

BUSINESS LAW TODAY

July 2016

Feature Articles

- **Our Mini-Theme: An Introduction to Benefit Corporations**
- **The Next Stage of Social Entrepreneurship: Benefit Corporations and the Companies Using This Innovative Corporate Form**

Benefit corporations are a new corporate entity, built on top of the existing corporate law. Before you can delve into the important and difficult questions that have emerged in the wake of this revolutionary development, you first need to understand what they are and which clients might find them appealing. This article is a primer on benefit corporations and the entrepreneurs who use the benefit corporation entity to build their companies.
- **Mastering the Benefit Corporation**

If you'd like to become expert in the newest evolutionary corporate form—the benefit corporation—and master the delicate board and stockholder politics that arise when your clients adopt this new entity, then this article is for you. Montgomery provides the historical context for the benefit corporation so that you can position your practice to profit from clients shifting to a more responsible and sustainable approach to business.
- **The Use of Benefit Corporations by Charitable Organizations**

Charitable organizations are not prohibited from undertaking profit generating activities and the benefit corporation entity form is a good option to consider when charitable organizations are structuring these activities. This article will discuss the business and tax issues an experienced business law practitioner should consider when structuring earned revenue options for charitable organizations and consider how the benefit corporation entity form fits into these structuring activities.
- **Understanding and Improving Benefit Corporation Reporting**

A majority of states have passed benefit corporation statutes, and proponents have touted the social reporting requirements as one of the statutes' distinguishing improvements on traditional corporate law. This article shares early data showing benefit corporation reporting compliance rates below 10 percent, highlights deficiencies in the substantive reporting requirements, and offers suggestions for improving the current benefit corporation reporting framework.
- **The Capital Markets and Benefit Corporations**

Many states have adopted a new corporate statute that authorizes benefit corporations. This article explains how new forms broaden the nature of fiduciary duties to include stakeholders and shareholders, and how those broadened duties can fit into the capital

markets. Alexander also explains how new forms are getting into public markets, and how lawyers can be prepared to guide clients interested in using the new structure.

Other Feature Articles

- **The Chief Compliance Officer Debate: Focus on Function Not Form**
The CEO must integrate the relevant staffs—legal, finance, compliance, human resources, and risk—and the relevant business leaders in different ways for different compliance tasks. This dynamic, functional reality is far more important for an effective compliance program than static organizational forms, including where the chief compliance officer reports (CEO or general counsel).
- **FinCEN's Lack of Policies and Procedures for Assessing Civil Money Penalties In Need of Reform**
For many years, the federal banking agencies have used publicly available processes, procedures, and matrices to determine both whether a Civil Money Penalty is justified and, if so, the size of the penalty. However, the Financial Crimes Enforcement Network has no publicly disclosed CMP matrix or procedures to determine either a penalty is warranted or, if so, the appropriate amount. Serino demonstrates the urgent need for FinCEN to bring its CMP assessment process into alignment with other regulators.
- **Practical Tips for Regulatory Compliance with a Company Jet**
If your client owns or operates or plans to purchase a business aircraft, it is important to understand that aviation is a highly regulated industry where the requirements of various government agencies are often at odds with each other and with certain of the client's goals. This article outlines basic ownership and operating options available to aircraft owners, and common pitfalls to avoid when selecting and implementing these options, to help your client achieve regulatory compliance.
- **The CFPB: Standing Up for Consumers in the Financial Marketplace**
This year marks five years since the Consumer Financial Protection Bureau opened its doors in July 2011. The CFPB, an independent federal agency, was created in 2010 by the Dodd-Frank Wall Street Reform and Consumer Protection Act as a direct result of the 2008 financial crisis. The CFPB was designed to stand up for consumers and ensure that they are treated fairly in the financial marketplace.
- **You Are What You Share: The Dos and Don'ts of Social Media Compliance for Financial Advisers**
The importance of social media use in the future of the finance industry is considerable. Over 80 percent of financial advisors use it for business. This article seeks to assist RIAs in developing or refining social media compliance policies and procedures reasonably designed to ensure compliance with the Investment Advisers Act of 1940.
- **Early-Stage IP Protection: A Primer and Overview for Working with the Startup**
Rubens summarizes key considerations in working as a principal business lawyer helping startup company client implement its first comprehensive IP protection plan and highlights main factors in approaching four key areas of IP. This article also provides guidance in how to prioritize and how to help the client focus on important IP protection issues.

- **Privilege and International Implications against the Backdrop of the Panama Papers**

This article addresses international implications of various legal privileges against the backdrop of the Panama Papers. The common law duty of confidentiality, attorney-client privilege, and work-product privilege are examined, and a brief overview of civil law privilege is provided.

Series

- **What Is Making Lawyers Unsatisfied and How to Fix It**

Many business lawyers are unsatisfied professionally. We can alleviate the problem by using science, data and real-world examples to determine what motivates us and how to work toward that. By working toward what motivates us as lawyers, we will deliver better results and save our clients time and money.

Departments

- **CYBER CENTER: Cyber-Security Considerations for Franchisors: Protecting the Brand While Avoiding Vicarious Liability**

A data breach can cost a company dearly in a variety of ways, and it is crucial for franchisors to understand the issues posed by cyber security and the methods to tackle it. This article provides an overview of the legal considerations for franchisors and pointers on bolstering the cyber security of a franchise system.

- **KEEPING CURRENT: SEC Enforcement Heightens Concern over Broker-Dealer Registration for Private Equity Firms**

The Securities and Exchange Commission recently announced it had settled charges for alleged unregistered brokerage activity and other alleged securities law violations with private equity fund advisory firm Blackstreet Capital Management. The enforcement action, in which a general partner was found to have improperly acted as an unregistered broker-dealer after earning a success fee on portfolio transactions that BCM brokered in-house, signals the SEC's increasing scrutiny of sponsors and managers engaging in similar activities.

- **DELAWARE INSIDER: In re Appraisal of Dell Inc.: The Continuing Relevance of Deal Price in Delaware Appraisal Proceedings**

The Delaware Court of Chancery has often found that the consideration received in a merger to be the best evidence of fair value in appraisal proceedings, but in a recent appraisal decision, the Court of Chancery rejected the deal price in the management-led buyout of Dell Inc. and held that the fair value for Dell Inc. was 28 percent higher than the deal price received by the public stockholders.

- **MEMBER SPOTLIGHT: An Interview with Kenneth J. Bialkin**

Kenneth Bialkin is synonymous with leadership in American business, law, and the Jewish community. Of counsel at Skadden Arps, Slate, Meagher & Flom, Bialkin has spent a lifetime building a thriving corporate and securities law practice, and, at the same time, serving as chairman to some of the top Jewish organizations. He's served on numerous committees at the ABA and advisory committees of the Securities and

Exchange Commission, the New York Stock Exchange, and the American Stock Exchange. In his legal career, he has been involved in some of the largest insurance company mergers and acquisitions in the United States.

- **INSIDE BUSINESS LAW**

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BUSINESS LAW TODAY

Our Mini-Theme: An Introduction to Benefit Corporations

Benefit corporations, a corporate form that aligns the business with a social mission, are the new kid on the corporate scene. Some lawyers and scholars think it is a fad that will eventually die out, but the trend lines tell a different story. Thirty-one states have passed benefit corporation statutes in just the past five years, including in Delaware. Consumers are choosing socially responsible alternatives to everything from the products they consume to the services they procure. Established mega-businesses like Clorox and Amazon are being forced to compete with socially responsible startups. Young entrepreneurs and MBA grads are looking for a businesses and work environments that offer value beyond just a paycheck. More of our clients are asking about it, and more are electing to found their companies using this corporate form. And the trends suggest that this is only the beginning.

Unfortunately, most attorneys still don't have a lot of information about how to counsel benefit corporations, their founders, their directors, or their shareholders. With no case law, limited public exposure, and only early commentary on the topic, there isn't a whole lot of information out there, but as these business entities continue to grow more numer-

ous, we will need more guidance on how they work. Sponsored by the ABA's Joint Subcommittee on Social Entrepreneurship and Social Benefit Entities (SESBE), this mini-theme is designed to fill in some of the gaps in our knowledge. We have gathered the architects of these statutes and leading scholars on the issue to answer some of the important and tough questions that have arisen regarding this innovative new corporate form.

Michael Vargas, co-chair of SESBE, provides an overview of the benefit corporation statutes and their essential components, and then delves into an exploration of the entrepreneurs and companies for whom this new corporate form might be appropriate. **John Montgomery**, one of the architects of the benefit corporation statute in California, offers some commentary on the responsibilities of directors in benefit corporations, and offers some reassurances to directors who may feel apprehensive about joining these new innovative operations. **Kim Lowe**, one of the architects of the benefit corporation statute in Minnesota, discusses how benefit corporations can be a powerful tool in the hands of charitable organizations looking to capitalize on earned revenue options. **Haskell Murray**, assistant professor of

management and business law at Belmont University, presents evidence on early trends in benefit corporation reporting, and offering recommendations for improving reporting standards, requirements, and compliance. Finally, **Rick Alexander**, head of legal policy for B Lab, takes a look at how benefit corporations may interact with capital markets now that at least one benefit corporation has registered for a public offering.

We sincerely hope that this mini-theme will serve as a thought-provoking introduction to a growing trend in corporate law. In the years to come, the Joint Committee on Social Entrepreneurship and Social Benefit Entities will continue to generate commentary and thought leadership on these and other important developments in the law of benefit corporations. If you are interested in being a part of this conversation, please contact Michael Vargas (michael.vargas@rimonlaw.com), Kim Lowe (klowe@juxlaw.com), or David Levitt (levitt@adlercolvin.com) for more information.

Michael Vargas

Co-Chair, Joint Committee on Social Entrepreneurship and Social Benefit Entities

BUSINESS LAW TODAY

The Next Stage of Social Entrepreneurship: Benefit Corporations and the Companies Using This Innovative Corporate Form

By [Michael Vargas](#)

A little over a year ago, I had a client come into my office to thank me for incorporating her benefit corporation. Before I could say anything she told me how excited she was to find an attorney who took her idea seriously, explaining that a number of other attorneys she had gone to had brushed off her request and told her to form a traditional “C” corporation. One attorney, who claimed to have performed over 200 hours of pro bono service to benefit corporations, had told her that a benefit corporation was merely a public relations stunt and wouldn’t be taken seriously. As she explained, when she came to me, she was almost ready to admit defeat and go home.

The attitude of these attorneys is surprisingly common, and yet it is also based on a misperception. Though there is a public relations aspect to the benefit corporation, it is much more than that. It is a legal development many decades in the making, incorporating a wide array of policy ideas and borrowing from different legal theories. And yet, as revolutionary as the idea is, it is executed in such a way that even Delaware’s Chief Justice Strine has joined in the praise for it, describing it as a modest and effective tool

for social innovation. The entrepreneurs who take advantage of this form are not merely looking to score a PR win; rather they are looking for business entity that empowers them, helps them break into crowded markets, and embraces the changing face of the American workforce. And a good business lawyer needs to know what a benefit corporation is and when it is the right corporate form for the client.

What Is a Benefit Corporation?

Let’s start by setting the record straight about what a benefit corporation actually looks like. A benefit corporation is a new corporate form designed to address two of the most common problems social entrepreneurs face when trying to start a company: (1) that traditional “C” corporations are legally required to pursue maximum shareholder value, potentially at the expense of all other stakeholders, and (2) that many large corporations have adopted the language of social impact to disguise and distract the public from very unethical behaviors (a.k.a. “greenwashing”), which has the added effect of crowding out legitimate social enterprises from the market even though a majority of

consumers would prefer to spend their money on sustainable products and companies.

In 2010, Maryland became the first state to pass “benefit corporation” legislation, enshrining these values into law. Benefit corporation legislation has since been adopted in 30 states and the District of Columbia. While there can be significant differences in the details, all these statutes follow the same three-part formula designed to ameliorate the two central problems above: the corporate charter must contain a clearly articulated social purpose, the directors must balance or consider interests beyond shareholder profit, and the company must report regularly on their efforts to promote or maintain their chosen social purpose.

1. The Social Purpose

The first defining characteristic of a benefit corporation is that all benefit corporations must incorporate a social purpose into their charter. Incorporating the social purpose into the charter serves as one way of preventing “greenwashing,” since it prevents a company from hiding socially irresponsible behavior behind a well-executed PR campaign. Benefit corporations must act responsibly

in all aspects of their business. The Model Benefit Corporation Legislation (MBCL), created by the nonprofit B Labs and passed in the vast majority of states, requires that the company incorporate a “general social benefit” statement, which is defined as “a material positive impact on society and the environment, taken as a whole.” This statement effectively prohibits any socially irresponsible behavior by the company.

Not all states have adopted this approach. Texas, for example, requires that the charter identify a “specific social benefit” for which the statutes offer a number of examples, along with an open ended option allowing the company to define the benefit itself. There are some benefits to this approach. A “specific purpose” statement promotes social innovation by freeing social entrepreneurs from the MBCL’s rigid focus on environmental sustainability. Professor Haskell Murray has also argued that narrower or more well-defined purpose statements promote focus and measurability, two things that are essential to effective corporate governance and enforcement.

The trend, however, appears to be a hybrid approach, allowing the corporation to choose whether to incorporate a general purpose, specific purpose, or both. Both California and Minnesota, for example, permit companies to choose which way they want to go. California separates these corporations into “benefit corporations” and “social purpose corporations,” while Minnesota labels them “general benefit corporations” and “specific benefit corporations.” Delaware takes perhaps the most laissez-faire approach in allowing any “public benefit corporation” to define their mission for themselves, leaving the specifics, broad or narrow, to the founders or managers. The differences may reflect the corporate law culture of the state, with Delaware taking the most flexible and management-friendly approach, or they may reflect an evolution in the law. As more states join the list, we will see how these trends develop.

2. Director Responsibilities

The second defining characteristic of a benefit corporation is the expanded responsibili-

ties of the board of directors. In a traditional corporation, the board is assumed to act on behalf of the shareholders and, either by law or business norms, manages the company in pursuit of profit and shareholder value. A chief goal of the benefit corporation movement was to step away from this narrow corporate purpose, and is achieved in the statute by expanding the scope of mandatory director duties. In the majority of states the directors of a benefit corporation must consider a host of interests in making their decisions, including the interests of shareholder, employees, customers, local communities, and the environment, among others. Some have described it as a mandatory constituency statute, but the scope is much larger than traditional constituency statutes.

Delaware is unique in bucking the trend with regard to director responsibilities. Rather than listing a host of “considerations,” Delaware’s public benefit corporation statute requires directors to “balance the stockholders’ pecuniary interests, the best interests of those materially affected by the corporation’s conduct, and the public benefit or public benefits identified in its certificate of incorporation.” This three-part formulation is distinct from the long list of considerations in the MBCL, but seems to embrace many of the same objectives. The “materially affected” qualifier, however, could be read as requiring a greater focus on local communities and other groups directly connected with the company. This may be appealing to some companies looking to make a more local impact, and even for larger companies, the statute clearly does not preclude larger, even global, social objectives. As such, the Delaware statute appears to parallel the MBCL, in not in the same words.

Though the precise contours of director responsibilities remain obscure, what is clear is that directors have much more to consider when making decisions on behalf of a benefit corporation. It is, however, also unclear if these new responsibilities translate into a shift in the fiduciary duties of a director. Delaware specifically allows companies to exculpate directors from duty of loyalty liability for failure to perform the

balancing described above, a somewhat understandable addition to the statute, particularly for larger companies. So, while this is perhaps the most direct rejection of the shareholder profit paradigm to date, the statute appears to be more permissive than punitive, giving the board plenty of breathing room without setting too many specific boundaries.

3. Accountability and Transparency

The third and final characteristic of benefit corporation statutes is the reporting requirement. All benefit corporation statutes require some form of reporting to the shareholders or the public. Like the social purpose requirement, the reporting requirement is intended to limit “greenwashing” by forcing companies to disclose their efforts in pursuit of their social purpose. If a company is pursuing only a narrow purpose at the expense of the environment or the community, that would show up in one form or another in the report. The model law requires annual reporting, and the report must be publicly available on the company’s website. Minnesota is a bit of an outlier, in that it requires the annual report to be filed with the secretary of state, adding still another layer of accountability on top of the model law. Delaware, most surprisingly, takes a more reserved approach, requiring only that the report be made available to the shareholders every other year, but creates the option for reporting to occur more often and to be disclosed to the public.

A point of some contention between advocates of the model law and the Delaware version is the use of a “third-party standard” to measure progress toward the company’s social benefit. The model law has very specific requirements for what qualifies as a “third-party standard,” perhaps too specific given that one of the requirements is that the standard be “comprehensive” in assessing the company’s impact on an array of interests. This is a high bar and there are very few available certifications or assessments to choose from. Some states, such as Minnesota, take a more modest approach, requiring a third-party standard, but leaving the definition more nebulous. This

doesn't necessarily let the company off the hook, however, as Minnesota requires that the company explain why it selected the standard and explain the implications of how the company performed relative to the standard.

Delaware is, again, a bit of an outlier when it comes to the third-party standard, making it optional, and the statute offers no definition at all. In the case of Delaware, home to almost 50 percent of America's public companies, this makes some sense. Many large Delaware companies will already be subject to a stringent disclosure regime under securities laws and the exchange rules. As such, an additional disclosure requirement would not be appealing, and may even be superfluous if you consider social impact to be "material" and therefore subject to disclosure (a question that I will leave for another day). Regardless, the "third-party standard" is perhaps one of the largest disparities between the many statutes, and we have yet to see if there will be some movement toward a single standard.

4. Benefit Corporations Are Not "B Corps"

Given the popularity of terms like "S Corp" and "C Corp," it is not surprising that clients and some other lawyers refer to benefit corporations as "B Corps," but this is wrong. A benefit corporation is not a B Corp. A "B Corp" is a certification offered through B Lab, a non-profit organization that has been offering the certification since 2007. The benefit corporation is a business entity chartered through a state. Many benefit corporations will seek "B Corp" certification because, as discussed above, it satisfies their "third-party standard" requirement. On the other side, B Lab does require that all "B Corps" switch, within two years of certification, to a corporate structure that aligns corporate interests with stakeholder interests. For corporations in those states that allow it, that means becoming a benefit corporation. As such, there will be a large degree of overlap between these two groups. Still, it is important to understand the distinction. "B Corp" is a certification. Benefit corporation is a legal status.

Looking Beyond the Statute: Who Would Choose a Benefit Corporation?

As business lawyers, we know that a corporation is not always the right choice for every entrepreneur. Some people just want the limited liability to house an investment, and we would encourage them to form an LLC. Some people just want to run a small family business, and we might encourage them to form an "S" Corp. Some people want to use their company to invest in other companies, and we might encourage them to form a limited partnership (LP). Particularly when working with a first time entrepreneur, figuring out the right business entity is a key part of our jobs. So when might we recommend a benefit corporation? I can think of two types of entrepreneurs or businesses where a benefit corporation immediately jumps to mind: the social activist and the mission-driven company.

The Social Activist

Social activists know what they want, and it's anything other than a traditional "C" corporation. This year I met my first true social activist, a woman who is starting a co-op delivery service, using the Uber model. I was working with a group of students at UC Hastings, and we spent almost a month trying to figure out the right corporate structure knowing that she was adamantly opposed to the corporate form and I was adamantly opposed to recommending a consumer co-op, a business form offered in California, so early in the process. In the end, the benefit corporation turned out to be the best middle ground, and the client was quite pleased to find out that she could benefit from the corporate form without the negative associations.

For an entrepreneur that is specifically looking to buck the corporate form, the benefit corporation is an excellent alternative to an LLC or cooperative. These entrepreneurs are interested in more than just the label though, they are interested in having a corporation that reflects their values and can always be expected to do so. Since the social consciousness is baked into the dough of the benefit corporation, even many years down the line the corporation will still reflect their values even if it grows in size and takes on

new directors and shareholders. For these entrepreneurs, the benefit corporation is about personal expression and realizing their dreams without compromising their principles. As lawyers we often see our jobs in terms of risk prevention, cost effectiveness, and/or cost-benefit trade offs, but sometimes our client's business vision doesn't fit neatly into our understanding of what is "best" for them. Social activists often just want to express themselves or be empowered by their business, and the benefit corporation allows them to do that.

The Mission-Driven Company

Not everyone is driven solely by their activism, however. For some sustainable entrepreneurs, it's about the market. Studies and surveys continue to show that consumers lean toward sustainable products and sustainable companies. In 2014, a Neilson Global Survey on Corporate Social Responsibility found that about two-third of global consumers would choose a sustainable product over an irresponsible competitor, and 52 percent of global consumers actively check the packaging to see if their products are sustainable. The same survey also found that 51 percent of younger consumers would go a step further and pay more for the sustainable product. This means that a wily entrepreneur can cut into a given market and peel away customers if they can offer a sustainable alternative from a mission-driven company.

There are some quite well known examples of the mission-driven company already out there. Method Products, for example, offers cleaning products that use less harmful chemical ingredients and more sustainable packaging than their competitors, which includes cleaning giant Clorox. Between 2008 and 2012, Method went from relying on private equity to doing more than \$100M in revenue, with their products gracing the shelves of such retail giants as Target. Following their merger with Ecover in 2012, Method's revenue shot past \$200M in 2015 making them the largest green cleaning supplies manufacturer in the world, and forcing Clorox to release their own line of green cleaning supplies, Clorox Green Works, in order to remain competitive. Other well-

known examples of mission-driven company's offering a sustainable alternative to their competitors include Ben & Jerry's Ice Cream and Etsy.

Grasping the socially responsible portion of the market or taking it away from a giant like Clorox requires a company to consider how they will prove to consumers that they are the sustainable alternative. A benefit corporation may be a good way of "authenticating" a company as socially responsible, and appealing to the consumer who is looking for a sustainable option. Method, Ben & Jerry's, and Etsy are all long time members of the "B Corp" community, even before there were benefit corporations out there. Method displays their benefit corporation status prominently on their website, along with a handful of other important labels that serve to authenticate their status as the sustainable alternative in the market. The benefit corporation, therefore, can be a useful tool for a mission-driven company looking to break into a crowded market and carve out a block of consumers looking for sustainable products or services.

Trending Toward the Mainstream: It's Not Just Social Entrepreneurs Anymore

Current trends suggest that the benefit corporation may become more than just a niche option before too long. The desire to do something good for society or their community is permeating even traditional companies, driven largely by changing demographics and a generation (millennials) who don't see a division between work and social consciousness. A 2012 survey by Net Impact found that 72 percent of students about to enter the workforce were looking for a job where they could "make an impact," and 45 percent would even be willing to take a pay cut to work there. The *New York Times* has also reported that MBA programs are incorporating ethical and social elements into their programs, responding to student demands and market trends in that direction. These trends suggest that the next wave of labor and management will be looking for ways to incorporate ethics and social responsibility into their companies.

Many established businesses have already responded to this trend by incorporating dif-

ferent socially responsible programs. The benefit corporation may be the next logical step for these companies. Kickstarter, for example, recently converted to a benefit corporation because it just fits their younger and more socially conscious company culture better than the traditional corporation. The company wanted to align their corporate structure with its commitment to serving the arts and culture, and announced that it would donate 5 percent of its profits to arts education and organizations fighting inequality. Kickstarter's founders are all young entrepreneurs, so this is not terribly surprising given the statistics shown above. Whether Kickstarter is an anomaly or a bellwether of conscious companies and entrepreneurs shifting over to become benefit corporations is yet to be seen.

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Mastering the Benefit Corporation

By [John Montgomery](#)

If you'd like to become expert in the newest evolutionary corporate form—the benefit corporation—and master the delicate board and stockholder politics that arise when your clients adopt this new entity, then this article is for you. This article also provides the historical context for the benefit corporation so that you can position your practice to profit from clients shifting to a more responsible and sustainable approach to business.

Your proficiency in corporate law is directly applicable to benefit corporations because all of the existing corporate codes and common law apply to benefit corporations. Except for the few provisions applicable only to them, the for-profit benefit corporation is identical to the regular corporation and subject to the same federal and state corporate tax rates.

Understanding the benefit corporation will help you properly serve the increasing number of clients who seek a corporate form more aligned with their social and environmental values. These clients may be devotees of sustainability practices, committed to social responsibility or millennials creating businesses that have purposes more meaningful to them than just making money. These clients want their corpora-

tions to not only be the best in the world but also be the best for the world.

The Historical Context

Under the prevailing corporate law of Delaware, the corporation has only one legitimate purpose—maximizing stockholder welfare. This prevailing law coupled with the widespread belief that the corporation exists solely to maximize profit for stockholders becomes the de facto law in most corporate boardrooms. This constrains conventional corporations, other than closely held or family-run corporations, from pursuing other corporate purposes or considering the interests of stakeholders other than stockholders. This real or perceived duty to maximize stockholder welfare often becomes the core guiding principle.

The benefit corporation changes the game because it turns the corporation into a dual-purpose entity with the twin purposes of optimizing stockholder welfare and creating general public benefit. It expressly authorizes corporations to provide a material positive effect on society and the environment while pursuing profits as usual. The legal architecture of the benefit corporation allows ethical corporations to put the full power of corporate law behind

their social and environmental values and higher purposes.

The benefit corporation may be the most significant development in corporate law since New York combined limited liability and free incorporation in 1811 because it endows the corporation with a social and environmental conscience and authorizes the pursuit of corporate purposes in addition to maximizing stockholder welfare. The benefit corporation represents a shift in our collective consciousness about business, from a narrow focus on profits to a triple bottom line orientation—planet, people, and profit. Benefit corporations, social entrepreneurship, impact investing, and corporate social responsibility are all part of this global shift in consciousness, which recognizes that humanity needs to take better care of its shared common home with its finite resources.

Since Maryland adopted the first benefit corporation law in 2010, more than 3,000 corporations in the United States have become benefit corporations. Thirty states, including Delaware and DC have adopted benefit corporation legislation. Patagonia, Method, and Ben & Jerry's are some of the more prominent benefit corporations. Laureate Education, a global operator of higher education facilities, is in registration to go pub-

lic and may soon become the first publicly traded benefit corporation. Italy has adopted benefit corporation legislation and similar national legislation is pending in Taiwan, Brazil, Chile, Argentina, and Columbia.

The Basics: Model Benefit Corporation Legislation

Most state benefit corporation statutes are based on the Model Benefit Corporation Legislation, which has three principal tenets: general public benefit, accountability, and transparency. As we will see later in this article, Delaware's law reflects its own unique interpretation of the model legislation.

A benefit corporation must provide a general public benefit, which means "a material positive impact on society and the environment, taken as a whole. . . . from [its] business and operations." In addition to the enterprise-wide commitment to create general public benefit, the model legislation allows corporations to choose one or more specific public benefits and put them in their charters. Accountability comes from the requirement to measure the provision of such general public benefit against an independent third party standard such as B Labs's Certified B Corporation assessment which measures a business's social and environmental impact. Transparency comes from the requirement to provide an annual benefit report to the corporation's stockholders and the public about how well the corporation provides the requisite general public benefit.

The Basics: Directors' Duties

At the heart of being a benefit corporation is the requirement that directors consider the effects of any corporate action or inaction on all of the corporation's stakeholders, including employees, customers, suppliers, the communities in which the corporation is located, society, the environment, and stockholders. This requirement recognizes that a corporation's long-term fiscal health depends on maintaining good relations with all of its stakeholders. As you will see later in this article, Delaware has its own unique approach to extending fiduciary duties to include other stakeholders. The book, *Firms of*

Endearment: How World Class Companies Profit from Passion and Purpose by Rajendra Sisodia, Jag Sheth, and David Wolfe, shows how corporations that adopt multiple stakeholder models provide a greater rate of return to investors than their conventional peers.

This fundamental change in directors' duties offers a legitimate alternative to the prevailing corporate paradigm in which the corporation exists solely to maximize stockholder welfare and in which fiduciary duties of directors flow exclusively to stockholders. *Dodge v. Ford Motor Co.*, 170 N. W. 668 (Mich. 1919) in which the Michigan Supreme Court observed that a "corporation is organized and carried on primarily for the profit of the shareholders" is often cited as the genesis of this paradigm. Recent court cases such as *eBay Domestic Holdings, Inc. v. Newmark*, 16 A. 3d 1 (Del Ch. 2010) in which the court observed that directors are bound by fiduciary duties and standards that include "acting to promote the value of the corporation for the benefit of its stockholders" have affirmed this paradigm. The current chief justice of the Delaware Supreme Court, Leo Strine, has made it clear in a recent law review article that directors "must make stockholder welfare their sole end, and that other interests may be taken into consideration only as a means of promoting stockholder welfare." See [The Dangers of Denial: The Need for a Clear-Eyed Understanding of the Power and Accountability Structure Established by the Delaware General Corporation Law](#).

In the prevailing paradigm, the focus on maximizing profits normalizes the practice of externalizing as many of the costs of corporate behavior on society and the environment as possible. Requiring its directors to consider the effect of corporate behavior on all of its stakeholders creates a social, environmental, and pecuniary conscience that encourages the benefit corporation be accountable for such costs.

The Basics: Getting Comfortable with the Benefit Corporation

It often takes several months for directors to become familiar with the benefit

corporation, understand the new fiduciary responsibilities, and feel safe and inspired enough to consider using the form.

Simple fear is often the biggest obstacle to corporations adopting this new form—fear of the relatively new, fear of being less profitable, and fear of learning how to consider the interests of all stakeholders. This fear is a normal part of the conversion process and a big part of your job will be making the directors feel comfortable. Once directors understand how simple the benefit corporation really is and that all of their knowledge about corporate law still applies, they begin to relax and feel comfortable about the new form.

You can often allay your clients' fears by providing them with key documents that answer the common questions about the benefit corporation, establish its legitimacy as a valid approach to doing business, and suggest that doing business in this form may actually provide a better rate of return to investors than a conventional corporation.

B Lab answers many [frequently asked questions](#) about benefit corporations on its website as do many of the other articles in this issue. The white paper, [The Need and Rationale for the Benefit Corporation](#), which includes an annotated copy of the model benefit corporation legislation, and a copy of the applicable state's benefit corporation statute establish how simple the benefit corporation really is.

Two recent law review articles penned by Delaware Supreme Court Chief Justice Strine, [Making it Easier for Directors to Do the Right Thing](#) and [The Dangers of Denial](#) cited above establish the legitimacy of the benefit corporation and show why socially and environmentally responsible businesses need the form to transcend the constraints of the profit maximization paradigm.

The white paper by Professor Robert Eccles and colleagues of Harvard Business School, [The Impact of Corporate Sustainability on Organizational Processes and Performance](#), and the Oxford University report, [From Stockholder to Stakeholder: How Sustainability Can Drive Financial Outperformance](#) demonstrate the financial superiority of businesses that adopt princi-

pals of sustainability such as those embedded in the benefit corporation.

Finally, there are no material expenses other than third party certification fees, which generally range from about \$1,000 per year for a small business to a few thousand dollars per year for a larger business, and there is an additional administrative burden to prepare the annual benefit report.

Directors' Liability

As counsel to boards of directors, you need to understand these new fiduciary responsibilities and how to apply them to the board's decision-making process. Many potential benefit corporation directors resist this new approach to business out of fear that it creates additional liability exposure.

To assuage concerns about directors' liability, although directors' fiduciary duties extend to all of the benefit corporation's stakeholders, only stockholders have standing to sue the corporation for failure to create general public benefit. The model legislation allows stockholders and directors a right of action to bring a benefit enforcement proceeding to compel a benefit corporation to create general public benefit, but the benefit corporation cannot be liable for monetary damages for failing to create general public benefit. The model legislation also contains an express waiver for directors for liability for monetary damages for failing to create general public benefit and affirms that directors are protected by the business judgment rule in fulfilling these expanded fiduciary duties. In addition, directors' and officers' liability insurance is generally as available to benefit corporations as it is to conventional corporations.

The intention behind expressly limiting the liability of the corporation and directors for monetary damages for failing to create general public benefit was to encourage widespread adoption of the form. The model legislation relies on the court of public opinion to inspire benefit corporations to honor their commitment to provide a material positive impact on society and the environment. The fastest growing consumer segment—LOHAS—lifestyles of health and sustainability—make buying decisions based on the values and qualities of a corporation. The

belief is that the transparency requirement of the annual benefit report to the public will inspire benefit corporations to create the desired general public benefit.

The Benefit Director

The model legislation includes the option for a corporation to have a benefit director. The benefit director is charged with the duty of preparing the annual benefit report and opining on whether the corporation created general public benefit and whether the officers and directors considered the effects of corporate action upon all of the corporation's stakeholders and, if applicable, how the corporation failed to consider the effects of corporate action on such stakeholders. Although most states, including Delaware, did not provide for a benefit director in their legislation, it is important to understand the concept in case you practice in a state that has authorized benefit directors so that you can explain that that the position should not increase a director's liability exposure because of the liability safe harbors discussed above.

Directors of Existing Benefit Corporations

Except for the expanded fiduciary duties to all of the corporation's significant stakeholders, serving as a director of a benefit corporation is just like serving as a director of a conventional corporation. This does, however, require new behavior in the boardroom. In a conventional corporation, directors only need to consider the effects of corporate behavior on stockholders but in a benefit corporation, directors must also consider the effect of corporate behavior on all of the corporation's stakeholders, including society and the environment. This may initially feel cumbersome and restricting but the result is often smarter and more comprehensive decisions. As we will see later in this article, Delaware requires directors of its benefit corporations to balance the effect of corporate behavior on all stakeholders with other considerations.

Representing Corporations Converting into Benefit Corporations

If you represent a conventional corporation that wishes to convert into a benefit corpo-

ration, you will need to guide your client through the mechanics of the conversion process. The model legislation requires a two-thirds vote to convert an existing corporation into a benefit corporation to protect the interests of minority stockholders who may be wary of the benefit corporation. Most states, including Delaware, provided additional protection to minority stockholders beyond the supermajority vote required by the model legislation and extend statutory dissenters' rights to stockholders who vote against converting into a benefit corporation and wish to be cashed out. Generally, dissenters' rights do not extend to stockholders of publicly traded corporations wishing to convert into benefit corporations.

Directors are often afraid to seek stockholder approval out of concern that the corporation will be forced to redeem shares. To date, however, the Association of Benefit Company Lawyers, which was recently organized by lawyers who helped pass benefit corporation legislation in various states, is aware of only one instance where stockholders of a corporation converting into a benefit corporation exercised dissenters' rights so that possibility is unlikely. Boards can reduce the perceived risk of redemption by reserving the right to remain a conventional corporation if too many stockholders dissent. Management can also reduce the risk of redemption by facilitating a private sale between a stockholder who may who may have expressed an interest in purchasing additional shares and a potentially dissenting stockholder.

Delaware's Public Benefit Corporation Law

When you represent [Delaware public benefit corporations](#), you need to understand that the fiduciary responsibilities of directors differ from those in the model legislation because Delaware's law reflects a unique expression of the three principal tenets of the model legislation. For example, the purpose of creating general public benefit is implied in Delaware's requirement for directors to consider the interests of those materially affected by the corporation's conduct and the precatory statement

to operate in a “responsible and sustainable manner.” Delaware deviates from the standard of conduct for directors set forth in the model legislation by creating a tripartite balancing test under which directors must balance “the pecuniary interests of the stockholders, the best interests of those materially affected by the corporation’s conduct, and the specific public benefit or public benefits identified in its certificate of incorporation.”

This balancing test creates some confusion if the term “balance” were read to imply that directors must give each of the three factors equal weight but the test was intended to give the corporation a purpose of creating general public benefit by requiring directors to consider the effect of corporate action on all stakeholders. Delaware provides a liability safe harbor for decisions implicating the balance requirement by affirming that directors of benefit corporations will be deemed to satisfy their fiduciary duties to stockholders and the corporation if their decisions are both informed and disinterested and not such that no person of ordinary, sound judgment would approve.

Delaware requires its public benefit corporations to select one or more specific public benefits from an enumerated list of categories and set such benefit(s) in their charters. This will require you to help your clients draft customized specific benefit provisions in their certificates of incorporation. In Delaware, specific public benefit means “a positive effect (or reduction of negative effects) on one or more categories of persons, entities, communities or interests (other than stockholders in their capacities as stockholders) including, but not limited to, effects of an artistic, charitable, cultural, economic, educational, environmental, literary, medical, religious, scientific or technological nature.” [Kickstarter’s charter](#) provides a good example of specific public benefits in several of these categories.

Delaware makes accountability to a third party standard optional and allows a benefit corporation to use a third-party standard in connection with and/or attain a periodic third-party certification addressing the corporation’s promotion of the public benefit(s) identified in the charter and/or the best interests of those materially affected by the corporation’s conduct. In addition, Delaware’s law does not impose any independence requirement for such third party standard. Delaware intended to provide a measure of accountability by requiring directors to consider the interests of those materially affected by the corporation’s conduct.

With respect to the transparency requirement, Delaware requires its public benefit corporations to provide a benefit report to its stockholders biannually. The statute permits a public benefit corporation to also provide the benefit report to the public and report to its stockholders more frequently than biannually.

How to Conform a Delaware Benefit Corporation to the Model Legislation

Some of your socially and environmentally oriented clients may perceive that the lack of an express enterprise-wide commitment to have a purpose to create general public benefit makes the Delaware public benefit corporation vulnerable to so-called “greenwashing.” Because the term “benefit corporation” connotes a commitment to have a material positive effect on society and the environment, some of these clients worry that Delaware public benefit corporations can take advantage of that connotation without making an express commitment. Their concern is that a Delaware public benefit corporation could “greenwash” by adopting a narrow specific public benefit of a charitable nature such as providing a public playground at its headquarters while marketing itself as a responsible and sustainable business.

You can match these clients with a benefit corporation law that is aligned with their values by incorporating them in states that conform to the model legislation or by crafting their Delaware public benefit corporation to conform to the model statute. To add a purpose of providing general public benefit, for example, you can define the statute’s precatory statement to operate in a responsible and sustainable manner in the charter to mean providing a material positive impact on society and the environment from the corporation’s operations taken as a whole. To conform to the accountability requirement of the model legislation, you can include a charter provision that requires the creation of general public benefit and the chosen specific public benefit to be measured against a third party standard that meets the independence requirements of, for example, Section 14601(g) of the California General Corporation Law. To conform to the transparency requirement, you can include a charter provision that requires the annual provision of a benefit report to stockholders and the public.

Conclusion

Now that you understand its basics tenets—general public purpose, accountability, transparency, and extension of fiduciary duties to all of the corporation’s stakeholders—you are ready to advise the growing number of businesses that are as committed to having a material positive impact on society and the environment as they are to maximizing stockholder welfare.

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BUSINESS LAW TODAY

The Use of Benefit Corporations by Charitable Organizations

By [Kimberly A. Lowe](#)

Introduction

For years nonprofit organizations exempt from taxation under Section 501(c)(3) of the Internal Revenue Code (charitable organizations) have dabbled (or sometimes more than dabbled) with profit-generating activities. Mixing for-profit and nonprofit, taxable and tax-exempt entities successfully requires more than a passing knowledge of business structures, governance structures, and tax. Now that the benefit corporation entity form has become somewhat mainstream, the question often arises as to how and when to mix the benefit corporation form within a charitable organization's structure of activities. This article will provide experienced business law practitioners with an overview of the business, tax, and mission considerations that go into using a benefit corporation within a charitable organization's enterprise structure. While this article is limited in scope to charitable organizations, the concepts discussed in this article can apply to other tax-exempt organizations.

Benefit corporations are for-profit business corporations that are taxed like any other for-profit corporation—either under Subchapter C of the Internal Revenue Code (the IRC) or Subchapter S of the IRC. While

benefit corporations are sometimes referred to as a hybrid between a for-profit entity and a nonprofit entity, this hybridization relates to mission and not to taxation. Benefit corporations, like all for-profit enterprises, have equity holders (i.e., shareholders), who legally have the same financial and economic rights to receive a return on investment as other equity holder any other for-profit enterprise. Charitable organizations (in fact all nonprofit organizations) are legally prohibited from having equity holders who have a right to some sort of pecuniary gain or return on investment. These two very important facts about benefit corporations are critical to understand and appreciate when structuring profit generating activities for a charitable organization.

Often a client (or a would-be client) will inquire as to how to “convert” a charitable organization into a benefit corporation or how to “drop-down” a benefit corporation (or a for-profit entity) subsidiary so as to make the charitable organization “economically sustainable” or “independent from charitable donations.” The benefit corporation entity form in and of itself will not make a charitable organization economically sustainable. The benefit corporation entity form merely provides a statutorily

created structure and set of rules that allow for-profit businesses to have a mixed purpose. An economically viable “business” plan is still required to make the benefit corporation entity form be of any sort of value. So within the context of charitable organizations, the benefit corporation entity form is merely a structural tool that a charitable organization can consider when planning for and thinking about generating earned income. For purposes of these discussions with charitable organizations, the key point on which to focus is “earned income” or “earned revenue.” Converting a donative charitable organization—a public charity dependent on charitable donations—into a benefit corporation is neither statutorily or practically possible since donative sources of revenue are dependent on a charitable organization being charitable. If, however, a charitable organization has discovered (or imagined) an earned revenue stream not dependent on its charitable tax-exempt status that the charitable organization can develop or maximize, then discussions about how the benefit corporation entity form fits in the mix become possible. Used correctly, the benefit corporation entity form can be a very valuable tool for charitable organizations to either (1) capture earned revenue

that the organization can create or generate or (2) create an enterprise that can attract and incent investors to “partner” with charitable organization to create or generate earned revenue. The key to success is using the tool correctly to accomplish the goals of the charitable organization.

The Charitable Organization’s “Tax-Exempt” Reality

Understanding how and when to use to benefit corporation entity form within a charitable organization’s enterprise structure requires a brief explanation of tax-exemption and unrelated business income tax and an understanding as to how these concepts interrelate for charitable organizations.

Tax Exemption Requirements for Charitable Organizations

Organizations that are exempt from income tax under Section 501(c)(3) of the Internal Revenue Code include: “. . . corporations, and any community chest, fund or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes . . . no part of the net earnings of which inures to the benefit of any private shareholder or individual . . .” To better understand how this provision of the IRC is implicated when considering a charitable organization use of the benefit corporation entity form, it is helpful to explain a couple of key tax maxims that impact every charitable organization.

Charitable organizations are only tax-exempt if they are *organized exclusively* for exempt purposes. To satisfy the Internal Revenue Services’s (IRS) exclusivity test, the charitable organization must have: (1) a written organizational document or charter that expressly describes its charitable purpose(s); and (2) language in its organizational documents that prohibits certain transactions that financially benefit individuals or for-profit entities. The IRS has denied exemption to many would-be organizations claiming to be charitable organizations (typically in the church context) because these organizations had other significant activities that called into ques-

tion the claimed charitable purpose. For example, the IRS denied exempt status to a church that was operating a restaurant.

A charitable organization must also be *operated exclusively* for exempt purposes. To obtain and maintain tax exempt status, a charitable organization must satisfy the IRS’s “operational test” that looks at all of the facts and circumstances surrounding the operations of the charitable organization including the organization’s sources of revenue and the nature of its expenses. Generally, most charitable organizations receive a significant part of their gross receipts from charitable sources such as donations and grants. Some charitable organizations operate exclusively by assessing related fees, charging admissions or otherwise selling goods and services related to the charitable purpose (think tuition to a nonprofit school). The key issue with charitable organizations is that the revenue is generated from activities substantially related to the charitable purpose of the charitable organization. Revenue generating activities become questionable (and problematic) when a related revenue activity changes or grows into an unrelated activity. Too much income from unrelated sources may bring into question whether a charitable organization is primarily devoted to tax-exempt purposes or otherwise. When a charitable organization’s revenue generating activity moves too far away from the charitable purpose of the organization, this activity becomes unrelated and moves into the realm of commercial business activity. Unfortunately, no bright line test exists as to how much commercial business activity is too much. The IRS will tend to look carefully at a charitable organization’s commercial business activities where it appears that excessive commercial objectives are being pursued.

No part of a charitable organization’s net earnings *can inure to the benefit of any private shareholder or individual*. “Inurement” occurs when someone who is a leader, or otherwise exercises control over a charitable organization, takes or uses money or other assets for personal use without due consideration in return. Reasonable salaries and

wages are paid in return for services, so they are not considered inurement. The concept of inurement becomes critical with the individual people who lead and operate a charitable organization become involved (and prosper financially) from business activities.

The basic concepts outlined above relate to how a charitable organizations originally obtains tax-exempt status as well as how such organizations maintain tax-exempt status throughout the charitable organization’s life cycle. Unfortunately, tax-exempt status is not a tax status that an enterprise can move in and out of with ease or without very detrimental consequences.

Unrelated Business Income Tax (UBIT)

Whenever the leadership of a charitable organization considers undertaking an earned revenue activity, with or without a new entity in the mix, unrelated business income tax (UBIT) must be considered. The IRS Publication 598 (Rev. January 2015) *Tax on Unrelated Business Income of Exempt Organizations* provides a relatively user-friendly guide to this very dense topic.

Unrelated business income is income that is generated from a trade or business regularly conducted by a charitable organization that *is not* substantially related to the performance by the charitable organization of its exempt purpose or function. The term *trade or business* generally includes any activity conducted for the production of income from the selling goods or performing services. An activity must be conducted with the intent to produce a profit to constitute a trade or business. Business activities of a charitable organization are ordinarily considered *regularly conducted* if they show a frequency and continuity, and are pursued in a manner similar to comparable commercial activities of nonexempt organizations.

The IRS specifically excludes certain activities from the definition of unrelated trade or business. These activities include: bingo games that comply with certain criteria; a trade or business conducted by a charitable organization primarily for the convenience of its people served; qualified convention or trade show activities conducted at a con-

vention, annual meeting, or trade show; activities related to the distribution of low cost articles incidental to soliciting charitable contributions; the providing of certain hospital services at or below cost by an exempt hospital to other exempt hospitals; a qualified public entertainment activity; qualified sponsorship activities and advertising income; the sale of donated merchandise; and any activity in which substantially all the work is performed by volunteers (without compensation). It is important to know what the IRS excludes from this definition since these activities should be kept within a charitable organization's operations.

Generally, unrelated business income is taxable, but there are exclusions and special rules that must also be considered. The following types of income (and deductions directly connected with the income) are excluded when determining unrelated business taxable income: all dividends, interest, annuities, payments with respect to securities loans, income from notional principal contracts, and other income from a charitable organization's ordinary and routine investments (with a whole host of exceptions to these exclusions); income from lending securities; royalties, including overriding royalties; rent from real property, including elevators and escalators (rents from personal property are not excluded); income from research; and income from services provided under federal license.

If a charitable organization directly or indirectly undertakes a trade or business to be regularly conducted that *is not* substantially related to the charitable organization's charitable purpose, the charitable organization will be required to pay taxes on that unrelated business income. Too much unrelated business income (and therefore taxation of such income) and the charitable organization risks losing its tax-exempt status.

When contemplating entity types and governance structures for revenue generating activities for a charitable organization, consider the following concepts:

1. If possible, connect the revenue generating activity to the active charitable purpose of the charitable organization.

This connection may help support an argument that the trade or business *is* substantially related to the charitable organization's charitable purpose. The benefit corporation entity form provides a very unique option for connecting activities.

2. Always consider the activities that have been excluded from the definition of unrelated trade or business. These activities should be conducted within the charitable organization so as to benefit from the exclusion.

Private Inurement and Excess Benefit Transactions

When considering earned revenue activities and structures, in addition to UBIT and tax-exemption, both the volunteer leaders and the professional managers of a charitable organization need to concern themselves with the concept of private inurement and excess benefit transactions. Charitable organizations cannot be operated for the personal wealth accumulation of donors, volunteer leaders or employees. These concepts seem clear when just the operations of the charitable organization are being considered. Unfortunately, these concepts tend to be lost when structuring for-profit enterprises coupled with a charitable organization. If a significant donor, board member or employee of a charitable organization "invests" in a for-profit enterprise, regardless of entity form, connected with a charitable organization for whom that individual serves, inurement needs to be considered. The same individual serving as an officer in both a charitable organization and coupled for-profit enterprise cause even more issues. Issues of duty of loyalty as well as conflicting, unresolvable fiduciary duty conundrums become real problems. Governance structures and investor mixes need to be carefully considered and reviewed when a charitable organization creates a for-profit enterprise.

More concretely, leaders and managers of charitable organizations who have donors, leaders or paid professional managers who personally benefit in any way from a charitable organization's for-profit

activities need to be mindful of the IRS's Intermediate Sanction Rules. Technically, Section 4958 of the IRC imposes an excise tax on excess benefit transactions between a disqualified person and a charitable organization. The disqualified person who benefits from an excess benefit transaction is liable for an excise tax. An organization manager that facilitates an excess benefit transaction may also be liable for an excise tax on the excess benefit transaction. Put in context, the following general concepts related to the Intermediate Sanction Rules should be helpful to consider.

An excess benefit transaction is a transaction in which an economic benefit is provided by a charitable organization, directly or indirectly, to or for the use of a disqualified person, and the value of the economic benefit provided by the charitable organization exceeds the value of the consideration received by the charitable organization. When determining if an excess benefit transaction has occurred, the IRS will include all consideration and benefits exchanged between or among the disqualified person and the charitable organization and all entities it controls. If a charitable organization makes a grant, loan, payment of compensation, or similar payment to a substantial contributor or a disqualified person related to the charitable organization and a controlled or related entity, the arrangement may be an excess benefit transaction.

A disqualified person is any person who was or is in a position to exercise substantial influence over the affairs of the charitable organization at the time and including a look back period. It is not necessary that the person actually exercise substantial influence, only that the person be in a position to do so. Disqualified persons include officers and directors of charitable organizations as well as family members of the disqualified person. Entities controlled by the disqualified person are also disqualified persons. For this purpose, the term control is defined as owning more than 35 percent of the voting power of a corporation, more than 35 percent of the profits interest in a partnership, or more than 35 percent of the beneficial interest in a trust. An orga-

nization manager is generally an officer, director or trustee of a charitable organization, or any individual having powers or responsibilities similar to officers, directors, or trustees of the charitable organization, regardless of title.

The excise tax imposed on the disqualified person is 25 percent of the excess benefit that went to the disqualified person. The disqualified person is liable for the tax. And if the excess benefit transaction is not corrected, an additional excise tax of 200 percent of the excess benefit is imposed. The organization manager who facilitated the transaction can be required to pay a 10 percent excise tax on the value of the excess benefit.

Much like UBIT, there are a few maxims related to the Intermediate Sanction Rules that a lawyer structuring a for-profit/charitable organization relationship should keep in mind: (1) if individuals involved with the charitable organization can or will personally benefit financially (either as an investor or as a paid employee or service provider) from the activities of the related for-profit enterprise, the Intermediate Sanction Rules must be considered: (2) keep the governance structures of the charitable organization and the for-profit enterprise completely separate so as to make fiduciary duties clear; and (3) do not cross pollinate senior level/management employees across related entities of different tax species.

Understanding the Intermediate Sanction Rules as well as governance structures of and for charitable organizations and related organizations is critical to structuring for-profit activities that include the leaders and managers of charitable organizations investing in and/or working for or with for-

profit enterprises. When a charitable organization considers using a benefit corporation within its enterprise mix these concepts are equally important to consider. The benefit corporation entity form does not remove these concerns and considerations. Thankfully, in several ways, using the benefit corporation entity form when structuring these sort of activities for a charitable organization allows for an opportunity to minimize these concerns.

Working the Benefit Corporation into the Charitable Organization's Enterprise Mix (or Not)

When structuring for-profit activities connected with or on behalf of a charitable organization, entity options are broad and narrow at the same time. The trusted limited liability company is always an option but the pass through nature of partnership taxation can be both a blessing or a curse for a charitable organization. The same is true with respect to using a taxable non-profit corporation.

Absent taxation consideration, the benefit corporation entity form, provides a unique opportunity for charitable organizations to structure for-profit ventures. While the taxable nature of a benefit corporation cannot be changed, the customizable mission focused dynamics of the benefit corporation entity form are very useful for contending with the issues outlined above. Under virtually all of the benefit corporation statutes enacted so far, a benefit corporation may include in its certificate or article of incorporation a specific benefit purpose within its declared purposes. The ability to specify an additional social (or charitable) purpose and give priority (or at least parity) to this

purpose above shareholder profit maximization allows a charitable organization to potentially scope a benefit corporation entity tightly enough to its charitable purpose and activities to counter UBIT and the other issues outlined above while at the same time creating an opportunity to attractive investors to a venture.

Of course, there are an array of traps and pitfalls that need to be considered when structuring this sort of venture that the benefit corporation entity form cannot erase. Jeopardizing tax-exempt status, UBIT, and intermediate sanctions are very real issues that charitable organizations always need to consider when structuring for-profit activities with or without the benefit corporation entity form.

What the benefit corporation entity form adds to charitable organization for-profit structuring that was not available before its inception is an entity option that includes an external, publically declared mission opportunity as well as a built-in transparency and disclosure system that is robust enough to provide a charitable organization and the public with insight into the operations of a for-profit business venture without having to contend with the full-blown disclosure imposed on tax-exempt organizations.

For practitioners assisting clients with these sorts of transactions, the key point of view should be from the tax-exempt perspective of any charitable organization since the consequences of making a mistake can be dire not only for the charitable organization but also for those individuals that lead them.

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BUSINESS LAW TODAY

Understanding and Improving Benefit Corporation Reporting

By [J. Haskell Murray](#)

Introduction

Beginning with Maryland in 2010, [30 states and the District of Columbia \(links to the legislation are included on the website\)](#) have now passed benefit corporation statutes. Benefit corporations, which are for-profit entities meant to serve a social purpose beyond the financial interests of shareholders, are the most prominent of a plethora of recently created social enterprise legal forms. Social enterprise legal forms also include public benefit corporations, benefit LLCs, social-purpose corporations, and low-profit limited liability companies (L3Cs). Proponents of the benefit corporation form claim that the entity [“meets higher standards of corporate purpose, accountability, and transparency.”](#)

Based on a [longer academic work published in the *West Virginia Law Review*](#), this article provides a brief overview of benefit corporations, followed by their statutory reporting requirements, which are the basis for the proponents’ claim of greater transparency. This article shows that reporting compliance among a data set of early benefit corporations was under 10 percent, and argues that not only are the statutory reporting requirements lacking appropriate enforcement mechanisms, but the substantive requirements lack sufficient specificity

as well. The article concludes by offering suggestions for statutory amendments to improve the benefit corporation reporting requirements.

Overview of the Benefit Corporation Legal Form

The benefit corporation statutes create a legal framework specifically intended to meet the needs of the social business movement, which is often associated with terms like “impact investing,” “triple bottom line,” and “sustainable business.” [The Model Benefit Corporation Legislation](#), upon which most of the state statutes are based, makes clear that the benefit corporation’s purpose is to “creat[e] a general public benefit.” A general public benefit is defined as “[a] material positive impact on society and the environment, taken as a whole, assessed against a third-party standard, from the business and operations of a benefit corporation.” A [white paper authored by benefit corporation proponents](#) claims that the major requirements of the benefit corporation form are: (1) pursuit of a general public-benefit purpose; (2) consideration by directors of both nonshareholder stakeholders and shareholders; and (3) annual reporting on social and environmental impact as measured against

a third-party standard. A separate [white paper on benefit corporations by the Corporate Laws Committee of the ABA’s Business Law Section](#) includes guidance for drafting benefit corporation legislation, but notes that the committee could not reach a consensus on whether benefit corporation laws were necessary or wise. In their white paper, the ABA committee recommends Delaware’s approach to benefit corporation law. The Delaware approach provides more flexibility in most areas than the Model Benefit Corporation Legislation. The Delaware version of benefit corporation law, which it calls “public benefit corporation” law, only requires reporting once every two years instead of annually, does not require use of a third-party standard, and does not require public posting of the benefit corporation reports. Currently, benefit corporations do not receive any state or federal tax benefits. Interested readers can find a bibliography of selected articles on social enterprise law, including benefit corporation law, [here](#).

Requirements and Results of Benefit Corporation Reporting

The Model Benefit Corporation Legislation requires annual reporting. In the annual report, the Model requires a narrative

description of the pursuit and creation of a general public benefit, and a narrative description of any hindrances encountered in attempting to create that general public benefit. Moreover, the process and reasons for selecting the third-party standard, and the results of the social and environmental assessment using the third-party standard, must be reported. The benefit corporation report does not have to be audited or certified by any third-party. (B-Corp certification is optional and is also open to nonbenefit corporations. If unfamiliar, the differences between benefit corporations and certified B corporations are explained [here](#)). The benefit corporation report must be completed annually, within 120 days of the end of the entity's fiscal year or at the time of another annual report. The report must be posted on a publicly available portion of the benefit corporation's website, or, if the benefit corporation does not have a website, the report must be made available free of charge to anyone who asks for the report.

I collected data on benefit corporation reports in four states: California, Hawaii, New York, and Virginia. I chose these four states because they were among the first to pass benefit corporation laws, and those states also made available the incorporation dates of their benefit corporations. In those four states, I limited my analysis to benefit corporations formed during or before 2012 to ensure that each entity had existed long enough to trigger the reporting requirement. Only 123 benefit corporations were formed in California, Hawaii, New York, or Virginia during or before 2012. Of those 123 benefit corporations, only 100 were active at the time of my research in July 2014. Of the 100 active benefit corporations, only eight posted or otherwise made available at least one benefit corporation report. A majority of the mere eight benefit corporation reports attempted did not, in my opinion, completely comply with the substantive statutory requirements. In short, at least among these early benefit corporations in four states, compliance with benefit corporation reporting has been abysmal—well below 10 percent.

Improving Benefit Corporation Reporting

Identifying flaws in any nascent legal framework is relatively easy; offering superior alternatives is admittedly more difficult. However, states could consider the following routes to improving benefit corporation reporting. First, states could consider not requiring benefit reporting at all and allow market demand to determine whether benefit corporations produce reports and, if so, in what depth and frequency. Second, and alternatively, states could consider creating reporting exceptions for small benefit corporations, and then create effective enforcement mechanisms to ensure higher compliance among the large benefit corporations. Small benefit corporations often do not have the resources to create regular, useful reports. Even for larger benefit corporations that do have the resources, enforcement mechanisms are virtually nonexistent in most states, so the benefit corporation reporting requirements often are overlooked. The Model Benefit Corporation Legislation requires filing the report with the Secretary of State, but many states have not followed this suggestion, making tracking and enforcement difficult. States could follow the lead of Minnesota and Florida by statutorily setting significant penalties for noncompliance with reporting requirements.

The enforcement of benefit corporation reporting is not the only area that needs improvement; the substantive reporting requirements are also suboptimal. Currently, the substantive reporting required is extremely vague, untied to specific metrics, and not especially useful to the public. The Model Benefit Corporation Legislation requires that the benefit report be completed using a third-party standard, but the third-party standards are of varying quality and ill-defined in the statutes. The current version of the Model Benefit Corporation Legislation requires third-party standards to be “recognized,” “comprehensive,” “credible,” and “transparent,” but does not provide much further guidance and does not appear to have an effective screening mechanism. Third-party standards could be overseen by a self-regulatory organization or a govern-

ment actor to reduce the race to the bottom among standards. Alternatively, as is the case in Delaware, the third-party standard could be made optional, and market forces could determine whether using a third-party standard is valuable. Further, neither the statutes nor the third-party standards currently have consistent objective social metrics that would allow comparison among benefit corporations and make accountability more likely. Although choosing appropriate objective social metrics for benefit corporations across all industries would be virtually impossible, benefit corporation law could require that qualifying third-party standards choose a set number of *objective* metrics. The statutes could list examples of these standards, such as a percentage of employees paid a livable wage, a percentage of revenue donated to charities, and a percentage of buildings obtaining certain LEED certifications.

Conclusion

Benefit corporation laws are becoming increasingly popular, and the social reporting requirements are used as one of the justifications for the passage of these new statutes. However, early data show that compliance with the reporting requirements is abysmal—below 10 percent. Further, the substantive reporting requirements are vague and subject to virtually no oversight. For states that choose to mandate benefit corporation reporting requirements, the requirements could be improved by enhancing enforcement mechanisms and by mandating more objective metrics in the substantive reporting.

Further Reading and Discussion

Cass Brewer (Georgia State), Joan Hemingway (Tennessee), Lyman Johnson (Washington & Lee and St. Thomas), Mark Loewenstein (Colorado), Brett McDonnell (Minnesota), Alicia Plerhoples (Georgetown), Dana Brakman Reiser (Brooklyn), Joe Yockey (Iowa) and I, J. Haskell Murray (Belmont), are among the academic authors who have written on benefit corporations. Our law review articles can be found on WestLaw and LexisNexis. This article is

adapted from J. Haskell Murray, *An Early Report on Benefit Reports*, 118 WEST VIRGINIA L. REV. 25 (2015). Benefit corporation issues are also discussed from time to time on the [Business Law Prof Blog](#) and on my Twitter account, [@HaskellMurray](#).

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BUSINESS LAW TODAY

The Capital Markets and Benefit Corporations

By Frederick H. Alexander

In 2010, Maryland became the first state in the United States to adopt a benefit corporation statute, and since then 31 U.S. jurisdictions (along with Italy) have followed suit. In 2013, Delaware, the leading jurisdiction for incorporating in the United States, adopted its own version, authorizing “public benefit corporations.” In this short time frame, more than 3,600 companies have been formed as benefit entities, including more than 500 corporations in Delaware. The expanded purpose, accountability and transparency requirements associated with benefit corporation law are discussed in depth elsewhere in this issue. Briefly, benefit corporations directors must consider the interests of all stakeholders, in contrast to the directors of traditional corporations, whose primary duty is to shareholders. The directors of benefit corporations can and must balance the interests of all stakeholders when making important decisions, and even when selling the company. Benefit corporations must also be transparent as to how they address stakeholder concerns, so that shareholders, employees, customers, and other stakeholders can distinguish good companies from good marketing.

From a capital markets perspective, the critical distinction between traditional corporations and benefit corporations is that the latter enable private capital to be deployed in a manner that takes into account all relevant stakeholders, and not just shareholders. This idea is in sharp opposition to the governance model of shareholder primacy that currently dominates our capital markets. As a recent ABA study described the current state of corporate law: “the primary focus of corporations is to return profits to shareholders. If stakeholder needs are considered, they are a secondary concern.” The ability for corporations to opt out of this system by using the benefit corporation statutes has the potential to fundamentally alter the system of capital allocation within the United States, and in global markets as well. The rapid uptake of this new model converges with a number of other developments in the capital markets and the legal regimes affecting them. These developments go by many names: ESG (environmental, social, governance); CSR (corporate social responsibility); CSV (creating shared value); sustainability; responsibility, and others. Each of these shares a fundamental idea: corporations bear a respon-

sibility to all of their stakeholders, not just shareholders.

Business Developments in the Direction of Sustainability

The demand for corporations that operate with a broader purpose than simply maximizing shareholder value is clear. For example, a recent Nielsen study showed that, among global online consumers surveyed in 60 countries, 55 percent were willing to pay extra for goods and services from companies that are committed to positive impact on society and the environment. In the United States, the American Sustainable Business Council reports that it represents over 200,000 businesses in promoting a sustainable economy. *Fast Company* reported that more than 50 percent of millennials would take a pay cut to find work that matches their values; they will comprise 75 percent of the work force by 2025, demonstrating the purposeful nature of an enterprise is essential in the war for talent. Businesses that participate in the supply chains of responsible companies must also constantly improve their social and environmental performance in order to satisfy

procurements requirements. PwC reported in 2015 that more than two-thirds of surveyed supply chain executives said that sustainability would play an important role in the management of their supply chains. In 2014, US SIF reported that \$6.6 trillion in assets under management that is managed with sustainability goals. Thus, throughout the business chain, there is increasing focus on sustainability.

Legal and Regulatory Developments

Regulators are recognizing the importance of sustainability as well. In 2015, the Department of Labor changed its guidance for ERISA trustees to specifically provide that there was no burden placed on trustees who invested in enterprises with an ESG strategy. Indeed, the DOL guidance recognized that such strategies may contribute to improved long-term performance. The Small Business Administration recently released proposed regulations that would formalize their “impact fund” program, which provides special incentives for SBICs that agree to invest at least 50 percent of their assets in companies that have a positive impact on society and the environment. More recently, in April, the SEC issued a concept release asking for comments with respect to periodic reporting. Within that release was a section setting forth specific questions relating to ESG reporting.

A number of NGOs have also focused on sustainability reporting. Principles for Responsible Investment, a UN-backed initiative, has signed up asset owners and managers with \$59 trillion under management to encourage responsible investing. The Sustainability Accounting Standards Board has promulgated sets of reporting standards applicable to a number of industries. Other NGOs have constructed well-respected standards, such as the Global Reporting Initiative and IRIS, which have created a catalog of performance metrics used to measure the social, environmental, and financial performance of investments. B Lab, a nonprofit organization that supports benefit corporations, has constructed an actual impact assessment that can assign a score to any for-profit business to deter-

mine its performance across a broad array of sustainability metrics.

Need for New Legal Paradigm

All of these developments contribute to the strong market forces demanding responsible and sustainable performance by companies. However, traditional corporate law and financial market norms do not provide a governance model that is fully consistent with operating businesses in a sustainable manner that respects the interests of all stakeholders. Instead, traditional corporate governance emphasizes shareholder value as the primary goal for directors and other fiduciaries. Under this rule of shareholder primacy, the interests of workers, communities and other stakeholders can be considered, but that that consideration is always secondary to maximizing shareholder wealth. Entrepreneurs and others who want businesses to serve the interests of all stakeholders may prefer “mission-aligned” governance, which does not prioritize the interests of shareholders over other stakeholders; benefit corporation law provides such an option.

Notably, proponents of responsible corporate conduct often argue that sustainability performance and reporting increase financial performance, at least in the long term. If this is true, it may beg the question why a new corporate form is needed to allow managers to take the interests of stakeholders into account. That is, if stakeholder governance benefits shareholders, why is it necessary to change the rules to say that directors can take into account the interest of stakeholders as well as shareholders? Shouldn't they already be doing this in order to maximum return to shareholders? There are several answers to this question, and the relevant answer in a particular situation may influence the advice given when clients consider adopting mission-aligned governance.

The first instance in which a mission-aligned company might make sense would be for an entrepreneur seeking so-called “concessionary” investments. This phrase refers to a situation where investors expect to sacrifice some returns in exchange for ensuring that a business has a positive

social impact. This concept appeals to impact investors who are willing to accept a lower return and who are most concerned that their investments have a positive social impact. This is an important use of the benefit corporation model—but it is not the primary use to which it can be put in the capital markets.

A more important function of benefit corporation governance is its use as a tool to create relationships of genuine trust and commitment among companies, investors, communities, workers, and other stakeholders. By allowing companies to make genuine commitments to stakeholders, i.e., commitments that are not contingent on continuing to be the most profitable option, benefit corporations can obtain greater commitment and cooperation from a broad range of stakeholders. Thus, in a seemingly paradoxical result, the legal commitment to pursue *stakeholder* value can create more *shareholder* value. This theory of value has been explained by Colin Mayer, a professor at the Said School of Business at Oxford in his book *Firm Commitment*, and by Lynn Stout, a professor at Cornell, in *The Shareholder Value Myth*. Although this argument may sound somewhat esoteric, it is probably the chief reason for which the form is used today. That is, mission-aligned governance is being used as a tool to prove to other stakeholders that responsible performance is “locked in.” Thus, the benefit corporation form is a tool that can demonstrate to regulators that a for-profit business can be trusted over the long term; it shows potential employees that they can work for an employer whose values are part of its DNA. This idea—that doing well by stakeholders is a way to do good for your shareholders—obviously appeals to all investors, whether they prioritize impact or not.

Lawyers may be better able to serve their clients if they understand that the benefit corporation has moved beyond concessionary investments, and is advancing into mainstream capital markets, and if they are able to advise clients who want to take advantage of the new model. Hundreds of millions of dollars have been raised from conventional venture capital investors by benefit corpora-

tions. These investors include brand names like Benchmark Capital, Union Square Ventures, Andreessen Horowitz, and Founders Fund. Moreover, benefit corporate governance is beginning to make its way into the public markets. For example, in 2015, Etsy, an online marketer of homemade products, went public as a certified B Corporation (certified by B Lab). The B Corporation certification requires a company to demonstrate a high level of social and environmental performance. In addition, the designation requires that the company change its corporate governance structure to one of mission alignment. In order to retain its B Corporation certification, Etsy will need to become a benefit corporation by August of 2017. In another development, Laureate Education, a KKR backed \$4 billion for-profit education company has filed a registration statement on Form S-1 in anticipation of a public offering. In addition, Brazil-based Natura, a multibillion dollar-market capitalization company presented a resolution to its shareholders in 2015 to amend its corporate charter to provide for mission-aligned governance. (In Brazil, there is no need for a separate benefit corporation statute: the current corporate law allows mission-aligned governance if so designated in the charter.) Natura obtained the vote and has amended its charter. Most recently, another Certified B Corp, Sungevity, announced it would go public through a reverse IPO.

Public companies are experimenting with the benefit corporation form in other ways as well. Campbell's Soup owns a benefit corporation called Plum Organics, and United Therapeutics owns a benefit corporation named Lung Bioscience. Other multinational companies are teaming up with B Lab to ensure that both B Labs's certification standards and its legal requirements work in the public markets. That effort, called the Multinational and Public Markets Advisory Council, includes multinational companies such as Unilever, Danone, and Campbell's, investors such as Morgan Stanley, Prudential Financial, and Perella Weinberg Partners, and professors from the business schools of Oxford and Harvard.

This movement is accelerating. As discussed above, responsible corporate behavior is just good business. It attracts customers and employees, and is important to government in their capacity as both regulators and customers. But just as importantly, there is another element that is beginning to motivate investors. Most investors in the market, including insurance companies, pension funds and individuals managing their own 401(k)s, are highly diversified. That is, they own most of the market. For them, company-by-company performance is not as important as the performance of the market as a whole. Investors are beginning to realize that companies that operate solely on a principle of chasing share value are incentivized to take actions that may hurt the rest of the market. For example, in the run-up to the 2008 financial crisis, financial companies had the incentive to take great risks in order to chase large returns, but the result of that risk-taking was absorbed not simply by those companies' shareholders, but by the entire stock market. Moreover, the ultimate beneficiaries of pension funds and insurance companies are the pensioners and the insured, and to them, it is important that the companies they invest in not harm the world in which they live. All of this means that active investors will begin to encourage mission-aligned governance as a way of maintaining valuable portfolios over the long term, and company advisors should be prepared to discuss these issues, and tools like benefit corporation governance.

The Role for Lawyers

As part of my job as head of legal policy at B Lab, I often hear that investors and entrepreneurs who want to pursue a benefit corporation structure are discouraged by some lawyers, who worry that the model is untested or unnecessary. Law firms that want to provide a full complement of options to their clients, especially clients that want to take leadership positions in the sustainable economy, should consider learning about this structure. Of course, reading the other mini-theme articles in this issue of *Business Law Today* would be an excellent way to begin that process. Resources are also available at www.benefitcorp.net, including a free

ePub version of *The Public Benefit Guidebook*, which includes practical advice as to how to form and operate a Delaware benefit corporation. These and other resources can help lawyers to answer questions about how governance of benefit corporations differs from traditional governance. This new governance framework, which requires directors to balance and consider all stakeholders will, like any new legal concept, require thoughtful counseling.

There are two critical concepts behind the adoption of benefit corporation statutes—the need for legal change and the stakeholder-based solution. Advocates have persuaded legislatures to adopt benefit corporation statutes because the traditional law—developed in well-known cases like *Revlon* and *eBay*—precludes corporations from making authentic commitments to stakeholders, and this disability prevents corporations from entering into long term relationships based on trust. It also prevents corporations and their investors from agreeing to forgo short-term strategies that interfere with the creation of long-term value. Benefit corporation law is intended to serve as a turnkey solution to this problem, which will allow corporations to expand corporate purpose to include stakeholder interests, while providing for corresponding accountability and transparency with respect to those concerns. It provides management with tools such as an expanded business judgment rule and special liability protections that allow a corporation to make commitments to stakeholders that are on par with its commitment to shareholders. The CEO of Laureate Education explained this principle in the company's registration statement:

I believe that balancing the needs of our constituents has been instrumental to our success and longevity, allowing us to grow even in challenging economic times. For a long time, we didn't have an easy way to explain the idea of a for-profit company with such a deep commitment to benefitting society. So we took notice when in 2010 the first state in the U.S. passed legislation creating the concept of a Public Benefit Corpora-

tion, a new type of for-profit corporation with an expressed commitment to creating a material positive impact on society. We watched this concept carefully as it swept the nation, with 31 states and the District of Columbia now having passed legislation to allow for this new class of corporation, which commits itself to high standards of corporate purpose, accountability and transparency. This includes Delaware, the state that we have selected as our new domicile and which has the most up-to-date Public Benefit Corporation law.

In light of these developments, lawyers may want to equip themselves to help clients who want to take a leadership role by creating or investing in benefit corps. Indeed, becoming knowledgeable is a good way for lawyers who are interested in stakeholder governance to show leadership. Lawyers active in this field can also help

benefit corporation fulfill their reporting requirements. As Haskell Murray points out elsewhere in this issue, it appears that many benefit corporations are out of compliance, and transparency is a key element in the structure. Specific examples of benefit corporation reports [can be found here](#). That page also includes a good description of the reporting requirements. One easy resource that clients can be referred to is a free tool to create a benefit report based on B Lab's B Impact Assessment. Your client can create a benefit report [by starting here](#).

Lawyers can also work to break down barriers to mission-aligned governance. In the 20 states that have yet to adopt a benefit corporation statute, bar associations can work to ensure that this tool is available to local businesses without requiring them to incorporate in another state. (And it is important to understand that the social purpose and flexible purpose statutes that a few states have adopted do not necessarily

supply the turnkey solution that benefit corporation law does.) Local bar associations can also develop forms and materials for their states, as well as CLE programs and other teaching materials.

Corporate law underwent a massive change in the latter part of the last century, culminating in the Delaware Supreme Court's holding that corporations are to be managed for the benefit of shareholders only. In many ways, this fundamentally changed our process of allocating capital in the private markets, and the results have not always been positive. The benefit corporation governance alternative gives business lawyers the opportunity to be on the cutting edge not simply of a change in the law, but of a change in the way that capital markets work, and in the ability of business to address some of our most pressing concerns.

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BUSINESS LAW TODAY

The Chief Compliance Officer Debate: Focus on Function Not Form

By [Ben W. Heineman, Jr.](#)

Driven by major scandals, there has been a dramatic increase in regulation, enforcement, and sanctions in the past 25 years. Without question, the most basic job of the general counsel (GC) is to determine what is the law and to help shape messages, systems, and processes so that the corporation is compliant and avoids legal risk all across the globe. In addition to preventing harm, compliance also creates value inside the corporation, in the marketplace, and in broader society by underscoring the corporation's commitment to integrity and differentiating it from less scrupulous rivals.

But it is also without question that the CEO must personally lead compliance. It is a team sport involving not just the legal function, but also finance, compliance, human resources, and risk as well as business leaders. In recent years, far too much time and effort has been wasted on debating the formalities of organization—for example, whether the CCO reports to the GC/CFO on one hand or to the CEO and the board on the other. I believe the CCO should report to the GC because the legal department is responsible for the foundational task of determining what the law is. But I offer this as a preference, not an iron-clad prescription, because companies vary in their cultures and because

the right teaming arrangements are far more important than reporting relationships. Most importantly, the CEO, as the corporation's chief compliance officer in effect if not in title, must provide intense leadership on this set of issues and must focus on function, not form, in deciding how to address different compliance issues in different corporate systems and processes in different markets posing different challenges.

What Is the Law?

A corporate program aimed at complying with the law naturally must first answer the knotty question, “What is the applicable law”? Writers about compliance often gloss over this most fundamental determination. When a company is operating in multiple countries, the GC must undertake the devilishly difficult task of determining the law that applies to each corporate function—from sales and marketing, to manufacturing and technology, to finance and human resources—in each country. In addition, there is the related problem that legal systems are constantly evolving through legislation, regulation, enforcement, investigation, and litigation. Given the law's dynamism, the GC must make three important judgments that involve not only superb technical law-

ying, but also wise counseling in answering the deceptively simple question, “What is the law”?

First, the GC must help the corporation choose among a range of reasonable interpretations of the law. For example, if faced with a “rule” that is ambiguous, how should it be interpreted in order to comply most fairly with the law? Frontier issues in business frequently put lawyers in frontier areas of interpretation, given the broad array of corporate processes and operations and the variety of regulations that may apply to each corporate function. Moreover, any given interpretation may also require a business judgment about how much legal risk the company should assume in choosing from a range of reasonable options.

The second judgment is deciding between pluralism or uniformity when the type of law in question has different interpretations in multiple jurisdictions. Should the corporation attempt an interpretation that is “reasonable” in each jurisdiction because the laws are so different (e.g., different privacy standards in the United States versus the European Union), even though that will involve significant administrative complexity? Alternatively, should the corporation decide on a uniform legal interpre-

tation that is at the most compliant end of the spectrum and thus provides administrative simplicity but may also lead to “over-regulation” in less severe jurisdictions? For example, child labor laws in various nations set different ages for when children may work (i.e., from ages 13 to 16). The GC may decide that a single age mandated in the most restrictive jurisdiction should apply, both in the company’s own facilities across the globe and in labor standards applied to third-party suppliers. In other words, the company simply will not hire anyone under the age of 16 even though a younger age is permissible in some of the countries in which it operates.

The third judgment is whether the company should adopt the “spirit” of the law, or the underlying purpose, and fashion a voluntary prescription for the company that advances that purpose but may not be technically required by the law in question. This raises difficult ethical questions for a global company that require weighing “prudential” factors (what is in the corporation’s enlightened self-interest) and “moral” factors (duties owed to stakeholders).

In determining what the law is, I must also underscore that there are certain improprieties to which a GC should *never* succumb when under pressure to bless proposed corporate actions. Inside counsel must never: (1) ignore the law and hope the company will not be caught (often through bribes); (2) act as Holmes’ bad man and try to assess whether the benefits of noncompliance outweigh the costs of discovery; or (3) attempt to interpret away the law’s purpose and effect through strained, hyper-technical readings that are obfuscatory and outside the range of credibility if viewed by a reasonable, independent third party. Trying to change the law or leaving a jurisdiction are acceptable alternatives to “bad” law; disobeying it or ignoring are not.

The CEO as CCO

If the foundational step is determining what the law is, the essence of compliance is management of complexity through disciplined systems and processes. Simply stated, compliance involves ensuring across an orga-

nizationally diffuse and fragmented global corporation that systems and processes prevent compliance misses, detect those that do occur, and respond quickly and effectively. For all the volumes on compliance, it really comes down to three words: prevent, detect, and respond. It is towards these objectives that classic management disciplines of planning, goal setting, organizing, staffing, budgeting, and auditing must be directed. These objectives are accomplished only when a compliance infrastructure is built into business operations that have a performance-with-integrity culture.

This is why I believe that the CEO must be the company’s CCO in at least a leadership, if not day-to-day, sense. Much ink has been spilled about the respective roles and reporting relationships among the GC, CFO, CCO, head of internal audit, ombudsperson, chief risk officer (CRO), and head of human resources. Whatever the organizational formalities, there is no doubt that these senior executives, who are jointly responsible for compliance, must work together with their respective personnel so that the program is carried out with intensity, integrity, and independence. However, there also can be no debate that, if the CEO does not view compliance as one of her core leadership duties, then the efforts of the senior executives are not worth much. Adoption of such a leadership role by the CEO means that she, in turn, holds other business leaders within the company accountable for integrating integrity into their business processes. Together they must drive this ethos of accountability down into the company so that the critical middle-management leaders of profit-and-loss segments in far-flung corners of the world know that it is the core of their job, too. Accountability is key; senior executives and middle managers alike must know that the failure to create a culture of integrity is a firing offense. General performance on integrity issues must affect promotion and compensation. Moreover, business leaders within the company must live compliance: they must speak about it both personally and publicly, emphasize integrity as the foundation of the company, lead compli-

ance reviews, and exemplify core integrity values in their own personal behavior.

The GC and other key staff must therefore work with the CEO to ensure that operational business leaders have “ownership” of the systems, processes, and resource allocations essential to an effective integrity infrastructure embedded into business operations. Plant managers must lead environmental health and safety in their facilities. Sourcing leaders must ensure that their third-party vendors follow local law. Division heads must have a comprehensive understanding of what is needed to follow the law and reduce legal risk and then effectively build those systems and processes into the business. That is addressing complexity. That is management—systematically applying disciplines to the different elements and operational details of prevention, detection, and response. I continue to be surprised at how legal, finance, or compliance experts puff about staff roles in compliance when writing about compliance outside the corporation without acknowledging the centrality of business leaders. The reality is that the CEO and business leaders must lead on compliance with the assistance of staff. The CEO must make this crystal clear.

At the same time, however, the CEO and business leaders must embrace a paradox. Yes, compliance fundamentals must be built into business processes for effective prevention. Yes, business leaders must make this a genuine, operational priority. However, the CEO and business leaders also must embrace the critical importance of personnel—legal, finance, compliance, and risk at both corporate and operating levels—who must have an independent role in the design, implementation, and monitoring of the prevent-detect-respond systems and processes. In sum, the CEO and business leaders must unequivocally support the paradox that compliance is a fundamental business operation but also a subject requiring independent staff involvement and review.

GC, CFO, and CCO: Function Not Form

The often-debated question of whether the CCO should report to the GC/CFO or to the CEO is far less important than deep, au-

thetic CEO and business-leader commitment to compliance. It is far less important than assessing in a particular corporation the strengths that legal, financial, compliance, risk, and human resources personnel bring to the multifaceted subject of compliance in the context and culture of the company's particular industry. It is far less important than ensuring that personnel in each of these areas work together seamlessly on the wide variety of tasks within the broad prevent-detect-respond framework.

Assumptions about the GC

To put this organizational issue in perspective, it is important to summarize "first principles." The CEO, board of directors, and senior executives must create a powerful culture of high performance with high integrity. They must expect the GC to be a lawyer-statesman who is concerned with not just the question of what is legal but with the ultimate question of what is "right" as seen through the lenses of performance, integrity, and risk. They must enthusiastically encourage the GC and other staff executives to be both partners in achieving corporate objectives as well as guardians of the corporation. They must want unvarnished views in discussion and debate before making decisions.

Compliance with the law is not one, substantive subject. It encompasses many subjects (antitrust, tax, accounting rules, labor and employment, etc.) that cut across the company's multiple functions (technology, manufacturing, marketing, sales, finance, etc.). Compliance also involves particular regulatory regimes governing specific industries (health law, communications law, banking law, etc.). In most corporations most of the time, the substantive experts on what is the law work for the GC (or for the CFO on mandated financial rules). They use that expertise in a variety of ways that create value for the corporation, including, but not limited to, compliance. It is simply ludicrous to argue as a prescriptive matter, as some do, that law and finance should be involved only in "performance" and not "integrity." It is simply ludicrous to think that the GC should be merely a passive figure doing what she is told by the CEO and

other senior executives. My prescriptive approach is based on the independence of the GC as lawyer-statesman and partner-guardian advocating for what she believes is the right course of action. As former GE General Counsel, I viewed the absolute core of my role as promoting corporate integrity and adherence to law.

Role of the CCO

In my view, the CCO's core job is to operationalize formal rules through engagement with the GC, CFO, and other experts and leaders within the company. Unless the company is very small and resource constrained, the GC should not also be the CCO. The CCO's main skills are process integration and organizational rigor. The CCO must meld the legal and financial expertise of the GC and CFO and their personnel (as well as the expertise of the risk and human resources organizations) with the day-to-day operational responsibility of the company's business leaders. Because there are many different substantive areas of compliance handled by different experts, it is vital that these threads be woven together into a coherent compliance approach. That is the job of the CCO. For example, there must be a single code of conduct and a uniform set of policy guidelines. There must be integrated general education and training for all employees. There must be an integrated method for tracking, training, and testing individuals who move into high-risk jobs. There must be a systematic and consistent company method to map out business processes, assess where risk exists in those processes, and then mitigate those risks. There must be oversight of the ombuds system to ensure that it is operated fairly, promptly, and without retaliation. There must be a continuing, energetic search for the best compliance practices outside the company. These are the kinds of vital process and organizational tasks for a CCO and her staff.

Thus, the CCO should first and foremost have organizational and managerial expertise. She must help create a coherent, company-wide framework that cuts across substantive areas, business groups, and di-

verse geographies within the company so that there is a coherent and comprehensive approach to prevention, detection, and response. Lawyers do not necessarily possess such organizational skills. Moreover, because she oversees the company's diverse compliance activities, the CCO should attend all meetings with the CEO or senior executives involving individual cases or systemic problems relating to compliance. She should have her own independent voice and should view as central to her role the task of asking difficult questions about whether corporate actions comport with concepts of integrity. In my view, this role is analogous to the head of the internal audit staff (a position of great prestige in many global companies that reports to the CFO). Like the head of the internal audit staff, the CCO should report independently on a regular basis to the board of directors, providing her perspective on the strengths and weaknesses of the broad compliance function or her view on individual cases with which she is familiar. At the end of the day, the role of the CCO in directing process management across the entire compliance system—and making compliance operational—is a central and vital job.

As a general matter, however, there should not be duplication in the CCO's function with the substantive expertise in the law and finance functions about the foundation of a compliance program, i.e., the formal legal and financial rules upon which compliance is built. That would be a source of confusion, waste, and possible turf fighting. The GC and CFO have primary substantive responsibility, and the CCO has primary process and organizational responsibility, but close working relationships between those with substance and process responsibilities are critical. Moreover, those demarcations are not always bright lines. Certain members of the legal team may have organizational and process skills. Certain members of the compliance organization may have substantive expertise in discrete compliance areas. For example, in financial services institutions, there may well be a compliance expert on financial regulation, while the legal team retains substantive expertise in more traditional areas like antitrust, tax, or labor and

employment. In these special cases, the GC, CFO, and CCO must sort out process and substantive responsibilities and, under CEO direction, make that division clear.

Independence

Under my view of the GC as lawyer-statesman and partner-guardian, I simply do not buy the idea that the GC is less independent than the CCO. Under a good CEO, both will be respected for their analysis of problems and for their unvarnished views as to “what is right.” Under a poor CEO, both will be diminished. Let us not be naïve; compliance officers are subject to the same financial and group pressures as GC and finance personnel. Like the GCs, they, too, can be cowed by business leaders. They, too, are fired—and indicted—for improprieties.

Functional Realities

Far more important than debating reporting relationships is creating a strong sense of shared purpose among personnel. An effective approach to the many dimensions of compliance under the leadership of the CEO and senior executives must effectively integrate law, finance, compliance, risk, and HR specialists.

The basic compliance dimensions—prevent, detect, and respond—require cross-functional integration as illustrated, for example, by competition law. First, there is the basic question of what the relevant antitrust law is that the corporation’s antitrust lawyers must differentiate and explicate among the legal regimes in different parts of the world. The legal expert on competition law can then formulate key issues that must be covered in a compliance audit; the compliance experts can present how such audits have worked across other substantive legal areas; the internal audit team (working under the CFO and with legal and compliance) can develop a work plan; the audit staff and compliance personnel can carry out the compliance audit; and personnel in all three functions—legal, compliance, and audit—can review the results and determine how to present issues and action items at compliance reviews at different levels of the corporation.

In a different context, the competition law specialist working for the GC can propose the critical rules—and the key Q&As—in the company policy guidelines, but the CCO and other experts in the compliance organization will help refine it, making it both engaging and consistent throughout the company as part of competition law education and training. If there is a serious antitrust problem and resulting government investigation, the GC, the inside antitrust leader, and outside counsel may lead the response to the subpoena, but both the compliance staff and the audit staff will help work inside the corporation to prevent document destruction, systematically gather information, and ensure that employees are both responsive to, but not terrified by, a rigorous internal probe. In addition, with the approval of the CEO and the board, the GC will either settle or litigate a case after careful consideration of what is “right,” given the facts.

Look at the strengths of each of the functions. The CCO can create the entire appearance and feel of the company’s compliance communications, from the code of conduct, to detailed policy guidelines, to education and training, to Web-based information, to a powerful video shown to new employees. Together, the CCO, GC, CFO, and CRO can design the template for annual business compliance reviews, with the CCO advising the business on how to sharpen both the form and substance of its presentation to the corporate compliance review board. The ombuds function can report to the CCO; however, determining which experts will investigate which complaints will emerge through a joint discussion among relevant personnel. The GC, CFO, and CCO will jointly analyze the results from that ombuds system to determine what is most important for business leaders and the board. Following a major compliance miss, the GC, with advice from the CCO and CRO, may develop a plan with the vice president of communications and experts in government relations for dealing with external constituencies—from Congress, to the executive branch, to the media, to NGOs. I could give literally countless other examples of compliance activity

that should be cross-functional for optimal effectiveness, with different combinations of various personnel assembled for different parts of the problem.

The point is that, under the leadership of the CEO, the myriad compliance tasks are a classic matrix of activities that require seamless (and egoless) integration of the general skills of specific personnel and the specific skills of particular individuals in different combinations on a wide variety of issues. It is truly a team effort. It is comprised of many critical but varied elements of the protect-detect-respond framework. Those accountable must have a deep sense of commitment to compliance *and* to each other—something that cannot be captured on any organizational chart. Without that sense of joint commitment, and without seamless GC, CFO, and CCO cooperation under the leadership of the CEO, the right compliance approach cannot exist.

Organizational Formalities

Thus, it is within this ethos of functional staff integration and under the broader assumptions about a “high performance with high integrity” company that I believe the appropriate model is for the CCO to report to the GC and the CFO, with the CCO having vital organizational and process responsibilities and an independent voice on both individual compliance matters and compliance system reforms. Putting the compliance function under the GC and CFO advances the ideal of personnel operating together seamlessly and avoids waste and turf fighting because the substantive expertise about the “rules” with which the corporation must comply—and which guide the entire compliance function—is found in legal and finance. This is the foundation of compliance. For purposes of the Sentencing and DoJ/SEC FCPA Guidelines, which require designation of a person responsible for compliance, the board of directors and the CEO should designate the GC and CFO with ultimate responsibility for ensuring corporate compliance with formal rules, and the CCO with day-to-day operational responsibility. The Sentencing Guidelines allow flexibility in designation

of both overall and day-to-day compliance leadership.

A Final Point in Favor of This Reporting Arrangement

Being an effective business partner to the CEO gives both the GC and the CFO the vision and the credibility necessary to be powerful and effective guardians of the company. It is more difficult for a CCO, who is dealing solely with compliance issues, to gain that kind of across-the-board trust, and the CCO simply cannot be at all the top-level meetings on strategy or operations where integrity issues, including compliance problems, may arise but are not the main topic. A related point is that the credibility of the GC and the CFO comes from presenting a range of options for accomplishing business objectives with legitimate integrity alternatives. The CCO may not have the same business exposure or experience and may argue

for the “safest” compliance option, which is not the only “legitimate” one.

I should also reiterate that my view about the CCO reporting jointly to the GC and CFO is a presumption and a preference, not an ironclad prescription. For example, particularly in financial services or pharmaceutical companies, a body of regulation may be so detailed and controlling that a CCO may have authority over the substantive interpretation of that body of regulation and thus an independent reporting line to the CEO (whereas the legal department is responsible for substantive interpretation on all other matters of compliance). Indeed, in financial services, the regulators may require this kind of division (at least with respect to financial regulation). Alternatively, a GC may come from the transaction side of the law, and the CCO may come from the prosecutorial, regulatory, or private litigation side of the law, and in such an

instance the CCO may work more effectively in tandem with the GC rather than as a direct report. Despite my preference, my point is that function is more important than form, given the needs of a particular corporation, the realities of staff integration, and the skills of particular individuals. This is truly a case where one size does not fit all—where, under CEO leadership, functional realities rather than organization charts should control.

[Ben W. Heineman, Jr.](#), General Electric Company’s senior vice president and chief legal officer from 1987–2005, is a senior fellow at Harvard’s Law and Kennedy schools. This article is based on his new book: [The Inside Counsel Revolution: Resolving the Partner-Guardian Tension](#) (Ankerwycke, April 2016).

BUSINESS LAW TODAY

FinCEN's Lack of Policies and Procedures for Assessing Civil Money Penalties In Need of Reform

By Robert B. Serino

In remembrance of Bob Serino and his many contributions to both the field of banking law and the financial services community, the ABA Banking Law Committee would like to honor his accomplishments and rich life and career. After a long illness, Bob recently passed away while this article was pending publication.

There are few in our profession so universally liked and respected as Bob. His long career at the Office of the Comptroller of the Currency (OCC) made a lasting mark. He set up the OCC's first formal enforcement office, pioneered anti-money laundering enforcement, and served for many years as deputy chief counsel. When he left the agency, he established the OCC Alumni Association, which last year was renamed the Robert Serino OCC Alumni Association. Bob subsequently joined BuckleySandler LLP, where he was a partner. He also served as a captain in the U.S. Navy Reserves.

What engaged Bob most was connecting with other people. He mentored many young lawyers and gave generously of his time and advice to colleagues. He knew how to nurture a friendship and had a wide circle of friends and colleagues, all of whom will deeply miss him.

* * *

For many years, federal banking agencies have used publicly available processes, procedures, and matrices to determine both whether a Civil Money Penalty (CMP) is justified and, if so, the size of the penalty. Most recently, on February 26, 2016, the OCC published a revised [Policies and Procedures Manual](#) "to ensure the statutory and 1998 FFIEC Interagency Policy factors are considered in CMP decisions, and to enhance the consistency of CMP decisions."

In contrast, the Financial Crimes Enforcement Network (FinCEN) has no publicly disclosed CMP matrix or procedures to determine either a penalty is warranted or, if so, the appropriate amount. Thus, there is no publicly known process in place to ensure that FinCEN's vast power is applied consistently and equitably. There is an urgent need for FinCEN to bring its CMP assessment process into alignment with other regulators.

Banks, Bank Secrecy Act officers, and other institution-affiliated parties live under constant threat of a FinCEN CMP, yet have no inkling whether they are, in fact, at risk and the extent of the risk. The agency's reluctance to publish its CMP standards and procedures perpetuates banks' and other regulated entities' perceived lack of due pro-

cess. Moreover, the uncertainty created by FinCEN's opacity is causing havoc among compliance officers. FinCEN's failure to act contributes to the exodus of compliance officers who face a high degree of uncertainty because of the lack of guidance on whether they may be subject to a FinCEN CMP and the amount of the penalty. Lalita Clozel, *Exodus of Compliance Officers Seen if NY Plan Goes Through*, American Banker, Feb. 24, 2016 (discussing potential effects on compliance officers if New York implements regulation requiring compliance officers to certify compliance with bank secrecy laws with the threat of criminal action if a problem arises); Jerry Buckley, *The Compliance Officers Bill of Rights*, American Banker, Feb. 22, 2016 (discussing concerns of compliance officers and need to establish protections for them so that they can perform their duties in good faith and without fear of the unknown). To illustrate, in December 2014, FinCEN assessed a \$1 million civil money penalty against the chief compliance officer/senior vice president of government affairs at a major money transmitter. And in January 2016, a U.S. district court ruled that the corporate officers could be held personally liable for Bank Secrecy Act compliance failures.

History

In 1970, Congress enacted the Currency and Foreign Transaction Reporting Act (BSA), which was the first legislative effort to curb a growing money laundering problem in the United States. (Money laundering, per se, did not become a crime until 1986, with the passage of the Money Laundering Control Act.) The BSA imposed record keeping and reporting requirements for certain currency transactions to help identify the source, volume, and movement of currency and other monetary instruments and to maintain a record of the funds. The goal was to assist law enforcement and regulatory agencies in pursuing investigations of criminal, tax, and regulatory violations and to provide evidence useful in prosecuting money laundering and other financial crimes.

The hearings leading up to the passage of the BSA demonstrate the intent to create a “paper trail” for law enforcement to trace funds gotten from illegal activity such as gambling, tax, and narcotic sales. While the BSA was intended to provide law enforcement with the tools to put bad guys in jail, the government has used it to take civil and criminal actions against banks and other financial institutions for technical and procedural errors.

The BSA provided the Treasury Department with power to enforce the act and its regulations and to impose civil money penalties for violations. (The secretary of the Treasury has delegated authority to administer the BSA to the director of FinCEN, a bureau of the Department of the Treasury.) Because the penalties are so broad and subjective, administrative limits on that discretion are appropriate and necessary. Also, unlike the banking agencies, which cannot impose a unilateral CMP except following an administrative hearing, presided over by an independent administrative law judge (ALJ), FinCEN, can impose a CMP without a fact finding hearing before an ALJ. Once imposed, the bank or other target would need to seek a federal district court order to overturn the penalty. Because of the standard of review applied by the courts, a target institution or individual would have great difficulty in successfully challenging

a FinCEN CMP order. In the meantime, the CMP becomes public and the target, especially a public reporting company, is subject to great risk.

Enforcement Powers of FinCEN

FinCEN should exercise its broad authority to assess penalties based on a determination of willfulness or negligence in a manner that is fair, consistent, and in the public interest. The act sets forth basic standards for penalties:

- Willful violations. The secretary may assess a penalty of (i) the amount involved in the transaction, up to \$100,000, or (ii) \$25,000, whichever is greater. 31 U.S.C. §§ 5321(a) (1)(a)(2). This statute establishes a higher penalty ceiling for violations of BSA provisions governing certain foreign transactions. For BSA/AML program violations, a separate violation occurs for each day that the violation continues, and at each office, branch, or place of business at which a violation occurs.
- Negligent violations. The secretary may assess a penalty of up to \$500. However, if a financial institution engages in a “pattern of negligent violation,” an additional penalty of up to \$50,000 may be assessed.

While the act provides some guidance on the size of a penalty, FinCEN CMP orders lack the facts necessary for the public to assess whether FinCEN is applying these statutory standards fairly and consistently. In contrast, a recent review of Securities and Exchange Commission (SEC) ALJ proceedings concluded that, even though there are three tiers of penalties dependent upon the severity of a violation, the general practice of the SEC and the judges has been to apply the guidelines using a common-sense approach. See Jonathan Eisenberg, [How SEC Judges Calculate Civil Money Penalties](#), Law360, Jan. 22, 2016. Reaching such a conclusion about FinCEN’s imposition of CMPs is impossible given the lack of information available about FinCEN’s decisions.

If a target cannot come to terms with FinCEN by signing a consent order with

substantial penalties, it faces the risk of FinCEN unilaterally imposing an assessment that would likely be much greater than the amount FinCEN would be willing to settle for and could possibly drive the target bank into insolvency or a forced sale. Therefore, very few, if any, penalties are litigated. An [article in *American Banker*](#) discussed a case in which FinCEN declared an institution to be a “primary money laundering concern” and banned it from processing transactions through the United States. The article indicates that FinCEN acted without much explanation and without a hearing to address the charge. Within a day, the bank was out of business.

If a target does not agree to a consent order and FinCEN imposes a CMP, the target has two alternatives for judicial review of the penalty.

First, the target may appeal the public assessment to a federal district court as a final agency action under the Administrative Procedures Act (APA). On review, the district court evaluates whether FinCEN has abused its discretion, a difficult burden for a bank or individual to overcome. Courts generally do not second-guess the judgment of an administrative agency unless it can be shown that the agency acted contrary to law, without basis in fact, or abused its discretion. In the case of a court challenge to a FinCEN CMP, a comparison of the CMP to other large penalties obtained through settlement may make the charge of arbitrariness more difficult to sustain.

Second, a target may wait for the Treasury Department to bring a recovery action, which it must do within two years. Under these circumstances, a target likely can seek a *de novo* review of FinCEN’s action in which the court decides whether the assessment was validly issued (i.e., that there was proof of a legal violation). A court could also find a lack of willfulness and deny enforcement of the CMP or find the action to be arbitrary and capricious, a task again made more difficult by large CMPs in settlements.

Neither alternative protects a target from the adverse publicity of a public penalty unilaterally imposed by FinCEN under broad statutory standards and without proper safe-

guards or assurance that FinCEN is acting on all of the facts. This enforcement architecture pressures institutions and individuals to voluntarily agree to FinCEN's demands or face large public penalties. Forced settlements under duress generally do not serve the public interest or the constitutional principles at stake.

Enforcement Powers of the Bank Regulatory Agencies

In 1978, Congress amended the Financial Institutions Supervisory Act of 1966 (FISA) to provide regulators with the power to assess civil penalties for violations of certain laws. This power was based on early studies of the Administrative Conference of the United States in 1972 and the belief that the cease and desist and removal powers of the 1966 act were overkill in certain circumstances. FISA was the first statute that gave the federal banking agencies remedies, such as cease and desist and removal powers, to address problems with banks and bank officials. Before FISA, conservatorship and liquidation were the only tools available to address issues. The Financial Institution Regulatory and Interest Rate Control Act of 1978 gave the agencies the power, for the first time, to assess penalties for certain bank laws or regulations. This was amended by the Financial Institutions Reform, Recovery and Enforcement Act of 1989, which among other things, expanded the ability to bring CMP action for violation of any law or rule.

In granting the power to the agencies, Congress required a formal hearing under the APA before an independent ALJ with a final opinion to be issued by the agency and the right to appeal to a federal court of appeals. The hearing has standards and procedures that provide for due process protections. In deciding whether to bring a case and impose a penalty, Congress required the bank regulator to evaluate five statutory criteria. The five statutory criteria are: (i) the size of financial resources; (ii) the good faith of the institution or institution-affiliated party charged; (iii) the gravity of the violation; (iv) the history of previous violations; and (v) such other matters as justice may require.

Following the 1978 act, the federal banking agencies began using their CMP powers. In doing so, they believed that the five statutory criteria were not sufficient to ensure consistent use of CMP authority. In light of this, using the federal sentencing guidelines as a model, the banking agencies through the Federal Financial Examination Council (FFIEC) created 13 additional criteria. To apply the criteria, they created a matrix of factors they would consider in determining whether to bring an action and the size of any penalty. Each factor has a point value which is adjusted based on severity. The total points determine whether a penalty should be assessed and if so, a recommended amount.

On February 26, 2016, the OCC reiterated its intention to continue to apply a CMP matrix, with some adjustments, to its decision-making process for the sake of fairness and consistency. The OCC's changes include one matrix for institutions and, for the first time, a separate matrix for institution-affiliated parties (IAPs).

Overview of the CMP Process for the OCC

If the OCC determines, after an examination or investigation, that a violation occurred for which a penalty can be assessed, the OCC evaluates a penalty based on the five statutory and now 14 other agency factors and decides whether the matter warrants additional inquiry. (The OCC's Policies and Procedures Manual contains additional details regarding the procedures and matrices that should be followed.) A violation without this analysis does not form the basis for an action.

If the OCC decides to proceed, it notifies a potential subject (institution or individual) that the agency is preparing to issue a notice of a penalty and that the subject has 15 days to explain to the agency why a penalty is not justified or should be limited. The notice, commonly referred to as a "Fifteen Day Letter," is not public, nor will the matter become public until there is a settlement or a hearing before an ALJ. The Fifteen Day Letter practice is similar to a "Wells Submission" with the SEC and

is an opportunity for the subject to provide additional facts and explain why no action is justified. Upon request, the OCC often extends the time period to respond.

If the OCC, after review of the submission, believes an action is appropriate, the subject can either settle with the agency or request a hearing before an independent ALJ. If no settlement is reached, a hearing is held. After the hearing occurs and submissions from counsel for both sides are received, the ALJ renders an opinion and makes a recommendation to the Comptroller.

The parties involved can use the statutory and agency factors to show why the OCC should or should not take action and, if taken, what an appropriate CMP would be. The OCC notes, however, that the "policies are internal guidelines for the use of the OCC and do not create any substantive or procedural rights." After receiving submissions from both the subject and the enforcement division, the Comptroller makes a final decision. The subject can appeal the decision to the court of appeals where the subject is located, or to the United States Court of Appeals for the District of Columbia. Similar procedures are in place for the Federal Reserve Board and the Federal Deposit Insurance Corporation Board.

BSA Cease and Desist Process for OCC

On February 29, 2016, three days after the OCC issued its new civil money penalty matrices, the OCC issued a revised bulletin on how it would apply its cease and desist powers in the case of "potential noncompliance with Bank Secrecy Act (BSA) compliance program requirements or repeat or uncorrected BSA compliance problems." The statute requires that the OCC issue a cease and desist order when these are found.

The bulletin stated that "to ensure that the process for taking administrative enforcement actions based on such violations is measured, fair, fully informed, and timely, the OCC's process generally includes notice and an opportunity for the bank to respond in advance of a decision to issue a mandatory cease-and-desist order." Under this process, the OCC issues a Fifteen Day Letter to the subject if the OCC determines that a vio-

lation satisfies the criteria for a mandatory cease and desist order. The OCC's enforcement and supervisory personnel review the case and the subject's response and, if they believe a violation exists, present the matter to a Supervision Review Committee (SRC) for its review and recommendation to the senior deputy comptroller for a final decision. As a side note, the Consumer Financial Protection Board (CFPB) also has a similar process to obtain the views of a potential subject *in private* and *before* any enforcement action is undertaken.

FinCEN's Lack of Process

In contrast to the OCC and other agencies, FinCEN has no uniform process or administrative standards and has never published any guidelines or standards that it applies in deciding whether to assess a penalty and, if so, the amount of the penalty. Furthermore, there is nothing unique about the BSA that would require a different process. FinCEN's BSA actions usually address problems occurring years ago that have already been resolved by law enforcement officials or the banking regulators. These other agencies follow a process and analyze legitimate factors that are well-known in the industry when deciding how to address BSA issues.

As a regulator for financial institutions, FinCEN should comply with the same or similar standards when seeking to assess penalties. Giving largely unfettered power to FinCEN, without limitations or procedural protections, opens the door for arbitrary and unjustified decisions. FinCEN has been encouraged for years to address these concerns.

Following the publishing of [my article](#) on the lack of process and criteria for FinCEN to follow, an attorney in private practice suggested that buried, deep in the [Internal Revenue Manual](#) for use of its examination personnel, were factors that the IRS examiners should take into consideration before they refer a matter to FinCEN to consider whether to commence a penalty action.

While this list exists, FinCEN has not indicated that a subject can use them to refute a civil money penalty action. Likewise, to my knowledge there are no such factors, followed by FinCEN, when it decides to unilaterally assess a civil money penalty. Furthermore and most importantly, FinCEN has not suggested that a subject address the IRS internal referral guidelines in response to a FinCEN charge. To the contrary, even though many of the IRS factors are similar to the bank regulatory agencies, FinCEN has specifically indicated that they would not use the factors of the banking agencies.

It is suggested that, until FinCEN develops public factors for a subject to address before FinCEN commences a civil money penalty, a subject should develop a response to FinCEN, if given a chance, using the IRS internal examiner guidance.

A Call for Reform

The concerns raised above with FinCEN's CMP process warrant reform to create a more fair and consistent process for affected institutions and individuals. Given that FinCEN has yet to address these concerns, a legislative solution may be necessary. A simple legislative fix would do the following:

1. Require FinCEN to prove its case before an independent ALJ in an APA hearing and remove its authority to impose unilateral assessments;
2. Subject FinCEN to statutory standards for CMPs similar to those that apply to the banking agencies, including good faith, financial capacity, etc.;
3. Require FinCEN to establish criteria, similar to the factors used by the banking agencies, to provide FinCEN and subjects guidance on the factors justifying a penalty and the amount;
4. Require FinCEN to provide notice, *in private*, of a possible CMP, the basis

- for the CMP, and an opportunity to respond within fifteen days or longer;
5. Define "willful" to require intentional misconduct or recklessness, assuming that a "willful" violation continues to trigger a possible CMP.
6. Until FinCEN develops factors on whether and how much of a penalty should be assessed, a subject should use the IRS examination manual factors in responding to a proposed civil money penalty

Alternatively, FinCEN could follow the OCC's lead and issue its own guidance explaining its CMP assessment process and criteria. In doing so, FinCEN should consider the OCC's recent adoption of separate CMP matrices for institutions versus IAPs. FinCEN may similarly consider separate CMP processes or matrices for institutions versus individual employees of those institutions, which may prove useful in providing individual industry actors with appropriate notice of their potential liability under the BSA. FinCEN should also follow the process for handling cease and desist actions for BSA violations set forth in the OCC's February 29, 2016, bulletin. These reforms would go a long way toward addressing some of the common concerns the industry has with FinCEN's implementation of its CMP powers.

Robert Serino founded the Office of the Comptroller of the Currency's Enforcement Division in 1971 and after 12 years became deputy chief counsel until retirement from government in December 2000. He was involved in the development of all enforcement policies and actions during that period. Before passing away, he was of counsel at BuckleySandler LLP. The views expressed herein are those of the author and should not be attributed to anyone else or the law firm.

BUSINESS LAW TODAY

Practical Tips for Regulatory Compliance with a Company Jet

By [Michelle Wade](#)

Overview

If your client owns or operates or plans to purchase a business aircraft, it is important to understand that aviation is a highly regulated industry where the requirements of various government agencies are often at odds with each other and with certain of the client's goals. This article outlines basic ownership and operating options available to aircraft owners, and common pitfalls to avoid when selecting and implementing these options, to help your client achieve regulatory compliance.

Step-by-Step Action Plan

The first step in achieving regulatory compliance for your client is to become aware of the range of potential regulatory issues. At the federal level, the FAA, DOT, IRS, FEC, and SEC all have regulations affecting aircraft. There are also state property tax and sales/use tax issues that can significantly affect owning and operating an aircraft. If the aircraft flies internationally, there are foreign regulations and tax issues to be considered. In addition, insurance must be considered. Although an insurance policy is not a regulation, it is important from a risk-management perspective to ensure that the aircraft operations comply

with the insurance application and insurance policy.

Identifying your team is the next step in achieving regulatory compliance for your client. When creating your team, consider including the flight department/pilot, regular legal counsel (in house or outside counsel), experienced outside aviation counsel, a tax advisor, a risk department/insurance agent, and the principal or his or her direct representative. The flight department knows the aircraft's operations, but does not necessarily know the federal tax issues that can affect how the aircraft is owned or operated. The tax advisor will understand the pertinent tax issues, but generally is not aware of conflict areas between the tax and aviation regulations. If the flight department or the tax advisor alone plans the ownership and operation of the aircraft, regulatory requirements are easily and inadvertently violated. Given that facts change, a review of the aircraft operations every few years is necessary to maintain regulatory compliance. A good team will enhance your ability to achieve and maintain regulatory compliance.

Your team's next steps are to gather facts and to prioritize the ownership and operational goals. Important facts include the passengers who fly on the aircraft, for what

purpose each passenger flies, and for which business entity each passenger flies. Priorities of ownership and operational goals include compliance with U.S. federal aviation regulations (commonly referred to as the Federal Aviation Regulations or FARs), the maximization of tax deductions, and the minimization of risk.

Decisions—Ownership and Registration

The FARs will affect which entity or individual will own and register the aircraft. To validly register an aircraft under its own name, an entity or individual must meet the FAA's definition of "citizen of the United States" provided at 49 U.S.C. § 40102. Although the definition is short, determining who is and who is not a citizen of the United States is not always as easy as it appears. For example, the FAA considers a partnership to be eligible to register an aircraft in the partnership's name only if each partner is an individual who is a citizen of the United States; therefore, a partnership that has a corporate general partner is ineligible to register an aircraft in its name.

For a corporation or a limited liability company to qualify as a citizen of the United States, the president, at least two-thirds of the board of directors, and at least two-thirds of

the other managing officers must be citizens of the United States. If a non-U.S. citizen becomes president of a corporation or LLC, that entity will no longer be in regulatory compliance, and the aircraft's registration will be immediately invalidated. The entity must also be under the actual control of U.S. citizens, and at least 75 percent of the voting interest must be owned or controlled by U.S. citizens. It is not uncommon for a non-U.S. citizen investor to acquire more than 25 percent of the voting interest without anyone considering the invalidating effect of this action on the aircraft's registration.

Fortunately, regulatory compliance with registration of the aircraft is achievable if the client does not meet the FAA's definition of "citizen of the United States". Options for registering the aircraft with the FAA include owner trusts, voting trusts, and registration as an aircraft "based and primarily used" (BAPU) in the United States. An owner trust requires the aircraft to be placed into a trust and registered in the name of the trustee. The client will have physical control of the aircraft and will not be required to obtain approval from the trustee for each flight. A voting trust requires that the shares of the entity be held in a trust and, under the more restrictive BAPU registration, that the FAA receive reports every six months that at least 60 percent of the total flight hours were within the United States. The BAPU option is not available to LLCs, and there is no regulatory cure period if at the end of the six months the 60-percent requirement is not satisfied. If the requirements are not met, the aircraft's registration is invalidated.

Decisions—Operations

Now that your team has considered some of the regulatory issues surrounding aircraft ownership and registration, your team must review the regulatory issues surrounding the aircraft's use. Will the owner be the sole operator of the aircraft? Will the owner lease the aircraft? Will the owner and various lessees operate the aircraft? Another decision involves where the flight crew will be employed. Although these decisions are frequently treated as afterthoughts, they

are essential to achieve compliant aircraft operations.

A common operational problem is a sole-purpose entity (SPE) that owns the aircraft, employs the flight crew and provide flights to other entities and individuals. If the SPE meets the FAA's definition of "citizen of the United States" the SPE can own the aircraft, however the FAA does not permit an SPE to provide flights to other entities or individuals. Many SPEs are organized to try to limit liability related to the operation of the aircraft. SPEs that operate aircraft violate the FARs, likely violate the insurance policy, and can inadvertently create additional risk.

If you identify an SPE operating an aircraft, action should be taken to remedy the violation and change the operation of the aircraft to meet the regulatory requirements. There are several options available, depending on the goals and priorities of the parties and the relationship of the various users. For example, the SPE may lease the aircraft to the individual or entity that is actually using the aircraft on business or personal trips, provided that the flight crew is obtained from an independent source. Alternatively, the SPE can lease the aircraft to a charter company that can then charter the aircraft to the various users.

Whether to operate the aircraft under the FAR Part 91 regulations or the FAR Part 135 regulations is an important decision to make during the regulatory compliance review. Unless the client has spent a significant amount of time, effort, and expense obtaining a Part 135 charter certificate, they are probably operating under FAR Part 91. Generally, when operating under FAR Part 91 (also called noncommercial operations), the aircraft should not be operated "for compensation or hire." The FAA's definition of "compensation" is very broad. Compensation includes cash, nonmonetary considerations, and capital contributions to the operator by those receiving the benefit of the use of the aircraft.

Besides regulatory compliance, there are risk and tax issues to consider when determining whether the aircraft will be operated under FAR Part 91 or FAR Part 135. FAR Part 91 may impart more operational

risk, but will allow a shorter depreciation period and not incur federal excise tax on the lease payments. Other tax issues to be addressed include passive activity tax issues when leasing the aircraft, state sales/use tax that may be imposed by multiple states, state property taxes, and the loss of tax deductions for entertainment use.

Additional Considerations

We have been reviewing regulatory considerations of a company aircraft. If an employee of your client wants to fly the employee's aircraft on business trips for the company, there are additional regulatory and risk-management considerations. Violation of the FAA reimbursement regulations carries risk exposure for the company as well as the employee. Your team should confirm under what section of the FARs the flights are to be operated. In addition, your team should review the insurance policies carried by the employee on the aircraft to confirm that the company's interests are sufficiently protected, and should review the company's employee health insurance, workers compensation, disability insurance, and travel accident insurance to verify that the policies cover claims from employees that might arise from these flights. The employee will be traveling on company business, and a gap in insurance coverages could become significant if an accident were to occur. The adoption of a company policy regarding an employee's business use of the employee's aircraft may be advisable.

As elections approach, be aware of applicable regulations if your client will provide flights to candidates for elected office. Failure to follow the regulations could land your client on the front page of a newspaper or a website in an unflattering article. Federal agencies that govern the use of a private aircraft by a federal candidate and his or her staff include the FEC, the FAA, and the IRS.

Now that you are aware of some of the regulatory requirements and potential pitfalls, your client may ask why they should care if they violate the FARs. The answer is that the FAA may impose substantial civil penalties on a per-flight basis that may be

multiplied by several violations on a single flight. Depending on the violation, the FAA may also refer a case to the U.S. Attorney General. In addition, noncompliant operations may invalidate insurance, and the insurer could deny coverage on a multimillion-dollar claim. Finally, operations that violate the FARs may also subject the client to additional taxes, penalties, and interest if they are audited by the IRS.

Your client may also ask how the FAA discovers regulatory violations. Two common methods include an anonymous tip to the FAA or an aviation accident. Anonymous tips are not uncommon. Aviation accidents are vigorously investigated by the Na-

tional Transportation Safety Board (NTSB), and the truth will come out. The insurance company will also investigate accidents and may deny coverage because the aircraft's operation at the time of the accident violated the insurance policy's coverages.

Summary

Corporate aviation is a highly regulated industry. Assembling a knowledgeable team and performing periodic regulatory reviews are ideal steps toward helping your client achieve compliance. Facts surrounding the ownership and operation of the aircraft can change without consideration of the regulatory violations or without consultation with

knowledgeable aviation advisors. There are viable options for complying with statutory and regulatory requirements when owning and operating a company aircraft and significant economic risks with regulatory noncompliance.

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BUSINESS LAW TODAY

The CFPB: Standing Up for Consumers in the Financial Marketplace

By [Mary Griffin](#) and [Mauricio Videla](#)

This year marks five years since the Consumer Financial Protection Bureau (CFPB) opened its doors in July 2011. The CFPB, an independent federal agency, was created in 2010 by the Dodd-Frank Wall Street Reform and Consumer Protection Act as a direct result of the 2008 financial crisis. The CFPB was designed to stand up for consumers and ensure that they are treated fairly in the financial marketplace. Our work is helping to create a financial marketplace that works for consumers. We are listening to consumers' experiences through the complaints they submit, creating new consumer protections for financial products and services, holding companies accountable, and developing useful tools and resources to empower and educate consumers to make more informed financial decisions to meet their own life goals.

Protecting Consumers

The CFPB conducts its work across several areas, serving as a regulator, supervisor, enforcer, researcher, and educator.

Consumer complaints and stories play an important role in the CFPB's work to identify problems, spot risks, and ensure a fair financial marketplace. Consumers can submit their complaints for free online at

consumerfinance.gov or by phone at 855-411-CFPB (2372). As of February 1, 2016, the CFPB has received more than 811,000 complaints about consumer financial products and services, including mortgages, credit reports, debt collection, and private student loans.

The CFPB writes rules that cover consumer financial products and services under the federal consumer financial laws. Since opening its doors in July 2011, the CFPB has put in place new, common-sense mortgage rules to protect consumers against the problems that led to and prolonged the housing crisis. In addition to new protections for international money transfers and for credit cards, the CFPB has also crafted new rules to supervise larger nonbank debt collectors, credit reporting agencies, student loan servicers, international money transfer providers, and auto finance companies for the first time at the federal level. The CFPB is now working to focus on rules that root out deception, debt traps, and dead ends across markets, and to develop more opportunities for consumers to obtain and sustain improved financial capability.

We also supervise certain bank and non-bank consumer financial institutions for compliance with consumer financial pro-

tection laws and rules and enforce the law when there are violations. The CFPB has pursued enforcement actions against financial institutions that violate the law and has secured more than \$11 billion in refunds or relief to more than 25 million eligible consumers.

The goal is a financial marketplace where costs and risks are clear, and where no consumer is harmed by unfair, deceptive, or abusive acts or practices.

Educating and Empowering Consumers

The Dodd-Frank Act charged the CFPB with working to improve the financial literacy of consumers across the country to help them make sound financial decisions. We work to develop and provide consumers with tools and support for skill building to help them make decisions about financial choices and products, to plan for goals they set for themselves, and to act on those plans.

The CFPB provides interactive tools to help consumers make important life decisions. The [Paying for College](#) tool enables students and their families to compare financial aid packages from different schools. This interactive comparison tool allows students and their families to learn

how much the monthly student loan payment will be if a particular school is chosen, essentially personalizing the selection process to incorporate each school's financial aid offer. The [Repay Student Debt](#) aspect of the tool allows consumers struggling with student loan payments to know what repayment options are available to them.

Additional life-stage tools include [Owning a Home](#), which assists consumers with buying and financing their home, including learning what to expect, what questions to ask, and where to find tools and resources for decision making. The [Planning for Retirement](#) tool helps consumers think through when to claim their Social Security benefits, which is the only guaranteed monthly income for 69 percent of consumers over 65 years of age.

On [Ask CFPB](#), consumers can access unbiased answers to commonly asked questions about financial products ranging from credit cards to mortgages to student loans.

Reaching More Consumers

We understand that we cannot achieve our mission alone and that, by working with organizations, frontline staff, and volunteers, we can reach and serve more consumers across America. We have established, and will continue to establish, strategic collaborations to bring financial education and empowerment tools and resources to communities of all sizes.

We work with intermediary agencies and organizations to reach a given consumer at the right moment in his or her financial life—the moment he or she is most receptive to seeking out and acting on assistance. Through our Libraries Project, the CFPB works to help libraries across America serve as a go-to source for financial education by training librarians and providing online resources, worksheets, guides, and other information to help consumers with financial decisions. By helping librarians build the expertise to help consumers research their financial questions, we are empowering communities across the country to provide their residents with access to basic financial education and skills that can make a difference in their financial lives. To date, there

are more than 470 library systems with 2,500 library branches that have participated in this initiative. For more information about this and other financial education resources, visit our [Financial Education Exchange](#).

The CFPB has forged relationships with social service providers, financial educators, and community-based organizations—including legal aid organizations—to better reach the more than 100 million low- to moderate-income consumers and to provide them with information when they need it most. We do this by working with public- and private-sector organizations to integrate financial skill-building programs into their existing programs. We also identify policy changes that increase this population's access to appropriate, high-quality products and services.

We are helping these entities address consumers' financial challenges through integrating specific and actionable financial empowerment concepts and tools into their programs. The CFPB developed [Your Money, Your Goals](#), a user-friendly, plain-language toolkit and training initiative in English and Spanish, which is designed to assist intermediaries to engage in money conversations with their clients and help their clients identify and get help with financial issues, such as accessing credit reports and managing cash-flow budgets. Since the initiative's launch in July 2014, the toolkit and training have equipped more than 6,500 front-line staff and volunteers to better engage with consumers.

The CFPB also focuses on the unique needs of special populations, such as servicemembers, older Americans, students, and low-income and economically vulnerable consumers.

Our [Office for Older Americans](#) works to prevent elder financial exploitation and fraud, which cost older Americans an estimated \$2.9 billion in 2010 alone. The CFPB regularly issues advisories to alert consumers about scams and fraud and provides resources and guides to help aging Americans. To help prevent financial exploitation, [Money Smart for Older Adults](#) provides resources and instructor-led training to raise awareness among older adults, their caregiv-

ers, and others on how to identify and avoid scams and other elder financial abuse. This product was prepared with the FDIC and is part of its Money Smart program. For the millions of Americans serving as financial caregivers and managing money or property for a loved one who is unable to pay bills or make financial decisions, we have a series of easy-to-understand [Managing Someone Else's Money](#) guides. These guides contain information on the fiduciary's responsibilities and tips on how to spot financial exploitation and avoid fraud.

Through our [Office of Servicemember Affairs](#), we are helping servicemembers, veterans, and their families handle financial challenges through financial education, monitoring of complaints submitted by consumers to the CFPB, and coordinating with other federal and state agencies on military consumer protection measures. One of its initiatives is an ongoing series of virtual [Military Financial Educator Forums](#) on consumer financial topics for service providers who deliver financial, educational, or legal counseling to servicemembers and their families on military installations worldwide. More information can be found on [consumerfinance.gov](#) or on the social media channels [Facebook](#) and [Twitter](#).

Building on the Momentum

Since the 2008 financial crisis, the CFPB has worked to reach consumers, to answer their financial questions, and to help them prepare for decisions that will affect their financial future. In an increasingly complex financial market, however, consumers often feel overwhelmed by financial decisions and do not know where to turn for help.

The CFPB welcomes the opportunity to collaborate with the legal community, including through pro bono programs and channels, to help financial empowerment and education resources reach consumers, and to help community service organizations integrate financial-capability building into their service offerings. We have several resources available that can support the work attorneys are doing to help consumers to take control of their financial lives, including:

- participating in [Your Money, Your Goals](#) training or connecting this resource to your local legal services, community organizations, or faith-based groups;
- contacting a local library to sign up to participate in our [libraries initiative](#);
- telling financial educators and others in your communities, including virtual communities, about resources and webinars available at the [Financial Education Exchange](#);
- becoming a trainer for [Money Smart for Older Adults](#) to help prevent seniors from getting scammed; and
- making [Managing Someone Else's Money](#) guides available to your employees and in your lobbies.

Many CFPB trainings take place via webinar, and the tools and resources are

available [online](#) or can be ordered in print through the [GPO website](#). To learn more about the CFPB and our financial education and empowerment resources, e-mail us at empowerment@cfpb.gov.

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BUSINESS LAW TODAY

You Are What You Share: The Dos and Don'ts of Social Media Compliance for Financial Advisers

By [David T. Ackerman](#)

The Bane and the Benefit of Social Media

For a Securities and Exchange Commission (SEC) registered investment advisory firm (RIA), managing social media is an arduous and, often times, formidable task. Instantaneous, mass communication offered by LinkedIn, Twitter, and Facebook understandably creates many areas of concern for both advisers and regulators alike. Misrepresentations and fraud can be disseminated to thousands of people with the click of a button. An internal miscommunication could lead to the accidental dissemination of proprietary or material nonpublic information—potentially leading to loss of revenue or, in extreme cases, an SEC claim of insider trading. The sheer power and influence yielded by social media around the world make it obvious why this is an area of contention with almost every regulatory body. Despite all these dangers, the beneficial use of social media as a tool for investors and RIAs cannot be ignored.

Social media has increasingly facilitated investors' abilities to research and conduct their own due diligence on current or prospective RIAs. According to a study published in the World Health Report, more than 40 percent of high-net-worth individuals

under 40 cite social media as important for accessing information on financial products or services. For RIAs, social media interaction helps build strong client relationships, find new prospects, improve client relations, and increase assets under management. This article seeks to assist RIAs in developing or refining social media compliance policies and procedures reasonably designed to ensure compliance with the Investment Advisers Act of 1940. There are numerous factors to consider when developing a social media policy, and the suggestions contained in the article are by no means exhaustive or fully comprehensive.

Caught in the Advisers Act

Social media should be treated as advertising under the Advisers Act. The SEC prohibits the use of client endorsements or testimonials in any advertisement under SEC Rule 206(4)-1. As such, much of the compliance risk associated with social media use by RIAs focuses around the use of potentially "false and misleading statements" and the use of testimonials.

A testimonial is a statement relating to a client's experience with or endorsement of an RIA. In some instances this is easier to recognize, such as with LinkedIn. An

investment adviser representative (IAR) is potentially at risk if a client, or in some cases someone completely unaffiliated with the IAR, posts a favorable recommendation on the RIA's LinkedIn profile. If a recommendation is isolated to that one individual or is unconfirmed by the site prior to posting and gives a rose-colored view of the IARs overall business, chances increase that the posting will be considered a testimonial by the SEC. The feature allowing third party posting can be turned off, and many firms require their employees to do so.

Similarly, and in a more abstract context, the SEC indicated in its 2012 Risk Alert that a "like" on Facebook could be considered a testimonial in certain circumstances. Unlike the recommendations feature of LinkedIn, the "like" feature of Facebook cannot be turned off. Depending on the facts, an abundant number of likes could be misconstrued as an implied endorsement. Firms must pay close attention to the type of information that is being disseminated on Facebook and the number of likes received. A "like" solicited by an advisor as an indication of a client's experience may be construed as a testimonial, but a "like" on a photo of an adviser's fishing trip will likely not. So much depends on context that it is essential

to monitor activity vigilantly and, when necessary, add disclosures within a posting to mitigate testimonial risk.

One consistent theme in multiple SEC guidance publications is if an RIA or IAR solicits comments from clients, the posted commentary will be scrupulously examined for compliance with advertising rules.

Competence Compliance

Basic requirements to address the aforementioned concerns should be implemented from the onset of an RIA's use of social media platforms. All RIAs are required to create and implement a written social media policy reasonably designed to prevent the intentional or accidental violation of applicable rules. The social media policy should be clear and concise, distinguish between an individual's personal use and business-related activities, and provide examples of appropriate and prohibited material.

Some policies can be implemented universally. The pre-approval of any static content can be administered uniformly across platforms. Changes in material such as a profile, work experience, or firm background can be submitted for approval prior to posting.

Ongoing monitoring procedures should ideally be platform specific to ensure clarity and increase the chances of observance. For example, to address the concern regarding LinkedIn endorsements, a simple remedy would be to prohibit the practice altogether. Since LinkedIn allows the user to block testimonials, endorsements, and recommendations, this is an effective way to avoid any accidental infractions caused by clients seeking to show their gratitude.

Finally, and perhaps most importantly, the social media policy should be treated as a living document and reviewed on an ongoing basis with an emphasis on preventing

false or misleading communications. The consequences of noncompliance should be clearly spelled out, and compliance enforcement should be assigned to a specific individual or department. Regulators often frown upon boilerplate policies and procedures. Thus, the more tailored to a firm's activities the social media policies are, the greater the reduction of risk.

If Men Were Angels We Wouldn't Need Training or Records

Once procedures are in place, ongoing training for compliance personnel, supervised persons, and access persons is essential. If feasible, create video training programs that will explain the policies and procedures as well as educate personnel on the risks posed by social media use. Develop a content library that includes redacted examples of approved and rejected content with explanations as to why the determination was made. Once trained, require employees and advisers to periodically sign an attestation confirming they have read and understand the policy, have not violated the policy, and are not aware of violations by others.

Moreover, in a 2013 survey, record retention was identified as the number one problem noted in audits and examinations by state securities regulators. The SEC has maintained that advisers must retain social media communiqués, including original content, third-party content, and responses. SEC registered IARs are subject to a five-year retention requirement for advertisements, calculated from the last day of the fiscal year during which the required record was last published or disseminated. The use of third party firms to maintain digital copies of social media pages are growing increasingly popular. However, low cost and no cost options are available. For firms that cannot

afford the additional costs of monitoring, a periodic screenshot of relevant data or use of Facebook's "Archive Feature" are compliant ways to maintain accurate records.

Conclusion

The importance of social media use in the future of the finance industry is considerable. Over 80 percent of financial advisers use it for business. Investment advisers readily connect with clients and prospects. Investors are able to conduct due diligence over and above the information available on the IAPD system, public filings, and other industry databases. The establishment of a social media policy is a threshold action, even for firms that do not utilize social media. For all SEC registered RIAs and IARs using social media, social media policies should be considered mandatory. Training on these policies to ensure compliance is critical as enforcement of advertising rules pertaining to social media use increases. Supervision of social media activities by a firm's compliance team is critical, as is diligent record keeping, to achieve and demonstrate compliance if a firm's or individual adviser's practice is challenged. Carefully managed, social media will be an increasingly effective tool to promote connectivity and transparency in the financial services industry for years to come.

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BUSINESS LAW TODAY

Early-Stage IP Protection: A Primer and Overview for Working with the Startup

By [Jonathan Rubens](#)

When representing a startup, a lawyer must identify key intellectual property (IP) issues and advise the client on an appropriate initial IP budget right from the start. Some startups will have a business plan that depends on patenting its technology, whereas others may seek to closely guard innovations as trade secrets or rely on strong trademark protection as they launch consumer-facing enterprises with a focus on branding and sales. Online businesses, social media, digital entertainment, and software enterprises may face surprisingly complex copyright issues as they grow. The lawyer must therefore tailor the IP strategy to the startup's business plan.

The first steps in tailoring a startup's IP strategy are to: (1) identify the most important existing IP assets; (2) identify potential (future) IP rights; and (3) implement an IP prosecution plan and budget. The startup likely will not be able to afford all the IP protection that it could pursue, so prioritization is crucial, as is consideration of whether any of the identified IP rights are already protected. Ask the client to identify the startup's core IP and to articulate a plan to protect, grow, and potentially leverage its

IP. For example, will the startup license its IP to third parties to manufacture products?

In addition, it is important to remember that *the client may be unaware of the IP rights it already owns* because some IP rights—notably, copyright—can come into existence automatically. Other kinds of IP rights require proactive steps to secure and protect them. For example, trademarks require use for protection, at least in the United States, and rights under patent law do not attach unless and until a patent issues after application and examination.

The four major categories of IP rights, what is protected by each of those rights, and how the protection arises are summarized as follows:

Although trade dress and design protection are additional categories of IP rights, this article considers only each of the four major categories of IP rights in turn, with particular focus on issues the lawyer will encounter when working with a startup.

Copyright: Securing Ownership of Software and Other Original Creative Works

Many startups rely on proprietary software and other creative works to launch their new businesses. Copyright extends to software as well as to other creative works, including literary and dramatic works, sound (music) recordings, visual arts, and technical drawings. Copyright protects such

TYPE OF IP	TO WHAT IT APPLIES	HOW IT ARISES
Copyright	Original creative works	Upon creation of original work
Trademarks	Identification of source of products or services	Use and registration
Trade Secrets	Valuable information not known to the public	With reasonable efforts to keep secret
Patents	New Inventions	Issued following application and examination

“original works of authorship . . . fixed in a tangible medium” (17 U.S.C. Section 102(a)) immediately upon their creation, but to reiterate one of the essential principals underlying copyright law, it protects the original creative *expression*, not the *ideas* being expressed. A copyright owner enjoys the exclusive right to

- reproduce (make copies of) the original work;
- make derivative works based on the original work;
- distribute the original work (in the case of music, this means sell or license copies of phonorecords);
- perform the copyrighted work publicly;
- prevent importation of works that infringe the copyrighted work; and
- assign or license any of these rights.

Outsiders often help a startup with software development, web design, or video or photography for a website or for marketing or brand-identity materials. When the startup works with third parties, however, it is not always clear that it will own all the rights it needs. The startup could be precluded from licensing its software, launching its online store, or distributing an original app.

The default rule under U.S. copyright law provides that the author or creator of a work of authorship is the owner of the copyrights in it. The exception is if the work is a “work for hire,” which is owned by the company that engaged the worker to produce the work. However, “work for hire” has a particular meaning under the Copyright Act. An original work will be a work for hire if: (1) it was created by an employee within the scope of his or her employment; or (2) if the work was specially commissioned in a written agreement *and* is one of the following nine categories of works: (i) contribution to a collective work; (ii) part of a motion picture or audio-visual work; (iii) translation; (iv) supplementary work; (v) compilation; (vi) instructional text; (vii) test; (viii) answer to a test; or (ix) atlas.

It may not be clear whether an original work is a work for hire and therefore owned

by the startup. Is a sufficient agreement in place? Does the work fall squarely into one of the enumerated categories? If not, did an employee create the work within the course and scope of his or her employment? In addition, often it will be far from clear whether an individual will be determined to be an employee, particularly in the context of the initial startup team, where founders may be doing many things at once without clearly acting as traditional employees. In *JustMed v. Bryce*, 600 F.3d 1118 (9th Cir. 2010), the court held that a tech startup, not one of the feuding cofounders, owned the copyright in its source code because the cofounder-developer was actually an employee, not a contractor. Therefore, the code was a work for hire. This was despite the fact the cofounder-developer claimed he was not regularly working in the company, there was no work-for-hire agreement, and he worked remotely from a different state, on his own time, with no employee benefits. The court noted that he was on salary for an extended period of time and that the startup team *intended* to treat him as an employee eventually, even if they did not yet implement all the formal structures of employment.

There can be unintended consequences to implementing a work-for-hire agreement. For example, California Labor Code § 3351.5(c) extends the definition of “employee” to persons who have signed work-for-hire agreements, and similar treatment results under California Unemployment Ins. Code § 621(d). A consequence of this is that a startup must pay unemployment and other payroll-related taxes in connection with fees (deemed wages) paid to such persons. To avoid these problems, startups should insist that workers assign to it the copyrights in the original works they create. Many employers will uniformly include assignment provisions in employee agreements, and many will include invention assignment provisions alongside work-for-hire clauses in a belt-and-suspenders approach to contracts with independent designers or developers to ensure that, in any event, the copyrights have been assigned to the company.

However, assignment provisions must be drafted with attention to other limitations.

For example, California Labor Code § 2870 imposes nonwaivable restrictions on all-inclusive employee invention assignment provisions. Even when exclusive rights under copyright are assigned to a company, those rights can be terminated (albeit after a fairly lengthy period of time). These “termination rights” under the Copyright Act survive the original creator of the work and can cause the copyrights to revert to heirs.

Trademark: Protecting the Startup's Brand Identity

Many startups have devoted resources to the creation of brand marketing materials by the time they first meet with a lawyer. The lawyer must consider whether the startup can secure and expand its rights in those materials efficiently, and sometimes the startup may be unaware of substantial impediments to securing all rights in and to those materials as it grows.

Advising the startup on trademark basics is useful. A trademark or service mark identifies the source of a product or service and distinguishes it from the source of competing products or services. Trademarks are typically made up of a particular word, phrase, symbol, slogan, or design or a combination of one or more of those elements, but a trademark can also be made of other kinds of nonlinguistic elements, including colors or even scents or sounds. In the United States, registration depends on use, and registration provides presumptive evidence of exclusive ownership and right to use a mark. Still, prior users of a mark can establish continuing rights to use a mark in the territory in which it was used prior to the other party's registration.

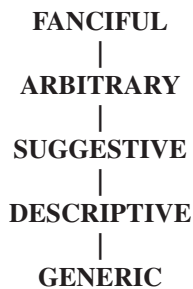
Trademark rights exist at common law but are afforded greater protection through registration at the state level or, for the greatest degree of protection, at the federal level with the U.S. Patent and Trademark Office. Federal registration provides access to the federal courts for infringement disputes, with the possibility of recovering attorney fees, statutory penalties, and increased damages.

It may be necessary to advise the startup on the unlikelihood of the ability to register a mark that has already been selected.

Under U.S. trademark rules, registration is not allowed for marks that are (among other things):

- likely to cause confusion, mistake, or deception in relation to an existing registered mark
- “merely descriptive” of the goods
- “deceptively misdescriptive” of the goods
- “primarily geographically descriptive” of the goods (with some exceptions)
- “geographically deceptively misdescriptive” of the goods
- “primarily merely a surname”
- “comprises any matter that, as a whole, is functional”
- “immoral, deceptive, or scandalous matter”
- “disparage or falsely suggest a connection with persons living or dead, institutions, beliefs, or national symbols, or bring them into contempt or disrepute.”

A word or a logo can be considered a trademark or a service mark only if it is distinctive. A distinctive mark is one that is capable of distinguishing the goods or services upon which it is used from the goods or services of others. A nondistinctive device is one that merely describes or names a characteristic or quality of the goods or services. The distinctiveness of a mark can generally be categorized into one of five categories that fall along the following spectrum of distinctiveness:



The “strength” of a mark is determined in part by where it falls on this spectrum. Marks that are fanciful, arbitrary, or suggestive can function as trademarks. Generic marks cannot. Fanciful marks are considered stronger than suggestive marks and are therefore granted greater protection

by the courts. Marks that are descriptive can be registered as trademarks or service marks only if they have obtained “acquired distinctiveness” or “secondary meaning,” the application for which requires a substantially higher degree of evidence than for a fanciful or suggestive mark. Many new businesses will not appreciate that descriptive marks, which may be immediately indicative of the services or goods offered, are much harder to register than those that are fanciful or unique. The more the proposed mark leans toward the fanciful or arbitrary end of the spectrum, such as marks that consist of unique, made-up terms or phrases rather than ordinary words that clearly explain the product or service sold, the more likely the mark is registrable.

The startup should carefully consider the budget for its trademark protection and corporate identity strategies. It may need to abandon marks that are clearly likely to be found descriptive because the cost to obtain registration will escalate. The attorney should caution the startup that initial trademark budgets do not contemplate oppositions or cancellation petitions, which can dramatically increase trademark prosecution fees. Consider the following scenarios, which could raise trademark concerns right from the beginning:

- A new line of products/services: Is the name available? Is it too similar to a competitor’s product name?
- Expansion of the startup into new markets: Does the foreign equivalent of the startup’s mark cause problems in that country? Is the mark unavailable for use in that foreign jurisdiction?
- Working with distributors or licensees: How should the startup allow strategic partners to use its marks? What controls are needed to govern third-party use?
- Cyber squatting: Is someone else using the startup’s trademark in a domain? Do they have legitimate reasons for use or can the startup stop their domain use? This might be done either through domain dispute arbitration or an action under the Anti-Cybersquatting Protection Act, a federal statute designed to provide a rem-

edy against domain registration without legitimate business purposes.

Trade Secret: Advising on the Appropriate Protection and Implementing Protection Strategies

Trade-secret protection can be a crucial mode of protection for some of a startup’s important assets where not otherwise protected by copyright or patent law. For many startups, trade-secret protection can be a significant alternative for patent protection for nontechnical information that is not otherwise patentable, or for information that maintains value so long as the competition cannot access it. If certain material is recognized as a trade secret, the startup will have a legal remedy in the event it is misappropriated and used without the startup’s consent.

In order to take advantage of the available remedies, a startup must ensure its assets are recognized as trade secrets. Most states have adopted the Uniform Trade Secrets Act, under which a trade secret is *any information that is secret; has commercial value derived from the fact that it is secret; and is the subject of reasonable efforts to be kept secret*. In other words, a startup can only keep the information protected, or obtain relief for misappropriation, if the information maintained value because it was kept secret, and if reasonable steps were taken to keep it secret.

Trade-secret information commonly includes customer lists, marketing information, technical information such as formulas, recipes, and algorithms, and unreleased software, but the startup’s contracts may be insufficient to protect all these items as trade secrets. License, distribution, and reseller agreements should include confidentiality, nonuse, and nondisclosure provisions to preserve trade-secret status. Employee agreements should include confidentiality and nondisclosure provisions to ensure that trade secrets are protected against employee disclosure, deliberate or otherwise.

When reviewing whether a company took appropriate steps to protect its trade secrets, courts will consider safeguards and restrictions on access to prevent disclosure. These “external controls” may include sign-in pro-

cedures for visitors; nondisclosure agreements with suppliers, customers, vendors, and business partners/joint venturers; and company policies precluding posting customer lists or detailed product descriptions online. In addition, the measures the company took internally to protect trade secrets are also important. These may include nondisclosure and confidentiality provisions in employment agreements; employee training and onboarding; reiterating trade-secret policies and procedures; employee termination procedures; marking confidential documents with a legend such as “Trade Secret—Document Contains Confidential and Proprietary Information—Strictly Limit Circulation”; imposing strict limits on internal distribution; using password controls for server access; requirements for pass cards, badges, keys, and locked cabinets; and policies for monitoring telecommuting arrangements and use of mobile devices.

Using nondisclosure agreements can be significant. In *MAI Sys. Corp. v. Peak Computer, Inc.*, 991 F.2d 511, 521 (9th Cir. 1993), the court found that an employer took reasonable steps to maintain the secrecy of its customer information when it required its employees to sign confidentiality agreements respecting the confidentiality of the customer database and promising to maintain that confidentiality. However, labeling information as a “trade secret” or “confidential” is not enough. In *Morlife, Inc. v. Perry*, 56 Cal. App. 4th 1514, 1522 (1997), the court explained that labeling information “trade secret” or “confidential information” does not conclusively establish that the information satisfies the definition of a trade secret, although it is an important factor in establishing the value placed on the information and that the information could not be readily derived from publicly available sources.

Patent: Evaluating the Costs, Risks, and Rewards of Pursuing Protection

Although trade secrets must remain secret in order to preserve their protected status, patented inventions can be disclosed to the

public; however, premature disclosure of new innovations can create an absolute bar to seeking patent protection.

Patent protection in the United States has undergone enormous shifts in the wake of the America Invents Act, which was passed in 2011 and changed the way patent applications are processed, reviewed, and issued if filed after March 16, 2013. The major changes include the transition from a first-to-invent patent system, meaning that inventions shown to have occurred earlier would be given priority, to a first-to-file patent system, which brings the U.S. patent system into conformity with the majority system around the world. There were also material changes made to the way assignees of patent rights may file for and obtain patents, and there were several material changes made to the patent examination process and to the way third-party proceedings are handled in the United States.

The basic requirements for issuance of patents remain the same: a patentable invention must be useful and novel and must be “nonobvious” to someone of ordinary skill in the art. In contrast to trade secrets, patents give their holders a “negative” right—a right to preclude others from making, using, selling, offering for sale, and importing the claimed invention. The United States recognizes three basic types of patents: utility, design, and plant. Many startups seek utility patents, which are allowed a term of 20 years from filing.

One of the first jobs of the startup’s lawyer is to ensure that steps have been taken to prevent unintentional disclosure of the startup’s inventions so the startup can determine whether to seek patent protection. Consider existing, pending, and potential future patent rights. Look for documents that may evidence preapplication disclosures, and help the startup determine whether significant innovations and new technologies could be the subject of patent protection. Consider whether a patent specialist must be retained to undertake a thorough review and analysis of patentability, although there can be some

important strategic reasons why the startup might choose not to undertake a complete “prior art” search (which can identify existing technology that could serve as a basis upon which a patent might not issue or might be contested).

Once the startup has determined that certain technology may be patentable, a budget must be worked out for the patent application, with a reserve for patent office review. The startup must understand that the budget for pursuing patent applications can consume substantially more than the entire amount that may have been reserved for copyright, trademark, and trade-secret protection put together.

In summary, the lawyer working with a startup must understand the basic structure of the four major categories of intellectual property protection. The lawyer must guide the startup through sometimes conflicting considerations when determining which of the four IP protection regimes is the best for the particular combination of proprietary content, branding and marketing material and design, confidential processes and secret materials, and/or proprietary inventions that are at the center of the startup’s business. In addition, the lawyer must help the startup implement an appropriate budget to get it through the initial phases of securing protection, emphasizing the particular form of IP protection best suited to the startup, until more money can be raised to help secure and protect its core IP and its new IP assets as the startup grows.

Jonathan Rubens is a former chair of the Cyberspace Law Committee and is cofounder of Javid | Rubens LLP in San Francisco. He began his career litigating copyright infringement cases for media companies and writers, he has worked with technology startups since the early 1990s, and his practice now includes commercial transactions, emerging companies, business acquisitions, and intellectual property.

BUSINESS LAW TODAY

Privilege and International Implications against the Backdrop of the Panama Papers

By [Ava Borrasso](#)

At the behest of Panamanian prosecutors, police raided the offices of the Mossack Fonseca law firm on April 12, 2016, just weeks after it was disclosed that the firm's confidential records were hacked or possibly leaked months earlier. The public disclosure in late March 2016 of a bounty of information—dubbed “the Panama Papers”—documented more than 200,000 companies and structures of the firm's rich and famous (and some infamous) clients in more than 20 jurisdictions. Although the bulk of those vehicles may turn out to be legal, the Manhattan U.S. Attorney's Office instituted a criminal investigation within weeks to determine whether U.S. tax and anti-money-laundering laws had been violated. Seemingly ignored in this frenzy of activity, or more accurately put aside for future review, is the very bedrock of legal jurisprudence—the attorney-client privilege.

The Panama Papers highlight the interplay of the application of privilege in the international arena. Although the Mossack Fonseca law firm is based in Panama, it has offices in multiple jurisdictions, its clients are located throughout the world, and the structures it employed utilize bank accounts and corporate entities from mul-

multiple additional jurisdictions. In addition to the unfolding cross-border investigations of the underlying information, the Panama Papers also raise multiple privilege issues for potential future proceedings. What law applies? The law of the jurisdiction where counsel provided the advice, the client was located, or ensuing litigation occurs? In addition, how are the privilege laws distinguished, and what impact will those distinctions have on the use of the documents as evidence in subsequent legal proceedings?

The documents may face challenges to introduction into evidence if they were obtained through hacking or other unauthorized taking on grounds including that the privilege was not waived. Although the crime-fraud and similar exceptions may permit privilege to be pierced by the wrongdoing of an attorney or client to permit disclosure of communications made in furtherance of criminal conduct or fraud, prima facie evidence of criminal or fraudulent conduct generally must exist first in order to invade the privilege. Mere allegations are insufficient, and after-the-fact application of the exception under the circumstances of a hacking would present novel issues. In addition, lawyers are ethically constrained from reviewing material they know to be privileged. Each of

these thorny determinations has yet to be made, is fact-specific, and will be the subject of close scrutiny. Further, the documents may soon become transformed as “public,” raising additional issues that will certainly be subject to judicial review and analysis in the months and years to come.

The law on legal privilege is vast, and each topic addressed here in summary form has been subject to extensive and detailed analysis elsewhere. Many privileges are not addressed here, including those involving joint defense, common interest, and settlement communications. Further, there are exceptions to the protection and variations in treatment even as to the same privilege. The attorney-client privilege alone has nuanced application within U.S. jurisdictions depending on the underlying facts, and treatment varies broadly internationally. As such, consultation with local counsel is the best practice in assessing the application and maintenance of privilege for particular material.

This article provides an overview of privilege issues limited to confidentiality, attorney-client, and work-product from a U.S. common law perspective as generally compared to a civil law perspective. The treatment of international privilege issues

in U.S. courts and in international arbitration proceedings is then addressed.

Common Law Confidentiality and Attorney-Client Privilege

Although there are many types of protected communications, the broadest duty owed by U.S. counsel is that of confidentiality. It extends beyond matters communicated by a client in confidence to all information relating to the representation. Particularities of confidentiality vary from state to state, but lawyers cannot reveal information relating to the representation of a client without the client's informed consent except in limited circumstances. Under Rule 1.6 of the ABA Model Rules of Professional Conduct, those circumstances include when disclosure is necessary to: (1) prevent reasonably certain death or substantial bodily harm; (2) prevent commission of a crime or fraud; (3) prevent substantial injury to financial interests or property reasonably certain to result from a client's crime or fraud; (4) comply with other law or a court order; (5) secure legal advice regarding a lawyer's compliance with the Model Rules; (6) serve as a claim or defense between the lawyer and client; or (7) resolve conflicts of interest.

The most sacrosanct protection conferred under U.S. law is the attorney-client privilege. In the landmark decision *Upjohn Co. v. United States*, 449 U.S. 383, 389 (1981), the Supreme Court summarizes its importance:

The attorney-client privilege is the oldest of the privileges for confidential communications known to the common law. Its purpose is to encourage full and frank communication between attorneys and their clients and thereby promote broader public interests in the observance of law and administration of justice. The privilege recognizes that sound legal advice or advocacy serves public ends and that such advice or advocacy depends upon the lawyer being fully informed by the client.

The classic definition of the attorney-client privilege applies when a party seeks

legal advice or a legal opinion from a professional legal advisor and protects from disclosure the communications relating to that advice made in confidence by the client or lawyer, unless the privilege is waived. 8 J. WIGMORE, WIGMORE ON EVIDENCE § 2292, at 554 (McNaughton rev. ed. 1961). Qualifying communications will lose the protection upon voluntary disclosure of the information.

U.S. law protects qualifying communications even when the party seeking advice does not become a client or when the communication is made to an unlicensed subordinate of a member of the bar that otherwise satisfies the requisite elements. By contrast, and barring unusual circumstances, other types of information do not fall within the scope of the attorney-client privilege, including the underlying facts upon which legal advice is sought, business advice, information regarding the payment of legal fees, or a client's identity. Under U.S. law, the attorney-client privilege belongs to the client, not the lawyer, although the lawyer can invoke the privilege on the client's behalf. However, foreign jurisdictions vary as to who holds the privilege.

Privileged information that does not fall within an *exception* is therefore protected from disclosure. The crime-fraud exception bars application of the attorney-client privilege to matters made in furtherance of or in contemplation of a crime or fraud. The fiduciary or *Garner* exception derives from English common law and precludes a fiduciary from asserting the privilege against those to whom a common fiduciary duty is owed (e.g., shareholders or beneficiaries). The U.S. Supreme Court has determined that the "fiduciary exception is now well recognized in the jurisprudence of both federal and state courts, and has been applied in a wide variety of contexts, including in litigation involving common law trusts, disputes between corporations and shareholders, and ERISA enforcement action." *United States v. Jicarilla Apache Nation*, 131 S. Ct. 2313, 2332–33 (2011) (citations omitted). See *Garner v. Wolfinbarger*, 430 F.2d 1093 (5th Cir. 1970); *Nama Holdings, LLC v. Greenberg Taurig LLP*, 2015 N.Y.

Slip Op. 7346 (N.Y. App. Div. Oct. 8, 2015) (adopting the *Garner* test).

Overview of Civil Law Treatment

Civil law jurisdictions (prevalent in Europe and Latin America as well as parts of Africa and Asia) generally protect a "professional secret" by statute through criminal code or ethical rules. There is also a recognized right of defense that generally protects communications from counsel arising from a party's right to a fair trial. For example, some jurisdictions include penal code provisions that provide that disclosure of professional secrets by counsel may result in a prison term and monetary fine. Generally, the client cannot waive the privilege. The lawyer is required to maintain as confidential information that which falls within the scope of the privilege subject to disclosure in judicial or administrative proceedings.

Similarly, many civil law jurisdictions preclude counsel from disclosing client secrets as set forth in the law by civil code or through bar or ethical regulations. A lawyer in violation of these laws may be subject to liability and penalty. In some instances, criminal sanctions may be imposed. Although the client generally holds the privilege, in some jurisdictions even the client cannot waive the privilege.

Views on Communications Involving Corporate Counsel

Historically, application of the attorney-client privilege in the United States for communications between employees and corporate counsel was determined by the control-group test or the subject-matter test. The minority view, the control-group test, essentially protects communications seeking legal advice from high-level corporate officers—that is, members of the control group. By contrast, the subject-matter test looks to the substance of the communication and protects those communications made by mid- or low-level corporate employees who seek legal advice on behalf of the corporation for actions within the scope of their employment. In 1981, the U.S. Supreme Court weighed in and determined that the control-group test was

too restrictive and, although not binding on state courts, adopted the subject-matter test for federal cases. *Upjohn*, 449 U.S. at 398. That test has since become the majority position and the prevailing view in most states as well.

Communications between corporate counsel and employees made for the purpose of obtaining legal advice fall squarely within attorney-client privilege protection in the United States. However, communications related to business advice or regulatory matters are not protected. Similarly, information shared with third parties or beyond those necessary to obtain legal advice falls outside the parameters of the privilege. As a result, corporate counsel caution against inadvertent waiver of privilege by separating legal advice from business advice, limiting dissemination of privileged information to protected employees, and advising recipients to avoid forwarding privileged advice on e-mail chains.

Recently, a Washington, DC, district court compelled disclosure of legal advice related to an internal investigation that also had a regulatory purpose. On appeal, the court reversed and rejected the district court's narrow analysis of privilege in favor of broader protection that covered communications involving legal advice as "*one of the significant purposes* of the attorney-client communication." *In re Kellogg Brown & Root, Inc.*, 756 F.3d 754 (D.C. Cir. 2014). The case demonstrates the care required to preserve privilege by avoiding the communication of legal advice with regulatory, compliance, or business advice.

Most of Latin America extends the professional-secret privilege to in-house legal counsel and does not distinguish between corporate and outside counsel. However, the European Union (EU) takes a completely different approach. The EU does not protect communications between in-house counsel and corporate employees. Although the legal-professional privilege is viewed as a basic right among European Community (EC) members, it requires the lawyer's independence, and the communication must be related to the client's right of defense. *AM&S Europe Ltd. v. Commis-*

sion of the European Communities, 1982 E.C.R. 1575, Case No. 155/79. Corporate counsel is viewed as lacking the necessary independence by virtue of their exclusive affiliation with a single client to prevent disclosure of communications (e.g., *Akzo Nobel Chemicals Ltd. v. E.U.*, 2010 E.C.R. Case No. 550/07 ("It follows that the requirement of independence means the absence of any employment relationship between the lawyer and his client, so that legal professional privilege does not cover exchanges within a company or group with in-house lawyers.")).

Many national European jurisdictions follow suit. Lawyers practicing in these jurisdictions are subject to the laws of the local jurisdiction. As a result, due care must be taken by U.S. lawyers, in-house counsel, and corporate employees in their communications with European corporate counsel.

In this age of globalization, the privileges applicable in one place may impact the ability to claim them elsewhere. Counsel in jurisdictions with stronger privileges like the United States face practical risks in dealing with corporate counsel abroad. By way of example, communications exchanged with European in-house counsel may subject a U.S. lawyer's communication to disclosure in EC courts even when those same communications would be privileged in the United States. Similarly, U.S. corporate counsel who knowingly exchange or provide legal advice with a European counterpart or employee located in the EC may waive the privilege in U.S. courts. In short, it is critical to understand local privilege laws when conducting business or operating in multiple jurisdictions to fully preserve privilege.

Work-Product Doctrine or Litigation Privilege

In addition to the attorney-client privilege, the work-product privilege adds another protection to facts uncovered and opinions formed in preparation or anticipation of litigation. Common law jurisdictions that protect such materials routinely refer to this as the "litigation privilege."

Under U.S. law, material collected and facts uncovered by counsel in anticipation

of litigation are generally protected from disclosure. See *Hickman v. Taylor*, 329 U.S. 495 (1947). Such material may be obtained only upon a showing of substantial need for the material, and that the party seeking the information would suffer an undue hardship in obtaining substantially equivalent material through other means. See e.g., Fed. R. Civ. P. 26(b)(3). Fact-based work product may be subject to disclosure upon satisfaction of this stringent standard.

The other category—opinion-based work product—protects the mental impressions, opinions, theories, and conclusions of counsel and is subject to an even higher level of protection. Opinion work product is rarely subject to discovery. Unlike the attorney-client privilege, the work-product doctrine requires waiver by both the client and counsel. A client alone cannot waive the work-product privilege. See e.g., *In re Grand Jury Proceedings*, 43 F.3d 966 (5th Cir. 1994).

Foreign Privilege Treatment in U.S. Litigation

Federal Rule of Evidence 501 provides that application of privilege is an issue of common law unless there is a conflict with the U.S. Constitution, an applicable federal statute, or U.S. Supreme Court rules. Rule 501 also provides that, in civil cases, state law governs privilege.

The common law of the United States generally employs a choice-of-law analysis in determining which privilege law governs multi-jurisdictional cases. Typically, U.S. courts apply a "touching-base" analysis to determine whether foreign communications are protected. Protection for communications that do not implicate the United States, or do so only incidentally, is generally determined in accordance with applicable foreign privilege law unless contrary to U.S. public policy. This approach is essentially one of comity.

However, in cases involving communications within the United States, the courts seek to balance the overall transaction or relationship to determine where the predominant relationship took place and to apply the privilege of the jurisdiction with the highest interest in confidentiality. The

jurisdiction with the “most direct and compelling interest” is generally either the location where the relationship was entered or centered at the time of the relevant communications. When multiple jurisdictions are involved, the issue is fact sensitive, and courts have generally been inclined to follow foreign law when issues of foreign legal proceedings are involved, and U.S. law when advice or legal proceedings in the United States are at issue.

Recently, in *Anwar v. Fairfield Greenwich Ltd.*, 982 F. Supp. 2d 260 (S.D.N.Y. 2013), the court applied the touching-base analysis to compel disclosure of communications between administrator Citgo and its unlicensed Dutch in-house counsel in litigation pending in the United States arising out of Bernard Madoff’s Ponzi scheme. Senior Dutch in-house counsel provided legal advice to Citgo in the Netherlands, which the court determined could have touched base with either the Netherlands (where the communications took place, the relationship was centered, and which in part related to Dutch law) or the United States (communications related in part to U.S. litigation and advice regarding U.S. law), but held the communications were not privileged in either case.

The court determined that, under U.S. law, the fact that the in-house counsel was unlicensed, and that Citgo knew that fact, precluded it from claiming the privilege. Under Dutch law, the communications would not be privileged because the Netherlands does not recognize a privilege between an employer and unlicensed in-house counsel. In addition, the court rejected Citgo’s contention that pretrial discovery was not available in the Netherlands and the communications were therefore subject to protection because the court determined that Dutch civil procedure and civil law did provide mechanisms to obtain disclosure of the underlying information.

Generally, documents sent to employees or created in jurisdictions that do not protect in-house counsel communications are not privileged in U.S. courts. See e.g., *Celeron Holding, BV v. BNP Paribas SA*, No. 1:2012cv05966 (S.D.N.Y. 2014) (compelling production of documents under

either Russian or Dutch law because relations were entered and centered there, and neither jurisdiction protected communications with unlicensed or in-house counsel). However, U.S. courts have protected communications from disclosure where the applicable foreign law would protect them. In *Cadence Pharmaceuticals v. Fresenius Kabi USA, LLC*, 996 F. Supp. 2d 1015 (S.D. Cal. 2014), the court protected communications between a client and a nonlawyer patent agent working under the direction of a patent attorney regarding the prosecution of European patent applications because that information was privileged under German law. This holding is generally in line with the U.S. perspective that extends privilege to qualifying communications with members of the bar or their subordinates and thus was not contrary to public policy.

Treatment of Privilege in International Arbitration

Although treatment of privilege in foreign courts is beyond the scope of this article, treatment within international arbitration proceedings may best exemplify problems that occur when privilege laws collide. In proceedings involving parties from both common and civil law jurisdictions, how should tribunals handle privilege? If a U.S. party seeks to protect a communication between a high-level employee and in-house counsel from disclosure to a French counterparty that does not recognize such protection, does the tribunal accord protection of underlying materials to the U.S. party and not to the French party consistent with application of their own legal systems? Does the answer differ if the proceeding is seated in the United States, France, or some other jurisdiction?

Commentators, institutions, and practitioners vary on these issues. Some favor application on an evidentiary basis opting for the procedural law of the seat, the law that governs the underlying arbitration agreement, or the law most closely related to the privileged communication. Arbitral tribunals exercise broad discretion in determining which law should be applied and, alternatively, may look to the law where the lawyer is licensed

or qualified to practice or where the client is located and the advice was given. The law of the location of the client or counsel is generally viewed as more predictable and consistent with the parties’ expectations.

In some instances, the rules of the administering institution attempt to address the issue directly. For example, Article 22 of the American Arbitration Association’s International Centre for Dispute Resolution Procedures (Including Mediation and Arbitration Rules) provides:

The arbitral tribunal shall take into account applicable principles of privilege, such as those involving the confidentiality of communications between a lawyer and client. When the parties, their counsel, or their documents would be subject under applicable law to different rules, the tribunal should, to the extent possible, *apply the same rule to all parties, giving preference to the rule that provides the highest level of protection.*

Other institutions provide for greater flexibility and, accordingly, less guidance (e.g., ICC, Art. 22.3 (“*Upon the request of any party, the arbitral tribunal may make orders concerning the confidentiality of the arbitration proceedings or of any other matters in connection with the arbitration and may take measures for protecting trade secrets and confidential information.*”)); IBA Rules on the Taking of Evidence, Art. 9.2(b) (“*The Arbitral Tribunal shall, at the request of a Party or on its own motion, exclude from evidence or production any Document, statement, oral testimony or inspection for any of the following reasons: . . . legal impediment or privilege under the legal or ethical rules determined by the Arbitral Tribunal to be applicable . . .*”).

Recently, the focus on these issues has led to various proposals, including incorporation of a clause in an arbitration agreement specifically addressing privilege. This is perhaps the safest course under the existing playing field. Some advocates have also suggested implementation of a model set of rules for privilege for international arbitra-

tion and undertaken some efforts toward drafting transnational rules. Barring further development, uncertainty is likely to continue permeating cross-border transactions involving parties subject to different privilege laws.

Conclusion

Not only is privilege at the foundation of the attorney-client relationship, but it provides a critical limitation on introduction of evidence as well, at least in most common law jurisdictions. Civil law jurisdictions provide a different view. Although less is protected, typically less is subject to disclo-

sure. In any cross-border deal or transaction, it is critical to understand the various protections in play and to exercise care in communicating with counterparties to preserve privilege.

Practitioners are likely comfortable with the limitations and particularities of their own system, but when these systems collide—as with the Panama Papers—things get more interesting. Undoubtedly, attorney-client privilege, work-product privilege, and the duty of confidentiality will be analyzed in future proceedings involving the documents taken from the Mossack Fonseca law firm. The impact each privilege will have on

access to this material in court proceedings may turn on the analysis of multiple jurisdictions and is likely to lack uniformity.

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BUSINESS LAW TODAY

What Is Making Lawyers Unsatisfied and How to Fix It

By [James Wendell May](#)

This is the third article in a three-part series focused on the evolution of risk management and the business lawyer. The first article, titled “The Moroccan Souk and Your Commercial Contract Headaches,” featured in May’s BLT, focused on solutions to problematic negotiations over limitations of liability, indemnity, and insurance clauses. The second article, featured in last month’s BLT and titled “Data, Contracts, and Making Hard Decision – Changing the Way We Manage Risk” argued that contracts are expensive and inefficient, and proposed a better way to assess and manage business risk, through systematic and methodical assessment, using data collection, analysis, and pragmatic risk management tools. This month’s article steps back from the technical analysis of the prior two articles, arguing for a humanistic approach to business law improvement that, in combination with the analytical techniques proposed in the earlier articles, will lead to more fulfilled lawyers and better outcomes for our clients.

* * *

We know that many business lawyers are generally unsatisfied with their work, either through personal experience or the

volumes of headlines, reports, and data that scream that conclusion to us: “[Unhappiest Job in America? Take a Guess](#),” “[Why Are So Many Lawyers Are Unhappy With Their Jobs](#),” “[Why Most Attorneys Are Unhappy](#).” These headlines and the data that underlie them are not new, and despite the many resources our profession has devoted to addressing the problem, it persists. I believe that there is a better way to combat this problem than the traditional remedies, and that is by helping lawyers understand what motivates us professionally, and by helping each lawyer form a plan that provides the best opportunity to realize those motivators. This article shows business lawyers how to create a plan that helps us work toward what motivates us, which will improve lawyer satisfaction and performance as well as generate enormous saving and efficiencies for companies and law firms.

What Motivates Lawyers?

Daniel Pink’s 2010 book, *Drive*, offers a compelling argument that there is a disconnect between conventional wisdom about what motivates people and what the science and data show. Pink’s central argument is

that, for creative professions like the law, financial rewards do not correlate with better performance and professional satisfaction. Pink persuasively argues that better performance and professional satisfaction are correlated with autonomy, mastery, and purpose, and that those businesses that have recognized and applied the science behind these conclusions have generated remarkable improvements to business performance and realized tremendous cost savings and efficiencies. Pink’s analysis helps us understand what motivates lawyers and, through the science and business cases described in the book, gives us a foundation for devising plans that can help lawyers work toward what motivates them. Let us begin by looking at one of our core motivators—autonomy—and how we can apply the lessons of science and business to our profession.

Autonomy

According to Pink, autonomy is “behaving with a sense of volition or choice” and is comprised of four key elements: time, task, technique, and team. At this point, a skeptical lawyer might question whether autonomy is a realistic objective for our profession. After all, we serve a client—how can we be

autonomous? However, what Pink means by autonomous is “not the rugged, go-it-alone, rely-on-nobody individualism of the American cowboy. It means acting with choice—which means we can both be autonomous and happily interdependent with others.” Autonomy does not mean that we act independently of our clients, but that we serve our clients in a way that gives us some choice about how we perform that duty.

The first essential element of autonomy is time. It is widely believed that lawyers have little or no autonomy over their time. Whether in-house or at a law firm, the client, the billing partner, or the general counsel needs you to meet a deadline. However, time autonomy is not about eradicating deadlines; it is about how you meet that deadline and how you are compensated for doing so.

The law firm business model is based on compensating lawyers for lawyer input (time) rather than lawyer output (work product). This is the antithesis of time autonomy and a great culprit of lawyer unhappiness. Since the financial crisis, it has become routine to see articles and panel forums commending lawyers for “creative alternative fee arrangements,” although law firm fee structures are rarely creative and usually amount to a discount on hourly rates. In addition, although firms selectively apply alternatives to the billable hour, the law firm business model has not yet changed. It is curious that the billable-hour standard remains, especially given that a viable alternative model has been widely used and refined by the consulting industry for decades. The consulting industry, like business law firms, provides mercenary services to the business world with legions of well-paid associates without sacrificing profits per partner that rival AmLaw 100 firms, and they do it with an output-focused, rather than an input-focused, business model.

Irrespective of why, it is clear that most business lawyers are still captive to the billable hour. So long as the billable hour is a staple of business law firm compensation, we will continue to struggle with giving law firm lawyers autonomy and, therefore, professional satisfaction.

Although time-autonomy restraints for law firm lawyers are more rigid, in-house lawyers also struggle with a lack of time autonomy. In many in-house environments, abiding by the conventional 9 to 5 (or 8 to 6) is expected. In one of my former in-house jobs, it was common to see department leaders strolling the halls at 6:00 p.m. to survey the troops and to hear them criticize department members who took afternoon workouts or who left the office before 5:00 p.m. For legal managers of departments like this, “face time” matters.

Those companies that have experienced success in developing time autonomy for their employees, like Best Buy, take a very different approach. Best Buy eliminated the conventional work schedule which, according to *Harvard Business Review*, resulted in better relationships, more loyalty to the company, better energy and productivity, and less employee turnover. The point here is that “face time” is not just a waste of time; it destroys value. There is no reason to think that the Best Buy model would not work in a law firm or in a legal department, especially if used in conjunction with task autonomy (described in more detail below).

Another essential element of autonomy as described by Pink is autonomy over task. Companies like Google and 3M give their engineering and technical teams, respectively, 15 percent and 20 percent of their time to devote to any work-related project that the employee wants. These case studies have different implications for in-house legal departments than they do for law firms. At first glance, it might seem impossible for an overburdened in-house legal department to do 15–20 percent less of its traditional workload without negatively impacting the client. However, that same argument is just as true for an engineer at Google or 3M. Most in-house business lawyers have more work than resources and must prioritize accordingly. In the short term, devoting 15–20 percent of a lawyer’s time to a chosen work-related project might jeopardize the bottom 15–20 percent priority of the traditional lawyer workload, but I suspect that the long-term return on investment would be just as dramatic as it has been

for engineers, coders, and technical experts at places like Google and 3M. It would be interesting to see what a lawyer would generate with that time, and how such legal experimental doodling might lead to better risk-management for the company or firm.

For a law firm business lawyer, task autonomy is seemingly even more complicated than for the in-house business lawyer. A law firm business lawyer practicing in the billable-hour environment does not really have the choice to find other risk-management solutions to the bottom 15–20 percent priority of his or her workload. However, one potential avenue for giving the conventional law firm business lawyer task autonomy would begin with partner transparency on projects and expected volume of work. Partners would be allowed to schedule a limited amount of work for any single associate (say, 80 percent of that associate’s required hours). The associate would be allowed (and encouraged) to schedule his or her remaining 20 percent on partner-advertised work that the associate finds interesting. Such an experiment would amount to working on task autonomy without time autonomy, and Pink does not speak to what impact achieving one element of autonomy has if others are fulfilled. However, experimenting with one element of autonomy while working toward a larger vision of autonomy is consistent with a spirit of continuous improvement and is preferable to the conventional law firm’s status quo.

Pink’s third essential element of autonomy is technique, or how an employee executes his or her responsibilities. Pink uses several business cases from the customer-service/call-center industry to make the concept real. Zappos.com does not have a supervisor monitoring conversations between service reps and customers, nor does it mandate specific solutions that its employees must give to customer complaints. JetBlue (among others) has added to the Zappos.com approach by letting their customer-service reps handle calls from home, rather than commuting to a drab outpost of cubicles and fluorescent lights. Although these concepts are intriguing, it is the measurable results that impress most: consistently high customer satisfac-

tion and dramatically lower employee turnover, reducing (and sometimes eliminating) recruiting costs.

How to apply technique autonomy to the legal field is less obvious than how time or task autonomy might translate. After all, giving lawyers time autonomy to work when and where they want seems to be the analogy for letting customer-service reps work from home. However, what is impactful to me from the customer-service business cases is not the work-from-home piece, but the freedom that the Zappos.com reps are given to create individual solutions that work under the unique circumstances of each problem. Lawyers often have little autonomy to create a risk-management technique that is appropriate for the circumstances. Too often, legal managers or corporate policy establish absolute parameters that, although provide clarity, do not effectively manage risk in a given circumstance. For example, a written contract for payment of over \$100,000 must be reviewed by the legal department and signed by a vice president. Alternatively, the company cannot source a material from a supplier who does not agree to everything in the company's corporate responsibility code (the drawbacks of these types of rigid standards are explored in my earlier article, "[Data, Contracts and Making Hard Decisions – Changing the Way We Manage Risk](#)"). Lawyers must have the autonomy to deliver solutions in a way that is best suited to the circumstances, without micromanagement by their manager, in the same way that the Zappos.com customer-service reps are free to solve customer's problems.

The fourth and final element of autonomy is team, or allowing an employee to choose with whom he or she works. Applying team autonomy to the legal field is another area that invites lawyers to protest that our field is different from others. Again, clients come to us with their problems, and those clients have often already selected other advisors to help them on the issue. Another barrier to team autonomy is that many lawyers are individualistic, and working on a team does not come naturally. However, those barriers to team building exist for other functions and businesses as well, and yet the

successful application of team autonomy has flourished. According to Pink, team autonomy has demonstrated its effectiveness in tandem with the time and task autonomy given by Google, 3M, and smaller companies like Atlassian whose employees pursue their 15–20 percent designated time for self-directed projects with other company employees.

For a legal department attempting to implement team autonomy, the most obvious method is to mimic these models by giving lawyers 15–20 percent designated time for self-directed projects and encouraging them to choose teams to pursue the project's goals. Those lawyers who like to work on teams must be given the freedom by their managers to form teams for problem solving, either with other lawyers or members of other functions. For the business law firm, there are no other "functions" with which to create teams, but creating cross-specialty project teams can deliver new and promising perspectives to entrenched problems that plague insular practice groups.

Mastery

The second key component of what motivates us is mastery—the continuous pursuit of getting better at something that matters to an individual. According to Pink, mastery has three laws: (1) mastery is a mindset; (2) mastery is a pain; and (3) mastery is an asymptote. The second law is easy to understand—one cannot master a rewarding endeavor without significant effort. The third law means that no one ever achieves complete mastery, but the way to conceptualize mastery is as an asymptotic arc that gradually approaches a line without ever touching it (mirroring the fact that absolute mastery can never be achieved, but can be approached, first with big jumps then through incremental improvement).

The most interesting of the three laws of mastery, especially for lawyers, is the first law—mastery is a mindset. The scientific basis for this comes from Stanford Professor Carol Dweck, who divides people's concept of intelligence into two groups: entity theory and incremental theory. Entity theory holds that a person's intelligence is fixed, whereas

incremental theory holds that one's intelligence is dynamic. For those who conceptualize intelligence by the entity theory, the pursuit of mastery is anathema. For those who conceptualize intelligence by the incremental theory, the pursuit of mastery is elemental and essential.

As lawyers, we see examples of colleagues who, through their behaviors, demonstrate a proclivity toward either the entity theory or incremental theory of intelligence. Entity-theory lawyers believe that our practice is a reflection of innate ability and personality. The entity-theory lawyer believes that evaluation of a lawyer's quality is subjective and therefore thinks that "mastery" is a concept inapplicable to the work we do. The incremental-theory lawyer believes that, through rigorous logic, modeling, statistics, and data, one can become a better lawyer. The incremental-theory lawyer would identify with the precept that "mastery is a mindset," knowing that perfection cannot be achieved, but the pursuit of perfection is a tremendous motivator.

When encouraging lawyers to pursue mastery, it is important to understand what type of lawyer is involved. If the lawyer is an entity-theory lawyer, trying to establish a plan for achieving mastery is likely to be fruitless. Mastery is a mindset, and without the right mindset, the effort will be futile. However, if the lawyer is an incremental-theory lawyer, fostering and cultivating a pursuit of mastery will likely pay dividends. Mastery of the law (or any law-related endeavor) is just as elusive as mastery of golf or painting, but establishing clear technical goals, understanding established practices, questioning those practices, consistently tracking one's progress toward those technical goals, and evaluating the lawyer's results can be done with lawyers from any practice area.

Purpose

The final of the three pillars of what motivates us, Pink asserts, is to seek purpose—a cause greater and more enduring than ourselves. Pink cites data showing how both baby boomers and millennials are motivated by more than the basic profit motives

and return-on-investment principles that are traditionally associated with corporations. This “more than profit” motivation is not a rejection of capitalism or corporations—it is merely a recognition that deriving noneconomic meaning in what we do is an essential element of the human experience.

Cultivating purpose in a business law environment is tough, especially when many of us have classmates and peers who use their law degrees in ways that are more visibly altruistic or less materialistic. I think that perspective underestimates the value that business lawyers provide to society. As *The Economist* notes, “Economists have repeatedly found that the better the rule of law, the richer the nation,” and business lawyers are essential to promoting and maintaining the rule of law in commerce. However, the point of this article is not to prove whether business lawyers have a purpose in society, but to determine how to motivate lawyers by orienting them to a defined purpose.

The starting point in helping lawyers to identify their purpose is to ask them. Many of us might respond by listing our job responsibilities or noting our role in supporting a business. A more effective way to help a business lawyer identify his or her purpose is to narrow the scope from the broad role a lawyer plays in supporting a business or an individual lawyer’s job responsibilities to the people who are helped by the work we do. For a law firm business lawyer, that could be a partner or an in-house client. For the in-house business lawyer, that could be a colleague in the finance or marketing department, but I believe that people see purpose in helping other people. That help might be insignificant from the perspective of the lawyer (“I just approved a radio ad—it only took five minutes.”), but if that help is beneficial to the recipient (and the lawyer knows that the work is helpful), our purpose motivator often is satisfied.

The problem for many lawyers is that we rarely get feedback on our contributions and, when we do, it can be inconsistent and haphazard. There are many tools available for obtaining more consistent feedback with better data, but the simplest involves

each lawyer establishing objectives with clients, circulating a client survey on a regular basis to monitor progress, evaluating the results, and reorienting and reprioritizing these goals with the client in order to improve.

I know of very few examples of in-house legal departments or law firms that use client surveys in the same way that many other corporate-service functions use stakeholder surveys to monitor performance. This may be because doing so is, at least initially, time and resource intensive. Alternatively, it simply may be an aversion to hearing criticism. I believe that if we are going to consistently give business lawyers purpose, we must collect data and feedback on our work from our clients as part of a consistent, methodical process.

Continuous Improvement Alone Will Not Save Us

Reading *Drive* got me thinking about what disciplines have used science and data to improve motivation and performance and how commonly that is done in the law. James Suroweicki, in his *New Yorker* article, “Getting Better at Getting Better,” notes how the application of rigorous science and data, along with a commitment to continuous improvement, has led to a performance revolution in music, sports, and manufacturing. Suroweicki contrasts that performance revolution with the general stagnation of performance in the field of education, which has not adapted the same rigorous approach. Legal writer Ken Adams has said education’s failure to adopt continuous improvement is similar to the legal profession’s resistance to the quality movement, especially contract drafting (<http://www.adamsdrafting.com/bringing-kaizen-to-the-contract-process/>). In fact, there is a small movement underway to bring the principles of continuous improvement to law, with academics and practitioners writing about how “legal operations,” “LEAN Legal,” statistical models, and rigorous data are going to transform the practice of our profession. Influential Indiana University Professor Bill Henderson has persuasively argued that the economic benefits derived from LEAN processes will dramatically

change how large law firms work (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2356330). There are even specialists offering “black belts” and other certifications in LEAN legal and organizations claiming that they can help law firms and legal departments implement those ideas.

The commonality among these proponents of the nascent legal continuous improvement field is their emphasis on finding waste in the legal value chain through rigorous data, logic, statistics, and analysis and using that information to deliver cost savings and efficiencies. This science- and data-driven approach is reminiscent of the revolution in professional baseball in the early 2000s that used and applied advanced metrics and statistics (in baseball parlance, Sabermetrics). The power of Sabermetrics was popularized in the 2011 film, *Moneyball*, which celebrated Oakland A’s General Manager Billy Beane for outsmarting wealthier teams in larger markets by cleverly applying data and science to maximize player performance.

Interestingly, although fields such as law and education are still trying to harness the power of rigorous data, logic, statistics, and analysis, professional baseball has moved on. Theo Epstein, a famous disciple of Sabermetrics as former general manager for the Boston Red Sox and currently the Chicago Cubs, [recently said](#):

Fifteen years ago there weren’t that many teams specializing in the statistical model to succeed. You could really get an advantage using it. I think the real competitive advantage now is in player development—understanding that your young players are human beings . . . investing in them as people—and helping them progress. And there’s no stat for that. I don’t think everything in baseball—or life—is quantifiable. Sure, if you ignore the stats, if you ignore empiricism, if you ignore objective evidence, then you’re a fool. But if you invest in stats so fully that you’re blind to the fact the game is played by human beings, then you’re just as much of a fool.

Epstein still believes in the power of rigorous data, logic, statistics, and analysis, but he believes that understanding what motivates his players is more important.

A single-minded focus on lawyer efficiency, processes, and cost savings is just as myopic as a baseball GM's blinded devotion to Sabermetrics. Lawyers need a continuous improvement program that focuses on what motivates them personally, and Daniel Pink has set the foundation for how to

accomplish that. All lawyers must understand what autonomy, mastery, and purpose means for them and establish a plan to help them achieve that, all while measuring results and monitoring progress with rigorous data, logic, statistics, and analysis. A well-applied program featuring these elements will have remarkable return on investment through talent retention, improvement in work quality, cost savings, efficiency, and, most importantly, satisfaction.

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BUSINESS LAW TODAY

Cyber Center:

Cyber-Security Considerations for Franchisors: Protecting the Brand While Avoiding Vicarious Liability

By [David B. Ramsey](#)

High-profile cyber breaches in franchised networks have increased in recent years, involving such notable franchise networks as Dairy Queen, Supervalu, Jimmy John's sandwich shops, Goodwill, and UPS, among others.

A data breach can cost a company dearly in a variety of ways, such as recovering (or doing without) lost records, paying for legal defense and settlement, notifying those impacted by the breach, and providing credit-monitoring services for affected customers or employees. In addition, simply not having enough data security in place—regardless of whether there is a breach—or using consumer data in an inappropriate way can result in hefty liabilities. Crucially, the public reputation cost can result in lost business.

The reputation cost is especially acute for franchisors because their most critical assets are their brands and the associated goodwill. Franchisors often operate in highly brand-competitive industries where consumers can easily take their patronage elsewhere. Customers are unlikely to distinguish between the franchisor that licenses the brand and the franchisee that owns and operates a particular franchised outlet

where a breach occurs. Therefore, a breach at the franchisee level, having little or nothing to do with actions by the franchisor, may discredit the reputation of the entire brand in the eyes of the public and drastically impact the bottom line of the entire franchise system.

For the above reasons, it is crucial for franchisors to understand the issues posed by cyber security and the methods to tackle it. This article provides an overview of the legal considerations for franchisors and pointers on bolstering the cyber security of a franchise system.

Cyber-Security Duties of Franchisors to Their Franchisees and to Consumers

Franchisors must be aware of, and concurrently manage, two emergent trends affecting their legal obligations on cyber security.

First, there is the increased number and scope of laws and standards requiring compliance with data security and consumer privacy. Second, there is the push by various government agencies to expand the boundaries of liability for a franchisor vis-à-vis the actions of its franchisees, depending on how the franchisor conducts its relationships with its franchisees.

The increase in cyber-security laws and standards has been dramatic. An expanding range of laws and industry best practices govern the security of personal information of the type often collected by franchisors and their franchisees in their business. For example, the Payment Card Industry Data Security Standards (PCI DSS) are industry rules mandated and regularly updated by the major credit-card companies. These rules are designed to ensure that all entities that process, store, or transmit credit-card information maintain a secure environment for such information. The PCI DSS are often used to determine whether a company's data security is adequate. If franchise systems interact with consumers using credit cards, the PCI DSS requirements likely apply. For example, as a condition of accepting credit-card payments, there are contractual disclosure obligations to notify credit-card companies and customers of a potential breach within a specific time frame, depending on the jurisdiction in which the breach occurs. Failure to do so can result in significant penalties, such as steep fines.

In certain industries, additional laws become relevant. Examples include the Health Insurance Portability and Accountability

Act (HIPAA) in businesses involving the collection or handling of health/medical information and the Gramm-Leach-Bliley Act in industries providing financial products or services to individuals. Various state and local regulations also apply. Nearly every state requires companies to report data breaches to the affected parties. Franchisors may have to scramble to comply with differing laws in the states in which their franchisees operate.

Data breaches also make franchisors vulnerable to individual and class-action lawsuits from consumers. These lawsuits are based on statutory and/or common law and have increased in recent years. The trend has been for federal courts to dismiss these cases for lack of Article III standing when the plaintiff's only alleged injury is that a data breach occurred and information might have been revealed, or that the plaintiff was compelled to purchase credit monitoring. The case law on standing appears to be shifting, however. Plaintiffs may not always need to show actual harm (such as identity theft) for their cases to go forward.

Accompanying the expansion of rules on cyber security is the growth in government agency interpretations of the duties of franchisors, including potential vicarious liability for the acts or omissions of their franchisees. Cyber security is a natural area in which government agencies have taken action in this regard. Given the nature of franchise systems, a franchisor often will impose requirements for certain types of computer systems or software that franchisees must use in their businesses to achieve uniformity and cohesiveness throughout the franchise system. The flip side of that uniformity is the danger of imputed responsibility of the franchisor if those required computer systems or programs are compromised. Regulators have attempted to place such imputed responsibility on franchisors for breaches of data security or data privacy whether the breaches occur at the franchisor or the franchisee level, although in the final outcome of such cases, the regulators have not always succeeded in doing so (for example, in the *Wyndham Hotels* case discussed immediately below).

In recent years, the Federal Trade Commission (FTC), acting in its capacity as a regulator for privacy and data security, has brought actions against companies that it deems to have ineffective cyber security. In 2012, the FTC filed suit against Wyndham Hotels, *FTC v. Wyndham Worldwide Corp.*, Civil Action No. 2:13-CV-01887-ES-JAD (U.S. Dist. Court, D. N.J.), for failing to maintain the security of the computer system it required franchisees to use to store customers' personal information. (Full disclosure: the author's law firm furnishes franchise counsel to Wyndham Worldwide Corporation and its subsidiaries from time to time, but played no role in and had no prior knowledge of the events of this case.) The FTC alleged that there were three data breaches in less than two years, resulting in fraudulent charges on customers' accounts and the export of hundreds of thousands of consumers' credit-card information to an Internet domain address registered in Russia. The FTC sought to hold Wyndham, as franchisor, liable due to the data and privacy breaches that occurred in its system at franchised hotels.

The settlement outcome with the FTC in *Wyndham* is instructive. It involved a stipulated order entered in December 2015 that entirely relieved the franchisor of any responsibility for data breaches at franchised Wyndham Hotels. This outcome is significant because the FTC's complaint strongly urged the court to impose vicarious liability for franchisee data breaches upon the franchisor. If the court had done so, it would have made the franchisor responsible for all data-security practices and lapses at franchised hotels. Happily for franchisors, that did not happen in this case, one of the first of its kind in the franchise sector.

Although the outcome of the *Wyndham* case provides some comfort to franchisors, another case brought by the FTC in March 2014 is much less comforting. In *In the Matter of Aaron's, Inc.*, 2014 WL 1100702 (F.T.C.), File No. 122-3264, the final Agreement Containing Consent Order made clear the danger of imputed liability for franchisors in some cases if the franchisor does not oversee and monitor its franchisees' consumer privacy practices.

Aaron's, Inc. was a national rent-to-own retailer of consumer electronics, appliances, and furniture, with over 700 franchised stores and over 1,300 company-owned stores throughout the United States. In *Aaron's*, a number of franchisees were alleged to have installed privacy-invasive software on the computers rented to consumers that covertly collected confidential and personal consumer information (e.g., the software logged keystrokes, captured screenshots, and activated computer webcams). The information collected was transmitted from the rented computers to franchisee e-mail accounts.

The circumstances in *Aaron's*, which involved what the FTC called "cyber-spying software" on computers that customers brought into their homes and used for a host of personal and private matters, might easily be distinguished from the type of business conducted by most franchisors and their franchisees. However, the FTC in *Aaron's* put forward a broader legal position that should concern all franchisors: that a franchisor can be liable for data security/privacy violations that were committed only by franchisees (and not committed in company-owned stores) if the franchisor "knowingly assisted" the franchisees in committing the violations. Based on the allegations advanced under the FTC's complaint in *Aaron's* (note that defendant Aaron's neither admitted nor denied these allegations), "knowing assistance" by the franchisor could include the following scenarios:

- The franchisor allowed franchisees, through access to a third-party software designer's website, to activate certain cyber-spying software from that designer, which the franchisees then used to monitor people through the computers rented to those people, thereby invading their privacy.
- The franchisor's corporate server was used to transmit and store e-mails containing content obtained through such monitoring.
- The franchisor provided franchisees with vital technical support about the software program and how to use it, such as pub-

lishing trouble-shooting advice about installing the program on rented computers and avoiding conflicts with antivirus software.

Based on the above, *Aaron's* tells us that a franchisor may be deemed an active participant in the franchisees' wrongful cyber activities through its knowledge of the practice and its technical support for those activities, even though the franchisor did not initiate the practice or utilize the practice in its own franchisor-owned stores.

The broader, unresolved issue for franchisors following *Aaron's* and *Wyndham Hotels* is the boundaries of the franchisor's obligation to monitor activities of franchisees in their use, disclosure, and handling of consumer information. How much "involvement" or "knowledge" makes a franchisor liable? In cyber security as in other areas, there is an unresolved tension between the efforts of franchisors to maintain their legal separation from franchisees and the involvement of franchisors in the activities of their franchisees in order to protect the brand. Thus, besides guarding the value of their brands from cyber attacks and making their franchise systems comply with data laws, franchisors should guide—but not excessively direct—their franchisees' data practices.

Cyber Vulnerabilities Common to Franchisors

As part of their everyday businesses, franchisors and their franchisees often collect, maintain, and share large volumes of customer information. As franchising expands into more industries (from insurance, to massage, to medical care and beyond), the types of information collected and the hardware and software involved also expand.

Especially vulnerable are small- and mid-sized franchised businesses, many of which are too small to implement sophisticated cyber defenses alone. The technology networks that franchisors use to collect and transmit data (e.g., sales tracking, royalty payments, and customer credit-card information) are often linked to their franchisees' systems. Accordingly, a single franchisee

that has not invested the time or money necessary to ensure its computer systems are protected can compromise an entire franchise system. Thus, a franchisor's franchise network is vulnerable from multiple entry points: each franchisee office; each franchisee outlet; each computer terminal or POS at a franchised outlet; the computer terminals and POS at each company-owned or affiliate-owned outlet; the franchisor's corporate headquarters; and all the vendors whose systems connect with the franchise system.

Many franchisors have a vested interest in ensuring that cyber-security "hygiene" training is frequently accomplished throughout the franchise system. For example, part of a franchisor's PCI DSS responsibility is to guard against physical modifications to swipe machines introduced by thieves to surreptitiously copy credit- and debit-card information. To prevent this, retail outlets with point-of-sale (POS) machines must check them regularly, and employees should be trained to do so.

Although many franchisors think of vulnerability mainly in terms of their POS systems, much more is at issue, as the following realities illustrate:

- Hardware setup vulnerabilities can easily go undetected. For example, where franchise locations handle both back-of-the-house transaction data and provide front-of-the-house Internet access to customers, the routers for these two functions should be on separate networks, but often are not.
- Franchisees must know about inappropriate means of taking payment or personal data from customers, but often do not.
- When personnel use mobile devices to remotely access their office computers, such devices should use encrypted software to transmit data, but often do not, giving hackers a way in.
- Data from the franchise system should be backed up regularly to mitigate loss, but often is not.
- Franchisors should run the data from and to vendors through a malware screen, but often do not.

Furthermore, certain industries where franchising is common, such as quick-service restaurants, have high employee turnover. This inherently increases the threat of data breaches. Disgruntled former employees may have passwords and knowledge of security practices, making a company vulnerable to theft or sabotage (hence the importance of frequent password-changing policies). As people leave, new training should be provided to newcomers on data-security practices, but is often overlooked.

A final vulnerability common to franchisors is that many guard trade secrets or know-how (such as a secret recipe) crucial to their brand. These materials are often stored and disseminated to franchisees via online intranets. For franchisors, the threat of electronic breach of such secrets is an especially worrisome danger of cyber crime.

Cyber-Security Provisions in Franchise Documentation

Franchisors should require their franchisees, where appropriate, to obtain cyber insurance coverage. Franchise agreements often have long terms (e.g., 10, 15, or 20 years); therefore, existing franchise agreements signed a number of years ago (and which may extend far into the future) probably do not address cyber insurance. However, many franchise agreements contain provisions permitting the franchisor to modify insurance requirements over time based on changes in the industry, the marketplace, or relevant risks. Therefore, in many cases adding a requirement of cyber insurance is not a foreclosed option.

Beyond requiring insurance, the franchisor should demand that the franchisee provide a Certificate of Insurance from the insurer, naming the franchisor as an additional insured. Typically a minimal burden on the franchisee, it often is overlooked by franchisors.

Furthermore, franchisors should require their franchisees, where appropriate, to comply with a data policy set by the franchisor. Franchisees often look to the franchisor for guidance on a data policy. The content of a data policy depends on the industry, but the elements are common:

what data should not be collected; what anti-virus programs must be installed and how frequently they must be updated; what e-mails should not be opened; under what conditions data may be transferred; how data may not be used; and a requirement that franchisees promptly report suspected data breaches to the franchisor.

Finally, franchisors may require that their franchisees participate in third-party or industry-sanctioned training programs and certify completion of the training and implementation of specified data safeguards. Here, as with certain other areas of franchisee operations, there is a balance the franchisor must strike: provide the franchisee with advice, guidance, and assistance (and even requirements where needed to protect the brand), but do not become too involved in franchisee operations to the point of risking vicarious liability claims against the franchisor.

Cyber Risks Overlooked by Franchisors

Much of cyber crime is committed by highly organized criminals based overseas. They aim to obtain sensitive information like user names and passwords to access company bank accounts online. With this access, they engage in unauthorized banking transactions and steal directly from corporate accounts.

A common way that cybercriminals steal information is through e-mail “phishing” and “spear phishing” scams: getting someone inside the company’s network to open an e-mail or the attachment to it, which implants malware in the target company’s computer systems. Both franchisors and their franchisees must ensure that the anti-virus and spyware software on their systems, and the operating systems themselves, are updated with the current version at all times. Companies whose employees have Internet access through company computers should educate their employees about e-mail scams, including recognizing phishing e-mails and always deleting such e-mails.

Given the breadth and hidden dangers of the Internet, however, addressing e-mail is not enough. Employees should exercise

caution with online social media. Criminals use social media to trick users into downloading malware or sharing account information. However, when it comes to employee use of personal social media accounts on company computers, there is only so much that companies can control. An increasing number of states (21 as of May 2015) ban employers, with some exceptions, from requiring an employee to provide his or her social media account username or password. Therefore, the key is communicating a clear policy, defining what social media use in the workplace is not permitted, and encouraging the use of robust privacy settings as opposed to the minimum that such websites might allow.

Franchisor Strategy for Cyber-Security Hardening

An outline for cyber-security preparedness:

1. Dedicate specific human resources to data-security and privacy compliance.
2. Conduct a risk assessment/audit. Map the data of the franchise system, asking: What information is stored? Who has access? Is it essential? If essential, is it encrypted properly? If not essential, should it continue to be stored? Companies should dispose of needless data if it is a reasonable business decision.
3. Involve legal counsel in determining what laws and contractual requirements apply to the franchised system and the data discovered through the mapping exercise.
4. Have legal counsel review the data security and privacy policies of the franchise system, create them where needed, or modify them to comply with applicable laws. Ensure consistency of internal policies and policies shared with the public.
5. Select appropriate cyber insurance policies for the franchisor and require franchisees to obtain appropriate insurance. Legal counsel or risk managers experienced with franchising, cyber security, and insurance play a vital role here.

6. Concurrently, review and update commercial contracts with third parties (for example, POS vendors) to ensure consistent and proper protection in light of the types of data involved. As a telling example, note that the massive customer data breach at retail chain Target was reportedly the result of a vendor’s lax protection of its password credentials, which allowed unauthorized access to the Target POS system. Contracts should include appropriate representations and indemnifications by such counterparties. Contracts might also address who pays for breach notification costs and forensic work and may mandate cooperation with law enforcement/regulatory investigations stemming from a breach.
7. Examine the franchise disclosure document, franchise agreement, operations manual, and other system documentation for proper protections and policies. For example, network security guidelines should be in place, such as requiring franchisees to maintain firewall logs for a certain period of time to provide a forensic audit trail when needed.
8. Adopt a cyber-security incident response plan.

Although the cost of the foregoing may worry franchisors, these types of prevention costs are dwarfed by the recovery costs of a major data breach. Cyber consultants can streamline the process, find key weaknesses, think like hackers, and use those tools to get in. They play an invaluable role in saving costs while designing a better security program.

Aside from the outline above, franchisors should enlist their franchisees, vendors, and other stakeholders in the franchise system in security practices. Franchisors should consider regular training for all stakeholders and their respective employees and vendors about the data security policies of the franchisor. The rationale for such training is protection of the franchisor brand. The banks a franchisor uses are also stakeholders. Working with them, franchisors can implement treasury-management products

and services to reduce their cyber risk. For instance, ACH Positive Pay (where companies set filters to control how much money can be paid electronically to any one vendor) prevents check and electronic fraud by alerting the franchisor and/or franchisees to potentially fraudulent transactions before they hit company accounts.

There are many simple choices that improve security. Using business credit cards reduces the instances where bank account information is shared with outside parties. Requiring two or more individuals to originate or approve significant electronic fund transfers reduces the risk of fraud. Conducting financial transactions on dedicated

computers and not on computers used for web browsing or e-mail reduces the chance of malware or other cyber vulnerabilities.

Finally, franchisors should stay abreast of developments in cyber-security technologies. Examples include point-to-point encryption, block-chain software, and tokenization (substituting a piece of information with a unique symbol or symbols (known as tokens) to disguise the information). Although some technologies are not yet mature and packaged for commercial implementation, it is worth following their development to stay ahead of the curve and hopefully protect one's brand better than the competition.

Useful resources where franchisors can learn more about cyber security are below:

- staysafeonline.org ([educational site of the National Cyber Security Alliance](#))
- pcisecuritystandards.org ([PCI DSS standards](#))
- verizonenterprise.com/DBIR ([Verizon's data breach investigations reports](#))

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BUSINESS LAW TODAY

Keeping Current:

SEC Enforcement Heightens Concern over Broker-Dealer Registration for Private Equity Firms

By [Michael C. Keats](#), [Lior J. Ohayon](#), [Michael Benz](#), and [Joel T. Dodge](#)

The Securities and Exchange Commission (SEC) recently announced it had settled charges for alleged unregistered brokerage activity and other alleged securities law violations with private equity fund advisory firm Blackstreet Capital Management (BCM). The enforcement action, in which a general partner was found to have improperly acted as an unregistered broker-dealer after earning a success fee on portfolio transactions that BCM brokered in-house, signals the SEC's increasing scrutiny of sponsors and managers engaging in similar activities.

Background on Broker-Dealer Registration in Private Equity Transactions

Private equity firms often assume that success fees charged on portfolio company transactions are safe from the broker-dealer registration obligations of Section 15 of the Securities Exchange Act of 1934, which require any person engaged in the business of effecting securities transactions for the account of others to register with the SEC and join a self-regulatory organization.

Sponsor confidence in this assumption was first called into question when, on April 5, 2013, David Blass, then chief counsel in the SEC's Division of Trading and Markets, raised the specter of registration in a [speech before the American Bar Association](#). Mr. Blass, speaking only for

himself and not on behalf of the SEC, told the assembled audience that broker-dealer registration requirements broadly extended to whenever "the private fund adviser, its personnel, or its affiliates receive transaction-based compensation for purported investment banking or other broker activities relating to one or more of the fund's portfolio companies."

To Mr. Blass, it was "crystal clear" that "at least for potential broker-dealer status questions, the fund and the general partner are distinct entities with distinct interests," and that a mere "salesman's stake" in any sale of a security by an entity other than its issuer was sufficient to require registration. In a subsequent informal exchange on September 26, 2013, Mr. Blass further stated that the SEC, except in the foreign broker-dealer context, had never used "sophistication of the purchaser" as a factor in determining if an entity's activity would require it to register as a broker-dealer. (The structure of private equity transactions, in which sophisticated investors are plainly aware of the close relationship of a fund to its sponsor or manager, was sometimes perceived to obviate the regulatory concern that underlies the broker-dealer registration requirement—that unsophisticated investors would be unaware of the potential conflicts of interest between the issuer of a security and the entity effecting the sale of that security.)

Uncertainty ensued, which eased somewhat when the [SEC issued a no-action letter](#) on January 31, 2014, (the M&A Broker No-Action Letter) that allowed brokers to engage without registration in certain activities related to the purchase or sale of privately held companies, including the receipt of transaction-based compensation, considered the "hallmark" of broker-dealer activity by the SEC. The letter itself, however, conditioned the exemption on a lengthy list of factors and was ineffectual unless also adopted by applicable state law regulators. In many ways, the relief experienced by the private equity community from the M&A Broker No-Action Letter arose not so much from actual guidance but from the appearance that the SEC had pulled away from the narrower, more aggressive enforcement posture articulated by Mr. Blass the preceding year.

SEC Enforcement Action against Blackstreet Capital Management

After a couple of years of relative stalemate, this interpretative tug of war resumed anew in mid-June with a sudden and forceful pull from the SEC, as it formally settled an enforcement action against BCM. *In the Matter of Blackstreet Capital Management, LLC, et al.*, No. 3-17267 (June 1, 2016), available at <https://www.sec.gov/litigation/admin/2016/34-77959.pdf>.

BCM is a Maryland-based private equity fund advisory firm owned by Murry N. Gunty. BCM, a registered private equity fund adviser that was neither registered as, nor affiliated with, a broker-dealer, provided investment advisory services to two private equity funds that invested in undervalued portfolio companies, for which BCM received a management fee. (According to SEC order, BCM neither admitted nor denied the SEC's findings as determined in the settlement.)

According to the SEC, BCM provided brokerage services to, and received deal fees from, portfolio companies of the funds in connection with buying and selling portfolio companies or their assets (some of which involved the purchase or sale of securities). (The SEC noted that, as part of BCM's investment strategy for acquisition transactions, BCM would first form an acquisition vehicle, which BCM referred to as a portfolio company, and then the acquisition vehicle would purchase a controlling interest in the actual operating company.) Rather than engaging investment banks or broker-dealers to provide those brokerage services, BCM allegedly performed them in-house, including soliciting deals, identifying buyers or sellers, negotiating and structuring transactions, arranging financing, and executing the transactions. The SEC alleged that BCM received at least \$1,877,000 in transaction-based compensation for providing these brokerage services.

Though the SEC order concluded only that BCM violated Section 15 of the Exchange Act by acting as an unregistered broker-dealer in this regard, the [SEC's press release](#) opined further that "[t]he rules are clear: before a firm provides brokerage services and receives compensation in return, it must be properly registered within the regulatory framework that protects investors and informs our markets . . . Blackstreet clearly acted as a broker without fulfilling its registration obligations."

The SEC order concluded by requiring BCM to pay more than \$3 million in total fines, including disgorgement and interest

penalties. The SEC also determined that BCM committed, among others, the following alleged securities law violations: (1) BCM charged its portfolio companies certain operating oversight fees that were not expressly authorized by the fund's governing documents, which fees were not disclosed to the fund's limited partners until after BCM received them; and (2) BCM used fund assets to make political and charitable contributions and to pay for entertainment expenses, neither of which purposes were expressly authorized by the funds' governing documents. BCM allegedly further failed to adequately keep records of whether entertainment expenses were for business or personal use.

Implications

This recent SEC action suggests that sponsor concerns over Mr. Blass's speech in 2013 were well founded. One immediate implication is that a sponsor or manager who performs in-house brokerage services for its portfolio companies may not receive transaction-based compensation unless it is registered as, or affiliated with, a broker-dealer.

Another implication appears to be that protections afforded by the M&A Broker No-Action Letter are indeed limited. Additional SEC guidance will be required, however, to determine how robust such inferences will ultimately prove. For example, to qualify for the M&A broker exemption under the M&A Broker No-Action Letter, the broker may not do, among other actions, any of the following:

1. Have the power to bind any party to the transaction.
2. Directly, or indirectly through affiliates, provide financing for the transaction.
3. Handle funds or securities issued or exchanged in the transaction.
4. Arrange a group of buyers (unless the group was formed without the broker's effort).
5. Facilitate a purchase or sale for less than 25 percent of voting securities.
6. Facilitate a transaction resulting in the transfer of interests to a passive buyer.

7. Facilitate a transaction where any party is a shell company.
8. Fail to be in compliance with bad boy provisions.

Because the SEC order did not mention the M&A Broker No-Action Letter in its ruling, it is not yet known whether the SEC considered the M&A broker exemption relevant at all. Even if it did, it is unclear whether BCM's alleged structuring of brokered transactions failed to meet one or more of the factors listed above, and if so, whether any of the factors weighed more heavily in the SEC's analysis. Consequently, additional SEC guidance will be required to determine what structuring considerations might be advantageous for unregistered sponsors or managers who would like to receive success fees for brokerage activity performed in-house on behalf of their portfolio companies. It should be noted that Mr. Blass stated that to the extent an advisory fee is wholly reduced or offset by the amount of the deal fee, such fee could be viewed as another way to pay the advisory fee, which would not raise broker-dealer registration concerns.

Conclusion

Unless and until the SEC issues further favorable guidance on this issue, sponsors or managers who expect to receive a deal fee for portfolio transactions (and do not qualify for relief under the M&A Broker No-Action Letter) should consider registering as a broker-dealer or else engage or affiliate with a registered third party broker-dealer to effect the securities transactions of their portfolio companies on their behalf.

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BUSINESS LAW TODAY

Delaware Insider:

In re Appraisal of Dell Inc.: The Continuing Relevance of Deal Price in Delaware Appraisal Proceedings

By [Timothy R. Dudderar](#) and [Rebecca E. Salko](#)

In a recent opinion, *In re Appraisal of Dell Inc.*, the Delaware Court of Chancery awarded the appraisal petitioners fair value for their shares well in excess of the price paid to the other public stockholders of Dell Inc. when it was acquired via a management-led buyout in 2012. Immediately following this decision, some practitioners noted that it broke with several recent appraisal opinions in which the Court of Chancery adopted the merger consideration as the best evidence of fair value and expressed concerns that *Dell* might signal a shift in Delaware appraisal law away from deferring to a negotiated merger price in appraisal cases. A closer review of the decision, however, indicates there is no cause for alarm. While the *Dell* court did not ultimately defer to the merger consideration, the opinion's thorough analysis of the underlying deal process should be read as affirming that Delaware courts will continue to routinely and carefully consider merger price in appraisal proceedings and "often," but not always, find that such price is representative of fair value. At most, *Dell* establishes that MBOs present special issues in the appraisal context and warrant careful consideration by the court when deciding whether the deal price should influence its determination of fair value.

Statutory and Decisional Law Regarding Delaware Appraisal Proceedings

Section 262 of the DGCL provides stockholders who did not vote in favor of a cash out merger a right to have the "fair value" of their shares determined by the Court of Chancery by way of an appraisal proceeding. In determining fair value, the court must consider "all relevant factors" and exclude "any element of value arising from the accomplishment or expectation of the merger. . . ." Fair value in the appraisal context has been interpreted by the Delaware Supreme Court as "the value of the company to the stockholder as a going concern." In practice, the appraisal statute gives the Court of Chancery broad discretion in determining the fair value of the shares at issue and the court may choose to accept a valuation submitted by either party or make its own independent determination of fair value.

For the past two decades, Delaware courts have considered, to varying degrees, the deal price as a relevant factor and in a number of cases have found it to be the best indicator of a company's going concern value. In *Union Illinois 1995 Investment Limited Partnership v. Union Financial*, decided in 2003, then-Vice Chancellor Strine gave 100 percent weight to the price resulting

from an auction of Union Financial Group (UFG). In finding that the merger consideration was the best indication of fair value, then-Vice Chancellor Strine noted that UFG "was marketed in an effective manner, with an active auction following the provision of full information to an array of logical bidders." Relying on the merger consideration as the sole evidence of fair value was appropriate, according to the court, because the merger resulted from an effective process with third-party bidders, as opposed to a squeeze-out merger, and the process had no material flaws. The court gave no weight to the expert-generated discounted cash flow (DCF) analyses, finding that method inferior to the value resulting from the sale process undertaken by UFG. Accordingly, the court found fair value to be the merger price less the value of merger-related synergies.

Between 2003 and 2010, the issue of merger consideration influencing the Court of Chancery's determination of fair value was addressed in a handful of appraisal cases. In *Highfields Capital Ltd. v. AXA Financial Inc.*, for example, the court gave significant weight to the merger price because it found that the merger, consistent with *Union Illinois*, "resulted from an arm's length bargaining process where no structural impediments existed that might prevent a topping

bid.” On the other hand, in *Global GT LP v. Golden Telecom, Inc.*, the court rejected the argument that the merger price was a reliable indicator of fair value because the special committee formed by the target’s board had not engaged in any efforts to sell the company, but had instead “concentrated solely on getting as good a deal as it could” from the acquirer. The court therefore accorded no weight to the merger process and instead relied upon a DCF analysis to determine fair value. On appeal, the Delaware Supreme Court affirmed. In its affirming opinion, the Supreme Court declined to adopt a presumption that merger price is indicative of fair value in appraisal proceedings, reasoning that “requiring the Court of Chancery to defer . . . to the merger consideration would contravene the unambiguous language of the statute”—which requires the court to consider “all relevant factors”—and would “inappropriately shift the responsibility to determine ‘fair value’ from the court to private parties.” Some post-*Golden Telecom* opinions, such as *Merion Capital v. 3M Cogent*, appeared to read *Golden Telecom* as diminishing the relevance of the negotiated merger price to the determination of fair value in the appraisal context.

More recently, however, the Court of Chancery issued a string of opinions in which it substantially, if not entirely, relied upon the merger price in determining fair value. The first of these opinions, *Huff Fund Investment P’Ship v. CKx, Inc.*, described the court’s task, post-*Golden Telecom*, as deciding which recognized method of valuation provides the most reliable evidence of fair value. Those methods, according to the *Huff* court, are the DCF method, a comparable companies analysis, a comparable transactions analysis and the merger price itself “so long as the process leading to the transaction is a reliable indicator of value and merger-specific value is excluded.” The *Huff* court ultimately determined that, in that case, the DCF and comparable companies and transactions analyses could not be relied upon as accurate indicators of fair value of the acquired company and that the merger price was the best, and indeed only, accurate evidence of fair value. Subsequently, in

Merlin Partners LP v. Autoinfo, Inc., *Longpath Capital, LLC v. Ramtron Int’l Corp* and *Merion Capital LP v. BMC Software, Inc.*, the court relied primarily on the merger consideration to determine fair value after finding that other methods employed by the parties’ experts to value the targets, most prominently the DCF method, were flawed or contained uncertainties. Importantly, in each of these cases, the Court also found no reason for concern in relying upon the merger price given the evidence regarding the effectiveness of the processes leading to the transactions at issue. In yet another case—*In re Appraisal of Ancestry.com*—the court gave great weight to the merger consideration, even though it found the DCF method reliable, based upon its view that the sale process was “reasonable, wide-ranging and produced a motivated buyer.” The *Ancestry* court also relied upon its earlier dismissal of a complaint challenging the transaction as a breach of the target board’s fiduciary duties but noted that “a conclusion that a sale was conducted by directors who complied with their fiduciary duties is not dispositive of the question of whether that sale generated fair value.”

The Dell Decision

As noted above, in *Dell*, the court declined to rely upon the merger price of \$13.75 per share as an indicator of fair value, relying instead upon a DCF analysis that indicated fair value was \$17.62 per share, a 28 percent difference. The fact that the transaction was a management buyout, led by Michael Dell the founder and longtime CEO of the company, featured prominently in the court’s consideration of the deal price as evidence of fair value. Citing the “vast amount of case law and scholarship” addressing MBOs, the court opined that “a claim that the bargained-for price in an MBO represents fair value should be evaluated with greater thoroughness and care than, at the other end of the spectrum, a transaction with a strategic buyer in which management will not be retained.” With that framework in mind, the court thoroughly analyzed the process, finding the following aspects of both the pre- and post-

signing phases undercut the reliability of the deal price as an indicator of fair value: (1) the heavy influence of the LBO pricing model on the bidding process; (2) lack of meaningful competition among prospective bidders; and (3) evidence of a significant gap between the company’s intrinsic value and the market’s perception of the company’s value.

The LBO pricing model is employed by financial sponsors to “determine whether and how much to bid” when proposing a leveraged buyout, like an MBO, and “solves for the range of prices that a financial sponsor can pay while still” achieving its target internal rate of return (IRR). According to the court, the range of prices resulting from an LBO model can differ significantly from fair value because of both the financial sponsor’s need to achieve significant IRRs and “limits on the amount of leverage that the company can support and the sponsor can use to finance the deal.” During the pre-signing phase, the committee handling the merger negotiations on behalf of Dell’s board engaged with only financial sponsors, meaning that the “price negotiations during the pre-signing phase were driven by the financial sponsors’ willingness to pay based on their LBO pricing models rather than the fair value of the Company.” Indeed, the committee’s financial advisors advised the committee that the financial sponsors involved in the process would determine their offering prices based upon their LBO models and that a going concern (DCF) analysis using the same inputs indicated a higher range of prices for the company. Accordingly, the court found that because the merger consideration resulting from the pre-signing phase of the process was “dictated by what a financial sponsor could pay and still generate outsized returns,” it necessarily “undervalued the Company as a going concern.”

The *Dell* court also found a lack of meaningful competition among bidders during the pre-signing phase of the transaction. As noted above, the committee engaged with only financial sponsors during the pre-signing phase of the process and did not contact any strategic bidders. Involving strategic bidders

would have not only meant additional parties submitting bids, but would also have introduced into the process an alternative form of transaction to the LBOs proposed by the financial bidders. The lack of such competition, according to the court, deprived the committee of a more meaningful bidding process, the “most powerful tool” a committee has to extract value from a potential acquirer. The court found the lack of pre-signing competition especially problematic here because post-signing market checks “rarely produce topping bids” in the MBO context, due in part to the reluctance among larger private equity sponsors to interfere with each other’s signed deals. Given the “critical” nature of the price established in the pre-signing phase of MBO transactions, the limited competition during this phase of the Dell process further undermined the reliability of the deal price as evidence of fair value.

Finally, the court found that the price generated by the pre-signing phase was negatively impacted by a “valuation gap between the market’s perception and the Company’s operative reality.” Over a period of several years, the company had spent approximately \$14 billion to acquire several businesses that Michael Dell believed would complete the company’s transformation from primarily a producer of personal computers to a provider of software and services to enterprise customers. But because, as of the pre-signing phase, this transformation had yet to bear fruit in the form of operating results, these expected results were not reflected in Dell’s market price. The court found ample evidence of such a gap, including that the committee’s advisors determined the standalone value of the company was well above Dell’s trading price. Relying on precedent, the court

noted that appraisal proceedings can and should address opportunistic timing and found that the evidence of the valuation gap was so compelling in this case that it further served to weaken the case for accepting the merger consideration as evidence of fair value.

The court also found flaws in the post-signing phase of the transaction that undercut the reliability of the merger consideration as fair value. The deal reached with the management group provided for a 45-day go-shop. Despite the go-shop having attracted two higher bids and caused a \$0.10 per share increase in the merger consideration, the *Dell* court found structural issues with the go-shop such that it could not remedy the pre-signing deficiencies. According to the court, the emergence of two additional bids, which it acknowledged are rare in the context of MBO go-shops, indicated the original merger consideration undervalued the company, even using LBO metrics. The court also found that although the go-shop may have been adequate in the abstract, the size and complexity of the company itself made the diligence necessary to submit a topping bid foreboding. The court found that the magnitude of such a task likely had a chilling effect on potential bidders. The court expressed further concerns about the value-reducing impact of a “winner’s curse;” that is, the perception that a bid above the price management had agreed to pay meant that the bidder was paying more than management, with its superior knowledge, thinks the company is worth. In addition, the court noted that any potential buyer faced a unique problem in potentially purchasing Dell without Mr. Dell’s full participation post-acquisition. The court indicated that it, and likely other potential bidders at the time, believed that if Mr. Dell left the company after a sale,

the company would lose significant value, as it had in the past when Mr. Dell temporarily left the company. Mr. Dell’s unique role was considered another impediment to potential bidders during the go-shop period.

In light of these findings regarding the pre- and post-signing process, the court declined to give any weight to the merger consideration in determining the fair value of Dell. The court instead found that a DCF analysis, based on projections the court found reliable, was the best indicator of fair value.

Conclusion

Dell does not appear to signal a shift in Delaware appraisal jurisprudence. As the *Dell* court recognized, Delaware courts are required to consider the deal price as one of the relevant factors in determining fair value, and, importantly, will “often” find the merger consideration is the best evidence of fair value, particularly where the merger consideration results from a robust sale process in which the board negotiates with potential bidders at arm’s length. *Dell* does, however, indicate that MBO transactions will be subject to more rigorous scrutiny in the context of appraisal proceedings and, given certain inherent realities, may be less likely to be found to have produced a price equal to fair value. Even so, *Dell* does not foreclose a finding that the deal price in an MBO transaction equals fair value.

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BUSINESS LAW TODAY

Member Spotlight:

An Interview with Kenneth J. Bialkin



Kenneth Bialkin is synonymous with leadership in American business, law, and the Jewish community.

Of counsel at Skadden Arps, Slate, Meagher & Flom, Bialkin has spent a lifetime

building a thriving corporate and securities law practice, and, at the same time, serving as chairman to some of the top Jewish organizations. From 1982–1986, he was the national chair to the Anti-Defamation League; from 1984–1986, he served as chair of the Conference of Presidents of Major American Jewish Organizations; from 1989–1992, he was president of the Jewish Community Relations Council of New York, and from 1996 to the present, Bialkin is chair of the America-Israel Friendship League.

Not only has he served the Jewish world, he's been just as active in the legal world. He's served on numerous committees at the ABA and advisory committees of the Securities and Exchange Commission, the New York Stock Exchange, and the American Stock Exchange.

In his legal career, he has been involved in some of the largest insurance company mergers and acquisitions in the United States. In 1995, he represented Metropolitan Life Insurance Company in its merger with New England Mutual Life Insurance Company. He also represented Travelers Group in its \$4 billion acquisition of Aetna's property-casualty operations and

in financing transactions related to the acquisition.

* * *

For most of your life you've been involved in supporting and advocating for the Jewish population. Can you talk about how you first got involved with this project?

I grew up in New York City, during World War II. I was too young to serve, but I became vaguely aware of anti-Semitism, and then learned about the Holocaust and the way Jews were treated in Nazi Germany and elsewhere. When the state of Israel was formed in 1948, I was 20 years old. In 1959 my wife and I went as tourists to Israel. We didn't know anybody, but we met a lot of people. The whole population of the country was less than a million at the time, and in many ways it was a primitive society and a very poor one. That touched me, realizing that so many of the people there were refugees from the Holocaust and World War II.

When I returned, I began to read more about Jewish history. I saw that the people of Israel were fighting my fight. What is my fight? Anti-Semitism. The less than one million people who were in Israel were really the first line of survival of the Jewish people. I came to learn that I am a member of the Jewish people and that I can see myself voluntarily as being in the line of David, Abraham, Jesus. That's a very nice line to be a part of. And so I view Jews of today as the survivors of the periods of history, in which they weren't always so welcome.

How did you first become involved with the Anti-Defamation League? Then become its chair?

In New York, I met Nathan Perlmutter, who was a lawyer, a former heroic marine, and head of the Anti-Defamation League of B'nai B'rith, which is now called the Anti-Defamation League or ADL. He enlisted me as a lay person to be a member of the ADL. The ADL is a political action group, designed to stop the defamation of the Jewish people and secure the benefits of American identity for everyone. I went up the ladder, so to speak, becoming involved in their activities, until the day I became the national chairman.

How did you become first become involved with the America-Israel Friendship League?

The American-Israel Friendship League was originated by U.S. Congressman Herbert Tenzer from New York. He was very popular congressional representative. He became chairman of the Federal Regulation Securities committee, of which I was a member. That's how we first met. He introduced me to the AIF, and, like the ADL, I worked my way up the ladder.

What is your vision for a Jerusalem today and how are you working to achieve that vision?

Jerusalem is the heart and soul of the Jewish people. It is also a holy place for Muslims because it's from Jerusalem that Muhammad escalated to the heavens. It's a

holy place for the Palestinians, even though we could talk a long time about who are the real Palestinians. They are not actually a people, but they call themselves Palestinians. They exist and you can't pretend they don't. Any group of people who exist and organize is entitled to put their cause forward and compete in the public marketplace of ideas and seek support.

There are the different claims of historical and religious claims to Jerusalem, all of which have the right to be heard, and all of which have the right to advocate for their desired sovereignty and leadership. That has to be worked out. The state of Israel has as its capital Jerusalem. The Jews will never leave it, they will never abandon it, but they have made it clear that they will negotiate with other people, namely the Palestinians, who say they have similar claims.

All the people who live there have to find a way of living together, of hearing each other's arguments and resolving them in a peaceful manner. That's what I advocate. Now what am I going to predict about Jerusalem? I predict there is no way of getting Israel out of it, and there's probably no way of getting the Muslims out of it. So they had better get together and find a way of separating, the way people in America, who have different backgrounds and different religions, separate and yet live and share principles which are holy to all of us. I don't want to sound like a naive preacher, but that's the reality of where it is.

How did you first become involved with the ABA?

I met Sam Harris, who had been a partner of the Fried Frank firm. He was chairman of the Corporation Business and Banking Law Section, which was the name prior to it being called the Business Law Section. Back then, the section was 15 or 20 people. It grew because the economy grew, the banking world grew, the investment bankers expanded.

I moved from one leadership position to another in the ABA. At one point, I became chairman of a subcommittee, then I became chairman of the Committee on Federal Regulation of Securities, a section of

the Business Law, then I became chairman of the Section of Corporation Banking in Business Law. Finally, chair of the Section of Business Law. I guess you could call me an ABA junkie.

How did you choose to focus your practice on corporate and security matters?

When I started college at the University of Michigan, I registered as a major in physics in 1947, but when I started, there were no physics courses available. So I took general courses. I went to Harvard Law School and became a young lawyer at the Willkie Farr firm. When I came to work the first day, one of the managing partners said to me, "What I want you to do is go read the New York and Delaware Corporation statute laws, read the laws of the states, follow the laws of securities law, because we're going to be assigning you to that kind of work." Being an obedient person I did that. I tried to make myself knowledgeable of the corporate world. I joined the New York City bar, I joined the New York County Lawyers, I joined the ABA.

The president of the New York County Lawyers Association was a partner at Willkie Farr named Mark Hughes who said to me, "Look, you're active in the securities law now, why don't you organize a Securities Law Committee with the New York County Lawyers Association?" So I did. I was also a member of the ABA Committee on Securities Law. I became active in the field of mutual funds and investment companies, so I became an expert on investment companies. My first ABA job was to be chairman of the Investment Company Committee of the Corporation of Business Law Section.

Did you get practical experience early on in your career that suggested you'd be good at it?

One day a senior partner sent me to Ohio where there was a company called Alside, which was going to go public. My firm represented the underwriter at that public offering. I was a very green lawyer. I met the owners of the company and we had a

very successful underwriting, after which the company asked me to be a member of the board of directors of Alside, which I agreed to.

I was then assigned to another hot company called Leasco, one of the first computer leasing companies. Leasco became Leasco Data Processing and then they took over Reliance Insurance and I happened to be the lawyer for all of their takeovers.

I also got into SEC work. At that time, the bar associations generally didn't accept government lawyers to the substantive bar committees. In the Securities Law Committee, which I came to chair, we didn't have anybody who was working for the SEC. Then a remarkable idea came to my predecessor: why don't we admit SEC lawyers to our ABA committee? There were pros and cons, because you invite the regulator into your home, it's like letting the fox into the chicken house. But we overcame that and we decided that our section and our committee would accept members who worked for the SEC. It was a very good move, because it permitted many, many lawyers to develop personal relations with the regulator.

Given your many years of practice, what advice would you give to a new lawyer about how to build a book of business?

The most important thing is to work hard at your job, become expert in the body of law and practice, and learn about the businesses that your clients are engaged in. Too many lawyers don't do that. They think that simply being a lawyer without having to understand the business, the market problems, the economic problems, and the political problems that your clients deal with. You have to be more than an SEC expert.

I wrote an essay once, for a book put out by the PLI on securities underwriting. In this essay, I advised young lawyers to open a brokerage account and hire and broker and learn how to buy and sell securities for your own account. If you want to trade, you have to learn about trading, if you want to short sales, you have to learn about short sales. If you want to speculate, you can buy puts or calls or strips and stripes or in different securities devices.

I would advise young lawyers to gain experience on their own, to invest small amounts of money. Never, never, never borrow any money, unless you know you won't miss a margin call. But that's not what I would advise for a young lawyer.

Is there anything else you'd like to add?

I grew up a very privileged person. I received a New York City public school education in the Bronx which got me through college and it got me through law school. Along the way, I realized there are two

kinds of people in this world; those who when they are asked something, they always say no or find a reason why what they heard was wrong or they disagree with it. And there are other people who have a more open mind, who try to find a way to agree with people, maybe skeptically, who talk to you. Looking back on it, I always wanted to learn as much as I could from as many people as I thought could teach me something. I wanted to have friends and to have a friend you have to be a friend. I tried along the way to like people, which I do.

I believe when you translate that into the practice of law, my advice has always been if you can't find a way of liking your client don't be his lawyer. You don't have to be a love mate of your client. But if you can't have a cordial, friendly, positive relationship with your client—I can't prove this statically—your success ratio will not thrive, and you shouldn't represent that client.

Thank you for much for your time!

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