BUSINESS LAW NEWS

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HAPPY ANNIVERSARY, BUSINESS LAW SECTION!

EDITH WARKENTINE AND DONNA PARKINSON[1]

The California State Bar Business Law Section ("BLS" or "Section") as of 2012 has been in business 35 years! The Section first marked its anniversary in 1997, when Roland Brandel,[2] a former Section Chair and valued advisor to the Section Executive Committee, wrote "Twenty Years of Growth,"[3] to mark the Section's first 20 years. Ten years later, Chuck Crouch, also a past Chair, updated Roland's history with a humorous and fact-filled recounting of Section activities between 1997 and 2007, liberally punctuated with funny but true movie quotes.[4] If it seems too soon to do yet another update; we agree. Instead, your authors have decided to write a brief comparison of the BLS in 1977 to the BLS as it operates now.

EDITH WARKENTINE

Edith Warkentine is a professor at Western State College of Law, focusing on contract and commercial law. She served as Chair of the Business Law Section of the California State Bar (2001-2002) and as Chair of the UCC Committee.

DONNA PARKINSON

Donna Parkinson is the managing partner of Parkinson Phinney where she focuses on complex bankruptcy and commercial insolvency law issues. She served as Chair of the Business Law Section of the California State Bar (2011-2012) and as Chair of the Insolvency Law Committee, and has been an adjunct professor at the University of the Pacific's McGeorge School of Law teaching bankruptcy law.

The Scope of the Section: In the Beginning

The evolution of the Section since its inception is truly remarkable, due in no small part to changes in technology that have dramatically changed all of our personal and professional lives. In 1977, Brad Clark[5] wrote a Report on Purposes and Scope of Activities of the Section ("Report").[6] The Report summarized the scope and organization of the Section and its committees, steps to be taken to gain and hold as large of a membership for the Section as possible, and specific tasks to be undertaken through Section committees. At that time, the practice areas encompassed by Section membership were corporations, partnerships, unincorporated business organizations, banking, bankruptcy, securities, and the commercial code, as well as matters of debtor and creditor relations, arbitration, unfair competition, antitrust, and litigation practice particularly related to business law. Roland Brandel reports that after its first full year, the Section had a membership of approximately 2,000. There are now over 8,300 members.

The Scope of the Section Today

Today, the Section, through its Standing Committees, continues to focus on many of the same legal areas identified in 1977, with some significant changes: arbitration, unfair competition, antitrust, and litigation practice have moved out of the Section's scope.[7] The Section's fourteen Standing Committees[8] now encompass the following areas of practice: Agribusiness, Business Law News, Commercial Transactions (formerly UCC), Consumer Financial Services, Corporations, Cyberspace Law, Financial Institutions, Franchise Law, Health Law, Insolvency Law, Insurance Law, Nonprofit Organizations, Opinions, and Partnerships and Limited Liability Companies. The following former Standing Committees no longer exist: Alternate Dispute Resolution Committee,[9] Corporate Law Departments Committee, Education Committee,[10] Labor Law Committee,[11] Legislation Committee,[12] and Public Interest Committee.[13]

BUSINESS LAW NEWS

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Section Executive Committee Functions: Then and Now

The Report described the 1977 Executive Committee of the Section as acting principally as a coordinating, reviewing, and recommending body.[14] Detailed research, investigative study, consultative work, drafting, and other work was delegated to the Standing Committees and ad hoc committees.[15] The Executive Committee continues its administrative functions, but its role in the growth and development of the Section has been much more pronounced than the Report envisioned. As the most talented and committed members of the Standing Committees rose to leadership roles on the Executive Committee, the Executive Committee took on a major role as a creative guide and innovator. Executive Committee initiatives now lead the Standing Committees in providing services to members and in developing the means to deliver content to members. In addition, the Executive Committee plays a critical role in trying to design and manage a structure that makes it possible for Standing Committees to function within the State Bar hierarchy.

In 1977, the Report stated that one of the highest priorities for the Section was to attract and hold a large membership for the Section.[16] Early Executive Committee members believed that an important method of attracting Section members was to provide for the widest, most efficient and practicable participation in the Section, committees, and other work. Including participation by the Standing Committees' members, there now are at least 250 to 300 active members attending meetings, producing programs and publications, and writing and commenting on legislation in the current Section.

Over the years, growing the membership of the Section as a whole has remained a high priority. The Executive Committee has tried a variety of experiments to accomplish that goal with varying success. Perhaps the most successful of these efforts, however, was originally known as "the Constituency Project." The goal of this project was to identify California lawyers with an interest in business law, determine their professional interests, involve them in Section activities, and provide them with a reason to be a member of the Section. In the beginning, Executive Committee members struggled to find a way to identify the BLS constituency, working with paper resources such as Martindale Hubbell. A membership survey was conducted, which was well-executed in all ways save one. The Section lacked the resources to process the volumes of hard copy responses and collate the results! The Constituency Project was over twenty years in development. The Executive Committee kept it alive each year, based on the idea that the best reason to be a Section member was to receive timely and relevant educational and other material that would help each Section member with his or her own professional practice and growth, and that identifying and communicating with members was an important step towards achieving this goal.

In the early years (1990's), the biggest obstacle to a successful Constituency Project was gathering up the names of the lawyers who might be interested in business law, and finding cost effective ways to contact them. We are literally talking about cardboard boxes in building basements, and people going through acres of paper to identify names and addresses of potential Section members!

With the advent of the Internet, identifying interested lawyers became much easier. The Section began to explore methods of electronic communication.

Before e-mail, listservs, and blogs were common, digging through reams of records and communicating through snail mail was the only way. The Constituency Project took a major leap forward with the ability to establish electronic "constituency lists" and send e-communications. As a result of the Constituency Project, each Standing Committee now has an electronic list of interested Section members who receive e-bulletins regarding timely and significant case, regulatory, and legislative developments. The e-lists comprise those Section members (and in some cases non-members whom the Section hopes to recruit) who have self-selected to be included in the constituency list or lists of his or her choice. About 60% of the members of the Section now subscribe to at least one Standing Committee Constituency List.

In the last five years, the number of e-bulletins sent has increased exponentially as has the size of the constituency lists. In 2012, until the writing of this article, over 250 e-bulletins have been sent to constituents, and the constituency lists continue to grow. The ability to communicate with members electronically about timely and relevant content is perhaps one of the greatest achievements of the Section.

Not content to rest on its laurels, the Executive Committee more recently convinced the State Bar that the Section should join the social media age and now, thanks to some very e-literate and dedicated members of the Section, we even have our own Facebook page[17] and Twitter[18] account.

Section Standing Committees

The substantive work of the Section has always been done by its Standing Committees. Although the Standing Committees have always done great work, the extent of communication between the Standing Committees and the Executive Committee has improved over the years, with dramatic results. One of the great achievements of recent years has been to formalize communications between the Executive Committee and the Standing Committees so that each Standing Committee has an active and involved liaison from the Executive Committee, who attends all Standing Committee meetings and helps the Standing Committee to work with State Bar staff to accomplish its goals. These contacts are further solidified by a Standing Committee Coordinator who, as a member of the Executive Committee and with the help of Bar staff, collects monthly liaison reports and prepares a spreadsheet so that the Executive Committee can see at a glance all of the activities of each of the Standing Committees. The Executive Committee also now conducts regular monthly telephone conference calls with all of the Standing Committee officers to keep the communication lines open and fluid between the Executive Committee and the Standing Committees. The Section is truly a well-oiled machine these days.

Panels and Programs

The 1977 Report recognized that another valuable method of gaining and holding members is the production of educational programs that Section members can attend either free of charge or at a reduced rate compared to that charged to non-members of the Section.[19] Over the years, the Section has been one of the most successful CLE providers of all of the State Bar Sections, presenting programs at the State Bar Annual Meeting, the Section Educational Institute, the Solo Summit, Standing Committee meetings, and now over the Internet via webinars and teleseminars. At the 2012 Annual Meeting alone, the Section presented ten programs.

In 2012, the Standing Committees collectively presented over 80 independent programs.[20] These programs included a program by Financial Institutions regarding the statutory reorganization of the Departments of Real Estate, Corporations and Financial Institutions, and a program by Corporations on crowd funding. The Agribusiness Committee puts on numerous programs every year for its constituents, including its always-popular site visits to agricultural enterprises like wineries, farms, and dairies. The Cyberspace Law Standing Committee presented a free program last fall in conjunction with Stanford University on free speech in the networked world as well as other programs during the year. The amount of content produced by the Standing Committees is too voluminous to recount in detail, but each Standing Committee is providing valuable content to its constituents. Certain State Bar-sponsored programs are now archived electronically and available for access, 24/7, at the convenience of Section members. As of the date of this article, current State Bar MCLE offerings include 122 such business law programs.[21]

Many Standing Committees provide educational materials at their monthly meetings, which are open to all members of the Section.

In addition to programs by the Standing Committees, since 2009, the Section has been presenting a series of educational programs, in the format of weekly one hour lunchtime programs. Each Standing Committee participates by delivering a program in its practice area. This concept was first established to educate lawyers on how to advise their clients in the wake of the economic crash of 2008. That series, entitled "Focus on the Economy," was so successful that it was repeated in 2010.

In 2011, the program expanded to two series per year that are now a recognized part of the Section's "brand": (1) a "Boot Camp" or "How To" series, developed in conjunction with the California

Young Lawyers Association ("CYLA"), offering basics for new or retooling lawyers in the fall of each year; and (2) a "Hot Topics" series, bringing up-to-date information about recent developments in business law in the spring of each year. If you missed any of the webinars in the Essentials of Business Law Series, you can access such programs as "Essentials of IP in Business Law," "Essentials of the New Consumer Financial Protection Laws: What They Mean for Your Law Practice," "Essentials of Cyberspace Law: User-Generated Content, Privacy, and Advertising," and "Essentials of Small Business Workouts and Bankruptcy" simply by going online.[22]

All of 2009's "Focus on the Economy" series is available free to BLS members in the BLS Members Only portion of the website.[23]

The 2012 CLE calendar is also available online.[24]

Publications

The 1977 Report stated that another major membership benefit would be a useful work product in the business law field in book or booklet form that could be read and discarded or permanently retained according to the members' wishes.[25] Since 1977, the Section has authored a wide range of important books, which have been made available to the membership in a variety of ways. It is now possible to order Section publications on the website,[26] and a number of free publications are available in the BLS Members Only portion of the website.[27]

The Hidden Liens Report,[28] now on the public side of the website, was prepared by the Commercial Transactions Committee. It is a major, long-term undertaking of the Committee, consisting of an extensively annotated list of liens on personal property that would not appear in a "UCC search" of the records of the California Secretary of State.

Another publication available on the website is The Lawyer's Guide to Drafting ADR Clauses.[29] Other currently-available publications include Guide to California Securities Law Practice (2006),[30] Handbook for Incorporating a Business in California (2006),[31] Cyberspace Law and Policy: A Primer for State Policymakers (2010),[32] The Agricultural Law Sourcebook CD (2010),[33] and Guide to Organizing and Operating a Limited Liability Company in California (2001).[34]

The Opinions Committee has made a major contribution to the national discourse regarding legal opinions. Its work is an invaluable resource for business law practitioners in California. Currently, the Opinions Report is available for purchase in hard copy and can also be accessed online.[35]

Finally, the Section's Business Law News puts out four quarterly volumes with five to ten articles by professionals in their fields as well as the Annual Review of legislative, regulatory, and case law developments from BLS standing committees.[36]

Coming soon is the California Assignments for the Benefit of Creditors Desk Guide.

Legislative Accomplishments

Looking back over the past 35 years, the accomplishments of the Section and its Standing Committees are impressive. The panels, programs, and publications described above speak for themselves. In addition, the Section, through its Standing Committees, has been involved in a wide range of legislative activities. The Section was involved in writing or revising many California statutes (and related administrative regulations) of importance to California business lawyers, including all aspects of the California Corporations Code (including the general corporations law, the non-profit corporations law, the law of partnerships, limited partnerships and limited liability companies, and the franchise investment law); commenting on proposed revisions to most articles of the Uniform Commercial Code, including most recently UCC Article 2 (which were never enacted) and Revised Article 9; and a recent unsuccessful attempt to repeal Article 6, the Bulk Sales Law. The Section has been involved in debates regarding revisions to the national bankruptcy law and state law regarding assignments for the benefit of creditors. Many Standing Committees have participated in the process of rewriting and passing uniform state laws.

The Section's role with regard to legislation has grown even more important in the State of California since the enactment of term limits. Often it is Section members who have the greatest expertise and willingness to work on significant improvements to laws that affect California businesses.

By way of example, for the 2011-2012 Bar year the following Section-initiated bills were signed:

- A.B. 571 (2011) {Corporations Committee}: Revisions to Streamline and Update Corporation Code Provisions Relating to Distributions and Repurchases of Shares
- A.B. 1211 (2011) {Nonprofit Organizations Committee}: Nonprofit and Unincorporated Association Law Cleanup
- A.B. 2668 (2012) {Nonprofit Organizations Committee}: Indemnification of Employee Benefit Plan Fiduciaries
- A.B. 2667 (2012) {Commercial Transactions Committee, formerly UCC}: Signature Requirement on Financing Statements
- S.B. 1069 (2012) {Insolvency Law Committee}: Proposal to Extend Anti-Deficiency Protection to Refinanced Mortgage Obligations

- A.B. 2364 (2012) {Consumer Financial Services Committee}: Service of Levies and Related Legal Process on Financial Institutions
- S.B. 323 (2012) {Partnerships and Limited Liability Companies Committee}: Revised Uniform Limited Liability Company Act.

That is a pretty impressive list of legislative accomplishments for a single year for the Section!

People, People, People

Literally hundreds of wonderful, talented people have made huge contributions over the years. Next year, the Section will honor some of its founding members. Each year, the Section honors one individual with a Lifetime Achievement Award, which often reflects extensive service to the Section as well as important contributions to business law developments. To avoid leaving anyone out, we have decided not to recognize and thank here the many people who have built today's Section, but you know who you are. We must make an exception, however, for our former Section Coordinator, Susan Orloff, who served the Section for 22 of its 35 years. Susan recently retired, and in honor of her service, all 22 of the chairs who had the privilege of working with her presented her with a book of memories, and most were able to attend a luncheon in her honor. Susan's valued service was exceptional, and we all wish her the very best in her retirement.

Ongoing Projects

In addition to the activities described above, the Section has implemented two exciting new programs designed to inform and educate prospective business lawyers and to introduce them to the Business Law Section. One is a series of "road shows" rolled out in 2010. These programs are designed to reach out to current law students, who can actually join the Section now as students, and involve a panel of business lawyers talking to students about their careers, training, and how to get into such a career. The road shows are presented annually and to date have attracted crowds of interested law students at most of the law schools in the State.

The other, more recent, initiative is a mentoring program. In partnership with the CYLA, the Section matches experienced practitioners with groups of young lawyers. The mentor confers with his or her protégés based on an actual educational curriculum developed by members of the Executive Committee. Mentors have groups of five protégés with whom they meet in person or by teleconference every couple of months. The program is designed to provide career guidance, feedback, and assistance to lawyers just beginning their careers. If you are reading this article and you are interested in participating in the program, either as a mentor or mentee, please contact Robert Hawn.[37]

Challenges, Frustrations, Opportunities

This article would not paint a complete picture of the state of the Section if we failed to mention the relationship of the Section to the larger California State Bar. Although part of the Bar,[38] the Sections are self-funded, primarily as a result of legislative action in the past.[39] The BLS is heavily dependent on the technology and staff services that it, in essence, purchases from or through the State Bar. The Bar staff that works most closely with the BLS is hard working, creative, and responsive, but the BLS, and the staff members who serve it, are frequently subjected to policies and decisions made without advance notice to staff members or the BLS and without soliciting relevant information from them, on the basis of which, better decisions might be made.

A primary Bar goal, emphasized by the legislature and the Bar itself in recent months, is public protection. The BLS is an enormous contributor to that goal with the services it provides to its members, services that help make those members better lawyers in the service of the public. In this respect, the goals of the Bar and the BLS are the same. What has been missing, historically, within the Bar administration and between the Bar and the BLS, is a smooth functioning transparency and collaboration in decision making, a transparency brought about by the timely sharing of information with regard to changes being considered, and a collaboration brought about by inviting feedback on the implications of policies being considered.

A new Executive Director came to his role in 2010 with a clear understanding of the high importance of transparency and collaboration and of inculcating those concepts as part of the Bar culture. If he is successful in doing so, the decision making will improve, and the frustrating surprises will diminish.

The importance of a continued quest for better collaboration between the Bar and the BLS cannot be overstated. In meeting the Bar's goals, the BLS is constantly expanding the range of services it provides. That expansion is good for the public, for the Bar generally, and for BLS members. Those increased services must be paid for by the BLS through Section reserves, voluntary dues and other revenues; no question about that. The BLS is working hard toward achieving a shared appreciation with the Bar for the concept that a well-considered expansion of services, using existing Section reserves and revenues, is a positive benefit to all concerned, especially to the staff that provides the essential administrative support. The Bar should not reject improvements and growth because they might strain existing

staff and technology resources so long as additional resources are paid for by the BLS. Rather, the Bar should enthusiastically welcome the growth of the BLS and facilitate any necessary BLS-funded expansion of internal and external resources to the end that the BLS can better serve the public and its own members.

Benefits of Section Membership

We asked past Section chairs why they became active in the Section and how they think it impacted their professional and personal lives. Most replied that they first joined the Section for its educational materials and that they then became active either (1) because of colleague recommendations or (2) because they did not practice in large firms and wanted the benefits of networking and meeting other practitioners who practiced in their areas. Uniformly they reported that the single personal advantage to them of such participation was that they met wonderful people. As one past chair stated, "Personally, as a result of my involvement in BLS, I now have strong friendships with attorneys throughout the state. Professionally, the attorneys I met through the BLS (particularly in leadership positions) act as non-judgmental, very knowledgeable resources for complicated legal questions when I cannot find answers myself or just want the input of someone I respect."

In the words of another past chair "[t]he State Bar was a forum for lawyers to drop their representations and focus solely on getting the best answers for the Bar, and in the process of doing so, interact with some of the best legal minds in California." That same chair described his involvement in Standing Committee matters as "one of the most intriguing and intellectually challenging projects with some of the most brilliant people with whom I have collectively interacted."

For those who do not choose to serve on Standing Committees, Section membership benefits include updates on legal developments, significant discounts on legal materials published by the ABA, discounts on certain CEB programs, and a subscription to the Business Law News, a quarterly Section journal with articles on topics of interest to business lawyers. More information is available on the Business Law Section's webpage.[40]

The Future

In comparing the Section today to the Section that began 35 years ago, we note the differences, but we are struck by the similarities. What the Section continues to have is a wealth of talented, professional, committed, and hardworking volunteers whose energy and enthusiasm continue to build an ever-more-effective organization that contributes to the betterment of business law in California and in the United States. As Chuck Crouch noted in his 30th anniversary article, "[t]he Section, for all its successes, is nothing more than groups of volunteers who give tirelessly of their time and abilities assisted by administrative staff who can be counted on to give more than they take."[41] As Rick Frasch (1991-1992 Chair) noted, "many of the challenges our Section faces today are the same as Section leaders have faced over the years but just with different intelligent people at the helm."[42]

We are encouraged by the constant stream of new, dedicated Section members who join and participate in Standing Committee meetings. We urge members of the Section to join constituency lists, attend Standing Committee meetings, apply for Standing Committees, attend Section programs, and read Section publications. With a strong membership working together, the Business Law Section is in business with a glowing future! ■

Endnotes

1 We wish to thank Roland Brandel and John Power for giving graciously of their time to comment on early drafts of this article. As always, their wise counsel and assistance has been invaluable.

2 Words cannot express all that Roland has contributed to the Business Law Section. In recognition of all of his hard work and support, he received the Section's Lifetime Achievement Award in 2006, but he just keeps on giving. No amount of praise and thanks to Roland could come near to being adequate.

3 Roland E. Brandel, *Twenty Years of Growth,* Business Law News (State Bar of California, S.F., Cal.), Summer 1997, at 11.

4 Charles L. Crouch, III, Celebrating the Section's 30th Year, Business Law News (State Bar of California, S.F., Cal.), Issue 2, 2007 at 1.

5 Brad Clark was one of the original members of the Section, and received its Lifetime Achievement Award in 2000.

6 Bradley Clark, Report on Purposes and Scope of Activities of the Section (1977) (unpublished report) (on file with the Business Law Section of the State Bar of California).

7 Several former BLS Standing Committees, such as Litigation and Labor and Employment Law, are now independent sections of the State Bar.

8 The State Bar of Cal., *Standing Committees,* http://businesslaw.calbar.ca.gov/StandingCommittees.aspx (last visited Dec. 4, 2012).

9 The Alternative Dispute Resolution Committee is now part of the Litigation Section.

10 Each standing committee now produces educational programs and publications within its specialized area.

11 There is now a separate Labor & Employment Law Section.

12 Each Standing Committee now produces its own affirmative legislative proposals and comments on pending legislation within its specialized area.

13 There is now a separate Public Law Section.

14 *See* Clark, *supra* note 6 (unpublished report at 4).

15 *Id.*

16 *Id.* at 7.

17 http://www.facebook.com/calbarbuslaw.

18 http://www.twitter.com. The Section's Twitter address is @calbarbuslaw.

19 *See* Clark, *supra* note 6 (unpublished report at 8).

20 A list of current programs offered by the Section may be found at Cal. Bar Journal (Dec. 2012), http://www.calbarjournal.com/CLECalendar.aspx.

21 For a complete catalog go to http://calbar.inreachce.com and click on "Business Law." Additional programs are available at versatape.com.

22 Go to www.calbar.org/online-cle and then click on "Business Law."

23 The State Bar of Cal., *Business Law Section,* http://members.calbar.ca.gov/sections/buslaw/mp3.htm (last visited Dec. 4, 2012).

24 Cal. Bar Journal, CLE *Calendar of Events,* http://www.calbarjournal.com/CLECalendar.aspx (last visited Dec. 4, 2012).

25 *See Clark, supra* note 6 (unpublished report at 9).

26 The State Bar of Cal., *Sections Bookstore,* http://sections.calbar.ca.gov/About/SectionsBookstore.aspx#bl (last visited Dec. 4, 2012).

27 The State Bar of Cal., *Business Law Section Publications,* http://businesslaw.calbar.ca.gov/Publications.aspx (last visited Dec. 4, 2012).

28 Commercial Transactions (Formerly UCC) Comm. of the Bus. Law Section of the State Bar of Cal., Hidden Liens Report (Dec. 1, 2010), *available at* http://businesslaw.calbar.ca.gov/Portals/13/documents/hidden-liens-report_final.pdf.

29 Litig. Section of the State Bar of Cal. ADR Comm., The Lawyer's Guide to Drafting ADR Clauses, http://members.calbar.ca.gov/sections/shared/adr.html.

30 The Corps. Comm. of the Bus. Law Section of the State Bar of Cal., Guide to Securities Law Practice (2006), http://businesslaw.calbar.ca.gov/Publications/SecuritiesLaw.aspx.

31 The Corps. Comm. of the Bus. Law Section of the State Bar of Cal., Handbook for Incorporating a Business in California (2006), http://businesslaw.calbar.ca.gov/Publications/IncorporatingaBusiness.aspx.

32 The Cyberspace Law Comm. of the Bus. Law. Section of the State Bar of Cal., Cyberspace Law and Policy: A Primer for State Policy Makers (2010), http://businesslaw.calbar.ca.gov/Publications/CyberspaceLawandPolicy.aspx.

33 The Agribusiness Comm. of the Bus. Law Section of the State Bar of Cal., The Agricultural Law Sourcebook CD, http://businesslaw.calbar.ca.gov/Publications/AgriculturalLawSourcebookCD.aspx.

34 P'ships and Ltd. Liabs. Comm. of the Bus. Law Section of the State Bar of Cal., Guide to Organizing and Operating a Limited Liability Company in California (2001), http://businesslaw.calbar.ca.gov/Publications/LimitedLiabilityCompanies.aspx.

35 The Ops. Comm. of the Bus. Law Section of the State Bar of Cal., Opinions Reports (various), http://apps.americanbar.org/buslaw/tribar.

36 For more information, *see* http://businesslaw.calbar.ca.gov/Publications/BusinessLawNews.aspx.

37 Mr. Hawn may be reached at rvh@structurelaw.com.

38 In many states, a mandatory organization exists primarily for the purpose of regulating admission to practice and attorney discipline, and a separate voluntary association exists for other purposes, such as education of the bar. The disciplinary bar derives its power from legislative statute and/or from the power of the state court system. The voluntary bar is a completely separate trade association with its own leadership, staff and facilities. California has an "integrated" bar in which the disciplinary bar and trade association functions are combined, leaving the Sections vulnerable to political pressures (such as the infamous bar dues crisis of 1997 and limitations on legislative proposals) and unable to manage and purchase needed resources even when Section funds are available to do so.

39 *See* Crouch, *supra* note 4, at 17 (explaining some of the tensions and solutions over the years).

40 The State Bar of Cal., *Business Law Section,* http://businesslaw.calbar.ca.gov/ (last visited Dec. 4, 2012). For information on how to join a Section, go to http://sections.calbar.ca.gov/About/JoinaSection.aspx.

41 *See* Crouch, *supra* note 4, at 19.

42 Email from Rick Frasch to Edith Warkentine (July 6, 2012, on file with authors).

Executive Committee: Message from the Chair

James P. Menton, Jr.

Celebrate! The Business Law Section ("BLS") marked its 35th anniversary in 2012. Since its inception, BLS has evolved, expanded, and enhanced the services and value for our members. For a terrific read on just how far BLS has come since 1977, check out this issue's cover story by Edith Warkentine and Donna Parkinson. The past 35 years have been made possible by your support and the hard work of our talented and dedicated volunteers, and we thank all of you for making it happen, year after year.

Connect! There are myriad ways for you to enhance your connections to business law, and stay current on matters that will improve your daily practice. One resource is the very publication you are reading now, which provides a good roundup of topical issues targeted to your interests. Attending the various BLS programs provides valuable time with colleagues, and participating in our social media outreach on Facebook and Twitter keeps the conversations going throughout the year. Another terrific way to enhance connections with others, and to make a difference, is by getting involved with our Standing Committees, through which the substantive work of BLS is done.

Standing Committees. Our Standing Committees include Agribusiness, Commercial Transactions (formerly UCC), Consumer Financial Services, Corporations, Cyberspace Law, the Editorial Board of *Business Law News*, Financial Institutions, Franchise Law, Health Law, Insolvency Law, Insurance Law, Nonprofit Organizations, Opinions, and Partnerships and Limited Liability Companies. Among other things, membership on our Standing Committees affords you a unique opportunity to participate in the legislative process in your practice area, to raise your profile among fellow practitioners, to work with the best and brightest in your field, and to stay on the cutting edge of developments and practice techniques. Here are some suggestions on how to connect with Standing Committees:

- Contact a committee officer
- Attend a monthly meeting
- Sign up for email updates
- Attend a committee program
- Apply for committee membership

To obtain more information on our Standing Committees and how to pursue one or more of the suggestions above, please do not hesitate to contact me at jmenton@peitzmanweg. com. You can also visit the BLS website at: http://businesslaw.calbar.ca.gov/StandingCommittees.aspx

If you have any suggestions on how we can provide more value or if there are additional areas or issues we should be looking at, please share your thoughts with me or any of our committee officers. Thank you for your continued support of BLS. ■

BLN Editorial Board: Message from the Editors-in-Chief

Robert Brayer and Marianne Man

Welcome to another year of the Business Law News. You may have noticed that the names on the masthead have changed. This is because Peter Menard, our Editor-in-Chief, has resigned from the journal. BLN thanks Peter for all of his hard work, both as Editor-in-Chief, and as a member of the editorial board. His contributions will be missed.

We (Robert Brayer and Marianne Man) have taken over as acting editors-in-chief and pledge to do our best to guide BLN to another outstanding year. We are honored and enthusiastic to take on this role at the beginning of the thirty-fifth anniversary of the Business Law Section. To honor this occasion, Edith Warkentine and Donna Parkinson have prepared an illuminating look at the section as it first began in 1977 in comparison to how it operates today.

The rest of the issue contains numerous timely and thought-provoking pieces that we are confident will benefit your practice. Here is a preview:

Michelle Sherman brings us an extremely timely article on the effect of social media on business, with specific reference to the legal issues confronting employers in the ever-accelerating digital landscape.

Also timely is Mauricio Leon De La Berra's article concerning doing business in Mexico. Mr. De La Berra provides a helpful, concise overview of Mexico's legal structure with a focus on Mexican business law and considerations to keep in mind for your clients who may be thinking of investing in Mexico or in establishing a distribution or manufacturing facility there.

Special mention should also be made of Mike Wallace and Michael Berg's article concerning the increasing market value of sustainability information, how and why voluntary sustainability reporting by organizations is recommended, and how such disclosures can benefit organizations and their standing in the marketplace.

Additionally, Curtis M. Dombek presents a look at new SEC disclosure requirements stemming from the Dodd-Frank law concerning "conflict minerals," Charles Barker provides an overview of new California employment laws and significant decisions from 2012, Aneeta Kumar and Randy G. Gerchick explore important notice requirements for coverage reductions in renewal insurance policies, and Phil Jelsma provides an overview of the Revised Uniform Limited Liability Act. Finally, Robert W. Wood describes developments in the IRS' offshore account amnesty policy and warns of the risk of ignoring the IRS' requirements.

Finally, Business Law News wishes to make both a correction and apology. In our last issue, Issue No. 4 of 2012, Monique Jewett-Brewster, co-author of the article entitled "*Stern v. Marshall:* The End of Bankruptcy Courts as we Know Them, or Just a Minor Correction to the Bankruptcy Code," was erroneously credited as Monica Jewett-Brewster. Our sincere apologies to Ms. Jewett-Brewster for the oversight.

We are both excited to be taking the reins of the Business Law News. Should you have any questions or concerns about this journal, please feel free to contact us directly. Robert Brayer can be reached by e-mail at rbrayer@lbinsolvency.com, and Marianne Man can be reached at Marianne@TheTaxCounsel.com.

Thank you and happy New Year. ■

Business Law News-Article Submission Guidelines

On behalf of the Business Law Section of the State Bar of California and the Editorial Board of the Business Law News ("BLN"), we welcome articles for possible publication. With approximately 8,200 members, the Business Law Section has a wide-ranging audience. Readership of the BLN is significant, and its impact is meaningful to business law departments throughout the state.

The following is a partial list of our submission guidelines. If you are interested in submitting, please see the full list at:
http://businesslaw.calbar.ca.gov/Publications/BusinessLawNews/BusinessLawNewsSubmissionGuidelines.aspx.

1. **Eligibility**: BLN welcomes submissions by licensed California practitioners on various topics of interest in the business law community.
2. **Deadlines**:

Issue Number	Articles Due
1	November 15th
Annual Review	January 15th
2	March 31st
3	June 30th
4	September 30th

3. **Review Process and Standards**:

Length: The article may range in length from about 2500 to 3500 words or approximately 10 double spaced pages.

Substance: While not a law review article per se, the article should not be a conversational/opinion piece, but rather a substantive discussion with legal citations and bibliographic support where necessary to support legal propositions. Each author is responsible for ensuring that the materials submitted are non-defamatory and substantively accurate.

Citations and Other Attributions: Citations should conform to *The Bluebook: A Uniform System of Citation*. Each author is responsible for ensuring that citations are complete, current, and citable, under the California Rules of Court.

Process: If BLN is interested in publishing your article, one of the issue editors will contact you, generally within 5-7 business days after receipt of your article. You will then be assigned editors who will work with you to edit your article for publication. Although your editors will work with you on specific deadlines, it is generally expected that you will turn around any revisions within two business days and that your final draft will be ready for submission as of the deadline listed above. Because we are a quarterly publication, our editorial process lasts approximately three months, not including unanticipated delays. ***Please note that your article will not be published after this process for a number of months while the issue is being prepared for publication.***

The Editorial Board retains complete discretion on whether to publish any article. Representations by an individual editor as to publication are considered only statements of that individual's opinion, and they are not binding upon the Editorial Board.

If you have any questions or comments about the process, please send an e-mail to:
Megan Lynch (megan@sublimedesignsmedia.com).

Inquiries about publication may be sent to the current Editor-in-Chiefs.

Social Media and Employers: Finding the Right Balance With Your Employees

Michelle Sherman

Michelle Sherman

Michelle Sherman has practiced litigation for over 23 years, and has advised companies on legal matters concerning their use of social media and the Internet. Ms. Sherman is an adjunct professor at USC Annenberg School for Communication and Journalism, and also serves as a faculty member for NITA teaching trial skills.

Every business—non-profit, school, private or public company—needs to consider the legal issues surrounding social media and its employees. A growing number of businesses are making employment decisions based on the social activity of their employees, and then paying the consequences of guessing wrong on what they can or cannot do. One university used information found on the Internet to question a job applicant about his religious beliefs and ended up settling a religious discrimination lawsuit for $125,000.[1] A New York non-profit organization was ordered to rehire and pay back-pay to five employees who were fired over their Facebook posts, in which they complained about criticisms of their job performance by another employee.[2]

Most recently, a state agency asked an employee for his Facebook password and set off nationwide alarm over privacy rights.[3] A number of states responded with legislation to prohibit employers from asking for social media passwords.[4] On September 27, 2012, Governor Jerry Brown of California signed bills prohibiting employers from asking current or prospective employees, and universities from asking college students or applicants, for their social media account passwords.[5]

Because social media is here to stay, businesses need to take seriously the legal issues surrounding social media. The following are some areas where businesses need to be thinking about their approach to social media and employees.

Does Your Business Have a Social Media Policy?

There are several reasons why every business should have a social media policy. A policy that is communicated effectively to employees may qualify the employer for a "safe harbor" under the Federal Trade Commission guidelines for online advertising should a rogue employee decide to post a favorable online review of the company's products without disclosing that he works for the company.[6] Having a policy is also evidence that the business is taking reasonable measures to protect its trade secrets by reminding employees not to disclose confidential proprietary information with examples by category of what the business considers its trade secrets. A policy also sets forth guidelines for how employees should or should not act with respect to business communications and provides a framework for sanctioning employees who violate the guidelines.

Here are some basics of a social media policy. Include a basic list of "Dos" and "Don'ts" in your policy. Do not try to prohibit lawful protected activity such as complaining about work conditions, compensation, benefits, or whistle blowing. Be wary of using overbroad language, such as "do not share 'confidential information' of the company," or "do not 'disparage' the company" because these types of provisions have been found to chill protected speech of employees.[7] An effective and enforceable social media policy should be specific enough that it addresses legitimate concerns of the business, such as maintaining good customer relations, protecting trade secrets, and prohibiting misleading advertising practices, without going too far.

Is Your Policy Overbroad (In Other Words, Is It From the Internet or Cut and Paste From a Sample Sent To You)?

The National Labor Relations Board ("NLRB") has issued three reports in which it has told employers in loud, clear terms that the majority of social media policies in circulation are overbroad.[8] The NLRB reports include examples of overbroad language. The common errors in these examples are employers doing one or both of the following: (1) trying to prohibit conduct that is protected, concerted activity, such as complaining about work conditions, compensation, or benefits with co-workers; or (2) using terms without defining them so they may be interpreted as possibly chilling protected activity, such as prohibiting employees from disclosing "confidential" information or "disparaging" the company.

The NLRB notes that context is important in giving meaning to these terms so businesses need to include good examples of what they mean by prohibiting certain social media activity. The NLRB has also stated that the social media policy should include language

that nothing in the policy is intended to prohibit protected National Labor Relations Act Section 7 activity.[9] Social media policies should be specially tailored to the nature and concerns of the business. The "cookie cutter" approach has only resulted in a flood of overbroad policies that will create problems for businesses when they try to enforce their policies.

Pull Your Head Out of the Sand; Many of Your Employees Use Social Media

Implement an effective training program on how your employees should use social media. In that training, emphasize areas of particular concern for your company which may include, for example, protecting the privacy interests of your company's clients, antitrust compliance, not disclosing confidential, proprietary information, and brand protection.

Do You Have a Documented Procedure for Researching Job Candidates and Employees on the Internet?

In response to some employers asking job candidates or employees for their Facebook passwords, there has been a flood of articles discussing the issue.[10] Setting aside the privacy concerns, and the fact that asking someone to share their Facebook password is a violation of Facebook's terms of use, there is a third reason employers should not ask for social media passwords. A business possibly opens itself up to employment discrimination lawsuits when it looks at social media activity. It is very common for people to share information that includes "protected" factors, that may not lawfully form the basis of employment decisions, on Facebook and other social media sites. In California, these protected factors include religion, political affiliation, sexual orientation, pregnancy, health-related information, such as cancer diagnoses, and more. Put simply, it is risky to make an adverse employment decision when you have looked at social media activity that includes protected information.

This does not mean that your business cannot research employees and job candidates on the Internet. It just means that you need to do so with a documented and well considered procedure that distances the person searching the Internet for information from the people making employment decisions. Protected factors should be identified and not included in any reports that the employment decision makers are reviewing. Further, the policy should clearly state that people conducting interviews or making employment decisions should not be researching candidates on the Internet, but should follow the procedure established by the business for gathering this information.

Alternatively, there are companies such as Social Intelligence that will gather this information for businesses. When using an outside vendor (including Internet application services), however, the business needs to comply with the Fair Credit Reporting Act.[11]

Is Your Business Ignoring the Wealth of Publicly Available Information on the Internet, and Possibly Making a Negligent or Uninformed Employment Decision?

Because employers can be held liable in some circumstances for the negligent hiring of an employee who harms or injures a co-worker or third person, employers need to take reasonable measures to screen job applicants. The harms that an employer are trying to avoid may include, for example, an employee who harasses or discriminates against co-workers, or sexually abuses children entrusted to them, or steals private credit card information from customers.

Today, the reasonable measures to screen for such employees arguably include searching both the Internet and public posts on social media to uncover information that may cause an employer to think twice about hiring someone. This does not mean that the employer should take what they find on the Internet completely at face value. However, it does mean not turning a blind eye to social media and ignoring it entirely when making employment decisions. The Internet and social media can be good resources for finding relevant information about job candidates.

Earlier this year, newspapers were covering the story of Richard Grenell, a foreign policy spokesman retained by Governor Mitt Romney in connection with his presidential campaign, who ultimately resigned after some Romney supporters complained vocally about tweets on Mr. Grenell's Twitter account. As reported in the New York Times, "a campaign known for its no-stone-unturned meticulousness overlooked [Grenell's] electronic footprints: namely dozens of cutting Twitter postings."[12] This is another example of why employers may want to remember to research the "electronic footprint" when hiring for some positions in the company.

Social media is here to stay, and whether or not your business allows access to these sites on work computers, a business should have a clear policy on social media and the Internet and how to navigate it to avoid more expensive legal problems down the line. ■

Endnotes

1 Dylan Lovan, *University of Kentucky Settles Suit With Astronomer Martin Gaskell,* Huffpost College (Jan. 18,

2011, 4:32 PM), http://www.huffingtonpost.com/2011/01/18/university-of-kentucky-se_n_810540.html.

2 Courtney Rubin, *Judge Orders Re-Hiring of Workers Fired for Facebook Complaints,* Inc.com, Sept. 7, 2011, http://www.inc.com/news/articles/201109/judge-says-workers-cannot-be-fired-for-facebook-complaints.html.

3 Meredith Curtis, *Want A Job? Password, Please!,* ACLU Blog of Rights (Feb. 18, 2011, 2:04 PM), http://www.aclu.org/blog/technology-and-liberty/want-job-password-please.

4 Martha C. White, *Lawmakers to Ban Facebook 'Shoulder Surfing' by Employers,* Time.com, Mar. 20, 2012, http://business.time.com/2012/03/20/lawmakers-try-to-ban-facebook-shoulder-surfing-by-employers/.

5 A.B. 1844 (2012) (prohibiting employers); S.B. 1349 (2012) (prohibiting colleges).

6 FTC Guides Concerning the Use of Endorsements and Testimonials in Advertising, 16 C.F.R. § 255 (2012).

7 NLRB, Office of the Gen. Counsel, Memorandum OM 12-31, Report of the Acting General Counsel Concerning Social Media Cases (2012), *available at* http://www.nlrb.gov/news/acting-general-counsel-issues-second-social-media-report.

8 *Id.;* NLRB, Office of the Gen. Counsel, Memorandum OM 11-74 (Aug. 18, 2011); NLRB, Office of the Gen. Counsel, Memorandum OM 12-59 (May 30, 2012).

9 NLRA Section 7 protects employees' right to engage in "concerted activity" that is for "mutual aid and protection." 29 U.S.C. § 157 (2012). In the context of social media, this has translated into protecting employee discussions on social media in which they may be complaining about a manager, work conditions, or their benefits and compensation.

10 *See, e.g.,* Doug Gross, *Facebook Speaks Out Against Employers Asking for Passwords,* CNN.com, Mar. 23, 2012, http://www.cnn.com/2012/03/23/tech/social-media/facebook-employers/index.html; The Associated Press, *Senators Question Employer Requests for Facebook Passwords,* NYTimes.com, Mar. 25, 2012, http://www.nytimes.com/2012/03/26/technology/senators-want-employers-facebook-password-requests-reviewed.html?_r=0.

11 Lesley Fair, *The Fair Credit Reporting Act & social media: What businesses should know,* Bureau of Consumer Protection Business Center Blog (June 23, 2011, 9:23 AM), http://business.ftc.gov/blog/2011/06/fair-credit-reporting-act-social-media-what-businesses-should-know.

12 Michael Barbaro, Helene Cooper & Ashley Parker, *Romney Camp Stirred Storm Over Gay Aide,* NYTimes.com, May 2, 2012, http://www.nytimes.com/2012/05/03/us/politics/richard-grenell-resigns-from-mitt-romneys-foreign-policy-team.html?pagewanted=all&_r=0.

Go South Without Going South: Key Legal Considerations for Doing Business in Mexico

Mauricio Leon de la Barra

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The ongoing drug war and increasing crime and violence are strong reasons to be gloomy about business in Mexico. Fortunately, Mexico offers much more opportunity than most people realize. Mexico is the United States' second largest export market,[1] and the U.S. is Mexico's largest.[2] The two countries trade more than a billion dollars in goods each day. For California, Mexico continues to be the number one export market with over $26 billion of exports in 2011.[3] As for foreign direct investment, the U.S. has contributed 50.4% of the capital invested in Mexico since 2000.[4] It is thus unquestionable that Mexico offers unique business opportunities and that U.S. persons are taking advantage of them. But successfully doing business in Mexico requires more than just business prowess and language skills. It requires substantive and practical knowledge of U.S., Mexican, and international laws and regulations, and of how such laws and regulations interrelate. This article contains an overview of Mexico's business laws, focusing on the main legal considerations that a California client and its attorneys must take into consideration when thinking of investing or establishing a distribution or manufacturing facility south of the U.S. border.

Overview of the Mexican Legal System

Hierarchy of the Law

Pursuant to Article 133 of the Mexican Constitution, the Constitution, together with the laws emanating from Congress and the international treaties in conformity thereto,[5] are the supreme law of the nation. Mexico's Supreme Court recently interpreted this Article and ruled, based on the international principle of "*pacta sunt servanda,*" that international treaties rank below the Constitution but take precedence over federal and state laws, as the obligations acquired under the treaties cannot be breached or ignored by invoking internal laws.[6]

Each Mexican state has its own constitution and its own set of local laws and regulations, although corporate, commercial, and foreign investment laws are enacted by Mexico's congress and, as federal laws, they are enforceable throughout Mexico. States do not have corporation codes or commercial codes as we have in the United States. This uniform business law system greatly simplifies business transactions.

Case Law or "Jurisprudence"

The Constitution also provides that laws in Mexico shall set forth the terms pursuant to which legal interpretations issued by the federal courts are to be mandatory.[7] Accordingly, the *Amparo* Law, through which such provision is implemented, provides in Article 192 that five Supreme Court resolutions that are similar, uninterrupted by contrary opinion and meet the voting requirements, and resolutions by the Supreme Court that resolve conflicting opinions by certain federal courts,[8] constitute mandatory "jurisprudence" or case law, binding on all lower federal and state courts. Similarly, five similar, uninterrupted, and unanimously approved decisions by federal circuit courts also constitute jurisprudence binding on all lower federal and state courts.[9] Decisions not constituting jurisprudence are not mandatory but do have persuasive influence in both state and federal courts.

One of the most noticeable differences between U.S. case law and Mexican jurisprudence is the way in which opinions are written. In the U.S., judicial opinions serve three functions: (1) to communicate a court's conclusions and the reasons for them to the parties and their lawyers; (2) when published, to announce the law and provide guidance to other lawyers, judges, academics, and the interested public; and (3) to require the judge to clarify his or her reasoning and assess the sufficiency of precedential support.[10] U.S. judicial opinions are similar to Mexican judgments. Mexican jurisprudence, however, consists of an abstract of a single criterion used to interpret a legal provision. Accordingly, the body of an opinion issued by the Mexican Supreme Court could consist of a single sentence, as the following opinion illustrates:

BILLS OF EXCHANGE ARE ENFORCEABLE EVEN WHEN ISSUED IN A FOREIGN CURRENCY. The payment obligation contained in a bill of exchange is liquid, even when the agreed amount is in foreign currency, as a simple arithmetic calculation allows the determination of the equivalent amount in national currency, even when there are currency fluctuations.[11]

Mexico's General Business Laws

The primary business laws of Mexico include the General Corporations Code, the Foreign Investment Law, the Commercial Code, and the General Law of Negotiable Instruments and Credit Transactions. These laws are generally applicable to all businesses regardless of the type of entity or the industry in which they operate, unlike industry-specific laws, such as Mexico's Financial Institutions Law, Stock Exchange Law, Credit Unions Law, Mining Law, and Insurance and Bond Law, among others.

Under the Mexican Commercial Code, foreign entities doing business in Mexico directly or through agencies or local branches are considered merchants[12] and are required to register in the Public Registry of Commerce.[13] Such registration requires each foreign entity to file its certificate of formation or similar documents, as well as a certificate of good standing from its home jurisdiction. Due to the legal, language, and cultural differences that exist between the U.S. and Mexican systems, and the burdens that may result therefrom, it is often best for a foreign entity intending to do business or establish a presence in Mexico to form a Mexican subsidiary.

Mexico's Corporate Law

The formation, operation, and liquidation of business entities, as well as the rights and obligations of their members and managers, are governed by the General Business Entities Act, or *Ley General de Sociedades Mercantiles* ("Mexico's Corporations Code"). Under Mexico's Corporations Code, there are six types of entities,[14] with corporations and limited liability companies being, by far, the predominant type. Other recently created—and more specialized—legal entities include: (1) the *Sociedad Anónima Promotora de Inversión* or "*SAPI,*" which is similar to a Mexican corporation but with more flexible corporate and economic rights; (2) the *Sociedad Anónima Búrsatil* or "*SAB,*" which is an entity that issues shares listed on the Mexican Stock Exchange; and (3) the *Sociedad Anónima Promotora de Inversion Búrsatil* or "*SAPIB,*" which is a *SAPI* capable of issuing shares to be listed on the Mexican Stock Exchange.[15]

Mexican Corporations

Mexican corporations, called *sociedades anonimas* or *S.A.s*, are a very close equivalent to California corporations. Like a California corporation, a Mexican corporation is a distinct legal entity, existing apart and recognized separately from its shareholders, which has all the powers of a natural person, including the rights to own property, sue in its corporate name, make contracts, and engage in any lawful business activity. Its basic characteristics include: (1) personal liability of its shareholders limited to the amount of their investment in the corporation; (2) greater availability of capital than generally exists for non-corporate business forms; (3) perpetual life; and (4) taxation as a separate entity.

There are, however, notorious differences between California and Mexican corporations. The main characteristics of Mexican corporations that are different from California corporations can be categorized as follows:

- *Jurisdiction*. As indicated above, Mexico's Corporations Code is federal. Accordingly, the state of incorporation has no effect on a Mexican corporation or its shareholders. Mexican corporations and their shareholders also receive similar income tax treatment throughout Mexico regardless of the state of incorporation.
- *Number of Shareholders*. Mexico requires corporations to have a minimum of two shareholders.[16]
- *Management and Control*. Generally, a California corporation is controlled by its board of directors, and its day-to-day management is conducted by officers appointed by the board.[17] Shareholder participation in management decision-making is generally limited to approving or disapproving major transactions affecting the life of the corporation, with the exception of close corporations, which allow their shareholders to participate in day-to-day management activities without losing the protection of the corporate form. Mexican corporations are similar to California corporations in that management is vested in one or more directors, who may, but are not required to, be shareholders, and that shareholders participate in major decisions affecting the life of a corporation, such as the appointment and removal of directors or the approval of a merger or reorganization, conversion into a different type of business entity, or dissolution. However, it is also generally within the authority of the shareholders of a Mexican corporation to determine corporate policy and authorize such corporate actions as raising capital, reducing capital, issuing

privileged shares, repurchasing shares, paying dividends or amending the bylaws, which actions in a California corporation tend to be within the purview of the board.

- *Tax Treatment*. Mexican corporations are subject to double taxation—once at the corporate level and again when the after-tax profit is distributed to the shareholders as dividend income, just like a California "C" corporation. Generally, California "S" corporations are taxed only once, however (at the shareholder level). There is, however, no Mexican equivalent to an "S" corporation, which is a corporation that has elected to be taxed under Subchapter S of the Internal Revenue Code and is generally treated as a conduit of income, loss, deductions, and credits to the shareholders.
- *Registered Agent for Service of Process*. California corporations must designate an agent of the corporation for the purpose of service of process. Mexico's General Corporations Code imposes no such requirement.
- *Franchise Taxes*. Corporations incorporated in California must pay an annual franchise tax for the privilege of doing business in California. Mexico does not impose a franchise tax.

Mexican Limited Liability Companies

Mexican limited liability companies, called *sociedades de responsabilidad limitada* or *S de R.L.s*, from a corporate standpoint, are quite similar to California limited liability companies. While they do not offer as much flexibility as California LLCs, Mexican LLCs can be used for the formation and operation of small, closely-held or operated business arrangements as well as larger, more complex business ventures. Mexican LLCs are favored by non-Mexicans because they allow members to adopt corporate resolutions by written ballot,[18] and, because under U.S. tax rules, U.S. members can make a check-the-box election to have the Mexican LLC treated as a foreign partnership for U.S. tax purposes. This may allow U.S. members of a Mexican LLC to take advantage of the capital gains rate and obtain a U.S. tax credit for Mexican taxes paid by the Mexican LLC.

The key attributes of the Mexican LLC are: (1) limited liability for its members;[19] (2) restricted transferability of membership interests,[20] requiring the approval by the majority of interest unless a greater vote is required by the bylaws[21] and granting existing members a right of first refusal in case of non-testamentary transfers to non-members;[22] (3) membership limited to not less than two and not more than 50 members;[23] (4) prohibition to raise capital via public offerings;[24] and (5) management vested in one or more managers, who may or may not be members,[25] with the members at a meeting being the supreme governing authority[26] and having the authority to issue dividends, appoint managers, approve the division and repurchase of membership interests, request additional capital contributions, amend the LLC's operating agreement, approve the transfer of membership interests and admission of new members, increase or reduce the capital, dissolve the LLC, and resolve any other matter over which the meeting may have authority pursuant to the LLC's operating agreement.[27]

Mexican LLCs are always taxed at the entity level, just like a Mexican corporation. No fees or annual taxes are imposed on Mexican LLCs, unlike California LLCs classified as disregarded entities or as partnerships, which are subject to an annual tax and an annual LLC fee based on their total income from all sources derived from or attributable to this state.[28]

The Organization Process

To form a Mexican corporation or a Mexican LLC, the following steps must be followed:

- *Choose a Name*. A permit for the use of the entity's name must be requested and obtained from the Mexican Ministry of Economy.
- *Decide where to incorporate*. As mentioned above, corporate and tax laws are federal. Thus, the decision of where to incorporate should, ideally but not necessarily, be based on the location in which the main office or center of business will be located. In addition, it is important to note that an entity does not need to register as a foreign corporation in each state in which it operates or transacts business.
- *Determine an appropriate entity purpose*. Purpose clauses are much more detailed and extensive than the ones generally used when incorporating a California entity. Broad purpose clauses stating, for example, that "the purpose of the entity is to engage in any lawful act or activity for which such entity may be organized under the Mexico's Corporation Law" are not illegal, but generally both public and private parties require the purpose clause to contain an itemized list of the specific activities that the entity may engage in.[29] In addition, it is important to verify that the corporate purpose does not fall within an activity that is reserved to the Mexican government or otherwise reserved or restricted by the Foreign Investment Law. Oil, nuclear energy, telegraph, mint, and

mail activities are reserved to the Mexican government. Sale of gasoline, radio and television (excluding cable TV), and credit union activities are reserved for Mexican nationals. Examples of activities in which foreign ownership is limited to 10%, 20%, 49%, or over 49% with governmental approval include domestic air transportation, insurance, retirement funds, explosives and firearms, press, agriculture, fishing, shipping, telecommunications, ports, schools, and law firms.[30]

- *Determine the capital structure*. Determine the ideal capital structure that should be in place upon the entity's incorporation.
- *Determine the management structure*. Determine how the entity will be managed and by whom, and specify the powers and authority of the board of directors and, when applicable, the officers.
- *Determine meeting and voting requirements*. Determine corporate meeting requirements and voting rights, and specify which resolutions, if any, may be adopted by written consent in lieu of a meeting.
- *Draft the articles and the bylaws*. The articles of incorporation,[31] known as "*contrato social*" or "*escritura constitutive,*" and the bylaws, or "*estatutos sociales,*" are generally drafted and filed as a single document.
- *Grant powers of attorney*. The powers of attorney granted in the U.S. to an individual executing the formation documents on behalf of the incorporators or initial members must be granted in accordance with the Protocol on Uniformity of Powers of Attorney which are to be Utilized Abroad, an international treaty adopted by various countries comprising the Pan American Union, including Mexico and the United States, to permit the use of powers of attorney in foreign jurisdictions.[32] Powers of attorney granted pursuant to the Protocol must conform to certain rules:
  - *Individuals*. If the power of attorney is executed by an individual, the attesting official (e.g., a notary, registrar, clerk of court, judge) must certify, based on his own knowledge, the identity of the appearing party and such party's legal capacity to execute the instrument.
  - *Entities*. If the power of attorney is executed on behalf of an entity, the attesting official must, in addition to certifying the signer's identity and legal capacity, also certify that the entity's representative has the requisite signing authority, that the entity is duly organized and in good standing, and that the purpose for which the power of attorney is granted is within the scope of the objects or activities of the entity. Such certifications must be based on the documents presented to the official, such as the instrument of organization, bylaws, resolutions of the board of directors or other governing body, and such other legal documents as shall substantiate the authority conferred.[33]

    However, neither U.S. federal nor state law has conferred upon public notaries the authority to make such certifications. In California, for example, a notary may only attest that the person(s) "who appeared proved on the basis of satisfactory evidence to be the person(s) whose name is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity, and that by his/her/their signature on the instrument the person, or the entity upon behalf of which the person(s) acted, executed the instrument."[34] Notarial acts that go beyond the authority granted to notaries within their states may not be *apostilled*.[35] Strategies to navigate this conflict of laws are beyond the scope of this article.
- *Have the power of attorney notarized, apostilled, and translated*. For a California notary's acknowledgment to be valid in Mexico, it must be *apostilled* by the California Secretary of State. An *apostille* is an international certification that authenticates the origins of a public document executed in the territory of a Hague Convention contracting state and which has to be produced in the territory of another Hague Convention contracting state.[36] An *apostille* does not certify the authenticity of the underlying document for which it was issued. When properly completed, an *apostille* certifies the authenticity of the signature, the capacity in which the person signing the document has acted and, where appropriate, the identity of the seal or stamp that the document bears.[37]
- *Translate the power of attorney*. The next step is to have the power of attorney, the notarial acknowledgment, and *apostille* translated into Spanish by a Mexican court-approved translator. It is generally more efficient to draft the power of attorney and the notarial acknowledgment in a document having two columns, with English in one column and Spanish in the other column, so that the only document that needs to be translated is the *apostille*.
- *Obtain preliminary approval*. Send the organization

documents and the powers of attorney to a Mexican notary public who will formalize the formation of the Mexican corporation or limited liability company.

- *Appear before a notary public to formalize the organization documents in a public deed*. Upon receipt and approval of all documents by a Mexican notary public, the incorporators' representative shall appear before a notary public in Mexico to formalize the organization documents in a public deed. This will conclude the formation process.
- *Post-formation steps*. Following execution of the public deed: (1) such deed must be recorded in the Public Registry of Commerce in the jurisdiction in which the notary public is located; (2) the newly formed entity must be registered in the Foreign Investment Registry; and (3) an employer identification number (known as the *Registro Federal de Contribuyentes* or *RFC*) must be obtained from the Ministry of Finance and Public Credit.
- *Obtain required permits and licenses, if applicable*. If the purpose of the Mexican entity is to manufacture or assemble products to be re-exported back to the U.S., a permit under the Decree for the Promotion of the Manufacturing, Maquila and Export Services Industry ("IMMEX"), also known as the Maquila Program, may be obtained. The Maquila Program allows the import of equipment and the goods and services that will be manufactured, transformed or repaired, and exported as the finalized product back to the U.S. without payment of import or export taxes or compensatory quotas. If the purpose of the new Mexican entity is to import and distribute products in Mexico, the entity may need to be registered with Mexico's National Importers Registry.[38] Depending on the entity's purpose, other permits and registrations may also be required.

Conclusion

The relationship and level of trade and investment between Mexico and the U.S. is likely to continue, with Mexico presenting numerous opportunities for U.S. parties wanting to invest or establish a distribution or manufacturing facility south of the U.S. border. To take advantage of those opportunities while minimizing the risks of doing business in an unfamiliar jurisdiction, U.S. parties need to understand the basics of Mexico's business and corporate laws and consult with competent counsel, preferably licensed and well-versed in both Mexican and California law. Other relevant factors to consider, which exceed the scope of this article, are the environmental, customs, tax, immigration, and labor regulations generally applicable to Mexican and cross-border business transactions. ■

Endnotes

1 Cal. Chamber of Commerce, *Trading Partner Portal: Mexico*, CalChamber.com, http://www.calchamber.com/international/portals/mexico/pages/default.aspx (last visited Dec. 31, 2012).

2 *Id*.

3 *Id*.

4 Ministry of the Economy Mexico, Mexico Continues Attracting Foreign Investment (2012), *available at* http://www.economia-snci.gob.mx/sic_php/pages/bruselas/trade_links/ing/maring2012.pdf.

5 All treaties are presumed to be in conformity with the Mexican Constitution. "*Tratados internacionales. Deben presumirse apegados al texto constitucional hasta en tanto se demuestre su inconstitucionalidad en la vía procedente,*" 9a. Época; 2a. Sala; S.J.F. y su Gaceta; XXVI, Julio de 2007; Página 384.

6 *"Tratados internacionales. Son parte integrante de la ley suprema de la unión y se ubican jerárquicamente por encima de las leyes generales, federales y locales. interpretación del artículo 133 constitucional,"* 9a. Época; Pleno; S.J.F. y su Gaceta; XXV, Abril de 2007; Página 6.

7 Constitución Política de los Estados Unidos Mexicanos [C.P.] (Mex. Const.) art. 94.

8 These resolutions are known as "*contradicciones de tésis*" or "*jurisprudencia por contradicción de tésis.*"

9 Mex. Amparo Act art. 193.

10 Federal Judicial Center, Judicial Writing Manual (1991).

11 "*Letras de cambio. Traen aparejada ejecucion aunque esten expedidas en moneda extranjera,*" 6a. Época; 3a. Sala; S.J.F.; Cuarta Parte, LIV; Página 62.

12 Codíngo de Comercio (Mex. Com. Code), art. 3.

13 *Id.* at art. 24.

14 Mex. Corp. Code, art. 1.

15 Mexican entities, with the exception of banks and other regulated businesses, are generally formed as entities of variable capital. This enables the members or shareholders to increase or reduce the entity's capital by meeting ordinary quorum and voting requirements (unless otherwise set forth in the entity's bylaws). Variable capital entities should include the words "de

capital variable" or "de C.V." in their name, after the type of entity. The name of a variable capital corporation entity would read, for example, "Name, S.A. de C.V."

16 Mex. Corp. Code, art. 89.

17 Cal. Corp. Code § 300(a).

18 Mex. Corp. Code, art. 82.

19 *Id.* at art. 58.

20 *Id.* at art. 65.

21 *Id.*

22 *Id.* at arts. 66–67.

23 *Id.* at art. 61.

24 *Id.* at art. 63.

25 *Id.* at art. 74.

26 *Id.* at art. 77.

27 *Id.* at art. 78.

28 Cal. Rev. & Tax. Code § 17942.

29 For example, a toy manufacturing and distribution company would have a purpose clause similar to the following:

> The purpose of the company is to: (a) acquire, hold, buy, sell, import, export, market, distribute and otherwise dispose of any type of toys; (b) acquire, hold, buy, sell, import, export, market, distribute and otherwise dispose of any type of plastics, fabrics, woods, papers and raw material, whether natural or synthetic, as required for the manufacturing of toys; (c) design and produce any toys; (d) execute any civil and commercial acts relating to the production, marketing, distribution, importation, exportation and design of any type of toys; (e) execute any acts of commercial nature, including buying, selling, acquiring, distributing, importing, exporting, producing, manufacturing, transforming, assembling, marketing and otherwise negotiating with any type of items, merchandise, personal property and real property, whether for itself or on behalf of third parties, in Mexico or abroad; (f) install, acquire, enjoy, constitute, operate, lease, use, hold under usufruct, hold or under any other title commercially exploit establishments, offices, warehouses, storage areas, shops, and hold the personal property and real estate, real rights and goods necessary or appropriate in furtherance of the achievement of the company's purposes; (g) acquire or participate, directly or indirectly, in the capital or equity of other companies and associations, whether civil or commercial, as a founding member or subsequently acquiring shares or interests in already organized entities, and dispose of or assign such shares or interests; (h) apply for, acquire, hold and transfer authorizations, licenses, permits and concessions for the exploitation of activities relating or inherent to the purposes of the company; (i) acquire and dispose of under legitimate means patents, patent rights, inventions, trademarks, copyrights and trade names as necessary or appropriate for the achievement of the purposes of the Company; (j) open and handle any type of bank accounts and investments, whether in national or foreign financial institutions, grant or receive loans with or without collateral; issue bonds, securities and other credit instruments, and legally acquire and negotiate with bonds, obligations, shares, securities and other credit instruments issued by third parties; (k) act as guarantor and undertake joint and several obligations, and grant security on behalf of third parties; and (l) carry out any other commercial acts and execute, within or without Mexico, for itself or on behalf of third parties, any type of acts, contracts and agreements, whether civil or commercial, principal or accessory, or of any other nature permitted by the law, always subject to the applicable laws.

30 This list is non-inclusive. *See* Mex. For. Inv. Law, arts. 3-10, for the full list.

31 While notaries may provide the corresponding template, foreign entities should consult with, and have the articles and the bylaws drafted by, qualified counsel.

32 Protocol on Uniformity of Powers of Attorney Which Are to be Utilized Abroad, drafted at the Pan American Union, Washington, February 17, 1940, entered into force for the United States on April 16, 1942.

33 *Id.* at art. I.

34 Cal. Civ. Code § 1189.

35 Bureau of Consular Affairs, U.S. Dep't of State, Travel.State.Gov., Pan American Protocol on Powers of Attorney, *available at* http://travel.state.gov/law/judicial/judicial_4319.html.

36 The Hague Convention Abolishing the Requirement for Legalisation for Foreign Public Documents, Oct. 5, 1961, 33 U.S.T. 883, 527 U.N.T.S. 189 (the "Hague Convention.")

37 *Id.* at art. 5.

38 Importers of chemicals, nuclear or radioactive materials, firearms, alcoholic beverages, tobacco, and power drinks may also need to register in Special Sector Registries.

Guide to Business Law Section Publications

Cyberspace Law and Policy: A Primer for State Policymakers (2010)

The purpose of this publication is to provide an overview for members of the California Legislature and other policymakers of legal issues in the rapidly developing world of the Internet, as well as a short summary of significant legislation that has been enacted or proposed to address those issues. The Cyberspace Law Committee of the Business Law Section presented the Primer to California state legislators and staff in Spring 2010.
http://businesslaw.calbar.ca.gov/Publications/CyberspaceLawandPolicy.aspx

The Agricultural Law Sourcebook CD (2010)

The Agricultural Law Sourcebook CD, produced by the Agribusiness Committee of the Business Law Section, contains a wide variety of forms in Microsoft Word format (68 in all), including real estate purchase agreements, leases, easements, intellectual property agreements, loan documents, farm labor contracts, crop purchase agreements and crop loss settlements.
http://businesslaw.calbar.ca.gov/Publications/AgriculturalLawSourcebookCD.aspx

Sample California Third-Party Legal Opinion for Business Transactions (2010)

The Sample California Third-Party Legal Opinion for Business Transactions ("Sample Opinion") was prepared by the Opinions Committee of the Business Law Section to illustrate what an opinion following the precepts of the opinion reports of the Business Law Section might look like. The Sample Opinion is intended as a sample, and should not be construed as a prescriptive model; there is no single form of legal opinion that can be viewed as the "sole" or "best" or "preferred" form. The Sample Opinion is based on a transaction involving an unsecured loan to a California corporation, guaranteed by a California limited liability company, using documentation governed by California law. With the addition of appropriate assumptions and qualifications (and the deletion of others), the Sample Opinion can be used as a basis to prepare opinions in other contexts.
http://businesslaw.calbar.ca.gov/Publications/OpinionResources/ThirdPartyOpinionforBusinessTransactions.aspx

Selected Legal Opinion Issues in Venture Capital Financing Transactions (2009)

The Report of the Opinions Committee of the Business Law Section of the State Bar of California on Selected Legal Opinion Issues in Venture Capital Financing Transactions ("Report") is a commentary on customary practice with respect to third-party legal opinions given in venture capital financing transactions (defined for this purpose as equity investments in privately held companies by professional investors). The Report supplements the Corporations Committee's Report on Legal Opinions in Business Transactions and the Opinions Committee's Remedies Report by addressing particular opinion letter issues that often arise in venture capital financing transactions. A primary objective of the Report is to give opinion practitioners guidance regarding whether specific opinions are appropriate in such transactions.
http://businesslaw.calbar.ca.gov/Publications/OpinionResources/VentureCapitalFinancingTransactions.aspx

Report on Third-Party Remedies Opinions (2007 Revision)

This ground-breaking report summarizes the Business Law Section's recent re-examination of the third-party remedies opinion in business transactions. The remedies opinion is an opinion that one or more transaction documents are enforceable. The opinion can serve as an important part of the opinion recipient's "diligence," but can also add significant time, financial cost and other burdens to the closing of a transaction.
http://businesslaw.calbar.ca.gov/Publications/OpinionResources/ThirdPartyRemedies.aspx

Corporations Committee 2005 Opinions Report: Legal Opinions in Business Transactions (October 2007 Revision)

The Corporations Committee of the Business Law Section has published its report, Legal Opinions in Business Transactions (Excluding the Remedies Opinion). Over two years in the making, the report updates and expands the Committee's 1989 Report on Legal Opinions in Business Transactions. Topics addressed include the definition and purpose of a legal opinion in a business transaction, the legal standards applicable to the preparation of the opinion, the preparation of an opinion letter, certain common opinions and special issues under California law and practice; and related topics.
http://businesslaw.calbar.ca.gov/Publications/OpinionResources/BusinessTransactions.aspx

Guide to Business Law Section Publications

Handbook for Incorporating a Business in California (2006)

The Handbook for Incorporating a Business in California is intended to give practitioners the basic tools to form a California corporation and to handle the customary legal necessities of a recently incorporated California corporation. It is aimed at the practitioner who does not practice corporate law full time, corporate attorneys who desire an additional reference, and newly admitted attorneys.
http://businesslaw.calbar.ca.gov/Publications/IncorporatingaBusiness.aspx

Guide to California Securities Law Practice (2006)

The 300+ page "Guide to California Securities Law Practice" was prepared by the Corporations Committee of the Business Law Section of the State Bar of California, and is designed in easy-to-read question-and-answer format. The work is full of up-to-date information on the typical issues confronting a busy transactional lawyer, including the scope of the most frequently used California securities exemptions (like Section 25102(f)) and a "how to" for preparation of applications filed with the Department of Corporations and the conduct of "fairness hearings" before the Department.
http://businesslaw.calbar.ca.gov/Publications/SecuritiesLaw.aspx

UCC Opinions Report: Legal Opinions in Personal Property Secured Transactions (June 2005)

The Uniform Commercial Code (now Commercial Transactions) Committee of the Business Law Section has published its report, Legal Opinions in Personal Property Secured Transactions. The report updates, expands and replaces the Report Regarding Legal Opinions in Personal Property Secured Transactions originally published by the Committee in 1989. The Committee believed it important to replace the 1989 Report in light of the adoption of revised Article 9 of the Uniform Commercial Code by the State of California and changes in customary opinion practice in the intervening years.
http://businesslaw.calbar.ca.gov/Publications/OpinionResources/PersonalPropertySecuredTransactions.aspx

Guide to Organizing and Operating a Limited Liability Company in California (2001)

Guide to Organizing and Operating a Limited Liability Company in California, 2001 Edition, Report of the Partnerships and Limited Liability Companies Committee of the Business Law Section of the State Bar of California. 361 pages. $25 for Section members, $65 for others. Forms diskette $25 additional for Section members, $65 additional for others.
http://businesslaw.calbar.ca.gov/Publications/LimitedLiabilityCompanies.aspx

Report on Legal Opinions Concerning California Limited Liability Companies (February 2000)

The Partnerships and Limited Liability Companies Committe published the Report on Legal Opinions Concerning California Limited Liability Companies in February 2000 to address the special opinion issues presented by such entities.
http://businesslaw.calbar.ca.gov/Publications/OpinionResources/CaliforniaLLCs.aspx

Report on Legal Opinions Concerning California Partnerships (February 1998)

The Partnerships and Limited Liability Companies Committee published the Report on Legal Opinions Concerning California Partnerships in February 1998 to address the special opinion issues presented by such entities.
http://businesslaw.calbar.ca.gov/Publications/OpinionResources/CaliforniaPartnerships.aspx

Voluntary Disclosures: How Markets Increasingly Value Sustainability Information

Mike Wallace and Michael Berg

Mike Wallace
Mike Wallace is the Director of the Global Reporting Initiative's (GRI) Focal Point USA, a non-profit organization that promotes non-financial reporting and produces a comprehensive sustainability reporting framework. GRI are the most widely used sustainability reporting guidelines in the world, with over 80% of the Global 250 using GRI when they report on sustainability performance.

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Beyond Green, Beyond the Public Equity Markets

The word "sustainability" (often associated with being "green") has become ubiquitous in the last few years, with nearly every provider of goods and services claiming to have some sort of skin in the sustainability game. Rigorous scrutiny of these claims is becoming an increasingly important part of the sustainability disclosure field, which now goes far beyond claims of "green" practices, such as reducing carbon emissions, to include an encompassing set of critical environmental, social, and governance topics across an organization's value chain. The flood of sustainability claims and information, coupled with modern due diligence techniques and tools, quickly overlaps into traditional legal, compliance, and risk management practices.

Of the "Global 250" (the world's 250 largest companies), more than 95% voluntarily report "something" about their sustainability performance via their website, annual reports and other reports on material environmental, social, economic and governance topics, of which 80% use the Global Reporting Initiative Guidelines ("GRI" and the "GRI Guidelines") as the basis for their sustainability performance disclosure.[1] While most of this "sustainability" reporting activity is voluntary, the supply of such information is rapidly increasing along with the demand among customers, employees, and financial stakeholders, which results in an increasing expectation across all parts of the market.

The sustainability audience is expanding exponentially because of a ripple effect that is occurring through nearly every corner of the global and local economy:

- Deans of academic institutions are offering specialized sustainability degrees, as well as promoting their own institutions' sustainability performance.[2]
- Mayors across the world are enrolling in sustainable city initiatives, measuring, managing, and reporting on a range of metrics often considered "sustainability performance measures."[3]
- Cities, counties, and local chambers are partnering on sustainability initiatives that highlight, promote, and support the sustainable practices of local businesses.[4]
- Public agencies at the federal and state level are not only measuring, managing, and reporting on their own performance, they are also requesting that their suppliers do the same.[5]
- Public companies are increasingly being asked to disclose sustainability information by shareholders, and it is no longer just the activist shareholders, but also well-known mainstream financial institutions that are making the request.[6]
- Employees—current and future—are increasingly asking, the local mayor's "green business program" is asking, local and national magazines and business journals are ranking and rating, and mainstream financial institutions are requesting sustainability related information.[7]
- Private equity is also involved as investors assess the sustainability performance of their own portfolios and prepare for the added demand for transparency when they eventually make their holdings public.[8]
- The perfect storm is upon us, and it is crucial that U.S. companies realize that even though they are not "required" to disclose their sustainability performance, the action of not disclosing sends its own loud message to an ever growing audience of influential parties.

Modern Due Diligence

First, it is important to recognize some market dynamics that are repeating themselves. Anyone who has been through a merger and acquisition ("M&A") transaction is familiar with the traditional concept of due diligence. Just as well, anyone that has been involved in an M&A transaction in the past twenty years is also familiar with the concept of environmental due diligence, the advent of the Phase I Environmental Site Assessment ("ESA") and the ASTM standard that defines what should be in a Phase I ESA.[9] This concept, the Phase I ESA, did not come about overnight. In fact, it evolved through the input and insights of a range of stakeholders who evolved the standard over time – similar to the GRI Guidelines. One of the primary driving forces in the early stages of the Phase I ESA was the financial services industry, primarily the banks who had felt the financial ramifications of holding title to a collection of environmental liabilities. Fast forward to today, and you have the same cycle repeating itself in the area of sustainability due diligence.

Modern due diligence on sustainability performance is being driven by the increasing collection of investor driven initiatives that are seeking a common end – greater access to sustainability related information. Initiatives like the Global Reporting Initiative ("GRI"),[10] United Nations Principles for Responsible Investment ("UNPRI"),[11] the United Nations Global Compact ("UNGC"),[12] Carbon Disclosure Project ("CDP"),[13] Ceres' Investor Network on Climate Risk ("INCR")[14] and the Interfaith Center on Corporate Responsibility ("ICCR")[15] have shaped the sustainability reporting field much like the banks shaped the Phase I ESA market twenty years ago. Literally thousands of investors representing trillions of dollars of assets are coalescing around a common interest – more transparency and credible sustainability performance data. A quick look at any of the groups mentioned above will show that this is no longer a modest collection of small activist investors. Today, hundreds of the world's largest, most influential and well-known pension funds and banking, venture capital, and private equity firms are now involved. Not only that, their largest customers: sovereign wealth funds, public pension plans, and institutional investors are now asking their fund managers to conduct specialized sustainability portfolio research.[16]

This demand is increasing the desire for more comprehensive analysis of existing data, which in turn has created a rapidly growing market of sustainability research providers. The interest in sustainability, coupled with the growing number of research providers and their respective methodologies, has in turn resulted in a growing number of public rankings and ratings of the least and most sustainable companies. Even well-known rankings like Fortune's World's Most Admired Companies have a selection methodology with a deep sustainability component,[17] and even financial institutions and S&P are creating indices made up of what they have identified as the most "sustainable" companies.

Not only that, stock exchanges like NASDAQ are creating indices built around a collection of what they have identified as the most sustainable companies.[18] In addition, stock exchanges like NYSE Euronext are reporting on their own sustainability performance.[19] In a growing number of instances, these stock exchange reports include the initiatives they have undertaken to embed sustainability into their respective markets.[20] For instance, the Johannesburg Stock Exchange now requires all listed South African companies to combine their annual report with their sustainability report, resulting in an "integrated report."[21] The Brazilian stock exchange, BM&FBOVESPA, recommended that listed companies produce a sustainability reporting according to GRI and also offers GRI training to listed companies.[22] The Singapore Stock Exchange ("SGX") also encourages listed companies to produce a GRI report and suggests that the report be third-party verified.[23]

These are just some of the examples of the activity in the financial services industry. Every major well-known financial institution in the U.S. is applying sustainability to their business practices in some way, shape, or form. Most of the biggest financial institutions are GRI reporters themselves. As such, they are increasingly understanding, measuring, managing, and reporting on their own sustainability performance. In addition, as investors, insurers, and lenders, they are doing their own due diligence on the sustainability risks and liabilities in their portfolios.

This interest from the financial markets gets rolled down into the supply chains of large publicly-traded companies. In financial stakeholders' due diligence processes, they are assessing not only a company's operations but also its supply chain. As a result, large corporate purchasers across nearly every sector now ask their suppliers to provide sustainability information. Notable examples include Walmart, who is expanding their sustainability questionnaires for suppliers from 15 to 100 questions, and Microsoft who is specifically requesting that its Tier 1 suppliers produce GRI reports.[24]

The modern due diligence phenomenon is part of the engine that drives demand for sustainability information from nearly all organizations: public and private, and large and small.

The Role of Voluntary Standards and Reporting Frameworks

In the absence of widespread federal mandates, a series of voluntary standards and reporting frameworks exist, which support this new modern due diligence process focused on sustainability. These include the GRI, UNPRI, UNGC, and CDP. In this article, we provide an overview of the GRI's history and function in the marketplace as an aggregator that encompasses and integrates other leading standards and reporting frameworks.[25]

Global Reporting Initiative

The GRI is a fifteen year-old, international not-for-profit that is charged with the development, enhancement, and dissemination of the world's most widely used sustainability reporting framework. Of the 95% of Global 250 that voluntarily report "something" about their sustainability performance, more than 80% do so according to the GRI Sustainability Reporting Guidelines.[26] GRI is now being mandated by some governments, being integrated into the listing rules of stock exchanges, and woven into the procurement policies of multi-national corporations.

If any organization is exploring whether and what to report about its own sustainability activities, it should—at a minimum—understand, measure, manage, and then disclose its own sustainability performance in a manner that is clear, concise, and credible. That is what GRI reporting strives to provide.[27]

The creation of GRI involves key people, institutions, and an ongoing philosophy that has led to GRI's global recognition and uptake. In essence, a diverse group of business, environmental, and sustainability professionals came together in Boston through the organization Ceres[28] to discuss how and why leading companies could effectively and voluntarily report on social, environmental, and economic issues. This was back in the late 1990s, post-Exxon Valdez, and during a time when there was growing interest in the topic of corporate responsibility.[29]

Initial discussions led to the realization that there was already a substantial amount of environmental disclosure occurring through an array of channels – both regulatory, via U.S. and E.U. requirements, and voluntary, through the emerging practice of self-reporting on environmental performance and community engagement efforts. For example, there were a number of well-known U.S. companies that were voluntarily producing more comprehensive reports about their respective actions around environmental stewardship, and/or corporate responsibility. The group decided that reporting guidance, such as generally accepted accounting principles (GAAP), was needed for this emerging area of non-financial reporting, and the GRI was formed.[30]

To add perspective, expertise, and credibility to the effort, the initial founders gathered additional supporters from other non-profits, corporations, and environmental experts and began to lay out the first set of reporting guidelines, as well as the foundations of GRI, its governance structure, and the due process by which the GRI Guidelines would evolve.[31] Almost 15 years later, and with the involvement and input of an estimated 30,000 stakeholders representing businesses, governments, associations, and advocacy groups from all over the world, GRI is in the midst of evolving the GRI Guidelines to their next phase, the G4.[32] The initial G1 version was primarily focused on environmental sustainability, but over the evolution of the GRI Guidelines, social and governance issues have become more prevalent and experts from human rights groups, labor organizations, and aboriginal and minority groups have increasingly become engaged in the definition of what should be in a sustainability report.

It is through this multi-stakeholder process of development, which is overseen by the GRI and its governing bodies, that the GRI Guidelines have become a globally recognized method for reporting on sustainability and sustainability performance. An institution's initial report provides the baseline or benchmark for its own conditions. Comparing this information to one's peers provides a sense of standing or performance within the peer group. Also, comparing this information over time provides another perspective on performance – against one's own performance, and/or against one's peers. Through repeated reporting using the GRI Guidelines, an interested market participant has the ability to compare and contrast the sustainability performance of reporting organizations across the world.

A Passing Fad or Here to Stay?

While terminologies may change, "sustainability" reporting and non-financial reporting is likely here to stay due to the deepening entrenchment of the notion of sustainability in business and society and the increased rigor and scope of sustainability assessments. For example, sustainability is increasingly referred to as "environmental, social and governance" or "ESG" within the financial community. The terminology of "ESG" reflects the view that sustainability is a governance issue for organizations, a proxy for the quality and their management teams, and a process to assess whether they are positioned for long-term success.

Many labor and corporate governance topics that are now rolled up into the ESG or sustainability reporting concepts that

have existed for decades are part of the boilerplate in corporate governance guidelines, employee handbooks, and supplier contracts. In addition to being used for modern due diligence, sustainability is also a next generation strategic and management framework to address, adapt, and create value from externalities in the twenty-first century.

Over the coming decades, externalities related to resource scarcity, climate change, and public health will likely become more real, observable, and pronounced. For example, extreme weather events such as the 2012 Superstorm Sandy affecting the east coast make the environmental, social, and economic impacts of externalities on business and society more top of mind. These externalities have direct impact on the bottom line of organizations, in addition to creating risk, they also present opportunities for forward thinking entities.

Additionally, the demand for increased sustainability information is part of a palpable social shift that all organizations are witnessing. In today's world of social media and advanced communications, there is a demand for increased transparency from organizations. Sustainability is also now a leading topic of interest among the newest generation of employees entering the workforce.

The question is perhaps better posed as: How will sustainability evolve and mature? We anticipate that sustainability information and disclosures will be further institutionalized through the GRI's new G4 framework in collaboration with a set of thought leaders that include the International Integrated Reporting Council ("IIRC"), the Sustainability Accounting Standards Board ("SASB"), and The Economics of Ecosystems and Biodiversity ("TEEB") Working Group. These efforts further mainstream and integrate sustainability with traditional financial reporting, valuation, and decision-making tools.

Preparing for Action and Organizing to Create Value

As a general counsel or legal advisor, it is important to consider what risks exist from non-disclosures on sustainability. If an organization is already disclosing some "sustainability" information, engaging in a strategic, credible, and targeted approach is recommended. General counsel and legal advisors should also assess the relevance of sustainability in specific disclosures, policies, and contracts including those pertaining to customers, suppliers, and providers of financial capital.

The following are some steps that organizations and their advisors can take to prepare for action and organize in a manner that will create value:

1. Understand your audiences and unique business drivers.
2. Assess where you stand.
3. Use publicly-available resources for ongoing monitoring.
4. Report, engage, and evolve.

1. Understand Your Audiences and Unique Business Drivers

A critical first step is to understand your audience for sustainability information and disclosures. Often, they include your customers, investors, lenders, regulators, or employees. What sustainability or ESG information requests are you receiving? Who are they from? What type of information are they asking for and why?

A best practice is also to engage in a materiality assessment where you assess your greatest risks, opportunities, and impacts internally and then engage with your stakeholders to validate your findings. Materiality assessments enable organizations to sharpen their strategies and identify key topics for sustainability reporting.

Often, investors will ask whether you have engaged in a materiality assessment and are interested in hearing the results. Additional information on materiality can be found in the GRI G3 guidelines.[33]

2. Assess Where You Stand

Through the hundreds of sustainability rankings, ratings, indices, certifications, and databases, there is a story that is already being told about most organizations, whether they like it or not. Through proactive sustainability reporting, organizations have the opportunity to control and shape the story that is told.

Benchmarking is an invaluable exercise. Through benchmarking, organizations can assess their current position in sustainability rankings and investor indices, the level of sustainability and ESG reporting in which their peers are engaged, and how their reporting and disclosure can be improved.

Understanding what you are already doing is an important component of assessing where you stand. Typically, organizations find that their sustainability accomplishments and measurement systems are more advanced than realized, but are fragmented and decentralized across operations. Taking the lead in bringing these systems together is a great place for legal departments and their advisors to begin to assume a strategic lead in this critical area impacting their company's operations, valuation, and market positioning.

3. Utilize Publicly-Available Resources for Ongoing Monitoring

There are numerous local, state, and federal databases that contain a range of data relating to regulated environmental,

injury, labor, philanthropic, or governance information. This is sustainability information, but in its raw format. If you are seeking additional sustainability information presented in context, then sustainability reports are the source for such information. As the not-for-profit promoting such reporting, GRI's own Reports Lists and Disclosure Database ("GRI Reports List") are the primary libraries for sustainability reports.

The GRI Reports List is maintained by GRI and made publicly available for all to review, analyze, and use for their own purposes.[34] It tracks reporters globally, and back to 1999 – the first year GRI reports were published by companies. The Reports List is sortable by sector and country, as well as application level, an indication of the level of transparency of the associated report. The Reports List is updated monthly and is regularly analyzed by GRI for global trends.

More importantly, however, is that the GRI Reports List is used around the world by a growing number of stakeholders who are reviewing sustainability reports for information, trends, risks, and opportunities. Not only are stakeholders reviewing these individual reports, but there are a growing number of technology firms, database providers, and specialized researchers now reading, analyzing, and recording the voluntary sustainability disclosures of companies from all over the world.

4. Report, Engage, and Evolve

Using a globally recognized system of reporting provides a more credible, reputable, and comparable collection of information not only for a company's financial stakeholders, but also for other interested stakeholders, such as customers, consumers, employees, and local communities. In addition to reporting, organizations should engage with interested stakeholders to maximize the value of reporting efforts.

And finally, the market for sustainability information is ever-evolving as it continues to mature. Organizations should also evolve with the marketplace. We recommend that sustainability reporting be viewed as more than just checking off boxes for "compliance." Sustainability is a profound, business-critical topic. Organizations that begin to internalize sustainability, articulate a unique value proposition, and execute from the board of directors down to C-level management in each operating location will reap the greatest rewards from reporting and related disclosures. ■

Endnotes

1 KPMG International Corporate Responsibility Reporting Survey 2011, KPMG (2011), http://www.kpmg.com/global/en/issuesandinsights/articlespublications/corporate-responsibility/pages/default.aspx (last visited Dec. 6, 2012).

2 *See* AASHE STARS, https://stars.aashe.org (last visited Dec. 6, 2012).

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Compliance with the SEC's Final Conflict Minerals Rule

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On August 22, 2012, the Securities and Exchange Commission ("SEC"), by a vote of three to two, adopted a final rule[1] to implement section 1502 of the Dodd–Frank Wall Street Reform and Consumer Protection Act (the "Act"),[2] which added section 13(p) to the Securities Exchange Act.[3]

1. Statutory Overview

New section 13(p) requires issuers with "conflict minerals"[4] that are "necessary to the functionality or production of a product manufactured by the issuer" to disclose annually in a new Form SD[5] whether any of those minerals originated in the Democratic Republic of the Congo or an adjoining country. If an issuer's conflict minerals originated in those countries, section 13(p) requires the issuer to submit a report to the SEC that includes a description of the measures it took to exercise due diligence on the conflict minerals' source and chain of custody. The measures taken to exercise due diligence must include an independent private sector audit of the report that is conducted in accordance with standards established by the Comptroller General of the United States. Section 13(p) also requires the issuer submitting the report to identify the auditor and to certify the audit. In addition, section 13(p) requires the report to include a description of the products manufactured or contracted to be manufactured that are not "DRC conflict free," the facilities used to process the conflict minerals, the country of origin of the conflict minerals, and the efforts to determine the mine or location of origin. Section 13(p) requires the information disclosed by the issuer be available to the public on its Internet website.

2. Application to Issuers

These new disclosure obligations apply only to issuers that file reports with the SEC under section 13(a) or section 15(d) of the Securities Exchange Act. They do not apply to investment companies required to file reports pursuant to Rule 30d-1 under the Investment Company Act of 1940.[6] There is no exception in the final rule for issuers whose products contain *de minimis* quantities of conflict minerals. The reporting requirements apply equally to domestic and foreign issuers. There is no exception for smaller reporting companies, although the phase-in period of two years for reporting "undeterminable" conflict minerals[7] is extended to four years for such companies.[8]

3. Conflict Minerals and Covered Countries

The final rule issued by the SEC clarifies that only tantalum, tin, tungsten and gold are covered by the new disclosure requirements, unless the Secretary of State later finds that other derivatives of the statutorily specified minerals (cassiterite, columbite-tantalite, wolframite, and gold) are also financing conflict in one of the Covered Countries.[9] The "Covered Countries" are defined as the Democratic Republic of the Congo, Angola, Burundi, Central African Republic, the Republic of the Congo, Rwanda, South Sudan, Tanzania, Uganda, and Zambia.[10]

4. Effective Date and Calendar Year Reporting

Issuers must comply with the final rule for the calendar year beginning January 1, 2013, with the first reports due May 31, 2014.[11] Unlike the earlier proposed rule, the final rule requires all issuers to report on the same schedule, May 31 of each year, with respect to their operations for the preceding calendar year.

The final rule provides for issuers that acquire control over a company that manufactures or contracts for the manufacturing of products with conflict minerals that previously had not been obligated to file a disclosure report. Pursuant to the rule, the issuers may delay reporting on the acquired company's products until the end of the first reporting calendar year that begins

no sooner than eight months after the effective date of the acquisition.[12]

5. Exemption for Minerals "Outside the Supply Chain" Prior to January 31, 2013

The final rule exempts any conflict minerals that are "outside the supply chain" prior to January 31, 2013.[13] Under the final rule, conflict minerals are outside the supply chain prior to that date if:

- any columbite-tantalite, cassiterite, and wolframite minerals, or their derivatives, have been smelted;
- any gold has been fully refined; or
- any conflict mineral or its derivatives that have not been smelted or fully refined are located outside of the Covered Countries.[14]

6. Form SD

The final rule requires issuers to provide the conflict minerals disclosures in the body of a new specialized disclosure report on a new form, Form SD.[15] An issuer required to provide a "Conflict Minerals Report"[16] will provide it as an exhibit to the Form SD. The final rule requires Form SD, including the conflict minerals information therein and any Conflict Minerals Report submitted as an exhibit to the form, to be "filed" under the Exchange Act and thereby subject to potential Exchange Act section 18 liability. This is a change from the proposed rule of December 2010, which would have required the information to be "furnished."[17] The SEC has noted, however, that the CEO and CFO certification requirements applicable to 10-Ks do not apply to this new Form SD filing.[18]

7. The Three-Step Compliance Process

The final rule establishes a compliance process consisting of three basic steps:[19]

> Step 1, in which an issuer determines whether its product manufacturing activities are such as to make it subject to the regulation;
>
> Step 2, in which issuers subject to the regulation must undertake a reasonable country of origin inquiry ("RCOI") and report the results on Form SD; and
>
> Step 3, in which issuers whose RCOI requires it must conduct due diligence on the conflict minerals' source and chain of custody and file a Conflict Minerals Report.

Step 1: Covered Manufacturing

As noted above, the new disclosure obligations apply to issuers with conflict minerals that are "necessary to the functionality or production of a product manufactured by the issuer." The final rule states explicitly that issuers that mine conflict minerals are not covered unless they also engage in manufacturing that uses such minerals.[20]

Further, the final rule defines "product manufactured by the issuer" to include products manufactured for the issuer by another company under a "contract to manufacture."[21] The rule does not define the phrases "contract to manufacture," "necessary to the functionality," or "necessary to the production," but it does provide the following guidance:

a. Contracting to Manufacture

Whether an issuer has "contracted to manufacture" a product depends on the degree of influence it exercises over the materials, parts, ingredients, or components to be included in any product that contains conflict minerals or their derivatives. An issuer will not be considered to "contract to manufacture" a product if it does no more than take the following actions:

- specifying or negotiating contractual terms with a manufacturer, such as training or technical support, price, insurance, indemnity, intellectual property rights, dispute resolution, or other like terms or conditions concerning the product, that do not directly relate to the manufacturing of the product (unless it thereby exercises a degree of influence over the manufacturing of the product that is practically equivalent to contracting on terms that directly relate to the manufacturing of the product);
- affixing its brand, marks, logo, or label to a generic product manufactured by a third party; or
- servicing, maintaining, or repairing a product manufactured by a third party.[22]

It follows from this guidance that, if an issuer provides design specifications to a contract manufacturer under a contract that requires the manufacturer to follow the issuer's specifications, it will be deemed to "contract to manufacture" the resulting product, and the issuer will be covered. Conversely, an issuer that buys and resells an off-the-shelf product designed and manufactured by another company will not be covered, even if the issuer places its own brand or mark on the product. An interesting case, however, is that of an issuer that provides a

performance specification to a supplier and leaves the detailed design and manufacturing to the discretion of the manufacturer. Asserting control over the "performance" to be met by the product is not the same as influencing the "manufacturing" of the product. Issuers that procure products based solely upon performance specifications should, it seems, be able to maintain the position that they are not thereby "contracting to manufacture" such products.

b. Necessary to the Functionality

Similarly, the SEC has provided guidance on whether a conflict mineral is "necessary to the functionality" of a product. In determining whether a mineral is necessary to the functionality, the issuer is to consider:

- whether the conflict mineral is intentionally added to the product or any component of the product and is not a naturally occurring by-product;
- whether the conflict mineral is necessary to the product's generally expected function, use, or purpose; and
- whether the conflict mineral is merely for ornamentation, decoration, or embellishment of a product whose primary purpose is not ornamentation or decoration.[23]

c. Necessary to the Production

In determining whether a conflict mineral is "necessary to the production" of a product, an issuer should consider:

- whether the conflict mineral is intentionally included in the product's production process (other than merely in a tool, machine or equipment used in production);
- whether the resulting product actually contains the conflict mineral; and
- whether the conflict mineral is necessary to produce the product.[24]

The new guidance states explicitly that, for a conflict mineral to be considered "necessary to the production" of a product, the final product must contain the mineral. Products produced using conflict minerals as catalysts that are no longer present in the final product are not covered by the final rule.[25]

Step 2: Reasonable Country of Origin Inquiry

If an issuer finds under Step 1 that the regulation applies to its manufacturing activity, it then proceeds to Step 2, which requires it to perform a "reasonable country of origin inquiry." The final rule requires the issuer to conduct a "good faith" inquiry regarding the origin of its conflict minerals that is "reasonably designed to determine" whether any of its conflict minerals originated in the Covered Countries and are not from recycled or scrap sources.[26]

The final rule does not prescribe the steps constituting a reasonable country of origin inquiry but indicates that an issuer satisfies the reasonable country of origin inquiry standard if it "seeks and obtains reasonably reliable representations" identifying the facility at which its conflict minerals were processed and demonstrating that those conflict minerals did not originate in the Covered Countries or come from recycled or scrap sources. The SEC guidance states that these representations could come "either directly from that facility or indirectly through the issuer's immediate suppliers," but the issuer:

- "must have a reason to believe these representations are true given the facts and circumstances surrounding those representations:" and
- "must also take into account any applicable warning signs or other circumstances" calling their truth into question.[27]

The guidance states further that an issuer would have reason to believe a facility's representations were true if:

- the facility had received a "conflict-free" designation by a recognized industry group that requires an independent private sector audit of the smelter; or
- the facility obtained an independent private sector audit that it made publicly available.[28]

The final rule also indicates that an issuer's "policies with respect to the sourcing of conflict minerals will generally form a part of the issuer's reasonable country of origin inquiry, and therefore would generally be required to be disclosed in the issuer's Form SD."[29]

The SEC guidance makes clear that an issuer is not required to receive representations from all of its suppliers. The SEC provides this explanation:

> The standard focuses on reasonable design and good faith inquiry. Therefore, if an issuer reasonably designs an inquiry and performs the inquiry in good faith, and in doing so receives representations indicating that its conflict minerals did not originate in the Covered Countries, the issuer may conclude that its conflict minerals did not originate in the Covered Countries, even though it does not hear from all of its suppliers, as long as it does not ignore warning signs or other circumstances indicating that the remaining amount of its conflict minerals

> originated or may have originated in the Covered Countries. For example, we would agree that, 'if reasonable inquiry has been made, and if no evidence of [Covered Country] origin has arisen, and if the origin of only a small amount of gold were still unknown, a manufacturer should be allowed to declare that its gold is not from the [Covered Countries] and is DRC conflict free.'[30]

This is an important element of the SEC's explanation of the reasonableness standard that will ease the burden on issuers in a variety of circumstances.

a. The OECD Due Diligence Guidance

The SEC notes that this "reasonable country of origin inquiry" is consistent with the "supplier engagement" approach described by the Organisation for Economic Co-operation and Development ("OECD") in OECD, *Downstream Implementation Of The OECD Due Diligence Guidance For Responsible Supply Chains Of Minerals From Conflict-Affected And High-Risk Areas, Cycle 2 Interim Progress Report On The Supplement On Tin, Tantalum, And Tungsten Final Draft* (June 2012) ("OECD Guidance").[31]

Because the OECD Guidance has the SEC's explicit endorsement, it can be regarded as a type of "safe harbor" that would allow a company to make a representation that its "due diligence has been designed to trace the supply chain back to conflict free regions." The OECD safe harbor has several elements, however, and these require a company to make genuine effort to "drill down" past its immediate suppliers using the various steps listed below.

The safe harbor steps consist of (1) using an industry template to gather data on the material content of products; (2) meeting with and training suppliers; (3) identifying smelters that serve the suppliers; (4) adding new terms to non-disclosure agreements (NDSs) to encourage suppliers to disclose their sources; (5) requiring sourcing from verified conflict-free smelters whenever possible; (6) following OECD recommended forms of supplier and customer communications; and (7) following the specific OECD recommendations concerning gold.

The SEC has not indicated which of these steps are essential to support an RCOI representation, but when a company relies upon an RCOI, the ultimate legal question remains whether the company has a "reason to believe" that its suppliers' representations are true and has taken into account any "warning signs" suggesting they may not be.

The OECD Guidance provides the following additional details concerning each of the steps:

1. The OECD Guidance states that most companies are identifying the products containing the four minerals "through material content data forms, company declaration systems, bills of material, and/or part codes assigned to all parts."[32] The OECD Guidance notes that "[t]he most commonly referenced data collection method cited is the EICC & GeSI Reporting Template and Dashboard."[33] Companies, therefore, should be seeking data from suppliers through these various means and should consider using the EICC & GeSI Reporting Template if possible.
2. The OECD Guidance states that most companies are communicating with suppliers about the requirements through "letters, webinars, and face-to-face meetings."[34] Companies should not merely send a few e-mails or letters to suppliers about conflict minerals compliance, but should offer training to explain the requirements more thoroughly.
3. The OECD Guidance states that downstream companies should "focus their due diligence efforts on identifying … smelters within their supply chains in order to manage the risk of contributing to conflict or serious human rights abuses."[35] Companies should begin working with their suppliers to identify as much as possible the actual smelters of the minerals used in their products.
4. The efforts the OECD recommends also include "contractual clauses and terms and conditions to ensure compliance with data disclosure and/or required policies as a prerequisite for doing business."[36] In this regard, the OECD reports that a majority of the companies it has surveyed are incorporating special confidentiality provisions "into their contract clauses and NDAs and using data collection and roll-up tools" in order to achieve sufficient reporting of data concerning their remote suppliers so that their due diligence representations can be considered reasonable.[37] Companies should consider whether additional contract clauses or NDAs could be used to maximize their own and their suppliers' access to remote suppliers' sourcing information.
5. The OECD Guidance indicates that efforts are being made to achieve an industry-level verification of specific "smelters . . . as conflict free through the EICC & GeSI Conflict-

Free Smelter (CFS) Program."[38] Once such verifications become available, companies should consider requiring that minerals used by their suppliers be sourced from these verified smelters.

6. In addition, the OECD Guidance attaches specific forms of a "Company Conflict Minerals Policy," "Dear Supplier Letters" and "Dear Customer Letter."[39] Companies should compare their policies and letters to these forms to ensure that they cover the same points.
7. Finally, in the case of gold, the OECD has now published the following specific instructions for downstream companies:

> E. For all other downstream companies (e.g., downstream users of gold and of gold materials and manufacturers of articles that contain gold):
>
> > 1. Request suppliers provide the identification of the upstream gold refiner/s for gold-bearing materials and products, either by direct sourcing or via marks imprinted on a refined gold product if available, or from information provided by other downstream product suppliers or bullion banks.
> >
> > 2. If gold refiner/s are identified, request verification that the refiner/s has conducted due diligence in accordance with this Supplement. Where possible, seek reference to recognised audits by Industry Programmes or Institutionalised Mechanisms that incorporate in their auditing protocols the standards and processes contained in the Guidance.
> >
> > 3. Pass on information on the identification of the upstream gold refiner/s for gold-bearing materials and products to downstream customers.[40]

Companies should consider adding these requirements to their supplier agreements for products containing gold.

b. RCOI Disclosure

If, as a result of its country of origin inquiry, an issuer determines that its conflict minerals

- did not originate in the Covered Countries, or
- did come from recycled or scrap sources,

it must disclose this on Form SD and "briefly describe the reasonable country of origin inquiry it used in reaching the determination and the results of the inquiry."[41] It must also provide this information on its website and provide the website link in its Form SD filing. An issuer that falls in this category is not required to proceed to Step 3 below, which consists of due diligence on the source and chain of custody of its conflict minerals and preparation of a Conflict Minerals Report.

An issuer is also allowed to stop at Step 2 if it has "no reason to believe" that its conflict minerals originated in the Covered Countries, or if it "reasonably believes" that they are from recycled or scrap sources.[42] This aspect of the rule offers comfort to issuers who obtain reasonable evidence from suppliers, or others in a position to know, that their minerals are not from the Covered Countries or are from recycled or scrap sources and have no information suggesting otherwise. Provided they describe their reasonable country of origin inquiry on their Form SD, such issuers will be spared the additional burden of conducting due diligence on the source and chain of custody of the conflict minerals or preparing a Conflict Minerals Report.

The final rule specifies that conflict minerals are considered to be from recycled or scrap sources if they are from reclaimed end-user or post-consumer products or from scrap processed metals created during product manufacturing.[43] For this purpose, recycled metal includes excess, obsolete, defective and scrap metal materials that contain refined or processed metals that are appropriate to recycle in the production of tin, tantalum, tungsten, or gold.[44] Minerals partially processed, unprocessed or that arise as by-products from another ore are not included in the definition of recycled metal.[45]

In another change from the 2010 proposal, the final rule does not require an issuer to retain reviewable business records to support its reasonable country of origin conclusion, although maintenance of appropriate records is obviously useful in demonstrating compliance and may also be required by a nationally or internationally recognized due diligence framework being followed by the issuer.

Step 3: Due Diligence and Conflict Minerals Report

If, based on its reasonable country of origin inquiry, an issuer:

- knows that its conflict minerals originated in the Covered Countries and did not come from recycled or scrap sources, or
- has reason to believe that its necessary conflict minerals *may* have originated in the Covered Countries and *may* not have come from recycled or scrap sources,

then it must exercise due diligence on the source and chain of custody of its conflict minerals that conforms to a nationally or

internationally recognized due diligence framework, if such a framework is available for the conflict mineral.[46] The final rule requires issuers exercising due diligence regarding whether their conflict minerals are from recycled or scrap sources to conform this due diligence to a nationally or internationally recognized due diligence framework, if one is available for a particular recycled or scrap conflict mineral.[47] The SEC has reported that the only such framework of which it is currently aware is the OECD framework for recycled or scrap gold.[48]

An issuer that reaches Step 3 must file a Conflict Minerals Report with its Form SD unless it finds as a result of its due diligence in Step 3 that its conflict minerals did not originate in the Covered Countries or come from recycled or scrap sources. In that case, the issuer only needs to submit Form SD with a brief description of its inquiry and due diligence efforts and the results demonstrating why the issuer believes that the conflict minerals did not originate in the Covered Countries or that they did come from recycled or scrap sources.[49]

The required content of the Conflict Minerals Report under the final rule is very similar to what was proposed in December 2010. It must contain the following:

a. Due Diligence Description

The issuer must describe the measures it has taken to exercise due diligence on the source and chain of custody of the conflict minerals, which must conform to a nationally or internationally recognized due diligence framework, if such a framework is available for the conflict mineral.[50] Presently, it appears that the only nationally or internationally recognized due diligence framework available is the due diligence guidance approved by the OECD. If a nationally or internationally recognized due diligence framework does not exist for a conflict mineral necessary to the production of one or more of its products,[51] then until such a framework is developed, the issuer is required to exercise appropriate due diligence in determining the source and chain of custody of the necessary conflict mineral, including whether the conflict mineral is from recycled or scrap sources, without the benefit of a due diligence framework.[52]

b. Independent Audit Report

An independent private sector audit of the Conflict Minerals Report is required with respect to products for which the issuer is not reporting "DRC conflict undeterminable" and where there is a nationally or internationally recognized due diligence framework for the conflict minerals that was in existence prior to June 30th of the preceding calendar year.[53] This independent private sector audit is to be conducted in accordance with standards established by the Comptroller General ("CG") of the United States.[54] The CG's staff has indicated that it does not intend to establish new standards for the Conflict Minerals Report audit but will instead look to the existing Government Auditing Standards ("GAGAS"), commonly referred to as "the Yellow Book."[55] The SEC characterizes this independent audit as a "critical component" of the issuer's due diligence in establishing the source and chain of custody of the necessary conflict minerals. The required audit objective is to express an opinion or conclusion as to whether the design of the issuer's due diligence measures as set forth in, and with respect to the period covered by, the issuer's Conflict Minerals Report, is in conformity in all material respects with the criteria set forth in the nationally or internationally recognized due diligence framework used by the issuer, and whether the issuer's description of the due diligence measures it performed as set forth in the Conflict Minerals Report, with respect to the period covered by the report, is consistent with the due diligence process that the issuer undertook.[56]

c. Audit Certification

The issuer's Conflict Minerals Report must state that the issuer has obtained the independent private sector audit of the Conflict Minerals Report, which shall constitute an audit certification.[57] As part of the Conflict Minerals Report, the issuer must identify the independent private sector auditor of the report, if the auditor is not self-identified in the audit report, and provide the audit report prepared by the auditor.[58]

d. Product Descriptions

The issuer must describe the products that have not been found to be "DRC conflict free" as well as the facilities used to process the conflict minerals in those products, the country of origin of the conflict minerals in those products, and the efforts to determine the mine or location of origin with the greatest possible specificity.[59] Products are regarded as "DRC conflict free" if any conflict minerals they contain did not originate in the Covered Countries, are from recycled or scrap sources or are found not to have directly or indirectly financed or benefited armed groups in the Covered Countries.[60] "Armed Groups" are defined as groups identified as perpetrators of serious human rights abuses in annual Country Reports on Human Rights Practices under

sections 116(d) and 502B(b) of the Foreign Assistance Act of 1961 relating to the Democratic Republic of the Congo or an adjoining country.[61]

e. DRC Conflict Undeterminable

For the first two reporting years (four years for "smaller reporting companies" under SEC rules), the issuers are allowed to report "DRC conflict undeterminable" in their Conflict Minerals Reports for products if they are unable to determine whether the conflict minerals in those products are DRC conflict free.[62] For any products that are reported as "DRC conflict undeterminable" during this transition period, the issuer must provide a description of the products, the facilities used to process the conflict minerals in the products, if known, the country of origin of the conflict minerals in those products, if known, and the efforts to determine the mine or location of origin with the greatest possible specificity. The issuer must also disclose the steps it has taken or will take, if any, since the end of the period covered in its most recent prior Conflict Minerals Report (including any steps to improve its due diligence) to mitigate the risk that its conflict minerals benefit Armed Groups.[63]

8. Concluding Observations

The new conflict minerals disclosure rules are intended to serve a worthy humanitarian objective: reducing, and if possible, eventually eliminating, the influence of mined minerals from the region of the DRC on the promotion and perpetuation of the armed conflict and atrocities occurring there. One fear, however, that the United Nations itself reported in late 2011, is that the effect of the new regulations may be to create a new layer of crime in the region aimed at disguising the true origin of minerals through sophisticated smuggling rings.[64] One cannot help wondering if the SEC has been recruited to aid in a task which a securities regulator is not well suited to undertake. The SEC is to be respected for having endeavored to do its best to fulfill its Congressional mandate. That mandate, however, has spawned a complex web of due diligence and audit obligations whose inevitable complexity and ambiguity reflect the enormity and truly unmanageable global scope of the many industries and distant supply chains that are affected.

In the meantime, issuers have no alternative but to make the investments necessary to fulfill their new legal obligations. The SEC has provided some markers and signposts to help issuers find their way along the uncertain paths back through the dimly lit reaches of their global supply chains. The challenge will be for issuers to find a way to make the smart and effective investments needed to achieve good faith compliance, but without launching a global search for the holy grail in an impossible exercise whose cost and supply chain disruption end up threatening the very existence of their businesses. ■

Endnotes

1 17 C.F.R. § 240.13p-1 (e-CFR 2012). On October 19, 2012, the U.S. Chamber of Commerce and the National Association of Manufacturers filed a petition challenging the conflict minerals rule. *Nat'l Ass'n of Mfrs. v. SEC,* Case No. 12-1422 (D.C. Cir. 2012, filed Oct. 19, 2012). An expedited decision is expected in the case, but in the meantime, issuers will need to prepare to comply with the new rule.

2 Pub. L. No. 111-203, 124 Stat. 1376 (2010).

3 15 U.S.C. § 78m(p).

4 Defined in the Act as "(A) columbite-tantalite (coltan), cassiterite, gold, wolframite, or their derivatives; or (B) any other mineral or its derivatives determined by the Secretary of State to be financing conflict in the Democratic Republic of the Congo or an adjoining country" Pub. L. 111-203 § 1502(e)(4) (2010).

5 17 C.F.R. § 249b.400 (e-CFR 2012).

6 17 C.F.R. § 270.30d-1 (e-CFR 2012).

7 *See supra* text accompanying note 4.

8 77 Fed. Reg. at 56,364 Item 1.01, Instruction 2.

9 *Id.* at 56,364 Item 1.01(c)(3).

10 *Id.* at 56,275 n.7.

11 *Id.* at 56,309.

12 *Id.* at 56,364 Item 1.01, Instruction 3.

13 *Id.* at 56,365 Item 1.01, Instruction 5.

14 *Id.* at 56,364 Item 1.01(d)(7).

15 17 C.F.R. § 249.448 (e-CFR 2012).

16 *See* discussion *infra* Section 7, Step 3, items a through d.

17 *See* 77 Fed. Reg. at 56,302.

18 *Id.* at 56,304 n. 343.

19 *Id.* at 56,279.

20 *Id.* at 56,350.

21 *Id.* at 56,345.

22 *Id.* at 56,345-46.

23 *Id.* at 56,297.

24 *Id.*

25 *Id.*

26 *Id.* at 56,312.

27 *Id.*

28 *Id.*

29 *Id.*

30 *Id.*

31 The Organisation for Economic Co-operation and Development (OECD) is an international organization of 34 countries founded in 1961 to promote economic progress and world trade. The OECD Guidance referred to by the SEC is available at the following link: http://www.oecd.org/daf/internationalinvestment/guidelinesformultinationalenterprises/DownstreamCycle2Report.pdf.

32 OECD Guidance at 7.

33 *Id.*

34 *Id.*

35 *Id.*

36 *Id.* at 8.

37 *Id.*

38 *Id.*

39 *Id.* at 54-58.

40 *Id.* at 17.

41 77 Fed. Reg. at 56,280.

42 *Id.* at 56,281.

43 *Id.* at 56,332.

44 *Id.*

45 *Id.*

46 *Id.* at 56,363 Item 1.01 (c)(1)(i).

47 *Id.* at 56,282, 56,363 Item 1.01 (c).

48 *Id.* at 56,282.

49 *Id.* at 56,363 Item 1.01 (c).

50 *Id.* Item 1.01(c)(1)(i).

51 *See* discussion *infra* Section 7, Step 1, item c.

52 77 Fed. Reg. at 56,280 Item 1.01(c)(1)(v).

53 *Id.* at 56,363 Item 1.01(c)(1)(v).

54 *Id.* Item 1.01(c)(1)(ii).

55 *Id.* at 56,281.

56 *Id.* at 56,363 Item 1.01(c)(1)(ii)(A).

57 *Id.* Item 1.01(c)(1)(ii)(B).

58 *Id.* Item 1.01(c)(1)(ii)(C).

59 *Id.* Item 1.01(c)(2).

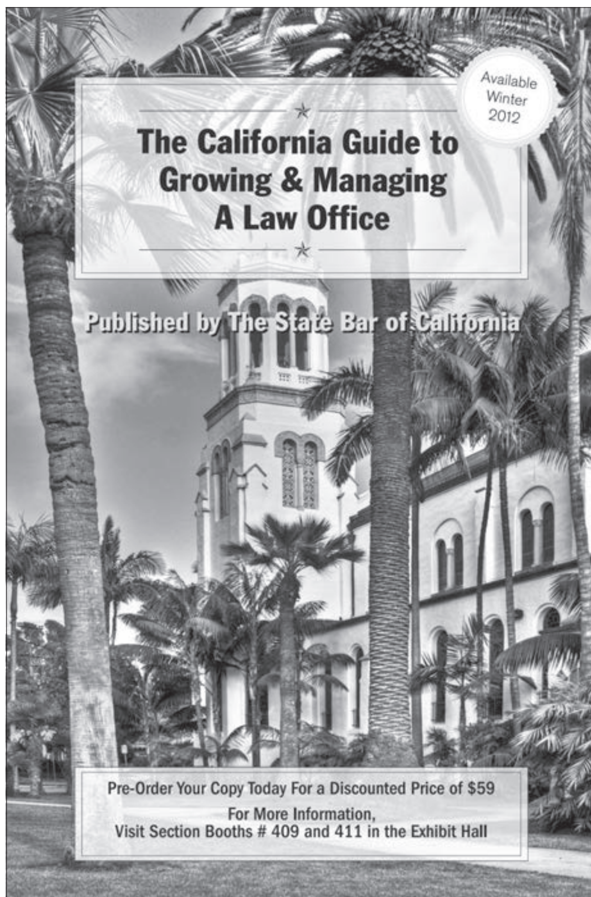
60 *Id.* Item 1.01(d)(4).

61 22 U.S.C. §§ 2151n(d), 2304(b); 77 Fed. Reg. at 56,364 Item 1.01(d)(2).

62 77 Fed. Reg. at 56,364 Item 1.01(d)(5) & Instruction 2.

63 *Id.* at 56,363 Item 1.01(c)(1)(iii).

64 *See DR Congo: UN experts outline sources of funding for armed rebels,* UN News Centre, Dec. 30, 2011, http://www.un.org/apps/news/story.asp?NewsID=40865.



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New California Employment Laws and Significant Employment Decisions in 2012

Charles Barker

Charles Barker

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New Employment Laws

Each year the California legislature enacts new employment laws that will require most employers to take action to ensure compliance by the following January 1. 2012 was no exception. Among the new laws that now affect a variety of employment requirements are (1) new rules for the inspection of personnel records by employees; (2) new protections for religious dress and grooming practices under the California Fair Employment and Housing Act (the "FEHA");[1] (3) new anti-discrimination protections under the FEHA for breastfeeding; (4) a law that expressly overturned a court opinion that had permitted employers and employees to agree that a salary for a non-exempt employee covered more than 40 hours per week; (5) a restriction on the ability of companies to ask applicants and employees for access to social media accounts; (6) an expansion of whistleblower protections under the California False Claims Act; and (7) new posting requirements for certain industries regarding human trafficking.

Inspection of Personnel Records

California Labor Code Section 1198.5 provides an employee the right to inspect his or her personnel records that the employer maintains relating to the employee's performance or to any grievance concerning the employee. A.B. 2674, effective January 1, 2013, provides significant new requirements regarding the employee's request for inspection of the personnel files:

- Employees now have the right to obtain a copy of their personnel records, whereas previously the right was only to inspect such records.
- The request for a copy of an employee's records may be made by a representative of the current or former employee.
- The employer must provide a copy of the records or make them available within 30 calendar days of the written request. The parties may extend this 30-day deadline but only for an additional five days.
- The employer must make the personnel file available to a current employee at the place where the employee reports to work. If the employee is required to go to a different location to inspect or copy the file, no loss of compensation to the employee is permitted.
- With regard to former employees, the employer must provide a copy of the records at the location where the employer stores the records or at a mutually agreed upon location. A former employee may receive a copy by mail if the employee reimburses the employer for actual postal expenses. If a former employee was terminated for a violation of law or an employment-related policy involving harassment or workplace violence, the employer may comply with a request by either (i) making the records available to the former employee at a location other than the workplace if the location where the records are made available is within a reasonable driving distance of the employee's residence or (ii) providing a copy of the records by mail.

The new law permits companies to redact the names of any nonsupervisory employees from the records. As with the previous law, the requirements of the new law do not apply to records relating to the investigation of a possible criminal offense or to letters of reference. If the employee files a lawsuit that relates to a personnel matter, the right to inspect or receive a copy of files under Section 1198.5 is suspended during the pendency of the lawsuit.

The new law further requires that the personnel records be kept for a minimum of three years after termination of the employee.

Religious Dress and Grooming Practices Now Included In Religious Discrimination Prohibition

The FEHA safeguards the right and opportunity of all persons to seek, obtain, and hold employment without discrimination on account of religious creed. Further, employers are required to reasonably accommodate a religious belief or observance of an individual unless the accommodation would cause an undue hardship on the conduct of the business. FEHA regulations address reasonable accommodation of religious dress by providing, "[d]ress standards or requirements for personal appearance shall be flexible enough to take into account religious practices."[2]

A.B. 1964, effective January 1, 2013, now includes religious dress and grooming practices as a type of belief or observance covered

by religious discrimination protections. The bill was sponsored by the Sikh Coalition, which argued that Sikhs suffered discrimination because of their Sikh identity, which includes a turban, beard, and unshorn hair.

A.B. 1964 amended California Government Code Section 12926(p), which defined "religious creed," "religion," "religious observance," "religious belief," and "creed" to include all aspects of religious beliefs, observance, and practice. The new legislation includes religious dress and grooming practices in that definition. The legislation also states that the term "religious dress and practice" shall be "construed broadly to include the wearing or carrying of religious clothing, head or face coverings, jewelry, artifacts, and any other item that is part of the observance by an individual of his or her religious creed." The term "religious grooming practices" shall also be construed broadly to include all forms of head, facial, and body hair that are part of the observance by an individual of his or her religious creed. The new legislation also clarifies that, for purposes of religious and disability accommodation, the term "undue hardship" is based on the definition contained in the FEHA. "Undue hardship" is defined to mean an action requiring significant difficulty or expense, when considered in light of a series of factors.[3] Finally, the new legislation provides that an accommodation of an individual's religious dress or religious grooming practice is not reasonable if the accommodation requires segregation of the individual from other employees or the public.

Breastfeeding

Under the FEHA, it is unlawful for an employer to engage in specified discriminatory practices on the basis of sex. Under previous law, "sex" was defined to include gender, pregnancy, childbirth, and medical conditions related to pregnancy or childbirth.[4] As a result of A.B. 2386, "sex" now also includes breastfeeding and medical conditions related to breastfeeding. In addition, California employers are obligated to provide a reasonable amount of break time to accommodate an employee desiring to express breast milk.[5] The new statute specifically provides that its provisions are declaratory of existing law.[6]

Non-Exempt Employees Who Are Paid a Salary

In *Arechiga v. Dolores Press,*[7] the California Court of Appeal ruled that an employer and employee may enter into an explicit wage agreement pursuant to which a non-exempt employee may receive a guaranteed fixed salary for all work (including overtime hours) so long as the employer pays the employee for all overtime wages at the correct premium rate.

A.B. 2103, which went into effect on January 1, 2013, specifically provides that it was the intent of the legislature to overturn the decision in *Arechiga*.[8] Section 515 of the California Labor Code was amended by the new legislation to specifically provide that payment of a fixed salary to a non-exempt employee shall be deemed to be compensation only for the employee's regular, non-overtime hours, notwithstanding any private agreement to the contrary. Under the previous language of Labor Code Section 515, for purposes of computing the overtime rate to be paid to a non-exempt full-time (40 hours per week) salaried employee, the employee's regular hourly rate shall be 1/40th of an employee's weekly salary.

Restrictions on Requesting Access to Social Media

Several states have recently passed laws that restrict the ability of employers to require or request an employee or applicant to allow access to the employee's personal social media. Likewise, California passed A.B. 1844, which added Section 980 to the California Labor Code. Under the new law, employers may not require or even request an employee or applicant to (1) disclose a user name or password for the purpose of accessing personal social media; (2) access personal social media in the presence of the employer, or (3) divulge any personal social media (with one exception). As an exception, however, an employer may request an employee to divulge personal social media that is reasonably believed to be relevant to the investigation of allegations of employee misconduct or employee violation of applicable laws and regulations, provided that the social media is used solely for purposes of that investigation or a related proceeding. In addition, the new law does not preclude an employer from requiring or requesting an employee to disclose a user name or password for the purpose of accessing an employer-issued electronic device. Employers are prohibited from discharging, disciplining, or otherwise retaliating against an employee or applicant for not complying with a request that violates the new law.

Expanded Whistleblower Protection Under California's False Claims Act

California's False Claims Act[9] prohibits the submission of false claims to the state government and authorizes individuals to bring civil actions to enforce the law and to share in any monetary recovery for those false claims. A.B. 2492 amended the anti-retaliation provisions of the False Claims Act by protecting not only employees but also contractors or agents. The bill also clarified that employees, contractors, and agents are protected from adverse employment actions "because of lawful acts done

… in furtherance of an action under this section or other efforts to stop one or more violations of this article."

An aggrieved employee, contractor, or agent is entitled to relief that includes reinstatement with seniority, two times the amount of back pay, interest on the back pay, special damages, punitive damages where appropriate, and attorneys' fees. The existing law provided these remedies to an employee who was a victim of retaliation if the employee had voluntarily disclosed information to the government or acted in furtherance of a false claims action and was harassed or threatened with termination or coerced into engaging in the fraudulent activity in the first place. The new law provides protection when the employee, contractor, or agent is retaliated against for furthering a false claims action or for trying to stop a violation.

Human Trafficking and Public Posting Requirements for Certain Businesses

California has enacted statutes to protect victims of human trafficking. Civil Code Section 52.5 provides for certain civil remedies and penalties for victims of human trafficking. More recently, the California Transparency In Supply Chains Act of 2010 requires certain retail sellers and manufacturers conducting business in California with over $100 million in annual worldwide gross receipts to disclose what efforts, if any, have been made by the company to address and eliminate slavery and human trafficking in the direct supply chains for tangible goods.[10]

The latest of the California's legislature's attempts to eradicate human trafficking is S.B. 1193, which became effective January 1, 2013. S.B. 1193 requires specified businesses to post a notice containing information related to slavery and human trafficking. The notice must be placed near the public entrance of the establishment or in some other conspicuous location in clear view of the public and employees. The following businesses are required to post a specified notice: (1) on-sale general public premises licensees under the Alcohol Beverage Control Act;[11] (2) adult or sexually oriented businesses; (3) primary airports; (4) intercity passenger rail and light rail stations; (5) bus stations; (6) privately owned and operated truck stops that provide food, fuel, shower or other sanitary facilities, and lawful overnight truck parking; (7) emergency rooms within general acute care hospitals; (8) urgent care centers; (9) farm labor contractors; (10) privately operated job recruitment centers; (11) roadside rest areas; and (12) certain businesses offering massage or bodywork services. Businesses that fail to post the notice are subject to civil penalties of $500 for a first offense and $1,000 for each subsequent offense.

SIGNIFICANT EMPLOYMENT DECISIONS IN 2012

In 2012, courts and administrative agencies issued decisions that significantly impact the policies and practices of employers in California. Three of the more important subjects of such decisions were (1) the use of class action waivers in arbitration agreements; (2) social media policies; and (3) meal and rest break policies.

Arbitration Agreements and Class Action Waivers

Employers have attempted to obtain a waiver of class actions from their employees by including the waiver in arbitration agreements. Over the past few years, the California courts have effectively prevented the enforcement of such waivers—but those court decisions are under attack on federal preemption grounds.

In April 2011, the Supreme Court of the United States decided *AT&T Mobility LLC v. Concepcion*,[12] which held that the Federal Arbitration Act[13] ("FAA") preempts the California Supreme Court's *Discover Bank* rule,[14] which had held that class action waivers in consumer arbitration agreements were unconscionable and unenforceable. In *AT&T Mobility*, the U.S. Supreme Court held that California's *Discover Bank* rule directly conflicted with the central purpose of the FAA, which is to ensure that private arbitration agreements are enforced according to their terms.

Prior to *AT&T Mobility*, the California Supreme Court had extended its *Discover Bank* holding that class action waivers are unconscionable and unenforceable to wage and hour class actions in *Gentry v. Superior Court*.[15] The Court in *Gentry* concluded that, in some cases, "the prohibition of classwide relief would undermine the vindication of the employees' unwaivable statutory rights and would pose a serious obstacle to the enforcement of the state's overtime laws."[16] The Court explained that class action waivers should not be enforced if the court determines, based on a set of factors, that class arbitration would "be a significantly more effective way of vindicating the rights of the affected employees than individual arbitration."[17] The factors are (1) the small size of potential individual recovery; (2) the potential for retaliation against members of the class by the employer; (3) the fact that absent class members may be ill informed of their rights; and (4) other real world obstacles to vindicating the rights through individual arbitration.[18]

The California courts of appeal have issued conflicting opinions on the applicability of the *AT&T Mobility* decision to class action waivers in the wage and hour context.[19]

In *Brown v. Ralphs Grocery Company*,[20] which was issued two months after *AT&T Mobility*, the court analyzed a mandatory arbitration agreement that prohibited class actions

as well as representative actions under the California Private Attorney General Act ("PAGA").[21] The court of appeal held that the PAGA representative action waiver was unconscionable and unenforceable, notwithstanding *AT&T Mobility*.[22] The court also noted that although it lacked the power to invalidate the California Supreme Court's decision in *Gentry*, the employee had failed to make a sufficient evidentiary showing that the class action waiver was unconscionable in the particular case.[23]

On July 18, 2012, a California court of appeal issued an opinion in *Nelsen v. Legacy Partners Residential*, *Inc.,* affirming an order compelling individual arbitration of a class action plaintiff's claims.[24] The court in *Nelsen* did not expressly disagree with *Brown v. Ralphs Grocery*. Rather, the court held that the plaintiff had failed to make a proper showing of the four factors listed by the court in *Gentry* that would lead a court to conclude that public policy renders an agreement to arbitrate only on an individual basis a violation of state public policy.[25] The California Supreme Court did not accept review of this case. Likewise, the court in *Truly Nolen of America v. Superior Court* explained that the *AT&T Mobility* decision did not directly rule on the issue of class arbitrations in the context of unwaivable statutory rights. Thus, the court stated it was still bound by *Gentry*.[26] However it questioned the validity of *Gentry.*[27] Nevertheless, the court reinterpreted *Gentry* to try to make it more consistent with *AT&T Mobility.* The Court of Appeal in *Truly Nolen* ruled that the trial court had used too lenient of a standard on the four *Gentry* factors.[28] The court noted that "assuming that the *Gentry* standard survives the United States Supreme Court holdings, the factual analysis as to whether the *Gentry* factors apply in any particular case must be specific, individualized, and precise."[29] The requirement of an individualized factual analysis of the four factors may lead to enforcement of arbitration agreements on an individual basis. In many cases, the individual plaintiffs have the potential to recover substantial amounts of wages and penalties and have the right to attorneys' fees, if they prevail. Moreover, given the customary limited time of discovery before the defendant moves to compel arbitration, plaintiffs may have a hard time building a sufficient record to meet the four *Gentry* factors.

On the other hand, the California court of appeal, in *Iskanian v. CLS Transportation Los Angeles, LLC* held that the U.S. Supreme Court's reasoning in *AT&T Mobility* that invalidated the California Supreme Court's decision as to consumer contracts also invalidated the *Gentry* decision.[30] The court of appeal noted that a California appellate court may properly recognize that the U.S. Supreme Court has overruled the California Supreme Court's interpretation of federal law.[31]

The plaintiff in *Iskanian* also argued that the individual arbitration could not be required for PAGA claims because PAGA was enacted for the purpose of enforcing the California Labor Code through deputizing private attorneys general, and private arbitration agreements cannot undermine such private attorney actions.[32] The *Iskanian* court disagreed with the *Brown v. Ralphs Grocery* decision and held that a state cannot insulate certain kinds of claims from arbitration.[33] Finally, based on the National Labor Relations Board's decision in *D.R. Horton,*[34] the plaintiff in *Iskanian* argued against requiring individual arbitration. The NLRB had held that, as a matter of federal law, the National Labor Relations Act[35] precluded mandatory individual arbitration of employment claims.[36] The *Iskanian* court noted that the U.S. Supreme Court in *CompuCredit Corp. v. Greenwood*[37] had held that a federal statute precludes mandatory arbitration only if there is clear "congressional command" to that effect.[38] The *Iskanian* court found no such command in the National Labor Relations Act and thus rejected the argument.[39]

Finally, on November 26, 2012, the court of appeal held in *Franco v. Arakelian Enterprises, Inc.* held that *Gentry* remains good law and is the proper authority for reviewing class action waivers in arbitration agreements.[40] The court explained that the FAA preempted the *Discover Bank* rule because the rule "operated as a categorical prohibition on class action waivers…."[41]. The *Arakelian* court held that *Gentry* was not a categorical rule against class action waivers but rather was a multifactor test applied on a case-by-case basis.[42]

The *Arakelian* court further concluded that *AT&T Mobility* did not address whether an arbitration agreement is enforceable if it fails to ensure that parties can vindicate their claims.[43] The court cited to a line of Supreme Court decisions that hold an arbitration agreement is unenforceable if the claimant is prevented from vindicating his or her statutory rights.[44] The *Arakelian* court concluded that preemption under *AT&T Mobility* occurs "if the arbitration process would make a prevailing claimant whole, but the amount in dispute is so small that a claimant does not think it worth the effort to pursue relief."[45] However, the court found, preemption does not occur "if the claimant lacks the means to pursue a claim in arbitration because the cost of pursuing relief on an individual basis—whether in arbitration or court—exceeds the potential recovery."[46] The court concluded that the plaintiff in *Arakelian* lacked the means, but not the incentive, to pursue his rest and meal period claims on an individual basis in

arbitration.[47] The plaintiff's attorneys had submitted evidence that it would be highly unlikely that an attorney would represent him on an individual basis in either arbitration or in court. The court concluded that the claim could not be vindicated unless it can be brought as a class action.[48]

Following the granting of the petition for review in *Iskanian*, the California Supreme Court will review (1) whether its *Gentry* decision has been overruled, and (2) whether arbitration agreements can preclude the right to bring a PAGA representative action.[49] It is difficult to predict when the California Supreme Court will issue a decision in *Iskanian*. Until then, the California courts will struggle with the applicability of *Gentry* in light of *AT&T Mobility*.[50]

Employers should stay apprised of developments regarding their ability to restrict class actions through waivers in arbitration agreements.

Recent Decisions on Social Media Policies under the National Labor Relations Act

Section 7 of the National Labor Relations Act (the "NLRA") provides employees the right to engage in concerted activities for their "mutual aid or protection."[51] Section 7 has been interpreted to include employee communications with each other about their terms and conditions of employment.[52] The National Labor Relations Board ("NLRB") has also ruled that employees have the right to communicate to third parties, such as the general public, about ongoing labor problems or disputes.[53] These basic principles are now being applied to the use of social media by employees and to the attempts of employers to control or limit such communications.

On September 7, 2012, the NLRB issued its first decision on an employer's social media policy in *Costco Wholesale Corp. and the Food and Commercial Workers' Union, Local 371*.[54] In that case, the NLRB held that Costco violated Section 7 of the NLRA by maintaining a rule prohibiting employees from electronically posting statements that damage the company or damage any person's reputation. The NLRB found that Costco's broad prohibition against making statements damaging to the company, defaming an individual, or damaging a person's reputation clearly encompassed concerted communications that might protest Costco's treatment of its employees.[55] The NLRB also found that there was nothing in the company's rule to suggest that the broad prohibition excluded "protected activities."[56] The NLRB concluded that the rule required the employees to refrain from engaging in protected communications and thus the policy was unlawful.[57]

Shortly thereafter, an administrative law judge struck down EchoStar's social media policy in *EchoStar Technologies LLC and Gina M. Leigh*.[58] EchoStar's social media policy was found in its employee handbook. Notably, it contained a savings clause that stated that should a conflict arise between the company policy and the law, the appropriate law should be applied and interpreted so as to make the policy lawful in that particular jurisdiction. The social media policy specifically prohibited employees from making disparaging or defamatory comments about EchoStar, its employees, officers, directors, vendors, customers, partners, or any of its or their products or services. The administrative law judge found that the savings clause did not save the policy because a reasonable employee would not understand that the savings clause applied to the policy.[59]

On November 14, 2012, a different administrative law judge ruled that a Dish Network Corp social media policy violated the NLRA.[60] The policy had banned employees from making "disparaging or defamatory comments" about the company. The judge also found that the company's media policy violated the Section 7 rights of employees because it required employees to obtain prior authorization from management before speaking about Dish Network to the media or at public meetings.[61]

Landmark Ruling on Meal and Rest Breaks

In April 2012, the California Supreme Court decided *Brinker Restaurant Corporation v. Superior Court*.[62] The key issue before the Court was the parameters of an employer's obligation to provide a meal period. The Court held that the meal period requirement is satisfied if the employee has at least 30 uninterrupted minutes for the meal, is free to leave the premises, and is relieved of all duty for the entire period. The employer may not undermine a policy of providing meal breaks by pressuring employees to perform their duties in ways that omit breaks.[63] On the other hand, employers are not obligated to police meal breaks and assure no work is performed. Once the employee is relieved from duty and no longer subject to the control of the employer, any work by the relieved employee during a meal break does not place the employer in violation of its obligations nor create liability for premium pay under the wage orders.[64] After deciding the *Brinker* case, the California Supreme Court returned several cases to the lower courts for further consideration in light of the principles set out in *Brinker*.[65]

Several decisions have been issued since the *Brinker* opinion relating to meal and rest break obligations and

to motions for class certification of such claims. The first decision of a Court of Appeal to be published was *Hernandez v. Chipotle Mexican Grill, Inc*. but the Supreme Court ordered that the opinion be depublished.[66] The Court of Appeal affirmed the trial court's order denying class certification based on lack of commonality, superiority, manageability, and because conflicts of interest permeated the class. The Court of Appeal ruled that the law requires that employers must "provide," but not ensure, that employees take meal and rest breaks.[67] The court further elaborated that the employer is not obligated to police meal breaks and ensure that no work is performed.[68] In light of the legal obligations to provide but not ensure meal breaks, the Court of Appeal affirmed the trial court's decision that class certification was not warranted. The employee did not show evidence of a common practice or policy that violated the law, and the court concluded that individual issues predominated.

In early September, the Court of Appeal in *Flores v. Lamps Plus, Inc.*[69] affirmed the decision of the trial court to deny certification of meal and rest break claims, saying, "[t]he notion that an employer must ensure all employees take their meal and rest periods is utterly impractical."[70] But that case was ordered depublished by the California Supreme Court.[71]

On the other hand, the Court of Appeal in *Bradley v. Networkers Int'l, LLC*, following remand from the California Supreme Court after *Brinker*, concluded that the class claims for meal and rest breaks should be certified.[72] The employer had no policy on meal or rest breaks and had not given any notification to the workers of their entitlement to take meal or rest breaks.[73] The Court of Appeal noted that the plaintiffs' theory of recovery (the lack of the meal and rest policy and the employer's failure to authorize the employees to take the breaks) was based on matters of common proof.[74] The company argued that common proof was lacking because the issues of which employees had missed breaks and how many breaks were missed and whether the breaks were missed because of the lack of a policy required a mini-trial on each class member's case. The Court rejected this argument and reasoned that the fact an employee may have actually taken a break does not show that individual issues will predominate when an employer has not authorized and not provided legally-required meal or rest breaks.[75]

Employers should review their written meal and rest break policies. Courts are more likely to certify a class for meal or rest break claims if the policies do not comply with the legal standards. Moreover, the California courts are still examining the parameters of the employer obligations regarding meal and rest breaks.

Endnotes

1 Cal. Gov't. Code § 12940 *et seq.*

2 Cal. Code Regs. tit. 2 § 7293.3(c).

3 Cal. Govt. Code § 12926(t).

4 Cal. Govt. Code § 12926(q).

5 *See* Cal. Lab. Code §§ 1030-1033.

6 Cal. Assembly Bill No. 2387, Section 2.

7 182 Cal.App.4th 567 (2011).

8 Cal. Assembly Bill 2103, Section 1.

9 Cal. Gov't. Code §§ 12650-12655.

10 *See* Peter M. Menard, *California Transparency in Supply Chains Act*, Bus. Law News (State Bar of California, S.F., Cal.), Issue 3, 2011.

11 Cal. Bus. & Prof. Code §§ 23000-23047.

12 ___ U.S. ___, 131 S. Ct. 1740 (2011).

13 9 U.S.C. §§ 1-16.

14 *Discover Bank v. Superior Court*, 36 Cal.4th 148 (2005).

15 42 Cal.4th 443 (2007).

16 *Id.* at 450.

17 *Id.*

18 *Id.* at 463.

19 *See Reyes v. Liberman Broadcasting, Inc.*, 208 Cal.App.4th 1537, 1546–1549 (2012), which examines the conflicting decisions on whether *Gentry* remains good law after *AT&T Mobility*.

20 197 Cal.App.4th 489 (2011).

21 Cal. Lab. Code § 2698 *et seq.*

22 197 Cal.App.4th at 503.

23 *Id.* at 498.

24 207 Cal.App.4th 1115 (2012).

25 *Id.* at 1132.

26 208 Cal.App.4th 487, 493 (2012).

27 *Id.* at 507.

28 *Id.* at 510-511.

29 *Id.* at 511.

30 206 Cal.App.4th 949 (2012), *review granted* 147 Cal. Rptr.3d 372 (Sept. 12, 2012).

31 *Id.* at 961-962.

32 *Id.* at 963-964.

33 *Id.* at 965.

34 357 NLRB No. 184 (2012), (which is on appeal to the Fifth Circuit Court of Appeals).

35 29 U.S.C. §§ 151-169.

36 357 NLRB No. 184.

37 ___ U.S. ___, 132 S.Ct. 665 (2012).

38 206 Cal.App.4th at 962-963.

39 *Id*.

40 __ Cal.App.4th ___, 2012 WL 5898063 (2012).

41 *Id*. at 35.

42 *Id*. at 37.

43 *Id*. at 38.

44 *Id*. at 42.

45 *Id*. at 40.

46 *Id*.

47 *Id*.

48 *Id*. at 41.

49 California Supreme Court Case Summary, Case 504032.

50 Furthermore, the *D.R. Horton* issue of whether the NLRA precludes a class action waiver may be affected by the upcoming decision of the U.S. Supreme Court in *In re American Exp. Merchants Litigation* (2d Cir. 2012) 667 F.3d 204, 219, certiorari granted *sub nomine, American Express Co. v. Italian Colors Restaurant*, Nov. 9, 2012, No. 12-133 [2012 WL 3096737]. The following question will be addressed: "whether the Federal Arbitration Act permits courts, invoking 'federal substantive law of arbitrability', to invalidate arbitration agreements on the ground that they do not permit class action arbitration of a federal-law claim." The Second Circuit had held that a class action waiver in an arbitration agreement between American Express and the plaintiff Merchants was unenforceable because it would effectively preclude the plaintiffs from vindicating the federal statutory rights under the Sherman and Clayton Acts.

51 29 U.S.C. §157.

52 See, e.g., *Cintas Corp.,* 344 NLRB 943, 943 (2005), enf'd. 482 F.3d 463, 465 (D.C. Cir. 2007).

53 *Id.*

54 358 NLRB No. 106 (2012).

55 *Id.* at p. 2.

56 *Id.* at p. 2.

57 *Id*. On May 30, 2012, the Acting General Counsel for the NLRB issued an updated report on employer social media policies. According to this report, social media policies that are ambiguous concerning their application to Section 7 activity and that do not contain limiting language or context that would clarify to employees that their Section 7 rights are not restricted would be found unlawful. Moreover, the report notes that an employer's "savings clause" in a handbook likely will not cure an overbroad and thus unlawful restriction on electronic communication because, according to the NLRB, employees may not understand that protected activities are permitted. While the report is instructive to employers, the Acting General Counsel does not have the authority to issue NLRB binding policy.

58 Case no. 27-CA-066726 (Sept. 20, 2012).

59 *Id.* at 24.

60 Decision in *Dish Network Corp*., case numbers 16—CA—62433, 16—CA—66142, and 16—CA—68261 (Nov. 14, 2012).

61 *Id.* at 9.

62 53 Cal.4th 1004 (2012).

63 *Id.* at 1040-1041.

64 *Id.* at 1040-1041.

65 *See, e.g.*, *Brinkley v. Public Storage, Inc.,* 167 Cal.App.4th 1278 (2008), *review granted* 87 Cal.Rptr.3d 674 (2009); *Falkinbury v. Boyd & Assoc's.* 185 Cal.App.4th 1363 (2010), review granted, 117 Cal.Rptr.3d 1 (2010), review granted, 117 Cal.Rptr.3d 1 (2010); *Hernandez v. Chipotle Mexican Grill*, 189 Cal.App.4th 751 (2010), *review granted*, 120 Cal.Rptr.3d 530 (2011); *Muldrow v. Surrex Solutions Corp.,* 202 Cal.App.4th 1232 (2012), *review granted* 2012 Cal. LEXIS 3472 (2012); *Tien v. Tenet Healthcare Corp.,* 192 Cal.App.4th 1055 (2011), *review granted*, 124 Cal. Rptr.3d 829 (2011).

66 208 Cal.App.4th 1487 (2012), *review denied* and ordered not published by California Supreme Court on December 12, 2012.

67 *Id.* at 1498-1499.

68 *Id.* at 1499.

69 209 Cal.App.4th 35 (2012), *reviewed denied* and ordered not published by the California Supreme Court order on December 12, 2012.

70 *Id.*; *see also Tien v. Tenet Healthcare Corp.,* 209 Cal. App.4th 1077, 1083 (2012) ("Employer satisfies its obligation to 'provide' a meal period by making meal periods available") (review denied and ordered not published by the California Supreme Court order on January 16, 2013); *Muldrow v. Zurrex Solutions Corp.,* 208 Cal.App.4th 1381, 1384 (2012) ("Zurrex only had to provide for such breaks, even if they were not taken.")

71 *See supra* note 69.

72 211 Cal.App 4th 1129 (2012) (as modified January 8, 2013).

73 *Id.* at 1149.

74 *Id.* at 1150.

75 *Id.* at 1151.

Strange Changes – Coverage Reductions in Renewal Policies are Not Enforceable Without Conspicuous, Clear and Specific Notice

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Companies and individuals often spend considerable time and effort selecting an insurer and an insurance policy that meets their needs. Once the initial policy period expires, it is common for policyholders to renew their insurance policies with the same insurer, while expecting that the renewal policy will provide the same coverage as the original policy. In many cases, insurance policies are renewed for several years before an incident takes place or a claim arises, and often it is the policy in effect at that time that applies to the specific matter. However, this is not always the case.

For example, as demonstrated by the cases discussed below, when an insurer renews a policy and makes changes that narrow the coverage or reduce the limits, the insurer must inform the customer of the specific changes made and must do so in a manner and with language that is conspicuous, plain, and clear.[1] Providing the insured with a copy of the revised policy language, advising the insured to read the new policy, or telling the insured that the policy has changed is not enough. When insurers have failed to provide the requisite notice, courts have held that the revised policy language is invalid and that the original policy language applies.[2]

Industrial Indemnity Co.

In *Industrial Indemnity Co. v. Industrial Accident Commission of California,*[3] the insurer issued a policy of "workmen's" compensation insurance to a partnership and to its two partners covering all of their employees for the period from January 22, 1946, to January 22, 1947. On the subject of whether relatives were excluded, the policy provided that if a partnership was the insured it would not include partners, but nothing was said as to relatives of the partners. The policy further provided that if it was issued to an "individual" then such individual's relatives were not covered. Thus, the court explained, it could be reasoned that, as long as the insured was a partnership, the employees of the partnership would not be excluded even though related to one of the partners, but when an individual was the insured, his relatives were excluded.[4]

While that policy was in effect, one of the partners, Mr. Schultz, sold his interest in the partnership business to the other partner, Mr. Cornish, in July 1946, and the partnership was dissolved on August 1, 1946. The insurer cancelled the policy that had been issued to the partnership and issued a new policy to Cornish, as an individual and not as a partnership, covering the period August 1, 1946 to August 1, 1947. According to the court, the evidence clearly indicated that Cornish only had sought to change the name of the insured from a partnership to him as the succeeding individual owner without any reduction in coverage. However, the clauses in the new policy with respect to non-coverage for relatives of individuals were the same as in the previous policy that had been issued to the partnership.

An accident took place on December 10, 1946, in which Cornish's son-in-law was killed while working for him. According to its terms, the insurance policy did not apply to the loss because the deceased employee was a relative of the insured. In the course of discussing whether the policy issued to Cornish as an individual should be reformed to provide the same coverage for employees as had been provided by the original policy issued to the partnership, the court discussed California Insurance Code section 304. That section provided, "[i]n the case of partners, joint owners, or owners in common, who are jointly insured, a transfer of interest by one to another thereof does not avoid insurance, even though it has been agreed that the insurance shall cease upon an alienation of the subject insured."[5] The court explained that section 304 indicated that the "interest in the insurance" passes when one partner buys out the others, and that the interest should embrace the character of the employees covered.[6]

The court also stated, "[t]here is some analogy to the renewal cases in the policy expressed by section 304 of the Insurance Code. Where an insured requests an existing but expiring policy to be renewed, no change may be made in the terms of the renewal policy without notice to the insured."[7] As examples of the "renewal cases," the court cited two out-of-state cases.[8] The court concluded that,

under the circumstances of this case, section 304 of the Insurance Code preserved the coverage in effect under the original policy although one of the partners bought the other's interest.[9]

Sorensen

In *Sorensen v. Farmers Insurance Exchange*,[10] the plaintiff was struck by an uninsured motorist while riding his motorcycle in 1973. His insurer denied coverage based on an exclusion in his policy that was in effect at the time of the incident.

Several years earlier, plaintiff had obtained a family automobile policy from Farmers on a 1959 Ford station wagon. Plaintiff did not own a motorcycle then, but he sometimes rented them. The agent for Farmers told plaintiff that he also had coverage under this policy while riding a motorcycle, and the policy provided uninsured motorist benefits for plaintiff while occupying a motor vehicle "or otherwise."

In 1968, California Insurance Code section 11580.2 was amended to permit insurers to exclude coverage for bodily injury of the insured while occupying a motor vehicle owned by an insured that is not an insured motor vehicle.

Plaintiff purchased a new automobile in 1970 and informed Farmers of the change of vehicles. He received a new edition of his automobile policy that excluded coverage to the insured if caused by an uninsured motorist unless the vehicle occupied by the insured was itself insured. A letter accompanying the new policy stated that the "most significant" change to the policy as compared to the previous policy "involves stereo tapes and tape players." The insurer's letter did not mention the change in the policy removing the uninsured motorist coverage that had been in the previous policy.

Plaintiff purchased a motorcycle in 1972. He obtained insurance coverage from the seller of the motorcycle through another insurance company for comprehensive and liability coverage only. Plaintiff testified that he specifically waived uninsured motorist coverage on the policy because he believed he was covered by the Farmers policy.

After Plaintiff was struck while riding his motorcycle in 1973, Farmers denied coverage based on the policy exclusion in the new policy it had issued in 1970. Plaintiff sued the insurer and claimed that the new policy's exclusion should not apply. He argued that the insurer had a duty to inform him of the material change in the terms of his uninsured motorist coverage, and that its failure to do so required it to cover him under the terms of his original policy.

Farmers did not dispute that it had not provided plaintiff with any specific notice of the change to his uninsured motorist coverage. Instead, Farmers argued that plaintiff had received notice of the change in coverage because he had received the new policy and the new policy contained the new exclusion.

The court of appeal noted that the original policy contained a provision requiring the insurer to provide a notice describing any reduction in coverage at least 10 days before going into effect.[11] The court stated that "merely" setting forth the new exclusionary clause in a subsequent policy does not comply with the original policy's notice requirement.[12] The court also noted that the letter accompanying the new policy ignored the new exclusion for uninsured motorist coverage while referring to another coverage change, and it would not be unreasonable under the circumstances for the insured to read only the changed provision identified in the letter.[13]

The court of appeal went on to explain that the insurer's attempt at a "buried notice" violated several fundamental principles found in this field of law:[14] (1) "[a]n insurer cannot escape its basic duty to insure by means of an exclusionary clause that is unclear"[15] and "any exception to the performance of the basic underlying obligation must be so stated as clearly to apprise the insured of its effect;"[16] (2) "[i]nterpretation of an insurance policy must be pursued in light of the insured's reasonable expectations;"[17] and (3) "[a]ny ambiguity or uncertainty in an insurance policy is to be resolved against the insurer."[18]

In addition, the court of appeal noted that the faces of the original and new policies showed boxes marked for uninsured motorist coverage, and there was "no indication in this facial gloss that the insured's coverage has been qualified or modified in any manner."[19] The court concluded that Farmers did not notify plaintiff by a conspicuous, plain, and clear notice that the coverage he originally had was "greatly reduced" by the new policy and held that plaintiff was entitled to the coverage contained in the original policy.[20]

Fields

Fields v. Blue Shield of California[21] arose out of an insurer's refusal to pay for the insured's psychotherapy under a group medical policy. The insured was a medical doctor who wished to become a psychoanalyst. To attain such a career goal, he enrolled in a psychoanalytic training institute and was required to complete 300 hours of personal psychoanalysis. The insured began receiving psychoanalysis in October 1974, and was subsequently diagnosed with a mental illness. The insured also received credit for the training analysis requirement from the time his analysis began in 1974.

When the insured enrolled in a group health insurance plan in June 1975, the policy had a supplemental benefits section providing coverage for psychotherapy for treatment of nervous and mental illness, with an exclusion for "marital, family or other counseling or training services." The insurer changed the policy that would go into effect in January 1976 to add an exclusion in the supplemental benefits section for "[p]sychoanalysis or psychotherapy . . . that is credited towards earning a degree or furtherance of the education or training of a Subscriber, regardless of diagnosis or symptoms that may be present."

In late 1975, the insured obtained a copy of the brochure for the plan that would go into effect in 1976. The new exclusion was contained at page 20 of the 32-page benefit plan in the "supplemental payments" section. On page 31 of the benefit plan, Blue Shield notified its insureds in bold type: "How Plan Changes In January 1976." The insurer warned that the brochure had been reorganized and should be read in its entirety. The booklet then stated: "[i]n addition to many clarifications, the following benefit changes are effective January 1, 1976." The insurer then listed several specific coverage changes, including new coverage for hypnosis and hypno-therapy, which had not been covered under the 1975 plan, and two reductions in benefits, but did not refer to the new exclusion for psychotherapy, also used in furtherance of training, set forth at page 20.

The insurer paid for the insured's psychoanalysis treatment until 1978, when it disallowed benefits based on the 1975 policy language "as clarified in the 1976 plan." The insured filed suit and the insurer prevailed at trial.

On appeal, the insured argued that the insurer could not enforce the reduction of benefits in 1976 because as a modification, and as an exclusion, it was not conspicuous, plain, and clear as required by California law. The court of appeal explained, "[i]t is a long-standing general principle applicable to insurance policies that an insurance company is bound by a greater coverage in an earlier policy when a renewal policy is issued but the insured is not notified of the specific reduction in coverage."[22]

The court of appeal also referred to previous California appellate decisions demonstrating that, in the case of standardized insurance contracts, made between parties of unequal bargaining strength, "exceptions and limitations on coverage the insured could reasonably expect must be called to the subscriber's attention clearly and plainly before the exclusion will be interpreted to relieve the insurer of the liability." [23] The court noted that the new coverage exclusion in the 1976 policy was not placed in the limitation or exclusion section, but at the end of benefit granting provisions, and that the insurer did not notify the insured by a clear, conspicuous notice in an expected place that the coverage he originally had was totally withdrawn.[24]

Regarding the insurer's notice to the policy to read the entire policy, the court stated that "such direction is not a substitute for notice to the subscriber of a loss of benefit."[25] The court also explained, "[t]he rule is and should be: Deletions or exclusions from a renewal group policy should be communicated and explained to the subscriber by a plain, clear and conspicuous writing. The prominent and express listing of certain specific changes whether grants or exclusions coupled with the omission of very specific exclusion of coverage, can only mislead the subscriber. Reduction of benefits, to be effective, cannot be placed in an unconspicuous place under the heading 'Supplemental Benefits.'"[26]

Fibus

In *Allstate Insurance Co. v. Fibus,*[27] the Ninth Circuit applied California law and ruled that an insurer's notice of policy changes was inadequate. The insurer issued an automobile insurance policy to the insured that contained a limit of liability of $100,000 per person and $300,000 per occurrence. The policy stated that the $100,000 limit for each person would apply to all damages because of bodily injury sustained by one person in any single accident. When the policy was renewed, the insurer added language to this provision stating that the $100,000 limit would include not only the damages to the person that suffered the bodily injury, but also to all resulting damages sustained by any other person. While the renewal policy was in effect, the insured was involved in an accident and another person was severely injured. The insurer paid $100,000 to the injured person, but would not pay the loss of consortium claim of the injured person's spouse.

In a lawsuit filed in federal court against the insurer, the insured asserted that the insurer did not properly notify the insured of the reduction in coverage and this failure rendered the policy amendment inoperative. The trial court ruled in favor of the insurer and the insured appealed. The Ninth Circuit quoted from and cited *Fields* for the propositions that "an insurance company is bound by a greater coverage in an earlier policy when a renewal policy is issued but the insured is not notified of the specific reduction in coverage" and "[t]o be adequate, notice must be conspicuous, plain, and clear."[28]

The insurer argued that it had properly notified the insured of the policy change because before it issued the

renewal policy it allegedly sent an eight-page "Amendatory Endorsement" to the insured that set forth the changes in the renewal policy. The first page of this document stated that the section of the original policy containing the $100,000 limit of liability had "been replaced by the following" and then set forth the language of the new section. The Ninth Circuit noted that the insurer had not highlighted any of the language of the new section, and thus the insurer had not identified what was new or different within the new section as compared to the original version. The court thus ruled that the insurer's Amendatory Endorsement did not conspicuously notify the insured of a reduction in coverage.[29]

Davis

In *Davis v. United Services Automobile Ass'n*,[30] the insurer issued an "all-risk" insurance policy to a homeowner and then renewed the policy for several years. When first issued in 1978, the policy used the "HO-3" policy form, which excluded coverage for loss resulting from earth movement. This same form was used when the policy was renewed during each of the next five years.

The insurer issued a renewal policy in 1984 with a new "HO-82" form that had the earth movement exclusion and also contained a new exclusion for loss caused by contractor negligence. The insurer also issued a chart to the homeowner comparing coverages of the old and new policies. The insurer further provided a notice stating that the new policy contained some changes and that the insurer hoped that the homeowner would read the entire new policy and, in particular, the section containing the coverage exclusions. However, the chart and the notice from the insurer did not specifically mention the new exclusion for loss caused by contractor negligence.

In 1986, the insurer renewed the policy with a new policy form, "HO-84", that continued the exclusions for earth movement and contractor negligence and added additional exclusions relating to contractor negligence. The insurer also issued a notice summarizing coverage changes in the new policy, including a section discussing policy exclusions. This section had three subparts for broadening of coverage, reduction of coverage, and clarification of coverage. The reduction of coverage section did not refer to the exclusion for contractor negligence. The "clarification" section stated that the insurer was attempting to clarify that the original policy intent was not to provide coverage for losses caused by or contributed by an excluded peril and added three new exclusions for weather conditions, acts or decisions, and faulty, inadequate, or defective planning, development, design, specifications, materials, or maintenance.

The homeowner sustained a loss to the home in 1986 due to soil subsidence. The insurer's investigation revealed that there were two causes of the loss: earth movement and the negligence of a contractor in failing to reinforce the foundation slab and properly prepare the subgrade soils. The insurer denied coverage based on the exclusions in the HO-84 policy form. The homeowner sued the insurer and asserted that the original HO-3 policy form, which did not exclude coverage for loss resulting from contractor negligence, should apply because the insurer had failed to notify the homeowner that the later HO-82 and HO-84 forms had the contractor negligence exclusion. The trial court and the court of appeal agreed with the homeowner.

The court of appeal quoted the *Fields* rule that an insurer must notify the insured of the specific reduction in coverage when a renewal policy is issued.[31] The court rejected the insurer's argument that *any* notice that the policy contains changes is sufficient to satisfy the insurer's duty.[32] "The law, however, requires notice of the *specific* reduction in coverage; a general admonition to read the policy for changes is insufficient."[33]

The court also stated that the insurer's chart comparing the policy changes was misleading because it made no mention of the new contractor negligence exclusion when discussing changes in the policies.[34] In addition, the court of appeal agreed with the trial court's finding that the notice accompanying the HO-84 form was ambiguous and did not provide clear and conspicuous notice of an exclusion for contractor negligence.[35] As a result, the court held that, since the insurer failed to provide adequate notice of the exclusion for contractor negligence in the HO-84 and HO-86 policy forms, the original HO-3 policy applied to cover the loss.[36]

Classic Distributing

Most recently, *Classic Distributing and Beverage Group, Inc. v. Travelers Casualty and Surety Co. of America*,[37] involved a dispute over an insurance claim arising under an employment practices liability ("EPL") policy issued to a company. The company initially had purchased an EPL policy from the insurer in October 2006. The company renewed the policy with the insurer in October 2007 and the insurer added a new Wage and

Hour Claim Exclusion endorsement that narrowed the policy's coverage as compared to the original policy. The policy was renewed in October 2008 and again contained the Wage and Hour Claim Exclusion endorsement that was not in the original policy.

The company was sued by its employees in April 2009 for violations of the California Labor Code. The insurer agreed to provide a defense under the policy that went into effect in October 2008, but it refused to provide independent defense counsel, and it reserved its rights to deny coverage for all claims based on the terms of the Wage and Hour Claim Exclusion. The company reached a settlement of the employees' lawsuit and sued the insurer in federal district court in California to recover independent counsel fees and indemnification for amounts payable under the settlement agreement.

The company asserted that the new Wage and Hour Claim Exclusion contained in the 2008 policy was invalid because the insurer had not provided adequate notice of the new exclusion. In its memorandum and order regarding the parties' motions for summary judgment, the district court noted that "[i]t is a long-standing general principle applicable to insurance policies that an insurance company is bound by a greater coverage in an earlier policy when a renewal policy is issued but the insured is not notified of the specific reduction in coverage" and cited several California cases.[38] The district court also stated that the Ninth Circuit had adopted and applied the "renewal rule" on more than one occasion.[39]

Applying the renewal rule, the court found that the insurer's notice of the new Wage and Hour Claim Exclusion was inadequate and held that the new exclusion was unenforceable.[40] The court noted that the EPL policy was nearly one hundred pages long and the exclusion was contained in an endorsement attached to the end of the policy, rather than in the body of the policy, along with other endorsements.[41] Like several other endorsements, it was labeled "This Endorsement Changes The Policy. Please Read It Carefully" and also had the label "Wage and Hour Claim Exclusion."

In addition, the court noted that the company's insurance broker stated in a declaration that the insurer had provided the company with no specific notice separate from the policy itself to direct the company's attention to the new exclusionary endorsement.[42] Further, when the insurer sent the broker a quote for renewal of the policy for the 2007–2008 policy period, the insurer did not include the endorsement. Regarding the insurer's contention that the company's insurance broker must have had notice of the endorsement because he admitted that it was included in the renewal policy issued in 2007, the court described this statement as "something of a non-sequitur" which "completely sidesteps the case law cited above concerning what constitutes adequate notice of material reductions in coverage."[43]

Conclusion

The cases discussed above demonstrate that California law requires insurers to provide specific notice of any reductions or limitations in coverage to their insureds in a manner that is clear, plain, and conspicuous. An insurer's failure to do so renders the new reductions or limitations invalid. This has been the law in California for many decades, yet insurers still sometimes fail to meet these requirements. Thus, whenever an insurer declines to provide full coverage for a claim, it may be beneficial to investigate whether the insurer is relying on policy terms that are different than those in an earlier version of the policy and if the insurer has met all the requirements of providing notice of the policy changes. ■

Endnotes

1 *See, e.g., Sorensen v. Farmers Ins. Exch.*, 56 Cal. App. 3d 328 (1976); *Fields v. Blue Shield of Cal.,* 163 Cal. App. 3d 570 (1985); *Davis v. United Services Auto. Ass.n,* 223 Cal. App. 3d 1322 (1990); *Allstate Ins. Co. v. Fibus,* 855 F.2d 660 (9th Cir. 1988).

2 *Id; See also Indus. Indem. Co. v. Indus. Accident Comm'n of Cal.,* 34 Cal. 2d 500 (1949).

3 34 Cal. 2d 500.

4 *Id.*

5 *Id.* at 505.

6 *Id.*

7 *Id.* at 506.

8 *Id.* (citing *Conn. Fire Ins. Co. v. Oakley Improved Bldg. & Loan Co.*, 80 F.2d 717 (6th Cir. 1936); *Ouachita Parish Police Jury v. N. Ins. Co. of N. Y.*, 176 So. 639 (La. Ct. App. 1937)).

9 *Id.* at 507.

10 56 Cal. App. 3d 328 (1976).

11 *Id.* at 332.

12 *Id.* at 333.

13 *Id.*

14 *Id.*

15 *Id.* (quoting *State Farm Mut. Auto. Ins. Co. v. Jacober,* 10 Cal. 3d 193, 201 (1973)).

16 *Id.* at 333.

17 *Id.* (quoting *Gray v. Zurich Ins. Co.*, 65 Cal. 2d 263, 270-74 (1966)).

18 *Id.* at 333 (quoting *McKinney v. Farmers Ins. Exch.*, 32 Cal. App. 3d 947, 950 (1973)).

19 *Id.* at 334.

20 *Id.*

21 163 Cal. App. 3d 570 (1985).

22 *Id.* at 579 (citing *Indus. Indem. Co. v. Indus. Accident Comm'n of Cal.,* 34 Cal. 2d 500, 506 (1949); *Sorensen v. Farmers Ins. Exch.*, 56 Cal. App. 3d 328, 333 (1976)).

23 *Id.* at 579 (citing *Steven v. Fidelity & Cas. Co. of N. Y.,* 58 Cal. 2d 862, 879 (1962); *Logan v. John Hancock Mut. Life Ins. Co.,* 41 Cal. App. 3d 988, 996 (1974); *Sorensen*, 56 Cal. App. 3d at 333; *Miller v. Elite Ins. Co.,* 100 Cal. App. 3d 739, 752 (1980); *Ponder v. Blue Cross of S. Calif.,* 145 Cal. App. 3d 709, 718 (1983)).

24 *Id.* at 579.

25 *Id.* at 583.

26 *Id.*

27 855 F.2d 660 (9th Cir. 1988).

28 *Id.* at 663 (quoting and citing *Fields v. Blue Shield of Cal.,* 163 Cal. App. 3d 570 (1985)).

29 *Id*. The court remanded the case to the district court for further litigation concerning whether the insurer used means other than the Amendatory Endorsement to notify the insured. *Id.* at 663-64.

30 223 Cal. App. 3d 1322 (1990).

31 *Id.* at 1332.

32 *Id.*

33 *Id.*

34 *Id.*

35 *Id.* at 1333.

36 *Id.*

37 No. CV 11–07075 GAF (RZX), 2012 WL 3860597 (C.D. Cal. Aug. 29, 2012). Following the issuance of the court's memorandum and order on August 29, 2012, the parties filed a notice of settlement and a joint application to vacate the August 29, 2012 memorandum and order, which the court granted on November 6, 2012.

38 *Id.* at *6.

39 *Id.* (citing *Lexington Ins. Co. v. Devaney,* 50 F.3d 15, No. 93-16284, 1995 WL 105985, at *1 (9th Cir. Mar. 9, 1995) (unpublished); *Allstate Ins. Co. v. Fibus*, 855 F.2d 660, 663 (9th Cir. 1988)).

40 *Id.* at *6-7.

41 *Id.* at *6.

42 *Id.*

43 *Id.* As noted, *supra* at note 38, the parties subsequently reached a settlement and the court vacated its memorandum and order pursuant to the parties' joint request.

RULLCA Comes to California – Overview

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On September 21, 2012, Governor Brown signed SB 323 (Vargas), California's new version of the Revised Uniform Limited Liability Act (RULLCA). SB 323 is the culmination of a three-year drafting process of the Partnerships and Limited Liability Companies Committee of the Business Law Section of the State Bar (PLLC). Like all Uniform Business Legislation proposed by the National Conference of Commissioners on Uniform State Laws (NCCUSL), RULLCA was significantly "Californiaized" by the PLLC. Nevertheless, RULLCA represents an improvement on existing California law, the Beverly-Killea Limited Liability Company Act.[1]

When the Beverly-Killea Limited Liability Company Act was adopted in September 1994, California was the 48th state to adopt an LLC Act. Although NCCUSL had proposed a Uniform Limited Liability Company, California and most other states had either already adopted an LLC Act or started a drafting committee to craft an LLC Act. As a result, the original Uniform LLC Act was only adopted by nine states.

In 2006, NCCUSL took another crack at a Uniform LLC Act. RULLCA modernized the prior Uniform LLC Act and included a number of novel provisions. For example, "shelf LLCs," LLCs that could be formed without members and the use of a Certificate of Authority that would designate the person who could bind the LLC, contravened the notion that apparent authority is part of RULLCA. The latter allow the members to have a completely flexible management structure. Though unique, neither provision was included in SB 323.

The focus of this article is to discuss first, what didn't change with SB 323, and second what will change in 2014 when SB 323 is effective. Unlike the Revised Uniform Partnership Act[2] ("RUPA") and the Revised Uniform Limited Partnership Act,[3] ("RULPA") there is no transition period for SB 323. Those other acts had a two-year transition period where new entities were governed by the new law and existing entities were covered by the old law for a two-year period. SB 323 is effective on January 1, 2014, and the Beverly-Killea Limited Liability Company Act is repealed the same day. This means practitioners will need to become familiar with SB 323 during 2013.

What stays the same?

1. **Formation** –The formation process and forms stay exactly the same.
2. **Forms** - All of the forms on the Secretary of State's website will remain the same.
3. **Dissolution** – The process for dissolution, including judicial dissolution, remains the same.
4. **Fiduciary Duties** - The existing duty of loyalty, duty of care, and obligation of good faith and fair dealing remain the same. NCCUSL had elected to change the duty of care to ordinary negligence measured by the business judgment rule. The PLLC elected to continue California's existing fiduciary duties.
5. **Mergers and Conversions** - SB 323 continues current law with respect to mergers, conversions, and dissenter's rights.

What changes with SB 323?

1. **Emphasis on Written Contract** - Section 17721.07 provides that "[i]t is the policy of this title and this state to give maximum effect to the principles of freedom of contract and to the enforceability of Operating Agreements." This should help judges and arbitrators to recognize the importance of the terms included in an Operating Agreement, particularly written Operating Agreements.
2. **Effect of Operating Agreement** – Section 17701.11 provides that the LLC is bound by and may enforce the Operating Agreement and a member is deemed to assent to the Operating Agreement. This prevents members who did not sign the Operating Agreement, such as those who signed a consent or subscription agreement, from disavowing its terms. This change may also be helpful in dealing with substituted members following an assignment of a membership interest.

3. **Third party consents** - Section 17701.12 provides that the Operating Agreement may require the consent of a third party, such as a lender, to amend the Operating Agreement. This revision will allow a nonmember to require its consent prior to an amendment to the Operating Agreement becoming effective.
4. **Preformation Agreements** - Section 17701.10 provides that Preformation Agreements can become part of an Operating Agreement. Prior to this change, it was unclear whether a Preformation Agreement could become either an Operating Agreement or part of an Operating Agreement.
5. **Members without an economic interest** – Section 17704.01(d) provides that a person can become a member without acquiring an economic or transferable interest. That is, a person can become a member holding mere management and voting rights without obtaining a transferable or economic interest in the LLC. The Beverly-Killea Limited Liability Company Act, at Section 17001(z), defines a membership interest as including an economic interest. SB 323 provides that a member may hold a membership interest without an economic interest. This change will make it easier for members to hold voting or approval rights without having an interest in profits, losses, and distributions.
6. **Application of Fiduciary Duties** - Section 17704.09 makes clear that for manager-managed LLCs, fiduciary duties apply to managers and not members. The Beverly Killea Limited Liability Company Act, at Section 17153, only provided that a manager owed fiduciary duties to the LLC and the members, but was silent on whether the members also owed the LLC and the other members fiduciary duties.
7. **Disassociation** – Although disassociation is found in RULPA, it was not a part of the Beverly-Killea Limited Liability Company Act. Including disassociation provides consistency among business entities and allows for penalties for wrongful disassociation. Further, SB 323 allows a member to be expelled with unanimous consent of the members if: (a) the member's presence makes it unlawful for the LLC to carry out its activities; (b) the member wrongfully transferred its interest; (c) the member is a corporation that has filed a certificate of dissolution; (d) the member is an LLC or LP that has been dissolved; (e) the LLC has obtained a judicial order of expulsion because the member has engaged in wrongful conduct; (f) the member dies or becomes bankrupt (in a member-managed LLC); (g) a member is a trust or estate that distributes its transferable or economic interest; or (h) the member is a legal entity that has terminated.
8. **Improper Distributions** – SB 323 maintains current restrictions found in Corporations Code section 17254 regarding the prohibition against distributions that cause the LLC to fail to pay debts as they become due in the ordinary course of business or cause its total assets to be less than its liabilities. SB 323 amends current law to provides that a "distribution" does not include amounts constituting reasonable compensation for present or past services or reasonable payments made in the ordinary course of business under a bona fide retirement plan or other benefits program.
9. **Liability for Improper Distributions** – SB 323 continues personal liability for members or managers who consent to improper distributions as set forth in Corporations Code section 17255, but removes that personal liability if that member or manager was not allowed to vote on the distribution. Therefore, only the persons who had the right to vote on the improper distribution may face personal liability.
10. **Transfers that Violate the Operating Agreement** – Section 17705.02(c) provides that a transfer in violation of a restriction in an Operating Agreement is ineffective as to any person who has notice of the restriction at the time of transfer.
11. **Automatic Dissolution** – Section 17707.01 states that an LLC with no members is dissolved except on the death of a sole member, whose heirs may be admitted as a substitute member. Current law is silent on the effect of non-members, although Corporations Code section 17001(t) defines a limited liability company as an entity having one or more members. Under current law, there was a question whether the LLC could survive the death of a single member.
12. **Judicial Dissolution** – Section 17703.03 provides that dismissal of an action for judicial dissolution does not terminate the other member's right to purchase the interest of the complaining member. Current law does not consider the effect of a dismissal of an action for judicial dissolution. At least one trial court

in Sacramento, in an unpublished opinion, found that dismissal of an action for judicial dissolution terminated the members' rights to buy out the complaining member's interest under Corporations Code section 17351.

What are the Ramification of the Changes?

LLCs will remain popular in California. Since the adoption of the Beverly-Killea Limited Liability Company Act, LLCs have been the fastest growing form of business entity. SB 323 will not impede their growth and will likely only accelerate it. California's LLC Act will look more like the NCCUSL Uniform Act or RULLCA, as well as the LLC acts of other states. The Beverly-Killea Limited Liability Company Act was unique as no other state had the same format or structure as California. Currently, the other states that have adopted the NCCUSL Revised Uniform Limited Liability Company Act include Iowa, Nebraska, Wyoming, New Jersey, Utah, Idaho, and the District of Columbia.

Legal Ramifications. As mentioned earlier, SB 323 is not effective until January 1, 2014. Until that date, there will be no impact on California LLCs. However, as of that date, the current Beverly-Killea Limited Liability Company Act will be repealed and replaced with SB 323. As a result, practitioners will need to be familiar with SB 323, in particular the changes enacted by SB 323, to properly explain to clients what changes or modifications may be required in existing Operating Agreements. SB 323 does not in and of itself require any amendments to existing Operating Agreements.

Practical Applications. If a client or practitioner liked LLCs before January 1, 2014, it is likely that they will like LLCs afterwards as well. LLCs will only become more popular as a result of SB 323. Nevertheless, practitioners who have used Delaware LLCs, either because of the contractual flexibility including fiduciary duties or the accelerated development of case law through the Delaware Chancery Court, are likely to continue to use Delaware LLCs. Nevertheless, practitioners who may be given the choice between a non-Delaware LLC Act and California LLC Act may be more likely to select a California LLC Act as a result of the flexibility created by SB 323. In particular, LLCs may become more popular with nonprofits, which may use single member LLCs to hold or receive contributions or as joint venture vehicles. It is not likely that SB 323 will have a significant impact on the selection or use of California's LLC Act.

Tax Ramifications. Generally, SB 323 does not change either the current taxation of LLCs under federal law or California law. Under federal law, LLCs will still be characterized as sole proprietorships if owned by a single member, but as partnership or corporation tax associations if Form 8832 is filed. California LLCs will continue to be subject to the $800 minimum franchise tax as well as the gross receipts fee under Revenue & Taxation Code section 19142 for California gross receipts.

Why is SB 323 an Improvement? Despite some protestations to the contrary, SB 323 is an improvement over the current Beverly-Killea Limited Liability Company Act. Current California law, the Beverly-Killea Limited Liability Company Act, predates not only the California Uniform Partnership Act but the California Revised Uniform Limited Partnership Act, as well. As a result, it was the oldest Act applying to unincorporated entities. Although SB 323 will require practitioners to refamiliarize themselves with certain provisions under California law, it is a vast improvement for out-of-state practitioners since California's LLC Act will more closely resemble both RULLCA and LLC Acts of other states. This should help to make California's business environment friendlier for out-of-state businesses and out-of-state practitioners, and reflect a commitment to modernization of California's current LLC laws and the adoption of uniform laws. California is clearly the largest state to adopt RULLCA and this adoption reflects favorably on California's policy of considering and implementing improvements to its business statutes.

Conclusion

SB 323 represents an improvement on current law. The Beverly-Killea LLC Act was drafted in 1991 and 1992 and was based on the Revised Uniform Limited Partnership Act of 1984, which was repealed in 2008. Although it does depart from RULLCA, where possible, the PLLC attempted to incorporate the new concepts described in RULLCA. In the next three issues of Business Law News, the PLLC will publish articles looking specifically at fiduciary duties, disassociation and transition issues. ■

Endnotes

1 Cal. Corp. Code § 17001 *et. seq.*

2 Cal. Corp. Code § 16601 *et. seq.*

3 Cal. Corp. Code § 15900.01 *et. seq.*

Do Not Ignore Latest IRS Offshore Account Amnesty

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Lawyers, law firms, companies, and their clients should be aware of the astounding developments in the Internal Revenue Service's continuing campaign to achieve full transparency of foreign banks accounts and financial assets. With a carrot and stick, the IRS has said again and again that these matters are serious and can even involve criminal prosecution. Do not ignore these rules.

U.S. taxpayers must report their worldwide income on their U.S. tax returns, even if the overseas funds are taxed by other countries. In addition, foreign bank and financial accounts must be reported on Foreign Bank Account Report ("FBAR") forms that are filed separately from tax returns. The penalties for failure to file an FBAR are worse than tax penalties. Failing to file an FBAR can carry a civil penalty of $10,000 for each non-willful violation. But, if your violation is found to be *willful*, the penalty is the greater of $100,000 or 50 percent of the amount in the account for *each* violation—and each year you didn't file is a *separate violation.*

Criminal penalties for FBAR violations are even more frightening, including a fine of $250,000 and five years of imprisonment. If the FBAR violation occurs while violating another law (such as tax law, which it often will) the penalties are increased to $500,000 in fines and/or ten years of imprisonment. Many violent felonies are punished less harshly.

Two IRS amnesty programs have ended: one in 2009 and another in 2011. In 2011, the IRS made it clear there would be no third bite at the apple.[1] But in January 2012, the IRS broke with its warning and announced a third voluntary disclosure program.[2] Unlike the prior two IRS programs, this one has no announced deadline.

Nevertheless, the IRS has made clear that it could close it any time.[3] Moreover, the IRS has said time and again that if it finds you before you come in from the cold, all deals are off the table. For that reason and many others, taxpayers—and that can include fiduciaries like lawyers—should act without delay. In fact, recent developments show that the stakes are going up and failures to comply with tax and disclosure rules will henceforth be harshly addressed.

Lawyers and their clients should pay attention even where their roles as signatories of foreign accounts are merely fiduciary rather than beneficial in nature. Some lawyers may think they need not be concerned if their role was solely as a signatory on a trust or other fiduciary account. In fact, there are filing obligations in that situation too.[4]

More than 34,000 taxpayers have come forward over the last few years to disclose foreign accounts.[5] The IRS knows there is a much larger number who have not done so. When U.S. citizens and permanent residents file U.S. tax returns they must include investment income anywhere, no matter how small. Each tax return also asks (on Schedule B to Form 1040) whether you have a foreign account.

If so (and if the total of all foreign accounts exceeds $10,000 at any time during the year), you must check "yes." Each tax return then refers you to a separate filing, an FBAR.[6] It must be filed each year by June 30 for the prior year. No payment is required, but this disclosure form has been the law since 1970. The FBAR contains separate sections for foreign accounts you own beneficially and for those over which you have signature authority but no ownership.

The IRS takes this very seriously. Penalties for failing to include income or disclose foreign accounts can be severe, including criminal prosecution. FBAR penalties are even worse, including a fine of up to $250,000 and up to five years in prison for each failure to file.[7] It is increasingly difficult for people to claim ignorance of these rules—some taxpayers are being indicted for failure to file FBARs apart from any tax evasion or other tax crimes.

The dollars involved are also large. In the last few years of the program, the IRS has collected $5 billion from offshore accounts.[8] For taxpayers without any beneficial ownership in foreign accounts or assets, it is still necessary to file FBARs disclosing that signature authority.[9] Fortunately, most such cases can be resolved outside of the IRS disclosure program by preparing and filing the past-due FBARs.[10] They should generally be accompanied by an explanatory letter noting that your tax returns are correct,

you just became aware of the FBAR requirements, you will commence filing FBARs annually, and you ask that no penalties be imposed.[11]

For lawyers having only fiduciary roles for foreign accounts but who failed to file FBARs, this is a very good deal—with no likely penalties attached—assuming you follow this procedure. Taxpayers whose noncompliance involved not only FBARs but also tax returns should consider the IRS's third offshore program. It is similar to the 2011 program, and although there is no deadline, its terms could change at any time. The biggest change in the current Offshore Voluntary Disclosure Program ("OVDP") is a 27.5 percent penalty (up from 25 percent in the 2011 program) on the highest aggregate balance (in foreign bank accounts or entities or on the value of foreign assets) during the eight years before disclosure.[12]

However, taxpayers whose offshore accounts or assets did not surpass $75,000 may qualify for a reduced 12.5 percent penalty.[13] In addition, taxpayers who feel the penalty is disproportionate may opt out and deal with the issue as an audit item.[14] Opting out to attempt to negotiate lower penalties can import more flexibility and a greater array of procedural rights (such as going to the IRS Appeals Office) if the case does not proceed to the taxpayer's liking.

Participants in the OVDP must file all original and amended tax returns, generally going back eight years, and include payment for back-taxes and interest as well as a twenty percent penalty.[15] They must also complete and file FBARs, usually for the last eight years.[16] However, even if the undisclosed foreign accounts and unreported income go back many more years, the scrutiny and payment obligations extend only eight years back.

One reason to consider joining this IRS program is the absence of alternatives. Regardless of penalties, remaining silent is increasingly risky. The IRS has made clear that "quiet disclosures" (in which a taxpayer prepares and files amended tax returns and FBARs without calling attention to them and without joining the program) will be dealt with strictly.[17] The IRS views such actions as lacking a true voluntary correction of the past, rather akin to trying to sneak something by them.

Moreover, the IRS is getting good information and is more and more likely to discover foreign accounts and assets and treat them harshly. The U.S. government is going after foreign banks and financial institutions and mining the data about financial advisers, trust companies, and others it received via thousands of taxpayers who have named names to the IRS. Disclosure is becoming inevitable. The massive and controversial law known as FATCA, the Foreign Account Tax Compliance Act, will soon cause financial institutions worldwide to turn over names of U.S. account holders to the U.S. government or face draconian penalties themselves.[18]

In late June 2012, the IRS released several more conditions that can spell ineligibility to participate in the OVDP. First is the Department of Justice notice requirement. When a U.S. person faces the pending disclosure of their name and details to the IRS, it is often possible for the person to hold it up in a foreign court. Many such challenges were mounted in Switzerland. But U.S. law has a trump card for such challenges. Under U.S. law, if you challenge the disclosure of your name in a foreign court you are required to notify the Justice Department of the appeal.[19] For many, that notice defeats the purpose of mounting the foreign legal challenge in the first place, so some taxpayers skip the notice.

Now, such inaction will have additional consequences. The IRS has announced that if you fail to notify the Justice Department of a foreign appeal as required, you will not be eligible for the OVDP.[20] In effect, even though there is no IRS pending investigation, you won't be allowed to join the OVDP.

Second, eligibility to participate in the OVDP could be terminated in another way, one that hardly seems to involve the taxpayer and over which the taxpayer has no control. If the foreign institution where a taxpayer has his or her account faces IRS action, the taxpayer is *also ineligible* for the OVDP. Once the U.S. government has taken action against a financial institution, any U.S. taxpayers with accounts at that institution cannot participate in the OVDP.

Both of these actions reflect a fundamental precept of voluntary disclosure. The IRS wants you to come forward *before* you must, not after. The consequences of being discovered before one voluntarily applies for amnesty can be severe.

For example, a California lawyer, Christopher M. Rusch, and two businessmen, Stephen M. Kerr and Michael Quiel, were indicted over alleged income tax and FBAR violations.[21] Similar criminal charges have been filed and more are likely on the way. In part, this is due to the treasure trove of information (including dates, names, and details) the IRS obtained via its 2009 and 2011 amnesty programs.[22]

Yet the IRS is getting still more data. The IRS has issued John Doe summonses forcing some banks to name names. The IRS has even resorted to issuing grand jury subpoenas to individuals suspected of overseas banking. The grand jury subpoena requires the suspect to produce his or her *own* bank records and details, including statements with the highest annual balances.

Unless you are within the IRS program, such information would be highly incriminating. Yet by definition if you receive such a subpoena it is too late to join the IRS program. Lawyers are used to assuming they have a right to be silent and not to incriminate themselves, but these subpoenas may be outside that protection.

Thus, it is unclear whether an individual receiving such a subpoena can refuse and successfully assert protection under the Fifth Amendment. There is an established exception for "required records" that are not covered by the protections of the Fifth Amendment.[23] The courts are only now considering whether offshore private banking falls within this exception.

The Ninth Circuit, in *In re Grand Jury Investigation M.H.*,[24] allowed prosecutors to compel an offshore account holder to produce account data even if it was self-incriminating. The taxpayer filed a petition for certiorari with the U.S. Supreme Court, but it was denied.[25] In contrast, in a similar case in Texas, *In re: Grand Jury Subpoena*,[26] the judge ruled that a taxpayer did not have to comply. The government is appealing.

All of this is occurring as criminal investigations of eleven Swiss banks continue. The banks are suspected of enabling tens of thousands of wealthy Americans to evade U.S. taxes. The banks in the crosshairs include Credit Suisse AG, HSBC Holdings plc, Basler Kantonalbank, and many others.[27]

In fact, there were massive data transfers by Swiss banks to comply with a January 30, 2012 deadline to turn over data on their offshore business. The data is said to contain thousands of pages of encrypted data, including the names of client advisers. It is unclear if the encrypted data is being used by the IRS in its current form, but the assumption is that it will be useful.[28]

Since the data is said to contain details of services to American clients, it could provide a rich vein of information for tax authorities and prosecutors to pursue. The Swiss government is attempting to prevent criminal charges being filed against the banks. Clearly, it hopes cooperation in data transfers plus the payment of fines may be enough.

As this drama plays out, additional account details and prosecutions are likely in what has become an epic battle over global transparency. Lawyers and their clients are almost certainly better off trying to get the best deal they can get and to get it soon. ■

Endnotes

1 *See* Robert W. Wood, *IRS Offshore Amnesty: Second (Last) Chance,* Forbes.com, Feb. 9, 2011, http://www.forbes.com/sites/robertwood/2011/02/09/irs-offshore-amnesty-second-last-chance/.

2 *See* I.R.S. News Release IR-2012-5, IRS Offshore Programs Produce $4.4 Billion to Date for Nation's Taxpayer's; Offshore Voluntary Disclosure Program Reopens (Jan. 9, 2012), http://www.irs.gov/uac/IRS-Offshore-Programs-Produce-$4.4-Billion-To-Date-for-Nation%E2%80%99s-Taxpayers;-Offshore-Voluntary-Disclosure-Program-Reopens.

3 *See id.*

4 *See* Instructions to IRS Form TD F 90-22.1 (Rev. Jan. 2012), *available at* http://www.irs.gov/pub/irs-pdf/f90221.pdf.

5 *See* I.R.S. News Release IR-2012-5, *supra* note 2.

6 *See* IRS Form 1040, Schedule B, Interest and Ordinary Dividends, *available at* http://www.irs.gov/pub/irs-pdf/f1040sb.pdf.

7 31 U.S.C. § 5321(a)(5)(C); *see also* 31 U.S.C. § 5322(a); 31 C.F.R. § 103.59(b).

8 *See* I.R.S. News Release IR-2012-5, *supra* note 2.

9 *See* Instructions to Form TD F 90-22.1, *supra* note 4.

10 *See* I.R.S., Offshore Voluntary Disclosure Program Frequently Asked Questions and Answers, FAQ 17, 38 (June 26, 2012) ("I.R.S. 2012 OVDP FAQ"), *available at* http://www.irs.gov/Individuals/International-Taxpayers/Offshore-Voluntary-Disclosure-Program-Frequently-Asked-Questions-and-Answers.

11 *See id.*

12 *See* I.R.S. News Release IR-2012-5, *supra* note 2.

13 *See id.*

14 *See id; see also* I.R.S. 2012 OVDP FAQ, *supra* note 10, at 51.1—51.3.

15 *See* I.R.S. 2012 OVDP FAQ, *supra* note 10, at 7.

16 *See id.*

17 *See* I.R.S. 2012 OVDP FAQ, *supra* note 10, at 15.

18 See Joint Comm. on Taxation, *Technical Explanation of the "Foreign Account Tax Compliance Act of 2009"* (JCX-42-

09), Oct. 27, 2009, *available at* https://www.jct.gov/publications.html?func=startdown&id=3596.

19 *See* 18 U.S.C. § 3506.

20 *See* I.R.S. 2012 OVDP FAQ, *supra* note 10, at 21.

21 *See* U.S. Dep't of Justice Press Release, UBS Clients and Tax Attorney Indicted in Phoenix for Hiding Assets in Secret Foreign Bank Accounts (Jan. 30, 2012), *available at* http://www.justice.gov/tax/2012/txdv12136.htm.

22 *See* U.S. Department of Justice Offshore Compliance Initiative Notice, http://www.justice.gov/tax/offshore_compliance_intiative.htm (last visited Dec. 3, 2012).

23 *See* Robert W. Wood, *IRS Makes Swiss Cheese Of Swiss Banks,* Forbes.com, Jan. 9, 2012, http://www.forbes.com/sites/robertwood/2012/01/09/irs-makes-swiss-cheese-of-swiss-banks/.

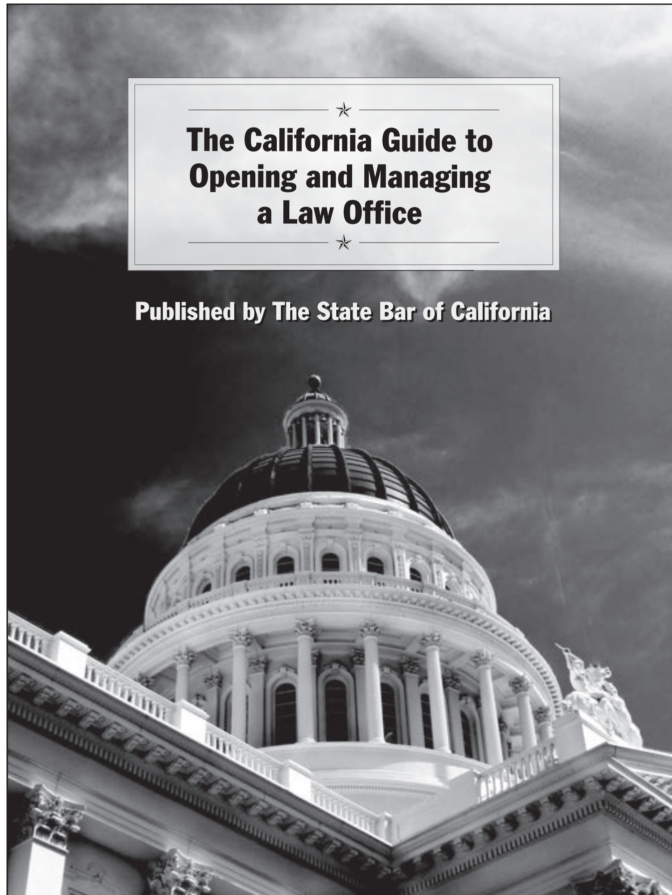
24 *M.H. v. United States* (*In re Grand Jury Investigation M.H.*), 648 F.3d 1067 (9th Cir. 2011).

25 *Id.*, *cert. denied*, 133 S. Ct. 26 (2012).

26 No. 4:11-mc-00174 (S.D. Tex. Feb. 11, 2011) (under seal).

27 *See* David Voreacos, *Swiss Banks Said Ready to Pay Billions, Disclose Customer Names*, Bloomberg.com, Oct. 24, 2011, http://www.bloomberg.com/news/2011-10-24/swiss-banks-said-ready-to-pay-billions-disclose-customer-names.html.

28 *See* Emma Thomason, *Swiss Banks Hand Over Encrypted Data in U.S. Tax Row*, Reuters, Jan. 31, 2012, *available at* http://www.reuters.com/article/2012/01/31/us-switzerland-usa-tax-idUSTRE80U10Y20120131.



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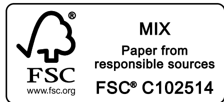

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