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Canadian M&A

Eleven Trends for 2011

By Richard E. Clark and Curtis A. Cusinato

As the global financial storm subsides, Canada's economy is commanding unaccustomed attention and some new-found respect. A solid regulatory system and strong demand for Canadian resources and commodities have kept the United States' northern neighbor in the global business headlines. In the M&A sector, there is every indication that the rebound experienced in 2010 will continue in 2011, as market players continue to seek out new opportunities. Canada's current popularity as a destination for foreign investment may be due to the reassuring familiarity of its legal and business culture, but that does not mean that U.S.–Canada cross-border transactions can be approached in exactly the same way as domestic U.S. transactions. Heading into 2011, there are a number of significant Canadian developments to watch out for, including the 11 key trends identified below.

1. Foreign Investment Review Post-Potash

In 2010, the government of Canada's decision that BHP Billiton's proposed US$38.6 billion unsolicited bid for PotashCorp was not in Canada's national interest effectively ended the bid and made headline news in the U.S. and around the world. In spite of this publicity, the consensus among Canadian practitioners is that the Potash situation was an anomaly. To put the matter into perspective, only two acquisitions have been rejected by Canada's foreign investment review process in over 20 years. In addition, the Canadian government has now indicated that it intends to review the relevant legislation, known as the Investment Canada Act (ICA), to determine whether, among other things, the "net benefit" test requires clarification. Every indication is that Canada remains open for business and that it will be business as usual in 2011 for most foreign acquisitions of control of Canadian businesses.

Another important piece of the Canadian foreign investment review process is the applicable threshold for review and approval of foreign acquisitions of control of Canadian businesses. In keeping with the current government's pro-investment stance, there is reason for optimism that the threshold figure will increase significantly. In 2009, the government announced its intention to raise the threshold amount in bi-annual stages to C$1.0 billion in 2015 (based on the "enterprise value" of the business). However, as this change has yet to be implemented, the review and approval test remains at the C$299 million threshold, based on the traditional "book value of assets" test, subject to certain exceptions. It is likely that in the near term (particularly in light of the government's proposal to review the entire Investment Canada Act) the review threshold will be increased in the normal course, under the existing rules, by annual cost of living indexing to approximately C$310 million. Finally, the lower review thresholds of C$5 million that had applied to certain sensitive sectors have been repealed for financial services, transportation services, and uranium mining. Only cultural businesses continue to be subject to the C$5 million asset threshold for direct acquisitions of control (as well as to a special review by Heritage Canada, the department of the government of Canada with responsibility for cultural affairs).

2. Developments in Canadian Poison Pills

Canadian regulators have opened new room for debate in one area of Canadian securities law that had long been considered settled—the role of poison pills in defending against a hostile take-over bid. In contrast to Delaware practice, Canadian shareholder rights plans have traditionally been strictly limited to the single purpose of helping the board "buy time" to seek out improved or alternative offers. Once that purpose had been served, Canadian securities commissions would routinely "cease trade" poison pills, sending whatever offer was on the table to a shareholder vote. It was widely accepted that, under such conditions, a "just say no" defense was not available in Canada. This position was consistent with National Policy 62-202 of the Canadian Securities Regulators (an umbrella organization that co-ordinates policy among Canada's provincially-based securities regulators), which policy clearly states that the primary objective of take-over bid regulation is to protect the bona fide interests of the target's shareholders.

In two recent decisions, however, the Alberta Securities Commission (*Pulse Data*, 2007) and the Ontario Securities Commission (*Neo Material*, 2009) refused to cease trade shareholder rights plans, even where the target's board had not solicited other bids. In each decision, the commission in question was influenced by the fact that the poison pill had been strongly endorsed by the shareholders, while in *Neo Material* the OSC also acknowledged that tough economic times and the possibility of coercive bids might justify keeping the pill in place and, in addition, placed considerable reliance on Supreme Court of Canada jurisprudence stating that the board of directors' duty is to the corporation as such, rather than specifically to its shareholders.

The trend that seemed to be developing in *Neo Material* and *Pulse Data* was revisited by the OSC in its 2010 *Baffinland Iron Mines Corporation* decision. In *Baffinland*, the OSC issued an order cease-trading the shareholder rights plan on the basis that the rights plan had provided sufficient time for the Baffinland board to obtain a competing offer from ArcelorMittal SA and that the plan had accomplished the objective of stimulating an auction by obtaining a competing offer. The Baffinland board later approved a new rights plan and the transaction is ongoing. As a consequence of *Baffinland* and certain other developments, it is widely believed that the *Neo Material* and *Pulse Data* rulings will have considerably less long-term effect on the traditional Canadian position on poison pills than appeared likely at the time those rulings were made.

3. Continuing Demand for Canadian Commodities

Continuing demand by foreign investors for Canadian natural resources is almost a certainty in 2011. The most prominent recent example was BHP Billiton's abortive bid for PotashCorp, but many other multi-billion dollar transactions have proceeded more quietly. A key development in this sector is the emergence of more creative and strategic-based structuring for effecting transactions, not just conventional going-private transactions and takeovers. Alternative transaction structures in the mining sector include acquirors taking toe-hold positions in a target, coupled with a joint venture arrangement to provide for offtake, supply, or other strategic agreements (an "offtake" being an agreement with respect to the purchase of a portion of the production of a mine going forward, based on a predetermined pricing structure). Another well publicized creative structure occurred in the acquisition of a 51 percent stake in Uranium One (a company listed on the Toronto-based TSX) by Russia's ARMZ, which included an asset "vend-in" by ARMZ involving that company's stake in two Kazakh uranium mines.

4. Bridging the Gaps in Financing and Valuation

Notwithstanding increasing confidence in the Canadian economy, acquisition financing is still not always easy to arrange, and residual economic uncertainty continues to produce many real or perceived value differences between buyers and sellers. The continued use of various techniques for bridging gaps in financing and valuations is therefore likely, at least in the short term. These include earnouts, seller financing (typically secured and subordinated), seller rollover equity, and the seller receiving buyer stock (often accompanied by mutual "puts" and "calls," to ensure an ultimate takeout). Other more creative techniques that have recently been used in the Canadian marketplace include:

- Structured equity, whereby the seller receives equity which provides a back-end payment tied to a hurdle rate of return—if the buyer meets the target over a period of time (usually three to five years), the seller participates in any upside.
- "Loan to own" strategies or creeping takeovers in distressed situations, where a potential buyer makes a secured loan to a troubled target (possibly accompanied by warrants) so that, in the event of default, the secured lender is in a very strong position in any insolvency proceeding to "foreclose" on the target and own all or a significant portion of the equity.
- Contingent value rights (CVRs), a form of transferable, earn-out security sometimes used as partial acquisition currency in the purchase of a public company. For example, CVRs have been used to guarantee the value of buyer's stock for a period after closing.
- Standby equity distribution agreements (SEDAs) have recently provided increased flexibility to issuers in raising financing in Canada. SEDAs provide that one or more investors contractually agree to purchase, upon demand of the issuer, unissued shares of (smaller) publicly-traded companies in one or more tranches at a small discount from market (usually 5 percent or less) over a period of time (usually two years, with a right to renew for one or two additional years).

5. Hedge Funds, Pension Funds, and Other Pools of Capital

As always, the adage "follow the money" applies. Hedge funds, pension funds and other pools of capital have increasingly been taking active positions in public companies or participating in *Companies' Creditors Arrangement Act*-based transactions (or other distressed transactions). Sovereign Wealth Funds (SWFs), state-owned enterprises (SOEs), and hedge funds have also been active in the natural resource and oil and gas industries, both in Canada and abroad. In addition to Canadian pension funds, another emerging source of investment is coming from certain U.S. state pension funds that are creating new independent firms—such as the South Carolina Retirement System Investment Commission—to oversee their funds' private equity holdings. These are similar to the direct investment funds created by two of Canada's biggest pension plans, the Ontario Teachers' Pension Plan and the Canada Pension Plan Investment Board. In 2011, the Canadian M&A

market is very likely to see increasing volumes of direct investment by large pools of capital that have not traditionally participated in such transactions. The indications are that this market is prepared to go where the cash is—whether it is with private equity firms, hedge fund investors, pension fund investment vehicles or elsewhere.

6. Growth of a Domestic High-Yield Debt Market

As credit markets begin to open up and liquidity pipelines begin to flow more freely, greater transactional leverage in Canadian M&A will almost certainly result. A key example is the emergence of a high-yield debt market in Canada. Beginning in 2009, such a market began to develop to raise the funds for potential acquisitions and other purposes. In 2010, as investors hungered for higher yields, Canadian companies continued to issue Canadian dollar-denominated, non-investment grade debt. Income trusts, which have been the principal Canadian issuers of high-yield debt, will likely retain their taste for this form of financing as they restructure as corporations (in response to a change in Canadian federal tax policy), providing new impetus to the high-yield market in the corporate sector. Certain recent Canadian transactions, such as the acquisition by RTL-Robinson Enterprises Ltd. of Westcan Bulk Transport Ltd., have already successfully used a high-yield debt issue as a financing mechanism. Over the coming year, as the domestic high-yield market continues to develop, high-yield debt should increasingly factor into M&A transactions, especially if, as expected, interest rates remain at near-historic lows.

7. Going with the (Cash) Flow in Valuations

In order to obtain more deal certainty on value, a number of Canadian institutional investors have begun to favor a multiple of "free cash flow" in valuing target companies in certain industries. Previously, potential acquirors had typically relied on any of several measures of the target's earnings multiple—derived from net income, "EBIT" (earnings before interest and taxes) or "EBITDA" (earnings before interest, taxes, depreciation and amortization), as the case may be.

The progression from net income to EBIT and EBITDA can be seen as an attempt to climb higher up the income statement to get a number closer to cash flow. The Canadian market is now seeing the free cash flow (FCF) method used with increasing frequency as an alternative way to achieve a valuation that reflects cash flow. FCF is generally defined as follows:

> FCF = [Net Income] + [Depreciation and Amortization] – [Changes in Working Capital] – [Capital Expenditures]

As this suggests, there are two fundamental differences between FCF and an alternative such as net income when it comes to valuation. First, the net income approach uses depreciation, while FCF measures the last fiscal period's net capital purchases, such that capital spending is in current dollars (although a disadvantage is that capital investment is discretionary and can be sporadic). A second difference is that FCF deducts increases in net working capital, while the net income method does not.

FCF is basically the cash flow available for distribution to all holders of security, including equity holders, debt holders, preferred stockholders, and convertible equity holders. It represents the cash that an entity is able to generate after expending the funds required to maintain and expand its asset base, thereby allowing the company to pursue opportunities that enhance shareholder value. Some investors, concerned that income can be clouded by accounting practices, believe that cash flow is much harder to obscure and that FCF gives them a much clearer view of the ability to generate cash (and thus profits).

8. Income Tax Developments

As the economy continues to improve and cross-border M&A activity increases, a number of recent amendments to the Canadian Income Tax Act and some long-standing deal structures and techniques will have an even greater impact:

- The repeal of withholding tax on most cross-border interest payments should continue to facilitate accessing the most favorable sources of acquisition debt financing outside of Canada.
- The repeal of Canada's compliance and withholding regime on cross-border equity dispositions (except where the equity effectively constitutes a real property interest) will facilitate sales by foreign investors holding shares of Canadian companies and will encourage new foreign investors contemplating an exit strategy devoid of most administrative hurdles.
- As purchase prices increase, the use of "exchangeable shares" may become more prevalent, in order to provide a rollover for capital gains purposes for Canadian shareholders of a Canadian target where the consideration includes, in whole or in part, stock of a foreign acquiror.
- Recent administrative rulings appear to have softened the harsh impact on Unlimited Liability Companies (ULCs) of the anti-hybrid rules contained in the Fifth Protocol to the Canada-U.S. Tax Convention, which had negatively impacted the payment of dividends and return of capital, among other things, to the U.S. ULCs have been used as "check-the-box" tax flow-through vehicles for U.S. tax purposes in many cross-border structures.

9. Bilateral Investment Treaties and M&A Transaction Structures

As global leaders in mining, resource and energy finance, Canada and its investors are increasingly recognizing the importance of bilateral investment treaties (BITs). BITs permit investors to seek monetary damages from foreign governments that violate their treaty obligations, as do the investment chapters of many free trade agreements, including Chapter 11 of NAFTA. The private, investor-state dispute mechanism typically allows foreign investors to bring claims for damages before independent arbitral tribunals in the event that foreign governments take harmful actions that violate BIT obligations, including those that prohibit discriminatory or unfair treatment or expropriation without adequate compensation.

In structuring investments and M&A transactions, Canadian counsel have traditionally been highly conscious of the implications of tax treaties and possible claims by indigenous peoples, but it is becoming equally important that investment into less stable countries is structured through a country that has a BIT with the host country (in conjunction with a favorable bilateral tax treaty). In light of this, it is likely that the Canadian government will continue to work toward the implementation of BITs in order to preserve Canada's leadership role in global mining, resource, and energy finance.

In August 2010, the Canadian government announced a C$130 million settlement of a Chapter 11 NAFTA claim by AbitibiBowater Inc. arising out of the expropriation by the government of Newfoundland and Labrador of certain water and timber leases held by Abitibi in that province. This is a reminder of the importance of bilateral investment treaties not only in Canada, but in making investments in other countries around the world.

10. Infrastructure

Infrastructure was one of the most robust trends in 2010, as pension funds and large private equity groups acquired infrastructure-focused companies and infrastructure assets. Examples include CPP Investment Board's October 2010 investment of C$894 million for a 10 percent stake in Ontario's Highway 407 Express Toll Route (407 ETR), soon to be supplemented with the additional 30 percent of 407 ETR that CPPIB will acquire as a result of its purchase of Intoll, an Australian company, for approximately C$3.6 billion. In 2011, there will be continued growth in acquisition and joint venture activity relating to transportation and energy infrastructure projects, including co-generation, nuclear, and hydro. Infrastructure-related M&A activity will remain a major theme in 2011, as stimulus spending continues and governments increasingly look to public-private partnerships (PPP) to bridge the gap between scarce public funds and public infrastructure needs—an important example being the recently concluded deal between Infrastructure Ontario and Windsor Essex Mobility Group to develop and maintain the C$1.6 billion Windsor-Essex Parkway. This was the first civil infrastructure PPP in Ontario and also the largest PPP in value in the province to date.

11. Similarities and Differences of Canadian and U.S. Deal Terms

We expect to see a continuation in 2011 of themes that have emerged over the past two years, namely a return to basics with cautious buyers; the return of more controlled auctions and the re-emergence of more strategic buyers (as distinct from financial buyers); the return of traditional bank financing (highly negotiated positive and negative covenants—no "covenant-lite" loans). In these respects, Canada and the United States are quite similar. However, while U.S. trends and practices in negotiated M&A transactions continue to be influential in Canada, counsel south of the border should nevertheless be aware of a number of marked differences. The recent *ABA 2010 Canadian Private Target Mergers & Acquisitions Deal Points Study* highlights some of the similarities and differences (compared with corresponding figures in the *ABA 2009 U.S. Private Target Study*):

- Canadian transactions involve far fewer earnouts than U.S. transactions (29% in U.S.; 3% in Canada).
- The concept of a Material Adverse Effect (MAE), as a defined qualifier of representations and warranties and/or conditions of closing, was defined in fewer purchase agreements in Canada than the U.S. (92% in U.S.; 73% in Canada).
- The general survival period for representations and warranties was longer in Canada than in the U.S. (75% of Canadian deals specify 24 months or less, as compared to 88% in the U.S.).
- "Baskets" (threshold or deductible for claims) as a percentage of transaction value totaled 69% for Canadian transactions for a basket of 1% of total value or less (U.S., 89%).
- More interestingly, the cap on indemnity claims was the "purchase price" in 45% of the Canadian transactions (U.S., 5%) with only 17% of the Canadian transactions having a cap of 15% or less of purchase price (U.S., 64%).
- Only 26% of Canadian transactions had an escrow or holdback component (U.S. figure not given; previous studies suggest that the figure in the U.S. is more than double that in Canada).
- Finally, provisions relating to sandbagging are less common in Canada than they are in the U.S. (31% vs. 47%), and even when found in Canadian agreements are far more likely—by 21% to 10%—to be anti-sandbagging than pro-

For More Information

For a more comprehensive consideration of earnouts and other bridging techniques please see the publication "M&A Trends and Opportunities in a Downmarket" by Richard Clark, presented at the Canadian Institute's National Summit on Private Equity in September 2010. For a copy, please contact the author or e-mail your request to info@stikeman.com

Dual-track exit structures are discussed from a Canadian perspective by Curtis Cusinato in "M&A Transaction or IPO: Why Not Pursue Both?," a paper published in Stikeman Elliott LLP's April 2010 M&A Update. The paper is available from the author or via the firm's securities law blog, www.canadiansecuritieslaw.com.

sandbagging (the reverse being the case in the U.S., where anti-sandbagging provisions were present 8% of the time vs. 39% of the time for pro-sandbagging provisions). Pro-sandbagging provisions are express statements that the buyer can seek indemnification for breach of warranties, notwithstanding knowledge of breach. Anti-sandbagging clauses can be dangerous for a buyer because, if not properly qualified, they invite the "you knew" defense for almost every claim.

Conclusion

These developments suggest that Canadian M&A is becoming increasingly globalized and increasingly creative. In an expanding economic climate with strong demand for energy and resources, there is every reason to believe that 2011 will see many more U.S.-Canadian transactions. For U.S. companies interested in international expansion, Canada is a familiar, accessible and stable market. For U.S. counsel advising such companies, the key is to understand that, in spite of the numerous similarities, there are certain distinctive aspects of Canada's legal landscape that must always be carefully considered when approaching a possible U.S.-Canadian transaction.

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Smaller Reporting Companies

Disclosure and Governance Considerations

By Sanjay M. Shirodkar and Kristi Darnell-Weichelt

Over the past few years, considerable time and energy has been spent on providing helpful commentary on the reporting and other obligations associated with mid- and large- sized public companies. This is particularly true since the adoption of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). However, one group of companies is frequently overlooked in this commentary: companies that, based on their size, are defined as a "smaller reporting company" (SRC) by the Securities and Exchange Commission (Commission). It is important to note that, based on published results, there are considerably more SRC companies than larger-accelerated or accelerated companies.

In this article, we discuss some of the Commission initiatives leading up to the creation of the SRC category, address some special Commission rules that relate to SRCs, summarize some of the hot-button disclosure issues relating to SRCs that the Commission staff has focused on, explain how some of the Commission rules applicable to SRCs are different from those applicable to larger reporting companies, and review recent rulemaking by the Commission related to the application of the Dodd-Frank Act to SRCs. We also include an annex listing Commission guidance that may be helpful to SRCs.

Commission Initiatives for SRCs

The Commission has historically made special efforts not to subject smaller companies and their investors to unduly burdensome federal securities regulation. For example, as mandated by the Small Business Investment Incentive Act of 1980, the Commission hosts an annual forum that focuses on the capital formation concerns of small businesses. The forum is called the "SEC Government-Business Forum on Small Business Capital Formation." According to the Commission, a major purpose of the forum is to provide a platform for small businesses to highlight perceived unnecessary impediments in the capital-raising process and address whether they can be eliminated or reduced.

The Commission's special concern for smaller companies was, in part, driven by the special role that such corporate entities historically have played as a driver of economic activity, innovation, and job creation in the United States. In March 2005, the Commission chartered an Advisory Committee on Smaller Public Companies (Advisory Committee) and asked the committee to assess the existing regulatory system for smaller companies under the federal securities laws and to recommend changes to that system. Based upon the Advisory Committee's recommendation in 2007, the Commission proposed far-reaching changes to improve federal securities regulations that significantly affect smaller companies and their investors. Final rules were adopted by the Commission in late 2007. The Commission explained that its rule changes had three primary objectives:

- Expanding eligibility for "scaled disclosure" and reporting requirements for smaller companies by making those requirements available to most companies with a public float of less than $75 million.
- Reducing unnecessary complexity by combining the two categories of "small business issuers" and "non-accelerated filers" into one category called "smaller reporting companies."
- Simplifying and improving the disclosure and reporting rules for smaller companies by maintaining the Regulation S-B disclosure requirements for smaller companies by integrating them into the disclosure requirements in Regulation S-K.

The revised rules permitted SRCs to comply with only a subset of the public disclosure requirements applicable to larger companies in their registration statements, periodic reports, and proxy statements, eliminated Regulation S-B, and moved the scaled disclosure requirements to Regulation S-K or the newly created Article 8 of Regulation S-X. Under the revised rules, an SRC has the flexibility to comply with the scaled disclosure requirements on an à la carte basis – meaning that it can either comply with the scaled disclosure and financial reporting requirements made available in Regulation S-K for SRC or the requirements in Regulation S-K that are applicable to larger companies. In other words, an SRC can voluntary report under the more rigorous requirements in Regulation S-K that are applicable to larger companies. SRCs are, however, required to comply with certain SRC item requirements that are more rigorous than the requirements of other companies in Regulation S-K. Foreign companies are permitted to qualify as an SRC if they otherwise qualify and choose to file on domestic company forms and provide financial statements prepared in accordance with U.S. Generally Accepted Accounting Principles.

Qualifying for SRC Status

There are three different categories of companies that may qualify to be an SRC: (1) reporting companies that have a public float at or below the SRC threshold of $75 million; (2) non-reporting companies that are filing a registration statement and have a public float at or below the SRC threshold of $75 million; and (3) reporting or non-reporting companies that do not have a public float and have annual revenues of less than $50 million. A company's public float is calculated by multiplying the price of the company's equity on the last business day of its most recently completed second fiscal quarter, by the aggregate worldwide number of shares of the company's voting and non-voting common equity held by non-affiliates of the company on such date. Each company's public float and revenues are then tested on an annual basis to determine whether its reporting status has changed. For example, if a company's public float or revenues are initially above the SRC threshold, it can still fall within the SRC category in subsequent years if its public float is less than $50 million, or, if it has no public float, its consolidated revenues for the prior fiscal year are less than $40 million. Non-reporting companies that file a registration statement under the Securities Act of 1933, as amended, are required to calculate their public float as of a date within 30 days of filing its registration statement. There is an alternative test for reporting companies or non-reporting companies that do not have a public float: such companies must have annual revenues of $50 million or less in the last fiscal year.

There are specific rules regarding entering and exiting the SRC reporting regime and most companies tend to solicit expert advice on such rules. A larger reporting company that determines it qualifies to be an SRC as of the last business day of its most recently completed second fiscal quarter is permitted to file as a smaller reporting company in its quarterly report for such quarter. SRCs are required to exit the scaled disclosure system the fiscal year after its public float rises above $75 million as of the last business day of its second quarter. In other words, an SRC is required to transition to the larger reporting company system if its public float rises above $75 million as of the last business day of its second quarter.

Hot Button Disclosure Initiatives

The following are some hot button issues relating to SRCs that have been identified by the Commission staff:

Management's Discussion and Analysis (MD&A)

The requirements of a company's MD&A are generally governed by Item 303 of Regulation S-K. The Commission staff has also published some interpretive guidance on MD&A. In addition, many securities law practitioners like to keep abreast of Commission enforcement actions in this arena. The three main aspects of MD&A are: result of operations, liquidity, and disclosure regarding potential upcoming events. The Commission staff has noted that MD&A is designed to provide a narrative explanation of a company's financial statements through the eyes of management, to enhance the overall financial disclosure and provide the context within which financial information should be analyzed, and to provide information about the quality and the potential variability of a company's earnings and cash flow so that investors can ascertain the likelihood that past performance is indicative of future performance. According to the Commission staff, companies should provide an overview highlighting both financial and non-financial key performance indicators as background and should focus on the factors contributing to fluctuations in operating results from period to period. In the Liquidity section, the Commission staff has noted that a registrant's sources and uses of cash may be an area where disclosure is rapidly evolving for SRCs. The key issues here are how a registrant funds its operations by considering what its significant bills are and how the registrant pays those bills. Additionally, the Commission staff has indicated that SRCs should disclose impairment losses and consider the need for disclosure of "non-impairments" or "non-events" in certain situations.

Reverse Mergers or Back Door Registrations

Reverse mergers, or back door registration transactions generally take the form of a private operating company merging with a public shell and gaining the ability to issue public stock. Over the past few years, a growing number of private companies domiciled in China have sought to access the U.S. capital markets through this method. The Commission staff and the staff of the Public Company Account Oversight Board (PCAOB) have increasingly focused on the qualifications of the auditor in such transactions. It is not uncommon for the Commission staff to issue comments on the ability of a domestic firm to perform fieldwork on the foreign company in light of the distance and language barriers. If a domestic auditing firm is relying on a firm overseas, the Commission staff has regularly inquired about the registration of the foreign firm with the PCAOB. Also, unless the same audit firm audited both the private company and the public shell (or the accounting acquirer), a reverse merger generally results in a change of the audit firm. Careful consideration should be given to the timing and contents of the various filings required in such transactions.

Embedded Conversion Options and Freestanding Warrants

The Commission staff has noted that it is a complicated path to determine the correct accounting treatment of embedded conversion options and freestanding warrants. The key here is to discuss the treatment with qualified accounting personnel and to involve your auditors early in the process. The Commission staff has issued comments related to the recognition and presentation of such instruments, including how derivatives and bifurcated embedded features have been measured.

Smaller Reporting Company Status

The Commission staff has focused on the manner in which a company calculated its public float, the timing of a company's assessment as to whether it qualified as an SRC, and the other transition rules that apply when a company either enters or exits the SRC regime.

Use of Proceeds

Item 504 of Regulation S-K sets forth the requirements for companies to disclose the principal purposes for which the net proceeds of an offering will be used and the approximate amount intended to be used for each purpose. When a company makes its offering on a best efforts basis, it is not unusual for its intended use of proceeds to change depending on the volume sold. The Commission staff frequently requests companies to pick benchmarks for the amount of securities that it may sell, for example, 25%, 50%, 75%, and 100%, and indicate how it will allocate the proceeds at each benchmark.

Differences in Regulation S-K Provisions

When working with SRCs, many practitioners find it somewhat difficult to identify which provisions of Regulation S-K are applicable. We have therefore prepared a brief list which sets forth the items under Regulation S-K that contain scaled disclosure requirements for SRCs, along with a description of the key differences between the requirements applicable to both larger companies and SRCs:

Description of Business (Item 101)

Larger reporting companies are required to describe the key elements of their businesses during the past five years, including lengthy narrative descriptions of their industry segments. Pursuant to paragraph (h) of Item 101, SRCs are required to describe the developments of their business during the last three years, as opposed to the last five years. Additionally, SRCs are permitted to provide less detailed description of their business and are not required to provide financial information about segments.

Market Price, Dividends and Related Stockholder Matters (Item 201)

Pursuant to Instruction 6 to paragraph (e) of Item 201, SRCs are not required to provide a performance graph.

Selected Financial Data (Item 301)

Larger reporting companies are required to provide selected financial data for the past five years. Pursuant to paragraph (c) of Item 301, SRCs are not required to provide the information required by Item 301.

Supplementary Financial Information (Item 302)

SRCs are not required to comply with this item.

Discussion and Analysis of Financial Condition and Results of Operation (Item 303)

Larger reporting companies are required to provide a discussion of the registrant's financial condition, changes in financial condition, and results of operations for the three year period covered by the financial statement, and they are required to use year-to-year comparisons. Pursuant to paragraph (d) of Item 303, if an SRC provides financial information on net sales and revenues and on income from continuing operations for only the two prior years, it can also provide information regarding the impact of inflation and changing prices on the SRC's net sales, revenues and income from continuing operations for the same two year period. SRCs are not required to provide the tabular disclosure of contractual obligation as required by Item 303(a)(5).

Executive Compensation (Item 402)

SRCs are not required to provide the significant compensation discussion and analysis (CD&A) narrative that must be provided by larger companies. An SRC's Summary Compensation Table needs only to provide information for the two prior years (as opposed to the three prior years). However, because there is no CD&A, an SRC must provide some additional narrative to explain the items contained in its Summary Compensation Table and Outstanding Equity Awards at Fiscal Year-End Table. SRCs can also omit from their reports the following tables: Grants of Plan-Based Awards Table, Non-Qualified Deferred Compensation Table, Pension Benefits Table, and Option Exercise and Stock Vested Table. Finally, SRCs are not required to disclose regarding the relationship between compensation and risk.

Transactions with Related Persons, Promoters, and Certain Control Persons (Item 404)

The threshold for related party disclosures by SRCs is lower than is applicable to larger companies (transactions with a value equal to the lesser of $120,000 or one percent of the SRC's total assets at the end of the last two completed fiscal years must be disclosed). However, an SRC is not required to disclose its review, approval, or ratification policies and procedures concerning related party transactions (Item 404(b)). Because many SRCs tend to be closely held, the Commission staff often issues comments pertaining to related party transactions related to forgiveness of debt and contributed services. The Commission staff has also noted that disclosures should not claim that transactions have been recorded at an arm's length unless the SRC has objective evidence to support that assertion.

Corporate Governance (Item 407)

SRCs are not required to provide information related to Compensation Committee Interlocks and Insider Participation, or a Compensation Committee Report. (407(e)(4) and (5).

Risk Factors (Item 503)

SRCs are not required to provide information regarding the ratio of earnings to fixed charges, or, in connection with

Forms 10, 10-K, or 10-Q, to provide risk factors. However, we believe that most SRCs should provide risk factor disclosure in order to take advantage of the safe harbor for forward looking statement set forth in Section 21E of the Securities Exchange Act of 1934, as amended.

Exhibits (Item 601(b)(12))

SRCs are not required to provide Exhibit 12, Statements re: Computation of Ratios.

In addition to the scaled disclosures listed above, SRCs have a longer period of time than larger companies to make their periodic filings: annual reports on Form 10-K are due within 90 days following the company's fiscal year end, and quarterly reports on Form 10-Q are due within 45 days following the company's preceding fiscal quarter.

Recent Dodd-Frank Act Provisions

In connection with the recent adoption of the Dodd-Frank Act, there are a number of new requirements applicable to proxy statements filed by public companies.

Say-on-Pay and Say-on-Frequency

A SRC does not have to comply with the "say-on-pay" and "say-on-frequency" requirements adopted under the Dodd-Frank Act until its first annual meeting at which directors will be elected, and for which disclosure regarding executive compensation will be required, which occurs on or after January 21, 2013. However, all public companies, including SRCs, holding an annual or other meeting on or after January 21, 2011, will be required to submit to shareholders for an advisory vote on any "golden parachute" compensation to be paid in connection with change-of-control transactions.

Independent Compensation Committee

The Commission is obligated to issue rules requiring national securities exchanges prohibiting them from listing any equity security of a company if its board of directors does not have an "independent" compensation committee. The Commission is also required to issue rules directing national securities exchanges to adopt listing standards containing explicit authority for compensation committees to engage their own independent advisors. Proposed rules on these compensation committee matters are expected to be issued in March 2011, with final rules being adopted during or before July 2011.

Pay for Performance Disclosure

The Commission is obligated to adopt rules that require companies to provide in any proxy statement for an annual meeting disclosure that shows the relationship between executive compensation actually paid by the company and the company's financial performance, which disclosure may be included in a graphic representation. The Commission currently predicts that these rules will be adopted sometime between April and July 2011.

Internal Pay Ratio Disclosure

The Commission is obligated to adopt rules that require disclosure of (1) the median total annual compensation of all employees of the company other than the CEO; (2) the total annual compensation of the company's CEO; and (3) the ratio of the two amounts. The issuance of proposed rules on this topic is expected to occur sometime between August and December 2011.

Incentive Compensation Clawback

The Commission is required to adopt rules for national securities exchanges to adopt listing standards so that listed companies must develop and implement policies to "claw back" executive compensation in the event of a financial restatement. These claw back rules are predicted to be adopted sometime between August and December 2011.

We also note that the Commission has recently published some interpretive advice relating to SRCs. These interpretations are available at www.sec.gov/divisions/corpfin/guidance/exchangeactrules-interps.htm#169-01. Note that the Commission rules and interpretations are subject to regular modifications.

Conclusion

SRCs have unique disclosure and corporate governance concerns in comparison to larger public companies. Among the benefits of being an SRC is the ability to comply with the less onerous disclosure obligations. A further benefit, resulting from the Dodd-Frank Act, is the exemption for SRCs from the auditor attestation requirements of Section 404(b) of SOX. In addition to the issues discussed above, there may be other reasons why a company may want to think about either qualifying for or exiting the SRC regime. For example, companies should keep in mind the status of their competitors and whether qualifying as an SRC may negatively impact market perception of the company. Given the complexity of the federal securities laws, it is prudent to consider some of these issues sufficiently in advance. As the old proverb goes, sometimes a good plan today is better than a perfect plan tomorrow.

The Commission has made available the following information on its website relating to SRCs:

- Contacting the SEC Office of Small Business Policy: www.sec.gov/info/smallbus/reachsec.htm
- Information For Small Businesses: www.sec.gov/info/smallbus.shtml
- Small Business Compliance Guides: www.sec.gov/info/smallbus/secg.shtml
- Completed Initiatives of Interest to Smaller Reporting Companies: www.sec.gov/info/smallbus/sbrules.shtml
- SEC Advisory Committee on Smaller Public Companies, Final Report 20-21 (2006) available at www.sec.gov/info/smallbus/acspc.shtml

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BUSINESS LAW **TODAY**
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Keeping Current: Intellectual Property

The 'Work for Hire' Doctrine and Start-up Technology Companies

By Elaine D. Ziff

Two 2010 federal cases, *JustMed, Inc. v. Byce*, from the Ninth Circuit, and *Woods v. Resnick*, from the Western District of Wisconsin, suggest that courts are stretching the "work for hire" doctrine to accommodate the commercial realities of how start-up technology companies operate. In particular, courts are taking into account that start-ups use creative compensation arrangements, have informal record-keeping, and that software programmers tend to work independently. As a result, the traditional factors for finding that an author is an "employee" for purposes of vesting copyright in the hiring party may be less relevant where start-up technology companies are concerned.

Under U.S. copyright law, the author is the initial owner of the copyright in a copyrightable work. Software code has long been recognized as copyrightable, as a form of literary work. The copyright owner (and only the copyright owner) has the statutory right to reproduce the work, prepare derivative works of it (i.e., modify or add to it), distribute copies of it to the public, and perform and/or display the work publicly.

If, however, the copyrighted work is created by the author as a "work for hire," then the copyright automatically vests in the hiring party. A work for hire has obvious advantages for a hiring party, even over obtaining an assignment of the copyright from the author. Authors have the right to terminate all assignments and licenses of their work during the period between 35–40 years after the grant was made, to give them a second bite at the apple to exploit the work, should it have become famous. Authors also have remedies under the Visual Artists Rights Act to prevent destruction or distortion of works of visual art. Neither of these rights applies to works for hire. In addition, the duration of the copyright term for a work for hire is the more straightforward, based on the number of years from publication or creation of the work rather than from the author's demise.

There are two ways that a work can be classified as a work for hire, set forth in the Copyright Act itself. If there is no written agreement between the author and the hiring party, then the only way that work for hire status can be obtained is "[a] work prepared by an employee within the scope of his or her employment." Principals of agency law apply to determine whether an author is an employee for work for hire purposes.

The U.S. Supreme Court in *Committee for Creative Non-Violence v. Reid*, 109 S. Ct 2166 (1989), set forth a multi-factor rubric for determining who is an employee under the Copyright Act. Known informally as the "Reid factors," they include the level of skill required for the task; who provides the tools; where the work is performed; who sets the work schedule; the duration of the relationship; whether the hiring party can assign other tasks to the hired party; how the hired party is paid; whether employee benefits are provided; and how the arrangement is treated for tax purposes.

Courts have historically relied on the tax and benefits treatment accorded the hired party as an important, if not the determinative, factor. How the parties themselves treated the arrangement financially was considered a virtual admission of an employment relationship. Further, it would be inequitable to allow the employer to benefit from independent contractor status for benefits purposes while claiming an employee relationship for authorship purposes.

Nevertheless, in *JustMed, Inc. v. Byce,* 600 F. 3d 1118 (9th Cir. 2010), the Ninth Circuit gave the financial factors short shrift in finding that a computer programmer was an employee; and the code he produced, a work for hire for the hiring party. Byce wrote a program for an artificial larynx for use by JustMed. On the one hand, Byce was engaged indefinitely, was compensated monthly, and did other work for the company, such as working on the company website and appearing at trade shows; all factors that would favor an employment relationship. On the other hand, Byce was paid solely in stock until right before the case was filed, worked from home in another state, received little direct supervision from the company, and, significantly, did not receive employee benefits or fill out employment tax forms.

Byce did, however, replace an employee, Leibler, who worked on the code but quit after taking a job in a distant state.

The Ninth Circuit applied the Reid factors and held that Byce was an employee. In so holding, it made some sweeping pronouncements regarding start-up technology companies that may reverberate in future cases, in particular: "JustMed's treatment of Byce with regard to taxes, benefits and employment forms is more likely attributable to the start-up nature of the business than to Byce's alleged status as an independent contractor." The court also noted that small start-ups operate more informally and that fact "should not make the company more susceptible to losing control over software integral to its product." Finally, with regard to programmers, the court concluded that they are expected to work independently and customarily are subject to a lesser degree of control.

Following on the heels of the *JustMed* decision, the Western District of Wisconsin, in *Woods v. Resnick*, 725 F. Supp. 2d 809 (W.D. Wis. 2010), held that Resnick, the co-owner of a start-up technology company, F & I Source, LLC, owned the copyright in the code he wrote for an auto finance product. Indeed, the Reid factors suggested that the programmer was an independent contractor, as Resnick wrote the code at home on his own computer, set his own hours, did not receive employee benefits, and was paid a cash draw against profit distributions, while other employees received a salary. However, the court did not rest its holding on this. Instead, it found that Resnick, a 50 percent owner of F & I Source's equity interests, was neither an independent contractor nor an employee for work for hire purposes. As a co-owner he had an inherent right to control the business and, so, was not an agent of it when he wrote the code. By default, Resnick owned the copyright as the sole author.

The holdings in *JustMed* and *Woods* indicate that courts are looking beyond the strict application of the Reid factors to the gestalt of the relationship of the author to the hiring party. This approach is particularly meaningful in the context of technology start-ups, where programmers routinely telecommute and may also be equity holders. However, it may have application to other start-up companies where, in the words of the Ninth Circuit, business is conducted "more informally than an established enterprise might."

The ambiguity surrounding whether an author is an employee, independent contractor, or neither, may well be resolved by a written agreement. Although it is not certain that a court would enforce the parties' characterization of their relationship if Reid factors clearly do not favor it, an agreement, like the tax and benefits treatment in past decisions, would be a useful piece of evidence of the parties' intent.

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BUSINESS LAW TODAY
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Keeping Current: Consumer Credit

California Supreme Court Expands Retailers' Liability Under Credit Card Privacy Laws

By Paul S. Rosenlund

Many California retailers have been impacted in recent years by lawsuits brought by self-styled privacy advocates seeking damages and other redress resulting from retailers' gathering customer addresses, e-mail addresses, telephone numbers, or other personal information during the course of a credit card transaction.

The Supreme Court of California issued a decision on February 10, 2011, that appears to render the privacy landscape even riskier for retailers that accept credit card payments from California customers. In *Pineda v. Williams-Sonoma Stores, Inc.*, 2011 Cal. LEXIS 1355 (Cal. Feb. 10, 2011), the state supreme court ruled that a customer's ZIP code constitutes "personal identification information" and that requesting and recording the customer's ZIP code during the course of certain credit card transactions may subject the requesting party to claims for up to $1,000 per transaction, plus other liabilities.

Song-Beverly Credit Card Act

The basis of the court's ruling in *Pineda* was the Song-Beverly Credit Card Act of 1971, California Civil Code § 1747, *et seq*. Many provisions of the Song-Beverly Credit Card Act were intended to parallel the federal Truth in Lending Act, 15 U.S.C. § 1601, *et seq.*, but the California law covers additional topics. One of its provisions, Civil Code § 1747.08, prohibits businesses that accept credit cards from doing any of the following:

1. Requesting, or requiring as a condition of accepting the credit card as payment in full or in part for goods or services, the cardholder to write any personal identification information upon the credit card transaction form or otherwise;
2. Requesting, or requiring as a condition of accepting the credit card as payment in full or in part for goods or services, the cardholder to provide personal identification information that the person, firm, partnership, association or corporation accepting the credit card writes, causes to be written or otherwise records upon the credit card transaction form or otherwise.
3. Utilizing, in any credit card transaction, a credit card form that contains preprinted spaces specifically designated for filling in any personal identification information of the cardholder.

The Song-Beverly Credit Card Act provides many exceptions to this prohibition, but each must be carefully considered when applied to the circumstances at hand. For example, a retailer may record information that is on the face of the credit card, but nevertheless must comply with Title I, section 113 of the Fair and Accurate Credit Transactions Act, Public Law 108–159, codified at 15 U.S.C § 1681c(g), which limits the data that may be electronically printed on receipts provided to the customer. The retailer may demand reasonable identification, but may not record identification information, such as a driver's license number, phone number, or address, on the transaction record or elsewhere. The law exempts transactions involving security or damage deposits; cash advance transactions; Internet, telephone, and mail order transactions; refund transactions; and a variety of other instances for which personal identification information is required for a special purpose incidental but related to the individual credit card transaction.

Potential Claims

Only the California attorney general can seek injunctive relief under the Song-Beverly Credit Card Act, but private parties pursuing individual claims and class actions can obtain civil penalties of up to $1,000 per transaction, plus costs and legal fees. Potential also exists for violations to draw parallel claims based on other California consumer statutes, such as the Consumers Legal Remedies Act (Calif. Civil Code § 1750, *et seq*.) or the Unfair Competition Law (Calif. Bus. & Prof. Code § 17200, *et seq*.).

Numerous class action suits have been brought under the Song-Beverly Credit Card Act. Plaintiffs typically contend that they made a purchase and were asked to provide a ZIP code, address, or telephone number that was then typed into the cash register, and that they were led to believe that providing this information was a mandatory condition of the transaction. They also may allege a panoply of potential losses of privacy and misuse of their personal information, but the core of their claims—and a potentially significant risk to retailers and others dealing with California consumers—is the $1,000 civil penalty *per transaction*, as well as attorneys' fees.

Impact on Retailers

Many retailers request ZIP codes from customers, not for the purpose of reconstructing their customers' addresses to send them junk mail or to sell their information to others, but for perfectly legitimate purposes such as determining where to locate new stores or focus newspaper advertising. Until this month, retailers who requested only ZIP codes enjoyed a respite from liability under the Song-Beverly Credit Card Act based on lower court holdings, such as *Party City v. Superior Court*, 169 Cal. App. 4th 497, 86 Cal. Rptr. 3d 721 (2008), that a ZIP code does not constitute "personal identification" under the statute.

However, in *Pineda v. Williams-Sonoma*, the supreme court disapproved the *Party City* ruling and others like it. The court held that a credit card customer's ZIP code—even when provided with nothing more—constitutes "personal identification information," and that businesses are subject to liability for requesting and recording it during a credit card transaction, irrespective of what they do with the information.

In so holding, the supreme court dismissed arguments that the statute violates due process because it could result in substantial penalties that might be confiscatory in nature. The court noted that the Song-Beverly statute provides flexibility to courts in setting penalties, because the $1,000 figure is a *maximum* penalty, and a court is free to award a lower amount "or even the proverbial peppercorn we all encountered in law school."

The supreme court also dismissed defense arguments that its new ruling should apply only prospectively, thereby potentially exposing businesses to liability if they relied on *Party City* or similar cases in thinking that they were compliant with the Song-Beverly law by requesting customer ZIP codes and nothing more.

Retailers' Response

All businesses who accept credit card payments from California consumers should consider assessing their credit card transaction and information-capture policies and procedures for compliance with the Song-Beverly Credit Card Act and other pertinent laws and regulations.

Even those businesses who have settled Song-Beverly claims and revised their operating procedures in the past should now consider taking a second look at their practices.

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BUSINESS LAW TODAY
The ABA Business Law Section's Online Resource

Training for Tomorrow

An Introduction to Negotiations for Future Transactional Lawyers

By Susan M. Chesler

Most transactional lawyers negotiate, yet few law students who plan to become transactional lawyers actually learn negotiation skills in law school. Most of these future lawyers do not take a course in Negotiation; it just isn't one of the law school courses seen as a requirement for transactional lawyers. These students are advised to take Business Organizations, Sales & Leases, Secured Transactions, Accounting for Lawyers, and Taxation, but not Negotiations. And most law school Negotiations courses are centered on the litigation context. While some law schools do offer courses on transactional lawyering or transactional clinics that include a component on negotiation, negotiation training for future transactional lawyers is most often ignored in law school. Thus, it often becomes the responsibility of law firms and employers to train new transactional lawyers how to effectively negotiate on behalf of their clients.

That is why I decided to include an introduction to negotiation skills in my contract drafting course several years ago. To me, it seemed a natural fit because you cannot really divorce the skill of drafting contracts from the skill of negotiating contracts. Of course, it would not be feasible for me to teach students everything they are going to need to know about negotiation in my contract drafting course; there just isn't enough time to accomplish that.

So when I decided to incorporate the teaching of negotiation skills, I chose to focus on introducing my students to three basic concepts: (1) the role of transactional lawyers in negotiations; (2) the benefits of interest-based negotiation and effective communication; and (3) the ethical obligations of legal negotiators. These objectives are aimed at providing my students with a practical introduction to the negotiation skills that they will likely need when they enter the workforce.

Since negotiation training for future transactional lawyers is so limited during law school, it is advantageous for law firms and employers to incorporate negotiation skills in their training. The concepts discussed below could be used to formulate a valuable introduction to the methods of effective and ethical negotiation for new lawyers, or even as a useful reminder for more experienced transactional lawyers.

The Role of the Transactional Lawyer

First, it is important for new lawyers to understand the role of the transactional lawyer in negotiations. When litigators speak about negotiations, they are generally referring to an adversarial process. In most instances, negotiations occur in an effort to settle a legal dispute between two parties on opposing sides of a lawsuit. The same is also true for other types of lawyers; for example, family lawyers often negotiate when their clients are embroiled in bitter divorce or custody proceedings. In these adversarial settings, not only do both sides often have completely divergent views, but success is often measured not only in terms of what one party wins, but also in terms of what the other party loses.

However, for transactional lawyers, negotiations often occur in a very different setting. Most transactional lawyers negotiate deals and contract terms in situations where both parties to the negotiations seek the same final outcome—the commencement or continuation of a contractual relationship. While I am not suggesting that these negotiations cannot be confrontational or get "ugly," the parties are likely more similarly situated than a plaintiff and a defendant engaged in a civil lawsuit, or two parents dealing with custody of their children. Thus, transactional lawyers play a different role than other types of lawyers when they engage in negotiations.

It is this role that all future transactional lawyers must be exposed to. A mock negotiation exercise that I use in my class reinforces the fact that law students are primarily trained to view every legal interaction as adversarial. For this exercise, my students are matched up as lawyers representing each side to a basic sales agreement and told the general parameters that the parties have agreed to, before I send them off to negotiate the specific terms of the agreement.

Every year, with every group of students, many do not actually reach a compromise. The result is often that the two student lawyers cannot agree on the terms of the contract, so they decide to walk away. In most instances, this is because one or both of the students do not want to give anything away to the other party. They stick to their guns to such a degree that not only does the other party not receive any concessions, but neither party gets a contract—the contract that they both desired. This exercise thus leads to a prime teaching opportunity—one in which we can discuss the role of the transactional lawyer in negotiations. More specifically, we discuss how for transactional lawyers, negotiations are not generally adversarial. Of course, the transactional lawyer must zealously represent his or her client in negotiations, trying to get the best possible outcome for the client. But since both parties' goals are usually to enter into a mutually beneficial contractual relationship, transactional lawyers do not generally view the goal of contract negotiations as being to win everything while the other party loses everything. When most law students enter practice, they do not understand this role that transactional lawyers engage in while negotiating a contract on behalf of their clients. Thus, any introduction to negotiations in practice should begin with this basic, yet fundamental, concept.

Interest-Based Bargaining

Second, new transactional lawyers must be exposed to the benefits of interest-based negotiation and effective communication. In my class, I emphasize the benefits of moving away from a purely adversarial approach to negotiation, which often results in a win-lose result, and to moving toward an approach that is aimed at finding a creative win-win solution to the negotiations.

To illustrate this concept, I use the well-known example of two sisters arguing over an orange. In this scenario, both sisters want the orange for undisclosed reasons. Thus, their conflict appears to be distributional; in other words, the resource over which they are negotiating is fixed and limited. As long as they continue to argue about who gets the orange, the result will be that one sister gets the whole orange and the other sister gets nothing. One of the sisters will win the proverbial "whole pie" and the other sister will lose everything, not even getting a slice of the pie.

Incorporating the concepts of underlying interest and effective communication can bring a new dimension to the negotiation about the orange. If the sisters were to disclose their underlying interests for desiring the orange, it is more likely that they will be able to find a creative win-win solution to their conflict. In fact, one of the sisters wants the orange so that she can use the juice for drinking, while the other sister wants the orange so that she can use the rind for baking. If these underlying interests are considered in the negotiation, a compromise can be reached where both sisters win. One sister gets the whole outside of the orange to use for baking and the other sister gets the whole inside of the orange to use for juice. Using underlying interests as the basis for bargaining and finding a creative solution to improve the negotiation is sometimes referred to as "expanding the pie" or "creating value" in the negotiation. Thus, any introduction to negotiation, especially for future transactional lawyers, should emphasize seeking creative solutions in order to reach value-maximizing results through interest-based bargaining.

Professionalism and Ethics

Finally, it is imperative that new lawyers gain a basic understanding of professionalism and the ethical obligations of legal negotiators, particularly in transactional settings. Most law students learn about ethics in the context of a Professional Responsibility course—one that is too often primarily focused on the Model Rules of Professional Conduct, is designed to help students prepare for the MPRE, and is grounded in the litigation context. In practice, what young transactional lawyers need to understand is how to recognize potential ethical dilemmas and how to handle them in a manner that is beneficial to their clients and to their own professional reputations.

The answers to ethical dilemmas in these situations are far from clear. The preamble to the Model Rules describes the role of the lawyer as negotiator: "As negotiator, a lawyer seeks a result advantageous to the client but consistent with requirements of honest dealing with others." Thus, while the lawyer must advocate on behalf of his or her client to achieve a favorable result to the negotiations, he or she may be constrained by ethical considerations. In the transactional setting, since negotiations generally take place when the parties are working toward entering into a mutual contractual relationship, the costs of engaging in unethical or deceptive practices include the very real risk that the parties will not reach the desired result.

In an effort to avoid teaching professionalism and ethics in a vacuum, I present my students with hypothetical situations that may actually arise during contract negotiations. For example, one scenario relates to whether a lawyer for the seller during negotiations for the sale of a small business may present a "highball" offer that represents a sales price the lawyer believes is unreasonably high. Rule 4.1(a) states that "a lawyer shall not knowingly make a false statement of material fact or law to a third party." Comment 2 acknowledges that in negotiations, there is some leeway because of the difficulty in determining what is truthful and what is false in the unique context of negotiations. In negotiations, certain types of statements by lawyers are not seen as "statements of material fact" and thus are permissible. Almost all lawyers in negotiations expect the other lawyer to engage in "puffing" and some embellishment of the facts. My law students know this—but the real questions are what types of deceptive tactics *may* ethically be employed to enhance bargaining interests and what tactics *should* be employed.

Comment 2 to Rule 4.1(a) specifically states that "estimates of price or value placed on the subject of a transaction" do not constitute material facts under the Rule. Thus, a lawyer is likely not violating ethical obligations if he or she begins the negotiations with a "highball" offer. The same is not likely true if he or she instead advised the buyer's lawyer that there are other interested buyers in an effort to make the offer more appealing, when in fact there are none. But the point of this discussion is also to focus on whether these types of tactics are necessarily wise decisions, even if not unethical ones. We talk about how lawyers may want to counsel their clients about relevant considerations that are non-monetary, such as the very real risk that the potential buyer will walk away from the negotiating table based on the impression that the seller is behaving unreasonably.

New lawyers also need to be introduced to the concept of professional reputation and how acts of dishonesty or unprofessionalism may negatively impact their reputations. The potential injury to the reputation of dishonest lawyers could be monumental. As other lawyers learn that a particular lawyer is not trustworthy, future interactions may become more difficult for that lawyer and his or her clients. If nothing else moves a lawyer to behave in an ethical and professional manner, the hope for a successful career should induce that lawyer to avoid conduct that may undermine his or her future effectiveness.

Conclusion

By incorporating an introduction to negotiations skills in my course, I strive to make my students' understanding of contract drafting more complete and more practical. But all that I really do is plant the seeds for their future learning about effective and ethical negotiating in a transactional setting. Law schools need to do more to sow those seeds—they need to encourage future transactional lawyers to learn about negotiations and they need to offer more opportunities for them to do so before they enter the practice of law. But regardless of whether law schools rise to this challenge, law firms and employers will need to train new lawyers about how transactional lawyers effectively and ethically represent their clients in negotiations. The three concepts discussed above would be a valuable starting point.

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BUSINESS LAW **TODAY**
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Focusing on Pro Bono: Youth Financial Literacy

What Business Lawyers Can Teach Students

By Allyn O'Connor

The ABA Business Law Section is pleased to announce its partnership with Junior Achievement to provide financial literacy education in schools across the nation.

On July 21, the nation's new Consumer Financial Protection Bureau will begin writing rules governing the everyday financial products used by consumers everywhere, including overdraft protection lines, private student loans, and payday loans. Consumer advocates and business leaders both expect the result to be the greatest increase in consumer-oriented rulemaking in decades. "But unless we improve financial literacy, what are we accomplishing?" asks Len Bernstein, a partner at Reed Smith LLP in Princeton, New Jersey. Bernstein even compares the never-ending attempts to regulate consumer financial products to the old Billy Preston song "Will It Go Round In Circles."

Bernstein is one of many business lawyers who volunteers his time educating high school students on financial products and personal finances. Bernstein volunteers through Junior Achievement of Delaware Valley, Inc. Junior Achievement of Delaware Valley is a local office of JA Worldwide. JA Worldwide is a nonprofit organization dedicated to educating students about workforce readiness, entrepreneurship and financial literacy through experiential, hands-on programs. Volunteers from local communities serve as instructors. The JA curriculum accommodates the learning levels of students from kindergarten through high school and ranges from simple self-awareness exercises to programs on careers, savings, borrowing, and the business world generally.

JA Worldwide has already developed materials for every instruction level. To ensure a successful experience for students and volunteers, JA Worldwide packages each lesson in a kit containing detailed activity plans, workbooks, and additional materials. Many local JA offices even provide on-line teaching instruction videos to prepare volunteers.

Local JA office staff is familiar with area public and private schools, including parochial schools. They connect with schools interested in the type of instruction JA can provide, and match lessons to grade levels. There is no need for a volunteer to contact school administrators or teachers directly. Volunteers simply contact their local Junior Achievement office and ask for an opportunity. Local staff will put the classroom teacher and the volunteer in contact with each other, giving them the opportunity to coordinate a schedule. Volunteer commitments vary depending on the grade level and the nature of the lesson. After a brief orientation session, commitments can be as short as a few hours ("JA in a Day") to one hour a week for a few weeks.

Lauren Campesi is an associate with McGlinchey Stafford PLLC in New Orleans. She first volunteered for Junior Achievement instruction when she was 18 and a college freshman. "The experience was very easy," she says. "Everything was completely planned. The lesson plans come prepackaged. They're easy to read, they're easy to prepare for. All of the materials that you need are there for you. You don't have to worry about finding the school . . . that guesswork is done for you."

Junior Achievement understands the need for financial literacy and has designed a personal finance instruction module aimed at high school students. As Junior Achievement representative Marcus Brooks explains, "JA Personal Finance introduces students to the importance of making wise financial decisions. You ask kids where money comes from [and they respond], 'My mom and dad gave it to me, that's all I know.' In most cases, they don't understand the value of it. This teaches them to plan; it teaches them goal-setting and thoughtful decision-making."

The JA Personal Finance lessons cover budgeting, saving, investment, credit, identity theft, and insurance. Students work in groups to complete exercises that give them experience in these areas. "The [budgeting] lesson explains the purpose of setting goals and making wise financial decisions that meet personal goals," says Brooks. "It opens their eyes to the idea that luxury cars, nice homes, and going out to eat every night takes work, and you are going to have to do some things in order to get to that place. It helps students make the connection between wanting something and working for it."

Students also get experience completing their own personal investment guide and planning their personal financial futures. "You'd be surprised how many kids have no clue how to invest. They don't even understand investments," Brooks says. "They think you make money, you spend money. Here they learn about the things you can invest in: homes, stocks, bonds, savings accounts." They also learn valuable lessons about the use and abuse of credit, considering the benefit of postponing credit purchases, and exploring other options before putting themselves into debt.

Though the focus of the JA Personal Finance is on money, volunteers have the opportunity to teach students other skills necessary for professional success: public speaking, reading comprehension, organization, and cooperative group work.

Kathy McLeroy, a Carlton Fields shareholder, notes that this kind of volunteer opportunity is ideal for business lawyers. Business lawyers "want things that they don't feel overwhelmed with . . . in this case, the materials [cover] an area that we all are somewhat familiar with," says McLeroy.

Mustering firm resources should not be difficult either, according to those who have already volunteered. McLeroy suggests getting summer associates involved in the efforts. "They love that kind of thing," she says. Len Bernstein urges law firms to invite clients, and not just in-house counsel. "There's nothing that says that somebody who has been anointed a lawyer is the only one capable of teaching this material." He points out that clients include bankers and other members of the client organization. Lauren Campesi notes that many large clients already volunteer for Junior Achievement, making a law firm's effort to collaborate even easier.

Some firms may be hesitant to commit billable hours to volunteering for what some consider to be non-legal activities. Kathy McLeroy, who also chairs the Business Law Section's Pro Bono Committee, notes pro bono rules will vary from state to state, but most follow the language of ABA Model Rule 6.1. She suggests looking closely at the state rule. If a state has mandatory pro bono reporting requirements, also look to those rules for guidance, advises McLeroy. "The Florida Bar rule about pro bono service is relatively narrow and the focus is on the poor," says McLeroy, who is based in Tampa. McLeroy suggests seeking out schools with a high level of free breakfast and free lunch participation to be sure volunteers work with low-income students.

Many consumer advocates believe the recent financial crisis arose in part from a lack of consumer sophistication about mortgages and other financial products. While no one can be completely certain how financial illiteracy may have contributed to the crisis, the need for raising financial awareness among young people remains. Studies suggest providing financial education to youth improves their overall economic and financial knowledge.

If your firm is interested in volunteering, contact your local JA office or ABA Business Law Section staff Allyn O'Connor.

Len Bernstein can attest to this. The students he instructed through a Junior Achievement program thanked him personally, letting him know how much they learned. "I was really shocked when I learned about the interest rates and how much you wind up paying if you only pay the minimum payment," said one. "I would never have realized that if you had not brought it to our attention." And from another: "One topic I'm particularly thankful you went over was identity theft. I had never thought of the necessity of destroying papers with personal information before putting them in the trash to prevent people from dumpster diving. Thank you for the head's up."

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