

March 31, 2020

## **The CARES Act: A Guide to the Economic Stabilization Provisions**

The CARES Act (the “Act”), enacted on March 27, 2020, authorizes the U.S. Department of the Treasury (the “US Treasury”) to provide up to \$500 billion in loans, loan guarantees and investments to certain eligible United States businesses impacted by the COVID-19 pandemic. These financial assistance provisions are contained in Title IV of the Act, which also provides for targeted regulatory relief with respect to the aviation industry, various banking regulations and certain consumer protection measures, including credit reporting and mortgage delinquencies. Together, these provisions form a central part of the federal government’s efforts to stabilize the US economy during the COVID-19 outbreak.

The financial assistance programs and related measures are designed to directly support severely impacted businesses (as well as States, municipalities and non-profits) through a combination of:

- up to \$46 billion in direct US Treasury loans and loan guarantees to businesses in the aviation industry and businesses deemed critical to national security; and
- an additional \$454 billion of loans and loan guarantees to be provided through Federal Reserve programs and facilities, including a new mid-sized business lending program. These are available to impacted businesses in any industry or sector.

Section 4003(b)(1)-(4) of the Act sets forth the applicable categories of loans and other financial assistance. Key provisions are summarized below. Although the Act contains a substantial amount of detail with respect to these programs, many terms and conditions likely important to potential participants remain subject to determination by the implementing regulators. The US Treasury (or the Federal Reserve in some cases) will issue procedures for applications and additional guidelines, and these can be expected to be material to evaluating the eligibility and desirability of any program. The Act requires the US Treasury to provide procedures for the programs for air carriers and related service providers and businesses critical to national security within 10 days – but there is no such requirement for the other programs.

We expect that in the coming days and weeks, important additional information will be provided through published regulations and other regulatory guidance. In the meantime, potential participants should consider the implications of complying with the statutory requirements, including liquidity requirements, public disclosure, employee and labor matters and tax impacts. Potential participants should also analyze important threshold financing considerations, such as the ability under their existing debt terms to incur, refinance and secure additional debt.

## Direct Lending Program for Aviation and Critical National Security Businesses

- **Overview.** \$46 billion of loan and loan guarantees to be made directly by the US Treasury allocated as follows:
  - \$25 billion in loans and loan guarantees for passenger air carriers, eligible businesses that are certified and approved to perform inspect, repair, replace or overhaul aircraft services, and ticket agents (the “(b)(1)” loans).
  - \$4 billion in loan and loan guarantees for cargo air carriers (the “(b)(2)” loans).
  - \$17 billion in loans and loan guarantees for businesses critical to maintaining national security (the “(b)(3)” loans).

The direct lending program provides for loans and loan guarantees, together with equity participations in certain cases. In contrast with the “(b)(4)” program described below, it does not expressly provide for any “other investments”.

- **Applicant Eligibility.** Applicants must satisfy each of the following criteria:
  - Applicant must be an “eligible business” which is either:
    - an air carrier; or
    - a US business that has not otherwise received adequate economic relief in the form of loans or loan guarantees under the Act.
 

*Note:* Non-aviation businesses will presumably need to demonstrate that they are “critical to maintaining national security”. While not addressed in the Act, eligible businesses will likely include defense and sensitive technology companies and may also encompass critical suppliers to any government agency with a national security mission in other industries (e.g. healthcare or communications).
  - Each applicant will need to certify that it is created or organized in the US or under the laws of the US and has significant operations in and a majority of its employees based in the US.
- Credit is not “reasonably available” to the applicant at the time of the transaction.
 

*Note:* Although not defined, “reasonably available” generally means that if through normal channels (e.g., bank loans), there are no loans available to the sector, then the applicant should qualify under this requirement.
- Obligations will be “prudently incurred”.
 

*Note:* Although not defined, “prudently incurred” generally means that no loans will be made if the ability of the borrower to repay is in doubt. There is no express borrower solvency requirement, which means lending to chapter 11 debtors is not statutorily excluded; however, DIP and Exit financings can be expected to be problematic if the ability to collect 100% of the loan is in question.
- Applicant must have incurred or expect to incur “covered losses” jeopardizing the continued operations of the business. Covered losses are defined as losses incurred directly or indirectly as a result of coronavirus.
- Conflict of Interest Certification – A business is ineligible if there is a controlling or 20% interest held by the President, Vice President, any head of an executive department or Member of Congress (and immediate family members in each case).

## ■ Key Economic Terms

- Terms Generally – The Secretary of the US Treasury (the “Secretary”) is granted broad discretion to set terms and conditions for loans to the extent not specified in the Act, including setting rates and the extent of equity participations as well as with respect to the form of documentation, including requiring representations, covenants and audit requirements.
- Interest –
  - Rates to be determined based on the risk and current average yield on outstanding marketable obligations of the US of comparable maturity.
  - Loan must be sufficiently secured or made at an interest rate that reflects the risk of the loan or loan guarantee.
  - To the extent practicable, the interest rate should equal at least the market rates for comparable obligations before the coronavirus outbreak.  
*Note: Date of outbreak is not specified (e.g. in other cases it is January 31, 2020, the date that the Secretary of the US Department of Health and Human Services (“HHS”) declared the related Federal Emergency) so this provides some discretion to the Secretary.*
- Maturity – The duration of the loan shall be as short as practicable but not longer than five years.
- Equity Participation –
  - Borrowers that have securities traded on a national securities exchange must deliver a warrant or equity interest in the eligible business.
  - Unlisted borrowers must deliver either a warrant or equity interest in the eligible business or a senior debt instrument issued by the eligible business.
  - If the borrower (listed or unlisted) cannot feasibly issue warrants or other equity interests, a senior debt instrument may be substituted in an amount and on such terms as the Secretary deems appropriate.
  - A broad range of equity instruments can satisfy the equity participation requirement. The related tax treatment provision (see below under Related Sections) refers to warrants, stock options, common or preferred stock or other equity interests as possible instruments acquired from eligible businesses through the programs. Presumably, convertible debt would also satisfy this requirement.
  - Any warrant, equity interest, or senior debt instrument must contain terms and conditions that are designed to provide for a “reasonable participation” in equity appreciation in the case of a warrant or other equity interest, or a “reasonable interest rate premium”, in the case of a debt instrument.
  - The Secretary may sell, exercise or surrender a warrant or any senior debt instrument received (for the benefit of taxpayers).
  - The Secretary may not exercise any voting power with respect to any shares of common stock it acquires pursuant to the Act.
- No cancellation or forgiveness – the principal amount of any loan may not be reduced or cancelled through loan forgiveness.

## ■ **Key Covenants and Restrictions**

- Share Buyback Restriction – Until 12 months after the loan is repaid, the borrower may not (nor may any affiliate) purchase any equity security of the borrower or of any parent company that, in either case, is listed on a national securities exchange, unless contractually obligated prior to March 27, 2020).

*Note:* This provision does not by its terms apply to repurchases of equity securities not listed on a national securities exchange, although the Secretary could impose that condition.

- Dividend Restriction – Until 12 months after the loan is repaid, the borrower may not pay dividends or make other capital distributions with respect to the common stock of the borrower.
- Executive Compensation Limits – The borrower must comply with the limitations on compensation set forth in Section 4004 (see Related Sections below).
- Employee Retention – The borrower:
  - must, until September 30, 2020, maintain its employment levels as of March 24, 2020, to the extent practicable, and
  - may not reduce its employment levels by more than 10% from the levels on March 24, 2020.

## Federal Reserve “(b)(4)” Programs

- **Overview.** \$454 billion, plus any unused amounts under the \$46 billion direct lending program, consisting of loans, loan guarantees and other investments to be made through existing and new Federal Reserve facilities and programs to eligible businesses, States or municipalities through:
  - purchasing debt directly from issuers;
  - purchasing debt on the secondary market; and
  - making direct loans (including secured loans).

Amounts funded by the US Treasury pursuant to these programs may be supplemented by the Federal Reserve, potentially significantly increasing the total available proceeds under this initiative.

The parameters of direct lending under this program remain largely unclear as considerable discretion is granted to the US Treasury and Federal Reserve in establishing facilities. This may result in expanded and differing eligibility criteria and restrictive covenants depending on the facility and programs being utilized. The statutory requirements outlined below can be expected to remain applicable for any program involving a direct funding to a borrower. However, as noted above, until the final terms and conditions are issued, it will be difficult for any participants to assess whether to apply for or participate in any of the “(b)(4)” programs.

- **Applicant Eligibility.** Applicants must satisfy each of the following criteria:
  - Applicant must be an air carrier or US business that has not otherwise received adequate economic relief in the form of loans or loan guarantees provided under the Act. This requirement appears intended to prevent utilization of more than one facility by any business.
  - Applicant must be organized in or under the laws of the US, have significant operations in the US and have a majority of its employees based in the US.

*Note:* This requirement can result in interpretive issues absent further guidance from the U.S. Treasury. For example, the treatment of US subsidiaries with foreign parent companies (including so-called “cross-market” companies) or with significant foreign shareholders is not addressed.

- Applicant must satisfy the solvency standard under the Federal Reserve Act (see discussion below re Federal Reserve Act Section 13(3) requirements).
- Applicant must be unable to secure adequate credit accommodations from other banking institutions (see discussion below re Federal Reserve Act Section 13(3) requirements).
- Conflict of Interest Certification – A business is ineligible if there is a controlling or 20% interest held by the President, Vice President, any head of an executive department or Member of Congress (and immediate family members in each case).
- **Key Economic Terms**
  - Terms Generally – As with the direct lending program, the Secretary has broad discretion to set terms and conditions to the extent not specified in the Act. For direct loans, this includes interest rates, commitment fees, maturity, amortization, collateral and the extent of any equity participations. Direct loans must be bilateral and not part of a syndicated financing or capital markets transaction. There are more specific terms outlined for the mid-sized lending program (which is a “(b)(4)” program) which are noted below.
  - Interest –
    - Rates to be determined based on the risk and current average yield on outstanding marketable obligations of the US of comparable maturity.
    - Rates are otherwise set by the Secretary or under the applicable Federal Reserve program being utilized.
  - Maturity – Not specified.
  - Equity Participation – Not required, although permitted.
  - No cancellation or forgiveness – The principal amount of any loan may not be reduced or cancelled through loan forgiveness.
- **Key Covenants and Restrictions**
  - Share Buyback Restriction – Until 12 months after the loan is repaid, the borrower may not purchase any equity security of the borrower or of any parent company, in each case listed on a national securities exchange (unless contractually obligated prior to March 27, 2020).

*Note:* As under the direct lending program, this provision does not by its terms apply to repurchases of equity securities not listed on a national securities exchange, although the Secretary could impose that condition. Unlike the direct lending program, this provision does not include affiliate purchases.
  - Dividend Restriction – Until 12 months after the loan is repaid, the borrower may not pay dividends or make other capital distributions with respect to the common stock of the borrower.
  - Executive Compensation Limits – The borrower must comply with the limitations on compensation set forth in Section 4004 (see Related Sections below).
  - Waivers – Any of the above restrictions may be waived upon a determination that such a waiver is necessary to protect the interests of the Federal Government.
    - If the Secretary exercises a waiver, however, then the Secretary is required to testify before Congress regarding the reasons for the waiver.
  - Federal Reserve Act Section 13(3) Requirements –
    - Loans may not be made to borrowers that are insolvent.

*Note:* Although the statute is not entirely clear on this point, we believe that it is not likely the Federal Reserve would require a potential borrower be subject to an insolvency proceeding in order to conclude that the borrower is ineligible pursuant to these programs due to insolvency. It is more likely that the Federal Reserve would employ a balance sheet test or a cash flow test or a reasonable combination of the two.

- Loan may not be for the purpose of assisting borrowers or their affiliates to avoid bankruptcy or a similar proceeding or structured to remove assets from the balance sheet of the borrower or any affiliate.

*Note:* An insolvency proceeding is defined broadly to include any bankruptcy, resolution under title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act, or any other Federal or State insolvency proceeding.

- Loans must be made pursuant to a facility that has broad-based eligibility (i.e. not tailored to an individual borrower).
- Evidence that the borrower is unable to secure adequate credit accommodations from other banks must be provided.
- Loans must have sufficient collateral and interest fixed at a rate “with a view of accommodating commerce and business”.

*Note:* Given the low interest rate environment, determining the unavailability of other credit will likely be a more significant issue than the rate related requirement.

### Mid-Sized Businesses Lending Program (part of the Federal Reserve program)

- **Overview.** The Act provides for the Secretary “to endeavor” to establish a program (which is included by the Act as a “(b)(4)” program) to facilitate lending by banks and other lenders to businesses and non-profit organizations. No aggregate program size or loan limits are specified for this program.

*Note:* As there is no requirement for establishment of the mid-sized lending program, the Secretary has room to abandon the effort if the requirement proves problematic or a determination is made that other facilities are addressing lending in this area (e.g. the Main Street Lending Program announced by the Federal Reserve, which is expressly carved out by the Act and which could be separately funded as (b)(4) program).

- **Applicant Eligibility.** Applicants must satisfy each of the following criteria:
  - Applicant must be an “eligible business” (i.e. an air carrier or a business that has not otherwise received adequate economic relief in the form of loans or loan guarantees under the Act) or a non-profit organization.
  - Applicant must certify that the uncertainty of economic conditions as of the date of the application makes the loan request necessary in order to support the ongoing operations of the Applicant.
  - Applicant must be an entity or business domiciled in the United States with significant operations and employees located in the United States.

*Note:* The Act also, somewhat ambiguously, imposes the same tests as to organization, operations and employees in the US as for the other programs described above.

- **Key Economic Terms**

- Interest – Capped at 2.0% per annum.

- Payments – No payments of interest or principal for six months (or for a longer period if the Secretary determines).

*Note:* The Act is unclear whether payments would be deferred or just not required during first 6 months and, in the case of interest, if it would accrue and be capitalized.

- Maturity – Not specified.
- Equity Participation – Not required, although permitted.
- No cancellation or forgiveness – The principal amount of any loan may not be reduced through loan forgiveness.

#### ■ **Key Covenants and Restrictions**

- Share Buyback Restriction – Until the loan is repaid, the borrower may not purchase any equity security of the borrower or of any parent company that, in either case, is listed on a national securities exchange (unless it is obligated to pursuant to a contractual obligation that is in effect as of March 27, 2020).
- Dividend Restriction – Until the loan is repaid, the borrower may not pay dividends or make other capital distributions with respect to the common stock of the borrower except under a contractual obligation in effect as of March 27, 2020.

#### ■ Employee Retention and Benefits –

- Any funds received by the borrower must be used to retain at least 90% of the recipient's workforce, at full compensation and benefits, until September 30, 2020.
- The borrower must intend to restore not less than 90% of its workforce as of February 1, 2020, and intend to restore all compensation and benefits to its workforce no later than four months after the termination date of the public health emergency declared by the Secretary of HHS on January 31, 2020 in response to COVID-19.

- Until 2 years after the loan is repaid, the recipient will not outsource or offshore jobs.

*Note:* Although not defined, "outsource" generally means to transfer to another a function which the borrower could or was already doing itself and "offshore" generally means to transfer a function to a non-US company or to a US company's foreign operations.

#### □ Labor Unions –

- Until 2 years after the loan is repaid, the borrower may not abrogate existing collective bargaining agreements.
- For the term of the loan, the borrower must remain neutral in any union organizing effort.

### Related Sections

#### **4003(h): Tax Treatment**

Any loan or loan guarantee made by the US Treasury will be treated as indebtedness for purposes of the Internal Revenue Code, issued for its stated principal amount. Stated interest on such loans will be treated as qualified stated interest. The Secretary is required to issue further regulations and guidance on related tax matters, including that any equity participations do not result in an ownership change for purposes of section 382 of the Internal Revenue Code.

## **Section 4004: Compensation and Severance Limitations**

As a condition to receiving a loan or loan guarantee under the Act, the eligible business must agree to both a limitation on compensation increases and a limitation on severance benefits for certain officers and employees. In addition, a cap on total compensation of highly compensated executives is imposed.

- **Applicable Period.** The limitations and cap apply during the period beginning on the date on which the financing arrangement is executed and ending on first anniversary of the date on which the financing is no longer outstanding (the “Applicable Period”).
- **Applicability.**
  - The compensation increase limitation and the severance limitation apply to any officer or employee whose “total compensation” from the eligible business exceeded \$425,000 in calendar year 2019 (other than an employee whose compensation is determined pursuant to certain pre-existing collective bargaining agreements) (each such officer or employee, a “Covered Employee”).
  - The cap applies to any officer or employee whose “total compensation” from the eligible business exceeded \$3,000,000 in calendar year 2019 (each such officer or employee, a “Capped Employee”).
  - On its face, the rules would be inapplicable to employees hired after 2019, but that omission may be addressed in future guidance or technical corrections.
- **Prohibition on Compensation Increases.** During the Applicable Period, no Covered Employee may receive from the eligible business during any 12 consecutive months of such period total compensation which exceeds the total compensation received in calendar year 2019.
  - **Total Compensation.** “Total compensation” is defined to include salary, bonuses, awards of stock, and “other financial benefits”.
- **Limitation on Severance.** During the Applicable Period, no Covered Employee or Capped Employee may receive severance pay or other benefits upon termination of employment which exceeds twice the maximum total compensation received from the eligible business in calendar year 2019.
- **Total Compensation Cap.** During the Applicable Period, no Capped Employee may receive during any 12 consecutive months of such period total compensation in excess of \$3,000,000 plus half of the amount over \$3,000,000 received in 2019. For example, if the Capped Employee received \$7,000,000 of total compensation in 2019, his or her total compensation for any consecutive 12 months of the Applicable Period would be capped at \$5,000,000.

*Notes:* The restrictions imposed under Section 4004 raise numerous interpretive and practical issues that will need to be addressed in future guidance including:

- **Measurement of total compensation.** There are a number of different ways to measure compensation, including for financial statement reporting, SEC compensation disclosure and tax reporting. It is unclear which measure or combination of measures, or other measures, will be used for this purpose. For example, would the value of stock options be determined based on an option pricing model? How, if at all, would vesting be taken into account? How would deferred compensation be treated? In addition, it is unclear how broadly “other financial benefits” will be interpreted or measured.
- **12 consecutive month measurement period.** Because businesses typically do not measure total compensation on a rolling 12-month basis, controls and procedures for monthly tracking and measurement may need to be implemented.



- **Implementation.** Participants in the TARP program were required to enter into “TARP Restricted Employee Agreements”. The terms of these agreements addressed the TARP restrictions and, among other things, required clawbacks under certain circumstances. Similar agreements may be required under the Act.

### **Section 4007: Suspension of Certain Aviation Excise Taxes**

From March 27, 2020 until January 1, 2021, the Act imposes a holiday on excise taxes for (a) air transportation under sections 4261 and 4271 of the Internal Revenue Code and (b) kerosene used in commercial aviation under certain sections of the Internal Revenue Code.

### **Section 4011: Special Inspector General**

The Act establishes an office of the Special Inspector General for Pandemic Recovery (the “Special Inspector General”), who will submit quarterly reports to Congress. The Special Inspector General will be appointed by the President and will conduct, supervise and coordinate audits and investigations of:

- the making, purchase, management and sale of loans, loan guarantees and other investments made by the Secretary under the Act; and
- the management by the Secretary of any program established under the Act.

### **Section 4026: Reporting**

- **Direct Lending Program.** Upon the consummation of any transaction under the direct lending program, the Secretary will (a) publicize the transaction within 72 hours, (b) submit a public summary report to Congress within 7 days and (c) publish an updated summary report every 30 days during the period when the loan or loan guarantee is outstanding.
- **Federal Reserve Program.** Upon the approval of any new transaction under the Federal Reserve program, the Federal Reserve will (a) submit a summary report to Congress within 7 days and (b) submit an updated summary report to Congress every 30 days during the period when the loan, loan guarantee or investment is outstanding, in each case, to be publicized within 7 days after submission.
- **Quarterly Testimony.** The Secretary and the Chairman of the Federal Reserve Board will testify before Congress every quarter regarding the transactions and obligations entered into in accordance with the Act.

## **Certain Provisions Relating to Accounting Relief for Banks and Other Financial Institutions**

### **Section 4012: Temporary Relief for Community Banks**

The Act allows insured depository institutions, including credit unions, bank holding companies or any of their affiliates, to opt temporarily to delay compliance with the Financial Accounting Standards Board’s (“FASB”) Current Expected Credit Losses (“CECL”), a new provision of the US Generally Accepted Accounting Principles (“U.S. GAAP”) that many larger financial institutions filing periodic reports with the Securities and Exchange Commission have been required to adopt and implement effective January 1, 2020 (calendar-year registrants). This option will expire at the earlier of December 31, 2020, or the date on which the current national emergency is terminated.

### **Section 4013: Temporary Relief from Troubled Debt Restructurings**

The Act allows certain financial institutions, including credit unions, to temporarily suspend application of U.S. GAAP for loan modifications related to COVID-19 that otherwise would be categorized as a troubled debt restructuring. This suspension relief is limited to modifications for loans that were not more than 30 days past due as of December 31, 2019 for the period beginning March 1, 2020 and lasting no later than 60 days after the lifting of the national emergency.

*Note:* Neither FASB nor the Securities and Exchange Commission, which oversees U.S. GAAP standard-setting by FASB, have issued a public response to the foregoing. This will be an important area to monitor in the coming days. On March 27, 2020, the Federal Reserve, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency issued an interim final rule that gives banking organizations that implement CECL before the end of 2020 the option to delay for two years an estimation of CECL's effect on regulatory capital, followed by a 3-year transition period.

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If you have questions concerning the contents of this alert, or would like more information, please speak to your regular contact at Weil or to any of the following:

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