Feature Articles

  Lawyers working in the commercial law field are familiar with choice-of-law rules for transactions in intermediated securities provided by Articles 8 and 9 of the UCC. Those rules have now been augmented and partially preempted by the Hague Securities Convention. The Convention, ratified by the United States in December 2016, became effective as a matter of U.S. federal law on April 1, 2017. Fortunately, the Convention’s choice-of-law rules lead in most instances to the same results as under Articles 8 and 9. There are some differences, however, and the Convention applies even to existing transactions.

- **Exploring the Legal Issues Relevant to Online Small-Business Lending**
  This article explores some of the key legal issues that are unique to small-business lending, including determining the purpose of the loan, whether certain consumer laws may apply, licensing and usury issues, electronic contracting issues, and Dodd-Frank Act considerations.

- **Navigating the Hazy Status of Marijuana Banking**
  Cannabis is currently illegal under federal law and, therefore, state-legal cannabis businesses have no access to financial services. While FinCEN guidelines from 2014 have alleviated some of the banking access epidemic, multiple issues still exist for state-legal cannabis businesses seeking traditional financial services.

- **A Practical Approach to Defending Fair Credit Reporting Act Class Actions in Federal Court**
  Over the past decade, civil litigation under the FCRA has surged, and putative class actions brought under the FCRA are increasing in frequency. The FCRA has become a favorite vehicle for putative class actions and often threatens outsized liability even when a plaintiff’s chance of success on the merits is slim. However, the technical aspects of the FCRA that make it such an attractive vehicle for class actions also provide a basis for defendants to contend that no class should be certified, using an increasing number of judicially accepted defenses. This article explains some of those defenses, which provide a starting point for any assessment of the prospects of defeating certification in an FCRA class action.
• **Of Spoiled Milk—Warnings That Should and Should Not Have Been Issued: Another Take on the Potential for Management and Controlling Shareholder Liability Related to an Insolvent Company’s WARN Act Violations**
   
   In this follow up to “Director & Officer Liability for WARN Act Claims in Light of Stanziale,” which appeared in the July 2017 issue, the author revisits this Delaware bankruptcy court opinion to offer a different perspective. Werkheiser argues that the Golden Guernsey decision does not portend an expansion of statutory WARN Act liability, but is more properly viewed as an opinion addressing a permutation of a Caremark claim, which is an established fixture of Delaware fiduciary law.

• **IRS Can Audit for Three Years, Six, or Forever: Here’s How to Tell**
   
   It pays to be statute savvy. When it comes to your own taxes, you should sigh in relief if the IRS tries to audit you too late. In this area of the tax law, the rules for corporations, partnerships, nonprofit organizations, and individuals are consistent. Author Robert Wood tells you what you need to know.

Departments

• **DELAWARE INSIDER: USACafes: A Return**
   
   USACafes was decided by the Delaware Court of Chancery a quarter century ago, but it has never been expressly adopted (or rejected) by the Delaware Supreme Court. This article advocates that returning the law to its pre-USACafes state would bring clarity to the law.

• **MEMBER SPOTLIGHT: An Interview with Anne Gwal**
   
   If there’s a through line in Anne Gwal’s legal career, it’s that she’s spent most of her years in-house. What’s been less constant are the numerous industries in which she has worked: medical devices, home health care, banking, and electric utility and energy. “The one thing that I can say, with respect to all my mergers in the past and in my career, was that I learned to adapt,” says Gwal, assistant general counsel at Exelon, a Fortune 100 electric utility, energy, and generation company based in Chicago and Washington, DC. She will join the Business Law Section’s Council in the fall.

By Carl S. Bjerre, Sandra M. Rocks, and Edwin E. Smith

Lawyers working in the commercial law field are familiar by now with the choice-of-law rules for transactions in intermediated securities provided by Articles 8 and 9 of the Uniform Commercial Code (the UCC). Those rules, appearing principally in certain subsections of UCC §§ 8-110 and 9-305, have functioned well as a matter of U.S. law in international as well as domestic transactions, but they have now been augmented and partially preempted by the Hague Securities Convention (the Convention), more formally known as the Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary.

The Convention was promulgated in 2006 by the Hague Conference on Private International Law. By its terms it became effective upon adoption by three nations, and the United States is the third of those nations—the other two to date being Switzerland and Mauritius. More countries are expected to follow, and as the Convention’s choice-of-law rules become internationally widespread, the transactions to which the Convention applies will be greatly facilitated.

The Convention applies only to transactions in intermediated securities, which U.S. lawyers often call the “indirect holding system.” In such transactions, the securities’ registered owner is typically a clearing corporation (e.g., a federal reserve bank, the Depository Trust Company, Clearstream, or Euroclear); the clearing corporation maintains accounts reflecting that the securities are held for the benefit of a bank, broker, or other securities intermediary (referred to in this article as an “intermediary”). When a customer says that he, she, or it owns securities against the intermediary, and the intermediary has a right to the securities against the clearing corporation. In the United States, the substantive commercial law rules governing these relationships are set forth in Part 5 of UCC Article 8. Naturally, other nations’ substantive rules can and do differ substantially.

The Convention determines the applicable law for a broad range of commercial law issues in any transaction or dispute “involving a choice” between the laws of two or more nations. In this globalized era, transactions in intermediated securities frequently present such a “choice” for purposes of the Convention, for example whenever any two of the following elements of the transaction are in different nations: the account holder; an intermediary; any party to an outright or collateral transfer; an adverse claimant; a creditor of either the account holder or an intermediary; the issuer; or the certificates held by the clearing corporation. (U.S. lawyers have generally never ignored elements such as the debtor’s location or the other elements just mentioned, for purposes of planning with respect to the likely jurisdictions of a possible insolvency proceeding, but they have also been accustomed to treating these elements as immaterial to a strictly UCC choice-of-law
The effect of a judgment creditor of the customer (the account agreement), or the strictly bilateral, rather than third-party, effects of attachment of a security interest.

It is important to note the differences between basic terms such as “securities” as used in the Convention and the same terms as used in UCC Article 8. The Convention defines the term “securities” as “any shares, bonds or other financial instruments or financial assets (other than cash) or any interest therein.” This definition is broader in some respects than the UCC Article 8 definition, yet the Convention’s overall reach is narrower than that of the UCC’s indirect holding system. This is because UCC § 8-102(a)(9) permits the intermediary and customer to agree that any property other than securities will also be treated as a “financial asset” to which the indirect holding system will apply. By contrast, the Convention contains no such option for expanding its scope by agreement. (The Convention uses “financial asset” as part of its definition of “security,” but does not define “financial asset.”) Similarly, the UCC’s indirect holding system clearly applies to “cash” (i.e., credit balances), either because credit balances are considered part of the securities account itself, or because the intermediary and customer have agreed to treat the cash as a financial asset, but the Convention expressly excludes cash even if the cash would otherwise have been considered a “financial asset” within the Convention’s usage of that term. Nonetheless, the Convention is designed like the UCC to be flexible and to have fluidly broad coverage that will meet the demands of market practices. An authoritative and in-depth Explanatory Report on the Convention, referring to “exchange traded financial futures and options” and to “credit default swaps” suggests that securities held with an intermediary for purposes of the Convention could encompass some assets that might be considered commodity contracts or otherwise not considered commodity securities or other financial assets under the UCC.

The Importance of Unified Transnational Choice-of-Law Rules: An Example

Suppose that a bank operating in New York acts as an intermediary, and that one of the bank’s custodial customers is a corporation organized under Texas law. The customer wishes to invest in securities of a certain issuer located in Ruritania, so the intermediary acquires those securities through a clearing corporation and credits them to the customer’s account. A German lender extends credit to the customer, is granted a New York law security interest in the customer’s Ruritian securities as collateral, and takes appropriate steps under New York law to perfect the security interest. Later, an Australian unsecured creditor of the customer obtains a judgment against the customer and also obtains a judgment lien on the customer’s interest in the securities.

The substantive outcome of the contest between the German lender and the Australian creditor will often depend on the choice-of-law rules of the forum in which the contest arises. In a New York forum, prior to effectiveness of the Convention—and generally now as well, although some details are discussed below—the German lender has generally prevailed if it has perfected under the substantive law made applicable by New York’s conflicts rules. Under those conflicts rules, if the account agreement designates, say, New York or New Jersey as the “securities intermediary’s jurisdiction” or, absent such a clause, provides that the account agreement is governed by New York or New Jersey law, then the lender may perfect by control under New York or New Jersey law, as the case may be. See NYUCC §§ 9-305(a)(3), 8-110(e). Also under New York’s conflicts rules, the fact that the customer is a Texas corporation means that the lender may perfect by filing a financing statement under the substantive law of Texas. See NYUCC §§ 9-305(c)(1) and 9-307(e). If perfected by either means, the German lender prevails under the applicable state’s version of UCC § 9-317(a)(2)(A).

Very different rules would likely apply if the Australian creditor brings its action in Ruritania. The Ruritian court could very well apply a widespread choice-of-law rule known as lex rei sitae, which points to the substantive law of the asset’s situs—and Ruritian law could very well view securities issued by a Ruritanian issuer as being located in Ruritania. Moreover, under
Ruritanian substantive law, a judgment lien of the Australian creditor could very well take priority over the German lender’s security interest if the German lender had not previously taken steps to perfect under Ruritanian law, rather than New York or Texas law. A similar scenario would arise if the Ruritanian choice-of-law rules viewed the securities as being located in, say, Sylvania, where the clearing corporation were located or where certificates representing the securities were physically held.

This problem can be especially acute under insolvency law. In a Ruritanian insolvency proceeding, the lender’s security interest may not be recognized at all, if the applicable substantive law is that of Ruritania or another jurisdiction in which the lender did not take appropriate perfection steps.

A similar issue could even affect the lender if the customer becomes a debtor under the U.S. Bankruptcy Code. In such a proceeding, the bankruptcy trustee would have the status of a hypothetical creditor with a judgment lien on the customer’s Ruritanian securities, obtained at the time of the commencement of the bankruptcy case. What is the choice-of-law rule that determines the substantive effects of this hypothetical creditor’s judgment lien? The Bankruptcy Code does not expressly provide such a choice-of-law rule, nor does the case law appear to be well-settled. If the substantive effects are determined by Ruritanian law, then the bankruptcy trustee could set aside the lender’s security interest and treat the lender as a general secured creditor, even though the security interest would have been senior to the judgment lien under New York’s substantive law.

The importance of all of the foregoing is multiplied for lenders that extend credit against a portfolio of securities of issuers located, or held through clearing corporations, in numerous countries. Without a clear and widely unified choice-of-law rule in these circumstances, it could easily become cost prohibitive for a lender to investigate and comply with the substantive laws that might apply under the choice-of-law rules of each country in which litigation might be brought. Conversely, the more widely adopted the Convention becomes, the more the parties contemplating a transaction can be confident that its broad set of issues will be resolved under a single body of substantive law, known in advance, irrespective of the forum in which a dispute is likely to arise. The prospect of approaching this goal—in a manner that also harmonizes well with the sound, existing rules of UCC Articles 8 and 9—is what led the American Bar Association, the Association of Global Custodians, the International Swaps and Derivatives Association, EMTA (formerly the Emerging Markets Traders Association), the Securities Industry and Financial Markets Association, and the Uniform Law Commission all to support U.S. ratification of the Convention.

The Convention’s Strong Kinships with UCC Articles 8 and 9

The Convention’s primary rule, set forth in its Article 4(1), provides that the law applicable to all of the choice-of-law issues covered by the Convention is the law chosen by the intermediary and its customer to govern their account agreement generally or, alternatively, to govern the issues covered by the Convention specifically. The only limitation, often referred to as the “Qualifying Office” test and further discussed below, is that this chosen law must be that of a country in which the intermediary, at the time that the parties enter the agreement, has an office that is engaged in the activity of maintaining securities accounts.

Many readers will already see that by giving effect to the account agreement’s governing-law clause, the Convention is directly parallel to UCC § 8-110(e)(2). By the same token, the Convention’s giving effect to an alternative clause, in which the parties designate a body of law different from the one that governs the account agreement as a whole, is directly parallel to UCC § 8-110(e)(1). The agreement between an intermediary and its customer is always at the essence of the customer’s interest in intermediated securities, and this is the reason that the Convention, just like UCC Articles 8 and 9, looks at this agreement in determining the applicable choice of law.

We offer one word of caution, however. UCC § 8-110(e)(1) and (2) refer to “an agreement” between the intermediary and its customer governing the account, whereas the Convention’s definition of account agreement refers to “the agreement” between those parties governing the account. The Explanatory Report makes clear that this agreement may consist of more than one document. However, it is probably advisable to avoid relying on the law designated only in a free-standing control agreement, i.e., one that is not clearly a part of the account agreement per se, unless the control agreement makes clear that it is amending the account agreement.

The Convention also generally disapproves the conflict-of-laws notion of renvoi, in which a forum would have to take account not only of another jurisdiction’s substantive law, but also of the other jurisdiction’s conflicts-of-law rules. Thus, under the Convention Article 10, if the parties have designated, for example, English law, then a U.S. forum would apply English substantive law without regard to England’s own conflicts rules. This treatment of renvoi also parallels UCC Articles 8 and 9, which express the same idea by designating the “local law” of the jurisdiction in question.

Also directly paralleling the UCC, for lenders that seek to perfect a security interest by the filing of a financing statement, the Convention generally does a remarkably good job of accommodating UCC Article 9’s choice-of-law rules for perfection by filing. See Convention Article 12(2)(b), further discussed below.

Applying all of these points to the earlier example of the New York intermediary and its Texas customer owning Ruritanian securities, a New York forum will reach exactly the same results under the Convention as heretofore under the UCC alone (assuming only that the Qualifying Office test is met; see below). If the German lender seeks to perfect its interest by control, and if the account agreement designates New York or New Jersey law as either the account agreement’s own governing law or as the law governing the Convention’s Article 2(1) issues, then control will be available.
under New York or New Jersey law, as the case may be. Alternatively, if the German lender seeks to perfect its interest by filing, then the Convention will take account of New York’s enactment of UCC §§ 9-305(c) (1) and 9-307, which enable perfection by the filing of a financing statement in Texas.

The Convention’s Principal Differences from UCC Articles 8 and 9
There are a few minor instances in which the choice-of-law outcomes under the Convention might differ from those under UCC Articles 8 and 9 alone. The most important of these are described here, but the risk of a different outcome in any of these circumstances is manageable by sound transactional planning. In the case of transactions already in place before the Convention becomes effective, some transitional attention may be required.

Qualifying Office
The Convention’s Qualifying Office test (the thrust of which is articulated above, although further details are set out in Convention Article 4(1), second sentence) has no counterpart in UCC Articles 8 and 9. However, the Qualifying Office test is not expected to have much effect in practice because intermediaries typically provide that their account agreements will be governed by the law of a country in which they have one or more offices satisfying the test. By virtue of Article 12 of the Convention, which addresses so-called Multi-unit States like the United States, the Qualifying Office test is met for a chosen law of a U.S. state, district, or territory so long as the intermediary has an office in any U.S. state, district, or territory. The Qualifying Office test was a product of compromise in the Convention negotiations, worthwhile for the sake of helping to pave the way for eventual ratification by many nations having different legal systems.

Filing and Non-U.S. Law Account Agreements
The Convention’s accommodation of UCC Article 9’s choice-of-law rules for perfection by filing does not cover transactions in which the intermediary and its customer have contractually chosen non-U.S. law under the Convention’s primary rule. Adapting the earlier example, if the New York intermediary and its Texas customer effectively provide that their account agreement is governed by English law (or that English law applies to all of the issues under the Convention), then the Convention will cause the New York forum to look to English law, and not to any rules of UCC Article 9, for all matters of perfection, including whether and how perfection by filing might be available.

Filing and Non-U.S. Debtors
The Convention’s accommodation of UCC Article 9’s choice-of-law rules for perfection by filing also does not cover transactions in which UCC § 9-307 views the debtor to be located in a non-UCC jurisdiction; instead, perfection by filing in those cases will be governed by the law that the intermediary and its customer contractually designate under the Convention’s primary rule. Again adapting the earlier example, suppose that the customer of the New York intermediary is an Ontario, Canada corporation with its chief executive office in Toronto, and that the intermediary and customer effectively provide that their account agreement is governed by New York law. In that case, New York’s own substantive law (notably NYUCC § 9-501(a)(2) regarding filing with the New York Secretary of State) will govern perfection by filing, and not New York’s choice-of-law rules for perfection by filing, which before the Convention would have pointed to a filing under the Ontario Personal Property Security Act. This is because Article 12(2)(b) accommodates UCC Article 9’s choice-of-law rules for perfection by filing only if those rules point to a jurisdiction within the United States.

Number of Issues Covered
The Convention’s package of choice-of-law issues is more comprehensive than the package under the UCC alone. U.S. lawyers have grown accustomed to thinking of perfection, the effect of perfection or nonperfection, and priority as being all generally determined together, but the law designated under the Convention also pulls in other issues: the requirements applicable to remedies (e.g., foreclosure sales or retention of the collateral), the characterization of a transaction (e.g., as an outright sale or secured loan), and even any effects as against the intermediary or third parties of attachment of a security interest.

Certain Transition and Other Practice Tips
Beginning on April 1, the Convention began applying to already-existing transactions, as well as to new transactions going forward, so long as the transaction is one “involving a choice” between two nations’ laws, and here as well regardless of whether a non-U.S. nation involved in the choice has also ratified the Convention. In most instances, no further action is necessary to preserve the attachment, perfection, and priority of a security interest.

Clauses designating a U.S. governing law for the account agreement under UCC § 8-110(e)(2) continue to be effective under Convention Article 4(1), provided that the Qualifying Office test is met. Clauses from a pre-Convention account agreement expressly designating a U.S. “securities intermediary’s jurisdiction” under UCC § 8-110(e)(1) continue to be effective (because in this context selecting the law to govern any of the issues specified in Article 2(1) of the Convention is sufficient), at least if the governing law clause also points to U.S. law, and again provided that the Qualifying Office test is met. In both of these cases, a secured party’s perfection by control under the relevant U.S. substantive law continues to be effective. But in a pre-Convention account agreement with a non-U.S. governing law, it is advisable for U.S. lawyers to obtain advice on the effects of the Convention under that body of non-U.S. law. In certain circumstances, such a review might prompt a reconsideration of the appropriate governing law.

Account agreements for new transactions on and after April 1 should not simply rely on the UCC term “securities intermediary’s jurisdiction.” As noted, the issues governed by the Convention are broader than those...
governed by UCC Articles 8 and 9 alone, and accordingly in this context, such a clause would likely not meet the Convention’s requirement that the clause cover all of the Convention’s issues. Instead of such a clause (and where simply using a governing law clause will not suffice), a two-pronged clause like the following is suggested, especially if the account will include financial assets that are not “securities” as defined in the Convention:

State X [or Nation Y] is the securities intermediary’s jurisdiction for purposes of the Uniform Commercial Code, and the law in force in State X [or Nation Y] is applicable to all issues specified in Article 2(1) of the Hague Securities Convention.

A secured party of course should also confirm that the intermediary has a Qualifying Office in the chosen jurisdiction or, if the chosen jurisdiction is a U.S. state, district, or territory, in any other U.S. state, district, or territory.

Where a secured party is relying on perfection by filing, the limitations discussed above on the Convention’s accommodation of UCC Article 9’s choice-of-law rules for perfection by filing must be borne in mind. As a transition matter in relation to filing, if the account agreement designates a non-U.S. body of law, then it is advisable for U.S. lawyers to obtain advice on perfection and priority under that body of non-U.S. law in order to assess the Convention’s effects. And as another transition matter in relation to filing, if the account agreement designates a U.S. body of law, but perfection has been by filing in a non-U.S. jurisdiction, then it is advisable to employ an alternative method of perfection under U.S. law, e.g., filing in the jurisdiction designated by the account agreement.

Further Resources
This article has necessarily been limited to some of the key issues arising from the Convention. The Hague Conference on Private International Law has made available the text of the Convention and the Explanatory Report referred to above. The Permanent Editorial Board for the Uniform Commercial Code has recently published a Commentary on the Convention, including amendments to the UCC’s relevant Official Comments. The Tri-Bar Opinion Committee is expected to issue a report on related opinion practice to supplement certain prior reports in which choice-of-law rules for the indirect holding system are discussed.

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The United States is home to more than 28 million small businesses. The businesses are diverse and range from sole proprietorships to companies that employ workers, produce goods or services in supply chains, or serve customers on Main Street. During and following the financial crisis, bank loans to small businesses fell 18 percent, exacerbating the credit crunch felt by small businesses. Accordingly, a number of new lenders, many of which leverage advances in technology and the availability of data to operate online, burst on the scene to serve the small-business market.

The new lenders emerged along three basic models. The first model, peer-to-peer marketplace lenders, connects prime and subprime small business borrowers with capital from individuals and institutional investors that are looking for a return on their investment. The second model, borrower-driven broker marketplaces, connects borrowers with traditional and alternative financing sources, from banks and SBA-backed loans to new online lenders. Finally, the third model, balance-sheet lenders, leverages capital provided by institutional investors that they hold on their balance sheet to make loan decisions based on proprietary risk-scoring algorithms that rely largely on cash-flow data.

Regardless of the model used to originate business credit, shared key legal issues emerged. We will explore some of the key legal issues that are unique to small-business lending, which include determining the purpose of the loan, whether certain consumer laws may apply, licensing and usury issues, electronic contracting issues, and Dodd-Frank Act considerations.

What Is a Business Purpose?
Determining what constitutes a “business purpose” for a loan is important because many federal and state laws apply only to loans originated for personal, family, or household purposes (i.e., a consumer purpose). The Truth in Lending Act (TILA) and its implementing regulation, Regulation Z, is the primary federal law regulating consumer credit. The TILA requires creditors to make disclosures to borrowers concerning the cost of the financing extended when the transaction is for a consumer purpose. The regulatory intent behind the TILA is to allow consumers to understand the true cost of the credit/money they are receiving and to facilitate easy comparison of credit terms across creditors.

The TILA and Regulation Z do not apply to extensions of credit primarily for a business, commercial, or agricultural purpose. In choosing to make the TILA disclosures, business lenders incur the risk of regulatory scrutiny in that a regulator may conclude a transaction has a primary consumer purpose. However, voluntary disclosure to a borrower is not without merit. TILA compliance, specifically in the form of fee transparency, can increase borrower confidence in a creditor’s business practices and products. Given the competitive nature of the online lending space, this is a decision worth giving careful consideration.

If the borrower has characteristics of an individual consumer (such as loans to home-based businesses), determining the loan’s primary purpose can be even trickier. The Official Interpretations to Regulation Z provide that “(a) creditor must determine in each case if the transaction is primarily for an exempt purpose. If some question exists as to the primary purpose for a credit extension, the creditor is, of course, free to make the disclosures, and the fact that disclosures are made under such circumstances is not controlling on the question of whether the transaction (is) exempt” from the TILA.

Regulation Z provides additional guidance as to the factors a creditor should consider to determine whether the credit is for a business purpose. For example, the borrower’s statement of the purpose for the loan is a powerful factor that can potentially ward off claims that the transaction is for a consumer purpose. Other factors include the relationship of the borrower’s primary...
occupation to the transaction—the more closely related, the greater the likelihood the transaction is for a business purpose. Outside of the suggestions in the Official Interpretations to Regulation Z, lenders can and should also try to look to other factors that showcase the strength and credibility of the small-business applicant. Business longevity, industry reputation and, if plausible, on-site visits are all valuable tools to analyze loan purpose, particularly for lenders that finance sole proprietorships.

Under the TILA and many state laws, the main risk with respect to the purpose of the loan comes when a lender makes a loan to a “natural person,” including individuals and sole proprietorships. To the extent the borrower is a non-natural entity, like a corporation or a limited liability company, the TILA and many state laws do not apply.

**Consumer Laws May Apply**

Although consumer laws generally do not apply to business-purpose lending, significant exceptions do exist. For instance, some of the consumer laws that may apply to business-purpose lending include state consumer licensing schemes that define a “borrower” broadly to capture business borrowers. For example, some versions of the Uniform Consumer Credit Code (UCCC), such as West Virginia’s adopted version of the UCCC, capture so-called agricultural loans, which are business-purpose. In addition, some versions of the UCCC provide rate regulation for different types of commercial-purpose transactions, such as Oklahoma’s adopted version of the UCCC, which covers transactions that do not qualify as a “consumer loan” and provides that the annual percentage rate for an “other loan” (i.e., a commercial loan) cannot exceed 45 percent per year. Further, some state consumer-protection acts may define a “consumer transaction” broadly to include transactions that are personal, household, or business oriented. Finally, many substantive state laws will also apply to business-purpose loans, including state disclosure requirements.

In addition, the Equal Credit Opportunity Act (ECOA) and its implementing regulation, Regulation B, applies to business-purpose loans and includes explicit requirements for informing business applicants of adverse action when a lender denies credit and fair-lending standards. Finally, the Fair Credit Reporting Act (FCRA) may also apply in some instances to commercial credit transactions involving a consumer. Certain aspects of the FCRA, such as the requirement to have a permissible purpose to obtain a consumer’s credit report and certain adverse action notice requirements, may apply when a lender “pulls” a credit report on an individual or a guarantor of a loan. One such example when it may apply is when the consumer is a co-obligor or a guarantor on the business-purpose loan.

**Licensing and Usury Issues**

An online lender, like any other nonbank lender, must observe all applicable state laws in each jurisdiction in which it lends. Chief among these laws are state-specific licensing and usury regulations, which are often intertwined with determining whether the online lender can offer a particular credit product to small businesses located in a particular state.

Many states do not require a license to engage in small-business lending. Certain states, such as North Dakota and California, however, have enacted licensing schemes where small-business lending activities are directly covered or may otherwise fall within the scheme’s ambit. In those states, online lenders cannot lend to small businesses unless they obtain the appropriate license. In those cases, the online lender becomes subject to all of the requirements of a licensee; generally, the requirements may include limitations on fees, periodic reporting, surety bonds, disclosures, and/or vetting and oversight by state examiners.

Similarly, many states do not impose interest-rate limits on small-business loans (or do not impose such limits if the lender is properly licensed). In these states, lenders and small businesses are free to contract for an interest rate of their choosing. Other states, however, enforce a range of interest-rate limits. Within a single state, the interest-rate limits may vary based on certain attributes of a loan or a small business, such as loan size or small-business entity type. In addition, the interest-rate limits may provide separately for civil penalties and criminal violations, with significant differences in the consequences based on the type of violation.

A significant challenge faced by many online lenders in navigating the state-specific licensing and usury regulations is that they can often be inconsistent in scope and application. In some cases, overbroad or vague consumer finance statutes indiscriminately pick up many small-business loans where such restrictive protections are less, or not at all, appropriate. In other cases, overly restrictive interest-rate limits inadvertently squeeze credit availability by consigning local small businesses to rely entirely on credit products originated by banks, which can offer loans without the need to consider the interest-rate limits. In still other cases, outdated requirements, such as in-state, brick-and-mortar operations requirements, persist in regulations. As a result of these challenges, many online lenders have employed the following three approaches to offer a more consistent, uniform lending footprint to small businesses on a nationwide basis.

First, many online lenders originate their loans by partnering with a chartered issuing bank. The National Bank Act (NBA) and the Depository Institutions Deregulation and Monetary Control Act of 1980 respectively entitle federal- and state-chartered banks to export the laws of their home state for loans, regardless of the state in which the loan was made. Under the issuing-bank model, loans are typically originated in the following manner: (i) an online lender evaluates the creditworthiness of an applicant small business; (ii) if the loan application is approved for funding, the partner issuing bank originates the loan; (iii) the issuing bank retains the newly originated loan on its balance sheet for a minimum hold period; (iv) the online lender purchases the loan from the issuing bank for a specified fee; and (v) the online lender either holds or sells the loan, or an interest in the loan, to an investor. An online lender that purchases loans from issuing banks and their investors can, accordingly, rely on preemp-
tion of state-law claims for all loans originated and sold through the online lender. Recently, the issuing-bank model has been the subject of a number of high-profile court cases, including Beechum v. Navient Solutions Inc. and Commonwealth of Pennsylvania v. Think Finance. The model has been under additional scrutiny due to the U.S. Court of Appeals decision in Madden v. Midland Funding LLC in which the court held that non-national bank entities that purchase loans originated by national banks cannot rely on the NBA to protect them from state-law usury claims.

Second, outside of the issuing-bank model context, some online lenders rely on choice-of-law provisions to apply the law of a specific state to loans regardless of the location of the borrower. The state chosen may be the lenders’ home state or another state with less restrictive usury laws. The tests applied by courts considering choice-of-law provisions in this context have differed state-to-state, but most courts typically have been willing to enforce the parties’ contractual choice of law, unless there is no reasonable basis for adopting the laws of the chosen state, or such adoption would be contrary to a fundamental policy of the borrower’s home state.

Nevertheless, a borrower or state regulator could seek to invalidate a choice-of-law provision and argue that loans may not lawfully be made at interest rates exceeding the maximum permitted under the usury laws applicable in the state in which the borrower is located. Given the fact-intensive analysis applied by courts, lenders fare better when the choice-of-law provision is clearly understood and agreed to by both parties, and the chosen state bears a substantial relationship to the loan transaction. It is important to note that the existence of a state licensing scheme often demonstrates a strong public-policy interest in favor of protecting borrowers located in that state. Accordingly, state licensing authorities generally conclude that a choice-of-law provision does not affect the licensing analysis, and instead a license is required if loans are made from within the state or are made to small businesses located in the state.

Third, some online lenders have designed credit products in a manner that results in characterization as something other than loans. Most state licensing and usury regulations apply solely to loans. Many courts have taken the position that a transaction will be deemed a loan only if the principal amount is repayable absolutely and is not contingent on any future circumstance of event. Common examples of such credit products are merchant cash advances or other agreements for the purchase and sale of future receivables. Courts, however, do have the ability to recharacterize alternative financial arrangements as loans on a case-by-case basis. Consequently, a product that is successfully recharacterized as a loan ultimately will be subject to the licensing and usury laws of the governing state.

Failure to have the appropriate license could result in severe consequences, including the voiding of originated loans. Consequences of contracting for an interest rate that exceeds the governing state law when a court sets aside a choice-of-law clause and/or recharacterizes a contract as a loan include voiding of the agreement, civil and/or criminal penalties, or other fines.

As of the date of this article, the Office of the Comptroller of the Currency has continued to work on a special-purpose, nonbank charter that would offer nonbank lenders a path toward federal preemption of state licensing and usury regulations. In addition, the Conference of State Bank Supervisors recently launched a series of initiatives called Vision 2020 aimed collectively at driving efficiency, standardization, and a convergence of supervisory expectations in state-based oversight of nonbanks.

Electronic Contracting Issues
It bears little surprise that online business lenders rely on electronic means for contracting and for storing records. The Electronic Signatures in Global and National Commerce Act (ESIGN Act) grants electronic documents and signatures the same legal weight as their paper counterparts, provided they meet the criteria outlined in the ESIGN Act.

The first and most important of the criteria is borrower consent. Creditors must obtain prior consent from the borrower before utilizing electronic contracting methods. In order to obtain consent, creditors must notify borrowers of the following:

1. the availability of paper records;
2. whether the borrower is consenting to electronic means for one specific transaction or to a class of records that may be provided over the entirety of the borrower-creditor relationship;
3. that the borrower can withdraw consent and any fees or conditions attached with withdrawal;
4. whatever hardware or software capabilities the borrower will need in order to access electronic records; and
5. how to obtain a paper copy upon request.

Borrower consent must be affirmative and not merely an opt-out.

In addition to consent, creditors must provide borrowers with post-consent disclosures of any significant changes the creditor has made to its means of storage that would change the hardware or software capabilities the borrower would need in order to access the records. Lastly, creditors must retain accurate records of the electronic transactions. Each record must reflect the information on the applicable contracts and records and must be kept for the period of time required by the applicable state and federal law for the record type.

Given that the ESIGN Act is federal law, it applies in all 50 states. The ESIGN Act does, however, permit states to modify, limit, or supersede it if the state has adopted the Uniform Electronic Transaction Act (UETA) or has created a law that is similar to it. To date, 47 states have adopted a version of UETA; only New York, Washington, and Illinois have not.

It is important to note that although many provisions of the Uniform Commercial Code (UCC) are exempt from the ESIGN Act, revised UCC Article 9 permits authentication or creation of security interests by electronic means. Under UCC Section 9-102, the UCC’s definition of “authentication” is “to sign” or “with present intent to adopt or accept a record, to attach to or logically associate with the record an electronic sound, symbol, or process.”
Section 1071 of the Dodd-Frank Act

In addition to granting the Consumer Financial Protection Bureau (CFPB) rule-making authority under various consumer-protection laws, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) also opened the door for the CFPB to extend its reach into business lending.

Enacted in 2010, Section 1071 of the Dodd-Frank Act tasked the CFPB with collecting data from “financial institutions.” This task came by way of Section 1071’s amendment to Regulation B, the implementing regulation of the federal ECOA.

The term “financial institution” is broadly defined under Regulation B as “any entity that engages in any financial activity.” By this loose definition, business lenders fall under the scope of CFPB authority. Under Section 1071, financial institutions are required to report details concerning credit applications made by female-owned, minority-owned, or small businesses (a term that is not defined in Section 1071). The specific details are:

1. the number of the application and date received;
2. the type of credit for which the applicant applied;
3. the amount of credit for which the applicant applied;
4. the amount of credit for which the applicant was approved;
5. the gross annual revenue of the applicant; and
6. the race, sex, and ethnicity of the principal owner(s).

Section 1071 also requires financial institutions to keep information on an applicant’s status as female-owned, minority-owned, or a small business away from underwriters and decision makers to the extent feasible. If an underwriter or decision maker must gain access to the information during the credit evaluation process, the financial institution is required to notify the applicant concerning that access as well as the fact that the financial institution may not discriminate on the basis of that information.

As Section 1071 is written, business lenders are not only required to track the detailed data noted above, but also to maintain records of the data and report the data to the CFPB. Naturally, this will be a huge burden to many financial institutions serving the small business market that, like their clients, may be small businesses themselves. They, unlike their larger counterparts, may not have the administrative or technological resources to comply with Section 1071 demands, which places them at risk for potentially crippling penalties.

The CFPB held a field hearing on small-business lending in Los Angeles on May 10, 2017, and issued a Request for Information (RFI) Regarding the Small Business Lending Market. As stated in the RFI, the CFPB seeks to learn more about: (i) the small-business financing market, including understanding more about the products offered to small businesses (including women-owned and minority-owned small businesses), as well as the financial institutions that offer such credit; and (ii) the business-lending data that currently is used and may be maintained by financial institutions in connection with credit applications made by small businesses (including women-owned and minority-owned small businesses) and the potential complexity and cost of small-business data collection and reporting. Finally, the CFPB is also seeking comment from the public on privacy concerns related to the disclosure purposes of Section 1071. The comments to the RFI were originally due on or before July 14, 2017, but the CFPB later extended the comment period by 60 days to September 14, 2017.

As of the date of this article, the future of Section 1071’s implementation is largely uncertain. Highlighting this uncertainty are calls for legislative repeal—ranging from financial reform recommendations issued by the U.S. Department of Treasury to legislation passed by the House Financial Services Committee to public stances of several prominent trade groups—as well as broader ongoing challenges to the authority of the CFPB. As a result, the impact of Section 1071 on business lenders also remains unclear.

Conclusion

Recent years have seen rapid growth in the number of new online lenders stepping in and serving the small-business market, which had experienced a marked decline in credit availability from banks. Regardless of the model used to originate business credit, whether a peer-to-peer marketplace lender, borrower-driven broker marketplace, or balance-sheet lender, the key legal issues that are unique to small-business lending discussed above should be reviewed in detail by the business lender for possible impact on its originations and operations.

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The views and opinions expressed in this article are those of the authors in their respective individual capacities and do not necessarily reflect the official policy or position of their employers, partners, entities or clients they represent.
Navigating the Hazy Status of Marijuana Banking

By Hilary V. Bricken

On August 29, 2013, after Washington and Colorado voters legalized marijuana, then-acting U.S. Deputy Attorney General James M. Cole issued an enforcement memorandum (2013 Cole Memo) to address the tension between the federal Controlled Substances Act and states with regulated marijuana programs. This memo essentially provides that the federal government will tolerate robustly regulated state marijuana licensing schemes for marijuana businesses, but that the Department of Justice will continue working to prevent the following:

1. the distribution of marijuana to minors;
2. cannabis revenues going to criminal enterprises, gangs, and cartels;
3. diversion of marijuana from states where it is legal to other states;
4. state-authorized activity used as a cover for illegal activity, including trafficking of other illegal drugs;
5. violence and the use of firearms in the cultivation and distribution of marijuana;
6. drugged driving and exacerbation of other adverse public health consequences associated with marijuana use;
7. the growing of marijuana on public lands; and
8. marijuana possession or use on federal property.

The 2013 Cole Memo “rests on [the Department of Justice’s] expectation that state and local governments that have enacted laws authorizing marijuana-related conduct will implement strong and effective regulatory and enforcement systems that will address the threat those state laws could pose to public safety, public health, and other law enforcement interests.” If a state’s oversight of its marijuana industry is insufficient, those who own, operate, or even provide services to marijuana businesses may be subject to federal enforcement and arrest under federal laws.

In February 2014, the Department of Justice issued a second marijuana enforcement memorandum (2014 DOJ Memo), extending the 2013 Cole Memo’s treatment of marijuana businesses to financial institutions that provide banking to marijuana businesses. By offering services to businesses that generate revenue from marijuana sales, a financial institution could potentially violate criminal anti-money-laundering and money-transmitting statutes. The February 2014 DOJ Memo communicated that these issues would be treated as low law-enforcement priorities so long as the financial institutions were working within the confines of robust state regulation and were continuing to follow adequate, risk-based anti-money-laundering procedures.

At the same time in complementary guidance, the Financial Crimes Enforcement Network (FinCEN), an agency within the Department of Treasury, addressed the issue of cannabis business banking accounts. These guidelines set forth that banks can provide financial services to marijuana businesses without violating existing federal regulations if they do the following:

- ensure the business is duly licensed and registered with its state regulators;
- vet and review all license applications and related financial and background documentation the cannabis business used to secure its license to operate from the state;
- request and receive from state regulators and law enforcement all available information about the cannabis business and its related owners and financiers;
- develop an understanding of the normal and expected commercial activity for the business, including the products to be sold and customer profiles; and
monitor publicly available sources, including social media accounts, to ensure the marijuana business complies with applicable state laws and the 2013 Cole Memo.

Banks also must file Suspicious Activity Reports (SARs) at least quarterly with FinCEN for all their marijuana-business clients. There are no direct or immediate consequences arising from these SAR filings, but these SARs enable the federal government to know exactly who owns and runs the marijuana businesses and with whom they are banking.

The FinCEN guidelines increase banking costs for banks with cannabis business accounts, nearly all of which the banks push onto their cannabis clients. In turn, most marijuana businesses must pay a financial premium just to have a bank account.

Some government entities and banking institutions have tried to build marijuana-only financial institutions. The state of Colorado attempted to create its own marijuana-only cooperative banking system, which failed because of federal-law conflicts and an inability to secure insurance. A few credit unions and small banks in Colorado and Washington have developed special pilot programs to take on state-licensed marijuana businesses. Despite these efforts, there remains a significant lack of banking for cannabis businesses, and major banking institutions are not expected to take on cannabis business accounts unless and until the federal prohibition against cannabis ends. In the meantime, many marijuana businesses will no doubt continue operating on an all-cash basis, which renders them easy targets for criminal activity and complicates their business operations.

Marijuana businesses that want banking services should expect their banks and credit unions to fulfill their FinCEN due diligence requirements, which include investigating their payment account to vendors, landlords, and others to verify who is receiving the proceeds of marijuana sales. Marijuana businesses must be prepared to disclose the details of their business operations to their financial institutions in a way required of no other business.

If a bank or credit union sees too many red flags with a cannabis business, that business will not secure a bank account. Red flags under the FinCEN guidelines include anonymous out-of-state or international investors or financiers; an inability to trace money flow to investors, owners, and/or vendors; failing to secure a state and/or local license to operate; owners and/or financiers who have significant criminal histories; the business’s failure to report income and/or pay taxes to the state or the federal government; the business’s violation of state operational laws and rules; and the failure to timely renew state and/or local operational licenses.

Since FinCEN issued its guidelines, the federal government has been mostly uninterested in addressing the cannabis industry’s banking problem. But California’s recent legalization of recreational marijuana could soon render this issue too big to ignore. Once California implements legalization (expected by 2018), its cannabis industry will be significantly larger than that of any of the other seven states that have legalized recreational cannabis. The sheer size of the market may force the federal government to expand the FinCEN guidelines to facilitate banking services for cannabis businesses.

On December 2, 2016, California’s then-acting State Treasurer, John Chiang, wrote to President Trump seeking increased guidance on California cannabis and banking:

Conflict between federal and state rules creates a number of difficulties for states that have legalized cannabis use, including collecting taxes, increased risk of serious crime and the inability of a legal industry under state law to engage in banking and commerce . . . We have a year to develop a system that works in California and which addresses the many issues that exist as a result of the federal-state legal conflict . . . Uncertainty about the position of your administration creates even more of a challenge.

Chiang also wrote about how California may “exacerbate” the banking problem because of the immense size of its current and anticipated marijuana marketplace. The Trump administration has yet to respond to Treasurer Chiang.

Under former Treasury Secretary Jack Lew, the Department of Treasury defended its cannabis banking guidelines to Congress on the grounds of public safety and increased transparency. The question now is whether newly appointed Treasury Secretary Steven Mnuchin will do the same. Mnuchin has so far said nothing publicly about marijuana banking or the FinCEN guidelines, so it is difficult to know whether he supports or opposes the cannabis banking status quo or whether he considers it a priority. In the meantime, banking uncertainty for cannabis businesses remains.

Even in states where cannabis is legal, financial institutions that do not want to work with marijuana businesses consistently deny and shut down cannabis business bank accounts. This causes financial chaos across the state-legalized cannabis industry, primarily in those states without banks and credit unions willing to work within the confines of FinCEN’s 2014 guidance. Experience has shown, however, that once one or two banks or credit unions begin working with marijuana businesses within the confines of the FinCEN guidance, other banks and credit unions begin to follow suit. As more and more financial institutions choose to work with cannabis businesses, federal lawmakers, regulators, and insurance providers must grapple with the complexities of providing deposit services within an industry that is federally illegal.

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Over the past decade, civil litigation under the Fair Credit Reporting Act (FCRA) has surged, and putative class actions brought under the FCRA are increasing in frequency. The FCRA is a complex, highly technical statute that allows recovery of statutory damages, actual damages, punitive damages, and attorney’s fees and has resulted in significant jury verdicts. For these reasons, the FCRA has become a favorite vehicle for putative class actions and often threatens outsized liability even when a plaintiff’s chance of success on the merits is slim. The class certification battle is therefore the decisive point of the litigation in many cases.

However, the technical aspects of the FCRA that make it such an attractive vehicle for class actions also provide a basis for defendants to contend that no class should be certified, using an increasing number of judicially accepted defenses. This article explains some of those defenses, which provide a starting point for any assessment of the prospects of defeating certification in an FCRA class action.

An Overview of the Fair Credit Reporting Act
According to the Federal Trade Commission in its report, 40 Years of Experience with the Fair Credit Reporting Act, an FTC Staff Report with Summary Interpretations (July 2011), the FCRA governs the collection, assembly, and use of consumer report information in the United States. Enacted in 1970, the FCRA has since been amended several times. The two most extensive amendments were the Consumer Credit Reporting Reform Act of 1996 (the 1996 Amendments) and the Fair and Accurate Credit Transactions Act of 2003 (FACT Act).

The FCRA regulates the practices of consumer reporting agencies (CRAs) that collect and compile consumer information into consumer reports for use by credit grantors, insurance companies, employers, landlords, and other entities in making eligibility decisions. The FCRA was enacted to: (1) prevent the misuse of sensitive consumer information by limiting recipients to those who have a legitimate need for it; and (2) improve the accuracy and integrity of credit reporting systems. Under the FCRA, CRAs are required to establish procedures to ensure accuracy and legitimacy in reporting, disclose information in their files to consumers, and investigate disputed items.

The 1996 Amendments expanded the duties of CRAs, particularly in regard to disputes, by establishing a time frame for investigations, mandating written notice of the results, and adding restrictions on the reinsertion of deleted items. The 1996 Amendments also increased the obligations of “users” of consumer reports, particularly employers. Most significantly, they imposed duties on a new class of entities by introducing requirements related to accuracy and dispute resolution by furnishers of information to CRAs. (The ensuing years brought a number of more modest revisions, the most significant of which was a 1999 amendment that specifically authorized the Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Office of Thrift Supervision, and National Credit Union Administration to promulgate regulations under the FCRA.)

The FACT Act bolstered protections against identity theft and its effects. It also ordered agencies to promulgate rules governing the proper disposition of consumer report information, granted consumers the right to request free annual reports, and required businesses to provide copies of relevant records to identity-theft victims. Under these provisions, sections 1681n and 1681o of the FCRA impose liability for willful noncompliance and negligent
noncompliance, respectively. In the case of negligent noncompliance, the consumer can recover actual damages, costs, and attorney’s fees. In the case of a willful violation, the consumer can also recover statutory damages between $100 and $1,000, plus punitive damages.

Consider Challenges to Plaintiff’s Standing

The Supreme Court’s 2016 decision in Spokeo, Inc. v. Robins, 136 S. Ct. 1540 (2016), provides new potential grounds for defendants to move to dismiss FCRA lawsuits, including class actions, where plaintiffs allege a procedural violation of the FCRA.

The Spokeo court considered whether Congress may confer Article III standing by authorizing a private right of action based on the violation of a federal statute alone, even if a plaintiff suffered no concrete harm from an alleged procedural violation. The court found that alleging a mere technical violation “does not mean that a plaintiff automatically satisfies the injury-in-fact requirement whenever a statute grants a person a statutory right and purports to authorize that person to sue to vindicate that right.” The Spokeo court cited examples of nonconcrete, statutory violations:

A violation of one of the FCRA’s procedural requirements may result in no harm. For example, even if a consumer reporting agency fails to provide the required notice to a user of the agency’s consumer information, that information regardless may be entirely accurate. In addition, not all inaccuracies cause harm or present any material risk of harm. An example that comes readily to mind is an incorrect zip code. It is difficult to imagine how the dissemination of an incorrect zip code, without more, could work any concrete harm.

The implications of Spokeo are just beginning to be addressed by courts across the country. Based on the Supreme Court’s holding, however, purely technical claims under the FCRA (e.g., those that challenge wording of consumer file disclosures under section 1681g(a), authorization forms under section 1681b(b), etc.) appear to be susceptible to attack. See Smith v. Ohio State Univ., 191 F. Supp. 3d 750, 753, 757 (D. Ohio 2016) (finding a lack of standing: “Plaintiffs were both hired by OSU but allege that they were injured by having their privacy and statutory rights violated [under § 1681b(b)].”). Even if the claims of the named plaintiff survive a jurisdictional attack, Spokeo can likely be leveraged by defendants to challenge the standing of absent class members. See, for example, Sandoval v. Pharmacare US, Inc., 2016 U.S. Dist. LEXIS 140717, at *22 (S.D. Cal. June 10, 2016) (denying class certification under Spokeo, holding: “Whether characterized as problems with overbreadth, commonality, typicality or Article III standing . . . [the Court concludes that class certification is not proper to the extent that Plaintiffs raise claims and theories they do not have standing to raise, and to the extent that the class includes consumers who have no cognizable injury . . . .”). For these reasons, a defendant facing an FCRA action, and particularly a class action, should carefully review any Article III issues with respect to the claims asserted to determine whether a motion to dismiss under Rule 12(b)(1) due to a lack of standing may defeat the claim.

Consider Availability of Individual, Binding Arbitration

A threshold consideration with respect to any FCRA class action should be a thorough examination of whether the defendant has a basis to move to compel arbitration under the Federal Arbitration Act (FAA) for the claim(s) pled, either as a party to a contract with the consumer or as an assignee.

The Supreme Court’s recent holdings are consistent with the FAA’s general policy in favor of arbitration in the area of consumer law and squarely favor defendants. The landmark decision, AT&T Mobility LLC v. Concepcion, 131 S. Ct. 1740 (2011), held that state law may not invalidate an arbitration agreement solely because the agreement prohibits the use of class procedures in arbitration. Concepcion has since been cited in hundreds of opinions and has been applied broadly to uphold individualized arbitration of state-law claims.

In a more recent case, American Express Co. v. Italian Colors Rest., 133 S. Ct. 2304, 2312 (2013), the Supreme Court held that class waivers in arbitration agreements are enforceable, even if the plaintiff’s cost of arbitration her federal statutory claim exceeds her potential recovery. Italian Colors should allow companies to compel individual arbitration—and avoid class arbitration—if the agreement at issue clearly prohibits class procedures.

Thus, defendants should assess the possibility of moving to compel binding individual arbitration at the earliest possible stage of the case to avoid any possible claim that the defendant’s right to compel arbitration has been waived.

The Standards for Class Certification

Against this perhaps unfamiliar statutory landscape lies the well-worn jurisprudence surrounding Fed. R. Civ. P. 23, the federal class-action vehicle. A class action is “an exception to the usual rule that litigation is conducted by and on behalf of the individual named parties only.” Wal-Mart Stores, Inc. v. Dukes, 131 S. Ct. 2541, 2550 (2011). Plaintiffs are required to affirmatively prove their ability to satisfy each element of Rule 23(a)—“numerosity of parties, commonality of factual or legal issues, typicality of claims and defenses of class representatives, and adequacy of representation”—and one of the three subparts of Rule 23(b) before the district court will certify a class. Thorn v. Jefferson-Pilot Life Ins. Co., 445 F.3d 311, 318 (4th Cir. 2006). Therefore, a court may not “simply . . . accept the allegations of a complaint at face value,” Gariety v. Grant Thornton, LLP, 368 F.3d 356, 365 (4th Cir. 2004), and to properly evaluate a motion for class certification, it is often “necessary for the court to probe behind the pleadings before coming to rest on the certification question.” Gen. Tel. Co. of Sw. v. Falcon, 457 U.S. 147, 160 (1982). These standards, although no doubt familiar to experienced federal court litigators, should be continually reinforced in any opposition to a motion for class certification.
FCRA-Specific Class-Action Defenses

Various defenses exist that can be asserted against a putative FCRA class action. Although the following list of defenses is not exhaustive by any means, they have garnered recent positive reception from federal courts.

Ascertainability/Class Definition Issues

Although not mentioned in Rule 23, “[i]t is well-accepted that class action suits brought pursuant to Rule 23(b)(3), where individual damage claims are likely, must concern a class that is currently and readily ascertainable based on objective criteria.” Brooks v. GAF Materials Corp., 2012 U.S. Dist. LEXIS 150717, at *11 (D.S.C. Oct. 19, 2012). Hence, a class should not be certified “unless the class description is sufficiently definite so that it is administratively feasible for the court to determine whether a particular individual is a member.” Solo v. Bausch & Lomb Inc., 2009 U.S. Dist. LEXIS 115029, at *4 (D.S.C. Sept. 25, 2009). Thus, if determining class membership would require a person-by-person adjudication, the class should not be certified. Eisen v. Carlisle & Jacquelin, 417 U.S. 156, 177 (1974).

Limitations on identifying absent class members. At least two distinct trends have emerged as potential defenses in the context of consumer claims. First, courts have repeatedly held that when a court is unable to determine potential class membership from a defendant’s records, a class is unlikely to be certified. In In re Wal-Mart Stores, Inc. Wage & Hour Litig., 2008 U.S. Dist. LEXIS 14756, at *1–2 (N.D. Cal. Feb. 13, 2008), the putative class of former Wal-Mart employees allegedly received their final pay late, in violation of California law. To trigger the relevant state law, however, the employee had to provide notification of termination and come to the store to receive final pay. Wal-Mart’s databases did not provide records of either termination dates or the dates that employees made themselves available for final pay. Thus, the court held that “where nothing in the company’s databases shows or could show whether individuals should be included in the proposed class, the class definition fails.”

Courts have reached similar conclusions in consumer cases where evidence may have theoretically been available to determine the members of the class, but where such an undertaking would require extensive “mini-trials.” See, for example, Marcus v. BMW of N. Am., LLC, 687 F.3d 583, 593 (3d Cir. 2012) (“[I]f class members are impossible to identify without extensive and individualized fact-finding or ‘mini-trials,’ then a class action is inappropriate.”). Defendants should thus consider any temporal or substantive limitations of their recordkeeping systems in identifying potential class members, and assert those limitations as a defense to certification. (Of course, from the time that litigation is anticipated, companies must enact adequate document retention and preservation policies. Moreover, to the extent possible, expert testimony can be helpful in identifying the limitations in a defendant’s data.)

Judicial rejection of fail-safe classes. A second line of ascertainability analysis rejects what has been termed as a “fail-safe” class, or a class that “cannot be defined until the case is resolved on the merits.” Young v. Nationwide Mut. Ins. Co., 693 F.3d 532, 538 (6th Cir. 2012). See also Messner v. Northshore Univ. HealthSystem, 669 F.3d 802, 825 (7th Cir. 2012) (a fail-safe class is “one that is defined so that whether a person qualifies as a member depends on whether the person has a valid claim. Such a class definition is improper because a class member either wins or, by virtue of losing, is defined out of the class and is therefore not bound by the judgment.”). As the court in Brazil v. Dell Inc., 585 F. Supp. 2d 1158 (N. D. Cal. 2008), framed the issue, “the proposed classes include California persons or entities who purchased Dell computer products that ‘Dell falsely advertised.’ To determine who should be a member of these classes, it would be necessary for the court to reach a legal determination that Dell had falsely advertised.”

Two main problems with a fail-safe class render it defective from the outset. First, because the members of the class will not be known until the case is resolved on the merits, notification is unmanageable. See Kamar v. Radio Shack Corp., 375 F. App’x 734, 736 (9th Cir. 2010) (noting that fail-safe classes are not only “palpably unfair to the defendant,” but are “also unmanageable—for example, to whom should the class notice be sent?”). Second, a fail-safe class presents an unfair Catch-22 for a defendant: “Either the class members win or, by virtue of losing, they are not in the class and, therefore, not bound by the judgment.” Randleman v. Fidelity Nat’l Title Ins. Co., 646 F.3d 347, 352 (6th Cir. 2011). See also Mazzei v. Money Store, 288 F.R.D. 45, 55 (S.D.N.Y. 2012) (explaining that because “[t]he merits of Mazzei’s claim depend on whether the fees ‘were not permitted’ . . . if the trier of fact decided that any or all of the fees were permitted under the form loan agreements, there would immediately be no members of the class for those fees.”). For these reasons, nearly every circuit to address the issue has determined that fail-safe classes are impermissible. See Young, 693 F.3d at 538; Messner, 669 F.3d at 802; and Kamar, 375 F. App’x at 736.

These decisions invite close attention to the proffered class definition and provide defendants facing an FCRA class action with a firm basis to resist any claim that attempts to build a legal conclusion into the class definition itself.

“Accuracy”/“Completeness” Issues Related to Procedural Violations

Several procedural requirements of the FCRA, such as sections 1681k(a) and 1681(e)(b), make it particularly tempting for plaintiff’s counsel to turn an alleged FCRA violation into a class action. Courts are increasingly willing to hold, however, that even if the FCRA-mandated procedure was not followed, no actionable claim can exist under the FCRA unless the consumer can demonstrate the information transmitted was “inaccurate” or “incomplete.” See, for example, Jones v. Sterling Infosystems, Inc., 317 F.R.D. 404 (S.D.N.Y. 2016); Farmer v. Phillips Agency, Inc., 285 F.R.D. 688, 699–700 (N.D. Ga. 2012); Haro v. Shilo Inn, Bend LLC, 2009 U.S. Dist. LEXIS 65562, at *8–*9 (D. Or. July 24, 2009) (“[A]bsent a showing that the information obtained from OJIN was inaccurate or incomplete by omit-
ting final disposition of the charge, plaintiff’s claim under § 1681k(a) must fail.”); Obabueki v. Choicepoint, Inc., 236 F. Supp. 2d 278, 283–84 (S.D.N.Y. 2002), aff’d, 319 F.3d 87 (2nd Cir. 2003).

This element of inadequacy or incompleteness provides defendants with a firm basis to contend that class certification is improper as a matter of law. As the Farmer court recently held (considering a claim under section 1681k(a)):

To sustain a claim, each consumer will need to prove that the adverse information in the report defendant furnished about that consumer was either incomplete or not up to date. This will entail an individual inquiry into the contents of each consumer report issued by defendant. The scope of this individual inquiry will require a variety of evidence specific to each case—such as the production of the actual up-to-date version of the public record at the time the report was issued. . . . [This] will require the presentation of significant amounts of new evidence for each putative class member. Thus, it is clear that the predominance requirement is not met and this class cannot be certified.

Thus, defendants can persuasively argue that when a showing of inaccuracy is required for liability, no class should be certified. See Williams v. LexisNexis Risk Mgmt., Inc., 2007 U.S. Dist. LEXIS 62193, at *4 (E.D. Va. Aug. 23, 2007) (“Asserting a § 1681e(b) claim for [an] entire class would render the class-action device useless . . . because it would require an assessment of whether or not each class member’s report was, in fact, inaccurate.”); Owner-Operator Indep. Drivers Ass’n, Inc. v. USIS Commercial Svs., Inc., 537 F.3d 1184, 1194 (10th Cir. 2008) (holding that “the accuracy of each individual’s [report], an essential element of a § 1681e(b) claim, required a particularized inquiry”); Lanzarone v. Guardsmark Holdings, Inc., 2006 U.S. Dist. LEXIS 95785, at *13–14 (C.D. Cal. Sept. 7, 2006) (“Because the Court would have to address each of these issues on a one by one basis for all of the officers in the proposed class, Plaintiff cannot meet his burden under Rule 23(b)(3).”).

Because of this authority, any defendant facing a putative class that asserts a procedural violation of the FCRA should consider advancing an “individualized-accuracy” argument against class certification.

**Typicality/Commonality Issues When Practices Vary over Time**

Typicality “goes to the heart of a representative[‘s] ability to represent a class”—Deiter v. Microsoft Corp., 436 F.3d 461, 466 (4th Cir. 2006)—thus, a named plaintiff’s “interest in prosecuting [her] own case must simultaneously tend to advance the interests of the absent class members.” Courts have applied the typicality requirements in the context of FCRA claims in a manner that provides certain defendants with an additional basis to defend against certification. In particular, variations in a defendants’ method(s) of data collection and/or data furnishing can prevent class certification or (at the very least) can help to narrow the scope of the proposed class.

For instance, in Soutter v. Equifax Info. Servs., LLC, 498 F. App’x 260 (4th Cir. 2012), the district court certified a class of persons whose judgment information allegedly was inaccurately reported, despite the company’s supposed knowledge of flaws in its data and reporting system. Seeking only statutory and punitive damages, the plaintiff alleged that Equifax violated 15 U.S.C. § 1681e(b) by issuing inaccurate credit reports and not maintaining reasonable procedures to assure maximum possible accuracy.

The Fourth Circuit held that the plaintiff had failed to show “typicality” under Rule 23(a)(3), which the court noted also bled into the “commonality” and “ascertainability” inquiries. “While Soutter’s claim need not be ‘perfectly identical’ to the claims the company seeks to represent, typicality is lacking where the variation in claims strikes at the heart of the respective causes of action.” Soutter’s claim failed because it had “meaningful differences” from the class, highlighted by the fact that Equifax’s records vendor “used in-person review for the circuit court records while employing at least three different means of collecting general district court records during the class period.”

In circumstances where a defendant’s methods of data collection or data furnishing have varied over time, the Soutter decision provides a compelling basis for defendants to argue that the FCRA violation at issue is not a common issue “capable of classwide resolution . . . in one stroke.” The Farmer court also recognized this issue at 285 F.R.D. at 703, holding that given the “broad range” of defendants’ data sources, under section 1681k(a), “the court would need to determine the source of each piece of adverse information in a consumer’s report and then evaluate the quality of that source. This will necessarily entail individualized inquiry for many reports, even if some of the record sources may be common to many potential class members and thus susceptible to classwide proof.” Accord Harper v. Trans Union, LLC, 2009 U.S. Dist. LEXIS 12760, at *8 (E.D. Pa. Feb. 19, 2009) (an assessment of the reasonableness of a defendant’s procedures under § 1681e(b) “will require highly individualized proofs”). Therefore, defendants should also consider this line of analysis when the particular circumstances of the case so warrant.

**Defenses to “Statutory Damages Only” Class Actions**

Under Rule 23(b), certification of a class action requires the identification of common issues that cannot only be answered on a class-wide basis, but also that decide the case for all class members, making individualized actual damages claims practically impossible to pursue in a large-scale class action. (The Supreme Court recently doubled down on its landmark Dukes decision in Comcast Corp. v. Behrend, 133 S. Ct. 24 (2012). In Comcast, the majority reaffirmed the position that all of Rule 23’s requirements must be met via a “rigorous” analysis at the class-certification stage, which often overlaps with the merits of the claim. The court made clear that certification required plaintiffs to “satisfy through evidentiary proof” at least one of the provisions of Rule 23(b). For the Rule 23(b)(3) class in Com-
cast, this required an evidentiary showing that classwide damages could be calculated. Comcast strongly suggests that a class of any meaningful size cannot be certified if it includes members with no damages along with members with damages.) Therefore, FCRA plaintiffs typically frame their class theories around the statutory damage claim available under 15 U.S.C. § 1681n, which allows for damages between $100–$1,000 per consumer without having to offer individualized proof of harm.

Defendants, however, still have a strong basis to contend that the amount of statutory damages any given class member should receive is an individual issue. At least one appellate court recently held that calculating statutory damages per consumer is an individual issue by nature, focusing on the individual circumstances of the putative “class members,” and that “statutory damages . . . typically require an individualized inquiry.” Soutter, 498 F. App’x 265. See also Gomez v. Kroll Factual Data, Inc., 2014 U.S. Dist. LEXIS 51303, at *13 (D. Colo. Apr. 14, 2014) (“The individualized nature of an FCRA claim—particularly one seeking statutory damages—has led most courts to deny class certification in these types of cases.”); Campos v. ChoicePoint, Inc., 237 F.R.D. 478, 486 n.20 (N.D. Ga. 2006) (individual issues precluding class certification included “the determination of the proper amount of statutory damages to impose for each violation”).

Thus, defendants can contend that the statutory damages measure will vary for each consumer based on class-member-specific considerations, meaning that a statutory damages class should not be certified. Nor should plaintiffs be able to avoid this challenge to typicality because class members with actual damages can opt out of the class. Class certification precedes the opt-out process, and the named plaintiff must be adequate and typical, even if no class member opts out. See Colindreas v. QuietFlex, 235 F.R.D. 347, 376 (S.D. Tex. 2006) (“Providing class members notice and opt-out opportunity may alert class members that they can pursue individual damages claims, but are not a substitute for the adequate, conflict-free representation required under Rule 23(a)(4).”); accord Gardner v. EquiFax Info. Servs., LLC, 2007 U.S. Dist. LEXIS 57416, at *6 (D. Minn. Aug. 6, 2007). Thus, any need to rely on class members with actual damages to opt out underscores the impermissibility of certification.

**Superiority Considerations under the FCRA**

Under Fed. R. Civ. P. 23(b)(3), superiority requires that use of a class action be “superior to other available methods for fairly and efficiently adjudicating the controversy.” Superiority “requires the court to find that the objectives of the class-action procedure really will be achieved.” Stillmock v. Weis Mkt., Inc., 385 F. App’x 267, 274 (4th Cir. 2010), “The court must compare the possible alternatives to determine whether Rule 23 is sufficiently effective to justify the expenditure of the judicial time and energy . . . and to assume the risk of prejudice” to putative class members not before it.

Defendants can argue that the class-action mechanism is not a superior method of adjudication for FCRA claims for many reasons. Multiple provisions of the FCRA make individual suits a practical alternative to a sprawling class action. Rather than limiting plaintiffs to actual damages, Congress also provided for a range of statutory damages under 15 U.S.C. § 1681n(a)(1)(A), anticipating that amounts will vary with consumer-specific evidence. Congress further incentivized individual FCRA actions by authorizing attorney’s fees for plaintiffs in “any successful action” and providing for punitive damages for willful violations. 15 U.S.C. §§ 1681n(a)(2), (a)(3); 1681o(a) (2); Harper, 2009 U.S. Dist. LEXIS 12760, at *10 (“I am further persuaded by defendant’s argument that the FCRA, by providing for the award of attorneys’ fees, already provides an incentive for the putative class members to bring individual claims.”).

Courts have consistently held that the availability of punitive or statutory damages and fee-shifting can demonstrate the viability of “individual actions in the absence of a class action.” Thorn, 445 F.3d at 328 n.20. See also, for example, Allison v. Citgo Petroleum Corp., 151 F.3d 402, 420 (5th Cir. 1998) (statutory damages and attorney’s fees “eliminate[d] financial barriers that might make individual lawsuits unlikely”). Therefore, defendants can contend that the FCRA’s scheme ensures that individual suits are a meaningful alternative to class actions. Indeed, not only are individual FCRA actions “costless” for consumers, they may produce substantial recoveries. For example, the Fourth Circuit has affirmed a jury award of $1,000 in statutory damages and $80,000 in punitive damages in an individual FCRA action against a bank that furnished information to a CRA. Saunders v. Branch Banking & Trust Co., 526 F.3d 142, 145 (4th Cir. 2008).

**Statute-of-Limitations Issues**

Depending on how the class claim is pled, defendants may also possess a procedural defense based on the statute of limitations. Section 1681p of the FCRA sets forth a “hybrid” limitations period:

> An action to enforce any liability created under this title may be brought . . . not later than the earlier of—(1) 2 years after the date of discovery by the plaintiff of the violation that is the basis for such liability; or (2) 5 years after the date on which the violation that is the basis for such liability occurs.

Because of the peculiar nature of this limitations period, plaintiffs will often plead a five-year class to maximize potential exposure. However, under the plain language of the statute, no class member whose claim was discovered within a two-year period can properly be included in such a class.

The Fourth Circuit has noted that even when the limitations period analysis has the mere potential for giving rise to individual inquiries, class certification is erroneous. As the court noted in Broussard v. Meineke Discount Muffler Shops, Inc., 155 F.3d 331, 342 (4th Cir. 1998), if a defendant’s limitations period defense “depend[s] on facts peculiar to each plaintiff’s case,” such as what each plaintiff “knew about Meineke’s operation . . . and when he knew it,” then “class
certification is erroneous.” In a subsequent decision, *Gunnells v. Healthplan Servs.*, 348 F.3d 417, 438 (4th Cir. 2003), the same appellate court emphasized the categorical nature of its holding in *Broussard*:

[W]e have *flatly held* that “when the defendants’ affirmative defenses . . . may depend on facts peculiar to each plaintiff’s case, class certification is erroneous.” *Broussard*, 155 F.3d at 342. . . . Although it is difficult to *determine with any precision*, it appears that here the Agents’ affirmative defenses are not without merit and would require individualized inquiry in *at least some cases*. (emphases added).

In short, *Gunnells* explains it is established that class certification is improper even when a statute of limitations defense “may depend” on individual facts “in at least some cases.” Accordingly, courts nationwide have rejected attempts to certify five-year FCRA classes due to the two-year discovery period. See *Molina v. Roskam Baking Co.*, 2011 U.S. Dist. LEXIS 136460, at *14 (W.D. Mich. Nov. 29, 2011) (because the FCRA two-year discovery period “turns on the individual question of when certain class members ‘discovered’ or ‘should have discovered’ [d]efendant’s alleged misconduct, a class action is not the best method of trying the suit.”). These holdings are subject to particular emphasis when defendants are confronted with a proposed class representative who himself has discovered the purported classwide violation well in advance of the expiration of the five-year period of repose. See also *Holman v. Experian Information Solutions, Inc.*, 2012 U.S. Dist. LEXIS 59401, at *42–43 (N.D. Cal. Apr. 27, 2012) (limiting proposed FCRA class to two years because to assess “liability to . . . more than 4,000 putative class members whose credit reports were disclosed more than two years before January 12, 2011, would require a determination of whether the class member . . . learned of Experian’s disclosure.”); but see *McPherson v. Canon Bus. Solutions, Inc.*, 2014 U.S. Dist. LEXIS 21081, at *14–15 (D.N.J. Feb. 20, 2014) (refusing to strike five-year class allegations at the Rule 12 stage). Therefore, any defendant faced with a purported five-year FCRA class can and should move on the pleadings to have the class period limited to two years.

### Conclusion

Given the highly technical nature of the FCRA, as well as the magnitude of recent awards under the statute, the FCRA is a dangerous statute for defendants. That danger is exponentially more acute in the context of a putative class action. Because of this, substantial attention to potential certification defenses is necessary from the very outset of the action, and defendants can then use the discovery process as a tool to substantiate any factual bases necessary to resist class certification. Simply put, any delay in planning a class-certification defense in an FCRA action jeopardizes the outcome of that critical ruling.

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Of Spoiled Milk—Warnings That Should and Should Not Have Been Issued: Another Take on the Potential for Management and Controlling Shareholder Liability Related to an Insolvent Company’s WARN Act Violations

By Gregory W. Werkheiser

Introduction
For the better part of three decades, an apocryphal tale has circulated on the Internet about a man who leaps from a terminal height off a building only to be mortally wounded by a shotgun blast as he hurtles past an open window on the way down. This dark fable then asks whether the medical examiner should conclude that the death of this man, who was imminently going to perish by his own hand, was a suicide or was murder.

The Delaware bankruptcy court’s brief opinion in Stanziale v. MILK072011, LLC (In re Golden Guernsey Dairy, LLC), 548 B.R. 410 (Bankr. D. Del. 2015), addressed the insolvency analogue to this hypothetical. Otherwise stated, if management and a controlling member of a Delaware limited liability company that is already hopelessly insolvent, without any apparent justification fail to take action that could have prevented the company from incurring a substantial liability, is their failure to act wrongful as to the company, and does equity provide a remedy for that wrong? According to the Golden Guernsey decision, the answer is plainly “yes.” This, it is submitted, is the real import of this six-page opinion issued in a lawsuit filed in connection with the chapter 7 bankruptcy liquidation of a failed private-equity-backed dairy operation.

If the name “Golden Guernsey” sounds familiar, it is because the opinion was the subject of an article by Bret Amron that appeared in the July 2017 issue of this publication. Amron provides readers with a thorough and helpful review of state and federal WARN Act obligations. At issue in Golden Guernsey was the company’s violations of the Wisconsin Wage Payment Act (WWPA). The WWPA is one example of many “baby” WARN Acts various states have enacted, modeled to one extent or another on the federal Worker Adjustment and Retraining Notification Act (federal WARN Act). Given that the differences between the federal WARN Act and the WWPA are immaterial for purposes of this article, both are generically referred to herein as the WARN Act.

Perhaps less helpfully, the article then sounds the alarm that “[p]rior to [Golden Guernsey], directors and officers generally have not been held individually liable for a company’s failure to provide timely notice under the WARN Act . . . .” It further cautions that “[i]n light of [Golden Guernsey], there is at least a colorable argument for trustees and plaintiffs to assert a claim for breach of fiduciary duty against corporate officials . . . .”

Why, you may ask, has this author bothered to write a second article about a semi-obscure bankruptcy court opinion that is now approximately two years old and almost certainly has a total word count less than this installment, let alone both articles? The Amron article implied that the Delaware bankruptcy court had somehow blurred the line between statutory WARN Act opinion that is now approximately two years old and almost certainly has a total word count less than this installment, let alone both articles. Why, you may ask, has this author bothered to write a second article about a semi-obscure bankruptcy court opinion that is now approximately two years old and almost certainly has a total word count less than this installment, let alone both articles? The Amron article implied that the Delaware bankruptcy court had somehow blurred the line between statutory WARN Act liability, which is generally confined to the specific business enterprise that employed the affected individuals, and fiduciary liability of such a business enterprise’s directors, officers, managers, shareholders, and members.
There are court decisions that arguably do that; however, *Golden Guernsey* is not one of them. Compare, for example, *D’Amico v. Tweeter Opco, LLC* (In re Tweeter Opco, LLC), 453 B.R. 534 (Bankr. D. Del. 2011) (holding second LLC that was indirect upstream owner of debtor LLC could be held liable as “employer” under federal WARN Act because of factors demonstrating indirect parent’s *de facto* control over relevant matters).

**Golden Guernsey’s WARN-Act-Related Caremark Claim**

Nothing about the *Golden Guernsey* case suggests that corporate actors now have any more reason to fear being sued on breach of fiduciary duty claims “based on [such] individuals’ failure to provide the requisite 60-day notice under the WARN Act,” as the Amron article put it, than they did prior to the issuance of this opinion. Although the failure of management and the controlling member to fulfill clear statutory obligations under the WARN Act indisputably served as the backdrop for this dispute, the bankruptcy trustee’s claim against the defendants had a well-established basis in Delaware fiduciary law. As such, the bankruptcy court properly focused on whether the complaint adequately pled a claim under Delaware law for a breach of fiduciary duty, based on the fiduciary-defendants’ failure to act in good faith. In the parlance of Delaware corporate law, at issue in *Golden Guernsey* was whether the trustee had alleged sufficient facts to state a so-called *Caremark* claim against the fiduciary defendants.

A *Caremark* claim—so named for the seminal case involving the directors of Caremark International (In re *Caremark Int’l Inc. Deriv. Litig.*), 698 A.2d 959 (Del. Ch. 1996), rev’d on other grounds, 74 A.3d 612 (Del. 2013)—is a special species of a breach-of-fiduciary-duty claim under Delaware law that “seeks to hold directors accountable for the consequences of a corporate trauma.” *La. Mun. Police Empls. Ret. Sys. v. Pyott*, 46 A.3d 313, 340 (Del. Ch. 2012). “In a typical *Caremark* case, plaintiffs argue that the defendants are liable for damages that arise from a failure to properly monitor or oversee employee misconduct or violations of law.” *In re Citigroup Inc. S’holder Deriv. Litig.*, 964 A.2d 106, 123 (Del. Ch. 2009). In a case decided after *Caremark*, the Delaware Supreme Court articulated how fiduciaries may be found liable under the *Caremark* standard as follows:

We hold that *Caremark* articulates the necessary conditions predicate for director oversight liability: (a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention. In either case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations. Where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith.

*Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006) (footnotes omitted) (emphasis added). It is well accepted in Delaware jurisprudence that a *Caremark* claim “is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment. . . .” *Citigroup*, 964 A.2d at 967.


Unfortunately, instead of detailing the complaint’s specific allegations that supported the *Caremark* claim, after identifying the standard to be applied, the *Golden Guernsey* opinion abruptly concluded that “[t]he Complaint alleges facts that support a finding that the Defendants breached their fiduciary duties to Debtor.” Although the court’s brevity on this issue is perhaps regrettable in light of the resulting confusion the opinion has spawned, it is certainly understandable that the bankruptcy court did not feel compelled to delve into the specific supporting allegations, considering the context in which this opinion issued.

Review of the parties’ briefing reveals that the defendants did not attempt to dispute the sufficiency of the complaint’s allegations under the *Caremark* standard. Otherwise stated, the defendants essentially conceded for purposes of the motion to dismiss that by not providing the WARN Act notices, they had failed to act in the face of a known duty to act in a manner that demonstrated conscious disregard for their responsibilities as fiduciaries for the company. Instead (and somewhat puzzlingly), the defendants challenged the sufficiency of the complaint on two grounds unrelated to *Caremark*: (1) that the trustee-plaintiff lacked standing to bring a claim on behalf of the debtor’s estate for what was argued to be an injury only to the debtor’s creditors; and (2) that the plaintiff’s claim was really a disguised “deepening insolvency” claim, a theory of liability that Delaware courts have squarely rejected. Accordingly, in view of how the parties had framed the issues in dispute, the bankruptcy court did not need to closely examine the complaint’s *Caremark*-claim-related allegations to dispose of the defendants’ motion to dismiss.

Had the bankruptcy court expounded in greater detail about the complaint’s allegations, it had plenty of support—even at this preliminary stage of the litigation—for the conclusion that the complaint adequately alleged a *Caremark* breach of duty of loyalty claim under applicable federal
pleading standards. As Delaware courts have recognized, “[i]n practice, plaintiffs often attempt to satisfy the elements of a Caremark claim by pleading that the board had knowledge of certain ‘red flags’ indicating corporate misconduct and acted in bad faith by consciously disregarding its duty to address that misconduct.” Melbourne Mun. Firefighters’ Pension Trust Fund v. Jacobs, 2016 WL 4076369, at *8 (Del. Ch. Aug. 1, 2016) (collecting cases). The Golden Guernsey complaint included numerous “red flag” allegations.

The complaint contained several detailed allegations that demonstrated that the debtor had been operating under dire financial circumstances for an extended period of time and that defendants were well aware that, among other things, the company was and had been for some time hopelessly insolvent and destined to run out of funds to operate. These allegations included the following:

- Each of the defendants during the relevant period was directly involved in the management of the debtor.
- The debtor had never operated profitably, either before or after being acquired by the indirect parent entity on September 9, 2011, and lost nearly $2 million in the initial three months after the acquisition.
- Management had prepared financial statements for the 12-month period ending September 30, 2012—over three months before the debtor ceased operations—showing a net loss from operations of $4.5 million and a net loss of approximately $6.5 million.
- The debtor’s insolvency was predictable and inevitable no later than September 2011, given its steady and consistent operating losses, capital structure, the onerous provisions contained in its milk supply agreement, its high labor costs, and interest payments.
- The parent made no net investment of its own capital in the debtor.
- The debtor had negative working capital of negative $113,190 as of December 31, 2011—a full year before operations were discontinued.
- The debtor’s management and sole member were aware of the WARN Act requirements, as evidenced by certain postings made in areas of the debtor’s computer servers accessible by its employees.
- By November 14, 2012—52 days prior to the closing of the debtor’s facilities—the debtor’s controller had provided senior individuals at the debtor’s parent with copies of a 16-week cash-flow forecast that showed the debtor would have overdrawn its line of credit by November 23, 2012, and would become even more deeply overdrawn over the next two months.
- By December 22, 2012, the debtor’s president had notified its parent’s managing partner that the company was entirely out of funds to operate.
- The debtor’s books and records for the relevant period contained no indication that the debtor had access to or was seeking alternate sources of funding.

The cumulative import of these allegations, if true, was to establish (1) the inevitability that the debtor’s business would have to be shut down for lack of funding; (2) the defendants’ awareness for months prior to the date that the debtor discontinued operations that the debtor would run out of money to operate; (3) the absence of any efforts to address the debtor’s financial distress; (4) the defendants’ failure to provide 60-days advance notice of the shutdown as mandated by the WARN Act; and (5) the inapplicability of any exceptions or exemptions to the WARN Act notice requirement.

To be certain, the complaint’s allegations concerning the defendants’ knowledge of the WARN Act obligations and their mental state in failing to fulfill those obligations were weak. As an element of a Caremark claim, “[c]onscious disregard involves an intentional dereliction of duty which is more culpable than simple inattention or failure to be informed of all facts material to the decision.” In re Goldman Sachs Gp., Inc. S’holder Litig., 2011 WL 4826104, at *13 (Del. Ch. Oct. 12, 2011) (quoting In re Walt Disney Co. Deriv. Litig., 906 A.2d 27, 66 (Del. 2006)). See also Lyondell Chem. Co. v. Ryan, 970 A.2d 235, 243–44 (Del. 2009) (“‘Only if they knowingly and completely failed to undertake their responsibilities would they breach their duty of loyalty.’”).

Had this action been filed in the Court of Chancery of Delaware, it is doubtful whether the complaint would have survived a motion to dismiss that targeted the sufficiency of these allegations under Caremark. Under the Chancery Court’s established pleading standards, the plaintiff would have been required to “plead particularized facts from which it [w]as reasonably inferable that the [defendants] consciously disregarded [their] duties by ‘intentionally fail[ing] to act in the face of a known duty to act.’” Melbourne, 2016 WL 4076369, at *9 (quoting Disney, 906 A.2d at 67).

The bankruptcy court is an arm of the federal district court, however, and as such federal rules of pleading apply. See, for example, Andresen v. Diorio, 349 F.3d 8 (1st Cir. 2003) (“[U]nder standard Erie doctrine, state pleading requirements, so far as they are concerned with the degree of detail to be alleged, are irrelevant in federal court even as to claims arising under state law.”) (collecting cases). No applicable analogue to the Chancery Court’s heightened pleading requirement for Caremark claims exists in either the Federal Rules of Civil Procedure or the Federal Rules of Bankruptcy Procedure. Accordingly, with the benefit of the less rigorous notice pleading standards under the federal rules, it is likely that the plaintiff’s claim would have survived a Rule 12(b)(6) motion to dismiss even if the defendants directly challenged the sufficiency of its allegations under Caremark and its progeny.

Golden Guernsey, Bankruptcy Trustee Standing, and Deepening Insolvency

The principal arguments the defendants presented in support of dismissal of the complaint should have been (and were) quickly disposed of by the bankruptcy court. The defendants argued that because the debtor was alleged to have been indubitably insolvent during the entire period when the WARN Act notice might have been provided, the trustee lacked stand-
ing. The defendants asserted that “the only conceivable injury that could result from Defendants’ alleged wrongdoing is to the general unsecured creditor body, who allegedly stand to receive less than what they might have received absent the WARN Act Claim.” Motion to Dismiss Adv. Compl. of Dfs. MILK072011, LLC and Andrew Nikou, ¶ 29, Stanziale v. MILK072011, LLC (In re Golden Guernsey Dairy, LLC, Adv. Pro. No. 14-50953 (KG) (Bankr. D. Del. Dec. 22, 2014), ECF No. 10. In further support of this position, the defendants sought to persuade the bankruptcy court that the trustee’s claim was really in the nature of a deepening insolvency theory of liability, which Delaware law has eschewed. The defendants argued at ¶ 28 that “an already insolvent company, with no prospects of reorganization and headed immediately towards a chapter 7 liquidation with no hope of satisfying its current liabilities, cannot be damaged by the existence of an additional claim subsequently lodged against the estate.”

Relying on a well-developed body of bankruptcy law in the Third Circuit and elsewhere, the bankruptcy court rejected this position, noting that “[t]he Trustee is charged with pursuing the estate’s interests . . . whether the claims are direct or derivative in nature.” Addressing the defendants’ attempts to characterize the trustee’s allegations as a deepening insolvency claim, the court observed:

The present case, as the Trustee alleges in the Complaint, is not one in which the Defendants made strategic errors . . . . The situation is not, as in Trenwick America Litig. Trust v. Ernst & Young, L.L.P., 906 A.2d 168 (Del. Ch. 2006), aff’d sub nom. Trenwick America Litig. Trust v. Billett, 931 A.2d 438 (Del. 2007), one in which the defendants made imprudent investments.

The court later concluded (albeit in somewhat summary fashion) that this case was one in which the trustee adequately alleged the defendants’ conscious disregard for their duties by their knowing failure, without justification, to provide the WARN Act notice to affected employees.

Although the understanding of the Golden Guernsey opinion once again could have benefitted from some further explanation of why the court reached the result it did, the answer to that question becomes clear upon examination of this decision in the context of the Delaware bankruptcy court’s other decisions addressing what remains of the deepening insolvency theory post-Trenwick. Initially, in Miller v. McCown De Leeuw & Co., Inc. (In re The Brown Schools), 386 B.R. 37 (Bankr. D. Del. 2008), a decision that issued soon after the Delaware Supreme Court affirmed Trenwick, the court explored the boundaries of what was and was not an impermissible deepening insolvency claim under Delaware law. The trustee’s complaint included claims that both asserted deepening insolvency as an independent cause of action (which, following Trenwick’s affirmation, the trustee agreed to dismiss) and claims for the breach of the duty of loyalty, aiding and abetting breach of fiduciary duty, corporate waste, and civil conspiracy. All of these claims revolved around allegations that the debtors’ majority shareholders had used its control position to wrongfully prolong the debtors’ existence while the debtors were insolvent so that certain transactions could be consummated through which the majority shareholder preferred itself over the interest of the debtors and their creditors.

The Brown School defendants made the now-familiar argument that the trustee’s claims, despite not being expressly denominated as deepening insolvency claims, were just that. The bankruptcy court was unpersuaded, noting that Trenwick itself implied that other causes of action were not impacted by its holding that a claim for deepening insolvency could not be maintained as an independent cause of action. See Trenwick, 906 A.2d at 205 (“If a plaintiff cannot state a claim that the directors of an insolvent corporation acted disloyally or without due care in implementing a business strategy, it may not cure that deficiency simply by alleging that the corporation became more insolvent as a result of the failed strategy.”). Additionally, citing the Third Circuit’s decision in Seitz v. Detweiler, Hershey & Assoc., P.C. (In re CitIX Corp.), 448 F.3d 672, 677–78 (3d Cir. 2006), the defendants argued that, as a matter of law, damages for deepening insolvency were unavailable. Rejecting this proposition, the bankruptcy court declined to extend CitX’s holding that deepening insolvency was not a viable measure of damages for a professional malpractice claim to the distinct claims in the action before it.

More recently, in Stanziale v. Versa Cap. Mgmt., LLC (In re Simplexity, LLC), 2017 WL 65069 (Bankr. D. Del. Jan. 5, 2017), the Delaware bankruptcy court was again asked by the defendants seeking to escape liability on breach-of-fiduciary-duty claims to read Trenwick’s holding expansively to reach other types of claims connected with the debtor’s insolvency. Specifically, in Simplexity, the trustee alleged that the director- and shareholder-defendants had engaged in self-dealing and acted in bad faith and with gross negligence by, among other things, not causing the debtor to file bankruptcy sooner and not providing WARN Act notices to employees, despite having actual knowledge that the lender had terminated any forbearance and was about to sweep all of the debtor’s cash. The Simplexity court reasoned that the trustee’s complaint did not implicate deepening insolvency because, instead of charging the defendants with causing the debtor’s insolvency, it sought redress for “the Defendants’ failure to act in the face of insolvency itself . . . .

Golden Guernsey likewise appears not to implicate deepening insolvency as an independent tort of the type Delaware courts have rejected. As reviewed above, the Golden Guernsey complaint appears to allege with some specificity that the defendants consciously and in bad faith ignored a known duty to provide the WARN Act notice. The trustee alleged, in substance, that by failing to act, the defendants proximately caused the debtor to incur a substantial liability for which it would not otherwise have been exposed (and for which it received nothing of value). These allegations, taken as true, do appear to state
a Caremark-type claim (at least under federal pleading standards) and cannot legitimately be labeled a disguised deepening insolvency cause of action.

The Lessons Golden Guernsey Does and Does Not Teach

The Golden Guernsey opinion provides important lessons for directors, officers, managers, shareholders, members, and other control persons for distressed entities. Even in situations where a company is irretrievably insolvent and beyond rehabilitation, these parties cannot—with impunity—ignore their responsibilities to the entity. Although their respective fiduciary obligations may run only to the entity itself, Delaware law is clear that creditors of such an insolvent entity are the ultimate beneficiaries. Under such circumstances, Delaware fiduciary law does not demand self-sacrifice, nor does it allow responsible persons to cut and run, however, ignoring in the process all potential consequences to the company and its other stakeholders.

Golden Guernsey does not represent any paradigm shift or even signal a developing trend away from established standards governing the conduct of business fiduciaries, however, as suggested by the Amron article. In particular, Golden Guernsey does not mean going forward that management and controlling members or shareholders of distressed enterprises will routinely face statutory WARN Act liability. The opinion merely illustrates one scenario in which a viable Caremark claim could be pled based upon the alleged exceptional and extreme lapses of the debtor’s management and controlling member.

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Fans of NBC’s *Law & Order* may have a negative reaction when a suspect gets away because of the statute of limitations, and cheer when the DA still finds a way to prosecute someone that viewers know is guilty. Statutes of limitations exist for a reason, however, and when it comes to your own taxes, you should sigh in relief if the IRS tries to audit you too late.

If you can point to the statute of limitations to head off the trouble and expense of a tax audit, you should. It is not pleasant to have to prove you were entitled to a deduction or to find and produce receipts. If it is too late for the IRS to audit you, the IRS is out of luck.

Given the importance of the statute—both to heading off audit trouble and to knowing when you can safely discard some of those receipts—it pays to be statute savvy. In this area of the tax law, the rules for corporations, partnerships, nonprofit organizations, and individuals are consistent. Here’s what you need to know.

1. **The IRS Typically Has Three Years.** The overarching federal tax statute of limitations runs three years after you file your tax return. If your tax return is due April 15, but you file early, the statute runs exactly three years after the due date, not the filing date. If you get an extension to October 15, your three years runs from then. On the other hand, if you file late and do not have an extension, the statute runs three years following your actual (late) filing date. There are many exceptions discussed below that give the IRS six years or longer, however.

2. **Six Years for Large Understatements of Income.** The statute of limitations is six years if your return includes a “substantial understatement of income.” Generally, this means that you have left off more than 25 percent of your gross income. Suppose that you earned $200,000 but only reported $140,000. Given that you omitted more than 25 percent, you can be audited for up to six years. Maybe this understatement was unintentional or you reported in reliance on a good argument that the extra $60,000 was not your income. The six-year statute applies, but be aware that the IRS could argue that your $60,000 omission was fraudulent. If so, the IRS gets an unlimited number of years to audit. What about not an omission of income, but overstated deductions on your return? The six-year statute of limitations does not apply if the underpayment of tax was due to the overstatement of deductions or credits.

3. **Six Years for Basis Overstatements.** The IRS has argued in court that other items on your tax return that have the effect of more than a 25-percent understatement of gross income give it an extra three years. There was litigation for years over what it means to omit income from your return. Taxpayers and some courts said “omit” means to leave off, as in do not report, but the IRS said it was much broader.

**Example:** You sell a piece of property for $3M, claiming that your basis (what you invested in the property) was $1.5M. In fact, your basis was only $500,000. The effect of your basis overstatement was that you paid tax on $1.5M of gain when you should have paid tax on $2.5M.

In *U.S. v. Home Concrete & Supply, LLC*, 132 S. Ct. 1836 (2012), the Supreme Court slapped down the IRS, holding that overstating your basis is not the same as omitting income. The Supreme Court held that three years was plenty of time for the IRS to audit, but Congress overruled the Supreme Court and gave the IRS six years in such a case, which is the current law. Six years can be a long time.
4. Foreign Income, Foreign Gifts, and Assets. Another hot-button issue these days involves offshore accounts. The IRS is still going after offshore income and assets in a big way, which dovetails with another IRS audit rule: the three years is doubled if you omitted more than $5,000 of foreign income (say, interest on an overseas account). This rule applies even if you disclosed the existence of the account on your tax return, and even if you filed an FBAR reporting the existence of the account. This six years matches the audit period for FBARs. FBARs are offshore bank account reports that can carry civil and even criminal penalties far worse than those for tax evasion.

Certain other forms related to foreign assets and foreign gifts or inheritances are also important. If you miss one of these forms, the statute is extended. In fact, the statute never runs. If you receive a gift or inheritance of over $100,000 from a non-U.S. person, you must file Form 3520. If you fail to file it, your statute of limitations never starts to run.

IRS Form 8938 was added to the tax law by the Foreign Account Tax Compliance Act (FATCA). Form 8938 requires U.S. filers to disclose the details of foreign financial accounts and assets over certain thresholds. This form is separate from FBARs and is normally filed with your tax return. The thresholds for disclosure can be as low as $50,000, so it pays to check out the filing requirements for your situation. Higher thresholds apply to married taxpayers filing jointly and to U.S. persons residing abroad. The form is nothing to ignore. If you are required to file Form 8938 and skip it, the IRS clock never even begins to run.

5. IRS Form 5471. Ownership of part of a foreign corporation can trigger extra reporting, including filing an IRS Form 5471. It is an understatement to say that this form is important. Failing to file it means penalties, generally $10,000 per form. A separate penalty can apply to each Form 5471 filed late, incompletely, or inaccurately. This penalty can apply even if no tax is due on the whole tax return. That is harsh, but the rule about the statute of limitations is even more harsh: If you fail to file a required Form 5471, your entire tax return remains open for audit indefinitely.

This override of the standard three-year or six-year IRS statute of limitations is sweeping. The IRS not only has an indefinite period to examine and assess taxes on items relating to the missing Form 5471, but also can make any adjustments to the entire tax return, with no expiration until the required Form 5471 is filed.

You can think of a Form 5471 a bit like the signature on your tax return. Without it, it is almost as if you didn’t file a return. Form 5471 is not only required of U.S. shareholders in controlled foreign corporations, but also when a U.S. shareholder acquires stock resulting in 10-percent ownership in any foreign company. The harsh statute-of-limitations rule for Form 5471 was enacted in 2010 as part of the same law that brought us FATCA.

6. No Return or Fraudulent Return. What if you never file a return or file a fraudulent one? The IRS has no time limit if you never file a return or if it can prove civil or criminal fraud. If you file a return, can the IRS ever claim that your return didn’t count so that the statute of limitations never starts to run? The answer is “yes.” If you don’t sign your return, the IRS does not consider it a valid tax return. That means the three years can never start to run.

Another big “no-no” is if you alter the “penalties of perjury” language at the bottom of the return where you sign. If you alter that language, it also can mean that the tax return does not count. Such a move may sound like a tax protester statement; however, some well-meaning taxpayers forget to sign or may unwittingly change the penalties-of-perjury wording. Other taxpayers just miss a form to end up in audit purgatory.

7. Amending Tax Returns. Taxpayers must abide by time limits, too. If you want to amend a tax return, you must do it within three years of the original filing date. You might think that amending a tax return would restart the IRS’s three-year audit statute, but it doesn’t.

However, where your amended tax return shows an increase in tax, and when you submit the amended return within 60 days before the three-year statute runs, the IRS has only 60 days after it receives the amended return to make an assessment. This narrow window can present planning opportunities. In contrast, an amended return that does not report a net increase in tax does not trigger an extension of the statute.

8. Claiming a Refund. The adage that possession is nine-tenths of the law can apply to taxes in some cases. Getting money back from the IRS is difficult. If you pay estimated taxes, or have tax withholding on your paycheck but fail to file a return, you generally have only two years (not three) to try to get it back.

Suppose you make tax payments (by withholding or estimated tax payments), but you have not filed tax returns for five years. When you file those long-past-due returns, you may find that overpayments in one year may not offset underpayments in another. The resulting lost tax money is painful, and it catches many taxpayers unaware.

9. Extending the Statute. The IRS typically must examine a tax return within three years, unless one of the many exceptions discussed here applies, but the IRS does track the three-year statute as its main limitation. Frequently, the IRS says that it needs more time to audit.

The IRS may contact you about two-and-a-half years after you file, asking you to sign a form to extend the statute of limitations. It can be tempting to relish your power and refuse, as some taxpayers do; however, doing so in this context is often a mistake. It usually prompts the IRS to send a notice assessing extra taxes, without taking the time to thoroughly review your explanation of why you do not owe more. The IRS may make unfavorable assumptions. Thus, most tax advisers tell clients to agree to the requested extension.

You may, however, be able to limit the scope of the extension to certain tax issues, or to limit the time (say, an extra year). You should seek professional tax help if you receive such an inquiry. Get some advice about your particular facts.

10. Other Statute Traps. Statute-of-limitation issues come up frequently, and the facts can become confusing. As but one
example, consider what happens when an IRS notice is sent to a partnership, but not to its individual partners. The audit or tax dispute may be ongoing, but you may have no personal notice of it. You might think that your statute has run and that you are in the clear; however, the partnership tax rules may give the IRS extra time.

Also watch for cases where the statute may be “tolling” (held in abeyance) by an IRS John Doe summons, even though you have no notice of it. A John Doe summons is issued not to taxpayers, but to banks and other third parties who have relationships with taxpayers. You may have no actual notice that the summons was issued. Even so, there is an automatic extension of the statute of limitations in some cases. For example, suppose a promoter has sold you on a tax strategy. The IRS may issue the promoter a summons, asking for all the names of his or her client/customers. While he or she fights turning those names over, the statute-of-limitations clock for all of those clients (which might include you) is stopped.

Another situation in which the IRS statute is tolled is where the taxpayer is outside the United States. If you flee the country for years and return, you may find that your tax problems can spring back to life. You might also be living and working outside the United States and have no knowledge that the IRS has a claim against you. Even then, your statute of limitations is extended.

11. State Tax Statutes. Some states have the same three- and six-year statutes as the IRS, but set their own time clocks, giving themselves more time to assess extra taxes. In California, for example, the basic tax statute of limitations is four years, not three. However, if the IRS adjusts your federal return, you are obligated to file an amended return in California to match up to what the feds did. If you don’t, the California statute will never run out. In addition, as in most states, if you never file a California return, California’s statute never starts to run. Some advisers suggest filing nonresident returns just to report California source income to begin California’s statute. There can be many tricky interactions between state and federal statutes of limitations.

12. Keeping Good Records. The statute of limitations is sometimes about good record-keeping. Proving exactly when you filed your return, or exactly what forms or figures were included in your return, can be critical. For that reason, keep scrupulous records, including proof of when you mailed your returns. The difference between winning and losing may depend on your records. The vast majority of IRS disputes are settled, and getting a good, or mediocre, settlement can hinge on your records as well.

If you file electronically, keep all the electronic data, plus a hard copy of your return. As for record retention, many people feel safe about destroying receipts and back-up data after six or seven years; but never destroy old tax returns. In addition, do not destroy old receipts if they relate to basis in an asset. For example, receipts for home remodeling 15 years ago are still relevant, as long as you own the house. You may need to prove your basis when you later sell it, and you will want to claim a basis increase for the remodeling 15 years back. For all these reasons, be careful and keep good records.

13. Ten Years to Collect. Once a tax assessment is made, the IRS collection statute is typically 10 years. This is the basic collection statute, but in some cases that 10 years can essentially be renewed, and there are some cases where the IRS seems to have a memory like an elephant. For example, in Beeler v. Commissioner, T.C. Memo. 2013-130, the Tax Court held Mr. Beeler responsible for 30-year-old payroll tax liabilities.

Conclusions. An audit can involve targeted questions and requests of proof of particular items only. Alternatively, audits can cover the waterfront, asking for proof of virtually every line item. Even if you do your best with your taxes, taxes are horribly complex. Innocent mistakes can sometimes be interpreted as suspect, and digging into the past is rarely pleasant. Records that were at your fingertips when you filed might be buried or gone even a few years later, so the stakes with these kinds of issues can be large.

Tax lawyers and accountants are used to monitoring the duration of their clients’ audit exposure, and so should you. It pays to know how far back you can be asked to prove your income, expenses, bank deposits, and more. Watch the calendar until you are clear of audit. In most cases, that will be either three years or six years after you file.

Robert W. Wood practices law with Wood LLP (www.WoodLLP.com) and is the author of Taxation of Damage Awards and Settlement Payments, Qualified Settlement Funds and Section 468B, and Legal Guide to Independent Contractor Status, all available at www.TaxInstitute.com. This discussion is not intended as legal advice.
Delaware Insider:

**USACafes: A Return**

By Aaron M. Nelson

It is often noted that alternative entities (e.g., limited partnerships (LPs), limited liability companies (LLCs)) are creatures of contract. *Fisk Ventures LLC v. Segal et al.*, 2008 WL 1961156, at *8 (Del. Ch.) (“[L]imited liability companies . . . are creatures . . . of contract, those duties or obligations must be found in the LLC Agreement or some other contract.”).

At the same time, over 25 years ago, during the formative years of the law regarding alternative entities, the Delaware Court of Chancery posed the following hypothetical in the seminal case of *In re USACafes, L.P.*

"Consider, for example, a classic self-dealing transaction: assume that a majority of the board of the corporate general partner [of a limited partnership] formed a new entity and then caused the general partner to sell partnership assets to the new entity at an unfairly small price, injuring the partnership and its limited partners. Can it be imagined that such persons have not breached a duty to the partnership itself? And does it not make perfect sense to say that the gist of the offense is a breach of the equitable duty of loyalty that is placed upon a fiduciary?"

600 A.2d 43, 49 (Del. Ch. June 7, 1991), appeal refused sub nom. Wyly v. Mazzafino, 602 A.2d 1082 (Del. 1991) (TABLE). Not suffering from subtlety, the court relied on “general [equitable] principles and trust law” to hold that the individuals who controlled the general partner of a limited partnership (either directly or indirectly) owed a fiduciary duty of loyalty to the limited partnership and its limited partners.

Stated differently, the duty of loyalty owed by the human controllers of an entity-managed LLC or LP is extra-contractual and stems from traditional equitable duties under common law. This was a dramatic change in the law, which previously only permitted finding liability against the human controllers of a corporate general partner under a veil-piercing theory, as opposed to the theory that they owed a direct fiduciary duty to the limited partnership and its limited partners. *See Gotham Partners, L.P. v. Halwood Realty Partners, L.P.*, 2000 WL 1476663, at *20 (Del. Ch.) (stating that, before *USACafes*: “Only if there had been abuse of the corporate form by the owners of the corporate general partner that would justify veil piercing would the limited partners be able to look beyond the corporate partner to others for redress.”).

This article argues in favor of a return to the pre-*USACafes* state of the law, because the equitable aims of *USACafes* and the contractarian nature of alternative entities are not inherently in tension. Who owes fiduciary duties to an alternative entity should be determined solely by looking at the operating agreement, not “[by] disregarding a negotiated agreement among sophisticated parties. . . .” *R & R Capital, LLC v. Buck & Doe Run Valley Farms, LLC*, 2008 WL 3846318, at *6 (Del. Ch.). Courts should reserve their equitable powers for the remedy stage, invoking veil piercing or joint and several liability as necessary to address the concerns raised in *USACafes*—just as they did before. Such an approach will return the law to a state of clarity.

The Operating Agreement Should Control Who Owes Fiduciary Duties

“Delaware is a freedom of contract state, with a policy of enforcing the voluntary agreements of sophisticated parties in commerce.” *Personnel Decisions, Inc. v. Bus. Planning Sys., Inc.*, 2008 WL 1932404, at *6 (Del. Ch.). As such, it is the express legislative policy of the Delaware Limited Liability Company Act (the “LLC Act”) “to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements.” 6 Del. C. § 18-1101(b). Members thus enjoy tremendous freedom to organize their business and affairs in the way that they see fit. This includes deciding who or what is to serve as the manager of the LLC. Section 18-401 provides that “[a] person may be named or designated as a manager of the limited liability company.” Section 18-101(12) defines “Person” as “a natural person, partnership (whether general or limited), [or] a limited liability company [among other entities].”
Thus, the LLC Act expressly provides for an entity-managed LLC.

Section 18-1101(c) states that the LLC agreement can expand, restrict, or eliminate the fiduciary duties owed by the manager “or to another person that is a party to or is otherwise bound by a limited liability company agreement.” Accordingly, the members could agree that a controller of the entity manager owes fiduciary duties to the LLC, or could specifically elect to eliminate any such duties.

Our Supreme Court has recently reminded us that: “[i]nvestors in [LLC] agreements must be careful to read those agreements and to understand the limitations on their rights.” The Haynes Family Trust v. Kinder Morgan G.P., Inc., 2016 WL 912184, at *1 (Del.) (ORDER), and further that, “[i]nvestors must appreciate that with the benefits of investing in alternative entities often comes the limitation of looking to the contract as the exclusive source of protective rights.” Dieckman v. Regency GP LP, 155 A.3d 358, 366 (Del. 2017); but see, Leo E. Strine, Jr., & J. Travis Laster, The Siren Song of Unlimited Contractual Freedom (Robert W. Hillman & Mark J. Loewenstein eds., 2015) (“But because bargaining, at best, occurs only sometimes . . . the practical alternatives for a skeptical investor are often stark: invest without adequate protection against self-dealing or avoid the asset class altogether”). Indeed, “investors can no longer hold the general partner to fiduciary standards of conduct, but instead must rely on the express language of the partnership agreement to sort out the rights and obligations among the general partner, the partnership, and the limited partner investors.” Dieckman, 155 A.3d at 366. As a result, the contractual nature of LLCs supports the argument that the LLC agreement should control when determining who owes what fiduciary duties.

Equitable Principles Under Common Law

At the same time, LLCs are not “purely contractual,” because an “LLC has powers that only the State of Delaware can confer.” In re Carlisle Etcetera LLC, 114 A.3d 592, 606 (Del. Ch. 2015). Accordingly, “the State of Delaware retains an interest in having the Court of Chancery available when equity demands. . . .” Indeed, “equity backstops the LLC structure,” because Section 18-1104 states that: “In any case not provided for in this chapter, the rules of law and equity, including the rules of law and equity relating to fiduciary duties and the law merchant, shall govern.” Thus, USACafes’ hypothetical conjures up the equitable maxims of “equity will regard substance over form” and “[e]quity always attempts to . . . ascertain, uphold, and enforce rights and duties which spring from the real relations of parties.” Monroe v. Metro. Life Ins., Co., 457 A.2d 734, 737 (Del.1983). At bottom, USACafes is premised on the notion that “the entity manager must be viewed as one in the same as the entity they control.” Martin v. D.B. Martin Co., 88 A. 612, 615 (Del. Ch. 1913) (“For the protection of the rights of stockholders of the dominant, or parent company, and for righting of wrongs done them by means of the control of the dominant, or parent, company . . . the latter are to be treated as agents of the former, or even as identical with each other.”). Accordingly, the nature of alternative entities and the equitable principles discussed above appear to be in tension. See Feeley v. NHAOCG, LLC, 62 A.3d 649, 669 (Del. Ch. 2012) (“The Delaware alternative entity statute highlights the tension between corporate separateness and the outcomes achieved in equity by imposing fiduciary duties on those actually in control.”).

Addressing the Tension

Indeed, much ink has been spilled over USACafes ignoring the “bedrock” principle of corporate separateness (even though there are many equitable exceptions); disregarding black letter contract law (same); or placing directors “in the situation of having potentially conflicting and irreconcilable fiduciary duties” to different entities. Bay Ctr. Apartments Owner, LLC v. Emery Bay PKI, LLC, 2009 WL 1124451, at *9 & n.44 (Del. Ch.) (citations omitted). These critiques have some validity, but they cannot be premised on the notion that equity is powerless to act or that the equitable aims of USACafes are invalid. Carlisle Etcetera, 114 A.3d at 606. There is no perfectly drafted LLC agreement and therefore there will always be gaps to fill and situations when a court will need flexibility to address the situation. Schoon v. Smith, 953 A.2d 196, 204–05 (Del. 2008) (“[T]he Chancellor always has had, and always must have, a certain power and freedom of action, not possessed by the courts of law, of adapting the doctrines which he administers.”); see also Huatuco v. Satellite Healthcare, 2013 WL 6460898, at *7 (Del. Ch.) (balancing equitable concerns in the context of the agreed upon bargain), aff’d, 93 A.3d 654 (Del. 2014).

But that flexibility—which is codified in Section 18-1104—is also limited by Section 18-1104 to “case[s] not provided for in this chapter”—meaning that equitable considerations have no place in resolving matters expressly provided for in the LLC Act, or by extension, an LLC agreement. As discussed above, the LLC Act provides the members of an LLC with the express authority to limit fiduciary duties to an entity manager. “If the parties have agreed how to proceed under a future state of the world, then their bargain naturally controls.” Loerngan v. EPE Holdings, LLC, 5 A.3d 1008, 1018 (Del. Ch. 2010). Indeed, “investors must rely on the express language of the [operating] agreement to sort out the rights and obligations. . . .” Dieckman, 155 A.3d at 366. Rather than engraving the duty of loyalty onto the human controllers of entity managers, when the duties of the entity managers themselves are subject to modification or elimination by the LLC agreement, the equitable aims of USACafes are better served at the remedy stage through veil piercing or joint and several liability—a court’s traditional equitable powers. Keenan v. Eshleman, 2 A.2d 904, 908 (Del. 1938) (affirming order of joint and several liability because, “[t]he conception of corporate entity is not a thing so opaque that it cannot be seen through.”); Gotham Partners, 2000 WL 1476663, at *20.

That approach better balances the contractor policy goals of the alternative entity statutes and the Court of Chancery’s constitutional authority to “extend those doctrines
to new relations, and shape . . . remedies to new circumstances, if the relations and circumstances come within the principles of equity. . . .” Schoon, 953 A.2d at 204–05.

Conclusion
The Delaware Supreme Court has never expressly adopted (or rejected) the reasoning of USACafes. See Feeley, 62 A.3d at 671 (“The Delaware Supreme Court indisputably has the authority to revisit this Court’s approach and address the tensions created by USACafes.”). Returning the law to the pre-USACafes state of play will allow both the contractarian goals of the alternative entity statutes and the Court of Chancery’s equitable aims to work harmoniously.

For defense counsel, this presents an opportunity to raise the issue in the appropriate case and potentially obtain clarity in our law.

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Member Spotlight: An Interview with Anne Gwal

If there’s a through line in Anne Gwal’s legal career, it’s that she’s spent most of her years in-house. What’s been less constant are the numerous industries in which she has worked: medical devices, home health care, banking, and electric utility and energy. “The one thing that I can say, with respect to all my mergers in the past and in my career, was that I learned to adapt,” says Gwal, assistant general counsel at Exelon, a Fortune 100 electric utility, energy, and generation company based in Chicago and Washington, DC.

Gwal is very involved in the community and bar associations. She served as President of the South Asian Bar Association of North America for 2015 through 2016 and currently is on SABA’s Board of Governors and National Advisory Council. She’s also been involved with the ABA’s Business Law Section, serving as Chair of the In-house Counsel Task Force and Co-Chair of the Corporate Counsel Committee. She will join this Section’s Council in the fall.

* * *

What inspired you to become a lawyer? I am of South Asian heritage, and growing up, it was presumed that I would be a doctor. I realized it wasn’t going to work for me. So after college, I worked for a year and a half as paralegal in a law firm because I was interested in the law. As I started to be a part of the legal community, I realized it fulfilled my penchant for justice and the rule of law.

Very early in your career, you obtained an in-house position. How difficult was that to do? When I graduated in the mid-’90s, it was a difficult time to get any job in the legal profession. I worked for a small boutique firm that focused on family law, but it certainly wasn’t what I was interested in doing so I continued to look for a position. I handled and managed some complex litigation successfully for a medical device company. The CEO offered me a very unique opportunity to help him build an in-house legal department, where one did not exist.

We built the company from $30 million in revenue to $300 million in revenue over the course of four years. We went through a lot of mergers of smaller medical companies and health-care companies and we became a one-stop health-care shop. It was a very rewarding experience, but as with many companies, it was one merger too many. At some point, the VPs and lawyers became extraneous.

Was that because you had merger and acquisition experience from your previous job? I’m sure that played a large role. The good thing about legal skills is that they are, for the most part, transient and able to be used in different industries, especially if it’s early in your career. You have the ability to take your skill set and move from one position to another or one industry to another, with the exception of maybe certain industries like pharma and highly regulated needs. At Axiom, the sale was successful, and I was offered a position at the new company. But since they were in the midst of a sale, it wasn’t necessarily attractive for me. At that point, I had already interviewed with a utility company.

One of the judges that I clerked for during one summer in law school said to me that the first day of a new job should be the first day you start looking for your next job. So I’ve always been, and not in a negative way, proactively looking ahead to advance. I think that’s really important to do.

What advice would you give to a new graduate who’d like to go in-house? Make sure you are looking at the big picture and don’t be afraid of the nontraditional path. There are so many other opportunities, if you are willing to take some of the risk of those opportunities. You might end up in a position that you really love and have a passion for.

I also would advise any new graduate, whether you’re going to a firm, academia,
or a corporate department, to pursue your interest. Pursue what you have a passion for, and you can’t go wrong.

In 1990, you moved to Exelon where you are now an assistant general counsel. How did you reposition yourself so you could work in the electric utility and energy industry?

I was looking for a very stable industry. At that time, the company had just merged with Atlantic City Electric to form Conectiv. This was before Enron. Then Enron happened, and that industry blew up. There were definitely some moments that I thought, “Wow, I come to an industry and it’s blowing up. What’s happening here?” Fortunately, I survived the first merger that Conectiv had with Pepco, which is the Potomac Electric Power company in DC and also in Maryland. Now I am part of the Exelon team.

I had thought I was positioning myself for a stable industry, and then it turned out it wasn’t as stable as I thought. And then it turned out that it didn’t matter because it was still exciting and there was a lot of innovation happening within the electric utility and energy industries.

What are three things you’d recommend to someone who is in-house and wants to be promoted?

The first few years, I put my head down. I believe I acted like most new associates act: I produced good work product. To do that, you need to go out and meet your internal clients. And by that, I mean your client is your company. Meet the engineers, marketing people, corporate communications, and fellow employees—you need to get involved with company endeavors.

It’s very important to navigate the company culture, to know what that culture is, and to be adaptable. That is key in making sure you position yourself for promotions and for success within an organization.

What do you like about working in-house? What don’t you like?

There’s not much that I don’t like about working in-house. There is a perception that in-house lawyers are generalists and they don’t have subject-matter experience. I can tell you that the in-house legal practice has changed over the years, and in-house legal departments are becoming very lean. There’s more pressure on in-house lawyers to do a lot of the work themselves, as opposed to just managing the work and sending the work outside. There are a number of in-house lawyers who have as much expertise in certain areas as outside counsel. In addition, they understand their company.

That’s a real change, isn’t it?

Yes. It varies, of course. If you’re with a smaller company, you’re basically a jack-of-all-trades, trying to manage anything that comes across your desk. For instance, I was at Pepco Holding Inc., which had a legal department of 25 or so lawyers. At Exelon, we have a legal department of 125 lawyers. At Pepco, I was essentially one of maybe four or five transactional lawyers, and now I am one of many transactional lawyers. Being with a larger company with a larger legal department affords you the opportunity to focus your practice area on certain areas.

What I like about working in-house is the diversity of the work. As an attorney, you have a role in helping to build a successful business. You are embedded with your internal clients, with the business folks and your business partners—you are a member of their team so you add to shareholder value. You have the ability to help your company be an excellent corporate citizen, a community partner. You can effectuate positive goals to build that business.

You’ve been very involved with the South Asian Bar Association of North America. In 2015–2016, you served as president. During that term, what did you set out to achieve?

First some background. I was the 13th president of the South Asian Bar Association of North America. We have two Canadian chapters, 26 in total. One of the things I wanted to do was bring the organization into its second decade in a real way and expand its reach. Our mission is to serve South Asian legal professionals throughout North America, and also be a resource for the South Asian community and promote civil rights and access to justice and provide resources, in terms of professional growth to our members and, of course, to promote diversity and inclusion.

Specifically, my platform was to call out to the senior members of our South Asian Bar and make sure they reach out to the more junior members. When I took on the role as president, I spoke about how it is uniquely a corporate counsel obligation to hire outside counsel, and if it makes sense, to staff our projects with diverse associates and to try to drive change from within and from your position.

You are now on the Board of Governors and National Advisory Counsel for SABA, what are your goals?

They’re a continuation of what I was doing during my year as president. In my year as president, we were involved with many issues including the nomination process for the next Supreme Court Justice as well as other seminal issues such as race relations and diversity. Our roles change as the needs change of the country and/or our membership. What I wanted to do was to continue to, again, expand our reach, build our name as a resource. If no one knows you’re there, they don’t know to reach out to you.

At our last convention, SABA had a lobby day. We sent 50, 60 representatives to members of Congress and spoke to them about our interests. The main goal was to let them know we’re here; we’re looking at what you’re doing with your political agenda, and we’re going to be weighing in and letting you know what we want for the future, not just for South Asians but for the country because a lot of these issues affect so many different groups.

You’ve also been very involved with the ABA, including Co-Chair of the Corporate Counsel Committee and Chair of the In-House Counsel Task Force. What did you accomplish in either position that you are most proud of?

I’ve been with the ABA, first as an ambassador. I have a real love for the Business Law Section, the work that they do in reaching out
to its members and providing excellent content. I’m proud of increasing our numbers at the Corporate Counsel Committee. I have found that the ABA Business Law Section provides curated and tailored resources that corporate counsel can use, and not just for subject-matter expertise, not just for specific areas of the law but also for soft skills, such as how to advance in your organization?

We’ve put on some pretty great programs at the Corporate Counsel Committee. A recent program was a Lean Six Sigma program, which focused on efficiencies and project management. We also put on programs for corporate counsel about what to consider when looking to hire outside counsel, and programs for outside counsel—what in-house counsel are looking for.

What has been the value of the ABA to you personally?

For me, it’s been building that network of colleagues and peers and folks that have more experience than I do, and that’s the majority of the ABA. It’s also learning and honing my leadership skills. I am so thankful that I have been chosen to be in a leadership position because I’ve learned so much.

What could the legal profession, including law schools, do to become more diverse?

It’s so important to walk the walk. It sounds very cliché, but it is very important that there’s a focus on diversity and inclusion and that there are actual structured programs within your law firm. The more diverse you are, the more you’re getting your ideas from a lot of different places, and that’s a recipe for success, whether you’re a law firm or a corporate legal department or a law school. Your approach to diversity has to be meaningful, not just putting together a diversity inclusion committee. Make sure there is a mandate to actually interview the minority candidates or women candidates and veteran candidates.

If you start holding people accountable for meeting certain benchmarks of what the company’s goals are or the firm’s goals are for diversity, then you might be able to effectuate change in that way.

What do you do for fun?

I love to write. It’s one of my favorite things to do. I have been writing a lot of children’s stories lately and children songs. I like fiction. When I write, I don’t really notice the time passing and I have to set my alarm when I’m doing something creative so I stop at some point.

I like to spend time with my family—my niece, my nephews, and my sisters. Also, I’m living with a brain tumor and doing very well so I’m getting back to the things I love to do that are more active. I love to travel and be in or near the water. So I am getting back to scuba diving.

Is there anything else you’d like to add?

It’s important for attorneys to do pro bono work and get involved with their communities and address the needs of their particular community. Exelon has incredible pro bono programs. I’ve been involved with Wills for Seniors and will soon participate in a homeless advocacy project. I think it’s very important as lawyers and professionals to be able to give back in that respect.

Thank you so much!
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