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FTC TO BEGIN RED FLAGS RULE ENFORCEMENT

By Daniel J. Malpezzi

On June 1, 2010, the Federal Trade Commission (FTC) will begin enforcing its so-called "Red Flags Rule." The purpose of the Rule is to require development, monitoring and updating of formal board-approved policies and procedures designed to detect, prevent and respond to customer/client data security or other identity theft breaches.

The Rule applies to all "financial institutions" and "creditors" maintaining "covered accounts" under the Rule. It was jointly adopted on November 9, 2007 by the FTC, The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Fed), the Federal Deposit Insurance Corporation (FDIC), the Department of the Treasury Office of Thrift Supervision (OTS) and the National Credit Union Administration (NCUA) under the authority of the Fair and Accurate Credit Transactions Act of 2003 amendments to the Fair Credit Reporting Act of 1970. The OCC, Fed, FDIC, OTS and NCUA have the authority to enforce the Rule as to regulated financial institutions such as banks, savings banks, savings and loan associations and credit unions. The regulation of all other covered entities, including private businesses, falls within the jurisdiction of the FTC.

The FTC has administratively postponed its formal enforcement of the Red Flags Rule four times since its adoption, most recently until June 1, in order to provide sufficient opportunity for businesses and other covered entities to understand the Rule and to develop and adopt compliance programs. The Rule has generated considerable consternation in the business community by virtue of its very broad definitions of "creditor" and "covered account," and will subject many different types of companies to FTC identity theft regulation.

Under the Rule, a "creditor" includes any natural person, governmental body, corporation, partnership, trust, estate or other entity which regularly extends or arranges for credit. This would most obviously include companies that provide or arrange for direct purchase money financing of goods, such as auto dealers, credit card companies, consumer finance companies and retailers. However, the concept of "credit" is defined extremely broadly, and virtually any business which sells a product or provides a service to a customer on an after-the-fact billing basis would be subject to the Rule if it offers a "covered account." This casts a wide net and picks up most commercial and nonprofit organizations, including hospitals, colleges and universities, continuing care retirement communities, nursing homes, assisted living or personal care homes, utilities, cell phone companies, businesses that provide ordinary course or other trade credit and many medical and other professional service providers.

Two categories of "covered account" are included in the Rule. The first is a "consumer account," which is an account that is maintained primarily for personal, family or household purposes and which allows multiple payments or transactions. Such accounts are automatically covered. The second type is any account, including business accounts, maintained by a creditor "for which there is a reasonably foreseeable risk to customers or the safety and soundness of the creditor from identity theft, including financial, operational, compliance, reputation or litigation risks." This requires a somewhat subjective analysis as to whether maintenance of non-consumer accounts poses any risk requiring compliance with the Rule. Realistically, however, it may be

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difficult to identify any electronically accessible account that is not potentially vulnerable to a data or information theft attempt through an online "hacking" attack.

Companies that are subject to the Red Flags Rule must develop and implement a written Identity Theft Protection Program designed to prevent, detect and mitigate identity theft in connection with new and existing accounts. The requirements of the Rule allow for flexibility in crafting a program tailored to the specific risks, facts and circumstances of each covered entity, but there are certain minimum requirements in order for a program to be FTC compliant.

What are the risks of noncompliance with the Red Flags Rule? Under its general enforcement powers, the FTC can levy civil penalties of up to $3,500 per violation, which could be significant if a company has a large number of customer accounts. The FTC can also bring enforcement actions in court to compel compliance, and the civil fines can increase up to $16,000 per violation after a court enters a compliance order. There is no criminal penalty provided under the Rule.

But perhaps the greatest risk in failing to comply with the Red Flags Rule is the threat of liability arising out of potential class actions or other civil cases which might be brought against a business following a data breach incident. While the Red Flags Rule does not specifically provide a right of private enforcement, it is likely that the Rule's standards, guidelines and requirements would serve as the judicial standard of reasonable care in a private civil action asserting losses or damages arising from an identity theft occurrence. A covered business or other organization that has failed to comply with the Rule would almost certainly face a very difficult defense if it found itself as a defendant in such a lawsuit. ■

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HELPING EMPLOYEES WITHOUT HURTING YOUR BUSINESS: LEGAL CONSIDERATIONS IN MAKING EMPLOYEE LOANS *By Jennifer Velencia*

Occasionally, we receive inquiries from clients who would like to make loans (or create a policy for making loans) to their employees. Typically, these clients want to make loans for one of the following purposes:

- To recruit new employees (for example, loans to pay relocation expenses)
- To encourage further education (for example, loans for relevant coursework)
- To assist employees experiencing financial hardship
- To assist employees in purchasing a home

Ideally, the documentation for loans (or loan policies) designed to benefit employees would be simple and easily prepared. The problem is that employee loans usually fall into the category of "consumer credit." While this definition varies by statute, "consumer credit" usually means a loan to an individual for personal, family, or household purposes.

Unfortunately, consumer credit is a highly regulated area of the law at both the state and federal levels. The following is a list of just some of the potential legal considerations in making employee loans:

In determining whether to make loans, does the employer plan to pull credit information on employees? If so, the employer must comply with the federal Fair Credit Reporting Act (the "FCRA"). To comply with the FCRA, a lender must certify to the credit reporting agency that it has a valid purpose for requesting the information. The lender must also provide an adverse decision notice to the consumer if the lender bases its decision to deny credit on any information obtained from the credit report.

Has the employer adopted a policy designed to prevent claims of discrimination? The federal Equal Credit Opportunity Act ("ECOA") prohibits creditors from treating one applicant less favorably than another because (i) of color, religion, national origin, sex, marital status, or age, (ii) the applicant receives some type of public assistance, or (iii) the applicant has asserted rights under a credit protection law. In addition to prohibiting discrimination, ECOA (and its implementing regulations) limits what information creditors can collect on the application, establishes the credit approval, denial, and revised offer notification process, sets forth when creditors must take action on requests for credit, and imposes recordkeeping requirements. A carefully drafted employee loan policy which clearly sets forth, among other things, eligibility criteria, may help an employer avoid claims of discrimination.

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Is the loan documentation written in plain language? Subject to certain exceptions, the Pennsylvania Plain Language Consumer Contract Act (the "Plain Language Act") applies to contracts whereby a consumer (i) borrows money, (ii) buys, leases or rents personal property, real property, or services for cash or on credit, or (iii) obtains credit. If applicable, the Plain Language Act contains tests for readability and disclosure requirements.

In documenting the loan, are any disclosures required? The federal Truth in Lending Act and its implementing regulations (commonly referred to as Regulation Z) apply to individuals or businesses that offer or extend credit when: (i) the credit is offered or extended to consumers; (ii) the offering or extension of credit is done regularly; (iii) the credit is subject to a finance charge or is payable by a written agreement in more than four installments; and (iv) the credit is primarily for personal, family, or household purposes. The threshold for determining whether credit is extended "regularly" depends on the number of loans made per year. Generally, when Regulation Z is applicable, a creditor must make certain disclosures in connection with the loan.

Will the employer charge interest? If applicable, the Pennsylvania Loan Interest Protection Law (commonly referred to as Act 6) sets forth maximum rates of interest. Generally, the maximum lawful rate of interest for the loan in a principal amount less than $50,000 is six percent. On the other hand, if the loan is interest free, the "imputed interest rules" contained in the Internal Revenue Code may require that some portion of amounts repaid be characterized as interest in the hands of the employer.

Will the loan be repaid through payroll deductions? If an employee agrees to repay the loan through payroll deductions, the employer must comply with Pennsylvania's Wage Payment and Collection Law, which requires that deductions be for the convenience of the employee. Care should also be taken to obtain written deduction authorizations and to ensure that the deductions will not violate applicable wage and hour laws.

Is the employer willing to accept limitations on enforcement and collection? Enforcing and collecting on a consumer debt is much more difficult than enforcing and collecting a commercial debt. For example, under Pennsylvania law, a confession of a judgment is unenforceable in a consumer transaction. Furthermore, lenders must take care to comply with any applicable federal and state collection laws, such as the Fair Debt Collection Practices Act. One way to ease the burden of complying with collection laws is to use a debt collection agency.

If the loan will be forgiven upon satisfaction of certain conditions, what are the income tax consequences? Forgiveness of an employee's debt may generate income to the employee for federal income tax purposes. With respect to the employer, if the debt is forgiven, the employer will need to determine whether the debt was business debt or non-business debt. This determination will affect the type of deduction (ordinary or capital) available to the employer.

As the above list of considerations suggests, consumer credit is a highly regulated area of the law. These laws are complex and sometimes counterintuitive. The penalties for violating these laws are harsh and may include **treble damages, criminal penalties, and an award of attorneys' fees**. For these reasons, we suggest that employers who wish to make employee loans seek our assistance before making any such loans. ■

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MORE THAN GOOD MANNERS – PERSONAL GOODWILL MAY REDUCE TAXES

By Timothy M. Finnerty and Andrew D. Clapp

Imagine a small business owner who is the only shareholder of an incorporated service business taxed as a C corporation by the IRS. Let's call the shareholder "Jane" and the company "SmallCo." Through years of hard work and dedication, Jane has built a reputation for excellent service. Furthermore, the relationships that she has forged with her customers are the reason that her company has had such success. Because it's her company, she has never had, nor needed, an employment agreement with SmallCo.

Now imagine that all of Jane's hard work paid off; a large corporation, "MegaCo," wants to acquire all of the assets of SmallCo. The purchase price will be $1 million, with half of the purchase price allocated to SmallCo's tangible assets and the other half allocated to SmallCo's goodwill and intangible assets. In addition, MegaCo wants to retain Jane's services after the transaction and asks Jane to sign a consulting and non-compete agreement. Jane, as sole shareholder, agrees to these terms. MegaCo pays SmallCo $1 million in exchange for all of SmallCo's assets, and, after satisfying its liabilities, SmallCo liquidates and distributes all of its remaining cash to Jane.

As the transaction is presently structured, the sale proceeds would be subject to double taxation. First, the proceeds would be taxed

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at the corporate level (the difference between the $1 million received and the tax basis of the assets sold), and, second, the amount paid to Jane in the liquidation of SmallCo, less Jane's basis in her SmallCo stock, would also be subject to tax.

Restructuring the transaction to account for Jane's personal goodwill may reduce that double taxation burden. The Treasury Regulations define goodwill as the value of a business that is attributable to the expectancy of continued customer patronage. Generally, goodwill is an asset of the business, as reflected in the transaction structure above. Courts have recognized, however, that in certain situations the goodwill properly belongs, in whole or in part, to certain key employees of the company. This "personal goodwill" is generated by, and is directly linked to, the relationships and interactions those key employees have with the company's customers.

Consider Jane and SmallCo again. Imagine that SmallCo's assets consist of a small office with a nicely appointed lobby, enough office furniture to fill a couple of rooms, some computer equipment, and, perhaps, a company car. Did any of those assets generate $500,000 of goodwill? The likelihood is that the vast majority, if not all, of the goodwill that MegaCo is buying is a direct result of Jane's personal relationships with her customers.

Jane should have structured the transaction as two separate sales: a sale by SmallCo of its assets; and a separate sale by Jane of her personal goodwill. Under that structure, MegaCo would have paid SmallCo $500,000 for the assets of the company. Those proceeds would still have been subject to double taxation. MegaCo would have paid the other $500,000 directly to Jane in exchange for her personal goodwill. That second $500,000 would have only been subject to taxation at the shareholder level. As a result, Jane could have realized a substantial tax savings. Personal goodwill is only available in select situations. Courts generally find personal goodwill in smaller, service-oriented businesses with few shareholders. The shareholder claiming personal goodwill must have created the goodwill personally through the unique relationships that he or she forged with customers. It is important that those relationships between the customers and the shareholder are "portable." In cases where shareholders or employees were prevented from taking customers from, or competing with, the company by an employment agreement or covenant not to compete, courts have found that the goodwill belongs to the business because the shareholders or employees could not have "taken it with them" when they left. Finally, it is important that the negotiations between the parties and the documents memorializing the transaction reflect the existence and acquisition of personal goodwill. Recent tax court opinions have disallowed claims based on personal goodwill where the transaction documents did not mention an allocation for *personal* goodwill; without such documentation, the courts typically view these positions as after-the-fact tax planning.

If you are considering a sale of your company and the scenario laid out above sounds more than a little familiar, we can assist you in evaluating whether to structure your transaction to include a sale of personal goodwill. ■

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