insights

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A Newsletter from Shumaker, Loop & Kendrick, LLP | June 2016

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TO SUFFER OR PERMIT:
How The Broad Scope Of The Fair Labor Standards Act Is Increasing The Risk Of Doing Business

2016 is shaping up to be a troubling one for employers subject to the provisions of the Fair Labor Standards Act ("FLSA"), 29 U.S.C. 201, *et seq*. In addition to the Department of Labor's ("DOL") revisions to the FLSA's white collar exemptions, which will go into effect on December 1, 2016 [see article on page 8], the DOL also recently issued Administrator's Interpretation No. 2016-1 ("AI") addressing the concept of "joint employment" under both the FLSA and the Migrant and Seasonal Agricultural Worker Protection Act ("MSPA"), 29 U.S.C. § 1801, *et seq*. This new guidance, which uses an "economic realities" standard to analyze the potential joint employment relationship, represents a stark departure from the common law control standard frequently utilized by courts. Because the economic realities standard is much broader than that of control, the AI has significant and detrimental implications for businesses that contract with third parties, such as staffing agencies, for workers or administrative functions, or for those that share employees with associated entities.

by Kate Decker

and Mechelle Zarou

The AI addresses two primary issues: the broad scope of employment relationships under the FLSA and the MSPA, and the standard for determining potential joint employment relationships. We will analyze both portions of the AI, and address the implications for affected employers.

The Broad Definition of Employment Under the FLSA and MSPA

The broad scope of the FLSA is evident in its definitions. For instance, the FLSA defines an "employee" as "any individual employed by an employer;" 29 U.S.C. § 203(e)(1); and an "employer" as "any person acting directly or indirectly in the interest of an employer in relation to an employee;" 29 U.S.C. § 203(d). Further, the FLSA defines the term "employ" as "to suffer or permit" to work, a definition that the MSPA adopts. 29 U.S.C. § 203(g). This definition does not require consideration of the level of control exerted by the putative employer, as the common law does. Instead, this definition rejects the common law control standard, and anyone who suffers or permits another to work is a statutory employer. The DOL thus concludes that this definition of "employ" is the broadest definition to ever be included in a statute.

The DOL next asserts that joint employment – as contemplated by the FLSA regulations – should be construed just as broadly, based on these broad definitions, which omit consideration of the narrower common law control standard. Notably, the DOL states that, "courts have found economic dependence under a multitude of circumstances where the alleged employer exercised little or no control or supervision over the putative employees."[1] Under the FLSA and MSPA definitions, this economic dependence is the most important factor in finding joint employment exists, far

more important than the exercise of control. Further, given the shared definition of employment between the two statutes and coextensive scope of joint employment between them, it is appropriate to rely on both statute's regulations to determine whether a joint employment relationship exists in a case arising under either statute.

If the intermediary employer is not an actual employee of the potential joint employer, the DOL requires that the vertical joint employment inquiry proceed to its second step – the "economic realities" analysis.

Types of Joint Employment

The AI distinguishes between two types of potential joint employment. The first type, horizontal joint employment, "exists where the employee has employment relationships with two or more employers and the employers are sufficiently associated or related with respect to the employee such that they jointly employ the employee."[2] The second type, vertical joint employment, "exists where the employee has an employment relationship with one employer (typically a staffing agency, subcontractor, labor provider, or other intermediary employer) and the economic realities show that he or she is economically dependent on, and thus employed by, another entity involved in the work."[3] Each type of joint employment is subject to its own analysis, which we outline below.

Horizontal Joint Employment

The DOL explains that the typical hallmark of a horizontal joint employment situation is an established employment relationship between an employee and various employers pursuant to which the employee usually performs separate work and works separate hours for each employer, where the employers are "sufficiently associated"[4] to be joint employers. Examples of potential horizontal joint employment scenarios include a waitress who works for separate restaurants that are operated by the same entity and a farmworker who picks produce at two separate orchards, where the orchards have arranged to share farmworkers. The hallmark of this arrangement is some type of cooperation or administrative coordination among the separate employers. The FLSA regulations governing joint employment, which also focus on the relationship of the employers to each other, are instructive here, whether the case arises under the MSPA or the FLSA.

In analyzing the relationship between potential horizontal joint employers, the FLSA regulations look for arrangements between the employers to share or interchange the employee's services, or where one employer acts (directly or indirectly) in the interests of another employer in relation to the employee, or where the employers share control of the employee (directly or indirectly) because one employer controls, is controlled by, or under common control with the other employer. In the AI, however, the DOL suggests a number of non-exhaustive factors to be considered, the focus of which is on the relationship (and often the degree of association) between the two (or more) potential joint employers, including the following:

- Who owns the potential joint employers (i.e., does one employer own part or all of the other or do they have any common owners);
- Whether the potential joint employers have any overlapping officers, directors, executives, or managers;

- Whether the potential joint employers share control over operations (e.g., hiring, firing, payroll, advertising, overhead costs);
- Whether the potential joint employers' operations are inter-mingled (for example, is there one administrative operation for both employers, or does the same person schedule and pay the employees regardless of which employer they work for);
- Whether one potential joint employer supervises the work of the other;
- Whether the potential joint employers share supervisory authority for the employee;
- Whether the potential joint employers treat the employees as a pool of employees available to both of them;
- Whether the potential joint employers share clients or customers; and,
- Whether there are any agreements between the potential joint employers.

Not all of the above facts need to be present for joint employment to exist. The DOL distinguishes horizontal joint employers from employers that "are acting entirely independently of each other and are completely disassociated with respect to an employee who works for both of them."[5] In the latter case, joint employment does not exist. By way of example, the DOL explains that a high school teacher who also worked as a tutor for a standardized test preparatory company would not be considered jointly employed by both the high school and the test prep company, as long as there was no relationship or intermingled operations between the two companies.

In sum, the central focus of a horizontal joint employment analysis is the relationship between the employers and the amount of control they share with respect to the employee.

Vertical Joint Employment

In contrast to the horizontal joint employment inquiry's focus on the relationship between the employers, the focus in a vertical joint employment analysis is the employee's relationship with the potential joint employer. According to the DOL, vertical joint employment relationships typically arise where the potential joint employer has contracted or made arrangements with the intermediary employer to provide it with labor and/or certain business functions, such as hiring or payroll. Although there is usually an established employment relationship between the employee and the intermediary employer, the employee's work typically benefits the potential joint employer as well. A prime example of a potential vertical joint employment scenario is an individual who is assigned by a staffing agency to work at a separate company. The AI cites the MSPA regulations as "useful guidance" in analyzing any vertical joint employment case.

The vertical joint employment analysis consists of two parts. Under the initial part of the analysis, the DOL determines whether the intermediary employer is actually an employee of the potential joint employer. If the answer is yes, then the intermediary employer's employees are employees of the potential joint employer as well and the inquiry ends there. While it may seem that only an individual could be deemed to be an employee of the potential joint employer, in fact, under the DOL's view, entities can also be deemed to be "employees." For this proposition, the DOL cites a prior Administrator's Interpretation, No. 2015-1[6], which was previously discussed in the Autumn 2015 edition of *Insights*, (available at http://www.slk-law.com/NewsEvents/Publications/123508/Your-Drivers-Are-Now-Your-Employees-Independent-Contractors-Under-the-New-Labor-Paradigm). There, the DOL addressed the proper classification of workers as either independent contractors or employees, and, largely relying on the same economic realities test, determined that most workers are properly classified as employees.

The DOL also provides several examples of vertical joint employment under this standard, including a farm labor contractor who is employed by a grower, but also employs his own farmworkers and a subcontractor who is employed by a general contractor, but also employs his own workers. Under these examples, both the farm laborer's employees and the subcontractor's employees are all employees of the potential joint employers, the grower and the general contractor. In addition, the DOL disregards the corporate form in making this determination.

If the intermediary employer is not an actual employee of the potential joint employer, the DOL requires that the vertical joint employment inquiry proceed to its second step – the "economic realities" analysis.

The AI specifically mandates that the vertical joint employment analysis **cannot** focus only on control, which is a stark departure from the control-centered analysis previously (and in some cases currently) applied by the courts. Instead, the central question is "whether the employee is economically dependent on the potential joint employer who, via an arrangement with the intermediary employer, is benefitting from the work."[7]

To answer that central question, the DOL looks to the seven economic realities factors described in the MSPA's joint employment regulation, 29 C.F.R. § 500.20(h)(f)(iv), but notes that the economic realities factors "should not be considered mechanically or in a vacuum; rather they are guides for resolving the ultimate inquiry whether the employee is economically dependent on the potential joint employer."[8] These factors include the following:

- Whether and to what extent the potential joint employer controls or supervises, either directly or indirectly, beyond a reasonable degree of contract performance oversight, the work performed by the employee;
- Whether and to what extent the potential joint employer has the power, directly or indirectly, to hire or fire the employee, modify employment conditions, or determine the rate or method of pay;
- The degree of permanency and duration of the relationship, considered in the context of the particular industry at issue;
- The extent to which the services rendered by the employee are repetitive, rote tasks requiring skills that are acquired with relatively little training;
- Whether the activities performed by the employee are an integral part of the overall business operation of the potential joint employer's business;
- Whether the work is performed on the potential joint employer's premises; and,
- Whether the potential joint employer performs administrative functions for the employee, such as handling payroll, providing workers' compensation insurance, providing necessary facilities and safety equipment, housing or transportation, or providing tools and equipment or materials required for the job.

Recognizing that the economic realities factors may vary by court, the DOL requires that every formulation "address the ultimate inquiry of economic dependence" and recognize "the broad scope of joint employment under the FLSA and MSPA."[9] Consequently, the DOL expressly rejected the approach applied by some courts which primarily or exclusively focuses on the potential joint employer's control, specifically hiring and firing authority, supervision and control of employment conditions or work schedules, determination of rates and methods of pay, and maintenance of employment records. This approach, the DOL concludes, "is not consistent with the breadth of employment under the FLSA."

In sum, any vertical joint employment analysis must consider the broad scope of employment under the FLSA and MSPA and resolve the ultimate inquiry of whether the employee is economically dependent on the potential joint employer.

How Does the AI Impact Employers?

The AI very clearly demonstrates that the DOL intends to interpret the FLSA as broadly as possible to protect employees and ensure that employers cannot evade their obligations under the statute by sharing employees with related entities or utilizing staffing agencies or contractors for labor. While the DOL does not significantly alter the horizontal joint employment analysis, its rejection of the common law control-based formulations in favor of the broader economic realities for the vertical joint employment analysis will likely have significant implications for employers that contract with third parties for staffing and administrative functions, or that share employees with affiliated entities.

For instance, as the DOL notes, when two or more employers jointly employ an employee, the employee's hours worked for **each joint employer** during each workweek are aggregated and considered as one employment for purposes of calculating minimum wage and overtime. Thus, employers that qualify as joint employers under the FLSA will need to implement procedures to record **all** hours worked by each employee of all of its joint employers, in order to calculate minimum wage and overtime based on the sum of all the hours worked in a workweek. Suppose, for example, that Companies A, B, and C jointly employ Mr. Smith and, during a particular workweek, Mr. Smith works 10 hours for Company A, 30 hours for Company B, and 20 hours for Company C. Under the FLSA's joint employer provisions, Mr. Smith would have worked a 60 hour workweek and would be entitled to overtime

for 20 of those hours. The three companies are responsible for paying the 20 hours of overtime, although the companies need not pay 20 hours of overtime each. How such overtime payments will be paid by the three companies must be determined as a matter of negotiation among the three companies.

Making matters worse, joint employers are jointly and severally liable for FLSA violations, including minimum wage and overtime violations. The DOL explains that "[i]f one employer cannot pay the wages because of bankruptcy or other reasons, then the other employer must pay the entire amount of wages; the law does not assign a proportional amount to each employer."[10] Thus, if the aforementioned Companies A and B cannot pay Mr. Smith's wages for that workweek, Company C must compensate Mr. Smith for all 60 hours worked, including the 20 hours of overtime, or face full liability for its failure to ensure the overtime is paid.

Moreover, should the DOL's analysis in the AI begin to permeate other employment law contexts, such as liability for employing unauthorized workers or for discriminatory acts, a joint employer could find itself liable for a host of violations committed by subcontractors, staffing agencies, and affiliated entities.

Given the severe consequences that employers face for violating the FLSA – specifically, back wages, liquidated damages, and attorneys' fees of both the employer and the employee(s) – we strongly recommend that all employers that currently share employees with related entities or contract with third party providers for labor or administrative services assess their employment relationships by reviewing the factors identified in the AI and confirm whether or not they qualify as a joint employer under either the horizontal or vertical joint employment analyses.

In light of the high risk of liability, employers who believe they may qualify as a joint employer should review their business models to determine whether the sharing of employees and/or the use of employees provided by third parties can be eliminated. If the employer's business model is reliant upon shared employees and/or contracted workers, we recommend that the employer review and amend their written agreements with its potential joint employers to establish each party's obligations with respect to employment law compliance, particularly FLSA compliance, and include specific provisions allocating responsibility for overtime payments and other compliance, as well as strong indemnification provisions in favor of the contracting employer as an additional safeguard.

Shumaker's experienced Labor and Employment attorneys stand ready to assist you with undertaking the recommended analysis, as well as any required contract review or drafting to ensure compliance with the DOL's latest trend toward expanding the definition of employment in all its forms. You can contact the authors, Kate Decker (kdecker@slk-law.com) and Mechelle Zarou (mzarou@slk-law.com), or any member of Shumaker's Labor and Employment Department for immediate assistance.

[1] AI at 4, quoting *Antenor v. D & S Farms*, 88 F.3d 925, 933 n. 10 (11th Cir. 1996) (internal quotation marks omitted).

[2] AI at 2-3.

[3] *Id.* at 3.

[4] *Id.* at 2-3.

[5] AI at 9, quoting 29 C.F.R. § 791.2(a) (internal quotation marks omitted).

[6] Administrators Interpretation No. 2015-1 (hereinafter "Misclassification AI").

[7] AI at 11.

[8] AI at 11, citing *Antenor*, 88 F.3d at 923-33 and the Misclassification AI, 5-6.

[9] AI at 13 (internal quotation marks omitted).

[10] AI at 2, fn. 4.

(REALLY)
Early Dispute Resolution

Georgia Pacific estimates that it saved over $30 million from the first ten years of its early dispute resolution ("EDR") program. GE estimated that its EDR program cut its litigation costs almost in half. EDR is something every company—not just Fortune 100 corporations—should be considering.

What is EDR?

At the first sign of a dispute, each side:

by Peter R. Silverman

- agrees to try to resolve the dispute voluntarily, cooperatively, quickly, and cost-effectively (or to follow an EDR clause in their contract that requires the process);
- internally gathers and analyzes the key facts and relevant law;
- exchanges the information (if any) the other side needs to make a reasoned judgment on the merits of the dispute; and
- negotiates or mediates to resolution.

EDR is something every company—not just Fortune 100 corporations—should be considering.

EDR reduces the costs of litigation, and frees management's and employees' time from the ongoing distraction of lawsuits.

The aim should be to resolve all disputes in thirty, but no longer than ninety, days. Even with a complex dispute, this is doable. Companies and trial counsel regularly put in that intensive level of work on a complex matter when they need to obtain a preliminary injunction. There is no reason they cannot do the same to resolve disputes early.

What *isn't* EDR?

- EDR is not mediation. Mediation is one tool that may help resolve disputes early as part of EDR. But EDR is much more—a rigorous, disciplined system that focuses internal management and outside counsel on resolving disputes early and cost-effectively.
- EDR is not holding up a neon sign saying *I am a pushover*. If you can resolve the dispute early and fairly, you do so. If not, all options are open.
- EDR is not a guarantee that you will resolve every dispute early. For

the process to work, you need the other side to act in good faith and be represented by ethical (not looking to run up fees), skilled counsel. Even then, there may be good reasons (e.g., precedent, timing, principle, or commercial reasons) why both parties cannot agree on terms. Business reasons can trump speed and cost-efficiency. EDR puts you in the position where, early in the process before significant litigation expense, you can make a reasoned judgment on what is best for your company.

How do you implement it?

1. Start by proactively minimizing suits. Look at your lawsuits the past five years. Are there patterns in what causes them? Change incentives and systems to discourage activities that lead to disputes.
2. Adopt internal policies so that everyone in the organization knows that the goal is to resolve disputes early and cost-effectively by rapidly gathering all the key facts (especially the potentially harmful ones) and analyzing what would be fair terms to resolve a dispute. This includes a hard look at issues like timing, what sort of leverage each side has, and whether the case has commercial ramifications or the potential to set a good or bad precedent.
3. Involve your outside counsel in planning the process. Have them committed to mastering the rapid gathering of facts; analyzing the dispute; figuring out what information, if any, you need to make a reasoned judgment on the case; and negotiating or mediating toward resolution. Consider a role for settlement counsel.
4. If you do not resolve the dispute, you may want to structure arbitration or litigation to try the case quickly or cost-effectively. Or you may want to do that with just one key issue, and then try to mediate or negotiate resolution. Or you may choose aggressive litigation. The benefit is being given the opportunity to make a reasoned decision based on how the EDR negotiations or mediation proceeded, and on the information learned in the process.
5. Be smart with the use of neutrals skilled in EDR. It may be worthwhile to bring on a neutral at the beginning of the thirty-day process to keep both parties on track in moving the process along quickly and cost-effectively.
6. State on your web site that you are committed to attempting early dispute resolution in good faith. That way, when you propose it, the other side will know that it is part of your culture and not a signal that you perceive weakness on your side of the dispute.
7. Think through how you may want to modify your dispute resolution clause to implement EDR.

Mediation was a new idea 35 years ago; it is now commonplace. While some companies such as Georgia Pacific and GE have implemented comprehensive EDR for a number of years, the disciplined, rigorous use of the process is new. My sense is that it will be rapidly adopted by companies nationwide and soon will become the new normal in dispute resolution.

Peter Silverman has written and spoken on EDR for a number of years. He has co-authored a detailed paper on the process that he presented at the IFA Legal Symposium in May. If you'd like a copy of the paper, e-mail him at psilverman@slk-law.com.

Employers Should Begin Preparing for New Overtime Rules

On March 13, 2014, President Obama directed the Department of Labor to update its overtime regulations under the Fair Labor Standards Act ("FLSA"), and the DOL issued its draft regulations in July 2015. After considerable delay (a welcome development from the standpoint of employers) during the comment and revision period, the DOL released the final rules on May 18, 2016, with employers required to be in compliance on December 1, 2016. Although there are several months remaining until the new regulations go into effect, employers should begin making preparations now for what will be a significant shift in overtime policy under the FLSA.

by Daniel R. Strader

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Existing Law under the FLSA

The FLSA, first enacted in 1938 and amended several times since then, provides for a federal minimum wage, a standard 40-hour workweek, and pay at time-and-a-half for all overtime hours, among other requirements. However, the law also includes several exemptions from its provisions for certain classes of workers, the most common of which are the so-called, "white collar" exemptions. These exemptions encompass three subcategories of workers: (1) executive (think supervisory/management employees); (2) administrative (think HR professionals, insurance adjusters, and other employees exercising substantial discretion as to important matters); and (3) professional (think doctors, lawyers, accountants, teachers, and other learned professionals with advanced degrees). Unlike non-exempt employees, none of the aforementioned classes of employees is entitled to premium pay for overtime hours.

To qualify for one of these "white collar" exemptions, an employee must satisfy a two-part test. First, the employee's actual job duties must be of a particular nature for each of the exemptions. To qualify as an exempt executive, for example, an employee must have the primary duty of management of the business, must customarily and regularly supervise at least two other full-time employees, and must have authority to hire and fire (or significant input into such decisions). Second, the employee must meet the "salary basis" test, which requires that the employee be paid a set salary of no less than $455 per week ($23,600 annually). Other than some narrowly construed,

permissible deductions, a salaried, exempt employee must receive at least his or her full salary during any week in which any work is performed, whether it be 1 hour or 100 hours. Non-exempt employees, in contrast, are generally (but not always) paid hourly, must be paid only for the hours actually worked, and must receive premium pay for all hours over 40 in a workweek.

What is Changing and What is Not (We Think)

By far the most significant change to the FLSA under the new overtime regulations is a sizeable increase in the required salary basis. In the final rule released on May 18, the salary basis was increased to $913 per week ($47,476 annually). Although this amount is somewhat lower than had initially been proposed last July, it still represents a substantial increase of more than double the current salary basis. Another significant change is that the salary basis will be tied to a national wage standard to be adjusted automatically every three years, beginning on January 1, 2020. This amount is set at the 40th percentile of the weekly earnings of all full-time, salaried employees in the lowest-wage Census Region (currently the South), and the salary amount will be adjusted every three years to maintain this level. That means that employers must continually monitor their salaried employees' wages and provide pay increases as necessary to stay above what will be a continually shifting threshold. A welcome development in the final rule which was not part of the proposed rule is that employers will be permitted to use nondiscretionary bonuses and incentive payments (including commissions) to satisfy up to ten percent of the new salary basis. This will provide some measure of flexibility to employers in adjusting their employees' compensation to qualify for the revised exemption. The final change in the new rules, which affects only a small number of employees, is an increase in the required compensation to qualify for the "highly compensated employee" exemption. This exemption applies to employees who meet some, but not all of the required duties for an exemption, receive at least the standard weekly salary basis, and receive total compensation of at least $100,000 annually. Like the standard salary basis, the total compensation level for highly compensated employees will also be tied to a national standard—the 90th percentile of earnings for all full-time, salaried employees nationally (currently $134,004 annually)—and will be adjusted every three years. In a nutshell, depending on the salary amounts currently paid to exempt employees, employers may have to pay substantially more than is currently required under the FLSA to qualify for an overtime exemption.

Although these new rules will certainly present a challenge for many employers—particularly those in industries such as hospitality and retail where relatively low wages are common among managers, shift supervisors, and similar positions—employers can take solace in the fact that it appears a significant area will stay the same: the duties tests. During the initial drafting and comment phase for the new rules, there were substantial indications that the DOL would tighten up the duties tests and make it even more difficult for employees to qualify as exempt. One possibility would have been a bright-line rule that an exempt executive employee must spend at least 50% of his or her time engaged in management duties, which would have virtually destroyed the exemption as it relates to, for example, retail store managers, who typically spend a significant portion of their time engaging in tasks such as stocking shelves, helping customers, and working the cash register in addition to their management responsibilities. Employers can breathe a sigh of relief that the duties tests will not be changing, at least for now.

What Employers Need to Do to Prepare

As it pertains to employees who are currently exempt but are not paid enough to qualify under the increased salary basis, there are really only two options for employers under the new overtime regulations: increase their employees' salaries at or above the new threshold, or treat such employees as non-exempt. The first option will come at an increased cost, and the DOL estimates that as many as four million currently exempt employees will become non-exempt in the first year of implementation alone due to the cost of compliance with the new rules. Choosing this option will also amount to a regulation-backed guarantee to provide an exempt employee with a raise every three years to ensure that he or she stays above the shifting (and likely increasing) threshold. The second option requires that an employer track the employee's hours and pay him or her the overtime premium for all hours over 40 in a workweek. Whether or not this results in an increase in compensation will depend upon how many hours the employee works.

We recommend that employers begin working now to analyze their work force to determine how they will manage the new overtime rules. Employers should begin by analyzing their workforce and identifying those employees most likely to be affected. For employees who make far less than the proposed new salary basis, the decision is likely an easy one—it will almost certainly be more beneficial to treat such employees as non-exempt than to more or less double their current salary. For exempt employees who are closer to the new salary basis, employers should begin requiring them to track their hours on an interim basis, which will allow the employer to accurately determine the relative costs to the company of reclassifying versus raising the salary of a particular employee. Many employers have no more than a general idea as to how many hours their exempt employees actually work—this is not surprising since it previously had not mattered. During the interim timekeeping period, exempt employees should be required not only to clock in and out at the beginning and end of a shift, but also for lunch breaks lasting at least 30 minutes, during which they are completely relieved from duty. Employers will want to tighten up their break procedures and ensure that "working" lunches taken at the employees' desks are prohibited. Employers should also require exempt employees to track time spent outside of work engaged in work tasks—checking emails, answering phone calls, and similar tasks. All of this work is compensable for non-exempt employees and contributes to the 40-hour-per-week overtime threshold. This timekeeping need not utilize fancy machinery or software—a notepad and pen will work just fine.

The employer should closely monitor its exempt employees' hours over a period of several weeks and determine the best course of action. For employees who are already near the proposed salary basis and work a high number of hours, the math will likely dictate that increasing their salaries makes the most financial sense. For those who work close to 40 hours and rarely work overtime, it may be more sensible to treat them as non-exempt and simply pay overtime when applicable. Paying non-exempt employees a salary is also an option. Paying a salary would allow the employer to pay the employee only half-time for overtime hours rather than the full time-and-one-half premium. Keep in mind, however, that paying salary to non-exempt employees is a double-edged sword, in that there may be workweeks where the employee works substantially less than 40 hours but is still entitled to the full weekly salary. Other measures, such as mandatory lunch breaks, hours reductions, and policies prohibiting working from home, may also help control the hours of non-exempt employees and avoid overtime situations. Another possible option is to divide job duties among multiple employees, which may involve new hires, in order to more evenly distribute the workload. There are a myriad of options to ensure compliance with the new overtime rules, but it is imperative that all employers begin the necessary analysis so that the appropriate decisions can be made.

One final consideration is employee morale, and employers should begin developing appropriate messaging to address these changes. Many employees may not appreciate the perceived loss in status which accompanies a switch from a salaried to an hourly role. The key message to employees should be that these changes should not result in a decrease in pay. Rather, the goal is to maintain pay at roughly the same level, which may take a bit of adjustment during the first few months to ensure that the hourly wage being paid and the amount of overtime being worked match their current salary. A silver lining to these changes is that they also give employers some cover to reclassify employees whose duties perhaps already made their exemption suspect—now employers have a built in reason to reclassify such employees as non-exempt without raising red flags. Developing consistent, positive messaging well before the new rules take effect on December 1 will go a long way towards maintaining a happy and productive workforce.

Clearly, the impending changes to the FLSA's overtime rules represent a significant challenge to employers. However, with careful thought and advance planning, employers can navigate this new landscape with minimal cost and disruption.

If you have any questions regarding the new overtime rules, or any other general employment compliance concerns, please contact Dan Strader at dstrader@slk-law.com or 941-364-2735.

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2016 Lexology Client Choice Award

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The Lexology Client Choice awards recognize those partners from around the world who offer excellent client services. Erin accepted the award in London in February.

National Diversity Council's "Ohio LGBT Ally Award"

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This award is given out annually to leaders in corporate America and within the community who exemplify recognizable LGBTA advocacy efforts. These individuals serve as role models within the LGBTA community and strive to promote inclusiveness within the workplace.

2016 Readers' Choice Award

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Received the 2016 Readers' Choice Award as one of the top authors who published content through JD Supra.

The above lawyers were selected to lists issued by private companies. A description of the selection methodology may be obtained at each such company's website. No aspect of this advertisement has been approved by the Supreme Court of any state in which a named lawyer has been admitted.

insights

International Sales Contracts:

Square Peg, Round Hole

The purpose of a sales contract is to define the parties' obligations and to optimize outcome if a dispute arises. As such, a contract is a tool to manage risk and prevent loss. The good news is the vast majority of contracts are performed as planned, and no issues arise. The bad news is when issues arise, they can be costly, eroding or eliminating the anticipated profits, or causing loss from the transactions.

by David H. Conaway

In particular, sales contracts for the sale of goods are based on Article 2 of the Uniform Commercial Code, which has been adopted by every U.S. state. When disputes have arisen, U.S. court rulings have been largely uniform and predictable. Litigation outside the U.S. can be less predictable and before courts that are less impartial.

We have noted a prevalent use of U.S. contracts, originally designed for domestic sales, in transactions involving foreign customers or supply chain. Usually these contracts have few or no modifications to address the laws, court systems or country risks of the foreign country.

When disputes have arisen, U.S. court rulings have been largely uniform and predictable. Litigation outside the U.S. can be less predictable and before courts that are less impartial.

Companies ideally would have bespoke contracts that address these differences. However, given that many companies do business in numerous foreign countries, it may be impractical to have a bespoke contract for every country. A reasonable approach would be to consider an over-arching "international" sales or supply contract, and variations for key market countries, or material customer relationships.

The key provisions to address in international sales contracts, other than normal trade terms, include:

What Law Applies?

Most contracts provide that the laws of a particular U.S. state apply, which would incorporate Article 2 of the Uniform Commercial Code. However, the United Nations Convention on Contracts for the International Sale of Goods ("CISG") is a treaty that, as a species of federal law, would trump application of U.S. state law. The CISG applies to any sales contract between parties from signatory countries. To date, 84 countries (covering over 80% of world trade) are signatories to the CISG treaty including the U.S., Canada, China, Germany, Japan, and Mexico. To

exclude application of the CISG and to provide for the UCC to control, the contract must expressly exclude application of the CISG, and provide that the UCC governs.

The relative bargaining position of the parties may compel using an "international" law, rather a U.S. law. Whether or not the UCC or the CISG is preferable focuses on a comparison of the seemingly similar, but materially different, laws. A comparison of the UCC and the CISG is beyond the scope of this article, but one example relates to a common occurrence in commercial transactions: the battle of the forms. Often parties utilize purchase orders, order acknowledgements, invoices, terms and conditions of sale, and sales contract, some or all of which may be electronic. Naturally the seller's and buyer's forms have materially conflicting provisions reflecting the parties' differing interests. When this occurs, the UCC would nevertheless create a contract, incorporating all the terms that are in common, and any non-material additional terms. However, any material additional terms, such as a warranty disclaimer, an arbitration clause, or an attorneys' fees provision, are excluded.

By contrast, the CISG utilizes more of a "mirror-image" rule. Unless the parties' forms are virtually identical, there is no contract. The seller's order acknowledgement, for example, containing additional terms or conditions, would be considered a counter-offer, typically accepted by performance of the parties. In this sense, the seller gets the "last shot", and the CISG protects the seller's forms to a greater extent.

In the context of a customer Chapter 11 filing, a seller of goods may have an enhanced recovery opportunity for goods shipped to and received by the customer within 20 days prior to the filing. The UCC provides that goods are received upon physical possession, while the CISG does not define when receipt occurs. A recent Bankruptcy Court (*World Imports*, E.D.Pa. 2014), in the context of Chinese suppliers of goods, ruled that the CISG applied and that the U.S. buyer received the goods when "delivered", which is when goods are loaded for delivery in an FOB plant contract. The CISG "receipt" would almost always occur earlier and outside the 20 day period, denying the seller the Section 503(b)(9) remedy. Of course, whether or not a seller of goods may or may not obtain a favorable Section 503(b)(9) treatment in future Chapter 11 filings of customers is not sufficient business justification to exclude application of the CISG. Rather, it is a factor to consider.

Where Will Disputes be Resolved?

Parties naturally seek the "home court advantage" of courts in their particular jurisdiction. Again, this may not be possible depending on relative negotiating advantage of the parties.

More importantly, parties should consider how a judgment would be enforced, which largely depends on where the counter-party's assets are located. The U.S. is not a signatory to any ratified international treaty for the recognition or enforcement of foreign court judgments. U.S. courts have and will enforce foreign judgments in the U.S. based on comity and U.S. state's laws, but without a treaty, foreign courts likely will not reciprocate. Thus, obtaining a U.S. judgment may be a waste of time, if the counter-party has no assets in the U.S.

To enforce any judgment obtained from a U.S. court, the U.S. company would be required to commence a separate, essentially duplicative, action in the customer's jurisdiction.

Arbitration of Foreign Disputes

By contrast, the U.S. is a signatory to the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the New York Convention). 156 countries are signatories, including the U.S., Canada, China, Germany, Japan, and Mexico. Clearly, arbitration has developed to be the preferred dispute resolution mechanism for international business disputes.

U.S. companies naturally gravitate to U.S.-based arbitration institutions such as the American Arbitration Association to conduct arbitrations in the U.S. However, if an arbitration award must be enforced by a foreign court (where assets are located), it is necessary to consider whether the foreign court favors or disfavors the arbitration rulings of certain arbitration institutions. For example, Chinese courts generally will only enforce arbitral awards of CIETAC (China International Economic and Trade Arbitration Commission). Mexican courts generally favor the arbitral awards of the ICC (International Chamber of Commerce), CAM (Arbitration Center of Mexico) and ICDR (International Center for Dispute Resolution), CAMCA (Commercial Arbitration and Mediation Center of the Americas).

Contract parties may not be willing to submit to the jurisdiction of the other party's forum. An international arbitration institution provides a neutral forum for dispute resolution.

Who Pays the Costs of Dispute Resolution?

In the U.S., the majority "American" rule is that each party to a dispute bears its own legal costs, unless that risk is shifted by contract.

By contrast, most countries have adopted the "English" rule that requires the loser to pay the winner's reasonable attorneys' fees.

Because legal costs of dispute resolution are material, and shifting the risk among the parties can impact incentives to initiate a dispute in the first instance, and to efficiently resolve a dispute, it is important that such provisions in international sales contracts are clear and comprehensive. The enforceability of such provisions varies among countries, but increasingly courts are recognizing the parties' rights to shift risks in their business dealings.

Miscellaneous Important Contract Provisions

A. Intellectual Property Rights should be protected by appropriate registration. Patent, trademark and copyright protection varies on a country-by-country or regional basis. Because of the time required to obtain these rights, the need to file should be anticipated, and initiated as soon as the need is recognized. Because of the cost involved, whether and how to shift these costs should also be taken into account.

   A seller of goods with associated patents or trademarks may also consider provisions terminating any express or implied license to sell or use its goods upon a default by the counter-party.

B. Certain goods may require special import/export or other regulatory compliance or government approvals.

C. As financial distress of contract counter-parties increases, parties should consider hedging the credit risk with security, title retention, credit insurance, or vigorous internal credit risk assessment, which includes country risk analysis.

D. Force majeure (act of God, strikes, political unrest) clauses are increasingly important to hedge risks created by turbulent financial markets and global conflicts and crises.

E. Currency fluctuations and risks are important considerations in contract profitability. Parties should certainly include contract provisions that allocate this risk. Moreover, parties are well-advised to evaluate financial products that hedge such risks.

F. The parties must also take care about the flow of electronic information that may be shared pursuant to the Agreement, particularly if it involves the transfer between countries of any sensitive personal information of customers, employees, or other users. Some countries may prohibit the transfer of certain information, and others, most notably the EU countries, require agreements addressing data privacy and breach, with additional EU data protection regulations effective in 2017.

For additional information, contact Dave Conaway at dconaway@slk-law.com or 1-800-797-9646, ext. 2149.

Enforcing Transparency in the Supply Chain

Many manufacturing supply agreements now contain a deceptively simple clause in the concluding boilerplate: Supplier shall comply with Buyer's Supplier Code of Conduct located at [buyer's IP address].com. With a sigh, careful readers may look it up, wondering what onerous requirements may be lurking within. *Does Buyer demand disclosure of my trade-secret raw materials?* Others will shrug it off—*the Code only codifies good business practices, and no one is enforcing the audit rights.*

By Regina M. Joseph

Still others may wonder whether they, too, should adopt a Code—*have I overlooked a new legal mandate? If so, what is really required? Does it need to be twelve pages?*

Companies have recognized the advisability of maintaining a Code of Conduct for internal purposes. The wide-spread usage of such a Code

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was partly driven by a Delaware judicial decision that recognized an oversight duty on the part of directors *(In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996)). An explicit Code of Conduct proved useful when defending shareholder lawsuits or criminal charges based on the alleged wrongdoings of employees. Since suppliers of product and outsourced services play an important role in the organizational framework, legal responsibility has crept beyond the corporate walls. Thus, many companies (as used herein, "buyer") have also created a Supplier Code of Conduct ("Supplier Code").

What Law Drives the Creation of a Supplier Code?

Internationally, the labor and human trafficking standards have been advocated by organizations associated with the United Nations. See, e.g., http://www.unglobalcompact.org/ the UN Universal Declaration of Human Rights, http://www.un.org/en/documents/udhr/index.shtml/ and the standards of the International Labor Organization, http://www.ilo.org/global/standards/information-resources-and-publications/

publications/WCMS_318141/lang--en/index.htm. For broader guidelines applicable to multinational corporations, see http://www.oecd.org/corporate/mne/. For environmental standards, see http://www.unep.org/.

Two international sets of standards address social and environmental matters. ISO 14000 (http://www.iso.org/iso/iso14000) essentials is a series of international voluntary standards and guidelines for environmental management systems, eco labeling, environmental auditing and performance evaluation, and related matters. SA 8000 (http://www.sa-intl.org/index.cfm?fuseaction=Page.ViewPage&PageID=937) addresses child labor, forced labor, workplace safety and health, and related matters.

For United States businesses, perhaps the biggest impetus for Supplier Codes has come from the State of California. Like the international standards, the focus has been on labor and environmental issues. The California Transparency in Supply Chains Act of 2010 ("California Human Trafficking Act") requires that retail sellers and manufacturers doing business in California (e.g., filing California tax returns) to disclose their efforts to eradicate slavery and human trafficking from their direct supply chains. It requires any retailer or manufacturer having $100,000,000 or more in annual worldwide gross receipts to disclose on its website whether it maintains policies, whether it verifies compliance and, if so, whether the verification was an independent, unannounced audit.

In California, AB. 708 has been winding its way through the legislative process, replacing previously proposed regulations that were dubbed a "green chemistry" initiative by the California Department of Toxic Substances Control. The new law, if enacted, will require a manufacturer that manufactures, assembles, produces, packages, repackages, or relabels a cleaning product that is sold or used in California to disclose each ingredient on the manufacturer's website, and to provide the website address on the product label, along with a prescribed statement. http://leginfo.legislature.ca.gov/faces/billNavClient.xhtml?bill_id=201520160AB708. The regulations failed under the green chemistry initiative in part because objections were raised about forced disclosure of trade secret information.

At the federal level, for many years suppliers have been required to supply Safety Data Sheets (formerly known as Material Safety Data Sheets or MSDS) (see, e.g., https://www.osha.gov/Publications/HazComm_QuickCard_SafetyData.html).

At the United States federal level, the proposed Business Supply Chain Transparency on Trafficking and Slavery Act of 2015 (H.R. 3226; S. 1968) directs the Securities and Exchange Commission ("SEC") to promulgate regulations within one year of enactment. The regulations are mandated to require disclosure in the annual report of whether the issuer has taken any measures during the year to identify and address conditions of forced labor, slavery, human trafficking, and the worst forms of child labor within the company's supply chains. It will apply to issuers of registered securities with annual worldwide global receipts in excess of $100,000,000. The regulations are also directed to mandate disclosure on the issuer's website under the label "Global Supply Chain Transparency." In the House, this legislation was referred to the Financial Services Committee and, in the Senate, to the Banking, Housing, and Urban Affairs Committee. Although not at the top of the legislative agenda, the legislation has picked up additional sponsors since first being introduced in the 2013-2014 session. The new mandated disclosure is similar to the SEC's controversial rules regarding "conflict minerals" disclosure (Section 1502(e)(4)) of the Dodd Frank Wall Street Reform Act), which require supply chain mapping. See, e.g., https://www.sec.gov/News/Article/Detail/Article/1365171562058.

Bribery and improper payments through the supply chain have been addressed in the United States through the Foreign Corrupt Practices Act (see, e.g., http://www.justice.gov/criminal/fraud/fcpa/), in the United Kingdom through the Bribery Act (see, e.g., http://www.fco.gov.uk/en/global-issues/conflict-minerals/legally-binding-process/uk-bribery-act), and generally through the OECD Convention on Combating Bribery of Foreign Officials in International Business Transactions (http://www.oecd.org/corruption/oecdantibriberyconvention.htm). Since September 2001, the United States Department of Treasury has been vigilant against transactions by blocked persons (see http://treas.gov/offices/enforcement/ofac/sdn/). Of course, long-standing principles of antitrust compliance and other legal compliance unique to certain industries are also subjects of supplier codes. Federal contractors under the Federal Acquisition Regulations potentially face additional requirements, such

as equal opportunity and Buy American compliance, which relies on certifications from suppliers. For trade, "point of origin" must be proved based in part on information from suppliers, in order to satisfy requirements of the North American Free Trade Agreement.

The American Bar Association issued the ABA Model Business and Supplier Policies on Labor Trafficking and Child Labor (70 BUSINESS LAWYER 1083 (Fall 2015)) (the "ABA Policy"). Its key points are to require: (a) suppliers to adopt a policy prohibiting the use of labor trafficking and child labor in its operations; (b) ongoing risk assessment, consisting of due diligence and verification of a company's own operations and those of its suppliers; (c) certification that the product or service provided complies with the labor trafficking and child labor laws of the country in which the seller and buyer have operations relating to the products and services being sold by the supplier; (d) notification to the seller of any noncompliance; (e) termination of the supply contract for failure to comply; and (f) indemnification for any violation of such laws.

Sustainability, or green, procedures are also receiving more attention, especially by large enterprises.

Codifying all of this in a simple manner can be daunting. The Electronic Industry Citizen Coalition® Code of Conduct published a model. It includes standards for working conditions in the electronic industry supply chain, aimed at safety, treating workers with respect and dignity, and promoting business operations that are ethically and environmentally responsible (http://www.eiccoalition.org/standards/code-of-conduct/).

The Conference Board has also published model supply chain labor standards (https://www.conference-board.org/topics/publicationdetail.cfm?publicationid=2219).

These are not all the laws having a bearing on Supplier Codes. Suffice it to say that there is a large body of law to support being sure that a buyer is dealing with a reputable supplier.

What subjects should a Supplier Code cover?

The above survey covers considerable ground. Must all these topics be included in a Supplier Code? No, although large, publicly held companies try to cover all or most of the laws applicable to their businesses, and many times more. Such Supplier Codes are frequently readily available from the corporate websites.

At minimum, a Supplier Code should include a statement about ethical dealing, as well as a policy against the use of labor trafficking and child labor in the business operations. Health and safety is also commonly addressed. A good sample is the Electronic Industry Citizen Coalition® Code of Conduct, cited above.

Must the Supplier Code require an audit?

Most Supplier Codes issued by publicly held corporations state that the buyer has the right to enter the supplier's premises for the purposes of auditing to determine if the supplier is in compliance with the Code. That sounds pretty intrusive. Is it necessary?

One could argue that establishing a policy without any means of enforcement is a meaningless gesture. From the above legal survey, it is clear that verification is a component of the California Human Trafficking Act, the ABA Policy, and the proposed federal disclosure legislation.

Including a requirement for a supplier to self-report its compliance is reasonable and unlikely to produce a serious objection from the supplier. But is it sufficient? Must a Supplier Code contain an audit requirement? At present, there is no binding authority to require an audit. Even under the California Human Trafficking Act, an audit is not required—the disclosure is whether one was done, as if to shame the entity into conducting an audit. Several pending class action suits are challenging disclosures given in the absence of an effective audit.

Given little guidance, I note one example involving the Buy American Act. The Federal Trade Commission ("FTC") entered into a final consent order with USA Brand, LLC that it deceived consumers. USA Brand, LLC had awarded "Made in USA" certification seals that marketers could then use. The FTC found it deceptive that USA Brand, LLC did not independently verify each applicant's claim itself, nor did it disclose that the companies had self-certified.

What are audit issues?

If a buyer requires an audit, some typical issues are:

- **Who pays?** If the buyer voluntarily sends in a team and uncovers no noncompliance, there is arguably no basis for charging the supplier for the cost of the audit. In audits that are limited to verification of the accuracy of invoicing and charges, the primary agreement might shift the cost to the supplier if errors above a certain threshold are discovered. Supplier Codes do not routinely address the cost, and it would be difficult to establish an

economic threshold—most Supplier Code provisions are more akin to policy statements.

- **What is the remedy?** If noncompliance is found, the supplier ought to be given a right to cure. Although human trafficking is a severe offense, many Supplier Codes cover many subject matters in general terms, and a violation might not necessarily be material or undisputable. If a material breach remains uncured after reasonable notice, the remedy would logically be termination of the supply agreement. This author has heard of no reports of a buyer having terminated purely on the basis of a violation of the Supplier Code.
- **What is the scope?** In my experience, this is the most unsettling issue. To verify compliance with not only human trafficking, but also labor laws, such as wage and hour, and other wide-ranging subject matters that are in some Supplier Codes, a similarly wide-ranging variety of confidential information might arguably be requested. Some files might contain personally identifiable information of employees. Other subjects might arguably require disclosure of proprietary trade secret information. Although a confidentiality agreement should be required of auditors, such agreement might be insufficient protection if the buyer and seller are competitors. The Supplier Code may permit the audit to be conducted by an independent third party under a confidentiality agreement, but that greatly increases the costs. This author has not heard of audits being conducted based solely on the Supplier Code. Audits for other purposes, such as to verify billing accuracy, are not uncommon. What differs here is the potential breadth of the audit.

  Nevertheless, as pressure mounts for increased supply chain transparency, as described in the initial section of this Article, these matters will need to be managed. Moreover, suppliers with a large number of customers might face a large number of such audits.
- **How can the process be managed?** Having an advance reaction plan is helpful. Many Supplier Codes require the buyer to deliver reasonable notice of the audit (ignoring the California Human Trafficking Act). The notice recipient should immediately advise the plant manager and designated legal counsel, whether in-house or otherwise designated in advance. One plant employee should be designated as the "point person." Before arriving for the audit, the buyer should be requested to provide a plan of audit or request list to the point person. The point person may be able to steer the audit to readily available, nonproprietary information. For example, some Supplier Codes require the supplier to provide workers with workplace health and safety information and warnings. The point person might be able to identify information in a non-confidential employee handbook or a notice on a non-confidential portion of an intranet site that would satisfy this requirement of the Supplier Code. If the supplier has received a recent certification from a governmental or other third-party on a given topic, that certification could be offered in lieu of an audit—this procedure has been adopted by many cloud IT providers in lieu of individual security audits by large customers.

Conclusion

Although the Supplier Code is arguably merely an extension of the ubiquitous supply-agreement representation that each party will perform in compliance with all applicable law, the issues raised above make its application uncertain. At one time, a supplier could refuse to include a Supplier Code as part of the supply agreement or purchase order terms. The prevalence of Supplier Codes, at least among large buyers, is making that position less likely to succeed. Suppliers with sufficient bargaining power may be able to negotiate only that it will comply with its own Code of Conduct, provided that it covers essentially the same range of subject matters. Some may negotiate to remove provisions that require notifications that are not mandated by law or that permit far-reaching audits. Most, however, will assume that, since there is little cost-benefit for the buyer to pursue verification, the Supplier Code is merely boilerplate that they can live with. For buyers and suppliers with long standing, good relationships, this may be a valid assumption. Good operators will be in compliance, and a poor supplier will no doubt be terminated for other reasons, such as quality or delivery failures.

However, if developing law pushes the supply chain into conducting audits or engaging in other forms of verification, the industry will need to develop procedures for cost effectively managing the process.

For additional information, contact Regina Joseph at rjoseph@slk-law.com ***or 1-800-444-6659, ext. 1435.***

The Ubiquitous Most Favored Nations Clause:

Old Wine in New Bottles

For literally centuries, buyers of goods and services have relentlessly attempted to impose upon sellers of those goods and services "Most Favored Nations" ("MFN") or Competitor Parity clauses in their contracts: "Thou shalt not give my competitors a better deal, and if thou doeth, thou shall either grant unto me the same favor or answer to the axe." In an apparent effort to satisfy procurement due diligence and what they may believe to be competitive parity, many modern buyer procurement officers have adopted this practice either in an effort to be thorough (i.e., to leave "nothing on the table") or, perhaps sometimes, in an effort to avoid the hard work connected with their job description. Also, some buyers (particularly some very large ones) are just arrogant and cannot stand to even contemplate the idea that anyone else would get a better price. In any event, historically these provisions have been reluctantly accepted by sellers who either lack the market leverage to insist upon their removal or who simply have adopted

by Michael M. Briley

The efficacy as well as the legality of these provisions under the antitrust laws has recently come into serious question in the U.S., Canada and the E.U.

the attitude that either the buyer will not actually enforce the provision or, alternatively, that no one will ever really care. Unfortunately, and albeit not commonplace, lawsuits to enforce these provisions have been brought and they are normally successful. However, several noteworthy lawsuits and governmental investigations have placed into question the legality and enforceability of MFN provisions, thus making them risky for buyers in certain circumstances. The efficacy as well as the legality of these provisions under the antitrust laws has recently come into serious question in the U.S., Canada and the E.U.

The recent *American Express* case[1] is an example of the current trend by antitrust enforcement agencies to look at vertical agreements between powerful buyers and sellers that may have the effect of restraining competition in the buyer's market resulting from restraints upon seller's ability to offer competitive alternatives to its customers. In that case, Amex was found to have significant "market power" (even though it was shown to enjoy only 30% of the credit card market) and was prohibited from using a contract provision that required its credit giving merchants to "push" Amex cards and to "steer" retail customers away from the cards of competitive credit card companies. Albeit not strictly an MFN clause, the impact of the initiative was to impose a vertical market restraint on retailers designed to impact competition horizontally at Amex's market level, akin to an

MFN provision that prevents the seller from offering better discounts to the buyer's competitors. Even absent proof of any consumer harm, the court perceived a harm to competition created by control of Amex over retail merchants. Similarly, in a recent decision against *Hotel Reservation Service* ("HRS"),[2] the German Federal Cartel Office ("FCO") found Hotel Reservation Service's ("HRS") use of a most favored nations pricing provision specifically to be unlawful notwithstanding HRS' modest market share of just over 30%. The FCO's concern was centered around a belief that the MFN provision would have a negative impact on small and medium sized hotels.

The focus of the U.S. antitrust enforcement agencies and the EU's antitrust concern about traditional MFN's is that they tend to discourage sellers from lowering prices in response to competition at the seller's market level (thereby preventing competitors of the MFN authors from gaining better prices), as well as stifling procurement price competition at the buyer level. In other words, they have the effect of establishing a "floor" on prices because the seller will be concerned that offering lower discounts (or base prices) will require them to then also have to lower prices to the MFN buyer. MFN buyers, of course, tend to be more powerful buyers with leverage over sellers and therefor, often higher volume purchasers.

Competing firms have also used MFN's to promote collusive agreements designed to stabilize prices. A good example of this was *U.S. v. Apple*,[3] where Apple entered into e-book MFN agreements with five of the six largest book publishers requiring each publisher to lower its retail price to match the lowest price offered by any other retailer with the purpose of creating a "price floor" in order to enable them to increase retail prices and to exclude competitive e-book publishers like Amazon. Both effects create economic price "stability" (a bad thing in antitrust economics) and eliminate <u>cost competitiveness</u> in buyer markets and <u>price competitiveness</u> in seller markets.

Traditionally, and at least in the U.S., it was maintained by antitrust economists that the negative, anticompetitive consequences of MFN's could only occur when the buyer has sufficient economic power <u>as a buyer</u>, to effectively coerce MFN's with less powerful sellers, thus restraining procurement cost competition in the markets of powerful buyer and secondarily price competition in seller markets. A good example of this concern can be found in U.S. Department of Justice Complaint against Blue Cross/Blue Shield of Michigan,[4] where Blue Cross/Blue Shield (with a significant market share of + 70% as a buyer of medical services in the State of Michigan) contractually obligated doctors and hospitals in Michigan to agree to grant to Blue Cross/ Blue Shield any lower price (rate for services) granted to any other medical insurance company or payor. The gravamen of the Complaint was that this practice artificially kept medical costs high and prevented emergent managed care plans from entering the market in competition with Blue Cross/Blue Shield.

In the ensuing years immediately following the *Blue Cross/Blue Shield* case it was believed that MFN's were suspect under the antitrust laws only when the buyer had very significant market power in its own market. Recent opinions, however, strongly suggest that the "bar is being lowered" and MFN's and competitive parity provisions (as in the *Amex* case) may be risky even in markets where the buyer has a smaller market share (e.g., 30% or less) than what was traditionally viewed as "dominant" (+60%). Interestingly, none of the decisions turning down MFN's have focused on potential harm to the consumer – the ultimate victim of efforts to prevent discounting that is inherent in MFN clauses.

In the late 1990's there was a number of federal enforcement consent decrees entered by the DOJ and the FTC that prohibited enforcement of MFN's by large health care payor companies. These cases included *U.S. v. Delta Rental Plan (I)*[5] (barred enforcement of an MFN by a health plan that signed up 85% of the dentists in Arizona), *U.S. v. Medical Mutual of Ohio*[6] (barred enforcement of an MFN by a large health insurance company that discouraged pharmacists from joining other networks) (similar to the more recent Amex case *(infra.)*, *U.S. v. Oregon Dental Services*[7] (barred enforcement of an MFN provision that discouraged dentists from discounting) and *FTC v. RxCare of Texas*[8] (barred enforcement of an MFN clause designed to discourage pharmacists from joining other networks that promised additional business but offered lower reimbursement rates). Perhaps the most interesting of these cases was *U.S. v. Delta Dental (II)*,[9] which involved a "penalty MFN clause." In a consent decree entered into with the DOJ, the defendant agreed to cease and desist use and enforcement of an MFN that operated to cause an actual reduction of reimbursement fees to

participating dentists who joined other (competitive) health plans which promised more business in exchange for lower reimbursement rates.

The situation in the EU is currently even more risky with attacks in several cases against OTA's (on line travel agencies) for violating Articles 101 and 102 of the Treaty on the Functioning of the European Union ("TFEU") and individual country competition laws. Defendants like Expedia had been using MFN's to prevent hotels from offering lower prices to competitive booking channels in order to protect the OTA's commissions and their ability to represent to the public that they would get (by using the OTA), the "lowest rate available." Knowing that their room rates offered to customers will be in line with that of their competitors, the OTA's will "have little (if any) incentive to compete against one another on commission rates charged to hotels."[10] In other words, the OTA's could raise commission without losing business because the room rate will go unchanged (at the expense of hotel margins). If a hotel did raise rates, per operation of the MFN the rates then would have to be equally increased to all other OTA's. The EU has also recently opened an investigation of Amazon's MFN clauses in its e-book publisher's contracts whereby Amazon, which is the largest e-book publisher in the EU, has insisted on MFN's with virtually all of its publishers requiring them to offer Amazon the best terms and prices offered to any other on-line retailer.[11]

The upshot of these developments is that antitrust enforcement agencies worldwide and most courts no longer view MFN's superficially as "pro-competitive" tools simply designed to get the lowest price for buyers and will look carefully at likely anticompetitive effects in both the buyer and the seller's market. Old presumptions by sellers that MFN's only present antitrust issues in markets where the buyer has a monopoly or dominant market power (e.g., in excess of 60%) are no longer valid and have become risky. The old belief that MFN's ultimately inure to the benefit of consumers is universally met with cynicism by today's economists and enforcement personnel. Rather, each transaction and each market represented by each transaction should be carefully considered, including an analysis of:

1. What is the market structure and how do the parties (especially the buyer) fit into the market? Does the buyer have a significant degree of market power (e.g., 30% or more) for the purchase of the product or service involved?
2. What is the purpose for the MFN? Is it simply to insure the lowest price or will it have the purpose or effect of establishing a floor to prices in the market? If the latter, will it prevent or discourage new entry into the market in competition with the buyer?
3. What percentages of the buyer's requirements are met by the goods or services subject to the MFN? Will it restrain competition in buyer markets by preventing cost (procurement) competition? Is the seller a dominant player in its market with a high market share? Do competitors of buyer have access to other suppliers who are not subject to the MFN contracts of the MFN author?
4. What is the true purpose of the MFN? How strict is it? Does it contain a retroactive clause that may gain the buyer an advantage (not just parity) over its competitors?
5. What is the length of the contract?
6. Does the provision prevent customers on one side of a two sided market from recovery of their costs? (For example, the MFN's and "steering" provisions used by Amex forced retailers to an "all-or-nothing" dilemma of having to lose significant business if they did not offer Amex cards to customers).
7. Will the clause harm consumers? Will the clause prevent sellers from lowering their prices without a dollar-for-dollar capitulation by the seller?
8. Are there less restrictive alternatives? For example, two excellent and far less restrictive alternative approaches are:
   (a) Meet-or release clauses. For example, "if you do not offer us the best price we can cancel the contract, but you are not contractually required to offer us the lowest price;" or
   (b) "Re-deal" clauses. "If you offer someone else a better deal you, have to let us know and we have the right to re-negotiate our deal."

   While both of these alternatives afford to the buyer assurance that the seller will not secretly give better deals to its competitors, they allow the seller to discount or offer a lower price to another buyer without obligating the seller to offer the same price to MFN buyer.

As global competition economics and consumer welfare both continue to loom larger in antitrust analysis, it

is my belief MFN's will come under greater scrutiny worldwide and alert buyer counsel should consider ways to protect their procurement position without causing harm to either competitive buyers or consumers.

For additional information, please contact Mike Briley at mbriley@slk-law.com or 1-800-444-6659, ext. 1325.

[1] *United States v. Am. Express Co.*, 88 F. Supp. 3d 143 (E.D.N.Y. 2015).

[2] German Federal Cartel Office (12/30/13, B 9-66/10).

[3] *U.S. v. Apple, Inc.*, 791 F.3d 290 (2nd Cir. 2015).

[4] *U.S. v. Blue Cross/Blue Shield of Michigan*, Case No. 2:10 cv-14155-DPH-MKM (E.D. Mich. 2010).

[5] 1995 U.S. Dist. LEXIS 9752 (D. Ariz. 1995).

[6] 1998 U.S. Dist. LEXIS 21508 (N.D. Ohio 1999).

[7] 1995 U.S. Dist. LEXIS 481363 (N.D. Cal. 1996).

[8] 121 FTC 762 (1996).

[9] 1997 U.S. Dist. LEXIS 11239 (D.R.I. 1997).

[10] *See, e.g.*, Konkurrensverket [Swedish Competition Authority], 2015 case no. 596/2013, http://www.konkurrensverket.se/globalassets/english/news/13_596_bookingdotcom_eng.pdf; and European Commission Press Release IP/15/4921, Antitrust: Commission Launches E-Commerce Sector Inquiry (May 6, 2015), http://europa.eu/rapid/press-release_IP-15-4921_en.htm

[11] *See*, European Commission Press Release IP/15/5166, Antitrust: Commission Opens Formal Investigation into Amazon's E-Book Distribution Agreements (June 11, 2015), http://europa.eu/rapid/press-release_IP-15-5166_en.htm.

welcome

Christopher Cavaliere
Tampa
Litigation

Kelly A. Leahy
Columbus
Healthcare

Theresa (Tara) L. Donovan
Tampa
Community Associations

Andrew J. Fruit
Tampa
Corporate

Marissa W. Pollick
Toledo
Labor & Employment; Title IX

New Life for Intrastate Offerings and

More Capital for Small Businesses

Small businesses are the "lifeblood of our economy," employing half of the workforce in the United States and creating nearly two out of every three new American jobs. Raising capital for new ventures starts out "locally" with funding by private money, initially from friends and family. Later funding comes from a wider circle of acquaintances, typically also close to home and then, perhaps, from angel investors and, only later, venture capitalists and private equity groups.

Raising capital for new ventures starts out "locally" with funding by private money, initially from friends and family.

While the Internet and social media have made the universe of potential funding sources theoretically unlimited—including by geography—as a practical matter, for an entrepreneur with untested products or new services, raising capital begins with people he or she knows, usually in the same community, or at least the same state. Therefore, the securities laws of the entrepreneur's state are particularly important. Given the pervasive reach of the federal securities laws, compliance with the Securities Act of 1933, as amended (the "Securities Act"), and the rules of the U.S. Securities and Exchange Commission ("SEC") is required, and often an impediment. While the Securities Act contains an "intrastate exemption," small businesses seeking capital have had a difficult time limiting their activities to fall within the exemption.

by Gregory C. Yadley

Section 3(a)(11) of the Securities Act provides an exemption from federal registration for *"[a]ny security which is a part of an issue offered and sold only to persons resident within a single state or territory, where the issuer of such security is a person resident and doing business within, or, if a corporation, incorporated by and doing business within, such state or territory."* SEC Rule 147 provides a "safe harbor" with objective standards for local businesses seeking to rely on the statutory intra-state exemption.

Rule 147 has not been substantively updated since it was promulgated more than 40 years ago, notwithstanding the exponential developments in communications technologies and the increasingly interstate nature of small business activities. Given the prescriptive threshold requirements that an issuer must satisfy in order to be considered "doing business" in-state, the availability of the Rule 147 safe harbor for local companies that would otherwise conduct intrastate offerings has been extremely limited.

In October 2015, the SEC proposed a new intrastate exemption rule. It is a particularly opportune time to do so because a majority of states recently have adopted equity

"crowdfunding" provisions. At least 29 states and the District of Columbia have enacted some form of crowdfunding exemption from state registration through legislation, regulation or administrative order. Additional states are expected to follow suit. Most of the states that have crowdfunding provisions require that the issuer comply with Section 3(a)(11) of the Securities Act or SEC Rule 147. However, the SEC has received feedback from state securities regulators and market participants indicating that the current statutory requirements in Section 3(a)(11) and regulatory requirements in Rule 147 make it difficult for issuers to take advantage of these new state crowdfunding provisions.

The SEC's proposals address the perceived constraints of Rule 147 and should make the intra-state offering more viable. The most significant provisions of the new intrastate exemption rule include the following:

- Each purchaser of securities is, or the issuer has a reasonable belief that the purchaser is, a resident of the same state or territory as the issuer's principal place of business.
- The issuer may engage in any form of general solicitation or general advertising, including publicly accessible Internet websites, so long as all sales occur within the same state or territory in which the issuer's principal place of business is located.
- The offering must be (i) registered in the state in which all of the purchasers are resident, or (ii) exempt from registration in that state pursuant to an exemption that (x) limits the amount of securities an issuer may sell pursuant to such exemption to no more than $5 million in a 12-month period, and (y) imposes an investment limitation on investors.
- The issuer's principal place of business is defined as the location in which its officers, partners, or managers primarily direct, control and coordinate the activities of the issuer.
- The issuer must satisfy at least one of four thresholds designed to demonstrate the in-state nature of the business within the state in which the offering is conducted:
    - at least 80% of its consolidated gross revenues are derived from the operation of a business or of real property located in or from the rendering of services within such state or territory;
    - at the end of its most recent semi-annual fiscal period prior to the first offer of securities pursuant to the exemption, at least 80% of its consolidated assets were located within such state or territory;
    - at least 80% of the net proceeds from sales made pursuant to the exemption are intended to be used in connection with the operation of a business or of real property in, the purchase of real property located in, or the rendering of services within, such state or territory; or
    - a majority of the issuer's employees are based in such state or territory.
- For a period of nine months from the date of the sale of the security by the issuer, resales may be made only to residents of such state or territory.
- An issuer's ability to rely on Rule 147 is no longer conditioned on a purchaser's compliance with the rule's resale restrictions.
- The safe harbor for "integration" of offerings has been expanded in a manner consistent with the SEC's most recently adopted integration guidance.
- The required disclosure regarding restrictions on resales are clarified and may be provided in the same manner as the offer, which might not always be in writing.

The proposals are published under the SEC's general exemptive authority under Section 28 of the Securities Exchange Act. Accordingly, if adopted as proposed, Rule 147 would no longer be a safe harbor for conducting a valid intrastate exempt offering under Section 3(a)(11). An issuer attempting to comply with the new rule that fails to do so would be entitled to rely on any other applicable exemption. However, as a practical matter, failure to satisfy the requirements of the new rule would likely also result in a failure to satisfy the Section 3(a)(11) statutory exemption since those requirements are more restrictive. Of course, any offer or sale under the proposed amendments to Rule 147 would still need to comply with the requirements of applicable state securities laws.

In the same release proposing the Rule 147 revisions, the SEC proposed amendments to Rule 504 of Regulation D under the Securities Act to facilitate issuers' capital raising efforts and provide additional investor protections. The SEC's proposals would increase the aggregate amount of securities that may be offered and sold pursuant to

Rule 504 in any twelve-month period from $1 million to $5 million and disqualify certain bad actors from participation in Rule 504 offerings. The proposals would facilitate capital formation by increasing the flexibility that state securities regulators have to implement coordinated review programs to facilitate regional offerings.

The SEC's proposed amendments are salutary and a significant step forward in making the intrastate exemption more relevant. The SEC also recognizes that to make intrastate and regional crowdfunding a reality, more work is needed. States that have crowdfunding provisions based on compliance with Section 3(a)(11), or compliance with both Section 3(a)(11) and Rule 147, will need to amend these provisions in order for issuers to take full advantage of the proposed amendments.

Other issues also need to be addressed. For example, should investors acquiring securities under Rule 147 be counted in the calculation of the number of security holders that give rise to the obligation to register under Section 12(g) of the Exchange Act? How can the SEC work more closely with the states to achieve more harmonized regulation? How do the Financial Industry Regulatory Authority communications and other rules apply to offerings under revised Rule 147? Nevertheless, the SEC proposals to the intrastate offering exemption are a major step forward. The Commission has incorporated flexibility in its proposed new rule and offers a new path for cooperation among federal and state regulators.

- *The author is a member of the U.S. Securities and Exchange Commission Advisory Committee on Small and Emerging Businesses. The views expressed in this article are those of the author. They do not reflect the views of the Advisory Committee or the staff or members of the Securities and Exchange Commission.*
- *An expanded version of this article was presented at the 34th Annual Federal Securities Institute in Miami, Florida, on February 4, 2016. The author would be pleased to provide a copy of the original article upon request.*

For more information, contact Greg Yadley at gyadley@slk-law.com or 1-800-677-7661, ext. 2238.

False Claims Act Penalties

In a largely unnoticed provision of the Bipartisan Budget Act of 2015, Congress required federal agencies to make inflationary adjustments, tied to the CPI, to civil monetary penalties with automatic annual adjustments. Recently the Railroad Retirement Board, which occasionally generates False Claims Act cases, issued an interim final rule increasing minimum FCA penalties from $5,500 to $10,781 and increasing maximum penalties from $11,000 to $21,563. Other agencies such as the Department of Justice are expected to employ the same calculation when issuing their rules, which are due out by July 1 for an effective date of August 1, 2016. The increased penalties are expected to boost the government's leverage in settlement discussions and impact settlement amounts, which are usually calculated as a multiple of the penalty amounts.

by Kelly A. Leahy

For additional information, contact Kelly Leahy at 614-628-6815 or kleahy@slk-law.com.

Recent Legislation will Require Changes to Most Partnership and Operating Agreements

The Bipartisan Budget Act of 2015 (the "Act") replaced the existing partnership audit rules with a dramatically different set of rules that will be applicable to the first partnership tax year beginning after 2017. For calendar year partnerships, these rules will be effective for the 2018 tax year. The new rules are complicated and have numerous exceptions and special rules. The purpose of this article is to highlight the major changes and the impact of those changes on transactions with partnerships occurring before the rules become effective. Many partnerships will find it helpful to amend their partnership agreements well in advance of 2018. All references in this article to partnerships include limited liability companies that are taxed as partnerships and all references to the partnership agreement also apply to the operating agreement of a limited liability company.

by Michael M. McGowan

The new rules are complicated and have numerous exceptions and special rules.

A partnership is not a taxable entity—all of its income and loss is allocated through to its partners and the partnership items are included in the calculation of each partner's tax liability. Under current rules, if the IRS audits a partnership tax year, any adjustment is allocated to the persons who were partners during the year to which the adjustment relates. For example, if the IRS were to audit a partnership's 2013 tax return and increase its taxable income, that increase in income would be allocated to the persons who were partners in the partnership during 2013 and would increase the tax liability shown on their 2013 tax returns. Under the new rules, all of the adjustments are made at the partnership level and any tax, penalty and interest that is determined to be due is owed by the partnership. The amount of the tax due is determined by applying the highest marginal tax rate for individuals or corporations for the tax year under audit. The partnership will be obligated to pay the tax due plus any applicable penalties and interest. Since these amounts are due at the conclusion of the audit, those persons who are partners at the time of the audit will bear the cost of the tax, penalty and interest, even if they were not partners during the year to which the adjustment relates. A Partnership should consider including a provision in its partnership agreement to obligate former partners, or partners whose interest has been

reduced, to make a payment to the partnership to reimburse it for the former or reduced partner's share of the additional tax.

The new partnership level liability for the tax, penalty and interest is reduced if a partner files an amended return and pays the resulting tax. Additionally, the IRS is authorized to issue regulations to establish a process by which the partnership can prove that lower marginal tax rates should apply to the amount of the adjustment because, for example, some of the partners were tax exempt entities, individuals subject to lower effective tax rates on capital gain or qualified dividend income or corporations subject to a lower tax rate. The IRS has also been given the authority to provide through regulations a process to establish that a lower tax rate should apply as a result of a partner's individual tax attributes, such as a net operating loss. The burden of proving that a lower tax rate should apply falls on the partnership, which means the partnership will need access to information about the individual partner's tax situation in order to substantiate a lower effective tax rate. Partners should consider whether it is appropriate to amend their partnership agreement to include a mechanism to compensate partners who report their share of an audit adjustment on an amended return thereby reducing the partnership level tax liability or to require the partners to provide information about their personal tax attributes upon request so the partnership can use that information to try to reduce the effective tax rate on the partnership level assessment.

If the audit results in a net increase in losses, deductions or credits for a year under audit, the benefit of those items passes through to the persons who are partners in the year the audit is finalized, not those who were partners during the year under audit. However, the partnership will have the option to amend its returns and report the increase in losses, deductions or credits for the applicable year so that the benefit of those items will pass through to the persons who were partners during that year.

There are exceptions to this new partnership audit regime. First, if a partnership has 100 or fewer partners and all of the partners are individuals, corporations, estates of deceased partners or foreign entities taxable as a corporation, the partnership can elect out of the new rules. For purposes of the 100 or fewer rule, if a partnership has one or more S corporations partners, the number of shareholders who receive a K 1 from the S corporation are included. Unless permitted under future regulations, a partnership with partnerships or trusts as partners will not be eligible to elect out of the new partnership audit regime.

Additionally, a partnership can avoid the partnership level liability for the tax, penalty and interest that is applicable to an adjustment by making an election within 45 days of the date that a notice of final partnership adjustment is provided by the IRS to the partnership. If the election is made, the partnership must provide to the IRS and to each person who was a partner in the year under audit a statement of the partner's share of any adjustments. The tax liability of those partners for the year in which the notice of adjustment is provided is increased by the increase in tax that would have been payable if the adjustment was made to the year under audit. For example, if a partnership receives a final notice of adjustment in 2020 with respect to an audit of its 2018 tax return and the partnership makes this election, each person who was a partner in 2018 will increase his 2020 tax liability by the amount that his 2018 tax would have increased had his 2018 tax return been amended to reflect the partnership adjustment. Increasing the partners' tax liability for the tax year during which the audit is concluded eliminates the need to file amended tax returns; however, the amount of the tax adjustment is calculated by reference to the earlier tax year. Additionally, the interest rate payable on the amount of the tax adjustment will be two percentage points higher than the interest rate that would have been paid by the partnership had the election not been made.

The new partnership audit rules will also impact the level of diligence required to be performed if an interest in a partnership is being acquired and the terms of the transaction between the seller and buyer of the partnership interest. Prior to the adoption of these new partnership audit rules, there was little risk to the purchaser of a partnership interest with respect to the past "tax sins" of the partnership because if a period prior to the date of acquisition was audited, any resulting tax, penalty and interest would have been the obligation of those persons who were partners during the year under audit. Now, the tax penalty and interest is the obligation of the partnership. As a result, the purchaser should perform additional diligence to review the tax filing positions of the partnership and should seek contractual indemnification from the

seller of the interest to protect the purchaser if the partnership incurs a cost as a result of an audit of a prior tax year.

As indicated above, the new partnership audit rules are a dramatic departure from those that have been in place for many years. There is more to be learned as the Treasury Department issues regulations providing much needed detail regarding the elections, special rules and exceptions that are authorized in the Code. We will continue to monitor developments in this area and will provide updates to our clients as those regulations are issued.

If you have any questions regarding the applicability of these rules to existing partnerships, new entities that are being formed or acquisition transactions involving partnerships, please contact Michael McGowan (mmcgowan @slk-law.com; 1-800-444-6659, ext. 1227) in our Toledo office, Warren Kean (wkean@slk-law.com; 1-800-797-9646, ext. 2906) in Charlotte, or Greg Marks (gmarks@slk-law.com; 1-941-364-2779) in Sarasota.

What's Trending on Shumaker Blogs?

Our Community Associations practice launched *The Condo and HOA Law Bulletin*. Topics to be addressed include pitfalls and potential liabilities, new developments, construction, board issues and updates in the law.

Visit https://thecondoandhoalawbulletin.com/ **to sign up!**

Our Construction practice launched the *Shumaker Construction Trend* which will focus on legal issues, trends and legislative updates related to the residential and commercial construction industry.

Visit https://shumakerconstructiontrend.com/ **to sign up!**

New Tax Law Allows Some to Avoid Paying Tax on the Sale of Their Business

At the end of last year, the President signed into law the ability of some investors to not pay tax on the sale of "qualified small business stock" ("QSBS") acquired after September 27, 2010 and held for more than five years. Under the new law (which permanently extends this special treatment that had been allowed on a temporary, annual basis since 2010), the gain from such sales (subject to numerous technical qualifications and limitations) is excluded from taxable income and, therefore, is not subject to federal and, for most states, state income taxes, the alternative minimum tax, or the 3.8% tax (sometimes referred to as the Obamacare tax) on capital gains and other net investment income.

by Warren P. Kean

The amount of gain that is excluded from tax is capped at the *greater* of $10 million or 10 times one's investment. For example, a person who invests $100,000 in a qualified small business after September 27, 2010, holds that investment for over five years, and meets the other eligibility requirements will not be subject to tax on gain of up to $10 million, and a person who invests $1.5 million will not be subject to tax on gain of up to $15 million.

The amount of gain that is excluded from tax is capped at the *greater* of $10 million or 10 times one's investment.

Not all investors are entitled to this tax break. Only individuals (directly or indirectly through flow-through entities, such as limited liability companies ("LLCs") classified as partnerships for federal tax purposes), estates and trusts are eligible (i.e., not C corporations), and those eligible investors generally must purchase the QSBS directly from the issuing corporation and not from any other person (except transfers upon death, by gift or distributions from LLCs and other entities classified as partnerships for federal tax purposes).

Only C corporations (including LLCs that elect to be classified as C corporations for federal tax purposes) may issue QSBS. Investments in partnerships, LLCs and other entities classified as partnerships, and S corporations do not qualify, except to the extent those flow-through

entities own QSBS in other companies. Moreover, only businesses that are deemed to be both "active" and, at the time of the issuance of the stock, "small" are eligible to issue QSBS.

The list of businesses that are not deemed to be "active" and, therefore, do not qualify to issue QSBS include professional-service, arts and entertainment businesses; insurance, financing, leasing, banking and investment companies; hospitality (hotels, restaurants, etc.) businesses; farms; and businesses entitled to depletion deductions (such as mining, oil and gas, and other mineral extraction businesses). Also excluded are those active businesses that immediately after the investment have a gross asset value of more than $50 million and, therefore, are not considered "small" for this purpose.

LLCs and other entities classified as partnerships for federal tax purposes are not completely left out from securing this tax break for their owners. Those entities may convert into C corporations (usually a fairly easy process) to have their future appreciation escape tax (i.e., only the owners' built-in gain at the time of conversion will be subject to tax when they later sell their QSBS), up to the above-described caps.

Hence, owners of existing companies that are LLCs or other entities classified as partnerships for federal tax purposes may be better suited to realize this tax break than existing C corporations that issued all or substantially all of their stock before September 27, 2010. However, those investors will want to weigh the benefits of maintaining flow-through status (e.g., one-level of tax on business earnings that are distributed to its owners, the ability to sell assets or the company itself at lower capital gains rates while allowing the purchaser of those assets or the company to receive a tax basis in those assets equal to the amount the purchaser directly or indirectly pays for them, and the ability to use company losses to reduce, subject to several limitations, the owners' taxable income from other sources) against the benefits of not having the future appreciation in their interest in the company subject to tax.

The ability to sell an asset for *cash* and not have to pay tax on the gain realized on the sale is extraordinary. This tax break was deliberately enacted by Congress to encourage investment in "active," "small" businesses. Every business owner who either has an investment in a small business (including a business that may otherwise not qualify but has a segment or division that may qualify) or is considering starting or investing in a small business should consider whether that business qualifies (or through restructuring or reorganization could qualify) for this tax break and, if it does, assess whether the ability to avoid tax on the sale of their investment outweighs the numerous, complex and, in some cases, unsettled compliance requirements and limitations and competing considerations of flow-through taxation.

For additional information, contact Warren Kean at wkean@slk-law.com ***or 1-800-797-9646, ext. 2906.***

If you'd like to receive an electronic copy of Shumaker's *insights* Newsletter, or if you have a suggestion for topics you would like to see in future issues, send us an email at newsletters@slk-law.com

Diversity at Shumaker

The Diversity and Inclusion Committee recently recommended, and the firm adopted, an update to its parental leave policy to provide up to 16 weeks of paid leave for associates and partners. This leave is available to mothers and fathers alike to enable them to care for and bond with the newest additions to their families whether the arrival be through birth, adoption, foster, or surrogacy.

Shumaker is proud to be INVOLVED and actively participates in organizations that support diversity initiatives in our communities.

- Toledo Partner, **Jeni Belt**, was recently selected as one of Ohio's 2016 LGBT Ally Award Winners by the National Diversity Council. She was recognized at the LGBT Roundtable and Awards breakfast on June 9, 2016.
- Toledo Partner, **Cheri Budzynski**, was sworn in as the President of the Toledo Women's Bar Association on May 25, 2016 at the Toledo Club for the 2016-2017 year. Cheri was a panelist at The Ohio Diversity Council's Women in Leadership Symposium on March 2, 2016 where she discussed the topic of branding.
- Tampa Partner, **Michele Hintson**, was a panelist at a Diversity Forum co-hosted by the Greater Brandon Chamber of Commerce and the University of Phoenix, on February 25, 2016.
- The **Tampa office** sponsored the Tampa Museum of Art's Pride & Passion event on April 23, 2016. **Erin Aebel** attended the event and **Julio Esquivel** serves on the Board of TMA.
- **Shumaker's Women's Leadership Initiative in the Toledo office** sponsored the Boys & Girls Clubs "Toledo Ladies for the Clubs Luncheon" on April 15, 2016 and also supported the YWCA of Northwest Ohio's "2016 Milestones - A Tribute to Women Awards Luncheon" on March 10, 2016.

Shumaker's Diversity and Inclusion Committee is comprised of partners and associates in all offices and strives to move forward with the firm's mission of attracting, retaining, and promoting individuals of diverse backgrounds to ensure that the firm reflects the clients we represent and our values of inclusion.

slknews

Erin Aebel presented "The Future of Healthcare: Challenges for Physicians and Innovations in Patient Care" at the Academy of Senior Professionals Eckerd College ("ASPEC") program at Eckerd College on April 4, 2016. Erin was invited to present a webinar on federal and Florida fraud and abuse laws to physicians at V.A. hospitals throughout Florida in January.

Steve Berman was a panelist at the 40th Annual Alexander L. Paskay Memorial Bankruptcy Seminar on April 2, 2016. His panel discussion was "You Be the Judge! Interactive Evidence for the Consumer Lawyer." He spoke on "Bankruptcy Without Borders: Chapter 15" at the 2016 Bankruptcy Battleground Southwest in Los Angeles. Steve was a guest lecturer at the University of Florida College of Law Advanced Bankruptcy Seminar on January 28, 2016.

Kevin Braig presented a webcast for the Ohio State Bar Association in January titled, "The Future of Sports Betting and Fantasy Sports."

Cheri Budzynski will be a panelist on "Greenstreams: Nutrient Regulation Under the Clean Water Act" at the American Bar Association's Key Environmental Issues in U.S. EPA Region 5 Conference on June 14, 2016 in Chicago, Illinois. Cheri was sworn in as President of the Toledo Women's Bar Association at their annual meeting on May 25, 2016. She was also a panelist at the Ohio Diversity Council's 2nd Annual Toledo Women in Leadership Symposium on March 2, 2016.

Doug Cherry presented a seminar on "Avoiding the Pitfalls of the Digital Era of Law: E-discovery, preservation and other technological issues" to the Manatee Bar on January 27, 2016. **Seth Traub** was a panelist at the seminar. Doug also presented "IP and IPAs" at AdFed Suncoast AdNites.

Jason Collier was recertified in Labor and Employment Law by The Florida Board of Legal Specialization and Education.

Ron Collier was selected as the recipient for the first quarter of 2016 for the Pro Bono Attorney of the Quarter by the Twelfth Judicial Circuit for his hours of service to Legal Aid of Manasota.

David Conaway presented to the National Steel Mill Group on February 18, 2016 in Clearwater, Florida and to the Furniture Manufacturers Credit Association on February 11, 2016 in Greensboro, North Carolina on Reducing Accounts Receivable in the Zone of Insolvency, and on Enforcing Vendors' Remedies in Chapter 11. He also presented to the International Textile Credit Clearing House on January 20, 2016 in Charlotte, North Carolina on Cross-Border Insolvency and Chapter 15, and Best Practices in Export Sales Contracts.

David Coyle was appointed Chair of the Bankruptcy Law Sub-Committee of the Ohio State Bar Association's (OSBA) Banking, Commercial and Bankruptcy Law Committee. The OSBA's Bankruptcy Law Sub-Committee is responsible for monitoring new developments in, and court decisions impacting, bankruptcy law.

Saralyn Abel Dorrill and Meghan Serrano co-chaired the Make-A-Wish of Central and Northern Florida's interactive "Dishes for Wishes" event on April 8, 2016 at Polo Grill and Bar in Lakewood Ranch, Florida.

Dan Hansen was appointed to the Board of Directors for the Green Teach Network of Charlotte. Dan co-presented "Mediating the Complex Fidelity Claim and Evaluating Claims Arising from Securities Law Violations," at the 2016 Fidelity & Surety Law Committee ABA Mid-Winter Meeting in New York, New York.

Michele Leo Hintson was a panelist at a Diversity Forum co-hosted by the Greater Brandon Chamber of Commerce and the University of Phoenix.

Wyatt Holliday spoke at the International Foundation of Employee Benefit Plan's annual Health Care Management Conference, presenting "Cyber Security: Don't Be Caught Unprepared," in Phoenix, Arizona on April 11, 2016. He also presented "How to Manage Cyber Liability" to the Employee Benefits Administrators Association on March 17, 2016.

Adria Jensen has been certified by the Florida Supreme Court as a Certified Circuit Mediator.

Warren Kean presented a joint webinar on drafting and administrating the economic provisions of LLC Operating Agreements. He was also a panelist for the ABA Business Law and Tax Sections webinar, "Responding to the Repeal of TEFRA."

Scott La Porta and Doug Cherry presented "You had a data breach. Now what? Practical steps to mitigate the consequences and protect your business" at the Suncoast Technology Forum Techbyte Luncheon in January.

Moses Luski was interviewed for the show "Charlotte: A City of International Success" which aired on WTVI, Charlotte's PBS affiliate. Moses was appointed to the Boards of the Latin American Chamber of Commerce and the Columbia Alumni Association of the Carolinas. He presented the March "Shumaker Legal Minute" at the monthly luncheon of the Latin American Chamber of Commerce in Charlotte in March and spoke on "Actionable Takeaways from The Paris Climate Change Agreement."

Suzi Marteny has been selected as a Fellow of the Litigation Counsel of America. She spoke to the Paralegal Association of Florida, Inc. on March 11, 2016 regarding IP Litigation.

Scott Newsom and Bennett Speyer spoke at the University of Toledo Center for Family and Privately-Held Business on "Incentive Compensation: Rewarding and Retaining Key Employees."

Scott Newsom and David Fournier spoke at the Employers' Association of Northwest Ohio's 2016 Annual Human Resource Conference on "The Wellness Wilderness. Legalities of Workplace Wellness Programs."

Mike Pitchford presented two lectures in Tampa, Florida on March 8, 2016 entitled "Title Insurance Commitments: Satisfying Requirements and Evaluating/Removing Exceptions" and "Reading Surveys" presented by the National Business Institute.

Mindi Richter spoke to the Small/Solo Firm Section of the Hillsborough County Bar Association about Intellectual Property Pitfalls on March 15, 2016. She also spoke to the Florida Public Relations Association (FPRA), Polk County Chapter, on media and intellectual property law issues on February 17, 2016.

Mindi Richter and Todd Timmerman spoke at the Hillsborough County Bar Association's Corporate Counsel Section Luncheon and CLE on January 7, 2016 on "Intellectual Property Pitfalls for Corporate Counsel."

Peter Silverman presented a national webinar sponsored by the American Arbitration Association on April 13, 2016. The webinar reviewed the new emergency relief arbitration rules and analyzed whether they may compel federal courts to reverse their longstanding policy to allow court injunctions pending arbitration.

Derick Thurman presented "Understanding the Family and Medical Leave Act in One-Half Hour" for the Mecklenburg County Bar in Charlotte, North Carolina. He also presented "The Family and Medical Leave Act" to the North Carolina Bar Foundation in Cary, North Carolina.

Lou Tosi was a presenter at the AHC Group's Carbon Innovation Workshop on January 19, 2016 in Phoenix, Arizona. Lou gave an update on the Clean Power Plan.

Bob Warchola has been elected to the Board of Governors of the St. Petersburg Area Chamber of Commerce.

Greg Yadley was a principal participant at the Business of Biotech Conference held March 18, 2016 at Moffitt Cancer Center. Greg moderated the panel "Be Smart in Financing Your Innovation – All Dollars are Not the Same." He was principal Chair of the 34th Annual Federal Securities Institute in Miami, Florida on February 4-5, 2016. Greg was reappointed to the United States Securities and Exchange Commission's Advisory Committee on Small and Emerging Companies.

Mechelle Zarou has been selected to join the Steering Committee for Welcome Toledo-Lucas County, an initiative that seeks to build a vibrant and welcoming community celebrating the region's immigrant heritage and focusing on talent attraction, retention, and immigrant integration. Mechelle was also selected to serve on the Board of Trustees for Legal Aid of Northwestern Ohio ("LAWO") and Advocates for Basic Legal Equality ("ABLE"), regional law firms that provide high quality legal assistance in civil matters to eligible low-income individuals. Mechelle has also been selected to serve on the Board of Trustees of The Arts Commission of Greater Toledo, which seeks to promote the visual, performing and literary arts throughout the region. Most recently, Mechelle was inducted as a Fellow of the Ohio State Bar Foundation, the charitable arm of the Ohio State Bar Association.

Spotlight on Shumaker Alum:

Shumaker takes pride in good relations with alums, and in this article we spotlight one of them:

Timothy J. Rathbun

Timothy J. Rathbun interned at Shumaker in the summer of 1988 and became an associate in the Corporate Department of Shumaker's Toledo office in 1989 upon graduation from Case Western Reserve Law School. Tim clerked for Shumaker with Terry Davis and survived Tom Wood as his Responsible Associate. As an associate, Tim worked with Jim White and Mary Ellen Pisanelli in Toledo and Paul Lynch, Greg Yadley, Darrell Smith and EJ Richardson. He swears Darrell and EJ wouldn't have made it without him.

Tim left the firm on September 5, 1994, to act as in-house counsel for Venture Packaging, and Encore Industries, two plastics businesses started by Tim's father. Tim also opened his private law practice, the Law Office of Timothy J. Rathbun. He practiced as a sole practitioner in Monroeville, Ohio between September 5, 1994, and August 29, 1997, and in Sandusky, Ohio from September 1, 1997, to February 4, 1999. The office was moved to its current Bellevue, Ohio location in February 1999, and has always had an emphasis on corporate and transactional law.

The family sold Venture Packaging in 1997 and devoted its attention to growing Encore Industries. Encore produces injection molded and thermoformed containers, paint trays, mixing containers and industrial pails for an array of markets, including Sherwin-Williams, Lowe's and Wal-Mart. The company has grown to 300 employees and has $55 million in annual sales from plants located in Cambridge, Ohio, Forsyth, Georgia and Remer, Minnesota.

Another Rathbun family company is SurEnergy, which is the largest installer of renewable energy in Ohio. Presently, it has in progress about 40 wind turbine projects and it employs nine people.

Tim misses Shumaker and takes considerable pride in having been a part of the firm.

When asked how Shumaker is "involved," he recalled his first memory of Shumaker. In college, he was invited to a tax law and accounting reception for the Beta Alpha Psi Fraternity hosted by Shumaker. He was impressed that Shumaker was reaching out to this group. He was also impressed with the conversion of the Toledo office building from a plumbing supply warehouse, and how important that project was in helping to revitalize the downtown area. As Tim noted, Shumaker had a real "vision" for downtown Toledo.

Shumaker was the only law firm he ever wanted to work for when he went to Law School. Tim still engages Shumaker today (specifically Greg Lodge, Jack Straub and Mike McGowan) and says that some of his best friends in the world are still with Shumaker.

Although Tim had many legal contributions while at Shumaker, he said his greatest contribution was on the Toledo office softball team where he insists that he "carried" the team while penning some of the finest game stories ever written. We had those Vikings by the horns back then! What happened?

Shumaker is proud of Tim and wishes him well!

insights

A Newsletter from Shumaker, Loop & Kendrick, LLP

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Our practice of involvement spans the entire community.

Whether it's our commitment to clients, or to our work in the community, involvement lies at the core of everything we do.

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