The PRACTICAL GUIDANCE Journal

IMPLICATIONS OF USING ChatGPT IN THE WORKPLACE

Risk of Crypto-Assets and Impact on Bank Failures

Contracting by Emoji

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Second Edition 2023

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SECOND EDITION 2023
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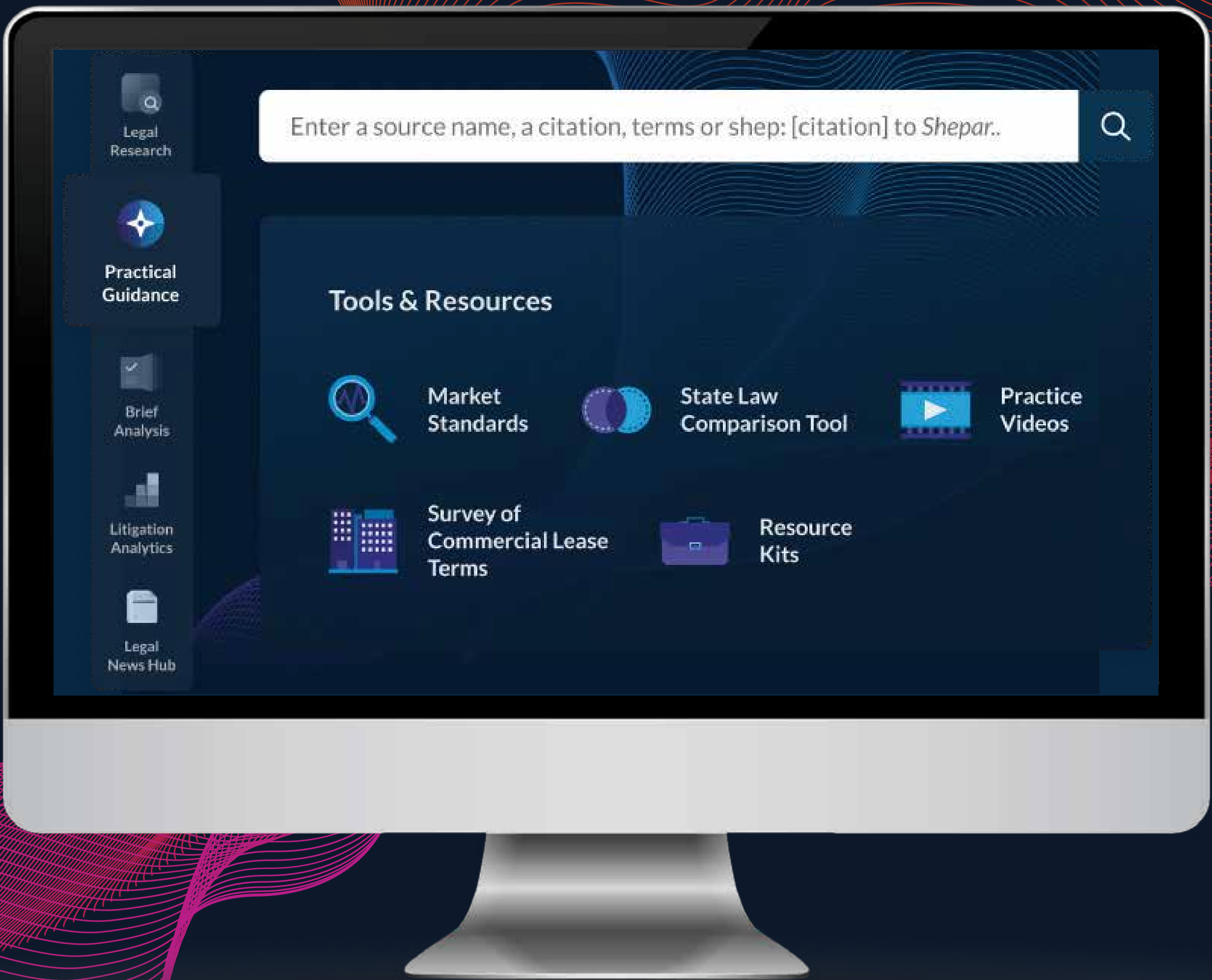
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The

PRACTICAL GUIDANCE Journal

SECOND EDITION 2023

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Introduction

GENERATIVE ARTIFICIAL INTELLIGENCE (AI) is attracting significant attention in the legal community as well as other professions and industries. In just a few short months, it's taking hold in the legal community, and its use will continue to grow as attorneys discover ways to use it for drafting, writing, and accomplishing a wide variety of legal tasks. From contract preparation, document reviews, and legal analysis, the use of AI has and shall continue to assist attorneys. In this edition, "The Use of Artificial Intelligence in the Legal Profession" looks at ways AI tools are likely to allow counsel to circumvent what in the past have been time-consuming undertakings in order to dedicate more time to higher level tasks associated with the representation of their clients.

The extensive potential uses of AI don't just stop there. Already, a number of AI tools are available to assist employers with processes once handled by Human Resources Departments, such as screening applications, recruiting and assessing job candidates, and measuring employee performance. "Legal Developments Around the Use of Artificial Intelligence in Hiring and Assessing," reviews the plusses and minuses of this technology. With a high potential for time-saving benefits, employers must also closely monitor results to be sure these tools do not lead to discriminatory hiring practices.

With a number of bank failures leading the news cycle recently, this edition includes an article examining the recent U.S. bank failures and the risk of cryptocurrency assets at insured depository institutions. In early March 2023, three U.S. banking institutions failed, resulting in increased focus on supervision and regulation by federal banking agencies, including the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (FDIC). Read "Risk of Crypto-Assets and Impact on Bank Failures" for an overview of applicable laws, the FDIC's role in a bank failure, and explore federal guidance on the management of risk related to crypto-assets.

Consider one more prudent warning discussed in this edition—the perils of using emojis in certain business communications. Did you know that an emoji sent in response to an offer could result in unintended contracting? Or that emojis in texts, emails, and tweets might induce reasonable reliance, potentially subjecting the sender to liability? Be sure to read "Contracting by Emoji," from Corbin on Contracts author Timothy Murray to understand the perils of what you thought were polite and friendly symbols.

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The Practical Guidance Journal is designed to help attorneys start on point. This supplement to our online practical guidance resource, Practical Guidance, brings you a sophisticated collection of practice insights, trends, and forward-thinking articles. Grounded in the real-world experience of our 1750+ seasoned attorney authors, The Practical Guidance Journal offers fresh, contemporary perspectives and compelling insights on matters impacting your practice.

Glenn Gordon THE PRACTICAL GUIDANCE ATTORNEY TEAM

The Use of Artificial Intelligence in the Legal Profession

This article discusses the use of artificial intelligence (AI) in the legal profession, including how AI can assist attorneys in accomplishing various legal tasks, as well as concerns about such usage. Also review the Lexis+ Legal AI Update offering results of a survey of legal professionals and their planned use of Generative AI going forward.

THE ARTICLE ALSO PROVIDES AN ASSORTMENT OF related resources that will provide additional guidance regarding the emergence of AI in the legal profession.

Overview of AI

AI is already well entrenched in the legal community, and it is readily apparent that it will play an increasingly prevalent and critical role in how attorneys accomplish a wide variety of legal tasks. From contract preparation, document review, and legal analysis, the use of AI has assisted, and will continue to assist attorneys in the representation of clients. AI tools will allow counsel to circumvent what in the past have been time-consuming undertakings and, thereby, allow them to dedicate more time to higher level tasks associated with the representation of their clients.

AI is computer software programmed to perform specific algorithms, which are sets of code programmed to perform tasks, analyze and recognize patterns in large sets of data, reach conclusions from such patterns, predict future outcomes, and make informed decisions based on such data. The primary concepts involved in AI are machine processing, machine learning, machine perception, and machine control. In this context the use of the word machine means an artificially intelligent system, which may include, among other things, computer software or a network of systems that serve to operate a more complex device. It entails training machines to learn based upon the data inputted into the machine, thereby allowing the machine to ascertain patterns in the subject data and reach conclusions based thereon. Data is what drives the AI machine engine, and the larger the data set, the more that AI can learn from that data.

AI can produce actual work product, legal analysis, and predictions, as opposed to providing information, such as search results, which require review and analysis to generate work product. While the potential use of AI in the legal field is substantial, it is not without risk and should be embraced with caution as this area continues to develop over time. While AI may perform numerous legal tasks and assist counsel in timely and efficiently representing clients, it should be viewed as a tool rather than a replacement for attorney work product and diligence. In other words, AI can serve as one of several tools counsel may use to enhance efficiency and provide advice and counsel to clients, but counsel must still perform their jobs, exercise care and judgment, and ensure that any reliance on any AI-generated results is verified and reasonable.

Use of AI in the Legal Profession

The benefits of AI in the legal industry are vast and include:

- **Contract preparation and review.** AI can prepare initial drafts of legal documents, such as contracts, briefs, and demand letters, and provide suggestions for language that can be used in legal documentation. AI can review agreements and documents to identify and correct problems, such as missing, inconsistent, or erroneous terms.
- **Document review and organization in litigation.** Complex commercial litigation matters and related discovery can involve voluminous document productions, sometimes consisting of tens of thousands of documents or more. AI can help counsel identify and locate relevant documents, such as documents that involve a specific subject matter or issue, a person's name, a geographic location, a date, or particular buzz words, and thereby assist counsel in what would otherwise be the exhausting endeavor of having each document individually reviewed. Human review can be time consuming and expensive and runs the risk that relevant documents will be inadvertently overlooked.
- **Due diligence in M&A and other transactions.** As with document review in litigation, AI products can assist counsel with the identification and retrieval of documentation pertinent to M&A transactions. Through the use of AI products, counsel can retrieve specific documents relevant to due diligence, such as documents regarding a particular subject matter, location, or agreements containing a specific term or clause.

- **Legal research.** AI can summarize important aspects of cases and decisions, such as fact patterns, legal conclusions, and court rulings. AI-powered legal research tools can allow counsel to rapidly search large databases to gather relevant data, precedents, laws, regulations, statutes, and case law for specific jurisdictions.
- **Predictive case analysis.** AI assistance can help counsel determine the potential value of a case and predict the outcome of a particular matter. Predictive coding can also be utilized to analyze relevant data and information and help identify potential risks in existing or threatened litigation, which can lead to more informed decisions and better risk assessments for counsel and their clients.
- **Document organization and management.** AI-based document management software[1] can enable attorneys to store and organize legal files[2], including case files, contracts, electronic communications, etc. AI-based organization can greatly facilitate and expedite locating, maintaining, and safeguarding critical documents and voluminous amounts of information.
- **Judiciary determinations.** AI has been utilized to assist judges with respect to sentencing and bail decisions.

Potential AI Issues

While the apparent benefits of AI in the legal industry are clear, the use of AI in conducting legal tasks must nonetheless proceed with caution. The technology is still evolving, and the accuracy of the results may be unproven, and, in certain instances, the results may contain errors. Counsel will want to verify, to the greatest extent possible, that any AI-generated results are accurate before relying on AI with respect to any work product or legal determinations. As AI's use in the legal profession is still, relatively speaking, in its initial stages, issues will likely arise as the technology progresses and usage is expanded over time.

1. Clio Manage, *Legal Document Management Software.* 2. Sharon Miki, Clio, *How to Successfully Organize Your Legal Files.*

> While AI-driven products can greatly facilitate counsel in accomplishing legal tasks, counsel is still ultimately responsible for their work product.

Counsel must ensure that any use and reliance upon AI in the performance of any legal task is reasonable under the circumstances and that the results are verified. Counsel may be subjected to liability if they utilize AI-generated results or work product that are erroneous and prove detrimental to the client's interests. While AI-driven products can greatly facilitate counsel in accomplishing legal tasks, counsel is still ultimately responsible for their work product.

The use of AI may entail entering into licensing and other agreements that will set forth the terms and permitted uses of the subject technology. In such transactions, important contract terms and legal issues that need to be addressed include, among other things, permitted usage, ownership issues, the protection of trade secrets and confidential information, representations and warranties, indemnification, limitation of liability, and product liability.

The prevalence and proliferation of AI in commerce and industries will create opportunities throughout the legal profession. For example, the ever-increasing use of AI in consumer products creates potential liability. Product liability is based on theories of (1) negligence, (2) breach of warranty, and (3) negligence. AI vendors will need to protect themselves from potential liabilities and claims through, among other things, the inclusion of warranty disclaimers and limitation-of-liability clauses in their agreements. On the other hand, consumers who sustain injuries while using AI-driven products will seek relief for their losses if they are attributable to the subject AI. Consider, for example, accidents that have occurred with AI-driven automobiles.

Related Content

For an overview of current practical guidance on Generative AI, see

GENERATIVE ARTIFICIAL INTELLIGENCE (AI) RESOURCE KIT

For an examination of legal issues arising from the use of AI in e-commerce, see

ARTIFICIAL INTELLIGENCE AND AUTOMATION IN E-COMMERCE

For a framework for thinking about the legal issues surrounding Big Data, see

BIG DATA ANALYTICS PRIVACY LAW CONSIDERATIONS

For an analysis of the primary legal issues relating to the acquisition, development, and exploitation of AI, see

ARTIFICIAL INTELLIGENCE KEY LEGAL ISSUES

For guidance and best practices for counseling employers on the legal implications of integrating AI and robots into their workplaces, see

ARTIFICIAL INTELLIGENCE AND ROBOTS IN THE WORKPLACE: BEST PRACTICES

For a look at emerging legal issues concerning the collection, use, and disclosure of biometric data and AI, see

BIOMETRIC PRIVACY AND ARTIFICIAL INTELLIGENCE LEGAL DEVELOPMENTS

For an update on the potential pitfalls associated with the use of AI tools, such as ChatGPT, in the practice of law, see

LITIGATORS SHOULD APPROACH AI TOOLS WITH CAUTION

For a discussion of the use of ChatGPT in the practice of law, see

EVALUATING THE LEGAL ETHICS OF A ChatGPT-AUTHORED MOTION

AI remains largely unregulated at the current time, but it is likely that more regulations will be adopted going forward. The American Bar Association adopted Resolution 604[3] at its 2023 midyear meeting, addressing how attorneys, regulators, and other stakeholders should address issues of accountability, transparency, and traceability in artificial intelligence. The resolution calls for (1) requiring entities that design, develop, and use AI to adopt guidelines that ensure that AI products and systems are controlled by human authority; (2) holding organizations accountable for consequences (including injury or harm caused by their actions) related to the use of AI, unless reasonable steps to prevent the injury were taken; and (3) requiring developers to document important decisions made with respect to the design and risk of data sets, procedures, and outcomes underlying the subject AI. The U.S. Chamber of Commerce has also recently called for the implementation of regulations to govern artificial intelligence technology,[4] with concerns that such technology does not impair growth or present a national security risk.

While the use of AI is already having a significant impact on the legal profession, there are many unanswered questions about AI. This article addressed some of the ways AI is already influencing the practice of law and potential issues attorneys may encounter using AI when representing their clients. While the potential uses of AI are extensive, such use in the legal profession is not without inherent and unknown risks. With increased use and visibility, the need for regulations and safeguards is becoming apparent, and the call for regulation will increase along with the growth of AI itself. Although the future use of AI by attorneys is exciting and will expand with time, caution is always advisable. L

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RESEARCH PATH: *Commercial Transactions > Trends & Insights > Articles*

3. https://www.americanbar.org/content/dam/aba/directories/policy/midyear-2023/604-midyear-2023.pdf. 4. U.S. Chamber of Commerce, *Artificial Intelligence Commission Report* (Mar. 9, 2023).

Tom Spiggle THE SPIGGLE LAW FIRM, PLLC

Implications of Using ChatGPT in the Workplace

Artificial intelligence (AI) isn't new, but AI technology that's good enough to catch the attention of the average person and affect their daily lives is rather novel. A great example of such technology is ChatGPT,[1] which is a type of chatbot[2] developed by OpenAI[3] that was launched in November 2022. Since then, it's received a lot of publicity, especially regarding its implications on professional and academic content creation.

IT HAS ALSO SEEN TREMENDOUS GROWTH, AS IT TOOK just five days for ChatGPT to reach one million users.[4] To put this in perspective, it took Twitter two years to hit one million users.[5]

Many of the uses for Chat GPT have been in the workplace, with roughly 27%[6] of professionals saying they've used ChatGPT for work-related tasks. But ChatGPT isn't always used openly at work, as 68%[7] of workplace ChatGPT users don't disclose that they use it and only 32%[8] use ChatGPT with their boss' knowledge.

So many people using ChatGPT for work in a covert manner is notable and brings up the question of what ChatGPT's use in the office could mean for workers. Taking a more in-depth look at ChatGPT and how it works might shed some light on this question.

What Is ChatGPT and How Does it Work?

ChatGPT is a chatbot that can engage in human-like text interactions with humans. Through these interactions, users can ask ChatGPT to provide answers to questions or help users complete certain tasks, such as suggesting ideas during a brainstorm or preparing a written work.

The exact details of how ChatGPT works are beyond the scope of this article, but in short, it's a generative AI that creates new content as opposed to simply acting or responding to existing information.[9] It's also based on a language model,[10] which works by using math to predict word combinations that make sense to a human reader.[11]

Language models are fairly good at certain tasks, such as predicting words to fill in the blanks of sentences. For example, imagine you asked a language model AI to fill in the blank for the following phrase: World War Two _______ in 1945.

The language model AI can easily figure out that it can fill in the blank with words like "began" or "ended" and have it make grammatical sense and read naturally. The problem is that while either word may sound correct, only one word can be used to have a factually correct phrase. The hard part is trying to develop a language model chatbot that can do all of this without having to expend an inordinate amount of resources to train and operate it.

ChatGPT makes use of neural networks[12] to learn more efficiently. ChatGPT is unique in that it has been designed to learn from vast amounts of unprocessed information on its own and avoid having to first have that information annotated by humans.[13] Only after this major learning step has taken place do people step in to train ChatGPT to refine how it interacts with humans and provide information more accurately and in a safer manner.[14]

The result is a chatbot that can generate original content in a way that sounds very human-like and is reasonably accurate, without having to expend an unreasonable amount of resources to develop and train it. Then there's the fact that ChatGPT often has the self-awareness to know when it needs more information to respond properly.[15] While it's clear that ChatGPT seems smart, the question then becomes, how smart is it really?

It's not perfect, as OpenAI readily admits to several limitations of ChatGPT, such as writing "plausible-sounding, but incorrect or nonsensical answers."[16] Despite this and other drawbacks to using ChatGPT, it's found plenty of uses in the workplace.

Using ChatGPT at Work

One of the popular ways many people are using ChatGPT at work (and in general) is as a research tool.[17] More precisely, they're using it to replace Google or another online search engine to find answers to questions. ChatGPT can do this by quickly cutting through the search-engine-optimized results and provide a more useful answer to the user in less time.

1. The GPT in ChatGPT stands for Generative Pre-trained Transformer. **2.** IBM defines a chatbot as "a computer program that uses artificial intelligence (AI) and natural language processing (NLP) to understand customer questions and automate responses to them, simulating human conversation." IBM, *What Is a Chatbot?*. **3.** OpenAI's website states that this company's mission is to "ensure that artificial general intelligence benefits all of humanity." *See* OpenAI, *About OpenAI*. **4.** Katharina Buchholz, Statista, *ChatGPT Sprints to One Million Users* (Jan. 24, 2023). **5.** *Id*. **6.** Fishbowl, *ChatGPT Sees Strong Early Adopting in the Workplace* (Jan. 17, 2023). **7.** Fishbowl, *70% of Workers Using ChatGPT at Work Are Not Telling Their Bosses; Overall Usage Among Professionals Jumps to 43%* (Feb. 1, 2023). **8.** *Id*. **9.** McKinsey & Company, *What Is Generative AI?* (Jan. 19, 2023). **10.** OpenAI, *Introducing ChatGPT* (Nov. 30, 2022). **11.** Sindhu Sundar, Business Insider, *If You Still Aren't Sure What ChatGPT Is, This Is Your Guide to the Viral Chatbot that Everyone Is Talking About* (Mar. 1, 2023). **12.** Brown University, *Brown Scholars Put Their Heads Together to Decode the Neuroscience Behind ChatGPT* (Feb. 9, 2023). **13.** Will Douglas Heaven, MIT Technology Review, *ChatGPT Is Everywhere. Here's Where it Came From* (Feb. 8, 2023). **14.** OpenAI says it uses something called the Moderation API "to warn or block certain types of unsafe content." *Introducing ChatGPT*. **15.** OpenAI provides an example of a user asking ChatGPT to look for problems in computer code and it replies by stating, "[i]t's difficult to say what's wrong with the code without more context. Can you provide more information about what the code is supposed to do and what isn't working as expected? Also, is this the entire code or just part of it?" *Id*. **16.** *Id*. **17.** Jacob Zinkula & Aaron Mok, Entrepreneur, *7 Ways to Use ChatGPT at Work to Boost Your Productivity, Make Your Job Easier, and Save a Ton of Time* (Feb. 9. 2023).

There are other ways in which individuals can use ChatGPT to save time while doing certain tasks at work. Entrepreneur.com[18] lists several workplace uses for ChatGPT such as using it to:

- Write essays, speeches, emails, and employee evaluation
- Look for patterns or conduct statistical analysis of large volumes of data
- Schedule events and/or help plan tasks
- Brainstorm a second opinion or a different perspective on a topic or question
- Apply for a new job by helping to write resumes and cover letters

How does this work in practice? Imagine a worker needs to send out a company email announcing an event for a product release. All the worker needs to do is tell ChatGPT, “Can you write me an email telling my coworkers about the upcoming Acme Product release on March 20, 2023, that will be held at company headquarters?” A few seconds later, ChatGPT will produce a sample email with a subject line that the worker can literally cut and paste into their email account.

Depending on the exact wording of the prompt and information given ChatGPT, the worker might need to tweak what ChatGPT creates. The worker can make the changes themselves or ask ChatGPT to do it, such as by asking ChatGPT to adjust the tone of the email or add certain information, like the time of the product launch event. Even when ChatGPT can’t complete a particular assignment for the user, it can help save time by providing a starting point or inspiration.

Many of the workplace applications for ChatGPT aren’t likely to cause problems or run afoul of any laws or company policies. Yet individuals who use ChatGPT for work may still need to be careful of when and how they use this technology.

18. *Id.*

In the earlier days of computer science, there was a saying, “garbage in, garbage out.” This meant that if a user gave bad information to a computer, the computer was likely to provide bad results. This concept applies to ChatGPT in that one reason it may provide undesirable results is that it’s been given incorrect information.

Potential Problems for Workers When Using ChatGPT

ChatGPT could cause problems for workers in three contexts. First, there are situations where the mere use of ChatGPT could violate an employer’s policy. Second, the use of ChatGPT is permissible by the employer, but it’s used in a particular way that could lead to a violation of a law or rule. Third, the worker relies on incorrect information from ChatGPT.

ChatGPT’s Use Violates a Rule or Policy of the Employer

Given how new ChatGPT is, there aren’t going to be many employers that have banned its use. That being said, there’s generally nothing to stop an employer from implementing a policy that forbids employees or other workers from using this technology. Whether it’s a moral objection or the fear that workers might somehow misuse it, most employers would likely be within their rights to prohibit its use, even for work-related tasks.

For instance, a company might modify its Internet-use policy to limit the use of chatbot tools in addition to stopping workers from visiting social media websites during work hours. A worker could then get into trouble if they violate this policy by using ChatGPT at work.

This is probably not the most likely concern a worker will face when using ChatGPT at work. What’s more likely is that the worker uses ChatGPT in a way that leads to an infraction of a different, seemingly unrelated company rule or requirement.

Improper Use of ChatGPT by an Individual

This is probably the most likely way a worker could get into trouble at work for using ChatGPT, although this misuse would probably be unintentional. There could be a scenario where the worker might be using ChatGPT for legitimate reasons but do so in a way that could cause problems for the worker and/or employer. Here are two hypotheticals to help illustrate.

In the first hypothetical, the misuse occurs when the worker provides confidential or otherwise protected information to ChatGPT. This could happen if someone is asking ChatGPT to write a performance review and includes information subject to a non-disclosure agreement (NDA). Or an attorney asks ChatGPT to help prepare a contract or discovery request and provides confidential client information to ChatGPT so it can complete the task.

Doing either of these things would result in providing protected information to an unauthorized third party, which would probably violate the terms of an NDA, privacy policy, employment contract, and/or professional privilege. This is because, according to OpenAI’s FAQ,[19] privacy policy,[20] and terms of use, [21] OpenAI may use the information from ChatGPT conversations for training purposes and OpenAI has the right to review the information provided to ChatGPT.

In the second hypothetical, ChatGPT is used to create a piece of work that an employer wants to have certain legal protections. But because ChatGPT helped create the work, it might not be eligible for those protections. For example, an engineer might use ChatGPT to help create new software code. Depending on ChatGPT’s involvement in creating it, the newly developed code may not be eligible for copyright protections.[22]

This isn’t to say that a work created with the help of ChatGPT can never receive copyright protections, but it will depend on the level of human involvement concerning the traditional elements of authorship. Needless to say, an employer might be upset to learn that there’s a possibility that the code for a groundbreaking new piece of software won’t be as profitable as it hoped because the U.S. Copyright Office won’t register it.

The Worker Relies on Incorrect Information Provided by ChatGPT

In the earlier days of computer science, there was a saying, “garbage in, garbage out.” This meant that if a user gave bad information to a computer, the computer was likely to provide bad results. This

19. Open AI, *ChatGPT General FAQ*. 20. OpenAI, *Privacy Policy* (updated Mar. 14, 2023). 21. OpenAI, Terms of Use (updated Mar. 14, 2023). 22. *See Compendium of U.S. Copyright Office Practice (Third) § 313.2* (stating that the Copyright Act only applies to works created by an author and that this author must be a human being).

Often, a mistake that's present in something ChatGPT creates won't be obvious. Instead, the problem might be something like a subtle bias that stems from biased information provided to ChatGPT.

concept applies to ChatGPT in that one reason it may provide undesirable results is that it's been given incorrect information. This incorrect information could come from the user, but it may also be a consequence of not having access to correct information during its training or development, which OpenAI readily admits is possible.[23]

Imagine a worker needs to write a press release and uses ChatGPT to help prepare it. Ideally, the worker will only use ChatGPT to create a very rough draft. But people don't often get to work under ideal conditions, with soon-approaching deadlines a common occurrence.

If this hypothetical worker were to essentially rely on ChatGPT to write the press release, this could lead to problems if it contains incorrect information. If the worker is lucky, the press release will simply come across as sloppy and unprofessional. If they're unlucky, the press release will contain untrue statements that can harm a particular individual or business. The worker and/or the employer could then be subject to potential defamation liability.

Often, a mistake that's present in something ChatGPT creates won't be obvious. Instead, the problem might be something like a subtle bias that stems from biased information provided to ChatGPT. This bias could come out despite the best efforts of OpenAI and the users to prevent this from happening.

Amazon.com's somewhat recent attempt at using AI to help it sort through the resumes of job applicants for software development and other technology-based positions serves as an example of what can happen when AI has a bias. The problem was that the software was biased against women because it was trained using resumes submitted to Amazon.com in the past. And because most of these resumes came from men, the software learned to "prefer" resumes that came from men by downgrading resumes that contained the word "women."[24]

Dealing with these potential errors or undesirable results from ChatGPT is especially challenging because ChatGPT doesn't provide citations or an explanation for how it reached its conclusions. So users must proactively do their own research to double-check ChatGPT's results. But they might have used ChatGPT to avoid doing their own research, so this verification may not always happen.

Related Content

For an overview of current practical guidance on Generative AI, see

GENERATIVE ARTIFICIAL INTELLIGENCE (AI) RESOURCE KIT

For an analysis of possible pitfalls in the use of AI in workplace hiring, see

ANTICIPATING WHAT ChatGPT MEANS FOR THE WORKPLACE

For guidance on counseling employers on the legal implications of integrating AI into their workplaces, see

ARTIFICIAL INTELLIGENCE AND ROBOTS IN THE WORKPLACE: BEST PRACTICES

For a discussion of the use of AI in the legal services context, see

EVALUATING THE LEGAL ETHICS OF A ChatGPT-AUTHORED MOTION

To track legal developments in the labor and employment area, see

LABOR & EMPLOYMENT KEY LEGAL DEVELOPMENTS TRACKER (CURRENT)

What Happens If a Worker Gets in Trouble for Using ChatGPT?

In the majority of cases, a worker who gets in trouble for using ChatGPT can probably be treated just like any other worker who does something the employer doesn't like. This will be especially true if the worker gets fired and is an at-will employee. As of the time of this writing, it's unlikely that getting fired for using a chatbot is against a particular law or violates public policy.

Workers who have a contractual agreement with their employers may enjoy greater protections from getting fired for using ChatGPT, unless the use of ChatGPT violates a provision in the contract. If the worker is a creative-content creator, the contract might contain a provision that prohibits the worker from using AI-based technology to create content.

23. *See* OpenAI, *ChatGPT General FAQ* (stating that ChatGPT "has limited knowledge of the world and events after 2021 . . . "). 24. Jeffrey Dastin, Reuters, *Amazon Scraps Secret AI Recruiting Tool That Showed Bias Against Women* (Oct. 10, 2018).

What Does the Future of AI Hold for Hourly Work?

ChatGPT is already a game-changer for many workers, but it's likely just the beginning of what's to come. So far, the major changes have revolved around how ChatGPT can save people time to complete tasks they were already able to do. This could have a dramatic effect on knowledge workers, especially those who work by the hour.

For many professions, there's an alignment between the quality and/or amount of work and the time the worker has to spend to produce that work. This alignment hasn't always been perfect, but ChatGPT will likely expand any existing misalignment, such that paying these types of workers by the hour will no longer be viable in certain situations. For instance, instead of getting paid by the hour, some workers who rely on ChatGPT might get paid with a flat or value-added fee arrangement.

Besides getting paid differently, this could turn non-exempt workers into exempt workers under wage laws like the Fair Labor Standards Act of 1938.[25] As a result, it could take away certain wage and hour protections. Of course, hourly jobs that focus on physical human labor as opposed to knowledge are probably going to be less affected by ChatGPT and similar AI technology, at least until AI-controlled robots become commonplace in the workplace.

The Bottom Line

The reality of ChatGPT or similar technology is that, sooner or later, employers will probably want their workers to use it, because it will save time that will help the employers save money. Eventually, society may get to a point where using a chatbot is as ubiquitous as doing a Google search or looking up how to do something on YouTube. L

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RESEARCH PATH: *Labor & Employment > Trends & Insights > Articles*

25. 29 U.S.C.S. §201 et seq.

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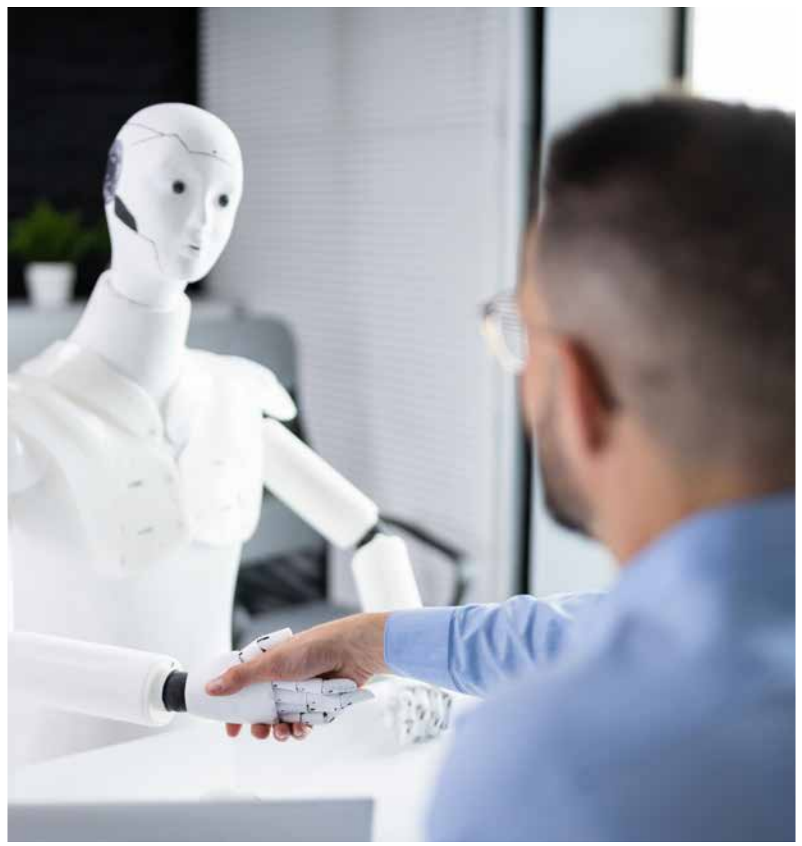
Ellen M. Taylor SLOAN, SAKAI, YEUNG, & WONG LLP

Legal Developments Around the Use of Artificial Intelligence in **Hiring and Assessing**

Introduction

Today, a variety of artificial intelligence (AI) employment-assessment tools are available to assist employers with nearly every stage of the hiring cycle, from recruiting and assessing job candidates to measuring the performance of current employees. There is AI software designed to screen applications and prioritize resumes based on key phrases relevant to the job,[1] monitor and assign scores to employees based on their typing speed,[2] find and recruit job candidates whose skills match a job posting,[3] evaluate job applicants' and current employees' skills and potential through game-based tests,[4] and even interview job candidates.[5]

AI employment-assessment tools are often marketed as tools that can reduce costs, decrease the risk of human error, and reduce or eliminate bias during the hiring process. However, AI employment-assessment tools can result in discriminatory hiring practices if they are not carefully designed, implemented, and monitored. Although AI technology is developing more rapidly than the laws regulating its use, there have been recent legal developments relating to the regulation of AI employment-assessment tools.



The Civil Rights Council's Draft Regulations Regarding the Use of AI for Assessing Job Candidates and Employees

On March 15, 2022, California's Civil Rights Council (CRC), formerly known as the Fair Employment and Housing Council,[6] published draft modifications to regulations that if enacted, would expand liability for employers around their use of AI, such as automated-decision systems, for evaluating job applicants and employees.[7] The CRC most recently published a revised version of these draft regulations dated July 28, 2022 (Draft Regulations).[8] The CRC Algorithms and Bias Hearing Subcommittee announced at its December 13, 2022, meeting that it was continuing to workshop these regulations in preparation for moving the next iteration of these Draft Regulations into the rule-making process.[9]

1. Equal Employment Opportunity Commission, *The Americans with Disabilities Act and the Use of Software, Algorithms, and Artificial Intelligence to Assess Job Applicants and Employees* (May 12, 2022) (hereinafter EEOC Guidance). **2.** *Id.* **3.** *Gary D. Friedman & Thomas McCarthy, Employment Law Red Flags in the Use of Artificial Intelligence in Hiring*, Bus. Law Today (ABA Oct. 1, 2020). **4.** *See* HireVue, *Game-Based Assessments*. **5.** *See* HireVue *Video Interview Software*. **6.** *See* California Civil Rights Department, *Department Name Change* (July 1, 2022). **7.** California Civil Rights Council, *Fair Employment & Housing Council Draft Modifications to Employment Regulations Regarding Automated-Decision Systems* (Attachment B) (Mar. 15, 2022). **8.** California Civil Rights Council, *Fair Employment & Housing Council Draft Modifications to Employment Regulations Regarding Automated-Decision Systems* (Attachment G) (July 28, 2022) (Draft Regulations) **9.** *See* Video, *Civil Rights Council: December 13, 2022 Meeting*, at 2:35-2:40.

> ...employers could be liable for actions taken by third parties that the employer hires to administer ADS decision-making tools if those decision-making tools have a discriminatory impact.

The Draft Regulations Broadly Define Automated-Decision System

The Draft Regulations define an automated-decision system (ADS) as a "computational process, including one derived from machine-learning, statistics, or other data processing or artificial intelligence techniques, that screens, evaluates, categorizes, recommends, or otherwise makes a decision or facilitates human decision making that impacts employees or applicants."[10]

Employers Could Be Liable for Actions Taken by Third-Party Companies Hired to Administer AI Employment-assessment Tools

The Draft Regulations also expand the definition of an employer's agent to include any person or third party that provides "administration of automated-decision systems for an employer's use in making hiring or employment decisions that could result in the denial of employment or otherwise adversely affect the terms, conditions, benefits, or privileges of employment." This means that employers could be liable for actions taken by third parties that the employer hires to administer ADS decision-making tools if those decision-making tools have a discriminatory impact.[11]

Aiding And Abetting Liability Could Expand to Include Entities That Supply AI

The Draft Regulations expand aiding and abetting liability for unlawful employment discrimination by defining unlawful assistance, unlawful solicitation or encouragement, and unlawful advertising to include "the advertisement, sale, provision, or use of a selection tool, including but not limited to an automated-decision system, on behalf of a person or individual for an unlawful purpose, such as limiting, screening out, or otherwise unlawfully discriminating against applicants or employees based on protected characteristics."[12]

The Record-Keeping Period for Certain Employment Records Would Be Lengthened

The Draft Regulations would require employers and all other covered third-party entities to retain any personnel or other employment records "dealing with any employment practice and affecting any employment benefit of any applicant or employee (including all applications, personnel, membership, or employment referral records or files and all machine-learning data)" for four years.[13]

Legal Developments in Maryland, Illinois, and New York City Related to the Use of AI Employment-assessment Tools

Illinois and Maryland, as well as New York City, have all already enacted laws (within the past three years) to regulate how employers may use AI in the hiring process.

Illinois

Illinois was the first state to enact a law specifically regulating the way employers can use AI to conduct employee interviews.[14] Illinois' Artificial Intelligence Video Interview Act[15] (the Video Interview Act) went into effect in January of 2020 and was amended effective January 1, 2022.[16] The Video Interview Act requires employers that are "considering applicants for positions based in Illinois" to do all of the following before they ask applicants to submit video interviews:

1. Notify applicants that the employer may use AI to "analyze the applicant's video interview" and evaluate the applicant's fitness for the role
2. Provide the applicant with information explaining "how the AI works and what general types of characteristics it uses to evaluate applicants"
3. Obtain the applicant's consent to be evaluated by AI[17]

Employers who rely "solely upon an artificial intelligence analysis of a video interview to determine whether an applicant will be selected for an in-person interview" must also collect and report certain demographic data to the Illinois Department of Commerce and Economic Opportunity.[18]

Maryland

Maryland's H.B. 1202, enacted in March of 2020, requires employers to meet specific requirements in order to use facial recognition technology when interviewing job applicants.[19] The law requires employers to obtain signed consent from applicants before the employer may use facial recognition technology "for the purpose of creating a facial template" during the interview.[20]

10. Draft Regulations, *supra* note 8. **11.** *Id.* **12.** *Id.* **13.** *Id.* **14.** Jeffrey Bosley, et al., *Illinois Becomes First State to Regulate Employers' Use of Artificial Intelligence to Evaluate Video Interviews*, JD Supra (Sept. 4, 2019). **15.** 820 Ill. Comp. Stat. Ann. 42/1 et seq. **16.** Bosley, *supra* note 14. **17.** 820 Ill. Comp. Stat. Ann. 42/5. **18.** *Id.* **19.** Md. Code Ann., Lab. & Empl. § 3-717. **20.** *Id.*

New York City

The New York City Council enacted Local Law 144 of 2021 on December 11, 2021.[21] Due to the high number of public comments on this local law, the Department of Consumer and Worker Protection (DCWP) has postponed enforcement of this law to July 5, 2023.[22] When implemented, the law will require employers to perform "bias audits" on any "automated employment decision tool before use of said tool" and to notify employees and candidates who reside in New York City about the employer's use of "such tools in the assessment or evaluation for hire or promotion," and the "job qualifications and characteristics" that the ADS will be evaluating.[23]

EEOC Guidance Related to Use of AI in Employment Decisions

On October 28, 2021, the EEOC launched an "Initiative on Artificial Intelligence and Algorithmic Fairness."[24] The EEOC issued its EEOC Guidance in May 2022, which includes questions and answers about when the use of AI may "violate existing requirements under Title I of the Americans with Disabilities Act (ADA)."[25] Through this technical guidance, the EEOC highlights three of the most common ways that an employers' use of AI might violate the ADA.

First, an algorithm that an employer uses may fail to "provide a 'reasonable accommodation' that is necessary for a job applicant or employee to be rated fairly and accurately."[26] For example, an employer might be in violation of the ADA if they require a job applicant with a disability that interferes with their manual dexterity to take a timed knowledge test that requires them to use a keyboard or trackpad, without any accommodation or alternative version of the test (unless doing so would result in undue hardship).[27]

Related Content

For an overview of current practical guidance on Generative AI, see

GENERATIVE ARTIFICIAL INTELLIGENCE (AI) RESOURCE KIT

For an overview of materials related to recruiting, screening, testing, hiring, and onboarding employees, see

SCREENING AND HIRING RESOURCE KIT

For a discussion of methods employers may use to screen job applicants, see

INTERVIEWING AND SCREENING JOB APPLICANTS

For a chart listing state law articles addressing key issues related to screening and hiring, see

SCREENING AND HIRING STATE PRACTICE NOTES CHART

For a presentation counsel can use to train employers on best screening and hiring practices, see

SCREENING, RECRUITING, INTERVIEWING, HIRING, AND ONBOARDING: TRAINING PRESENTATION

For an evaluation of the risks that employers may encounter when integrating artificial intelligence in their workplaces, see

ARTIFICIAL INTELLIGENCE AND ROBOTS IN THE WORKPLACE: BEST PRACTICES

For step-by-step guidance for employers engaged in recruiting and screening applicants, see

SCREENING, RECRUITING, INTERVIEWING, HIRING, AND ONBOARDING PROCEDURES CHECKLIST

Second, an algorithm that the employer uses may intentionally or unintentionally screen out an individual with a disability, even though that individual is able to do the job with a reasonable accommodation."[28] This could happen, for example, if interviewing software that is designed to analyze an applicant's problem-solving skills gives lower marks to a job candidate with a speech impediment that makes it difficult for the software to interpret their response according to the speech pattern that the software has been trained to recognize.[29]

Third, an algorithmic decision-making tool that an employer uses to evaluate job applicants or employees might violate "the ADA's restrictions on disability-related inquiries and medical examinations."[30] This type of violation might occur if the AI tool that the employer is using to assess job applicants or employees asks questions that either directly ask about whether they have a disability, or are likely to elicit a response that includes information pertaining to whether the individual has a disability.[31]

Notably, the Strategic Enforcement Plan that the EEOC released on January 10, 2023, which discusses the EEOC's priorities from 2023-2027, repeatedly references the use of artificial intelligence in hiring, and states that the EEOC plans to "focus on employment decisions, practices, or policies in which covered entities' use of technology contributes to discrimination based on a protected characteristic" including "the use of software that incorporates algorithmic decision-making or machine learning" and AI.[32]

21. 2021 N.Y.C. Local Law No. 144. 22. NYC Consumer and Worker Protection, *New Laws & Rules*. 23. 2021 N.Y.C. Local Law No. 144; *New Laws & Rules*, *supra* note 22. 24. EEOC Guidance, *supra* note 1.

25. *Id.* 26. *Id.* 27. *Id.* 28. *Id.* 29. *Id.* 30. *Id.* 31. *Id.* 32. Equal Employment Opportunity Commission, *Draft Strategic Enforcement Plan*, 88 Fed. Reg. 1379 (Jan. 10, 2023).

Best Practices for Employers Regarding the Use of AI for Assessment of Job Candidates or Employees

As the laws regulating the use of AI employment-assessment tools develop further, there are several best practices that employers can keep in mind.

First, employers should be aware of whether and how they are already using AI to make hiring decisions.[33] This includes taking the time to learn which processes the organization uses that are dependent on AI and which judgment calls are being made by AI rather than humans.[34] Employers should consider appointing a task force to create an organization-wide policy regarding the use of AI employment-assessment tools.[35]

Second, employers should make sure that any AI employment-assessment algorithms they are using are not resulting in unlawful discrimination.[36] If the employer itself is creating the AI employment-assessment tools that it will use, the employer should consider seeking input from people of diverse backgrounds when designing the algorithm that the software will use.[37]

Third, employers should alert job applicants and employees when they are being evaluated using AI decision-making tools and notify those individuals that reasonable accommodations are available to them if they have a disability.[38]

Lastly, employers should ensure that their staff members are trained to recognize requests for reasonable accommodations (e.g., a request for an alternative test format).[39] If another company controls and administers the AI decision-making tool the employer is using, the employer should make sure that the outside company is forwarding requests for accommodation to the employer so that the employer can process them.[40]

Conclusion

As the use of AI in hiring and evaluating employees becomes more commonplace, employers should keep informed about legal developments relating to AI employment-assessment tools and ensure that they remain in compliance with applicable law. L

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RESEARCH PATH: *Labor & Employment > Screening and Hiring > Articles*

33. *Alysa Austin, et al., AI Regulation in the U.S.: What's Coming, and What Companies Need to Do in 2023*, JD Supra (Dec. 12, 2022). 34. *Id*. 35. *Id*. 36. Dylan Walsh, MIT Management Sloan Sch., *How can human-centered AI fight bias in machines and people?* (Feb 2, 2021). 37. *Id*. 38. EEOC Guidance, *supra* note 1. 39. *Id*. 40. *Id*.

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Recent Bank Failure and Related Bankruptcy Resources

The financial services industry is experiencing shock waves following the recent Federal Deposit Insurance Corporation (FDIC) insured bank failures. At a rate unseen since the 2008 financial crisis, three regional banks have succumbed to liquidity challenges and were either placed into FDIC receivership, or voluntarily dissolved.

ON MARCH 8, 2022, SILVERGATE CAPITAL CORPORATION (parent company of Silvergate Bank) decided to voluntarily liquidate. On March 10, 2023, California financial regulators stepped in and took possession of Silicon Valley Bank (SVB) and put it into FDIC receivership, in what was the largest failure of a U.S. bank since 2008. On March 12, 2023, New York financial regulators took possession of Signature Bank and put it into FDIC receivership. On March 17, 2023, SVB Financial Group (the former parent of SVB) filed a Chapter 11 in the Southern District of New York.

Attorneys across multiple practice areas are dealing with the fallout from these bank failures. Practical Guidance offers a resource kit that includes materials on bank failures and related issues, with detailed practice notes, templates, and checklists. It includes guidance in the Financial Services Regulation practice area related to the FDIC's role in winding down or managing receivership of a failed institution and the federal laws and regulations governing effective risk management. In addition, related resource in the Finance practice area are designed to assist borrowers and lenders in commercial lending transactions in evaluating their potential exposure to these bank failures. Bankruptcy guidance and analysis provides various resources for dealing with distressed entities in relation to bank failures.

Review the complete Bank Failure Resource Kit here.

Celeste Mitchell-Byars PRACTICAL GUIDANCE

Risk of Crypto-Assets and Impact on Bank Failures

This article examines the recent U.S. bank failures and the risk of cryptocurrency assets at insured depository institutions.

IN EARLY MARCH 2023, THREE U.S. BANKING INSTITUTIONS failed, resulting in increased focus on supervision and regulation by the Board of Governors of the Federal Reserve System (Federal Reserve Board), the Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC) (collectively, the federal banking agencies). The article will provide an overview of applicable laws, examine the FDIC role in a bank failure, and explore federal guidance on the management of risk related to crypto-assets.

Overview of Crypto-Assets and U.S. Financial Market

Banks collaborate with financial technology (fintech) and other companies to provide traditional banking services. Such collaboration is found in the areas of commercial banking, online marketplace lending, open banking services, capital markets, trade finance, real estate transactions, venture capital investments, sponsorship of programs, and other areas closely related to banking. Fintech companies are also altering the bank payments landscape by replacing legacy bank payment systems with technologies such as mobile wallets, digital currency, and cryptocurrency transactions.

Fintech companies are subject to regulation by the federal banking agencies, insomuch as they partner with, or provide third-party services to, regulated financial institutions.

Examination of Cryptocurrency Collapse and Recent 2023 Bank Failures

In November 2022, a historic event occurred as FTX Corp., a top transactional exchange platform used to buy and sell cryptocurrency, collapsed, and filed for bankruptcy. The collapse triggered a level of financial instability that is yet to be realized, as customers attempted to cash out billions of dollars in deposits and venture capital firms suffered major losses and write-offs of debt. FTX Corp. did not maintain adequate reserves against customer deposits and was unable to cover trades executed on the platform. Subsequently, the Securities Exchange Commission (SEC) charged Samuel Bankman-Fried, the CEO and co-founder of the cryptocurrency trading platform FTX, with orchestrating a scheme to defraud FTX investors using an affiliated entity, Alameda Research Fund.[1]

Another notable cryptocurrency crash occurring in 2022 involved Terraform Labs PTE Ltd. (Terraform), a blockchain platform offering stablecoins LUNA and TerraUSD. These algorithmic stablecoins, pegged to the U.S. dollar, crashed after deposits dropped, investors withdrew funding, and the stablecoin's value plummeted to $0.30. Stablecoins can be collaterized (backed by U.S. dollar denominated assets or crypto-assets such as tokens), or uncollateralized (not backed by any external assets). The SEC charged Terraform and its principal, Do Kwon, with securities fraud involving stablecoin and other crypto-asset securities.

Volatile markets and broad swings in pricing also resulted in exchange platforms Blockfi, Voyager Digital, and Celsius Network experiencing liquidity issues and later filing for bankruptcy. The events associated with cryptocurrency in 2022 followed a period of high growth and financial gains for many institutions. The bankruptcy and other civil cases arising out of these events highlight that the instability and collapse of crypto-asset-related institutions such as FTX and Terraforms transcend the online digital market to affect many other forms of financial services.

Between 2020 and 2023, six banks have closed or received assistance from the FDIC:

BANK NAME	CITY	CLOSING DATE	FUND**
Signature Bank	New York	March 12, 2023	DIF
Silicon Valley Bank	Santa Clara	March 10, 2023	DIF
Almena State Bank	Almena	October 23, 2020	DIF
First City Bank of Florida	Fort Walton Beach	October 16, 2020	DIF
The First State Bank	Barboursville	April 3, 2020	DIF
Ericson State Bank	Ericson	February 14, 2020	DIF

* Data obtained from FDIC BankFind Suite

** Depository Insurance Fund (DIF)

1. S.E.C. v. Samuel Bankman-Fried, No. 1:22-cv-10501, 2023 SEC LEXIS 143 (S.D.N.Y. filed Dec. 13, 2022).

> The federal banking agencies have regulation, supervision, examination, investigation, and enforcement authority of banking activity at the federal level. Other federal and state agencies are also empowered with certain responsibilities to support the stability and viability of the U.S. financial system.

In March 2023, Silvergate Bank decided to wind down its operations and voluntarily liquidate, and two other banks, Signature Bank and Silicon Valley Bank, were placed into receivership with the FDIC. Several other banking institutions continue to experience liquidity concerns:

- First Republic Bank's credit rating status was downgraded by a rating agency. On March 16, 2023, 11 banks announced support of $30 billion in deposits to First Republic Bank.[2]
- Credit Suisse Bank was provided with a $54 billion dollar loan from the Swiss National Bank to bolster liquidity. UBS is currently seeking regulatory approval to take over Credit Suisse.[3]
- Various other U.S. regional banks face potential credit rating downgrades.

While the impact of the crypto-exchange collapse on banking institutions unfolds, the proximate cause of the bank fallout from crypto-assets has yet to be determined.

Current Risk, Economic, Regulatory, and Financial Conditions

There is no single cause that points to the FTX or Terraform cryptocurrency collapses. Common to their demise are a concurrence of control failures including overextension, inadequate or no risk management framework, and fraudulent activity. Such is not an isolated case, as the same common control failures are seen as the precondition to current bank failures. The current environment for financial services risk—economic, regulatory, and financial conditions in the United States—may also have a causal effect on bank failures:

- Market volatility of cryptocurrency risks to the stability of the U.S. financial system
- High credit concentration risk, particularly where bank deposits funding base is highly concentrated in crypto-asset-related entities and these entities are interconnected or share similar risk profiles
- Economic conditions marked by Russia's war against Ukraine, high inflation, increasing federal funds rates, high interest rates, and low unemployment
- Deregulation for small and mid-sized banks and rollback of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010's (Dodd-Frank Act)[4] enhanced prudential standards

The Financial Stability Oversight Council (FSOC), established by the Dodd-Frank Act to identify risks and respond to emerging threats to the financial stability of the United States among other functions, issued the Report on Digital Asset Financial Stability Risks and Regulation (October 3, 2022),[5] noting that crypto-asset activities contributed to instability within the crypto-asset ecosystem. The primary risks from crypto-assets were a result of:

- Failure to establish basic risk controls to protect against run risk or to ensure that leverage is not excessive
- Highly speculative crypto-asset prices with repeated and recorded significant and broad declines
- High interconnections among crypto-asset entities that have risky business profiles and opaque capital and liquidity positions
- Increased operational risks due to concentration of key services or from vulnerabilities related to distributed ledger technology

Federal Bank Regulators—Authority and Response to Bank Failures

The federal banking agencies have regulation, supervision, examination, investigation, and enforcement authority of banking activity at the federal level. Other federal and state agencies are also empowered with certain responsibilities to support the stability and viability of the U.S. financial system. Federal laws and regulations are in place to safeguard FDIC-insured banks from the risks associated with deposits sourced from crypto-assets. Following is a discussion of the key laws in place to safeguard FDIC-insured banks. This listing is not all inclusive.

2. U.S. Department of the Treasury, *Joint Statement by the Department of the Treasury, Federal Reserve, FDIC and OCC* (Mar. 16, 2023). 3. Federal Reserve Board, *Statement by Secretary of the Treasury Janet L. Yellen and Federal Reserve Board Chair Jerome H. Powell* (Mar. 19, 2023). 4. Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010). 5. https://home.treasury.gov/system/files/261/FSOC-Digital-Assets-Report-2022.pdf.

Dodd-Frank Act

The Dodd-Frank Act was enacted following the financial crisis of 2008 and is intended to address systemic risks of systemically important financial institutions (SIFIs). SIFIs are subject to the Dodd-Frank Act's enhanced prudential standards (EPS), which include among other areas, heightened supervision and examination by the Federal Reserve System, increased regulation, and increased regulatory reporting. While EPS requires larger capital requirements of SIFIs, small to mid-sized banks (with total consolidated assets of $100 billion but less than $250 billion) are not subject to EPS requirements.

The Dodd-Frank Act also included the Volcker Rule,[6] which prohibits lenders from engaging in certain hedge fund or private equity firm proprietary trades or investments, thereby reducing potentially risky investments by lenders. FDIC-insured depository institutions, U.S. bank holding companies, and affiliated institutions and nonbank financial companies supervised by the Federal Reserve Board are subject to the prohibitions under the Volcker Rule.

Economic Growth, Regulatory Relief, and Consumer Protection Act

The Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA)[7] was passed on May 24, 2018. The EGRRCPA amended certain regulations implementing the Dodd-Frank Act, among which were creating exemptions from the U.S. Basel III-based capital requirements for smaller banking institutions, reducing EPS to the largest U.S. bank holding companies or SIFIs, and amending the Volcker Rule to exempt institutions with less than $10 billion in total consolidated assets from its proprietary trading prohibitions.

FDIC Insures Depository Institutions and Systemic Risk Exception

The FDIC is a federal banking agency with authority and responsibility[8] to:

- Insure deposits of banks and savings associations (insured depository institutions (IDIs))
- Examine and supervise state-chartered IDIs that are not members of the Federal Reserve System
- Manage receiverships of failed IDIs
- Manage resolution of financial institutions pursuant to the Orderly Liquidation Authority established under the Dodd-Frank Act

The net amount due to any depositor at an IDI is an aggregate of deposits in all accounts of the institution and shall not exceed the standard maximum deposit insurance amount.[9] The standard maximum deposit insurance amount is currently $250,000.

FDIC insurance extends to IDIs. At the onset of a liquidity crisis, crypto-asset entities are unable to seek a bailout from the federal government under the programs in place for insured deposits and investments.

6. 12 U.S.C.S. § 1851. 7. Pub. L. No. 115-174, 132 Stat. 1296 (May 24, 2018). 8. 12 U.S.C.S. §§ 1811 through 1835a. 9. 12 U.S.C.S. § 1821.

Bank runs and bank failures may result in serious instability to the U.S. banking system. To address the immediate liquidity needs of a bank and forestall potential systemic disruptions, a systemic risk exception may be granted. A systemic risk exception is permissible if the failure of an institution under FDIC receivership would have serious adverse effects on economic conditions or financial stability, and action or assistance from the FDIC would avoid or mitigate such adverse effects.[10] On March 12, 2023, Secretary of the Treasury Janet Yellen, in a joint statement with the Federal Reserve Board and FDIC,[11] made a systemic risk exception for Silicon Valley Bank and Signature Bank, allowing the FDIC to cover all of the institutions' depositors for more than the insured portion of deposits (currently $250,000). While depositors will have access to all of their deposits, the exception does not extend to shareholders and certain unsecured debtholders.

Further, the Federal Reserve Board made additional funding available to eligible depository institutions. This new Bank Term Funding Program (BTFP)[12] offers loans secured by qualified collateral to banks, savings associations, credit unions, and other eligible depository institutions. BTFP loans are available through the Federal Reserve Board Discount Window.

Crypto-Asset Entities' Federal Regulation, Supervision, and Examination

Nonbank crypto-asset entities are not directly regulated, supervised, or examined by the federal banking agencies. A special-purpose national bank charter, known also as the fintech charter offered by the Office of Comptroller of the Currency (OCC) for nonbank technology firms, a trust charter, or a bank partnership with fintechs, are ways in which nonbank crypto-asset entities would be brought into the scope of federal banking agencies' supervision, regulation, and enforcement. State laws and regulations also govern the activities of nonbank crypto-asset entities, requiring state licensing where the entity engages in cryptocurrency or other virtual currency activities in order to protect consumers, safeguard customer funds through cybersecurity rules, prevent money laundering, and root out illicit activity.

The federal banking agencies, the Consumer Financial Protection Bureau, an independent agency of the Federal Reserve Board established under the Dodd-Frank Act, and the U.S. Department of Treasury Financial Crime Enforcement Network (FinCEN), each have statutory authority to supervise entities that contract or partner with regulated financial institutions. A crypto-asset entity providing material services to a bank in connection with a financial service or product is subject to regulatory oversight. The federal banking agencies and FinCEN have issued regulatory guidance requiring the crypto-asset entity to:

- Maintain an adequate risk management program to monitor and control the risks associated with the business (including credit, liquidity, and operational risk processes)
- Establish and maintain an effective anti-money laundering and countering the financing of terrorism compliance program that corresponds to the risk of the entity
- Disclose key information to consumers about its products, services, or activities

While fintech firms focus on a range of activities, products, and services that complement traditional banking activities, crypto-asset entities are not themselves banks, and the entities' deposits are not insured by the FDIC. Crypto-assets are prohibited from advertising deposits as insured or holding themselves out as regulated entities. "Section 18(a)(4) of the Federal Deposit Insurance Act ('FDI Act'), 12 U.S.C. § 1828(a)(4), prohibits any person from representing or implying that an uninsured deposit is insured or from knowingly misrepresenting the extent and manner in which a deposit liability, obligation, certificate, or share is insured under the FDI Act."[13] The FDIC is charged with enforcing this provision.

Regulatory Response to Bank Failures

Following the Silicon Valley Bank and Signature Bank failures, the U.S. Department of Treasury, the FDIC, and President Joseph R. Biden immediately addressed the public, seeking to promote trust in the U.S. banking system, restore consumer confidence, and curb additional bank runs. Additionally, federal banking agencies have called for tightened scrutiny of crypto-assets and increased scrutiny of banks' credit, interest, and liquidity risk management practices.

The U.S. Department of Justice and the SEC opened investigations into the collapse of Silicon Valley Bank. Key congressional committees have begun hearings on the cause of bank failures and regulatory response.

Crypto-Asset Risk Linked to Bank Failures

Analysis of the impact cryptocurrency may have played in recent bank failures is ongoing. A review of the financial services of Silvergate, Silicon Valley, and Signature Bank confirms a range of commercial banking, commercial and residential real estate lending, and deposit taking activity. The institutions also partnered with and provided specialized commercial banking products and services to emerging fintech companies throughout the United States.

Treasury Secretary Yellen, speaking at the U.S. Senate Banking Committee hearing on March 16, 2023, did not confirm a financial

Related Content

For a list of key practice notes, templates, and checklists covering major financial services regulation issues and tasks, see

FINANCIAL SERVICES REGULATIONS FUNDAMENTALS RESOURCE KIT

For a comprehensive collection of Practical Guidance resources covering topics related to the recent bank failures, see

BANK FAILURE RESOURCE KIT

For an examination of the special-purpose national bank charter, known also as the fintech charter, developed and offered by the OCC for nonbank technology firms, see

OCC FINTECH CHARTER RESOURCE KIT

For more information on virtual currency, including bitcoin and cryptocurrency, see

VIRTUAL CURRENCY, BITCOIN, AND CRYPTOCURRENCY RESOURCE KIT

For a video that highlights the key regulatory agencies overseeing cryptocurrency and covers the federal and state laws applicable to cryptocurrency, see

CRYPTOCURRENCY REGULATION OVERVIEW VIDEO

For timely information on current cryptocurrency litigation and administration proceedings from the SEC, the Commodity Futures Trading Commission, the U.S. Department of Justice, and other federal agencies, see

CRYPTOCURRENCY LITIGATION AND REGULATORY PROCEEDINGS TRACKER

For a review of the examination, investigation, and enforcement responsibilities granted to federal banking authorities, see

FEDERAL BANKING REGULATORY AGENCIES EXAMINATION AND ENFORCEMENT AUTHORITY

For a discussion of the prohibitions directed at banking entities under the Volcker Rule, contained within the Dodd-Frank Act, see

VOLCKER RULE

10. 12 U.S.C.S. § 1823 (c)(4)(G). 11. U.S. Department of the Treasury, *Joint Statement by the Department of the Treasury, Federal Reserve, FDIC and OCC* (Mar. 12, 2023). 12. https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20230312a1.pdf.

13. FDIC and Federal Reserve Board, *Joint Letter Regarding Potential Violations of Section 18(a)(4) of the Federal Deposit Insurance Act* (July 28, 2022); 12 U.S.C.S. § 1828(a)(4); 12 C.F.R. § 328.102.

> Banks and other institutions providing banking services are expected to have a risk-based risk management program to properly identify, measure, monitor, and control funding and liquidity risk.

crisis for the U.S. financial system or that the risk from crypto-assets was the primary cause of the bank failures. Yellen acknowledged that Silicon Valley Bank's high reliance on uninsured deposits coupled with a massive bank run on deposits caused a liquidity crisis for the institution. Such would be the case for even the strongest bank. Yellen reaffirmed that the U.S. banking system remains strong and deposits safe.

The FSOC 2022 Annual Report[14] includes an assessment and recommendations to address the financial stability risks of digital assets. The FSOC 2022 Annual Report indicated that while the risks associated with digital assets were increasing for banking institutions transacting in crypto-assets, the instability in the crypto-asset ecosystem did not result in notable effects on the stability of the traditional financial system. The FSOC recommended the following actions to address identified regulatory gaps in the regulation of digital assets:

- Enact legislation providing for rulemaking authority for federal financial regulators over the spot market for crypto-assets that are not securities
- Address regulatory arbitrage as it relates to crypto-asset entities that offer services similar to traditional financial institutions but do not have a consistent or comprehensive regulatory framework
- Assess vertically integrated market structures
- Continue to build capacities related to data and the analysis, monitoring, supervision, and regulation of digital asset activities

Interagency Statement on Liquidity Risks from Crypto-Assets

On February 23, 2023, the federal banking agencies issued an interagency statement on the liquidity risks presented by certain sources of funding.[15] The banking agencies highlighted increased liquidity risks arising from crypto-deposits, particularly where the client is a cryptocurrency exchange, stablecoin issuer, financial technology company, or other crypto-related institutions.

According to the interagency statement, liquidity risk for crypto-assets is heightened due to various factors, including the unpredictability of the scale and timing of crypto-asset deposit inflows and outflows, unanticipated redemptions, dislocations in crypto-asset markets, noted periods of stress, market volatility, and other related vulnerabilities in the crypto-asset sector.

Regulators, while calling for more stringent regulation around crypto-assets, are pointing to existing federal guidance on effective risk management practices. Banks and other institutions providing banking services are expected to have a risk-based risk management program to properly identify, measure, monitor, and control funding and liquidity risk. Additionally, the risk management program must include procedures and appropriate strategies covering:

- Governance
- Capital
- Liquidity
- Compliance risk management
- Financial inclusion
- Recovery and resolution planning

The guidance emphasizes the importance of certain processes for sound liquidity and funding risk monitoring and management, including cash-flow projections; diversified funding sources; a cushion of liquid unencumbered assets; and a well-developed, documented and board-reviewed contingency funding plan. The interagency statement supplements existing guidance on funding and liquidity risk management, which remains in effect.

Prudential Standards for the Treatment of Crypto-Asset Exposures

In an effort to promote global liquidity risk management principles to ensure the safety and soundness of financial institutions, the Basel Committee has published the Prudential Treatment of Cryptoasset Exposures (Cryptoasset Prudential Standard).[16] Crypto-asset is defined as "private digital assets that depend on cryptography and distributed ledger technologies (DLT) or similar technologies. Digital assets are a digital representation of value, which can be used for payment or investment purposes or to access a good or services."[17] Crypto-asset does not include central bank digital currencies within the Cryptoasset Prudential Framework. This Cryptoasset Prudential Standard, agreed to by members of the Basel Committee, establishes the following risk standards for crypto-asset exposures:

- Minimum risk-based capital requirements for:
  - Credit risk
  - Market risk
  - Credit valuation adjustment risk
  - Counterparty credit risk
  - Operational risk
- Allocation of crypto-assets between the banking book and trading book
- Minimum liquidity risk requirements
  - For the liquidity coverage ratio (LCR) and net stable funding ratio (NSFR) requirements, the crypto-asset exposures, including assets, liabilities, and contingent exposures, must generally follow a treatment that is consistent with existing LCR and NSFR approaches for traditional exposures with economically equivalent risks, and must also reflect additional risk that may be present for crypto-assets. The treatment must generally consider the classification of the crypto-asset and whether it is (1) tokenized claims on a bank, (2) stablecoins, or (3) other crypto-assets.
- Leverage ratio requirements

The implementation date for the Cryptoasset Prudential Standard is January 1, 2025. Bank for International Settlements plans to closely monitor the implementation and effects of the Cryptoasset Prudential Standard through Basel III-required data and regulatory reporting. For more information on the Classification of Crypto-assets, Redemption Risk Test and Supervision/Regulation Requirement, follow this link to read the full practice note.

Minimum Capital Requirements

Federal banking regulators require banks to maintain a level of regulatory capital based on the risk profile and complexity of their operations. Banks may be required to maintain higher regulatory capital at the discretion of the supervising federal banking regulator. The federal banking agencies' prompt corrective action authority enforces capital adequacy standards.

Under Basel III capital rules, SIFIs must maintain sufficient capital to satisfy minimum risk-weighted and leverage capital ratios. The leverage ratio buffers apply to global systemically important banks and serve to complement the risk-weighted capital requirements by providing, among other things, a safeguard against unsustainable levels of leverage.

14. https://home.treasury.gov/system/files/261/FSOC2022AnnualReport.pdf. 15. Federal Reserve Board, FDIC, OCC, *Joint Statement on Liquidity Risks to Banking Organizations Resulting from Crypto-Asset Market Vulnerabilities* (Feb. 23, 2023). 16. Basel Committee on Banking Supervision, Bank for International Settlements, *Prudential Treatment of Cryptoasset Exposures* (Dec. 2022). 17. *Id*.

Supervisory Review Process

The Cryptoasset Prudential Standard provides for a supervisory review process for banks' exposures to crypto-assets. It establishes responsibilities for banks to establish a comprehensive risk management framework that includes policies, procedures, and controls (informed by existing Basel Committee statements) to identify, assess, and mitigate the following risks on an ongoing basis:

- Any operational risks, credit risks, liquidity risks including funding concentration risk, and market risks related to crypto-assets or related activities
- Crypto-asset technology risks
- General information, communication, and technology and cyber risks
- Legal risks
- Money laundering and financing of terrorism risks
- Valuation challenges

Bank supervisors' responsibilities include reviewing a bank's policies and procedures for appropriateness and identifying and assessing the crypto-asset risks and the adequacy of their assessment results. Supervisory actions, in cases where crypto-asset risks are not sufficiently covered, may vary based on supervisory authority and may involve a supervisor requiring the banks to address any deficiencies in their identification or assessment process of crypto-asset risks, making additional stress testing or scenario analysis recommendations, or imposing additional charges or other provisioning to cover potential or foreseeable losses. L

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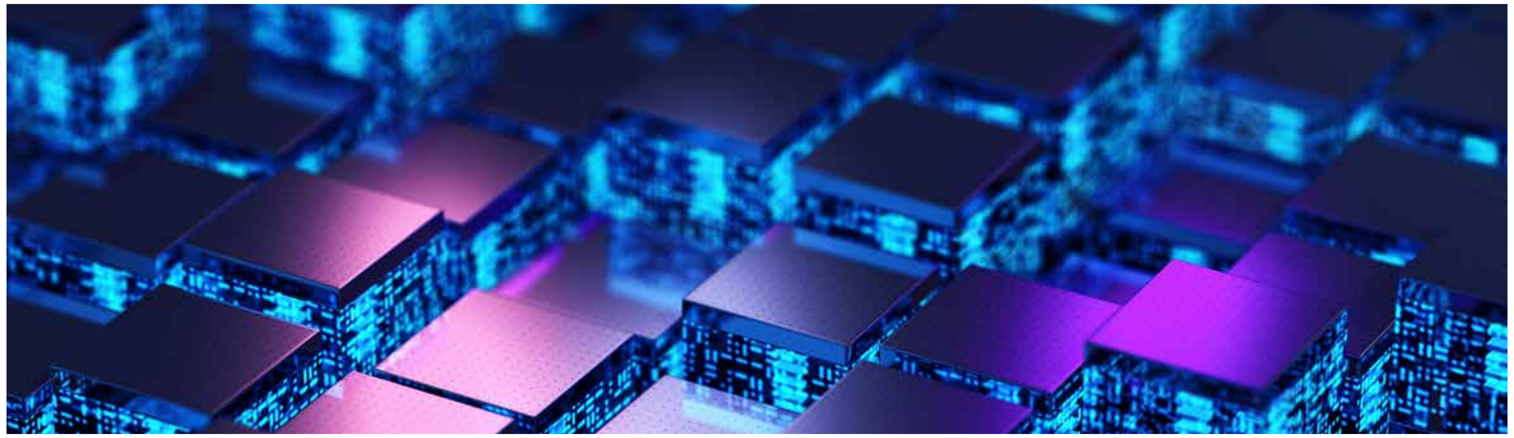
Matthias Geurts SCHALAST LAW,
Oded Ofek M. FIRON & CO,
Stephen Rutenberg POLSINELLI,
and Jill Wong formerly of HOWSE WILLIAMS

Cryptocurrency & Blockchain: When Do the Benefits Outweigh the Risks?

The collapse of FTX in early November 2022, and subsequent fallout in the cryptocurrency services industry, while disastrous in scope, reflect the growing pains of the industry.



IN RECENT YEARS, REGULATORY AGENCIES around the world have both intensified regulatory enforcement and litigation against bad actors, while at the same time are building regulatory sandboxes in the hopes of nurturing the industry's development.

Multilaw held a webinar in November 2022 with a panel of attorneys from four of its member firms in Germany, Hong Kong, Israel, and the U.S., who have active practices in cryptocurrency issues. The panel, moderated by Jacob Kirkham of Multilaw, featured discussions around regulatory and industry trends in cryptocurrency and other blockchain applications. The following edited excerpts from the webinar (with recent updates) summarize the discussion.

What is the position of the authorities in your jurisdiction in relation to crypto activities? Have they been welcoming or discouraging?

Jill Wong (formerly of Howse Williams): In Hong Kong, the authorities have been welcoming; although in the early days, there was some skepticism about cryptocurrency (or virtual assets, as we now call it). But the concerns have somewhat dissipated since then. Since around 2018, Hong Kong has gradually recognized virtual assets as an alternative asset class and there was investor appetite. Initially Hong Kong authorities allowed asset managers to make limited investments in virtual assets, then the Hong Kong authorities allowed the virtual asset exchanges a framework to opt in to the regulatory regime. Now they are fast moving to regulate through new legislation. In 2023 Hong Kong will have a licensing regime for virtual asset trading platforms or, in other words, exchanges. This is a very positive environment for industry players.

Oded Ofek (M. Firon & Co.): In a way, for years, this has been a pending problem in Israel. Since October 1, 2018, a law regulating services in financial assets, including crypto currency assets, called Supervision of Financial Services (Regulated Financial Services) Law, came into force in Israel. Whoever was a veteran provider in crypto services was issued the right to continue as a veteran until issued a perpetual license for a term. However, until September 2022, no company was actually issued a perpetual license. The Capital Markets, Insurance and Savings Authority in Israel was very diligent before it issued any licenses for virtual currency (aka crypto). The term virtual currency refers to services in these financial assets, including exchange of financial assets, and management of the trading of financial assets; NFTs have still not been tackled, whether said tokens should be regulated under said law or the Securities Law in Israel. The first two licenses were issued in September 2022, one to an aggregator of services and another is a broker; showing that the capital markets authority in Israel is pursuing this agenda.

[UPDATE – On December 2022, a third company has been issued said license, an Israeli service provider of the Altshuler Shaham investment house.]

Matthias Geurts (Schalast): Germany is one of the key drivers in the European market for virtual currencies. Germany introduced a law in 2021 which allows security tokens in the form of a fixed income type token. Such regulation generally transforms the old world of securities into the world of electronic means by using the same legal concepts. Germany is also driving EU regulation, the so-called MiCA (Markets in Crypto-Assets) which may come to force soon; this regulation should close the gap to financial instruments regulated under MIFID. Virtual or digital assets are considered as an alternative asset class, and consequently requires regulatory regulation and guidance but also with respect to its taxation. From a market perspective we see lots of projects in that field of products in Germany intended to create a new alternative investment market. With respect to the custodian services there is a specific license requirement in Germany, but specific regulation for marketplaces and trading do not exist so that the general requirements for trading financial instruments and products apply.

> Due to a lack of international regulation in some jurisdictions, cryptocurrencies will be considered as authorized money, as e-money or as security. This makes such instruments so complex.
>
> *Matthias Geurts*

Stephen Rutenberg (Polsinelli): United States regulators, at least initially, took a relatively practical view regarding the regulation of cryptocurrency and related activities. Examples of this include: the IRS (Internal Revenue) issuing guidance as far back as 2014; treating Bitcoin as property; and most state regulators treating cryptocurrency as a money, meaning that in most of the 50 states a money transmission license is required for a non-bank or trust company to operate a crypto-related business. Bitcoin and other crypto currencies are regulated by the CFTC as a commodity. Even the SEC (the federal Securities and Exchange Commission), set up a FinHub and requested industry feedback, though their interpretation of fairly old securities law precedent rarely worked to allow for the issuance of payment or in-network tokens in the United States. More recently, with the combination of the fallout from the FTX debacle and the SEC appearing to have a vendetta against anything blockchain/crypto related, there are dark regulatory and enforcement clouds hanging over this entire space.

Geurts: You just pointed out correctly that different terms have different understandings: in some jurisdictions cryptocurrencies will be considered as authorized money, as e-money or as security. Different regulations require different wording and have different consequences. This is one of the key aspects to consider on a global level, that terms used in one jurisdiction may have different meaning in another jurisdiction. Due to the complexity in the U.S. and Canada, often, we have to exclude these jurisdictions, even though the US is the biggest market; it is just because we don't know whether the virtual currency is qualified as a security or not.

Rutenberg: Trying to be optimistic, there is a chance that XRP will win against SEC in whether its token sales violated securities laws. However, there are many ways that the XRP case can be decided which won't provide any clear permissive guidance for the sale of digital assets. The real reason that I am optimistic about crypto-related business having a future in the United States is that we remain the top financial hub in the world, with a combination of funding, talent, and where people want to start companies. As such in the long term a regulatory balance will be reached.

Ofek: We have a kind of "Twin Peaks" regime in Israel, which is that the Israeli Securities Authority regulates whether this is a security, while the Capital

> The industry as a whole is like a teenager, still growing, though it's time for it to become an adult.
>
> *Jill Wong*

Markets Insurance and Savings Authority regulates crypto as services in financial assets.

Wong: It's quite an interesting issue: whether it's a utility token or security token. Recently, we've seen court decisions that recognize virtual assets as property. In the past, there were a lot of people interested in issuing a coin, saying it's a utility token and would not be considered as a security and therefore not caught by the regulatory regime. Over time, it became clear that the category of coins that can be considered utility tokens is actually quite narrow from a regulatory standpoint. The industry as a whole has been like a teenager, still growing, though it's time for it to become an adult.

How has the technology behind cryptocurrencies helped or hindered initiatives in your jurisdiction?

Rutenberg: Bitcoin, the first of the ccryptocurrencies, came out of a dream of many years, where people wanted the ability to have a currency without government involvement, or without some other centralized authority involved. However, such theoretical currencies always came up against what is called the double spend problem, which is that, unless there's a centralized authority, I can give the same check to you and to somebody else. In many ways the internet today, almost in its entirely, is limited by a form of this double spend problem. For example, if I sell a song to one person and send them a copy; nothing technically stops me from selling the same song to three other people thus providing limited means of ensuring any value in any sale. What the bitcoin protocol did was a genius idea of getting around the double spend problem through a complicated combination of several different technologies. Based on this protocol one could design a payment system to work in an automated fashion with no central party controlling it, thus opening up the dream of decentralization, which has in turn lead to a huge rush of innovation, and creative ideas about property, which we're still trying to "grow up with" as Jill said today. At this same time, we are also trying to figure out what aspects of our society and economy we want decentralized and when a centralized authority is more fair, efficient, or secure. For example, do we want a legal system that's fully efficient, or do we want one that gives courts room to slow a process down, maybe to let a bankrupt company restructure? Such an option is unlikely to be feasible on a fully decentralized protocol. What's particularly fascinating in this industry is you have these growing pains that are forcing us to think through these big ideas rather quickly.

Geurts: The European regulation is relatively open-minded with respect to the technology being used. They don't have specific requirements in particular with respect to the protocol. So, there is sufficient flexibility for technologic development. Another key driver is that the EU government realizes the opportunity for the overall digitalization in particular when government becomes more flexible, efficient, and transparent to everybody. Initially under the perspective of ESG, in the parliamentary process of the MICA regulation, the so-called proof of stake concept has been considered as consuming too much e-power. Finally, they stopped discussing ESG as this would have an impact on the respective type of technology.

Wong: On the ESG question, the thinking in Hong Kong is developing. I don't think the authorities here have made up their minds on how exactly to address that problem. But, certainly, in terms of the technology behind crypto, one example I can give you is with regard to distribution ledger technology (DLT).

> What the bitcoin protocol did was a genius idea of getting around the double spend problem.
>
> *Stephen Rutenberg*

The Hong Kong government, together with the central banks of Thailand, the UAE, and the PRC, have been using DLT to study whether central banks can use DLT more efficiently for cross-border payments under Project mBridge. The project intends to ultimately develop the mBridge platform into a production-ready system. NFTs and gaming are seen as more tools for entertainment, not really as alternative asset classes in the same way as an established cryptocurrency such as bitcoin.

Geurts: This is one of the use cases. As Jill mentioned, the authorities are thinking that in cross-border scenarios, currency exchange transactions or cash flows can be eliminated. That is what companies are very keen on—reducing currency fluctuations costs. By the way, this was one of the drivers for the introduction of the euro which may apply to cryptocurrencies too. With cryptocurrency, they could have a real view of what their cash position is. So, in the European market they are saying this is one of the goals to go for because this would make their treasury activities more efficient.

Ofek: As for ESG, we see it developing side by side with the technology. In Israel, the regulators are probing the players in the industry, whether they would take ESG in consideration as an aspect of investment. Or whether that would jeopardize deals with investors. As for blockchain technology, that should move things forward with crypto; they will each push each other forward in developing the technology. Israel has developed a unique startup hub, with a regulatory sandbox, giving financial technology startups an easier environment to set up their company and experiment with their products and services. Companies that meet the initial requirements can develop their products and services and engage with the government authorities in real time.

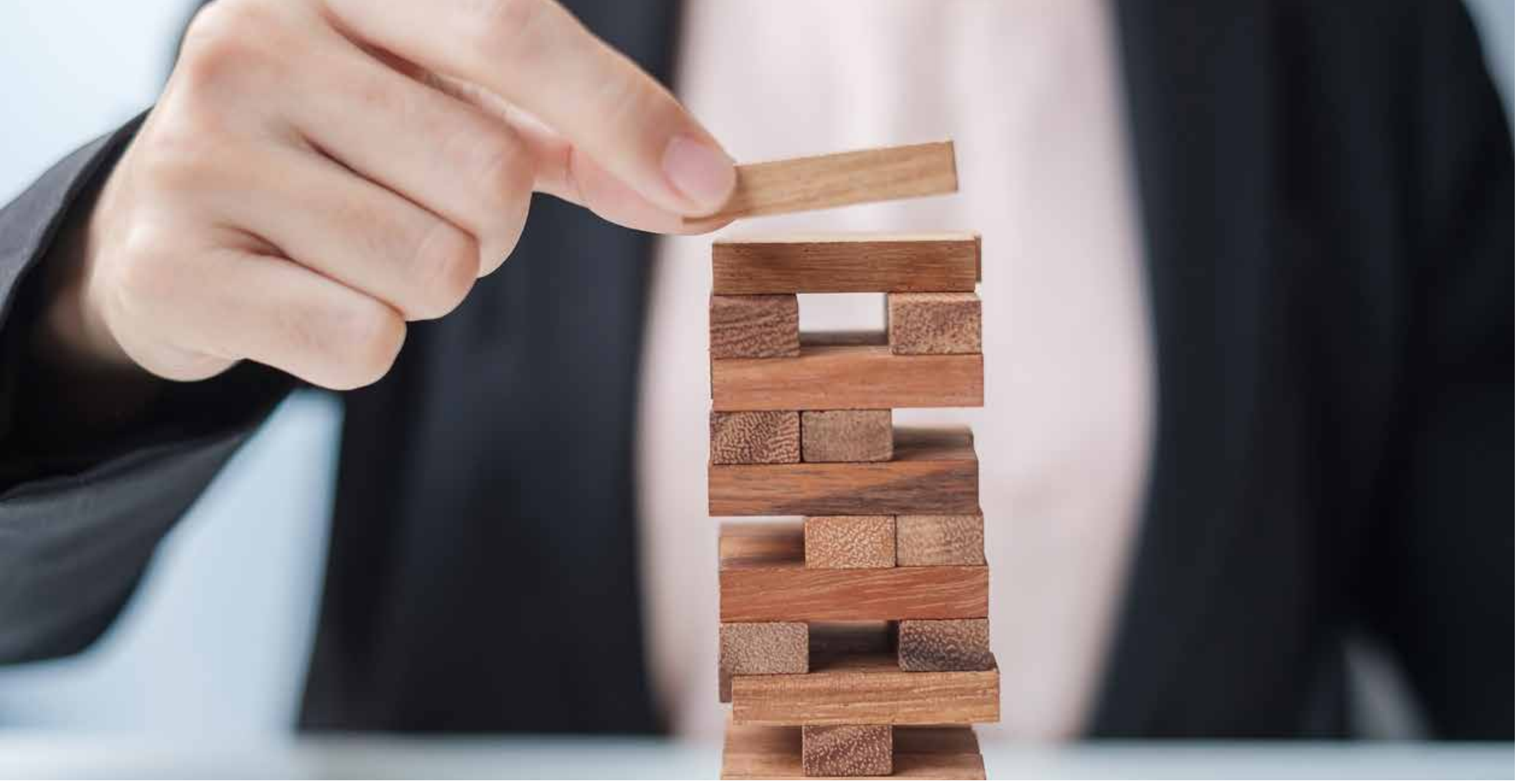
How is the crypto industry expected to develop in your jurisdiction, regulatory or otherwise?

Wong: We are going to have new legislation, probably in Q2 2023 which would allow securities regulators in Hong Kong to grant licenses to virtual asset exchanges. This would be a welcome development in Hong Kong; exchanges are a very important part of the cryptocurrency ecosystem. It will be interesting to see if these exchanges will be allowed to offer products to only sophisticated investors only or whether or not the retail investors will be able to trade as well. *[Update: Hong Kong's*

> As for ESG, we see it developing side by side with the technology.
>
> *Oded Ofek*

Securities and Futures Commission is considering a proposal to allow all types of investors, including retail investors, to access trading services provided by licensed virtual asset trading platform operators, provided that the platforms comply with a range of investor protection measures. They are currently consulting market participants and interested parties on this.] The law is not being introduced as part of the existing securities laws, but as an amendment to the anti-money laundering laws. This evolution in regulatory thinking means that, for the right industry players, Hong Kong is the place to be.

Rutenberg: Since its establishment in the 1930's the U.S. Federal securities regulation has been principally concerned with protecting investors, and in particular retail investors, perhaps more so than in other countries. In some ways this explains the SEC enforcement actions focused on the sale and promotion to the public of what it considers to be a security without hesitation or pursuant to an exemption. However, in bringing actions against issuers of the LBRY or XRP tokens, among others, without providing a legal framework for regulation that would allow the underlying protocols to build their network, is to many a dereliction of the regulators' duty. Recent SEC statements and actions, including those related to insider trading allegations, could be seen as an attempt to shut down anything crypto-related that is not a registered or exempt security. We are now in a situation where the industry cannot reasonably expect significant



> We see companies having a complex and risky business model, in particular by leveraging inappropriately, which gives rise to concerns due to the massive impact on consumers when such risks occur. Authorities may react to this kind of behavior in such a manner that it stops the business overall.
>
> *Matthias Geurts*

regulatory relief as there is an immense lack of trust on the part of regulators for any company connected to this space. Any regulation is going to be limiting and stifle the availability of the technology. It's hard to predict what the future will bring. Our goal should be to work for a new form of regulation that can protect the markets while also unleashing the technical and societal power of blockchain technology. For this to be a possibility, we need all the smart and thoughtful people on both the government and industry side to get together to save the industry, hyperbolic as that may sound.

Geurts: Jill and Stephen pointed it out correctly, AML and consumer protection are two elements governments will react to with regulation. But the truth is, this market just exists and grows because the retail market considers the crypto world as unregulated, virtual, and more like a world of gambling and speculation. That's where we have to balance the diverging interests. If one looks deeper into the collapse or insolvency of FTX, they will realize that this is not the consequence of the technology, it is just the consequence of an inappropriate business model. Do we just let it play out? Or do the authorities start with regulations which generate trust in the crypto world and its products? If the philosophy of cryptocurrencies is to be decentralized, de-controlled and transparent, we haven't seen such behavior. The reality is different, we see companies doing really complex transactions and leveraging themselves inappropriately; we will see how the authorities react because it can cost consumers billions. If the authorities react with strong regulation, will that stop the business overall?

Ofek: Is regulation taking us forward or actually hindering crypto services as a whole? Israel does have regulation and a license regime, but licenses are issued only if the license applicant satisfies the preconditions and requirements of the Capital Markets Insurance and Savings Authority. On the other hand, they did not yet come to the institutional world, where you have custodianship rules, rules to safeguard the assets and assets in transit. This is where the Israeli regulators are trying to mandate now two directives. One of them is on safeguarding crypto assets; however, I think the regulator is taking it to the other edge. Mandating that an institution would be liable to a consumer/client of crypto services, this is something no financial institution in Israel could comply with. There needs to be an equilibrium so you can actually move the industry forward as well as safeguard the assets. You can take the regulation of the traditional industries, from brokers, banks, custodians and apply them to this new world.

What is the current status of expected future trends in the tokenization of assets in your respective jurisdictions?

> We need all the smart and thoughtful people on both the government and industry side to get together and, really, save the industry.
>
> *Stephen Rutenberg*

Rutenberg: By tokenization of assets, I am discussing taking real world assets and using a blockchain in some capacity to increase the durability, liquidity, and efficiency of their transferability and recordkeeping. Since, unlike cryptocurrencies, these tokenized assets generally can function under the confines of the securities laws, the U.S. laws are for the most part open to them. They do fall under the securities laws and can only be sold pursuant to registration of an exemption. Even in the current environment we are seeing projects related to tokenization of real estate and NFTs as well as other types of assets including debt. Tokenization of assets is increasing but slowly. In my view what is holding up asset tokenization, are mostly business-side issues such as cost and efficiency rather and legal constraints. This is in comparison to other types of digital assets such as cryptocurrency and in-game tokens, where the law in the United States does not currently provide a workable solution.

Wong: I agree with Stephen, that tokenized assets are treated as securities in Hong Kong; it is a financial product. What is interesting in Hong Kong is that we have a stricter regime for investment products that are considered to be complex, as this goes to investor protection. One would have thought that tokenized securities may be considered to be complex, but actually, no: simply because it's issued or traded on a blockchain doesn't mean it's necessarily complex, what will actually be looked at are the features of the product themselves. Some may be available to retail investors if they can be considered as non-complex products.

Geurts: We will see two different things: on the one hand financial products, and on the other hand products like music or real estate, which are in a way illiquid. However, they have a sound and continuous cash flow. Therefore, where there is an illiquid asset, but which provides for strong cash flows, this will be a product for the next generation because currently securities as an instrument to make them liquid and markable is too cost intensive. If the technology is quicker and cheaper, this might give the opportunity for more of these kinds of products which would lead to more trading, more of a market, more transparency and more efficiency. For example, for people who don't want to own the real estate itself, but rather the stable income from the real estate, or want to invest into returns from music licenses, the digital assets can provide solutions; this is where Germany' s product developers are going to.

Ofek: I agree with what others have said with respect to ICOs (initial coin offerings); we don't see a big wave of ICOs in Israel. But as for tokenization as a whole, it's becoming more institutionalized going forward. The Bank of Israel has appointed a steering committee to study potential issues of the digital shekel, and the Tel Aviv Stock Exchange has already announced it will be venturing into virtual currencies with the introduction of a platform for trading of digital assets in Israel. The Tel Aviv Stock Exchange in conjunction with the Israeli Ministry of Finance has announced they will conduct testing of blockchain-backed platform for trading of digital bonds issued by the Ministry of Finance. I do see tokenization in Israel moving forward and moving the industry forward.

Please give one example of where you think crypto is helping, and where it's hindering.

Wong: I think crypto is helpful as an alternative asset class, and there is investor appetite for it, so it provides choices for investors. What is hindering development is that the industry is still young, it's still a teenager that is learning to behave in an adult world. And so there is misconduct, whether it's intentional or not intentional. Going back to what Stephen said, [the day FTX collapsed] was a very bad, terrible day for the industry, and we can do without scandals like this one, but unfortunately this is not the end of scandals for this industry. So that's hindering the industry's development—these incidents do not build trust. Matthias mentioned this concept of building trust. But overall things are moving in the right direction, albeit with some hiccups along the way.

> Tokenization as a whole is becoming more institutionalized going forward. The Bank of Israel has appointed a steering committee to study potential issues of the digital shekel.
>
> *Oded Ofek*

Geurts: We see all the positive aspects of crypto, but one thing we need to think about is cybercrime. It is important to build trust in this kind of new ecosystem.

Ofek: Crypto is essential, it's inevitable, you see the new generation pushing out the old generation. You need regulation to stop misleading the public and protections from this going AWOL, but crypto is needed in the industry in the new world, to bring new opportunities, and it's inevitable that it will move forward. It needs regulation that won't pin it down and stop the industry from moving forward.

Rutenberg: On the positive side, as mentioned above, one of the most powerful things about crypto is how it's making people rethink basic social constructs, particularly with regard to assets and ownership. What does it mean to own property? What is the ideal role of regulators? The negative side, history littered with the attempts by well-meaning people to develop a better system that is fairer with often disastrous results as these systems get used nefariously. This risk of misuse is particularly acute related to blockchain and privacy, as a blockchain keeps an almost indestructible ledger of any assets and transaction on it. In this way GDPR and blockchain at their core functions, contradict each other. As such it could easily be used as a tool for tyranny. For example, we often talk about central banks adopting digital currencies, and helping the unbanked but does that really mean that the shoe shiner is going to be taxed on their tip? Do you really want the government to know every one of our transactions? We need to move cautiously and not assume the industry will regulate itself.

Has the collapse of the crypto exchange FTX had any concrete impacts, to date, on the cryptocurrency market or regulation in your jurisdiction?

Wong: The FTX collapse underscores the need for a robust regulatory regime. Hong Kong is ready; on 1 June 2023, a new licensing regime for virtual asset service providers will come into effect in Hong Kong. All centralised VA trading platforms carrying on businesses in Hong Kong, or actively marketing their services to Hong Kong investors, will need to be licensed and regulated by the Securities and Futures Commission (SFC).

The proposed guidelines for virtual asset trading platform operators are based on existing requirements, with modifications. This includes requirements regarding the safe custody of assets, Know Your Customer, conflicts of interest, cybersecurity, accounting and auditing, risk management, Anti-Money Laundering/counter-financing of terrorism, and prevention of market misconduct.

There is currently an ongoing public consultation on the proposal, including whether retail investors should be allowed access to licensed virtual asset trading platforms.

In its consultation paper on the proposed regulatory requirements for licensed virtual asset platform operators, regulators including the SFC and the Hong Kong Monetary Authority have specifically cited turmoil in the virtual asset market, including the collapse of FTX amidst the ongoing "crypto winter", to underscore the importance of effective regulation and oversight of the virtual asset industry.

Ofek: The collapse of crypto exchange FTX did not have any concrete impacts on the Israeli market, but it intensified and emphasized the need to process the new directives concerning custodianship of financial assets and mainly crypto assets, and drawing down on capital where a service provider is a custodian of financial assets, and mainly crypto assets. Following said event, the Israeli inter-committee in the ministry of finance published its final report concerning crypto-assets, and the Israeli Securities Authority published a new memorandum to amend different securities laws in Israeli regulating services in crypto-assets of mutual funds, investment advice, and portfolio management and in trading platforms.

> This risk of misuse is particularly acute related to blockchain and privacy, as a blockchain keeps an almost indestructible ledger of any assets and transaction on it..... As such it could easily be used as a tool for tyranny.
>
> *Stephen Rutenberg*

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Timothy Murray MURRAY, HOGUE & LANNIS

Contracting by Emoji

A mid-level executive at a client's company routinely included a smiley face on everything the executive wrote. It didn't matter what it was—a letter, a greeting card, and presumably even his grocery list. The smiley face practically became part of his name, akin to when the late musician Prince changed his name to an unpronounceable symbol.

WHEN THE EXECUTIVE INCLUDED A SMILEY FACE ON A thank you note or a letter of commendation, it was regarded as a friendly gesture, and no one objected.

But some people began to suspect that maybe—just maybe—he might be overusing the smiley face when he put it at the end of a note saying, "More details will follow as we receive them, but I have just learned that our human relations director passed away last night."

Whether we like it or not, the dreaded emoji—the smiling face, the thumbs up, and all the rest—have become a more important part of peoples' electronic communications than the exclamation point and the semi-colon. "Emojis are a global phenomenon. Ninety-five percent of the online population sends over ten billion emojis each day."[1]

It would be foolhardy to assume that emojis are confined to social settings. Newsflash: our clients use them in business, and sometimes they even use them to make informal contracts. The ease and convenience of using a thumbs up emoji often outweigh the lawyer's pleading and cajoling not to use it.

A former head of global contracts at a Fortune 50 company said this: "I was in a negotiation with a client and they sent me an email with their counterproposal. My response was an emoji. Specifically, a thumbs up. 👍 After I sent that I realized I had just contracted with the client using an emoji! There is no other paperwork for this thing we are doing together."[2]

The fact that businesspeople use emojis in contractual settings does not make it a prudent practice. An emoji sent in response to an offer can lead to unintended contracting, and emojis in texts, emails, and tweets can induce reasonable reliance that subject the sender to liability if that reliance is misplaced.

In short, the legal landscape of contracting by emoji is littered with traps for the unwary. Our clients ought to be aware of them, and you might want to add this topic to your standard cautions about contracts.

The Wide Variety of Emojis

Before discussing the legal landscape of contracting by emoji, it is well to note that there are many different kinds of emojis,[3] and they vary in the risks they pose from a contract law perspective. The thumbs up emoji is the one most likely to find its way into informal contracts. There is a consensus about its meaning: Dictionary.com's Emoji Dictionary defines it as follows: "WHAT DOES 👍 THUMBS UP EMOJI MEAN? The thumbs-up emoji is used to express assent, approval, or encouragement in digital communications, especially in Western cultures."[4]

While the thumbs up emoji lacks the clarity of saying "I accept," it generally does not pose the same risks as other emojis, including the smiling face, the grinning face, the winking face, and the clapping hands. One commentator noted "that there is no consensus as to the meaning of each emoji."[5] That alone should counsel against the use of emojis in general.

The Legal Landscape of Emojis: Case Study

Lightstone RE LLC v. Zinntex LLC[6] dealt with the question of whether an emoji was a legally operative acceptance. Lightstone claimed that it paid Zinntex for protective masks that it didn't receive. The parties exchanged text messages to resolve their dispute. On June 25, 2020, Zinntex agreed in a text to pay $1,475,000 by September 25, 2020, in four installments of $368,750 each.

But Zinntex also texted: "I can keep paying you with no written agreement." An apparently astonished Lightstone responded: "You won't sign an agreement is what your [sic] saying. So how I can [sic] make a deal this way?"

More texts followed. Lightstone wrote: "So are you agreeing to pay me over the next 3 months 1,475,000?" Zinntex responded: "I am not going to sign anything but I will have you paid out within 3 months." Lightstone then sent a text reciting the dates that the four payments would be expected. Zinntex responded by texting a thumbs up emoji. That last text came just nine minutes after Zinntex told Lightstone that Zinntex would not sign anything.

Zinntex paid only $475,000, so Lightstone sued for the other $1 million, claiming that the thumbs up emoji constituted a signature of an executory accord that satisfied the statute of frauds. Lightstone moved for summary judgment, and Zinntex argued that the text messages were not legally binding.

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1. Leslie Y. Garfield Tenzer & Ashley Cangro, *An Emoji Legal Dictionary*, 83 U. Pitt. L. Rev. Online 1 (2022). 2. Tim Cummins, Commitment Matters, Contracting with Emojis, (Aug. 29, 2017). 3. *See* the Unicode Full Emoji List, v15.0. 4. Dictionary.com, Emoji Dictionary. *See also* Emojipedia (defining the thumbs up emoji as "A thumbs-up gesture indicating approval"). 5. Moshe Berliner, *When a Picture Is Not Worth a Thousand Words: Why Emojis Should Not Satisfy the Statute of Frauds' Writing Requirement*, 41 Cardozo L. Rev. 2161, 2172 (2020). 6. Lightstone RE LLC v. Zinntex LLC, 2022 N.Y. Slip Op 32931(U) (Kings Cty. 2022).

Was the thumbs up emoji a legally operative acceptance? The court thought it was questionable whether texts and emojis can satisfy the statute of frauds, but "even if such an electronic signature in the form of an emoji can create a valid contract, there still must be a meeting of the minds and an intent to be so bound . . . " Given the procedural posture of the case (a motion for summary judgment), there was a fact question as to whether Zinntex intended to be bound by the thumbs up emoji, especially given that it was texted just minutes after Zinntex had "categorically asserted he would not sign any document." The court concluded that this issue was not appropriately resolved on a motion for summary judgment. (Alas, the issue won't be resolved at a trial: the court held that "while the text messages may not have been sufficient to afford the plaintiff summary relief," the parties otherwise agreed that Zinntex owed the money sought, so there is no necessity to resolve the fact issues about the texts.)

The *Lightstone* court's holding seems correct: the mixed signals in Zinntex's texts—in essence Zinntex said, "I'll pay you, but I will not be bound by any such promise"—forecloses any conclusion, as a matter of law, that Zinntex manifested the unqualified assent necessary to form a contract.[7] But the court was likely wrong about the statute of frauds, as explained below.

Statute of Frauds

We can't discuss contracting by emoji without a brief detour down the dark and twisted corridor of the statute of frauds (my apologies in advance). Certain contracts have to be in writing to satisfy the statute of frauds.[8] If a contract falls into one of those categories, the text or email containing the emoji has to satisfy the statute's requirements.

The statute of frauds raises some thorny issues when the writing (more accurately, the record) is a text or an email. It gets even thornier when the purported signature necessary to satisfy the statute of frauds is an emoji.

In the *Lightstone v. Zinntex* case discussed above, the court's comment questioning whether texts and emojis can satisfy the statute of frauds misses the mark. It is widely accepted that "[t]ext messages and emails can potentially satisfy the Statute of Frauds, provided that they, like other writings, contain the essential terms of the transaction and are signed by the parties to be bound or their authorized agents."[9] Whether there is a sufficient signature in a text or email is often the principal issue in dispute.[10]

7. *See* Timothy Murray, Corbin on Contracts § 3.30. **8.** *E.g., see* Henry F. Luepke, III, *Promissory Estoppel and the Statute of Frauds in Missouri*, 58 J. Mo. B. 132, 133 (May/June 2002):

> Substantially tracking section 4 of the English version, Missouri's Statute of Frauds prohibits enforcement of five categories of oral contracts: 1) contracts of executors or administrators (i.e., personal representatives under the Probate Code); 2) contracts to answer for the debt, default, or miscarriage of another; 3) contracts in consideration of marriage; 4) contracts for the sale of real property or an interest in real property; and 5) contracts not to be performed within one year from the making thereof. Like section 17 of the English statute, Missouri law includes, under the Uniform Commercial Code, a sixth category: 6) contracts for the sale of goods valued at $ 500 or more.

9. Donius v. Milligan, 24 LCR 440, 442 (Mass. Land Ct. 2015). *See* Massachusetts v. Greg Cohen Promotions, LLC, 2023 U.S. Dist. LEXIS 33525 (S.D. N.Y. Feb. 28, 2023); Han v. Chen, 2022 NY Slip Op 31501(U) (N.Y. Cty. 2022). **10.** Restatement (Second) of Contracts § 134: "The signature to a memorandum may be any symbol made or adopted with an intention, actual or apparent, to authenticate the writing as that of the signer." *See* Brewfab, LLC v. 3 Delta, Inc., 2022 U.S. App. LEXIS 28429 (11th Cir. Oct. 13, 2022).

One of the authorities cited by the *Lightstone* court is internet law guru Professor Eric Goldman. But Professor Goldman does not agree with the court's take on the statute of frauds: the court was "wrong about whether there is doubt that text messages and emojis can satisfy the statute of frauds," said Goldman. "This is squarely governed by UETA/E-Sign, and the answer is they can."[11]

Other commentators say that an emoji in a text can constitute a signature that satisfies the statute of frauds: "It seems clear that, under the right circumstances, an emoji could serve as an electronic signature or otherwise bind a party . . . The question is whether the parties *intended* the emoji to serve that purpose in this case."[12]

If it is surprising that an emoji might be regarded as a signature, consider that the Supreme Court of Mississippi has held that even the automatic "Sent from my iPhone" line that attaches itself on emails sent from iPhones "may satisfy a trier of fact that the user had the requisite intent to adopt the closing as his or her signature for mobile emails."[13] Unlike the "Sent from my iPhone" line, an emoji does not appear automatically on emails or texts—it has to be added by an affirmative act of will. In this sense, the emoji has a greater claim to signature status than the "Sent from my iPhone" closing.

An unsigned email or text message in a chain of emails or texts can also satisfy the statute of frauds so long as the unsigned email or text is closely related to a signed email or text; the emails or texts in the chain all clearly refer to the same subject matter; and the sender intended to adopt the unsigned email or text by signing the other.[14]

All of that is a long way of saying that, depending on the circumstances, a text or email containing an emoji can satisfy the statute of frauds. Given the factual nature of any such determination, it is prudent not to assume that a texted or emailed emoji will—or will not—satisfy the statute of frauds.

Mutual Assent

Aside from the hurdle of the statute of frauds, there's the pesky question of mutual assent (meeting of the minds). Can a thumbs up emoji constitute a legally operative acceptance that forms a contract? The answer is—why not? Emojis are not words, but that doesn't matter. An acceptance need not be couched in words. A "proposal might be accepted with a nod of the head"[15] or hand gestures at an auction. Here's what we wrote in *Corbin on Contracts*:

> There are different modes of expressing assent. Expression may be by the tongue, the eye, the hand, or by all of them at once. It may be by language, by words in any language, by words written or spoken. Yet there is also "sign language" which may consist of signs that are mere translations from a language of words, or of signs that convey ideas independently of any word language. A contract made by sign language is an express contract.[16]

Depending on the definiteness of the offer, the context, and all the surrounding circumstances, a texted or emailed thumbs up emoji ought to be regarded as a legally operative acceptance that forms a contract.[17] But as shown by *Lightstone v. Zinntex*,[18] discussed above, this might be a fact issue, and no one should assume that an emoji response to an offer is—or is not—an acceptance.

Cross-cultural differences might prevent one party from understanding the other when it comes to thumbs up emojis, a serious impediment to mutual assent. In some cultures, the thumbs up emoji does not manifest unqualified assent—some regard it as obscene or take it to signify not assent but the numeral one or five.[19] "[I]n countries such as Italy, Greece, Iran and Afghanistan, people interpret it as a sign of disrespect."[20] And then there's this: "Sending a thumbs-up can be seen as passive aggressive and even confrontational, according to Gen Z who claim they feel attacked whenever it is used."[21]

Unintended Contracting

If an offeree responds to an offer with an emoji but subjectively intends only to convey a friendly gesture short of an acceptance, that offeree nevertheless bears the risk of unintended contracting if the offeror reasonably interprets the emoji-response as an acceptance. In such case, a contract will be formed whether the offeree likes it or not.[22]

As one court put it: "So long as the offeror's interpretation of the offeree's equivocal acceptance is plausible or reasonable, New York courts will find a contract has been formed."[23]

The offeree who uses emojis has what the Restatement (Second) of Contracts calls the "[r]esponsibility for unintended appearance of assent."[24] That is, if the offeree "has reason to know that [the offeree's] conduct may cause the other party to understand that [the offeree] assents," the offeree has negligently created "an appearance of assent." The offeree is thus bound to a contract if the other party

11. Eric Goldman, Technology & Marketing Law Blog, A Million-Dollar Thumbs-Up Emoji?–Lightstone v. Zinntex, (Oct. 14, 2022). *See* John E. Murray, Jr. & Timothy Murray, Corbin on Contracts Desk Edition, § 23.03: "[U]nder UETA, 'electronic signature' 'means an electronic sound, symbol, or process attached to or logically associated with a record and executed or adopted by a person with the intent to sign the record.'" In addition, "[u]nder U.C.C. § 1-201(b)(37) 'signed' 'includes using any symbol executed or adopted with present intention to adopt or accept a writing.'" **12.** Stephen M. Kramarsky and John Millson, New York Law Journal, *Thumbs Up or Thumbs Down: New York Court Analyzes Meaning and Impact of Emoji in Contract Negotiations* (Nov. 14, 2022). **13.** Parish Transp. LLC v. Jordan Carriers Inc., 327 So. 3d 45, 54-55 (Miss. 2021). **14.** *Parish Transp.*, 327 So. 3d 45. *See also Han*, 2022 NY Slip Op 31501(U), 9 ("[A]lthough signed and unsigned writings may be read together for purposes of the statute of frauds, . . . they must clearly refer to the same subject matter or transaction, contain all of the essential terms of a binding contract, and the unsigned writing must be prepared by the party to be charged . . . "); Calderwood v. Rinsch, 2022 U.S. Dist. LEXIS 213305 (E.D. Pa. Nov. 28, 2022) (if there is a signed text in a chain of unsigned texts, the unsigned texts may satisfy the statute of frauds if the texts "expressly reference each other."). **15.** Andra v. Lena P. Peebler Revocable Tr., 286 P.3d 576 (Kan. App. 2012). **16.** Timothy Murray, Corbin on Contracts § 1.19. **17.** *See, e.g.*, Menscher, Keith, "Thank you, I Emoji Your Offer: Emojis Translating Acceptance in Contracts" (2021). *Student Works*. 1265, at 16. **18.** *Lightstone*, 2022 NY Slip Op 32931(U). **19.** Moshe Berliner, *supra* n. 5, 41 Cardozo L. Rev. 2161, 2164, n.21. **20.** Menscher, Keith, *supra* n. 17, *Student Works*. 1265, at 23. **21.** Belinda Cleary, Daily Mail.com, *Why NOBODY should be using the 'thumbs up' emoji in 2022 - and the 10 symbols only 'old people' use that have Gen Z rolling their eyes* (Oct. 12, 2022). **22.** IBM Corp. v. Johnson, 629 F. Supp. 2d 321 (S.D.N.Y. 2009); Trademark Props., Inc. v. A&E TV Networks, 422 Fed. Appx. 199 (4th Cir. 2011). **23.** *A&E TV Networks*, 422 Fed. Appx. 199, 205. **24.** Restatement (Second) of Contracts § 19, cmt. C.

> The possibility of unintended contracting is a sufficient reason to counsel against using emojis in contractual settings.

"also manifest[s] assent, but no further change of position on [that party's] part is necessary to the formation of a bargain."[25]

The possibility of unintended contracting is a sufficient reason to counsel against using emojis in contractual settings.

Reliance

Use of an emoji may, in some circumstances, induce or contribute to inducing expectations and reliance. In *Friel v. Dapper Labs, Inc.*,[26] plaintiffs sued Dapper Labs, promoters of non-fungible tokens (NFTs), for allegedly violating the securities laws by offering for sale to the public NFTs known as NBA Top Shot Moments without filing an SEC registration statement. The court refused to dismiss the action.

In order for plaintiffs to show that Top Shot Moments was an investment vehicle, they had to prove that "a person invests [their] money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party." The last point—the expectation of profits—is pertinent here. The court found that Dapper Labs' public statements and marketing materials—including its tweets with emojis—objectively led purchasers to expect profits. The emojis included a rocket ship, a stock chart showing stocks on the rise, and a bag of money.

The court explained: "Each Tweet promotes a recent sale or statistics of recent sales of Moments on the Marketplace. And although the literal word 'profit' is not included in any of the Tweets, the 'rocket ship' emoji, 'stock chart' emoji, and 'money bags' emoji objectively mean one thing: a financial return on investment."

Just as sign language, a nod of the head, and emojis may form a contract, emojis may also induce reliance that is actionable. Under the right facts, an emoji can be the basis for a recovery on a claim of promissory estoppel.

The Dangers of Hasty Contracting

In days long gone, the formation of important contracts often was a ritualized affair, replete with an elaborate signing ceremony and formal seal, which was "originally a stamp of hot wax or something similar to authenticate a document and serve as evidence of the deliberation behind and solemnity of a legal undertaking."[27]

Today, though many contracts still are entered into with old fashioned paper and ink, for most contracts, paper and ink are unnecessary. Modern contracts are often of the browsewrap or clickwrap variety, or they are stored in the cloud, instantaneously accessed online, and executed by parties who have never met and who might be on opposite sides of the globe. For most contracts, there is no signing ceremony, no ritual handshake, and certainly no hot wax or seal.

25. *Id.* 26. Friel v. Dapper Labs, Inc., 2023 U.S. Dist. LEXIS 29176 (S.D.N.Y. Feb. 22, 2023). 27. Shawn J. Bayern, *Against Certainty*, 41 Hofstra L. Rev. 53, 67 (2012).

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For a review of the contract concepts and rules used to determine if an enforceable contract was formed during contract negotiations, see

AVOIDING ACCIDENTAL CONTRACTING

It is a sobering thought that multi-million-dollar contracts can now be made and modified by whipping out a cellphone and texting a thumbs up emoji, a process that might take a few seconds at most and requires no deliberation, much less an opportunity for legal counsel to review the new deal. For all the wonders of the modern age of texting—speed and convenience—this one is fraught with peril.

It is one thing when the owner of the company does this sort of thing, but it may be quite another when it's the proverbial loose cannon who seems to roam the halls of every company in America. (We all know the type: this person is a self-identified contract expert who makes sure to tell the company's legal counsel that whatever the expert does "has never been a problem—so stop overreacting!")

Is there a way to protect the client from impulsive thumbs up contracting? Education is critical—the client needs to understand that texts, emails, and tweets can have contractual significance. The client should never assume that the informality of these forms of communication immunize them from being contracts.

To prevent hasty modifications of existing contracts, consider adding a provision to the original contract stating that certain specified classes of agents (including the loose cannon) shall have no power to modify the contract or to waive the performance of conditions—that such power is confined to only certain persons. Such a clause ought to be effective to this extent: it would provide unequivocal notice that the loose cannon and others had no such power when the contract was made. Therefore, a party who claims that the loose cannon later modified the contract must show that such person somehow acquired that power after the contract was made—an extra hurdle that will be difficult to prove.[28]

This suggestion is not a silver bullet or ironclad, it is just an added protection.

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RESEARCH PATH: *Commercial Transactions > General Commercial and Contract Boilerplate > Articles*

28. *E.g.*, Blair v. Nat'l Reserve Ins. Co., 293 Mass. 86 (1936).

Pay Transparency and Disclosure Requirements Compliance Checklist

This checklist provides guidance on pay disclosure laws cropping up around the country.

One of the goals of these laws is to provide workers with more information regarding an employer's pay practices so they have greater leverage to discuss and negotiate their salaries. The broader objective of these laws is to help close the wage gap between women and men.

As these salary transparency laws proliferate coast to coast, the increasing patchwork of laws can be difficult to navigate. The problem facing employment lawyers is that this legislative trend is accelerating quickly and taking a variety of forms, making it difficult to have a clear handle on compliance. This checklist aims to simplify this compliance challenge for employment attorneys.

California's Landmark Salary Legislation

The first sweeping state law to be passed governing pay equity took place in California with the California Fair Pay Act (applicable to employers starting on January 1, 2016).[1] It amended the California Equal Pay Act and created a new standard of equal pay for substantially similar work.

- **Additional California pay equity laws**
  - ✓ **Salary history inquiry ban.** In 2018, California prohibited employers from inquiring about prospective employees' salary histories.[2]
  - ✓ **Pay data reporting.** In 2021, California became the first state to require companies with 100 or more employees to report wage data by race and gender across 11 pay bands. The goal is to reduce gender pay gaps and make it easier to enforce equal pay laws already on the books.
  - ✓ **Job postings.** On January 1, 2023, California began to require employers to include compensation and benefits information in job postings.[3]

Pay Transparency in Job Postings

Below is a summary of states and localities that have laws on pay transparency in job postings.

- **State and local laws on pay disclosure in job postings**
  - ✓ **Sample state laws.** In addition to the law regarding salary disclosure in job postings in California, several other states, such as Colorado, Connecticut, Maryland, Nevada, New York (effective September 17, 2023), Rhode Island, and Washington, have laws on pay disclosure in job postings.
  - ✓ **Sample local laws.** Several localities, such as New York City, Albany, NY, Ithaca, NY, Westchester County, NY, Cincinnati, OH, and Toledo, OH, have corresponding pay disclosure laws on the books as well.

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1. 2015 Bill Text CA S.B. 358 (Oct. 6, 2016). 2. *See* Cal. Lab. Code § 432.3(b). 3. *See* Cal. Lab. Code § 432.3(c).

Laws Barring Employers from Stopping Employees from Discussing Their Pay

Below is a summary of states that have laws prohibiting employers from preventing their employees from disclosing their pay to each other.

- **State and local laws on disclosure of wages between employees**
  - ✓ **Sample state laws.** Many states, such as California, Colorado, Connecticut, Delaware, Hawaii, Illinois, Maine, Maryland, Massachusetts, Michigan, Minnesota, Nebraska, Nevada, New Hampshire, New Jersey, New York, Oregon, Rhode Island, Vermont, Virginia, and Washington,and the District of Columbia have enacted laws barring employers from preventing employees from sharing their salary information—or from retaliating against them if they discuss their pay package with coworkers.

Laws Barring Salary History Inquiries

Below is a summary of states and localities that have laws prohibiting employers from asking about prospective employees' salary histories.

- **State and local laws on salary history inquiry bans**
  - ✓ **Sample state laws.** Many states, such as Alabama, California, Colorado, Connecticut, Delaware, Hawaii, Illinois, Maine, Maryland, Massachusetts, Nevada, New Jersey, New York, Oregon, Rhode Island, Vermont, and Washington, have laws that prohibit employers from requesting salary information from job applicants.
  - ✓ **Sample local laws.** Several localities also have prohibitions on inquiring about salary histories, such as San Francisco, CA, Kansas City, MO, New York City, Albany County, NY, Suffolk Country, NY, Cincinnati, OH, Toledo, OH, and Philadelphia, PA.

Practical Steps for Employers

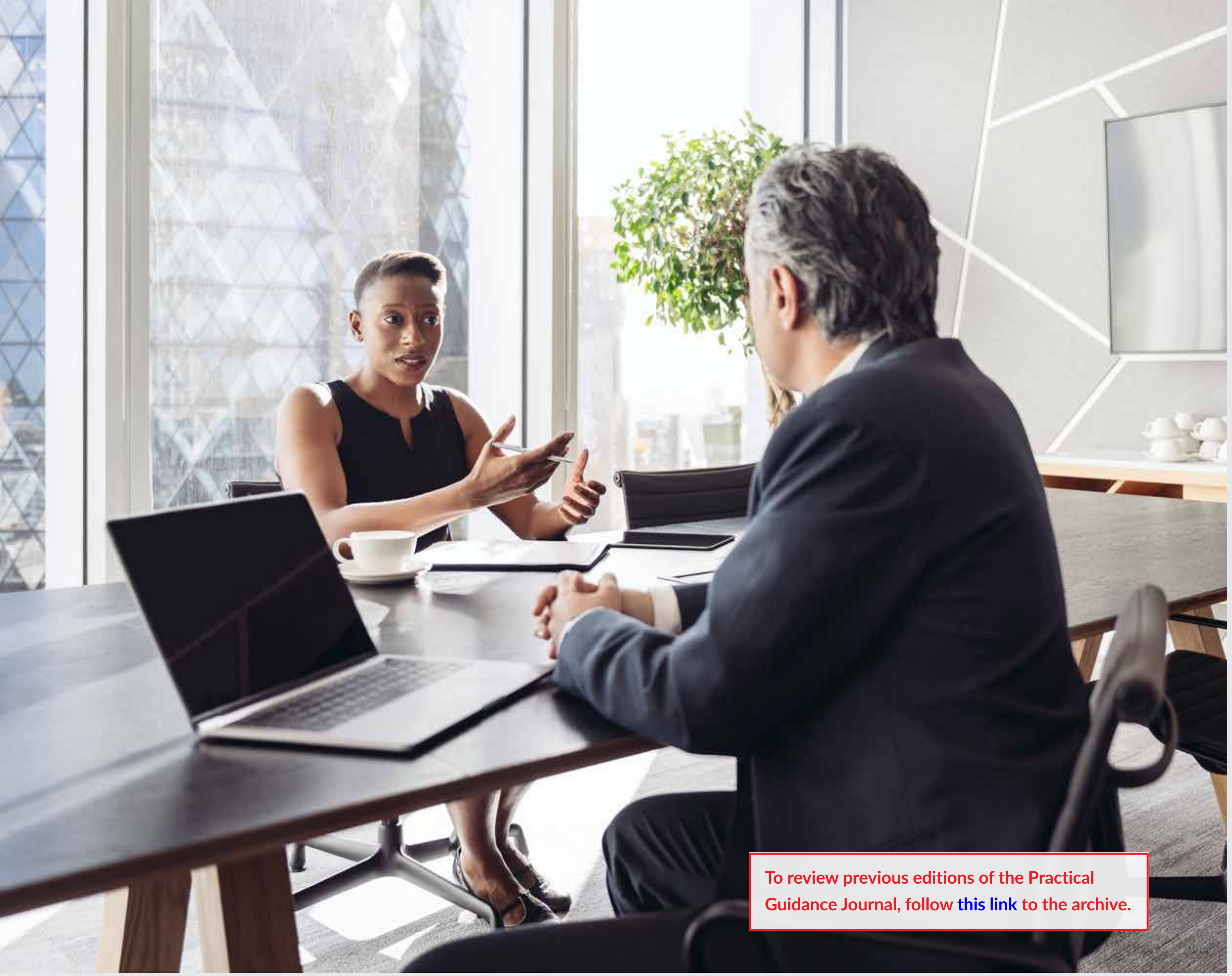
Employers should consider the following steps when handling pay transparency issues:

- **Consider salary benchmarking.** Applicants and employees will now be able to see if the employer's salaries are at a similar level to competitive employers. To help ensure the employer's pay is competitive, employers should consider engaging in salary benchmarking. The benchmarking should compare jobs by equivalent duties rather than titles. The benchmarking should also only include recent pay data (i.e., no more than six months old). It is generally helpful to hire an outside consulting firm to help conduct this benchmarking. They often have access to the most current, accurate, and relevant pay data.
- **Review and create salary ranges/bands.** After receiving salary benchmarking data, it will be necessary to review and create compensation bands at least every 6–12 months. These bands show a minimum, middle, and maximum compensation point for each level of each position in the organization. Developing set compensation ranges for each job level will help avoid pay equity claims and pay secrecy.
- **Educate managers on compensation ranges, pay disclosure laws, and documenting employment decisions and performance.** Managers must be aware of the pay transparency laws and the employer's commitment to equitable compensation. Because applicants and employees will be more aware of the employer's pay structures, managers need to be consistent in documenting hiring, promotion, disciplinary, and termination decisions. To help defend against potential pay discrimination claims, the employer will need to show there are legitimate reasons for any pay disparities between employees. Managers should avoid taking adverse action against applicants or employees due to their complaints about potential pay discrimination.

Navigating the Patchwork of Legislation

To navigate this patchwork of salary transparency laws, here are key elements of pay disclosure requirement laws at the state and local levels to consider:

- **Employee eligibility and exemptions.** Does the law refer to external applicants and current employees? What about promotion opportunities as well as nonpromotion opportunities? Are certain employers exempt from the law, such as those with fewer than 15 employees? Are remote positions exempt from the requirements?
- **Required information.** How much detail does the law require to post? A general description of the pay scale? Is there specific application to bonuses, commissions, or other forms of compensation? Is the offered employee benefits plan, such as employee healthcare or retirement plans, subject to disclosure requirements?
- **Timing and triggering events.** What is the effective date of the law? What specific employee information requests must employers grant? Are there additional salary disclosure requirements that the law imposes when employers announce promotion opportunities?
- **Notice and posting requirements.** What communication channels must employers use to notify employees and prospective employees of pay scales? May employers keep some job openings confidential? Do the disclosure requirements apply to any third parties that employers engage to recruit job candidates on their behalf?
- **Penalties.** How much are the potential fines that state labor commissioners can impose for failure to comply? Are there any mitigating circumstances that will be considered? Is there a private right of action for individuals to seek injunctive relief or other relief?
- **Other key provisions.** Do employers have the discretion to post compensation ranges with wide gaps between the lowest and highest salary figures? Is there a good faith provision that allows employers to pay more or less than the posted range, based on extenuating circumstances? What, if any, specific records of job descriptions and wage rate history must employers maintain?



To review previous editions of the Practical Guidance Journal, follow this link to the archive.

- **Carefully review the pay transparency laws in all jurisdictions.** As stated above, several jurisdictions have a variety of pay transparency laws with different requirements. To keep up with the different and developing laws, it will be helpful to review state and local law surveys on pay transparency by Lexis® Practical Guidance.
- **Revise job postings.** National or multistate employers may want to revise their job postings to be consistent with the most restrictive pay transparency requirements to ensure compliance. If a national employer wants to have one job posting that applies all around the country, the employer should consider crafting their job postings on compensation to meet the most rigid jurisdictional pay disclosure requirements. This way, the employer will not run afoul of pay transparency laws in any state or locality where they offer the job posting. Of course, companies can also opt to customize their job postings to the pay transparency requirements of each state or locality.
- **Consider prohibiting salary negotiations.** Sometimes applicants or employees are able to negotiate higher pay for themselves. These negotiations can sometimes take pay outside the set compensation bands and/or cause inequality between male and female employees' salaries.
- **Conduct regular pay equity audits.** It is a best practice to regularly investigate pay equity at the organization. Some key steps in pay equity audits include the following:
  - ✓ **Preserve attorney-client privilege and work product.** Engage outside counsel, in-house counsel, and outside experts (e.g., statisticians) in writing to provide advice on the audit. The audit team should include only those individuals who are needed to help determine the legal analysis.
  - ✓ **Compare the compensation of employees who perform the same or significantly similar work.** To make this comparison and to avoid equal pay claims, consider pay scales, job descriptions, performance review procedures, and other factors influencing pay. These factors include length of time at the organization and/or in the industry, where the employees work, and their educational levels.
  - ✓ **Conduct a statistical analysis on compensation between male and female employees.** It is often helpful to hire experienced statisticians to conduct this analysis.
  - ✓ **Take action to fix unjustified pay disparities.** If the audit shows there are gender disparities in pay that are not explainable by legitimate factors (e.g., seniority), the employer must adjust the pay ranges so that male and female employees are receiving equal pay for equal work. The employer will also want to consider whether to remedy these pay issues retroactively.

Pay disclosure requirements will continue to proliferate and there may soon be similar legislation across many more states and localities. Stay apprised of the latest legislative and regulatory developments governing salary transparency to mitigate compliance risk and to provide the best possible counsel to clients.

Adapted with permission from an earlier version that first appeared on Legal Dive as "How in-house counsel can navigate pay disclosure laws." L

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WAGE TRANSPARENCY STATE LAW SURVEY: BANS ON EMPLOYERS PREVENTING EMPLOYEES FROM DISCUSSING THEIR PAY

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For information that will assist attorneys in providing advice and counsel to employers regarding how to ensure compliance with equal pay laws, see

PAY EQUITY AUDITS: BEST PRACTICES

RESEARCH PATH: *Labor & Employment > Screening and Hiring > Checklists*

Laurie E. Leader EDITOR-IN-CHIEF, BENDER'S LABOR AND EMPLOYMENT BULLETIN

No-Poach Agreement as *Per Se* Violations of the Antitrust Law

The United States Department of Justice (DOJ) is aggressively prosecuting employers who enter into no-poach agreements[1] under the antitrust laws. Until 2021, DOJ enforcement was civil in nature.

A SEA CHANGE OCCURRED ON JANUARY 7, 2021, WHEN the DOJ announced that it indicted Surgical Care Affiliates, LLC and SCAI Holdings, LLC (together, SCA) on charges of orchestrating an antitrust conspiracy with two other healthcare providers, also operating outpatient medical centers—United Surgical Partners International, Inc. (USPI) and DaVita, Inc.[2] Notably, these indictments closely followed on the heels of the DOJ's first criminal wage-fixing indictment based on alleged agreements among competing therapist staffing companies to set lower wages for physical therapists and their assistants.[3]

In *In re Medical Center Employees Antitrust Litigation*,[4] former SCA senior employees filed a civil class action in the U.S. District Court for the Northern District of Illinois following announcement of the DOJ indictments issued against SCA, USPI, and DaVita.[5] The complaint sets forth a single antitrust conspiracy claim under Section 1 of the Sherman Act,[6] alleging that SCA, USPI, DaVita, and unnamed Doe defendants "entered into an overarching conspiracy to restrict competition for Plaintiffs' and other senior employees' services by agreeing to refrain from proactively soliciting or hiring each other's current employees."[7] Notably, in denying a motion to dismiss for failure to state a claim and for lack of standing, the district court held that no-poach agreements are illegal *per se* under the Sherman Act.[8] The DOJ has assumed a similar stance in criminally prosecuting employers engaged in wage-fixing or no-poach schemes.[9] The *Medical Center* case is instructive on the elements for pleading *per se* antitrust violations in connection with no-poach agreements.

1. A no-poach agreement is an illegal agreement between competitors in which they agree not to hire, recruit, or pursue each other's employees or not to match offers made by competitors. The agreements may be verbal or in writing and are often made without the knowledge of the employees affected by them. 2. *See* In re Outpatient Med. Ctr. Emp. Antitrust Litig., 2022 U.S. Dist. LEXIS 173925, at **8-9 (N.D. Ill. Sept. 26, 2022), citing United States v. Surgical Care Affiliates, LLC, No. 3:21-cr-00011 (N.D. Tex. Jan. 5, 2021). 3. *See* United States v. Jindal, 2021 U.S. Dist. LEXIS 227474, at **1-6 (E.D. Tex. Nov. 29, 2021). The *Jindal* indictment charged the defendants with violating: Section 1 of the Sherman Act, 15 U.S.C.S. § 1 (antitrust price-fixing conspiracy); 18 U.S.C.S. § 371 (conspiracy to commit offense); and 18 U.S.C.S. § 1505 (obstruction of proceedings before the Federal Trade Commission). A Sherman Act violation was, similarly, alleged in *In re Outpatient Med. Ctr.* and the underlying indictments and, like in *In re Outpatient Med. Ctr.*, the court in *Jindal* found the underlying agreements to be *per se* illegal conspiracies in restraint of trade. Specifically, the *Jindal* court found wage-fixing to be a form of price-fixing in violation of the antitrust laws. *Jindal*, 2021 U.S. Dist. LEXIS 227474, at **15-21. 4. 2022 U.S. Dist. LEXIS 173925. 5. 2022 U.S. Dist. LEXIS 173925, at *4. 6. 15 U.S.C.S. § 1. 7. 2022 U.S. Dist. LEXIS 173925, at *6. 8. 2022 U.S. Dist. LEXIS 173925, at *38-40. 9. *See, e.g.*, United States v. DaVita, Inc., 2022 U.S. Dist. LEXIS 16188, at **24-28 (D. Colo. Jan. 28, 2022) (allowing the government to proceed under a *per se* theory against one of the employers involved in the SCA conspiracy); *Jindal*, 2021 U.S. Dist. LEXIS 227474, at **15-21 (endorsing the government's position that the underlying wage-fixing scheme could be prosecuted under a *per se* theory as opposed to a rule of reason theory). The criminal case against the *DaVita* defendants proceeded to a jury trial in which DaVita and its CEO were found to be not guilty on all counts. *See* In re Outpatient Med. Ctr., 2022 U.S. Dist. LEXIS 173925, at *9 n.4.

Earlier DOJ Prosecutions and Guidance on the Illegality of No-Poach Agreements

No-poach agreements originated in the Silicon Valley. They came to the forefront in 2011 when a lawsuit was filed alleging that Apple, Google, Intel, and Adobe Systems, Inc. agreed not to poach each other's employees, thereby restricting employee mobility and freezing employee salaries.[10] The no-poach agreement was based on a series of emails between Apple co-founder Steve Jobs and the CEO of Google, Eric Schmidt, that outlined a plan designed to avoid the poaching of high-level engineers at each of the companies.[11] The case ultimately settled for the hefty price tag of $415 million.

Since that time, no-poach agreements have been on the rise, notwithstanding prosecutions of offending employers by the DOJ's Antitrust Division. Currently, the DOJ has made no-poach agreement prosecutions a priority, prosecuting such cases both criminally and civilly.[12]

In October 2016, the DOJ and the Federal Trade Commission jointly published a primer on no-poach agreements and the antitrust laws for human resource professionals entitled "Antitrust Guidance for Human Resource Professionals" (Guidance).[13] The Guidance highlighted the DOJ's civil enforcement actions against no-poach agreements in the healthcare and technology sectors. Again, since the Guidance was published, the DOJ has expanded its prosecution of no-poach agreements into the criminal realm.

In re Outpatient Medical Center: Standing to Sue Under No-Poach Agreements and Alleging Related Violations of the Sherman Act

The *Outpatient Medical Center* class action decision provides a clear analysis of how no-poach agreements and antitrust law intersect. In addition to SCA, USPI, DaVita, and several unidentified Doe defendants, the alleged conspiracy also involved defendants Andrew Hayek and Kent Thiry, the former chief executive officers of SCA and DaVita, respectively. UnitedHealth Group, Inc., the current parent of SCA, and Tenet Healthcare Corp., the current parent of USPI, were also named as defendants.

The purported conspiracy was evidenced by an email that USPI's CEO sent to certain of USPI's employees in May 2010, informing them that he and SCA's then-CEO Hayek had reached an agreement not to proactively approach each other's employees. USPI and SCA further agreed to alert each other to potential violations of their agreement. Consistent with the

"Currently, the DOJ has made no-poach agreement prosecutions a priority, prosecuting such cases both criminally and civilly."

agreement, USPI's human resources personnel told recruiters to avoid contacting SCA employees, since USPI could not hire SCA employees unless they had first informed SCA that they were actively pursuing other opportunities.[14] A similar agreement was reached between SCA and DaVita. Eventually the alleged conspiracy was expanded to the Doe defendants.[15]

The complaint alleged that the defendants' agreements constituted a *per se* violation of the Sherman Act and that, as a result, plaintiffs were "deprived of free and fair competition in the market for their service, which, in turn, caused the artificial suppression of their compensation.[16]

Defendants moved to dismiss the complaint for lack of standing and for failure to state a claim under Rules 12(b)(1) and 12(b)(6) of the Federal Rules of Civil Procedure.[17] The district court denied the defendants' motions in their entirety.

On the issue of standing, defendants argued that the plaintiffs failed to plead "antitrust standing," specifically that they suffered an antitrust injury proximately caused by defendants' conduct.[18] Stated differently, defendants claimed that plaintiffs failed to provide specific facts demonstrating that defendants' conduct actually suppressed their compensation or caused them to miss out on job opportunities. The court rejected that argument as well as the defendants' related claim that plaintiffs' damages were only speculative in nature.

Specifically, the court highlighted some of the plaintiffs' "detailed allegations" explaining how they were injured by the defendants' conduct. Noting that defendants are among the largest employers in the outpatient medical care market, that they compete with each other nationwide for a limited supply of senior talent, and that lateral hiring is a key form of competition in the industry and is particularly beneficial for hiring senior employees, the defendants' agreements interfered with the free flow of information between employees and prospective employers and the proactive solicitation

10. *See generally* https://www.reuters.com/article/apple-google-ruling/u-s-judge-approves-415-min-settlement-in-tech-worker-lawsuit-idUSL1N11908520150903. 11. *Id.* 12. *See* https://www.justice.gov/atr/file/903511/download. 13. *Id.* 14. In re Outpatient Med. Ctr. Empl. Antitrust Litig., 2022 U.S. Dist. LEXIS 173925, at **6-7. 15. 2022 U.S. Dist. LEXIS 173925, at *8. 16. 2022 U.S. Dist. LEXIS 173925, at *10. 17. Fed. R. Civ. P 12. 18. 2022 U.S. Dist. LEXIS 173925, at *12.

process generally. Along the same lines, "the mere possibility of losing an employee serves to pressure an employer to increase compensation preemptively to ensure that its employees feel properly valued and loyal" but "by agreeing with each other not to solicit senior employees proactively, Defendants had less reason to fear losing those employees and thus less incentive to take preemptive measures to retain them."[19] Accordingly, where the competition for employees is distorted, compensation is suppressed for all of them. Under the circumstances, the court found that plaintiffs adequately alleged that the defendants' conspiracy caused them an injury-in-fact, thus allowing them to seek damages. The court further found that the plaintiffs plausibly alleged a substantial threat of future harm to satisfy the pleading requirements for seeking injunctive relief.[20]

Not only did plaintiffs adequately allege an injury-in-fact to themselves, but—in the court's view—they also alleged an antitrust injury, "as they allege that Defendants' anticompetitive conduct has restrained competition for qualified outpatient medical services employees and artificially suppressed their competition" and link that injury to the purported conspiracy.[21] Under all of these circumstances, the court held that plaintiffs satisfied the proximate-cause element of their antitrust conspiracy claim.[22]

The court then considered whether plaintiffs adequately pled an antitrust violation, since only unreasonable restraints of trade are outlawed by Section 1 of the Sherman Act.[23] To state a claim under Section 1 of the Sherman Act, a plaintiff must allege: "(1) a contract, combination, or conspiracy; (2) a resultant unreasonable restraint of trade in the relevant market; and (3) an accompanying injury."[24] Finding that plaintiffs alleged a common motive to conspire, outlining the existence of three bilateral agreements between the defendants and several "plus factors" from which a single overarching conspiracy could be inferred, the court focused its attention on the second element of a Section 1 violation, specifically, whether the alleged restraint of trade is unreasonable.

19. 2022 U.S. Dist. LEXIS 173925, at *15. **20.** 2022 U.S. Dist. LEXIS 173925, at **18-21. **21.** 2022 U.S. Dist. LEXIS 173925, at **22-23. **22.** 2022 U.S. Dist. LEXIS 173925, at *23. **23.** 2022 U.S. Dist. LEXIS 173925, at **23-24, citing Ohio v. Am. Express Co., 138 S. Ct. 2274, 2283 (2018). **24.** 2022 U.S. Dist. LEXIS 173925, at *24 quoting Agnew v. NCAA, 683 F.3d 328, 335 (7th Cir. 2012) (internal quotations omitted).

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There are three methods of analysis to determine whether a particular restraint of trade is unreasonable: quick look, *per se*, and rule of reason.[25] Although antitrust violations are generally analyzed under the rule-of-reason approach, plaintiffs argued that the defendants' no-poach agreements constituted *per se* violations of the Sherman Act, because the nature and necessary effect of the defendants' agreements are "so plainly anticompetitive that no elaborate study of the industry is needed to establish their illegality."[26] Noting that "[t]ypically only 'horizontal' restraints—restraints 'imposed by agreement between competitors'—qualify as unreasonable *per se*," the court found that the agreements at issue could qualify for *per se* analysis on this basis.[27]

But whether the restraint is horizontal does not end the inquiry as to whether the restraint is entitled to *per se* treatment. A horizontal restraint may escape *per se* treatment if the restraint is "ancillary" rather than "naked."[28] "A restraint is ancillary when it may contribute to the success of a cooperative venture that promises greater productivity and output."[29] By contrast, a "naked" restraint is one "in which the restriction on competition is unaccompanied by new production or products."[30] If an agreement arguably promoted enterprise and productivity at the time it was adopted, the court must employ the rule-of-reason approach, which requires a plaintiff to show that "an agreement or contract has an anticompetitive effect on a given market within a given geographic area."[31] If the only effect of the agreement is the "stifling of competition," by contrast, it is a "naked" restraint that is *per se* unlawful.[32]

The court found that the defendants' no-poach agreements plausibly alleged "*per se* unreasonable naked horizontal market allocation agreements."[33] Noting that other courts applied *per se* treatment to naked agreements by which employers refrained from hiring a competitor's employees, the court underscored that it legally makes no difference that the defendants were dividing employees as opposed to "territories, customers, or products."[34] Because plaintiffs pled a plausible *per se* claim, the ultimate question of proof—left for a later date—is "whether the evidence will establish that the non-solicitation [no-poach] agreements do, in fact, nakedly allocate the market for outpatient medical care employees."[35]

Takeaways

The DOJ's actions and words demonstrate a continued commitment to focus on anticompetitive conduct in labor markets. No-poach agreements are classic examples of a restraint of trade subject to antitrust scrutiny and prosecution. Companies should review their current non-solicitation and non-compete agreements to excise no-poach clauses and to establish a company antitrust compliance policy to detect potential violations. Although a bona fide compliance program will not avoid antitrust prosecution, it will mitigate against criminal charges if the company is targeted. L

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25. 2022 U.S. Dist. LEXIS 173925, at *30; *see also* Cal. Dental Ass'n v. FTC, 526 U.S. 756, 780 (1999). **26.** 2022 U.S. Dist. LEXIS 173925, at *31, quoting Nat'l Soc'y of Prof'l Eng'rs v. United States, 435 U.S. 679, 692 (1978). **27.** 2022 U.S. Dist. LEXIS 173925, at **32-33, quoting *American Express*, 138 S. Ct. at 2283-84, and Bus. Elecs. Corp. v. Sharp Elecs. Corp., 485 U.S. 717, 730 (1988). **28.** 2022 U.S. Dist. LEXIS 173925, at *33. **29.** Polk Bros., Inc. v. Forest City Enters., Inc., 776 F.2d 185, 189 (7th Cir. 1985). **30.** 776 F.3d at 188. **31.** 2022 U.S. Dist. LEXIS 173925, at *34, quoting *Cal. Dental Ass'n*, 526 U.S. at 780. **32.** 2022 U.S. Dist. LEXIS 173925, at *34, quoting White Motor Co. v. United States, 372 U.S. 253, 263 (1963). **33.** 2022 U.S. Dist. LEXIS 173925, at *34. **34.** 2022 U.S. Dist. LEXIS 173925, at **34-36. **35.** 2022 U.S. Dist. LEXIS 173925, at *39, citing *DaVita*, 2022 U.S. Dist. LEXIS 16188, at **24-28.

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Long COVID Presents New Challenges for Employers

It has been more than three years since COVID-19 changed not only the way in which we work, but our entire lives as well. The lockdowns have ended, and we now are venturing into uncharted waters in what has been termed the new normal.

WHAT THAT TERM MEANS IS NOT PRECISELY CLEAR, AS THE COVID-19 virus continues to surprise us. We are just starting to learn about some of the strange effects that the virus has upon people, such as hairy tongue, as well as the potential long-term effects of having been infected with COVID-19—so-called long COVID. The impact of long COVID is just being felt, and just as the advent of the pandemic had unforeseen effects upon the workplace, it is safe to say that the impact of long COVID will present new challenges for employers and those who represent them.

Long COVID Is Real

Over the past few years, we have been inundated with false or misleading information about COVID. However, one thing is clear: long COVID is real and has been diagnosed by medical professionals in the United States and in countries around the world. Long COVID is defined by the Centers for Disease Control and Prevention (CDC) as new, recurring, or ongoing health problems experienced at least four weeks after infection with COVID-19, including brain fog, headaches, heart palpitations, mood swings, light headedness, and autoimmune conditions damaging internal organs.[1]

According to a recent study published in *The Lancet*, persons infected with COVID-19 have an increased risk for two years of developing brain disorders, including dementia, epilepsy, psychosis, and cognitive deficits (including what has been termed chemo brain).[2] Additionally, according to the CDC, COVID-19 survivors have twice the risk of developing pulmonary embolisms or respiratory conditions.[3] Most worrisome, according to a recent Veterans Administration study reported in *Nature Medicine*, vaccines may not prevent long COVID from occurring.[4]

1. *See* Centers for Disease Control and Prevention, *Long COVID: Household Pulse Survey* (June 22, 2022, updated Jan. 25, 2023), and Centers for Disease Control, *Long COVID or Post-COVID Conditions* (updated Dec. 16, 2022). 2. M. Taquet, et al., The Lancet, *Neurological and Psychiatric Risk Trajectories After SARS-COV-2* (Aug. 17, 2022). 3. Centers for Disease Control and Prevention, *Caring for People with Post-COVID Conditions* (updated Mar 21, 2022). 4. Ziyad Al-Aly, Benjamin Bowe and Yan Xie, Nature Medicine, *Long COVID after breakthrough SARS-CoV-2 infection* (Vol. 28, July 2022, 1461-1467).

Although the National Institutes of Health (NIH) has embarked upon a multi-billion-dollar study of long COVID, at the present time there is no established verification through medical tests nor established treatments for the malady. So far, the NIH has hypothesized that there may be three possible causes of long COVID: (1) COVID-19 particles become active again, causing symptoms to reappear; (2) the immune system goes into overdrive in fighting the COVID-19 infection, causing inflammation and damage throughout a person's body; or (3) the immune system never shuts down (even after the COVID-19 infection dissipates) and, as a result, continues to wreak havoc in a person's body.[5]

What is the Extent of Long COVID?

Although many employers are now just reporting that some of their employees are experiencing the symptoms of long COVID, it is more than likely that in the near future, increasing numbers of employers will be dealing with the impact of long COVID. It has been estimated that one in four persons who contract COVID-19 become long haulers, and according to a study published by the Brookings Institution, 16 million working-age Americans are struggling with the effects of long COVID. Moreover, between two and four million Americans are not working as a consequence—resulting in over 150 billion dollars per year in lost wages.[6]

The Legal Impact of Long COVID

Dealing with what may become a tsunami of long COVID-infected employees will create legal challenges for all employers. Most prominently, federal and state laws protecting persons who may be classified as disabled will affect how employers deal with the disruption caused by employees experiencing the effects of long COVID. State and federal leave laws, including the federal Family and Medical Leave Act (FMLA), may come into play as well.[7]

Is Long COVID a Disability?

Both the Equal Employment Opportunity Commission (EEOC) and the courts have generally recognized that being infected with the COVID-19 virus and having mild symptoms with no lasting consequences does not rise to the level of an actual disability under the Americans with Disabilities Act (ADA).[8] Persons who have contracted COVID-19 and, as a result, need to quarantine and miss work for a few weeks cannot be said to have a physical or mental impairment that substantially limits a major life activity, which is the definition of an actual disability under the ADA and many state and local statutes, which mirror the ADA definition.[9]

Long COVID, however, is a different story. In July of 2021, both the Department of Justice (DOJ) and the Department of Health and Human Services (HHS) issued guidance that long COVID can be a medical impairment under the ADA and, depending upon its impact and effects, rise to the level of a disability. DOJ and HHS reached this conclusion because long COVID can cause severe damage to a person's lungs, heart, and kidneys, as well as neurological and circulatory systems.[10] The federal agencies also recognized that memory lapses and brain fog can substantially limit such major life activities as brain function, concentrating, and thinking. In 2022, the EEOC issued similar guidance, advising that long COVID may be a disability for individuals infected with COVID-19 that causes ongoing intestinal pain, headaches, fatigue, heart palpitations, and shortness of breath.[11]

5. National Institutes of Health, *Long COVID* (updated Oct. 5, 2022). 6. Katie Bach, The Brookings Institution, *New data shows long COVID is keeping as many as 4 million people out of work* (Aug. 24, 2022). 7. Family and Medical Leave Act of 1993, Pub. L. No. 103-3, 107 Stat. 6 (Feb. 5, 1993), codified at 29 U.S.C.S. § 2601 et seq. 8. Equal Employment Opportunity Commission, Section N of *What You Should Know About COVID-19 and the ADA, the Rehabilitation Act, and Other EEO Laws* (updated July 12, 2022), (hereinafter, EEOC Guidance). *See also* Champion v. Mannington Mills, Inc., 538 F.Supp.3d 1344 (M.D. Ga. 2021) (being required to quarantine and miss work for 10 days due to COVID infection not substantially limiting); Payne v. Woods Services, Inc. et al., 520 F.Supp.3d 670 (E.D. Pa. 2021) (same); McCone v. Exela Techs., Inc., 2022 U.S. Dist. LEXIS 45734, *9 (M.D. Fla. Jan. 14, 2022) ("being infected with COVID-19, standing alone, does not meet the ADA's definitions of disability or impairment."); Harakal v. Composite Motors, Inc., 2022 U.S. Dist. LEXIS 227917, *4-5 (M.D. Fla. Dec. 19, 2022) ("It would be absurd to hold that any employee who contracted COVID-19 was disabled."); Baum v. Dunmire Prop. Mgmt., 2022 U.S. Dist. LEXIS 54555, *11 (D. Colo. Mar. 25, 2022) ("plaintiff has failed to plausibly allege that her father's COVID-19 diagnosis and related respiratory issues constitute a disability under the ADA."); Worrall v. River Shack, LLC, 2022 U.S. Dist. LEXIS 146077, *8 (N.D. Tex. Aug. 15, 2022) ("[t]he fact that [plaintiff] was instructed to isolate [following a positive COVID-19 test] does not itself suggest that he suffered from a disability."); Southall v. Ford Motor Co., 2022 U.S. Dist. LEXIS 223045, *9 (S.D. Ohio Dec. 9, 2022) ("but merely alleging a COVID diagnosis without more facts which make plausible that the disease substantially limited one or more of the employee's major life activities, is not enough to survive a motion to dismiss."). *Cf.* Roman v. Hertz Local Edition Corp., et al., 2022 U.S. Dist. LEXIS 88154, *16 (S.D. Cal. May 16, 2022) (employee who contracted mild case of COVID-19 was not disabled under California's Fair Employment and Housing Act, but recognizing that long COVID "may well fall within FEHA's definition of disability."). 9. 42 U.S.C.S. § 12102(1)(A). Even if infection with COVID-19, in and of itself, is not actually disabling by substantially limiting a major life activity, a person still may be protected under the ADA where an employer takes a job action against an individual due to that person's actual or perceived infection with COVID-19 "whether or not the impairment limits or is perceived to limit a major life activity" as long as the impairment is not "transitory and minor." Under the statute, "[a] transitory impairment is an impairment with an actual or expected duration of six months or less." 42 U.S.C.S. § 12102(3). In Matias v. Terrapin House, Inc., 2021 U.S. Dist. LEXIS 176094 (E.D. Pa. Sept. 16, 2021), the district court in denying the defendant's motion to dismiss, held that "the immediate temporal proximity between [the employee's] disclosure of her COVID-19 symptoms . . . and her termination raises a strong inference that [the employer] regarded her as disabled." *See also* Brown v. Roanoke Rehab. & Healthcare Ctr., 586 F.Supp.3d 1171, 1180 (M.D. Ala. 2022) (plaintiff's complaint sufficiently alleged that she was regarded as disabled "by alleging that she was discharged shortly after informing her employer that she was continuing to suffer from a severe, symptomatic case of COVID-19."); Moody v. Mid-Michigan Med. Ctr.-Midland, 2022 U.S. Dist. LEXIS 130822, *13 (E.D. Mich. July 22, 2022) (where complaint alleged that hospital reduced nurses' hours because it regarded her as having COVID-19, nurse sufficiently alleged an ADA claim); Booth v. GTE Fed. Credit Union, 2021 U.S. Dist. LEXIS 224333 (M.D. Fla. Nov. 20, 2021) ("COVID-19 is not so obviously transitory and minor that [Plaintiff's] claim must fail as a matter of law."). Other courts have reached a different conclusion and held that merely alleging that an employer took an adverse job action due to an employee's actual or perceived COVID-19 infection does not rise to the level of a regarded as disabled claim because "the typical course of COVID-19 does not run for six months" and, therefore, is transitory. *Southall*, 2022 U.S. Dist. LEXIS 223045, *10. As explained by the *Southall* court, "simply alleging that an employer perceived an employee as disabled because he tested positive for COVID, without more, is not enough to make plausible that the employer regarded the employee as disabled." *Id.*, *9. *See also Worrall*, 2022 U.S. Dist. LEXIS 146077, *11 (because plaintiff failed to "allege[] that his COVID illness lasted or was expected to last longer than the fourteen days that he was told to quarantine for" and that "his transitory illness was non-minor," plaintiff failed to show that employer regarded him as disabled.); *Rice v. Guardian Asset Mgmt., Inc.*, 2021 U.S. Dist. LEXIS 184868 (N.D. Ala. Aug. 19, 2021) ("While [Plaintiff] may disagree with [Defendant's] decision to send her home to quarantine and to request a negative [COVID-19] test before she could return, following public health protocols does not establish that [Defendant] regarded her as disabled.") 10. U.S. Department of Justice, *DOJ and HHS Issue Guidance on 'Long COVID' and Disability Rights Under the ADA, Section 504, and Section 1557* (July 26, 2021). *See also* U.S. Department of Health Human Services, *Guidance on "Long COVID" as a Disability Under the ADA, Section 504, and Section 1557* (July 26, 2021). For a further discussion of the DOJ and HHS Joint Guidance, *see* Jonathan. Mook, *Is Long COVID an ADA Disability: The Jury Is Still Out*, 21-10 Bender's Lab. & Empl. Bull. 01 (Oct. 2021). 11. EEOC Guidance, *supra* n. 8.

Lawsuits alleging that an employer discriminated against an employee suffering from long COVID are starting to be filed, but to date, there have been no definitive court decisions holding that long COVID constitutes an ADA disability.[12] Nonetheless, courts have allowed claims that an employer terminated or failed to accommodate employees suffering from the long-term ill effects of COVID-19 to continue past the initial dismissal stage.[13] Accordingly, in order to avoid being the subject of an ADA lawsuit, employers are well advised to attempt to accommodate those employees who have been diagnosed by a medical provider as having symptoms of long COVID.

Accommodating COVID Long Haulers

Examples of reasonable accommodation found in the statute and EEOC regulations that may be applicable to long COVID[14] include:

- Physical changes in the way a job is performed, such as allowing employees who generally stand to perform their job tasks to sit instead
- Alternative work schedules, such as giving employees more flexibility in swapping shifts on days when they are not feeling well due to the adverse effects of long COVID[15]
- Reassigning marginal job functions, particularly those functions that may be more physically taxing
- Part-time or modified work schedules, such as providing employees with extended deadlines, longer or more frequent breaks, as well as flexible hours
- Providing equipment or devices, such as an ergonomic chair to reduce fatigue or a white noise machine to assist an employee with brain fog in concentrating on the job tasks[16]

The most common type of accommodation that COVID-19 sufferers have been seeking is to continue to telework,

12. *See* Hurtado v. SAP Amer. Inc. C.A. No. 1:22-cv-02972 (N.D. Ga., filed July 27, 2022) (plaintiff who was left disabled from a debilitating COVID-19 infection alleges employer violated ADA by holding him to a higher standard and reassigning any of his clients to co-workers); Viera v. Scotts Co., LLC, et al., CA. No. 5:22-cv-00327 (M.D. Ga., filed Sept. 8, 2022) (plaintiff with chronic respiratory condition due to COVID-19 alleges employer terminated health benefits and constructively terminated her after she asked to work from home). **13.** *See, e.g., Roanoke Rehab.*, 586 F.Supp.3d 1171 (plaintiff sufficiently alleged actual and regarded as disability where plaintiff was fired while in COVID-19 quarantine and thereafter continued to suffer from severe weakness, fatigue, brain fog, high blood pressure, cough, difficulty breathing, fever, and swollen eyes). **14.** *See* 42 U.S.C.S. § 12111(9); 29 C.F.R. § 1630.2(0)(2). **15.** *See* Solomon v. Vilsack, 763 F.3d 1 (D.C. Cir. 2014) (budget analyst with depression whose flexible schedule was revoked by supervisor created jury issue as to whether request was a reasonable accommodation). **16.** Kassa v. Synovus Financial Corp., 800 Fed. Appx. 804 (11th Cir. 2020) (allowing an employee suffering from bipolar disorder and intermittent explosive disorder to take short breaks when he was frustrated could be a reasonable accommodation, especially where such accommodations had been provided by the employee's prior supervisor); EEOC v. Treehouse Foods, Inc., C.A. No. 1:21-cv-0204 (N.D. Ga. January, 2021) (EEOC claims employer violated ADA by denying intermittent unpaid leave to employee for treatment and hospitalization due to COPD, chronic bronchitis, chronic bleeding ulcer, and high blood pressure).

Related Content

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ACCOMMODATING A DISABILITY UNDER THE AMERICANS WITH DISABILITIES ACT CHECKLIST

For key issues that private employers should consider when preparing for future influenza, coronavirus, and other pandemic outbreaks, see

PANDEMIC FLU/INFLUENZA/CORONAVIRUS (COVID-19) PREVENTION, RESPONSE, AND RETURN TO WORK CHECKLIST (BEST PRACTICES FOR EMPLOYERS)

For resources that provide vital guidance for employers on employment issues related to the return to work of employees as a result of COVID, see

CORONAVIRUS (COVID-19) RESOURCE KIT: RETURN TO WORK

For a discussion of how employers should be preparing for issues related to long COVID, see

LONG COVID-19 AND THE WORKPLACE (ADA ISSUES AND RECENT LITIGATION) PODCAST

particularly as an accommodation for those experiencing fatigue of various types.[17] In the past, courts generally did not require work at home as a reasonable accommodation, especially where it would be an exception to an employer's existing policies or practices.[18] But, this may be changing due to the pandemic. The EEOC's Guidance on COVID-19 and the ADA says that while a telework arrangement allowed during COVID-19 pandemic is not necessarily required as accommodation for disabled employees post-pandemic, it may be. The answer will turn on an individualized fact-specific determination, and the success or failure of telework during the pandemic may be considered as part of the analysis.[19]

Time Off and Leaves of Absence

In order to deal with the impact of long COVID, many employees may need to take time off for doctor's visits as well as to rest before returning to the workplace. For many individuals, being diagnosed with long COVID will constitute a serious health condition under the FMLA, since the definition encompasses an illness that involves incapacity of more than three calendar days and continuing treatment by a healthcare provider.[20] Hence, where an employee experiencing the symptoms of long COVID is unable to perform his or her job for more than three days, that employee likely will be entitled to take up to 12 weeks of unpaid FMLA leave.[21] Because many states and local governments have enacted paid leave laws, it also is likely that long COVID sufferers will be entitled to take advantage of those laws as well.

17. *See, e.g.*, Burbach v. Arconic, 561 S.Supp.3d 508 (W.D. Pa. Sept. 22, 2021) (denying motion to dismiss former attorney's suit that joint employers violated FMLA and ADA by not informing him of FMLA leave to recover from COVID-19 and revoking approval of telework from Slovenia where he could obtain treatment and wife's family could assist with childcare). *See also* Lin v. CGIT Sys., 2021 U.S. Dist. LEXIS 179695 (D. Mass. Sept. 21, 2021) (denying motion to dismiss disability discrimination claim of employee with history of high blood pressure and who lived with elderly mother, who was fired after denial of telework request due to medical concerns as to the impact of contracting COVID-19) (decided under Massachusetts state law). *But see* Thomas v. Bridgeport Bd. of Educ., 2022 U.S. Dist. LEXIS 151864 (D. Conn. Aug. 24, 2022) (dismissing teacher's claim that school board violated ADA by rejecting request to teach remotely until COVID vaccine was available because in-person teaching was an essential function of job). **18.** *See* EEOC v. Ford Motor Co., 782 F.3d 753, 761 (6th Cir. 2015) *(en banc)* ("regularly attending work onsite is essential to most jobs, especially the interactive ones" because "most jobs require the kind of teamwork, personal interaction, and supervision that simply cannot be had in a home office situation."); Credeur v. State of Louisiana, 860 F.3d 785 (5th Cir. 2017) (state attorney general not obligated to allow litigation attorney to continue to telecommute as a reasonable accommodation because attorneys engaged in an interactive and team oriented approach that could not be accomplished working from home); Yochim v. Carson, 935 F.3d 586 (7th Cir. 2019) (employer not obligated to allow legal department employee to telework as a reasonable accommodation because employee's job responsibilities and job description required teamwork, collaboration, and cross training); Brunckhorst v. City of Oak Park Heights, 914 F.3d 1177 (8th Cir. 2019) (employer not obligated to provide work at home as a reasonable accommodation to senior accountant because position required performance of a number of functions that could not be performed at home, including interacting with the public). **19.** Section D.16 of EEOC Guidance, *supra*, n. 8. **20.** *See* 29 U.S.C.S. § 2611(11); 29 C.F.R. § 825.114. **21.** 29 C.F.R. § 825.200.

Additionally, where an employer is covered by both federal and state leave laws and the ADA, an employee may be entitled to more than the 12-week FMLA period as a reasonable accommodation under disability law.[22] How much longer will depend upon the nature of the specific factual situation. The EEOC has taken the position that unpaid leave under the ADA may last until it would constitute an undue hardship for the employer, which the employer would need to justify.[23] However, at least some courts have recognized that a multi-month leave of absence does not constitute a reasonable accommodation under the statute.[24] Indefinite leave also is not required.[25]

Strategies for Compliance

The challenge of COVID-19 is likely to continue into the foreseeable future as we deal with the effects of long COVID and the continued disruption not only in the workplace, but in our lives generally. Accordingly, it is important for employers to keep abreast of the developing medical science concerning long COVID and to take those employees diagnosed with the medical condition seriously.

As is generally the case in matters dealing with employment, it always is prudent for employers to attempt to assist an employee in performing that employee's job functions. Adhering to rigid work schedules or job requirements can get employers into trouble. Employers need to remain as flexible as possible in dealing with the challenges of the new normal and to make sure that they can present their best face to a judge or to a jury.

Because the law still is evolving with respect to the legal protections for persons diagnosed with long COVID and the requirements placed upon employers to accommodate the malady, employment counsel have an enhanced obligation to ensure that their clients are appropriately dealing with the situation. Missteps can result in an EEOC charge or a lawsuit. Taking preventive steps is the best way to deal with medical issues arising from the COVID-19 pandemic as well as the legal issues that result therefrom. L

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22. *See* Blanchet v. Charter Communs., LLC, 27 F.4th 1221,(6th Cir. 2022) (holding that an employer violated the ADA by failing to provide an employee suffering from postpartum depression with additional leave as a reasonable accommodation where, upon exhausting her FMLA leave, the employee requested an additional 60 days of leave, which the employer denied). The failure of an employer to provide additional leave under the ADA has been the subject of litigation involving an employee suffering the ill effects of COVID-19. *See* Brittany Hope v. Amazon.com Services LLC, et al., C.A. 1:22-cv-03537 (S.D.N.Y., filed May 2, 2022) (plaintiff alleged Amazon terminated her for job abandonment after she took medical leave due to severe health issues she suffered after a COVID-19 infection). **23.** Equal Employment Opportunity Commission, *Employer-Provided Leave and the Americans with Disabilities Act* (May 9, 2016) ("an employer can deny requests for leave when it can show that providing the accommodation would impose an undue hardship on its operations or finances.") **24.** *See* Severson v. Heartland Woodcraft, 872 F.3d 476 (7th Cir. 2017); Lipp v. Cargill Meat Solutions Corp., 911 F.3d 537 (8th Cir. 2018) (taking additional leave following the employee's nine months of unplanned absences was not a reasonable accommodation under the ADA). **25.** *See* Henry v. United Bank, 686 F.3d 50, 60 (1st Cir. 2012) (employee's request for open ended additional leave following exhaustion of FMLA leave was not a reasonable accommodation); Silva v. City of Hidalgo, 575 Fed. Appx. 419 (5th Cir. 2014) (plaintiff's claim that her employer "was under an obligation to keep her position open for an unspecified amount of time until she was able to return (which turned out to be at least five months after her FMLA leave expired) . . . simply cannot be squared with the statute's entitlement to a 'reasonable accommodation.'").

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Jonathan B. Wilson TAYLOR ENGLISH DUMA LLP AND THE FinCEN REPORT COMPANY

The Corporate Transparency Act and Beneficial Ownership Reporting Requirement

The Corporate Transparency Act

As part of the William M. (Mac) Thornberry National Defense Authorization Act for Fiscal Year 2021,[1] Congress adopted the Corporate Transparency Act (CTA). The CTA includes some of the most significant changes to the Bank Secrecy Act (BSA) and U.S. anti-money laundering (AML) laws in recent years. Those changes, in turn, will result in extensive changes to U.S. corporate governance.

The CTA requires companies that are formed or registered to do business in the United States to file a beneficial ownership report with FinCEN—the Financial Crimes Enforcement Network of the U.S. Treasury Department. These beneficial ownership reports will enable FinCEN to assemble a massive database of beneficial ownership information. FinCEN will use its database to fight money laundering in cooperation with other U.S. law enforcement agencies. Although the FinCEN database will not be publicly available, FinCEN will make the database accessible to U.S. law enforcement agencies, U.S. financial institutions, and some non-U.S. law enforcement agencies pursuant to proposed regulations that will govern access.[2]

FinCEN issued an advance notice of proposed rulemaking on April 5, 2021, soliciting comment from the public on a proposed version of the regulations that would implement the beneficial ownership reporting requirements of the CTA (the Reporting ANPRM).[3] FinCEN issued a notice of proposed rulemaking (or NPRM) on December 8, 2021, providing an initial draft of its

proposed implementing regulations and a detailed discussion of its considerations (the Reporting NPRM).[4] Because the Reporting NPRM contains a discussion of the considerations that applied to the development of FinCEN's implementing regulations, the Reporting NPRM sheds some light on the thinking behind some of the regulatory language.

FinCEN adopted a final rule to implement the beneficial ownership report provisions of the CTA on September 30, 2022, (the Reporting Rule) that will take effect on January 1, 2024.[5] The CTA, as implemented by FinCEN through the Reporting Rule, establishes a series of obligations for companies formed or registered to do business in the United States.

1. Pub. L. No. 116-283, 134 Stat. 3388 (Jan. 1, 2021). 2. Beneficial Ownership Information Access and Safeguards, and Use of FinCEN Identifiers for Entities, 87 Fed. Reg 77404 (Dec. 16, 2022). 3. 86 Fed. Reg 17557 (April 5, 2021). 4. 86 Fed. Reg. 69920 (Dec. 8, 2021). 5. 87 Fed. Reg. 59498 (Sept. 30, 2022).

Summary of CTA Requirements

The CTA, as implemented through the Reporting Rule, requires any domestic reporting company created on or after January 1, 2024, to file a report within 30 calendar days of the earlier of the date on which it receives actual notice that its creation has become effective or the date on which a secretary of state or similar office first provides public notice, such as through a publicly accessible registry, that the domestic reporting company has been created.[6]

Similarly, any entity that becomes a foreign reporting company on or after January 1, 2024, must file a report within 30 calendar days after the earlier of, the date on which it receives actual notice that it has been registered to do business or the date on which a secretary of state or similar office first provides public notice, such as through a publicly accessible registry, that the foreign reporting company has been registered to do business.[7]

In contrast, both domestic reporting companies created before January 1, 2024, and foreign reporting companies that became foreign reporting companies before January 1, 2024, must file an initial report not later than January 1, 2025.[8]

Each reporting company that is not exempt must identify in its initial beneficial ownership report each of its beneficial owners and provide five pieces of personally identifiable information about each of those beneficial owners.[9] In addition, the initial beneficial ownership report must disclose the reporting company's full legal name, any trade name or doing business as name, a complete current address, the state or jurisdictions of the reporting company's formation, and the reporting company's taxpayer identification number (TIN) (including an Employer Identification Number (EIN)) or, where a foreign reporting company has not been issued a TIN, a tax identification number issued by a foreign jurisdiction and the name of that jurisdiction.[10]

For each beneficial owner of the reporting company, the reporting company must disclose in its initial report each beneficial owner's (1) full legal name; (2) date of birth; (3) residential street address; (4) a unique identifying number (which may be a non-expired U.S. passport, a non-expired identification document, such as a driver's license, issued by a state, local government or Indian tribe, or a non-expired passport issued by a foreign government if the individual does not possess any of the other document types listed), and (5) an image file of the document that provides the unique identifying number.[11]

In addition, for reporting companies that are formed (or registered to do business in the United States) after January 1, 2024, the initial beneficial ownership report must also include these same five pieces of information for the reporting company's company applicant. The Reporting Rule defines company applicant as (1) with respect to a domestic reporting company, "the individual who directly files the document that creates the domestic reporting company," and (2) with respect to a foreign reporting company, "the individual who directly files the document that first registers the foreign reporting company."[12]

If there is more than one individual responsible for the filing of the document that forms the domestic reporting company (or that registers the foreign reporting company to do business in the United States), the company applicant is the individual "who is primarily responsible."[13]

After a reporting company files its first beneficial ownership report, the company must amend its report within 30 calendar days after there is any change to the information required in that report.[14]

Each reporting company that is not exempt must follow the CTA's definition of beneficial owner to identify its beneficial owners. The Reporting Rule defines beneficial owner as "any individual who, directly or indirectly, either exercises substantial control over such reporting company or owns or controls at least 25 percent of the ownership interests of such reporting company."[15]

An individual who would otherwise be included as a beneficial owner may be omitted if they fall into one of the following categories: (1) a minor child; (2) an individual acting as a nominee, intermediary, custodian, or agent on behalf of another individual; (3) an employee of a reporting company, acting solely as an employee (other than a senior employee); (4) an individual whose only interest in a reporting company is a future interest through a right of inheritance; or (5) a creditor of a reporting company.[16]

The CTA exempts from the obligation to file a beneficial ownership report any reporting company that falls into any of 23 exemption categories.[17] The exemption categories cover several classes of entity that are the subject of extensive regulation or that are otherwise required by law to disclose their ownership information to the government.

The CTA contains serious penalties for noncompliance. A reporting company that fails to file a beneficial ownership report (or a required amendment) when due is subject to a

6. 31 C.F.R. § 1010.380(a)(i). 7. 31 C.F.R. § 1010.380(a)(ii). 8. 31 C.F.R. § 1010.380(a)(iii). 9. 31 C.F.R. § 1010.380(b). 10. 31 C.F.R. § 1010.380(b)(i). 11. 31 C.F.R. § 1010.380(b)(ii). 12. 31 C.F.R. § 1010.380(e). 13. 31 C.F.R. § 1010.380(e)(3). 14. 31 C.F.R. § 1010.380(a)(2). 15. 31 C.F.R. § 1010.380(d). 16. 31 C.F.R. § 1010.380(a)(3). 17. 31 C.F.R. § 1010.380(c)(2).

$500-per-day fine up to a maximum of $10,000. A willful failure to file a report when due or an intentional filing of inaccurate information is punishable as a felony by up to two years imprisonment. A willful violation in combination with other anti-money laundering violations can result in an amplified penalty of up to 10 years imprisonment.

Definition of Reporting Company

To determine whether it must file a report under the CTA, a company must first determine if it is a reporting company.

The Reporting Rule defines reporting company in 31 C.F.R. § 1010.380 (c)(1), largely following the statutory definition, as either a domestic reporting company or a foreign reporting company.

A domestic reporting company means any entity that is "(A) a corporation, (B) a limited liability company, or (C) created by the filing of a document with a secretary of state or any similar office under the law of a State or Indian tribe."[18]

A foreign reporting company means any entity that is "(A) a corporation, limited liability company or other entity, (B) formed under the law of a foreign country, and (C) registered to do business in any State or tribal jurisdiction by the filing of a document with a secretary of state or any similar office under the law of a State or Indian tribe."[19]

The Reporting Rule specifies that the term Indian tribe refers to the definition given for that term in Section 104 of the Federally Recognized Indian Tribe List Act of 1994.[20]

Examples of Reporting Companies

Practitioners will identify domestic reporting companies by including corporations, limited liability companies, and those entities that are "created by the filing of a document with a secretary of state or any similar office under the law of a State or Indian tribe."[21] In the Reporting NPRM, FinCEN explained that the requirement of filing a document with a secretary of state was a matter of state law.

In states that adopted the Uniform Limited Partnership Act (2001), a limited partnership is formed by the filing of a document with the secretary of state, so that limited partnerships will fall into the definition of domestic reporting company.[22]

In contrast, in most states, parties may form a general partnership without filing a document with the secretary of state or any similar office. As a result, a general partnership formed in such states will not be a domestic reporting company for purposes of the CTA.

This generality has some exceptions, however, as Delaware requires the filing of a document with its secretary of state to form a general partnership. As a result, a general partnership formed in Delaware will be a domestic reporting company.[23]

Practitioners will need to review the statutory requirements of other types of legal entity to determine whether they are "created by the filing of a document with a secretary of state or any similar office under the law of a State or Indian tribe."

In most states, for example, a trust can be formed without filing a document with a secretary of state.[24] A Delaware statutory trust, however, must file a certificate of trust in the office of the secretary of state of Delaware and would therefore be a domestic reporting company.[25]

In the Reporting NPRM, FinCEN explained that it "believes the proposed definition of domestic reporting company would likely include limited liability partnerships, limited liability limited partnerships, business trusts (a/k/a statutory trusts or Massachusetts trusts), and most limited partnerships, in addition to corporations and limited liability companies (LLCs), because such entities appear typically to be created by a filing with a secretary of state or similar office."[26]

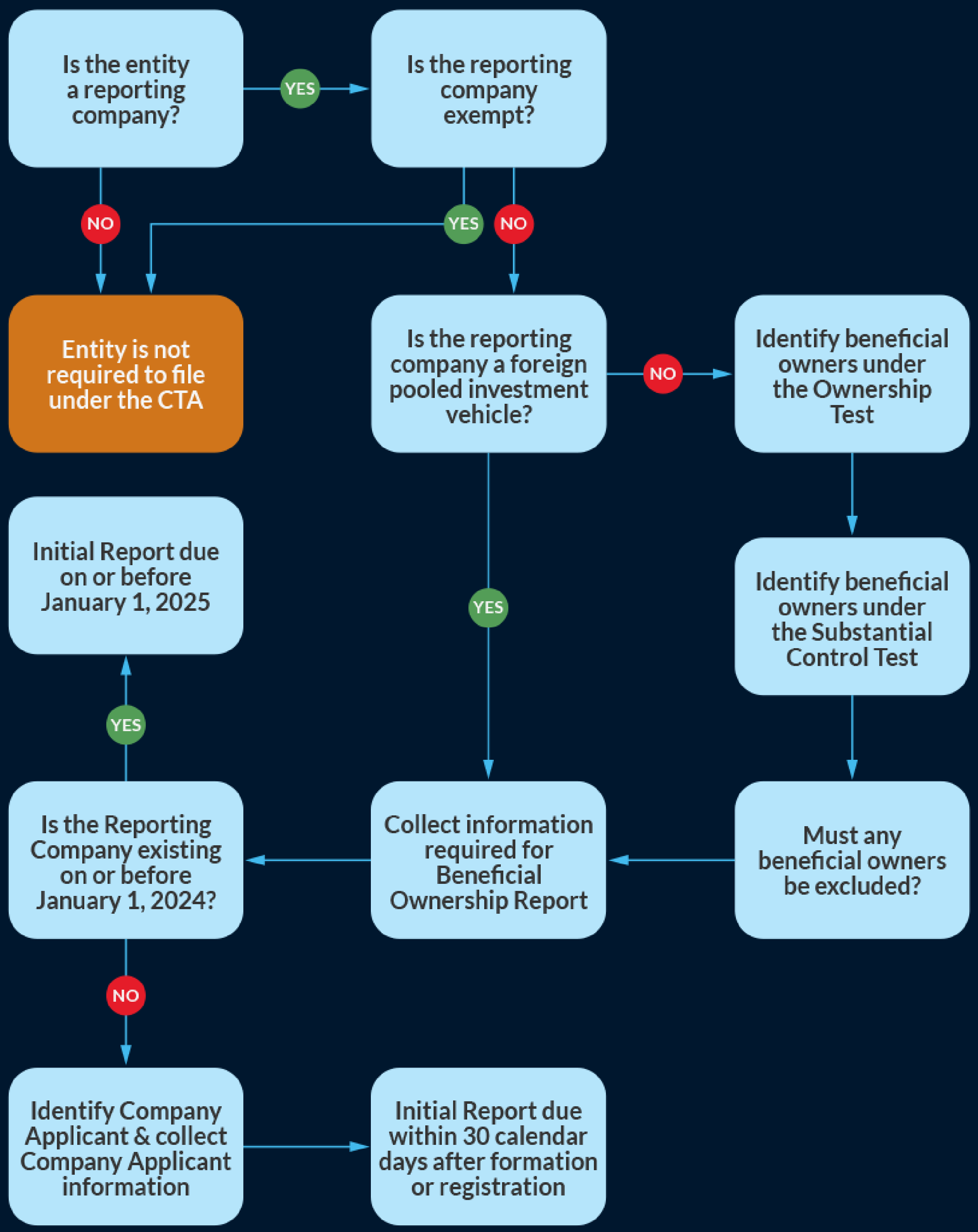
FinCEN also explained that "state and Tribal laws may differ on whether certain other types of legal or business forms—such as general partnerships, other types of trusts, and sole proprietorships—are created by a filing, and therefore does not propose to categorically include any particular legal forms other than corporations and limited liability companies within the scope of the definition."[27]

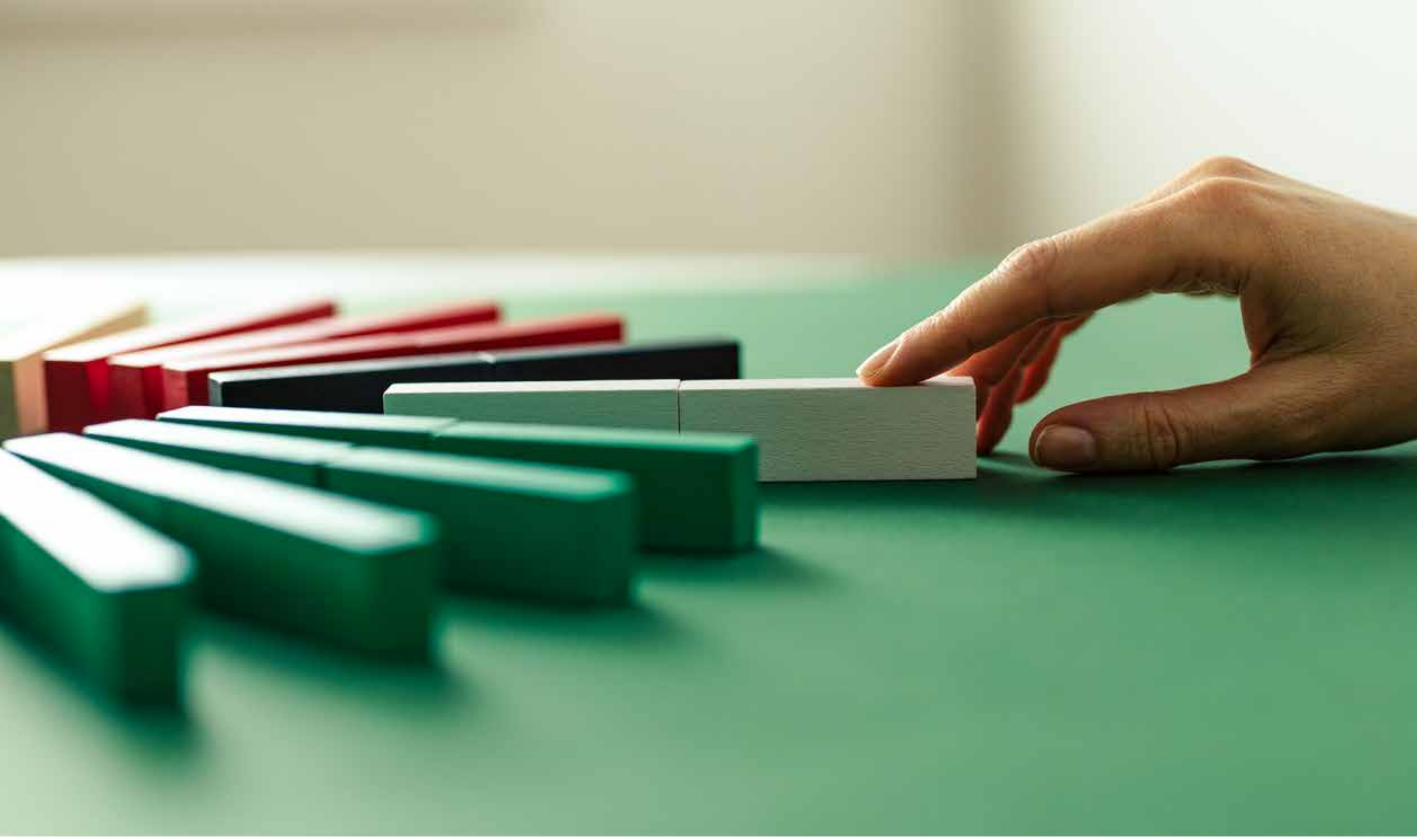
In the Reporting NPRM, FinCEN attempted to quantify the number of entities that might be subject to the reporting obligations of the CTA. Based on that exercise, FinCEN estimated that, as of 2021, there were a little more than 30 million domestic reporting companies, and that more than 3.7 million domestic reporting companies were created each year.[28]

The defining characteristic of a foreign reporting company is that it is "registered to do business . . . by the filing of a document." In the Reporting NPRM FinCEN expressly considered the possibility that this definition might "capture more entities than 'created by the filing of a document' because typically a jurisdiction within the United States will require any legal entity formed under the law of any other jurisdiction—including another jurisdiction within the United States—to register to do business as a 'foreign' entity if it engages in certain types of activities."[29]

18. 31 C.F.R. § 1010.380(c)(1)(i). 19. 31 C.F.R. § 1010.380(c)(1)(ii). 20. 25 U.S.C.S. § 5131. 21. 31 C.F.R. § 1010.380(c)(1)(i). 22. *See, e.g.*, Uniform Limited Partnership Act (2001) (Last Amended 2013), Section 201(a) ("to form a limited partnership, a person must deliver a certificate of limited partnership to the Secretary of State for filing"). 23. Delaware Revised Uniform Partnership Act, 6 Del. Code § 15-101. 24. *See, e.g.*, Uniform Trust Code (Last revised 2010). 25. 12 Del. Code § 3810 26. Reporting NPRM, 86 Fed. Reg. 69920, 69938-939. 27. Reporting NPRM, 86 Fed. Reg. 69920, 69939. 28. *See* Reporting NPRM, 86 Fed. Reg. 69920, 69957. 29. Reporting NPRM, 86 Fed. Reg. 69920, 69939.

CTA Decision Tree





The definition included in the Reporting Rule, however, was the same as that included in the Reporting NPRM, so that practitioners will identify a foreign reporting company based upon whether the entity has registered to do business in any state or tribal jurisdiction by filing a document with a secretary of state or any similar office under the law of a state or Indian tribe.

Exemptions from the CTA's Reporting Obligations

The CTA itself exempted 24 classes of entity that would otherwise have been reporting companies.[30] The 24 statutory exemptions consist of a list of entities whose beneficial ownership is already a matter of public record, entities that are already subject to substantial governmental oversight, and a catch-all for "any entity or class of entities that the Secretary of the Treasury, with the written concurrence of the Attorney General and the Secretary of Homeland Security, has, by regulation, determined should be exempt [from the statute's beneficial ownership reporting requirements]."[31]

In the Reporting Rule, FinCEN declined to list any such additional exemption categories, leaving the remaining 23 categories in the regulation generally as they were defined in the statute.

As a result, an entity that would otherwise fall within the definition of a reporting company is exempt from any obligation to file a beneficial ownership report with FinCEN if it falls into one or more of the 23 listed categories.[32]

Each category refers to a class of entity that is already subject to some form of regulation that would allow the federal government to identify either the beneficial owners of the entity or the individuals responsible for the entity. Having an ability to identify such persons eliminates the need to have such entities provide their beneficial ownership to FinCEN under the CTA.

Because each category involves the application of some other body of law, practitioners may need to enlist the assistance of attorneys with specialized experience in those areas.

Determining Who Is a Beneficial Owner

In the Reporting Rule, FinCEN defined beneficial owner as any individual who, directly or indirectly, either (1) exercises substantial control over the reporting company or (2) owns or controls at least 25% of the ownership interests of the reporting company.[33]

As a result, an individual is a beneficial owner if the individual satisfies either of these two tests.

Importantly, the definition of beneficial owner is limited to any individual and does not include legal entities. Any interest in a reporting company held by a legal entity will be calculated with respect to the individual natural person who has the ultimate beneficial ownership of that interest.

Calculating Ownership Interests

The Reporting Rule in 31 C.F.R. § 1010.380(d)(2)(iii) provides several rules for calculating whether an individual owns or controls at least 25% of the ownership interests of a reporting company as follows:

- **Calculate on a fully diluted basis.** Ownership interests of the individual shall be calculated on a fully diluted basis, with any options or convertible securities being treated as exercised.
- **Tax partnerships measured as a percentage of outstanding capital and profits.** For reporting companies that issue capital or profit interests (including entities treated as partnerships for federal income tax purposes), the individual's ownership interests are the individual's capital and profit interests in the entity, calculated as a percentage of the total outstanding capital and profit interests of the entity.
- **Corporate ownership rule.** For corporations, entities treated as corporations for federal income tax purposes, and other reporting companies that issue shares of stock, the applicable percentage shall be the greater of:
  - The total combined voting power of all classes of ownership interests of the individual as a percentage of total outstanding voting power of all classes of ownership interests entitled to vote –or–
  - The total combined value of the ownership interests of the individual as a percentage of the total outstanding value of all classes of ownership interests
- **Failsafe rule.** If the facts and circumstances do not permit the calculations described in either above to be performed with reasonable certainty, any individual who owns or controls 25% or more of any class or type of ownership interest of a reporting company shall be deemed to own or control 25% or more of the ownership interests of the reporting company.

An individual who owns 25% or more of the ownership interests of the reporting company under any of these measures is a beneficial owner for reporting purposes.

Determining Substantial Control

Even if an individual is not a beneficial owner under the 25% ownership test, the individual may be a beneficial owner if the individual directly or indirectly exercises substantial control over the reporting company.

FinCEN's Reporting Rule defines substantial control through a facts and circumstances test that requires the reporting company to consider several factors, including whether the individual:

- Serves as a senior officer of the reporting company
- Has authority over the appointment or removal of any senior officer or a majority of the board of directors (or similar body)
- Directs, determines, or has substantial influence over important decisions made by the reporting company (including several examples of important decisions) –or–
- Has any other form of substantial control over the reporting company

Because the definition of substantial control is a facts and circumstances test, many reporting companies and their counsel should consider any facts and circumstances that might bear on substantial control, including family relationships among beneficial owners, voting rights, employment agreements, and other arrangements.

Attributing Beneficial Ownership to Individuals

Importantly, the definition of beneficial owner is limited to any individual and does not include legal entities.[34] Any interest in a reporting company held by a legal entity will be calculated with respect to the individual natural person who has the ultimate beneficial ownership of that interest.

34. 31 C.F.R. § 1010.380(d).

Attorneys assisting clients in determining the beneficial owners of a reporting company will need to attribute the beneficial ownership of any non-natural person to the individuals who, in turn, are the beneficial owners of the non-natural person.

While this process could become complicated in situations where a reporting company is owned by several non-natural persons who, in turn, are owned by other non-natural persons, FinCEN's Reporting Rule provides some guidance on the logical process to follow when attributing beneficial ownership to individuals.

The Reporting Rule provides, generically, that "an individual may directly or indirectly own or control an ownership interest of a reporting company through any contract, arrangement, understanding, relationship, or otherwise . . ."[35]

The Reporting Rule lists several examples of indirect ownership, including:

- Joint ownership with one or more other persons of an undivided interest in such ownership interest
- Through another individual acting as a nominee, intermediary, custodian, or agent on behalf of such individual

Where an interest in a reporting company is owned by more than one non-natural person, determining those natural persons who will be attributed ownership in the reporting company requires the reporting company to look "through ownership or control of one or more intermediary entities, or ownership or control of the ownership interests of any such entities, that separately or collectively own or control ownership interests of the reporting company."[36]

With respect to ownership interests in a reporting company owned by a trust "or similar arrangement," the Reporting Rule provides a series of rules that determine which natural person should be treated as the natural person with attributed ownership.[37]

Under the trust rules (1) the trustee of the trust has ownership of an interest in a reporting company held by the trust if the trustee has the authority to dispose of trust assets; (2) a beneficiary of the trust has ownership of an interest in a reporting company held by the trust if the beneficiary (i) is the sole permissible recipient of income and principal from the trust, or (ii) has the right to demand a distribution of or withdraw substantially all of the assets from the trust; and (3) the grantor or settlor of a trust has ownership of an interest in a reporting company held by the trust has the right to revoke the trust or otherwise withdraw the assets of the trust.

Excluded Individuals

The Reporting Rule provides that certain individuals are excluded from the definition of beneficial owner notwithstanding the other provisions of the Reporting Rule that would otherwise attribute beneficial ownership status.

The Reporting Rule provides that beneficial owner does not include:

- A minor child
- An individual acting as a nominee, intermediary, custodian, or agent on behalf of another individual
- An employee of a reporting company, acting solely as an employee (not including senior officer), whose substantial control over or economic benefits from such entity are derived solely from the employment status of the employee
- An individual whose only interest in a reporting company is a future interest through a right of inheritance
- A creditor of a reporting company

When Reporting Companies Must File an Initial Beneficial Ownership Report

Each reporting company that is not exempt and that is either created on or after January 1, 2024, or first registered to do business after that date (in the case of a foreign reporting company) must file an initial report within 30 calendar days of the earlier of the date on which it receives actual notice that its creation has become effective or the date on which a secretary of state or similar office first provides public notice, such as through a publicly accessible registry, that the domestic reporting company has been created.

In contrast, domestic reporting companies created before January 1, 2024, and foreign reporting companies that were registered to do business before January 1, 2024, must file an initial report not later than January 1, 2025.[38]

30-Day Amendment Rule

The Reporting Rule requires a reporting company that has filed an initial beneficial ownership report to file an amendment with FinCEN within 30 calendar days after there is any change to the information required in the initial report.[39]

The 30-day amendment rule includes several key provisions that will require close attention.

35. 31 C.F.R. § 1010.380(d)(ii). 36. 31 C.F.R. § 1010.380(d)(ii)(D). 37. 31 C.F.R. § 1010.380(d)(ii)(C). 38. 31 C.F.R. § 1010.380(a)(iii). 39. 31 C.F.R. § 1010.380(a)(2).

Must File Notice of Change in Exempt Status

If a reporting company files an initial report but subsequently meets the criteria for an exemption under 31 C.F.R. § 1010.380(c)(2), "this change will be deemed a change with respect to information previously submitted to FinCEN and the entity shall file an updated report."[40]

Must File Notice of Change in Exclusion Status from Inheritance

If an individual who was excluded from disclosure in the reporting company's prior beneficial ownership report because the individual's interest was solely "by virtue of property interests or other rights subject to transfer upon death . . . a change with respect to required information will be deemed to occur when the estate of the deceased beneficial owner is settled, either through the operation of the intestacy laws of a jurisdiction within the United States or through a testamentary deposition."[41] Such a circumstance would obligate the reporting company to amend its report to identify the previously excluded individual. In any such updated report, the reporting company must, if applicable, also identify any new beneficial owners.[42]

Must File Notice of Change in Exclusion Status from Change in Minority

If an individual who was excluded from disclosure in the reporting company's prior beneficial ownership report because the individual was a minor, "a change with respect to required information will be deemed to occur when the minor child attains the age of majority."[43]

Must File Notice of Change in Information Shown on Document Image

A change in required information is deemed to occur "when the name, date of birth, address or unique identifying number" changes on the image of the document provided by the reporting company.[44]

Importantly, a change in the imaged document (such as a change in the individual's picture or the document's expiration date) that does not alter any of the designated items of information does not trigger a duty to amend a prior report. In its discussion of comments considered in its adoption of the Reporting Rule, FinCEN noted that "a change in the details of a document's image that do not relate to a change in information to be reporting in 31 C.F.R. § 1010.380(b)(1)(ii)(A)-(D) on the identification document will not trigger a requirement to update the image."[45]

40. 31 C.F.R. § 1010.380(a)(2)(ii). 41. 31 C.F.R. § 1010.380(a)(2)(iii). 42. 31 C.F.R. § 1010.380(a)(2)(iii). 43. 31 C.F.R. § 1010.380(a)(2)(iv). 44. 31 C.F.R. § 1010.380(a)(2)(v). 45. Reporting Rule, 87 Fed. Reg. 59498; 87 Fed. Reg. 58592, 58597 (Sept. 27, 2022).

Contents of an Initial Beneficial Ownership Report

In its initial beneficial ownership report, a nonexempt reporting company must identify each of its beneficial owners and provide five pieces of personally identifiable information about each of them.[46] In addition, the initial beneficial ownership report must disclose the reporting company's full legal name, any trade name or doing business as name, a complete current address, the state or jurisdictions of the reporting company's formation, and the reporting company's TIN (including an EIN) or, where a foreign reporting company has not been issued a TIN, a tax identification number issued by a foreign jurisdiction and the name of that jurisdiction.[47]

For each beneficial owner, the reporting company must disclose in its initial report such beneficial owner's (1) full legal name; (2) date of birth; (3) residential street address; (4) a unique identifying number (which may be a non-expired U.S. passport, a non-expired identification document, such as a driver's license, issued by a state, local government or Indian tribe, or a non-expired passport issued by a foreign government if the individual does not possess any of the other document types listed); and (5) an image file of the document that provides the unique identifying number.[48]

In addition, for reporting companies that are formed (or registered to do business in the United States) after January 1, 2024, the initial beneficial ownership report must also include these same five pieces of information for the reporting company's company applicant. The Reporting Rule defines company applicant as (1) with respect to a domestic reporting company, "the individual who directly files the document that creates the domestic reporting company," and (2) with respect to a foreign reporting company, the individual who directly files the document that first registers the foreign reporting company."[49]

If there is more than one individual responsible for the filing of the document that forms the domestic reporting company (or that registers the foreign reporting company to do business in the United States), the company applicant is the individual "who is primarily responsible."[50]

In its disclosure of the reporting company's company applicant, the reporting company may report the company applicant's business street address, if the company applicant formed the reporting company in the course of the company's applicant's business.[51]

46. 31 C.F.R. § 1010.380(b). 47. 31 C.F.R. § 1010.380(b)(i). 48. 31 C.F.R. § 1010.380(b)(ii). 49. 31 C.F.R. § 1010.380(e). 50. 31 C.F.R. § 1010.380(e)(3). 51. 31 C.F.R. § 1010.380(b)(ii)(C).

Special Rules Affecting Beneficial Ownership Information Reports

Reporting Company Owned by Exempt Entity

If a reporting company is owned, in part, by an entity that itself is exempt from beneficial ownership reporting, and an individual would have a direct or indirect ownership interest in the reporting company exclusively by virtue of the individual's ownership interest in such exempt entities, the non-exempt reporting company may include the names of the exempt entities in lieu of the information that would otherwise have been required in respect of such individual.[52]

Minor Child

If a reporting company reports the information required to be reported in respect of the parent or legal guardian of a minor child as required by the Reporting Rule, the reporting company's beneficial information report must indicate that such information relates to a parent or legal guardian.[53]

Foreign Pooled Investment Vehicle

If an entity would be a reporting company but for the exemption provided for pooled investment vehicles in 31 C.F.R. § 1010.380(c)(2)(xviii) and is formed under the laws of a foreign country, such entity shall be deemed a reporting company for purposes of beneficial ownership reporting, except the initial beneficial ownership report shall include otherwise required information solely with respect to an individual who exercises substantial control over the entity. If more than one individual exercises substantial control over the entity, the entity shall report information with respect to the individual who has the greatest authority over the strategic management of the entity.[54]

FinCEN Identifiers

The CTA contemplated that some individuals might need to be included in so many beneficial ownership reports that they might prefer to obtain a unique FinCEN identification number that could be substituted for such individual's personal information in beneficial ownership reports.

The Reporting Rule allows that an individual may obtain a FinCEN identifier by completing an application (on a form to be specified by FinCEN) that provides the same information as a reporting company would be required to disclose in a beneficial ownership report in which such individual was a beneficial owner.[55]

Because the purpose of the CTA is to enable FinCEN to develop and maintain a database of beneficial ownership data, Congress included penalties in the CTA to encourage compliance and to punish violators.

A reporting company may obtain a FinCEN identifier by submitting to FinCEN an application at or after the time the entity submits its initial beneficial ownership report.[56]

If an individual obtains a FinCEN identifier, a reporting company may include the individual's FinCEN identifier in its beneficial ownership report in lieu of providing the requisite information items for the individual.[57]

Obtaining a FinCEN identifier does not, however, relieve an individual from ongoing reporting obligations; it merely shifts the duty from the reporting company to the individual. An individual who obtains a FinCEN identifier and who has provided it to a reporting company, must update the individual's application "to update or correct any information previously submitted to FinCEN" in the application for the FinCEN identifier within 30 calendar days after the date on which the change occurs.[58]

Enforcement and Penalties

Because the purpose of the CTA is to enable FinCEN to develop and maintain a database of beneficial ownership data, Congress included penalties in the CTA to encourage compliance and to punish violators.

The CTA provides that it is unlawful for any person to willfully provide, or attempt to provide, false or fraudulent beneficial ownership information or to willfully fail to report complete or updated beneficial ownership information to FinCEN as required by the CTA.[59]

The CTA provides for a civil penalty of not more than $500 for each day a reporting violation occurs.[60]

An individual who willfully files false information or willfully fails to file information required to be filed may be fined not more than $10,000 or imprisoned for not more than two years or both.[61]

52. 31 C.F.R. § 1010.380(b)(2)(i). 53. 31 C.F.R. § 1010.380(b)(2)(ii). 54. 31 C.F.R. § 1010.380(b)(2)(ii). 55. 31 C.F.R. § 1010.380(b)(4)(i)(A). 56. 31 C.F.R. § 1010.380(b)(4)(i)(B). 57. 31 C.F.R. § 1010.380(b)(4)(ii)(A). 58. 31 C.F.R. § 1010.380(b)(4)(iii)(A)(1). 59. 31 U.S.C.S. § 5336(h)(1). 60. 31 U.S.C.S. § 5336(h)(3)(A)(i). 61. 31 U.S.C.S. § 5336(h)(3)(A)(ii).

One of the ambiguities presented by the statute, however, was who would be responsible for a reporting company's reporting errors or omissions. By its terms, the statute required a reporting company to file its beneficial ownership report. The enforcement provisions of the statute, however, relate to individuals. In the regulatory process, commenters asked, if a reporting company failed to file (or filed inaccurate information), who would be liable for that corporate reporting failure?

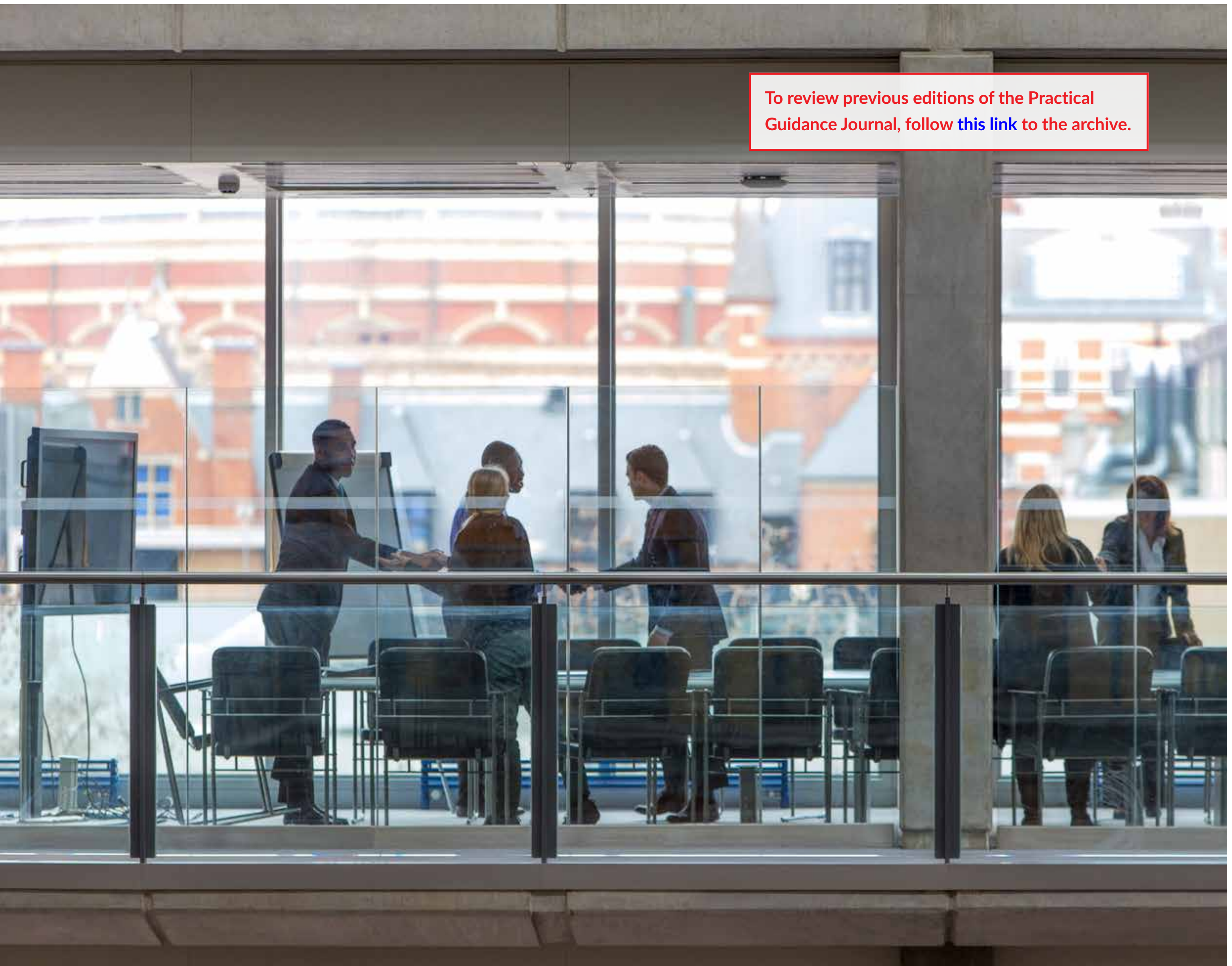
FinCEN answered that question in the Reporting Rule when it provided that a reporting failure is an obligation of both the individual who "causes the failure . . . or is a senior officer of the entity at the time of the failure."[62]

The Reporting Rule defines senior officer to mean "any individual holding the position or exercising the authority of a president, chief financial officer, general counsel, chief executive officer, chief operating officer, or any other officer, regardless of official title, who performs a similar function."[63]

As a consequence, a beneficial owner or company applicant who willfully provides false or fraudulent information to a reporting company may be liable for the reporting company's failure to provide accurate information when required.

Likewise, each senior officer of the reporting company will also be liable for any willful failure on the part of the reporting company to provide accurate information when required.

62. 31 C.F.R. § 1010.380(g)(4). 63. 31 C.F.R. § 1010.380(f)(8).



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Practical Considerations

For closely held companies, especially those owned by family members, compiling beneficial ownership data will not be too difficult. Family members will trust each other with their personal data and will be able to collect that data manually and provide it directly to FinCEN. Family members will often also be able to track changes in personal data (such as a change in residential address) in order to report such changes in an amendment to FinCEN.

Related Content

For a summary of registration requirements for foreign limited liability companies, see

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For a survey of reporting requirements under the Bank Secrecy Act, see

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For a list of key federal anti-money laundering laws and regulations, see

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KNOW YOUR CUSTOMER CHECKLIST

For an overview of the key federal anti-money laundering laws and regulations, see

COMPLIANCE WITH OFAC, AML, AND USA PATRIOT ACT RESOURCE KIT

For companies not owned by family members, however, beneficial owners might not be willing to trust each other with personal data. Personally identifiable data is sometimes used to perpetrate identity theft, and many are accustomed to keeping personal data secret and secure.

To assist companies and their beneficial owners in collaborating for CTA purposes while maintaining the secrecy and integrity of their confidential data, companies and their counsel may want to explore third-party tools like those provided by The FinCEN Report Company. L

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RESEARCH PATH: *Business Entities > Limited Liability Companies > Practice Notes*

LexisNexis Voting Center Wins National Justice Technology Award at Legalweek

THE LEXISNEXIS U.S. VOTING LAWS AND LEGISLATION CENTER was honored with the Justice Technology Award at the 2023 Legalweek Leader in Tech Law Awards in New York City on March 20. The Tech Law Awards, given at the annual Legalweek expo sponsored by American Law Media and Law.com, celebrate the achievements of law firms, legal departments and vendors leading the legal profession into the future through technology and innovation.

Launched in August 2022 by the LexisNexis Rule of Law Foundation, the Center provides free public access to a comprehensive collection of unbiased, nonpartisan, data-driven information, including more than 40,000 state and federal voting laws, related legislative developments, and news.

The Center was created by a LexisNexis team of more than 50 employee volunteers in collaboration with various organizations, including the Uniform Law Commission and the National Conference of State Legislators. A 50 State Voting Laws Comparison feature and updates on voting laws and litigation from the Law360 news service provide continuous updates.

Users can search the legislation site by various keywords, including bill name and sponsor, and filter results by proposed legislation, recently enacted laws, and failed legislation. State voting laws can be compared using topics such as mail-in voting, military voting, and absentee and electronic voting. A separate tracker provides information on the more than 190 federal voting law proposals currently pending in Congress.

A recent presentation to the North Carolina Bar Association showed how the data contained in the Center could be used to highlight the impact of the judicial selection methods used in the various states on individuals' perceptions of the local judiciary. Data derived from the Center showed that the majority of states use elections in varying degrees during of the judicial selection process. In 16 states, judges are appointed by the governor and reselected in retention elections; in 14 states, judges are chosen in contested nonpartisan elections, while in eight states, contested partisan elections are used. Governors appoint judges in 10 states; the state legislature makes the appointments in the remaining two states.

While data shows that individuals may have less confidence in the courts in states where judicial elections are partisan, the legislative tracker contained on the Center shows that many proposals to change the judicial selection process have failed. Some examples:

- **Alaska**: **H.B. 339** Would have required court of appeals judges and district judges to be approved or rejected by a majority of the legislature two years after the judge's appointment and then again, every two years. Required governor's judicial nominees to be confirmed by majority of legislature.
- **Idaho: H. 600, S.1382, and H 782:** Three bills introduced that would give the state's governor more control over the seven-member judicial council, which vets and recommends nominees to the governor for vacancies on the state's trial and appellate courts, by either adding more members to the council or requiring additional governor approvals.
- **Missouri:** Proposed constitutional amendment **(S.J.R. 30)** would have removed all state bar–appointed members on the state's nominating commissions, replacing them with nonlawyer members appointed by the governor.
- **Maryland: H.B. 306** was intended to replace the state's judicial nominating commission for circuit court judges with nonpartisan elections.
- **Oklahoma**: Proposed constitutional amendment **S.J.R. 28** would have abolished the state's judicial nominating commission, thereby allowing the governor to directly appoint state supreme court justices and court of criminal appeal judges, subject to confirmation by the state senate.

The Lexis Nexis Rule of Law Foundation defines the rule of law as containing four main components: transparency of law, equality for all under the law, an independent judiciary, and access to legal remedy. In addition to the Center, the Foundation's projects include the Lexis Nexis Rule of Law Impact Tracker, which tracks public sentiment on the rule of law in 170 countries, and the eyeWitness to Atrocities app, which allows users to document evidence of war crimes using their smartphones.

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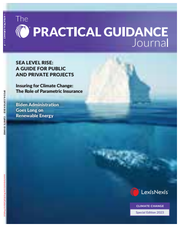

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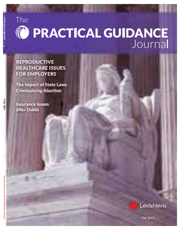

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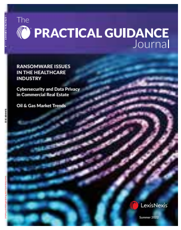

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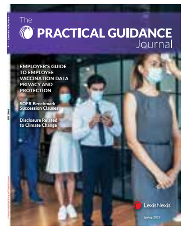

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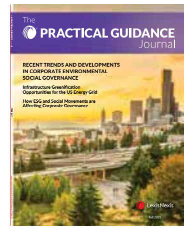

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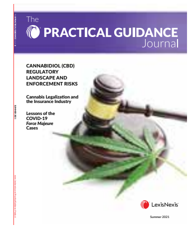

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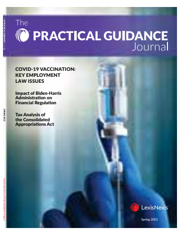

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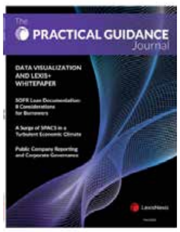

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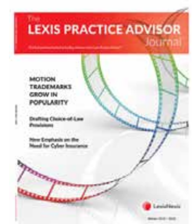

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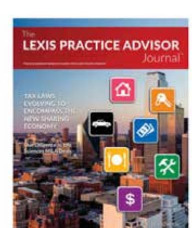

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