leases with borrowings under the warehouse facility may not be able to find an exclusion from the definition of financial end user in the margin rule. Clause (xi) of the definition of "financial end user" is very broad.

Consequently, an SPE borrower in an aircraft lease warehouse facility would appear to be required to post margin for an interest rate hedge. This is not practical since the SPE borrower is unlikely to have the ability to post such margin. The same issue applies to aircraft lease securitizations that employ a swap in the transaction.

One possible solution for the SPE borrower is to enter into an interest rate cap, but caps can be expensive. Another possible solution is to obtain a liquidity facility to cover margin requirements, but that may raise bankruptcy true sale issues if there is recourse to the originator under the liquidity facility.

Another possible approach is the treasury affiliate exemption. This exemption is available if the SPE borrower forms a subsidiary whose sole purpose would be to enter into the swap, which would be guaranteed by the parent SPE borrower. This approach is based in part on a CFTC no-action letter dealing with the treasury exemption in the context of the clearing rules. This no-action letter predates the uncleared swap margin rules, but there is language in the CFTC final swap margin rules

1. See CFTC Letter No. 17-11, February 13, 2017.

that supports extension of the no-action letter to the margin rules. One caveat to this approach is that the parent of the treasury affiliate cannot be majority owned by a “private fund” (a company that would be an investment company but for Sections 3(c)(1) or 3(c)(7) of the Investment Company Act).

Volcker Rule

The Volcker Rule is the rule that implements Section 619 of the Bank Holding Company Act that was added by the Dodd-Frank Consumer Protection Act. An SPE issuer in an aircraft lease securitization will generally be deemed to be a “covered fund” under the Volcker Rule unless it can rely on an exemption from the Investment Company Act of 1940, other than Sections 3(c)(1) or 3(c)(7). A covered fund is subject to numerous requirements under the Volcker Rule and securitizations are normally structured so as to avoid relying on those two exemptions.

The good news for the aircraft lease securitization market is that the OCC recently published a Request for Comment (RFC) asking for industry input as to how the Volcker Rule can be improved. The questions in the RFC fall into four categories:

- The scope of entities subject to the Volcker Rule
- The proprietary trading prohibition
- The covered funds prohibition
- The compliance program and the metrics reporting requirements

The questions in the RFC suggest that the OCC is likely to push for significant modifications to the Volcker Rule. While the Volcker Rule cannot be modified by the OCC alone but must include the consent of the other agencies who originally issued the Volcker Rule, the RFC suggests that there may be some relief in the future for SPE issuers in aircraft lease securitizations.

Conclusion

Some issues that have come up in recent transactions include the following:

- Does it make sense for aircraft leasing companies (as opposed to airlines) to enter into EETC lease securitizations?
- In connection with the sale of equity/residual interests to third parties, are the interests of the seller/servicer aligned with those of the equity purchasers and how are the equity interests made more liquid?
- What are the advantages and disadvantages of Rule 144A offerings of bonds versus term loan transactions?
- Is the E.U. risk retention rule applicable to aircraft lease securitizations?
- In connection with aircraft lease securitizations that contain C-tranches, how far down the capital stack should C-tranches go and are C-tranches mitigated by their short weighted average life?
- How should collections be allocated between bonds and equity, and specifically what is the impact of the concept of excess proceeds, which provides that revenue that is not typical basic rent or maintenance reserves and which could result in the reduction of the value of the aircraft (e.g., end of lease payments, payments in lieu of maintenance, green-time lease rentals, finance lease rentals, etc.), get split between bonds and equity pro rata based on the then loan-to-value ratio?
- What is the impact on aircraft lease securitization deal structures of the addition of turbo prop planes, older planes, and engines?
- What is the impact of the recent bankruptcies of Air Berlin, Alitalia, VIM, and Monarch Airlines on transaction structures?
- Regarding the Cape Town Convention, how do investors value the Cape Town Convention and how much help does the Cape Town Convention provide in the repossession of the aircraft?

The aircraft lease securitization market is an evolving one and the transaction structure issues continue to be interesting.

__Patrick D. Dolan__ is a partner with Norton Rose Fulbright. He focuses his practice on asset-backed and mortgage-backed securitizations, including those involving innovative structures. Patrick has more than 30 years of experience representing warehouse lenders, issuers, underwriters, investors, and multi-seller commercial paper conduits. Patrick has worked on financings and securitizations of various asset types. Patrick chairs the New York City Bar Association's Structured Finance Committee. __Ramy Ibrahim__ is an associate in Norton Rose Fulbright's New York office. He focuses his practice on finance and M&A, helping clients in the financial institutions, technology, energy, transportation, and innovation industries. His background includes corporate finance, private and public mergers and acquisitions work, and equipment finance.

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Tyler B. Dempsey TROUTMAN SANDERS LLP

TYLER DEMPSEY IS A PARTNER AT Troutman Sanders LLP, Atlanta, Georgia. With over 12 years of experience, he focuses his practice on mergers and acquisitions for both public and private companies, and his clients include Domtar Corporation; Swank, Inc.; Mangrove Equity Partners, L.P.; and PRGX Global, Inc.

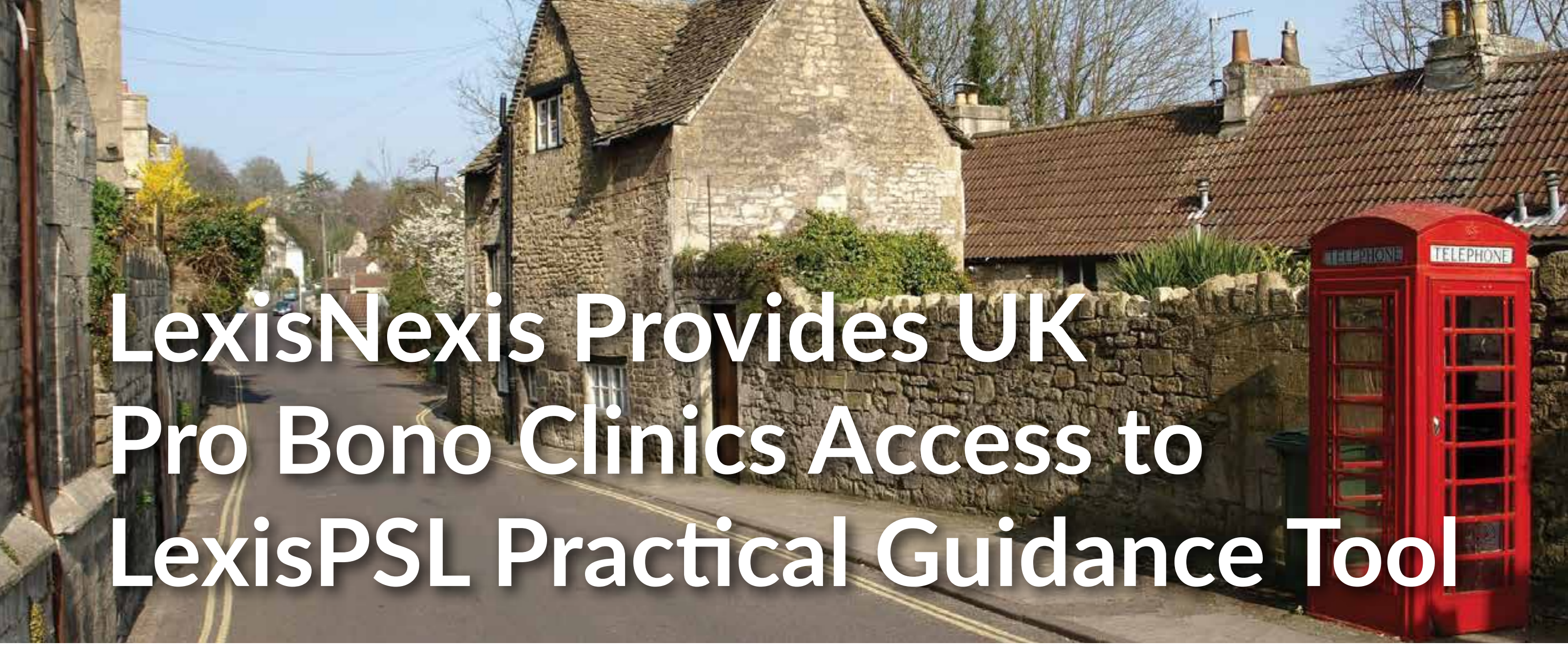
Tyler has significant experience with private equity financings and joint venture transactions, as well as experience representing payment processing companies in general corporate and commercial matters. He was selected as a Rising Star in Mergers & Acquisitions by Law & Politics and Atlanta Magazine and named to Georgia Trend magazine’s Legal Elite in Business Law. Tyler received his J.D. with honors from the University of North Carolina, where he was a member of the North Carolina Law Review.

Tyler serves on the board of directors for CURE Childhood Cancer and on the finance committee for The Center for the Visually Impaired.

Lawrence Weinstein THE CHILDREN'S PLACE, INC.

LAWRENCE WEINSTEIN IS CORPORATE counsel at The Children’s Place, Inc. The Children’s Place is the largest pure-play children’s specialty apparel retailer in North America. The company designs, contracts to manufacture, sells, and licenses to sell fashionable, high-quality merchandise at value prices, primarily under the proprietary “The Children’s Place,” “Place,” and “Baby Place” brand names. As of July 29, 2017, the company operated 1,026 stores in the United States, Canada, and Puerto Rico, an online store at www.childrensplace.com, and had 161 international points of distribution open and operated by its seven franchise partners in 19 countries. Prior to joining The Children’s Place, Lawrence was in private practice, where he counseled clients on a wide range of intellectual property–related transactions and trademark law matters.

Lawrence received his J.D. from the University of Pennsylvania Law School. He is licensed to practice in New York and New Jersey.



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