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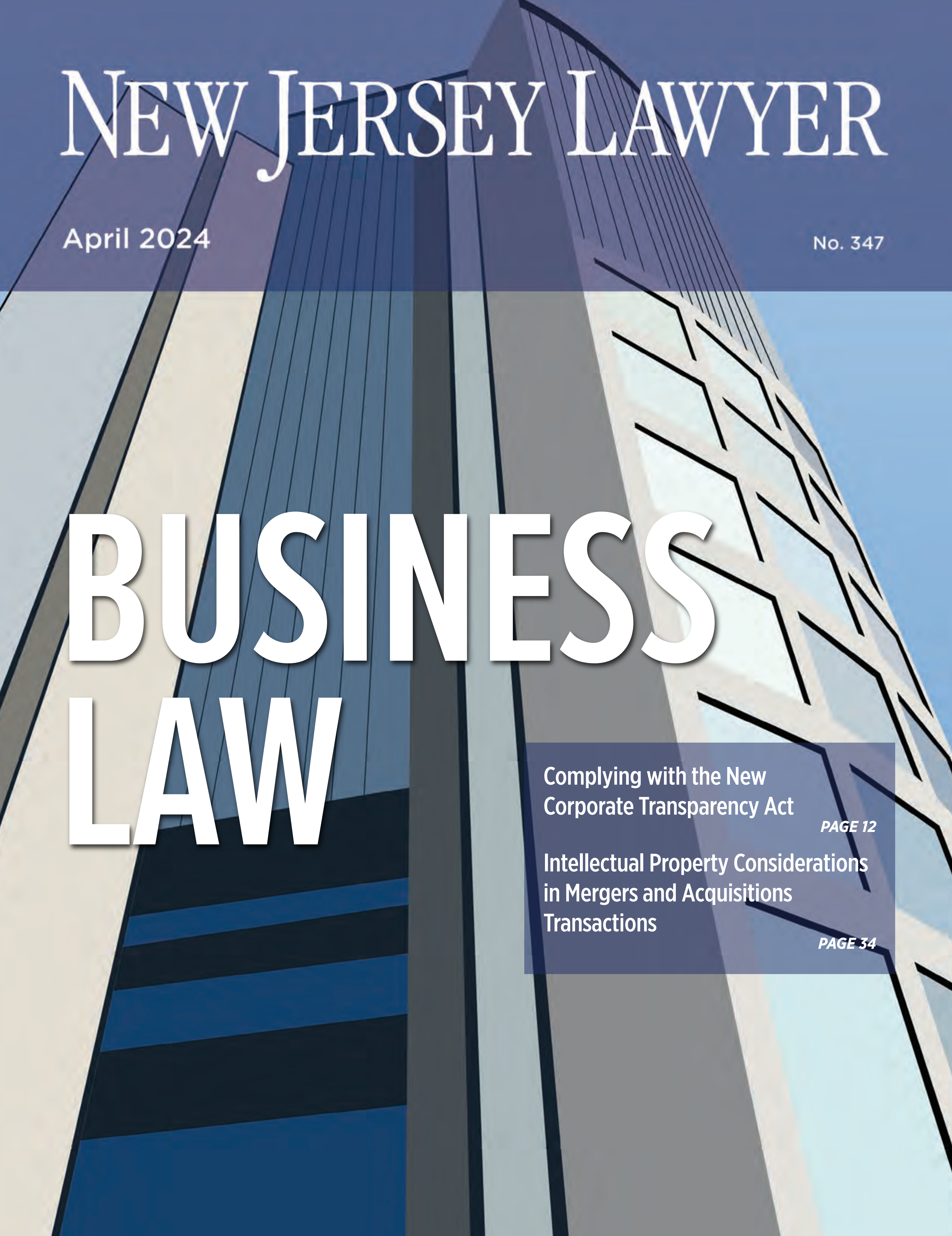

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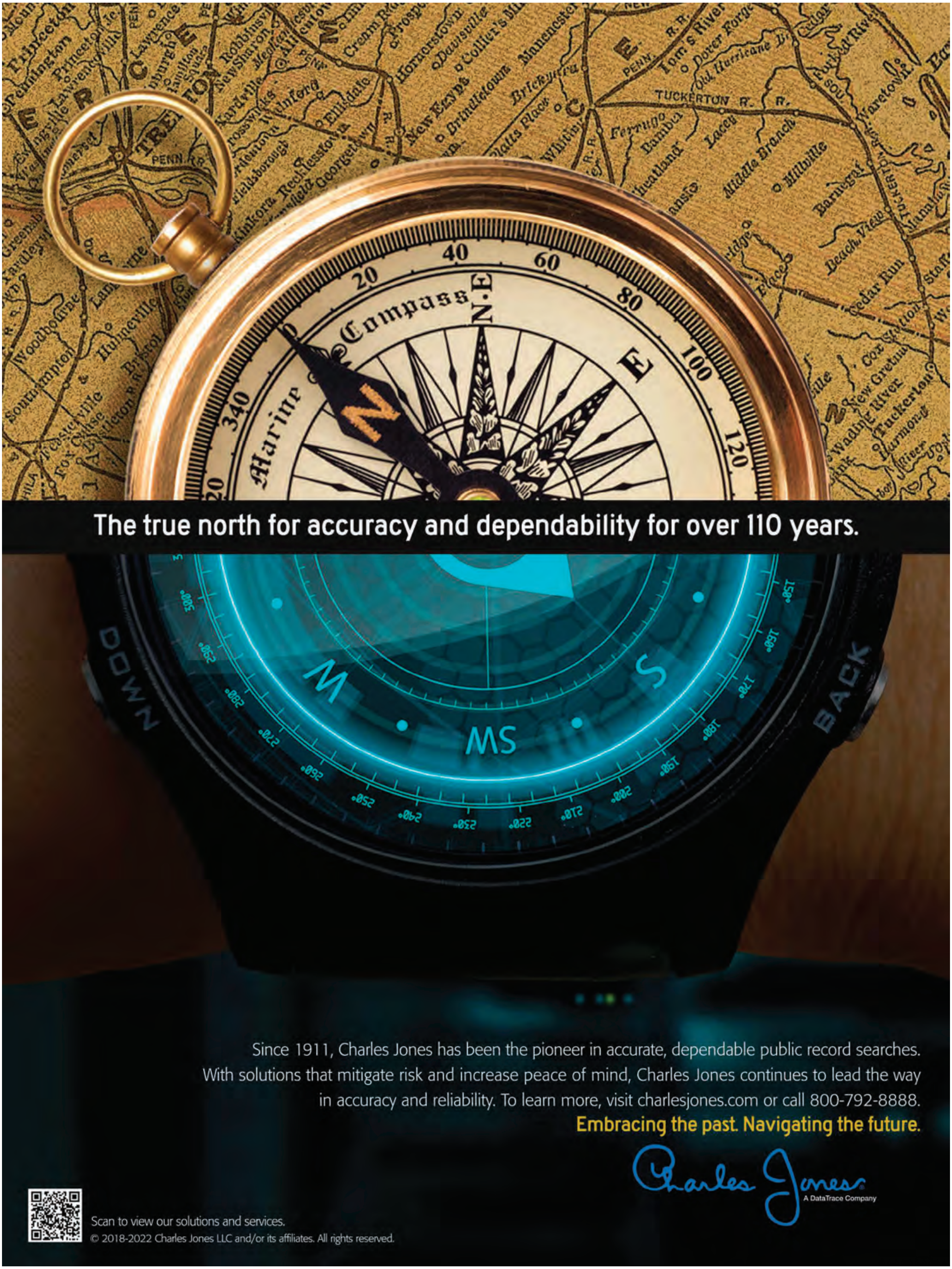

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The NJSBA is Here to Help

The NJSBA Member Assistance Program connects our members—and anyone else in their household—to trained, experienced mental health professionals and resources.

At the heart of the program, provided through industry leader Charles Nechtem Associates, is 24/7 access to a mental health professional with at least seven years of experience. The professional will counsel callers and help them find resources. If needed, they will help people find an accessible clinician who is accepting patients. Members are eligible for **up to three** in-person counseling sessions per issue. They can also access **unlimited text, phone and email support** and search an extensive Wellness Library with 25,000 interactive resourses to improve their personal and professional lives.

Contact MAP Counselors Anytime

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Phone counseling services are available 24 hours a day, 7 days a week, 365 days a year with immediate access to clinicians. Access to English and Spanish speaking therapists, with other languages upon request.

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Connect via the website, charlesnechtem.com
Click "Member Login" and log in as a new user.
The employer is NJSBA.

Email
Reach out to inquiries@charlesnechtem.com

The Member Assistance Program is a benefit of membership.

NJSBA

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TIMOTHY F. MCGOUGHRAN

Reflecting on a Year of Service with Gratitude

Unbelievable!

This year has flown by so quickly and has been more rewarding than I ever dreamed. Serving as president of this great organization and on behalf of the dedicated and compassionate volunteer members of the New Jersey legal community has been an incredible gift. I am humbled and honored to have served as your 125th President. Thank you.

Together we have accomplished an impressive body of work that will bolster our profession, our clients, and society for years to come.

The NJSBA has remained a tireless voice in urging our elected officials to fulfil their constitutional duty to ensure our courts have a full slate of judges. We have been a strong voice in the press and in Trenton explaining how these vacancies affect real people and the very real issues they are trying to resolve.

Our Judicial and Prosecutorial Appointments Committee has committed itself to vetting candidates, and there are nearly a dozen waiting in the judicial nomination pipeline. We have seen a reduction in judicial vacancies from 67 last May that has been cut in half. While we have seen important steps to addressing this crisis, I can assure you the NJSBA will not take its foot off the pedal nor decrease the urgency of its calls for action until our courts have the full judicial staff called for in the constitution.

One of the efforts I am most proud of this year is the way the New Jersey State Bar Association stepped up to support the mental health needs of our colleagues and the residents of this state. Much of that was continuing the good work of the Putting Lawyers First Task Force created by my dear friend and predecessor Jeralyn Lawrence. We also thank Chief Justice Stuart Rabner for creating the Supreme Court Committee on Wellness in the Law, chaired by Justice Lee A. Solomon. It includes representatives from the New Jersey State Bar Association and other legal associations, the Attorney General's Office, the Office of the Public Defender, as well as Acting Administrative Director of the Courts Glenn A. Grant. Reminding legal professionals to look after each other and look after themselves will be an ongoing mission of the NJSBA.

This Association has taken concrete steps to support the mental health of our profession. In the first year of its existence, the NJSBA's Member Assistance Program has helped thousands of attorneys and their immediate families get the resources they need to stem the decline in mental health and wellness that threatens our profession.

If you remember nothing of my tenure or even of what the Association has done, please remember that you can get help 24/7 from trained, experienced mental health professionals by phone, text or mobile access at 800-531-0200 via the CNA app available from the Apple App Store and Google Play or at inquiries@charlesnechtem.com.

Mental help for criminal defendants has long been needed and is now a reality as the state begins to expand mental health diversion programs in courts across the state. It's an effort the NJSBA has supported at every step of the way and one we back for statewide implementation. This expansion marks a significant step forward for the treatment of nonviolent defendants in the criminal justice system who suffer from a mental health disorder. These programs will help provide more opportunities for rehabilitation and redemption than any trip to jail, a fate that many who struggle with their mental health suffer. Programs like this are proven to create safer communities and cut incarceration costs that our taxpayers must pay and return offenders to society rehabilitated and productive.

In addition to our achievements externally, the Association has—unlike many organizations around the country—seen its membership expand into new groups that will ensure it truly captures all voices in the profession, from private practice to corporate counsel, to government lawyers including our public defenders and prosecutors. Throughout this year we have held lunchtime Zoom meetings with bar leaders from every county and affinity bar to share ideas and find areas of collaboration. While we are technically different bar associations, we all serve the common purpose of helping our members be better lawyers and work in a system that allows our members

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FROM THE SPECIAL EDITOR

Business Law Updates Cover Vast Ground

This issue of *New Jersey Lawyer* covers a wide spectrum of topics that will provide tangible benefit to general practitioners in New Jersey, including articles on recently enacted laws and trending topics in business law.

This issue opens with an article by Michael F. Schaff and Jason J. Krisza on the Corporate Transparency Act (CTA), which went into effect on Jan. 1, 2024. Millions of entities are now obligated to report details on their ownership and on the people who form the entities. Practitioners should know that many small businesses and real estate companies formed in New Jersey are required to comply with the CTA's reporting obligations, and the CTA imposes penalties for failing to comply.

Most business lawyers in New Jersey have some familiarity with the New Jersey Revised Uniform Limited Liability Company Act (NJ-RULLCA), since the overwhelming majority of entities formed in New Jersey are LLCs. Gianfranco A. Pietrafesa discusses cases interpreting NJ-RULLCA since its adoption about a decade ago. He also suggests numerous amendments that he believes would make it a better statute.

In his article, W. Raymond Felton points out that the New Jersey Legislature did not amend the New Jersey Business Corporation Act (NJBCA) at the same time that NJ-RULLCA was adopted, so the use of the conversion provisions contemplated by NJ-RULLCA has been limited. On Nov. 4, 2023, certain amendments to the NJBCA became effective that now allow a corporation or limited liability company to efficiently change its state of incorporation (or formation) and its form of entity. Felton reviews some of the details of these amendments.

Next, Jason Navarino and Hannah Greendyk discuss the unique considerations that go into selling a substantial interest in a company, but where the seller retains a substantial interest as well, either by retaining partial ownership of its existing business or through receipt of rollover equity from the buyer.

Onome Adejemilua then examines the upswing in corporate venture capital (CVC) participation in startup funding, and structuring considerations in making those investments. She highlights corporations, particularly in New Jersey, that are engaging in CVC investments.

The next two articles focus on important topics that general business lawyers may not always carefully consider when handling mergers and acquisitions

SENWAN AKHTAR *is a partner at Potomac Law Group PLLC, where she is a member of the corporate, cybersecurity and real estate practice groups. She is a member of the editorial board of New Jersey Lawyer, and she is co-chair of the real estate committee of the Middlesex County Bar Association. She serves as outside general counsel to middle market businesses, and represents clients on mergers and acquisitions, data privacy and general corporate matters. She also handles the sale, acquisition, leasing and financing of commercial properties.*

transactions. Melissa Skrocki and Ammad Ahmed provide advice on issues a buyer should consider when acquiring a target company's intellectual property assets, including trademarks, copyrights, patents and trade secrets. In their article, Karen Painter Randall, Joshua P. Previl, and Adam J. Salzer point out that it is critical to conduct substantive due diligence on the organizational cybersecurity infrastructure of a buyer's target investment. This is especially true given the constant threats of data security breaches and new regulatory reporting standards in cybersecurity.

Galit Kierkut then discusses federal and state attempts to restrict worker non-compete restrictions. She suggests that trade secret protections are an employer's best tool to protect confidential information if key employees depart to competitors and non-competes become unenforceable under federal or state law.

Finally, Robert Bartkus and James Harry (JH) Oliverio, who work in the areas of arbitration and litigation, state that they routinely see arbitration clauses in commercial contracts that contain fatal defects. They give practical advice to transactional attorneys by providing a checklist of suggestions on drafting and implementing dispute resolution clauses.

I would like to thank all of the authors for their valuable contributions to this issue of *New Jersey Lawyer* magazine. ■

President's Perspective

Continued from page 5

to succeed. We are very proud that we are the largest bar association in the state, but this outreach allows us to be the most representative of the many, rich facets of the profession. Having that breadth of knowledge and expertise among our members enriches everything we do, from every benefit we offer to every advocacy position we take.

Among our many achievements, there have also been moments of grief this year for our Association.

Last May, shortly after my installation, we lost Assignment Judge Lisa P. Thornton, a trailblazing leader who brought an innate sense of fairness and compassion to everything she did. I look forward to the NJSBA presenting the inaugural award in her honor at the upcoming Annual Meeting and Convention in Atlantic City.

I am also saddened to share that the state bar lost an extraordinary member in Jeremy Farrell—a former chair of the NJSBA's Legislative Committee and At-Large Trustee—who passed away in December. Jeremy volunteered countless hours to provide expertise on the Association's legislative initiatives. He was instrumental in helping educate our members about the legislative process and legislative intent. As a tribute to his work in advancing the Association's legislative positions and mission, I was proud to present him with a posthumous Distinguished Legislative Service Award in January. Jeremy's contributions to the Association and its members, both personal and professional, will be deeply missed. We are all better off for his service to the bar.

If you would like to donate to the scholarship fund honoring Judge Thornton or to the 529 fund benefitting Jeremy's son, please contact askthenjsba@njsba.com for details.

As I conclude this year of service, I am profoundly grateful to many people who have volunteered on behalf of the Association in the shared pursuit of improving the profession that are simply too many to name as well as the fantastic staff at the NJSBA and NJSBF led by Angela Scheck. I am confident that my friend William H. Mergner Jr. who will be sworn in as president next month, along with our officers and Board, are ready to address any challenge that presents itself and to advance the mission of our organization. The members of this Association are in the good hands of thoughtful, zealous advocates who will continue to burnish the reputation of our organization as it proudly marches into its 125th year.

As always—or at least until May 17—if you have any matters of concern, please contact me at 732-660-7115 or tmcgoughran@mcgoughranlaw.com.

Be well. ■

PRACTICE TIPS

TECH TIPS

How ChatGPT and Other AI Could Impact Your Practice

By NJSBA Staff

Artificial intelligence (AI) is here to stay. The emerging technology of ChatGPT, a powerful AI language model, has the potential to transform legal practice through its ability to provide general legal advice, along with legal research, contract drafting and document review. Here are some key points on the basics of AI and how attorneys can use it to their advantage.

What is AI and how does it work?

AI is a technology that leverages computers and machines to mimic the problem-solving and decision-making capabilities of the human mind. Popular AI programs like ChatGPT take question prompts from users and create an answer by pulling data from the internet, research papers, computer code and other sources. When the question is entered, high-speed algorithms do quick math to calculate the frequency that certain words or ideas appear in the search. The answer is determined by the probability that the information is relevant to the user.

Is AI a new phenomenon?

Other industries, like the medical field, have relied on AI technology for years. Doctors save time and lives by using computer-generated reports from MRIs, CT scans and blood tests to flag health issues. Attorneys may one day rely on AI to help draft their legal filings. But just like AI didn't replace doctors, lawyers will always be needed to interpret the results and make decisions. You, and your humanity, are essential to the equation.

Is the information produced by AI accurate?

Not always. AI scrubs the internet for information and pulls from an extremely wide set of data. Of course, the internet is rife with misinformation and well-intentioned articles that may be inaccurate. ChatGPT will present the information it collects as accurate, so it's up to the user to fact-check the information provided and exercise good judgment when applying it to a case. Attorneys have been fined for submitting legal briefs prepared by ChatGPT that cited cases which didn't exist. Remember, AI is best used as a guide or a tool for generating ideas. It is not meant for copying and pasting.

WRITER'S CORNER

Allow Me to Introduce Myself

By Veronica J. Finkelstein
Wilmington University School of Law

An effective introduction enhances any piece of writing. As lawyers and advocates for our clients, we should consider using introductions more often and purposefully.

Most of us intuitively react the same way when we meet a person—we introduce ourselves. That introduction is short and helpful. It is designed to share something about the speaker that will be meaningful for the conversation to follow.

Yet when we write, we often dispense with helpful, plain language introductions. By habit or convention, we often launch immediately into the argument. If we include any introduction at all, it is comprised primarily of unhelpful legalese like "Comes now the plaintiffs by and through their attorney…" Without an effective introduction, we lose a valuable opportunity to orient the reader and to persuade.

An effective introduction exploits what is known as the "serial position effect." This effect was first discovered by the psychologist Hermann Ebbinghaus whose experiments on memory

revealed that listeners most accurately recalled the first and last items on a list. The first item on the list had the benefit of recency, because this information was learned first it was most solidified.

An introduction occupies the serial position in our legal writing. The information conveyed in the introduction and conclusion will be most memorable to the judge. For this reason, the introduction is valuable real estate in the landscape of our briefs that we can use for persuasive effect.

An effective introduction contains four elements.

First, it sets the stage. It introduces the parties and their dispute. It states concretely what legal issue or issues are addressed in the brief. It puts focus before detail, priming the judge to understand the argument to follow.

Second, it creates a roadmap. It contains a few reasons why the client should prevail. These should be pithy versions of the best arguments for the relief sought. If the judge retains nothing else from the brief, the judge will retain these helpful highlights.

Third, it motivates. It uses logos, ethos, or pathos to persuade the judge to take some action rather than allow the status quo to persist. Appeals to logos focus on rationality. These types of appeals typically rely upon facts, figures, and data. Appeals to ethos focus on credibility and authority. These types of appeals ask the judge to put trust in the lawyer. Appeals to pathos play on the judge's emotion. These appeals ask the fact-finder to evaluate the case using beliefs and values. The path of least resistance for any judge is to do nothing. Motivation appeals push the judge into action.

Fourth, it previews the clash. Except in cases of joint or unopposed motions, there will always be counterarguments and oppositional positions. An effective introduction frames the issue in a way favorable to our clients, staking out the appropriate ground and forcing our opponent to argue on out turf.

Here is an example of a brief introduction to a summary judgment motion that contains these four elements:

This case is about the ice defendant Big Store, Inc. allowed to accumulate on December 15, 2023, not about what shoes plaintiff Patricia Pedestrian was wearing that day. Ms. Pedestrian is entitled to summary judgment in her favor because there is no dispute of material fact that this ice was a known and dangerous condition that Big Store, Inc. should have remedied. Big Store, Inc. was negligent. Ms. Pedestrian was not the first person to fall that day. In fact, for weeks Big Store, Inc.'s employees had reported customers slipping as the entered the store. Big Store, Inc. had a contract with an on-call snow removal company but elected not to call for service because Big Store, Inc. was trying to cut costs. They put profits over people, and now they should pay.

As you can see from this example, an effective introduction primes the reader to not only understand but agree with the argument to follow.

Not only do the four elements of an effective introduction improve our legal writing, thinking about them before writing an argument forces us to become more strategic advocates. If we cannot communicate this key information in a paragraph or two, there is little hope that the judge will be left with these points as the major takeaway after reading the entirety of the brief. Consider spending additional time crafting an effective introduction in your next piece of legal writing. ■

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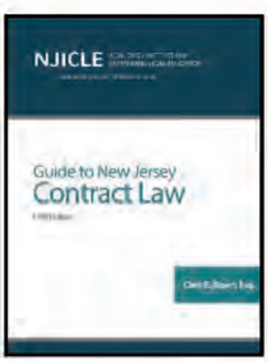
Business Law: Treatise



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Guide to New Jersey Contract Law (2020, 5th Edition)
Bound Book and Forms CD

Written by: Clark E. Alpert, Esq.

This substantially revised and updated book covers every major aspect of New Jersey contract law (and some related statutory topics), providing you with the information you need to know. Important topics have been restructured since the last edition, and vital new legal developments have been incorporated. General rules are set forth, exceptions are enumerated, citations are provided, and examples from case law are presented. From common law to the Uniform Commercial Code, you'll find this book an essential tool in your law library

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A spotlight on some April programs.

Civility in the Law

Earn up to 3.0 credits, including 1.2 in Ethics!

Tues., April 9
9:30 a.m. – 12 p.m.

Presented in cooperation with the NJSBA Labor and Employment Law Section

Did you know that the EEOC has highlighted "incivility" as a precursor to harassment in the workplace? Our expert panel will delve into the essence of civility training and its profound impact. We'll explore compelling research validating the imperative need for civility training and delve into the crucial concept of psychological safety. Don't miss this opportunity to elevate your practice and foster a culture of civility in the legal profession. Register now to secure your spot!

Records Destruction: Privacy and Privilege Versus Spoliation

Earn up to 2.3 credits, including 0.6 in Ethics!

Thurs., April 18
10 a.m. – 12 p.m.

This seminar will provide practical advice and perspectives from a panel of experts on topics ranging from the definition of "record," to the challenges posed to RIM today, including those that may arise from the recent New Jersey Data Privacy Act. The panel will also address the ethical obligations of attorneys implicated by RIM and sanctions that might be imposed when information is mishandled or lost.

Cultivating Mindfulness, Diversity and Inclusion

Earn CLE credits!

Tues., April 23
1 p.m. – 2:40 p.m.

This program will discuss types of common biases faced by diverse attorneys and will examine effective methods to balance personal wellness amidst the demands of legal practice, fostering resilience and professional growth. Join us to discuss various ways to maintain balance amid client challenges, embrace diverse perspectives, and optimize mental well-being.

Science Fiction and the Law

Earn up to 2.4 credits!

Thurs., April 25
11 a.m. – 1 p.m.

In the modern age, we use many products or services in everyday life that first appeared in science fiction. Join us for a discussion of how imagination becomes reality and how we, as attorneys, should be prepared to incorporate new technology into our practice. Our faculty will take some examples of flights of the imagination, bring those into daily life and consider how to respond to the consequences.

Diverging Paths: The Perils of Becoming an AI Lawyer

Earn up to 2.4 credits, including 2.4 in Ethics!

Tues., April 30
1 p.m. – 3 p.m.

Join ethics attorneys Glenn Reiser and Marc Garfinkle, along with Ethics Hotline guru Carol Johnston in this fast-moving two-hour webinar as they explain AI, discuss its potential and limitations for lawyers and analyze the ethical challenges that can result from its use. Learn about the obligations that you assume when using AI, and how to tweak your practice to accommodate it.

Visit NJICLE.com to register today.

Complying with the New Corporate Transparency Act

By Michael F. Schaff and Jason J. Krisza

MICHAEL F. SCHAFF *is a co-chair of the Corporate, Healthcare, and Cannabis Law practice groups and a member of the Management Committee at Wilentz, Goldman & Spitzer, P.A. Michael is a former chair of the* New Jersey Lawyer *editorial board and is currently on its editorial board. Michael's professional mission is to provide his clients with the most comprehensive and well-heeled advice in the dynamic and complex world of health care and corporate law.*

JASON J. KRISZA *is a shareholder on the Corporate and Health Law practice groups at Wilentz, Goldman & Spitzer, P.A. Jason represents health care entities and individual health care professionals as well as businesses and business owners in a variety of legal disputes, business transactions, and regulatory matters affecting their operations.*

The Corporate Transparency Act (Act) went into effect on Jan. 1, 2024. Codified at 31 U.S.C. 5336 as part of the Anti-Money Laundering Act of 2020 in the National Defense Authorization Act for Fiscal Year 2021, the Act establishes requirements for smaller and unregulated business entities to disclose certain ownership and control information to the U.S. Department of the Treasury's Financial Crimes Enforcement Network (FinCEN).

The legislative intent for the Act was to curb money laundering by increasing transparency of ownership in otherwise unregulated entities. The Act provides a system whereby applicable companies will provide FinCEN with ownership and decision-making data. In turn, FinCEN will collect the data in a secure database (Beneficial Ownership Secure System or BOSS). The data will then be available to be used by various law enforcement entities during their investigations. Proponents of the Act believe that this will permit law enforcement agencies to conduct quicker and more efficient investigations. Opponents argue that disclosure of this information constitutes another example of government intrusion into the private sector and believe that the information contained in the database could be abused and/or fall into the hands of unauthorized individuals, e.g., hackers. While novel in the United States, many other counties, including Canada, British Virgin Islands, and the United Kingdom, have similar reporting requirements.

While the Act was passed over four years ago, the effective date was delayed to Jan. 1, 2024, to permit FinCEN to adopt reporting rules and databases. Even with the delay, much uncertainty surrounded the rollout of the Act. As the calendar turned to December, 2023, law firms, expeditors, and third-party vendors all scrambled to ensure they were in a position to assist their clients in complying with the Act's requirements. While practitioners likely have a baseline understanding of its requirements, this article will examine some of the Act's basic requirements and explore how law firms may want to enact policies to mitigate the newfound risk imposed on law firms by the Act.

Reporting Companies

The Act refers to entities which are required to report beneficial ownership information as "reporting companies." Reporting companies are corporations, limited liability companies, or other similar entities that are (i) created by the filing of a document with the secretary of state or a similar office under the law of a state or Indian tribe or (ii) formed under the law of a foreign country and registered to do business in the United States by filing a document with a secretary of state or similar office under the laws of a state or Indian tribe.[1]

While the Act sets forth a rather lengthy list of 23 exceptions[2] to the types of entities which are not reporting entities, i.e., not required to report beneficial ownership information, in practice, the exceptions are fairly narrow. Most of these exceptions are for entities which are already required to provide the beneficial ownership information under separate statutory or regulatory regimes, e.g., banks. FinCEN has published a checklist[3] to guide individuals through the process of whether the entity is a reporting entity or meets one of the exceptions.

While the Act sets forth a rather lengthy list of 23 exceptions to the types of entities which are not reporting entities, i.e., not required to report beneficial ownership information, in practice, the exceptions are fairly narrow. Most of these exceptions are for entities which are already required to provide the beneficial ownership information under separate statutory or regulatory regimes, e.g., banks.

FinCEN estimates that there will be at least 32 million existing entities which will be required to submit BOI reports and about five million entities that will be created on an annual basis that have reporting requirements.

The most common exception is the large operating company exception. In order to meet this exception, all six elements must be met: (i) the entity employs more than 20 full-time employees; (ii) at least 20 employees are employed in the United States; (iii) the entity has an operating presence at a physical office in the United States; (iv) the entity filed a federal income tax or information return in the United States for the previous year demonstrating more than $5 million in gross receipts or sales[4]; (v) the entity reported this greater-than-$5 million amount as gross receipts or sales (net of returns and allowances) on the entity's applicable IRS form; and (vi) when gross receipts or sales from sources outside the United States are excluded from the entity's amount of gross receipts or sales, the amount remains greater than $5 million.

Beneficial Owners

Once it is determined that the entity is a reporting entity, the next step is to identify the beneficial owners of that entity. FinCEN defines beneficial owns as any individual who, directly or indirectly:

1. Exercises substantial control over a reporting company; or
2. Owns or controls at least 25% of the ownership interests of a reporting company.[5]

Ownership or control can be obtained through contract, arrangement, understanding, relationship or other means.[6] Further, the rules require disclosure of all individuals who exercise substantial control over the reporting company, not just the one or two that the reporting entity may want to report. An individual exercises substantial control over a reporting company if they meet any of the following four general criteria:

1. the individual is a senior officer;
2. the individual has authority to appoint or remove certain officers or a majority of directors of the reporting company;
3. the individual is an important decision-maker; or
4. the individual has any other form of substantial control over the reporting company.[7]

These definitions are intentionally broad and open ended. Take, for example, the definition of ownership or control of 25% of the reporting company. It is subject to interpretation. At the time of writing, we can only speculate as to how this will be interpreted and enforced, but in light of complicated ownership structures, especially those employed by private equity investments, it remains to be seen who will need to be reported as a beneficial owner.

FinCEN has published additional guidance clarifying who an important decision-maker is. This additional guidance provides that an important decision-maker is any individual who has substantial influence over important decisions made by the reporting company. This includes decisions regarding the reporting company's:

1. Business, such as:
   a. Nature, scope and attributes of the business
   b. The selection or termination of business lines or ventures, or geographic focus
   c. The entry into or termination, or the fulfillment or non-fulfillment, of significant contracts
2. Finances, such as:
   a. Sale, lease, mortgage, or other transfer of any principal assets
   b. Major expenditures or investments, issuances of any equity, incurrence of any significant debt, or approval of the operating budget
   c. Compensation schemes and incentive programs for senior officers
3. Structure, such as:
   a. Reorganization, dissolution, or merger
   b. Amendments of any substantial governance documents of the reporting company, including articles of incorporation or similar formation documents, bylaws, and significant policies or procedures[8]

As alluded to above, ownership in complicated corporate structures, such as private equity investment vehicles, is often murky as ownership is often shrouded in convertible instruments, purchase options, warrants, profit interest, and "B" shares. FinCEN does consider these types of interests similarly to physical ownership interests, with very limited exceptions. There are a series of exceptions for beneficial owners, including minor children, future inheritors, employees (non-senior officers), creditors, and advisors, e.g., tax and legal professionals.

Company Applicants

In addition to beneficial owners, FinCEN also requires the disclosure of Company applicants, i.e., the individual(s) who creates/forms the domestic reporting company, the individual who creates the foreign company (not the person who qualified it to do business in the United States), and someone who is primarily responsible for directing or controlling such filing.[9] Company applicants have to be reported for any reporting company that is created or registered on or after Jan. 1, 2024. Applicants are individuals. They are either the direct filer, e.g., attorney or paralegal, or the individual that directs or controls the filing, even if that individual directed the filing.

Information to Be Reported

The regulations and statute require reporting companies to provide the following information:

1. Full legal name of the reporting company;
2. Any trade name or "doing business as" name(s);
3. Principal place of business in the United States;
4. Jurisdiction of formation;
5. For foreign reporting entities, the jurisdiction of first registration in the United States; and
6. Taxpayer Identification Number or the equivalent for a foreign registration.

For each beneficial owner and company applicant, the following must be reported:

1. Full legal name;
2. Date of birth;
3. Current residential street address (not P.O. Box) and this can be a foreign address; and
4. Unique identifying number, issuing jurisdiction, and image of one of the following documents:
   a. U.S. passport;
   b. State driver's license;
   c. Identification document issued by state, local government, or tribe; or
   d. If the individual does not have any of these, a foreign passport.

If requested, all reporting companies, beneficial owners, and company applicants are eligible to obtain a FinCEN identifier or a number assigned to it by FinCEN for future identification. The number can be obtained by checking a box when the company completes its initial report.

Timing of Reporting

Existing reporting companies are required to report all information required under the Act based upon the time that they were created or registered. The chart on the next page sets forth the timing of the reporting requirements.

Following the initial report, reporting

Creation Date	Filing Deadline
Before Jan. 1, 2024	Jan. 1, 2025
Between Jan. 1, 2024 and Dec. 31, 2024	Within 90 calendar days of earlier of: (i) date received actual notice of creation or registration; or (ii) date SOS first provides public notice of creation or registration
On or after Jan. 1, 2025	Within 30 calendar days of earlier of (i) date received actual notice of creation or registration; or (ii) date SOS first provides public notice of creation or registration
Once Exempt but No Longer Exempt	Within 30 calendar days after no longer meeting exemption criteria

companies have an obligation to report any changes to FinCEN within 30 calendar days after the date on which the change occurred. A reporting company is not required to file an updated report for any changes to previously reported personal information about a company applicant. Some examples of reportable changes include the registration of a new d/b/a or the sale of the company resulting in new ownership.

Penalties

Failure to comply with the Act can result in high penalties and possible imprisonment. The escalating fines range from $500 to $10,000 per violation and jail time of up to two years.[10]

Law Firm Considerations

Due to the Act's broad application to a significant number of entities coupled with its severe penalties and today's litigious society, law firms need to be prepared to not only assist clients with compliance questions, but also need to enact internal proactive measures to mitigate risks to the firm and clients. Firms should enact policies and procedures internally to ensure all attorneys are unified in their message to clients regarding the Act and compliance therewith.

Firms should consider adding explicit limitations in retainer letters as to whether they will be providing advice/filing services related to the Act. Attorneys should also consider whether they want to identify and advise existing and former clients as to the Act's enactment and basic requirements. Specific attention should be given to matters where the firm is providing advice in connection with items that may trigger a change in beneficial ownership, e.g. regulatory counsel in connection with an ownership transfer of a licensed facility, ownership transfer, or litigation that may result in transfer of ownership.

Further, due to the need to report company applicants to FinCEN, law firms may want to consider limiting the number of individuals within the firm who can form and file new corporate entities.

Firms should consult with their malpractice providers to determine whether they have any advice or requirements for coverage.

Conclusion

The Act imposes significant reporting requirements on millions of entities. It remains to be seen what level of enforcement FinCEN and law enforcement will apply to violators of the Act, however we believe that no one should take that unknown risk. It is also uncertain as to how the BOSS database will be rolled out. The next few months will hopefully be met with more answers than questions. ■

Endnotes

1. 31 U.S.C. 5336(a)(11)(A).
2. 31 U.S.C. 5336(a)(11)(B).
3. The checklist is available at fincen.gov/sites/default/files/shared/BOI_Small_Compliance_Guide_FINAL_Sept_508C.pdf.
4. There is a specific analysis for affiliated groups of corporations that are filing consolidated returns.
5. 31 U.S.C. 5336(a)(3).
6. 31 U.S.C. 5336(a)(3).
7. 31 C.F.R. 1010.380(d)(1)(i)
8. See FinCEN FAQ Chart 3, available at fincen.gov/sites/default/files/shared/BOI_Small_Compliance_Guide_FINAL_Sept_508C.pdf.
9. 31 C.F.R. 1010.380(e).
10. 31 U.S.C. 5336(h)(3)(A).

Awaiting Case Law, Amendments a Decade Into NJ-RULLCA

By Gianfranco A. Pietrafesa

New Jersey adopted the New Jersey Revised Uniform Limited Liability Company Act (NJ-RULLCA) on Sept. 19, 2012.[1] It became effective on March 18, 2013, for new limited liability companies (LLC) formed on or after such date, and on March 1, 2014, for all LLCs, which was when the prior LLC statute was repealed.[2] So, in a sense, we can more or less say that March 1, 2024, is the 10th anniversary of NJ-RULLCA.

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NJ-RULLCA was based on the Revised Uniform Limited Liability Company Act (2006) (RULLCA) drafted by the National Conference of Commissioners on Uniform State Laws, which is the same organization that drafted the Uniform Commercial Code.[3] RULLCA has been adopted by 20 states plus the District of Columbia.[4] In New Jersey, a select committee of the Business Law Section of the New Jersey State Bar Association reviewed and modified RULLCA for adoption in New Jersey.[5] One of the benefits of adopting RULLCA is that, as a "uniform" law, the Uniform Law Commissioners' comments to RULLCA, case law from other jurisdictions, law review articles, and other sources can be used to understand NJ-RULLCA.

Popularity of LLCs

The LLC is the entity of choice. In New Jersey, approximately 88% of the entities formed in 2022 were LLCs. By comparison, only 8% were corporations.[6]

By now, we all know why LLCs are so popular. First, they provide owners with limited liability protection, identical to the protection of shareholders of corporations.[7] Second, they provide owners with the one level of taxation of partnerships (for LLCs with two or more owners) or disregarded entities (for LLCs with one owner) where the LLC's income passes through and is reported on the personal tax returns of its owners, as opposed to the double taxation of corporations.[8] Third, they provide owners with freedom of contract.[9] That is, although LLCs are creatures of statute, they are also creatures of contract giving owners the flexibility to structure the management, voting, economics and other aspects of the LLC as they please through the LLC operating agreement. For example, an LLC may replicate the management structure of a general partnership, a limited partnership, a corporation, or any other type of management through its operating agreement. An owner's rights and obligations are set forth in NJ-RULLCA and the LLC's operating agreement, with NJ-RULLCA allowing the owners the flexibility to modify the statutory default provisions in the LLC's operating agreement.

Amendments of NJ-RULLCA

Delaware amends its LLC statute annually; New Jersey, not so much.[10] NJ-RULLCA was an important update to New Jersey LLC law. Since its adoption, it has been amended a few times, but none of the amendments have made significant substantive changes in the law.[11]

Sparse Case Law on NJ-RULLCA

Unfortunately, there has been little case law interpreting NJ-RULLCA. Most of the case law mentioning NJ-RULLCA does so in passing fashion, meaning that NJ-RULLCA was not central to the decision.[12]

In 2016, in *IE Test, LLC v. Carroll*,[13] the Supreme Court addressed the expulsion (i.e., dissociation) of a member from an LLC on the grounds that it was not reasonably practicable to operate the LLC in light of the member's conduct. Although the case was decided under the repealed LLC statute, the Court reviewed the comparable provisions under NJ-RULLCA and noted that the result would have been the same.[14] *IE Test* is the seminal case on expulsion / dissociation of a member from an LLC.[15]

In 2021, in *Premier Physician Network, LLC v. Maro*,[16] the Appellate Division addressed when an agreement becomes the operating agreement of an LLC binding on all members.

Fortunately, as noted, decisions from other states interpreting statutory provisions comparable to those found in NJ-RULLCA can be reviewed to understand NJ-RULLCA. For example, in 2021, the Iowa Supreme Court addressed judicial dissolution on the grounds of oppression and not being reasonably practicable to operate the LLC in light of a member's conduct.[17] Also in 2021, the Connecticut Supreme Court addressed a member's right to inspect books and records of a manager-managed LLC.[18]

Proposed Amendments to NJ-RULLCA

NJ-RULLCA can be amended to improve it. If a state legislator expresses a *bona fide* interest in improving New Jersey's business entities statutes, there would be a number of business lawyers willing and able to draft such legislation. A *bona fide* interest means not simply introducing legislation, but actively working the legislation through the legislative process toward adoption.[19]

There are numerous amendments that could, and perhaps should, be made to NJ-RULLCA to make it a better statute. Among them, in my opinion, are the following:

1. Instead of equal distributions to all members and dissociated members,[20] require distributions to be made pro rata based on the agreed value of the contributions made by the members (and dissociated members) to the extent that the contributions have been received by the LLC. Distributions were made in this manner under New Jersey's repealed LLC statute,[21] and are made in this manner in other states that have adopted RULLCA.[22] This would also apply to voting rights. Although these items can be addressed in an operating agreement, many LLCs do not have written operating agreements. This change is the one most mentioned by practitioners.
2. When a member of an LLC dies, the member's estate has limited rights. It holds a transferable interest, which is an economic interest giving the estate the right to receive distributions if and when made by the LLC, but no right to vote and limited rights to information. As such, unless there is an operating agreement giving the estate the right to compel the LLC and the surviving members to buy the estate's interest or giving the estate the right to be admitted as a member of the LLC, the estate is subject to the whims of the surviving members. For this reason, NJ-RULLCA should be amended to give the estate of a deceased member the right to compel the LLC and the surviving members to purchase the estate's interest in the LLC for fair value, to be paid over a period of years.[23]
3. When dealing with charging orders and the rights of judgment creditors, NJ-RULLCA should distinguish between single-member LLCs and multi-member LLCs. NJ-RULLCA should be amended to allow the foreclosure and sale of a judgment debtor's interest in a single-member LLC. The Florida LLC statute, for example, makes this distinction.[24]

Conclusion

LLCs will remain the entity of choice in New Jersey. There are over 900,000 domestic LLCs in New Jersey, which equates to 70% of all existing entities in New Jersey.[25] It is inevitable that sooner or later we will have more published opinions addressing NJ-RULLCA. It is important that the state Legislature propose legislation amending NJ-RULLCA to improve it in order to keep New Jersey relevant and competitive with Delaware and other states. ■

Endnotes

1. PL 2012, c.50, codified at *N.J.S.A.* 42:2C-1 et seq.
2. *N.J.S.A.* 42:2C-91.
3. The current version of RULLCA (dated August 19, 2015) is *available at* uniformlaws.org/committees/comm

unity-home?communitykey=bbea059c-6853-4f45-b69b-7ca2e49cf740. NJ-RULLCA was based on the July 20, 2011, version of RULLCA, a copy of which is available from the author.

4. *See* Enactment History of RULLCA *available at* uniformlaws.org/committees/community-home?attachments=&communitykey=bbea059c-6853-4f45-b69b-7ca2e49cf740&libraryentry=df2ec88b-fcb0-4d18-b674-d498044e10f5&pageindex=0&pagesize=12&search=&sort=most_recent&viewtype=card. Among the states adopting RULLCA are California, Florida, Illinois, Pennsylvania, and Connecticut.
5. I had the privilege of serving on the select committee, which modified RULLCA by adding certain provisions specific to New Jersey. For example, ensuring that indemnification for LLCs was similar to indemnification for corporations. In hindsight, the committee should have taken a more deliberate approach and modified more sections of RULLCA by using the best statutory provisions from New Jersey Limited Liability Company Act (repealed), the Delaware Limited Liability Company Act, etc. Such was the approach taken by other states, such as Florida. *See* Fla. Stat. 605.0101 *et seq. available at* flsenate.gov/Laws/Statutes/2023/Chapter605.
6. These statistics are from the New Jersey Division of Revenue and Enterprise Services and are available from the author.
7. *See N.J.S.A*. 42:2C-30. *See also N.J.S.A.* 42:2C-6(b).
8. *See N.J.S.A*. 42:2C-92; IRS page on LLCs is *available at* irs.gov/businesses/small-businesses-self-employed/limited-liability-company-llc. A corporation can elect to be taxed as a pass-through S corporation, but an S corporation has certain restrictions required to maintain its S corporation status and, as a result, does not provide its shareholders the flexibility provided to the members of an LLC.
9. *See N.J.S.A*. 42:2C-11(i), -11(a) & -11(b).
10. For an editorial on how New Jersey could become more business friendly by consistently improving its LLC laws, *see* Gianfranco A. Pietrafesa, "Why New Jersey is Not Delaware," 222 N.J.L.J. 91 (January 11, 2016; online version January 7, 2016) *available at* archerlaw.com/a/web/iFkjYAwGtGxRmqHaVHAUyN/pietrafesa20op-ed20in20nj20law20journal20-20why20new20jersey20is20not20delaware-c.pdf.
11. *See* PL 2013, c. 276 (addressing creditor rights by amending charging order provisions and making technical (e.g., cross-referencing) corrections); PL 2019, c.149 (addressing reinstatement after revocation due to the failure to file annual reports). *See also* PL 2023, c. 38 (amending the New Jersey Business Corporation Act to allow corporations to convert to LLCs, and vice versa).
12. *For example*, *State v. Ehrman,* 469 N.J. Super. 1 (App. Div. 2021) (filing complaints for housing code violations against the member of the LLC instead of the LLC owning the real property); *East Bay Drywall, LLC v. Dept. of Labor, etc.*, 467 N.J. Super. 131 (App. Div. 2021) (whether the member of a single-member LLC should be considered an employee of another LLC); *Namerow v. Pediatricare Associates, LLC*, 461 N.J. Super. 133 (Ch. Div. 2018) (whether the members' course of conduct modified the terms of an operating agreement with regard to valuation in a minority member oppression case).
13. 226 N.J. 166 (2016).
14. *See, e.g., id.* at 183 and 184.
15. The Court relied on a Colorado appellate court opinion addressing the dissolution of an LLC. *See id*. at 184 n.7 (citation omitted). As a result, it is reasonable to speculate that the *IE Test* opinion may also be used in cases involving the dissolution of an LLC on the grounds that it is not reasonably practicable to carry on the LLC's activities in conformity with its operating agreement. *See N.J.S.A.* 42:2C-48(a)(4)(b).
16. 468 N.J. Super. 182 (App. Div. 2021).
17. *Barkalow v. Clark*, 959 N.W.2d 410 (Iowa 2021).
18. *Benjamin v. Island Management, LLC*, 267 A.3d 19 (Conn. 2021).
19. It has taken 10 years for the adoption of amendments to the New Jersey Business Corporation Act to allow corporations to convert to LLCs, and vice versa. *See* PL 2023, c. 38. Companion legislation to amend the New Jersey Uniform Partnership Act, *N.J.S.A*. 42:1A-1, *et seq.*, and the New Jersey Uniform Limited Partnership Law, *N.J.S.A*. 42:2A-1, *et seq.,* to allow general and limited partnerships to convert to LLCs, and vice versa, has been languishing in the legislature for ten years.
20. *N.J.S.A*. 42:2C-34(a).
21. *See N.J.S.A*. 42:2B-35 (repealed).
22. *For example, see* Fla. Stat. 605.0404(1). Distributions are made in this manner under the Delaware Limited Liability Company Act. *See* 6 Del. C. 18-504.
23. This concept is comparable to a buyout of a resigning member under the repealed LLC statute. *See N.J.S.A.* 42:2B-39 (repealed).
24. *See* Fla. Stat. 605.0503.
25. This information is from the New Jersey Division of Revenue and Enterprise Services and is available from the author.

Corporate and Limited Liability Company Conversions and Domestications

By W. Raymond Felton

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For a variety of reasons, business entities such as corporations, partnerships and limited liability companies may desire to change their state of incorporation or formation or their form of entity. For example, a New Jersey limited liability company could decide, acting pursuant to its governing procedures, to become a New Jersey corporation or a Delaware corporation. The reasons are limitless, but very often are driven by a desire to facilitate a financing transaction such as a venture capital investment or an initial public offering. This article outlines the process for accomplishing these changes, which can now be accomplished more efficiently thanks to recently enacted New Jersey legislation.

Historically, migration from one state to another, referred to as domestication, or from one form of entity to another, a conversion, was done by using a statutory merger. If a corporation formed in New Jersey elected to become a Delaware corporation, it would cause a new corporation to be incorporated in Delaware and merge the New Jersey corporation into the Delaware corporation, with the latter being the surviving corporation. The New Jersey corporation would cease to exist as such although it might need to qualify to do business in New Jersey, now as a foreign corporation. The documentation would include an agreement and plan of merger between the two corporations and certificates of merger consistent with the corporate statutes in both states, as well as authorizing resolutions. Similarly, a New Jersey limited liability company could convert itself into a New Jersey corporation through a similar merger process, albeit confined to New Jersey.

In recent years, there has been a trend in the United States, most notably led by Delaware, to enable these changes in a more streamlined manner. New Jersey joined this trend partially upon adopting its version of the Revised Uniformed Limited Liability Company Act (RULLCA), which became effective on March 18, 2013.[1] RULLCA authorized a corporation to convert to a limited liability company and a limited liability company to convert to a corporation if the applicable counterpart statute authorized such a conversion. Unfortunately, the New Jersey Legislature did not amend the New Jersey Business Corporation Act (NJBCA) at the same time or since then prior to 2023, thereby limiting the use of the conversion provisions by RULLCA.

These deficiencies in the NJBCA were resolved by the adoption of amendments signed by Gov. Phil Murphy on May 8, 2023, with an effective date of Nov. 4, 2023.[2] By adding new provisions to the NJBCA, the following can be accomplished relatively efficiently:

- A New Jersey corporation may convert to a New Jersey or foreign limited liability company or a foreign corporation;
- A New Jersey limited liability company may convert to a New Jersey or foreign corporation or foreign limited liability company;
- A foreign corporation may convert to a New Jersey corporation or limited liability company;
- A foreign limited liability company may convert to a New Jersey corporation or limited liability company.

As noted above, the migration of an entity's state of incorporation or formation to another state is typically referred to as domestication, but this legislation does not use that term, instead using "conversion" for both a change of the form of the entity and a change of the domicile state. As used in this article, references to a foreign jurisdiction include both other states and other countries.

Conversion of a New Jersey Corporation

The NJBCA now explicitly now authorizes a New Jersey corporation to convert to any other entity.[3] The conversion must first be approved by the Board of Directors of the corporation and then submitted to its shareholders for approval at a meeting or by written consent. The shareholders need to approve the conversion unanimously to be effective, and for this purpose the holders of non-voting shares of stock are included in the unanimity requirement. If the corporation is converting to a New Jersey limited liability company, RULLCA already addressed the limited liability company side of the conversion,[4] so the circle has now been closed by the new legislation. If the corporation is being domesticated in another state, whether as a corporation or a limited liability company, that state's laws must be consulted and followed to make the conversion effective in that state.

Just as in any business transaction, it is important to review the tax consequences of a conversion of a corporation. In particular, the conversion of a corporation to a limited liability company, whether domestic or foreign, is likely a dissolution of the corporation for tax purposes and the income tax imposed could be substantial depending on the specific facts pertinent to that corporation. Counsel should consult with a tax attorney or the client's accountant to determine the tax implications, if any.

As with all corporate and limited liability company filings in New Jersey, certificates of conversion are to be filed with the Division of Revenue and Enterprise Services in the Department of Treasury (DORES). DORES provides fillable forms on its website, nj.gov/treasury/revenue. Form CD100 is to be used where the resulting business will be a New Jersey entity and Form CD101 when the resulting entity will be domiciled in a state or foreign jurisdiction other than New Jersey.

Conversion of a New Jersey Limited Liability Company

The conversion of a New Jersey limited liability company was already covered in RULLCA.[5] The new statute now allows the conversion to the corporate form in New Jersey by adding the necessary authorization to the NJBCA. Similar to the conversion of a corporation, all members of the limited liability company to be converted must consent to the transaction, regardless of whether they are otherwise given a say on management issues. The forms are the same as referenced above for corporations, Forms CD100 and CD101.

Foreign Corporations

If an unincorporated entity, most typically a limited liability company, was formed in another jurisdiction and is qualified to do business as such in New Jersey, and then coverts to the corporate form in its state or county of formation, the new statute amends the NJBCA to create a filing for the new converted corporation to be authorized to transact business in New Jersey as such.[6] The statute spells out the application that should be filed which is essentially the same as if the original entity had not been authorized to do business in New Jersey and this were an initial application. The application will need to include a certificate of good standing for the corporation from its state of incorporation as part of the application process.

A foreign corporation may convert to a New Jersey corporation or limited liability company upon the approval of the Board of Directors and shareholders of the foreign corporation in a manner consistent with the corporate law of the state of incorporation pursuant to a plan of conversion.[7] The plan of conversion and certificate of conversion, as noted above, will complete the process.

Domestication of a Foreign Limited Liability Company

A limited liability company formed in a jurisdiction outside of New Jersey can convert its state of formation to New Jersey, or domesticate, if permitted by the laws of its original state of formation.[8] The foreign limited liability company must, of course, comply with the requirements imposed by the law of the state of formation. The plan of domestication should be adopted by the members of the limited liability company and filed in New Jersey and whatever filing is required by the original state must be completed.

Partnership and Limited Partnerships

The new statute does not address conversion or domestication of partnerships and limited partnerships. Legislation has been introduced in New Jersey regarding such incorporated entities but has not been adopted at this writing. ■

Endnotes

1. *N.J.S.A.* 42:2C-1 *et. seq.*
2. Pub. Law. 2023, Ch. 38.
3. *N.J.S.A.* 14A:11A-2(2).
4. *N.J.S.A.* 42:2C-78.
5. *N.J.S.A.* 42:2C-78.
6. *N.J.S.A.* 14a:13-6.1
7. *N.J.S.A.* 14A:11A-1(3).
8. 2022 Session, Senate Bill No. 134.

TWO DEALS IN ONE

Sales of Less than the Whole of a Business

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By Jason D. Navarino and Hannah J. Greendyk

It is common to think about the sale of a business as a single transaction—the seller is selling its equity or business assets, and the buyer is purchasing such equity or assets. However, depending on the structure of the transaction, the deal may actually contain two separate but related transactions. This "double" transaction structure often arises in mergers and acquisitions (M&A) with a rollover component, where a portion of the deal consideration is comprised of equity in the buyer or the buyer's holding company. It also occurs when a buyer is looking to get into a business in a significant way but without acquiring complete ownership, at least up front. In both situations, not only must the parties navigate the complexities of the sale of the business, but they must also focus on the structure of rollover equity and the parties' post-closing relationship with buyer and seller remaining as partners or co-owners.

This article will describe the unique considerations that go into selling a substantial interest in a company, but where the seller retains a substantial interest as well, either by retaining partial ownership of its existing business or through receipt of rollover equity from the buyer. In particular, this article will discuss the liability, due diligence, decision-making, exit planning, and structural and tax considerations that come into play in these transactions.

M&A Transactions with Rollover Equity

Rollover equity is common in acquisitions by private equity funds, where the fund sponsor is often looking to the seller and existing management to continue running the business post-closing. In any rollover structure, whether it be a private equity acquisition or a strategic buyer, the deal consideration is comprised of cash plus a percentage of equity in the buyer or the buyer's holding company. This incentivizes rollover equity recipients—generally sellers and key management—to participate in the growth of the company post-closing. This structure also means that the buyer has to bring less cash to the table.

Liability

In the M&A context, the parties generally negotiate seller indemnification for pre-closing liabilities and, to a lesser extent, buyer indemnification for post-closing liabilities. Accordingly, the allocation of liability is generally clear as between the seller for pre-closing liabilities and the buyer for post-closing liabilities. The seller may indirectly bear a portion of the buyer's liability as a co-owner of the buyer, but that is consistent with the overall deal structure.

Due Diligence

Although due diligence is generally performed by the buyer in any acquisition, the seller in a rollover transaction will also want to perform due diligence, including reviewing the buyer's financials and performing a lien and judgment search on the buyer. The seller should also request a valuation if the buyer is privately held to ensure that the amount of the rollover equity is adequate, meaning that the equity is actually worth what the buyer says it is worth.

Decision-Making

The seller will hold equity in the buyer or the buyer's holding company post-closing. Accordingly, the parties must give thought to the seller's decision rights as set forth in the buyer's governing documents (usually a shareholders' agreement if the buyer is a corporation, or a limited liability company agreement or operating agreement if the buyer is an LLC). The seller will sometimes have the right to appoint a certain number of directors to the buyer's board. If the seller holds a minority position, as is often the case, the seller is likely to have, at minimum, a limited list of "major decision" rights on topics such as sales of the company or its assets, capital contributions, admission of new members, etc. These rights often range from mandatory consultation to veto power.

Transfers and Exit Planning

The seller's counsel should ensure that the buyer's governing documents provide the seller with an exit route and address the subsequent sale of the company, particularly in the private equity context where the company is generally resold within three to five years. In light of this, the seller's counsel should review the transfer provisions of the governing documents, including any drag-along (requiring minority owners to sell alongside the majority, usually on the same terms) and tag-along provisions (allowing minority owners to elect to participate in sales by majority owners, again usually on the same terms), to ensure that the seller will be entitled to proper distributions upon sale or transfer of the equity. Given that the rollover equity is in lieu of cash consideration at closing, it is incumbent on the seller's counsel to ensure that the seller can properly cash out and realize the value of such equity at a future date.

Additionally, a buyer will often not permit a seller to freely transfer its rollover equity (and the equity may even be subject to a lock-up period during which the seller cannot transfer its equity at all), but the seller's counsel should try to negotiate the ability to transfer to a seller's affiliates, family members, and certain other estate planning-related transfers, if possible.

Structural and Tax Considerations

If properly structured for tax purposes, the rollover portion of the deal consideration can often be shielded from tax, meaning that the seller only has to pay tax on the cash portion of the consideration for the year of the closing. In a properly structured part-sale, part-contribution, the seller is treated as selling a portion of the company's equity or its assets for cash and contributing the balance of the equity of the company or its assets to the buyer in exchange for equity in the buyer. In the partnership context, the contribution in exchange for equity is tax-free under Section 721 of the Internal Revenue Code of 1986, as amended (Code).[1] Also in the partnership context, the seller's counsel should carefully review the buyer's limited liability company or operating agreement to ensure that there are no disguised sale issues with the rollover equity.[2] For example, the entitlement to disproportionate distributions, particularly within two years of the closing, can give rise to a rebuttable presumption of a disguised sale.[3]

If the buyer is a corporation, the contribution must meet the requirements of Section 351 of the Code in order to be tax-free. Among other things, Section 351 requires that the contributing shareholders must possess at least 80% of the voting power and value of the corporation immediately following the contribution.[4] This 80% requirement can be difficult to achieve unless the buyer is a newly formed entity being capitalized concurrently with the rollover. If the buyer is a foreign corporation, the rollover is likely to be taxable, absent creative and possibly less certain tax planning.[5]

Acquisitions of Partial Ownership Through a Substantial Investment

The other common type of transaction where there is the sale of less than the whole occurs when a buyer is looking to make a substantial investment in a company without purchasing the entire company. In this situation, the arrangement is essentially structured as a joint venture with the existing owner or owners and the buyer as partners in the business on a go-forward basis. Although not technically an M&A transaction, the same considerations generally apply.

The delineation of liability is sometimes not as clear here as in the M&A context because the buyer is stepping into partial (as opposed to full) ownership of an existing company. The buyer will often require the company and existing owners to indemnify it for actions taken prior to the date of its investment, but this indemnification is often limited on account of the buyer's partial ownership...

Liability

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Due Diligence

Due diligence efforts in this type of transaction are often significant. The buyer will want to perform due diligence on the company to ensure its viability and continued economic success. Similarly, the existing owner or owners will want to investigate the buyer as a potential partner.

Decision-Making

Governance is as important here as in the M&A context, given that the parties are essentially operating as a joint venture following the investment. Consideration must be given to the decision rights of the buyer and existing ownership, including the scope of the minority owners' decision rights and entitlement to appoint board members or managers. If the buyer holds a majority interest, it will want to limit the minority owners' decision rights as much as possible, and the minority owners will want to expand their rights as much as possible.

Transfer and Exit Planning

The same considerations here apply as in the M&A context. The buyer will likely seek to limit transfers of the minority members' equity as much as possible, to ensure that it is doing business with the parties it intended to do business with. The buyer may also want to set itself up for the ultimate acquisition of 100% of the business. For example, the buyer could include a right of first refusal requiring the other owners to present any third party offers to the buyer prior to accepting such offers. Finally, the buyer may wish to include drag-along provisions in a shareholders' agreement or limited liability company or operating agreement enabling it to require the minority owners to participate in an ultimate sale (and corresponding tag-along provisions permitting the minority owners to participate if the buyer/majority owner sells its equity).

Structural and Tax Considerations

In these types of transactions, the primary question is whether (1) the buyer is contributing money into the target company to fund its growth and expansion, or (2) the buyer is paying the seller - and the seller is taking money off the table - in exchange for some of its equity. If the transaction is drafted as a contribution, but it is really a sale in practice, the disguised sale rules are likely to bite in the partnership context.

In the first scenario, the buyer's contribution of cash in exchange for equity of a company that is taxed as a partnership will be tax-free under Section 721 of the Code.[6] If the company is a corporation, the contribution of cash in exchange for shares of stock will only be tax-free if the buyer acquires at least 80% of the vote and value of the corporation and the other requirements of Section 351 of the Code are met.[7] In the second scenario, non-recognition treatment will not be available and the transaction will generally be a capital gain transaction, except to the extent of "hot assets" (i.e., unrealized receivables, inventory, and recapture of previously taken depreciation and amortization deductions) in the case of a partnership.[8]

Conclusion

As noted throughout this article, transactions appearing at first glance to be a simple sale of a business can really be two distinct transactions with many layers and facets. Recognizing these complexities going into the transaction can make a world of difference in terms of whether the parties are satisfied with the ultimate outcome. ■

Endnotes

1. *See* Code § 721.
2. *See* Treas. Reg. § 1.707-3.
3. Treas. Reg. § 1.707-3(b)(2)(ix).
4. Code § 351(a) and Code § 368(c).
5. *See* Code § 367.
6. *See* Code § 721.
7. *See* Code § 351.
8. *See* Code § 751.

Corporate Venture Capital

Rise Amid the Changing Venture Capital Market and Lessons in Making and Structuring Corporate Venture Capital Investments

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By Onome Adejemilua

Rise in Corporate Venture Capital Investments

The ecosystem that provides the funding necessary to finance the development and growth of startups and early-stage companies has traditionally been dominated by venture capitalists with funds dedicated to taking risky bets. These venture capitalists source investments in hopes of spurring rapid growth in portfolio companies, scaling them and putting those companies on the trajectory to successful exits. Corporations, considered slow and bureaucratic, generally took a backseat and did not pose a serious challenge to venture capitalists.[1] The funding landscape, however, is changing. In recent years, venture capital investors have pulled back from startup funding amid market turmoil caused, in part, by high interest rates and inflation.[2]

Given the slowdown in financing from traditional venture capitalists, corporations are slowly rising from their shadows to establish themselves as dominant players in the venture sphere. By 2019, corporate venture capital (CVC) participation in startup funding reached a record high. That year, CVCs participated in 25% of all venture capital-backed deals, and CVCs invested alone, without venture capitalists as co-investors, in 10% of their deals.[3] By the second quarter of 2023, global CVC funding rose by 4% to $14.6 billion, even as overall venture funding for the same period fell 13% to $60.5 billion, the lowest level in three years.[4]

A growing number of large corporations have created separate venture capital arms specifically dedicated to sourcing and investing in startups focused on innovative solutions within their industries. These CVC units operate independently from their parent corporation, acting more like a venture capitalist but with financial support from the parent.[5] Through strategic investments in early-stage companies, corporations see value in being able to "get in on the action" without changing their core business, and view strategic investments as an essential part of their corporate development efforts.[6]

This article will discuss the upswing in CVC investment activity, including the benefits and challenges of strategic investments. It will also address structuring considerations in making those investments, and highlight corporations, particularly in New Jersey, that are capitalizing on the momentum to augment corporate development efforts by engaging in CVC investments.

The Benefits and Challenges of Strategic Investments

While traditional venture investors singularly pursue financial return for their limited partners, CVCs often have broader strategic goals.[7] These corporations tend to be motivated by the strategic and commercial synergies realized by investing in companies focused on products or services that are often complimentary, and sometimes competitive, to their operating businesses.[8]

From a financial perspective, a corporation can capture significant financial upside if it funds a successful venture.[9] From a strategic perspective, however, exposure to an emerging or competing technology or product can serve as a hedge against a competitive threat or disruption to the corporation's existing business.[10] A CVC can gain advantages for its parent corporation by surveying the landscape of what startups are doing.[11] This informational advantage can be critical in determining whether to pursue acquisition opportunities. Through this exposure, the corporate investor can observe how the startup operates, build relationships with its founders, and decide whether to pursue a more significant transaction.[12] Even if acquisition is not the main driver, the strategic investment can boost a corporation's research and development initiatives and enhance the opportunity for the corporation to penetrate growth markets.[13]

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For the startup, in addition to getting access to the capital it needs to scale, CVCs offer key value-added services. Their established distribution networks, relationships with strategic partners and entrenched domain intelligence are consequential for the startup. Through corporations, startups gain invaluable introductions to important industry contacts and access to an experienced sales force, among other benefits.[14] Moreover, since the companies with CVC arms are generally some of the biggest and most significant industry players, their investments also validate and provide credibility to the startup's products and services.[15]

Startups also appreciate the patience that comes with a strategic investment. Traditional venture capital funds with limited life spans face pressure to exit early and return funds to their limited partners.[16] Corporate venture capital units, by contrast, are not bound by limited partnership agreements that have defined terms of seven to 10 years and, given the proliferation of CVC units within large corporations in recent years, corporations have demonstrated a commitment to investing in startups for longer terms.[17] The strategic investor's ability to stay the course is even more acute during down cycles when those corporate investors are willing to support startups in spite of lower valuations. As the president of one CVC unit put it, "If the company continues to deliver on what we are looking for from an innovation perspective, and if they continue to progress against those milestones, absolutely, we want to continue to help them. We want that company to be successful."[18] This longer horizon is attractive to startups that wish to stay private longer and sidestep a premature acquisition or initial public offering.[19]

The CVC model is not without its challenges. Given that CVC investments are often negotiated alongside commercial agreements (see the discussion below) that may include rights of first refusal on future sales or other exclusivity provisions, these investments may limit the fundraising or financing alternatives for startups, as well as a startup's ability to pursue opportunities with other strategic partners.

Structuring Corporate Venture Capital Investments

Initial Structuring Considerations

A corporation's investments into early-stage companies are largely driven by strategic and commercial motivations. Whether it's obtaining a license to the startup's technology, cooperating on a research and development initiative, securing a commitment from the startup to supply a product or technology, or the opportunity to evaluate the startup with an eye toward acquisition, the key drivers of CVC investments are often strategic objectives the corporation wishes to address.[20]

The CVC structure can take a few forms. For one, corporations can join an existing venture capital fund as a limited partner.[21] Alternatively, corporations can use current operating business units and task them with venture capital investing.[22] Another option would be for dedicated funds to be co-managed by a venture capital fund and the corporation.[23] Most commonly, however, a corporation creates a wholly-owned subsidiary, and that subsidiary operates exclusively to make venture capital investments and retains employees to manage those investment activities.[24]

Type of Equity Investments and Special Terms in Legal Documents

Like traditional venture capitalists, corporate investors prefer to invest in preferred equity rather than common equity. Preferred equity offers the holder downside protection in the form of a liquidated preference or the right to receive,

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in preference to any distributions to holders of common equity, on a sale, liquidation or winding up of the issuer, some multiple (often 1x) of their invested capital.[25] Corporate investors also seek preferred equity that is convertible[26] into shares of common equity based on a conversion price per share that is typically tied to the purchase price paid by the investor at funding and, thereafter, subject to anti-dilution protection. That anti-dilution protection is intended to protect the strategic investor (who is often a minority investor in the startup) from its ownership percentages being diluted upon the occurrence of certain dilutive events like a stock split, stock dividend or down-round funding, over which the corporate investor as a minority investor may not have a veto right.[27]

To address their commercial and strategic objectives, corporations tend to negotiate special terms in investment documents or craft stand-alone agreements that align with those objectives. For instance, in addition to the traditional investment documents for venture capital financing,[28] corporate investors typically negotiate a separate business, commercial or intellectual property agreement addressing their commercial needs. If the strategic investor's interest in the startup is as a prospective acquisition target, it should consider negotiating a right to be provided with notice of the startup's receipt or solicitation of an acquisition offer, and the opportunity to make a competing offer if the corporate investor desires, generally on the same terms and conditions as the acquisition offer.[29] Finally, a strategic investor should consider entering into a side letter with the startup that provides the investor with certain financial and reporting information, particularly if the corporate investor does not have a seat on the startup's board of directors. These informational rights will grant the strategic investor access to financial statements (quarterly and annual) and annual budgets to enable the investor to monitor its investment.[30] The side letter form will also ensure that the strategic investor's informational rights cannot be eliminated without the investor's approval.[31]

Additional Legal Considerations: Disclosure Obligations and Conflicts of Interest

Corporations interested in pursuing strategic investments in startups should keep some key legal considerations in mind. While CVC investments are generally not made in amounts that trigger disclosure requirements, particularly for public companies,[32] corporations should be mindful that startups will likely disclose their investment by publicizing the list of investors participating in capital raising rounds.[33] These disclosures "[serve] an important market signaling function" for the startup but can have other consequences for the corporate investor.[34] Disclosing a corporation as an investor can signal that corporation's strategies concerning future acquisition areas or specific targets.[35] For corporations in highly competitive industries, this information may incite competition among other industry players, so corporations should be prepared and negotiate tighter confidentiality restrictions, if necessary, within their investment documents.

Another important consideration is the conflict of interest that may arise when corporate investors appoint individuals to a startup's board of directors.[36] In connection with their investments, investors often negotiate the right to appoint a director to the startup's board and often designate one of their employees to fill that role.[37] The corporate investor generally expects that its board designee will protect the investor's interests by consulting with the investor on major company decisions and reporting to the investor on non-public financial results.[38] However, the question that often arises is whether the board designee's obligations to their designating investor conflicts with their duty of loyalty to the startup on whose board the designee sits. While the board designee owes an "uncompromising duty of loyalty" as a director in the startup,[39] disclosures to their designating investors are generally permitted; provided that the corporate investor does not cause harm to the startup by, for example, using that information to compete with the startup or to divert business opportunities away from the startup.[40]

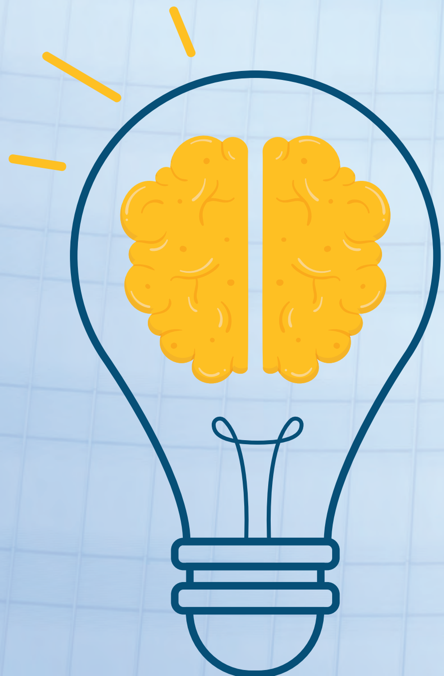
Corporate Venture Capital Activity Within New Jersey

New Jersey is home to several corporations with robust CVC activity. Johnson & Johnson (J&J) has been a leader on this front, boasting a 50-year old CVC practice that has had many successes, including launching and establishing J&J as a significant player within the HIV-treatment market.[41] Like J&J, many New Jersey companies are embracing the opportunity to gain visibility into emerging markets within their respective industries through strategic investments in innovative, early stage companies. ■

Endnotes

1. Darian M. Ibrahim, *Corporate Venture Capital*, 24 U. PA. J. BUS. L. 209 (2021).
2. Kaloyan Andonov, *Corporate Investors Hold Steady as VCs Retreat*, Globalventuring.com (Jan. 15, 2023) *available at* globalventuring.com/corporate/corporate-investors-2022-deal-numbers/.
3. Darian M. Ibrahim, *Corporate Venture Capital*, 24 U. PA. J. BUS. L. 209 (2021).
4. *Global Corporate Venture Capital-Backed Funding Ticks Up for the First Time in Nearly 2 Years*, CB Insights (August 3, 2023) *available at* cbinsights.com/research/report/corporate-venture-capital-trends-q2-2023/.
5. Darian M. Ibrahim, *Corporate Venture Capital*, 24 U. PA. J. BUS. L. 209 (2021).
6. *Ibid.*
7. Steven Rosenbush, *Pro Take: Corporate Venture Capital Provides Path for Long-Term Tech Strategy*, wsj.com (August 25, 2023) *available at* wsj.com/articles/pro-take-corporate-venture-capital-provides-path-for-long-term-tech-strategy-6f75eb75.
8. Darian M. Ibrahim, *Corporate Venture Capital*, 24 U. PA. J. BUS. L. 209 (2021).
9. It is often cheaper to invest at early stages in an emerging company, scale it and acquire the business, than to buy out a mature company when it poses a competitive challenge. *Ibid.*
10. *Strategic Equity Investments in Startups* (Practical Law 2023); Darian M. Ibrahim, *Corporate Venture Capital*, 24 U. PA. J. BUS. L. 209 (2021) (A corporation that has no ownership in disruptive technologies may fall victim to one.).
11. *Ibid.*
12. *Ibid.*
13. *Ibid* (While internal research and development within corporations generally focuses on enhancing existing lines of business, engaging with startups can supplement internal R&D efforts).
14. Jennifer S. Fan, Catching Disruption: Regulating Corporate Venture Capital, 2018 COLUM. BUS. L. REV. 341 (2018).
15. Evan Kipperman and Paul Hughes, *Practice Tips For Structuring Corporate Venture Capital Deals, Law360.com* (June 13, 2023) *available at* law360.com/articles/1687275/print?section=capitalmarkets.
16. Darian M. Ibrahim, *Corporate Venture Capital*, 24 U. PA. J. BUS. L. 209 (2021); Jennifer S. Fan, Catching Disruption: Regulating Corporate Venture Capital, 2018 COLUM. BUS. L. REV. 341 (2018) (Limited partnership agreements that govern the operation of the venture capital fund have terms of between seven to 10 years).

17. *Ibid.*
18. Steven Rosenbush, *Pro Take: Corporate Venture Capital Provides Path for Long-Term Tech Strategy*, wsj.com (August 25, 2023) *available at* wsj.com/articles/pro-take-corporate-venture-capital-provides-path-for-long-term-tech-strategy-6f75eb75.
19. Darian M. Ibrahim, *Corporate Venture Capital*, 24 U. PA. J. BUS. L. 209 (2021).
20. *Strategic Equity Investments in Startups* (Practical Law 2023).
21. Jennifer S. Fan, Catching Disruption: Regulating Corporate Venture Capital, 2018 COLUM. BUS. L. REV. 341 (2018).
22. *Ibid.*
23. *Ibid.*
24. *Ibid.*
25. *Startup Venture Finance: Overview* (Practical Law 2023).
26. The right to convert is triggered by certain specified events, such as a qualified public offering, or the sale or liquidation of the startup. *Startup Venture Finance: Overview* (Practical Law 2023).
27. *Strategic Equity Investments in Startups* (Practical Law 2023). To protect itself in the case of a subsequent down round, the CVC generally negotiates a price-based anti-dilution provision which is designed to reduce the conversion price of the preferred equity, thereby increasing the number of common equity issuable to the investor on conversion in proportion to the relative reduction in the conversion price. The anti-dilution provision generally takes the form of either (i) weighted average anti-dilution, which is more commonly used in typical institutional venture capital financing, or (ii) full ratchet anti-dilution, which is less commonly used but more favorable to the investor. *Ibid.*
28. The five main documents of a venture capital financing are: the Certificate of Incorporation, the Stock Purchase Agreement, the Investors' Rights Agreement, the Right of First Refusal and Co-Sale Agreement and the Voting Agreement. Jennifer S. Fan, Catching Disruption: Regulating Corporate Venture Capital, 2018 COLUM. BUS. L. REV. 341 (2018).
29. *Strategic Equity Investments in Startups* (Practical Law 2023).
30. *Ibid.*
31. *Ibid.*
32. Public corporations must disclose "significant subsidiaries" in a 10-K filing; however, the corporate venture capital arms of corporations do not often meet the threshold of a significant subsidiary given the size of those subsidiaries in relation the larger parent corporation's operations, cash flows and financial position. Darian M. Ibrahim, *Corporate Venture Capital*, 24 U. PA. J. BUS. L. 209 (2021).
33. Following a capital raise, startups routinely disclose, through industry trade publications, company press releases, website and social media, the investors who participated in a funding round, how much was raised during that round, which investors led the round and what stage the company is in. *Ibid.*
34. *Ibid*.
35. *Ibid.*
36. Corporate law imposes duties of care and loyalty on directors of corporations. To meet the duty of loyalty, in particular, a director must serve the corporation on whose board such director sits rather than the interests of such director, and, by extension, the interests of their designating corporate investor. *Ibid.*
37. David M. Morris, Lois Herzeca and Julie E. Kamps, *Designated Directors and Designating Investors: Early Planning is Key*, The Corporate Governance Advisor (May/June 2008).
38. *Ibid.*
39. Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983) (directors owe an "uncompromising duty of loyalty").
40. David M. Morris, Lois Herzeca and Julie E. Kamps, *Designated Directors and Designating Investors: Early Planning is Key*, The Corporate Governance Advisor (May/June 2008).
41. Steven Rosenbush, *Pro Take: Corporate Venture Capital Provides Path for Long-Term Tech Strategy*, wsj.com (August 25, 2023) *available at* wsj.com/articles/pro-take-corporate-venture-capital-provides-path-for-long-term-tech-strategy-6f75eb75 (J&J's investment in Tibotec-Virco provided it with entry into the HIV-treatment market).



Intellectual Property Considerations in Mergers and Acquisitions Transactions

By Melissa Skrocki and Ammad Ahmed

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Intellectual property (IP) plays a crucial role in the activities of businesses, and when purchasing or selling a company, a business's IP rights are a key asset. In mergers and acquisitions (M&A) transactions, IP considerations are important in assessing the value and risks of the target company. With careful consideration of the IP of the target, acquirers can mitigate risks, maximize the value of the transaction, and integrate seamlessly with the target business.

To start, attorneys conducting due diligence should be familiar with four types of IP:

1. Trademarks or service marks are words, phrases, symbols or designs that identify the source of specific goods and services.
2. Patent registration is an exclusive right granted for an invention, which is a product or process that details a unique means of doing something or offers a new technical or scientific solution to a problem.
3. Copyright protects original works of authorship when an author fixes the work in a tangible form of expression, such as written works, software code, drawings, artwork, and photographs.
4. Trade secret information is confidential information protected from public disclosure, such as formulas and business methods.

Identifying and analyzing the IP of a target through due diligence is important in evaluating the overall value of the target business and the ability of the buyer to use the IP following the transaction.

Trademarks

Trademark due diligence involves identifying the trademark rights of the target and confirming their validity. Trademarks may be highly valuable to businesses and therefore, a thorough review of the target's trademark portfolios is important to an M&A transaction. Due diligence should focus on whether the mark is registered or unregistered, whether it is being properly used, and what licenses, if any, have been granted for use of the mark by others. The acquiring entity should request a docket of all trademarks, unregistered and registered. For marks that have applied for or received registration, the docket should include the mark's serial and registration numbers, filing date, date of registration, description of goods and services, and the country in which the application or registration is filed.

A careful review of the registration and verification of proper use of the marks in the portfolio, along with any upcoming maintenance filing deadlines, is critical to maintaining the value of the trademark assets. Additionally, an important consideration for the letter of intent or a purchase agreement that has a preclosing period is to confirm the timing of any trademark filings that may be ripe for submission prior to or following the closing. Many trademark filings, including maintenance filings, have broad windows of time when a USPTO filing can be completed. If the target has trademark registrations, the parties should confirm the responsibility for said filings as they can be overlooked during the frenzy of an M&A transaction.

Additionally, a buyer should review any unregistered trademarks and determine if the mark is eligible for registration and if the buyer would like the target to begin the registration process in advance of the closing.

Copyrights

Copyright due diligence should begin with the fundamental consideration of ownership. Copyright ownership vests in the author of the work unless: (i) it was created by an employee in the course of their employment, in which case it is owned by the employer; or (ii) has been created as a "work made for hire" pursuant to a written agreement, in which case the copyright is owned by the contracting party. Assets that would have copyright considerations may be the target's website content, software code, written materials that are used in the business of the target, or drawings, advertising copy or photographs used in connection with the business. Ownership of the copyright is critical when determining the target's ability to sell the copyright assets and the buyer's ability to use the works. Additionally, a lack of clarity regarding the ownership of the copyright could impact the value set on the assets and potential future liability surrounding the assets. For example, assume a target relies on software that was developed specifically for the operations of the company. If we further assume that the bespoke software was written by an independent contractor with no contract, this would mean the target has no assignment or work for hire language transferring the software code to the company. The ownership of the copyright of this critical asset would then be called into question. When considering any writings (including software code), drawings or photographs used by the target, confirming ownership should be paramount to the buyer.

Once ownership is established, the potential buyer should confirm whether all the material works of authorship have been registered with the U.S. Copyright Office. While ownership and certain common law rights vest in copyright protected works upon their initial publication, in most instances parties are not able to pursue an infringement claim without a valid copyright registration with the U.S. Copyright Office. Additionally, timely registration in advance of the infringement or within three months of publication of the work may allow the copyright holder to seek statutory damages and attorney's fees in certain circumstances. These additional remedies are not available to those copyright holders who fail to timely register their works. The buyer's due diligence team should review all copyright registrations to determine the strength of the copyright assets of the target.

Patents

When examining the patent portfolio of the target, the buyer should conduct a patent search and request copies of all historic documents relating to patent filings. It will be critical to calculate any upcoming due dates for patent filings, the expiration date for each patent, and to understand the current use and any anticipated use of the patent technology in connection with the post-closing business. A buyer should request all materials related to the ownership and assignment of each patent, including any employment agreements that assign ownership rights from the inventor to the target. An additional consideration for targets with patents is any licenses that have been granted to targets in connection with the patents. Licenses should be reviewed to determine if they are freely assignable, require notices and/or consents upon a change of control or assignment, have terms consistent with the patent filing, include terms that would result in misuse of the patent and any terms that would not be consistent with the buyer's business plan.

Trade Secrets

Trade secrets can be a critical but sometimes overlooked area for IP due diligence. To do so would be at the buyer's peril. Trade secrets are often the crown jewels of a company's business operations. They include items such as proprietary software code, customer lists, recipes, and business and financial models. Once the buyer determines which trade secret assets it intends to acquire and use after closing, it should request a list of all individuals who may have access to confidential information and copies of all non-disclosure agreements (NDAs) along with any employee contracts or handbooks, independent contractor agreements, or other contracts that include confidentiality obligations. These agreements should be reviewed to confirm that the relevant trade secrets are adequately protected, determine the term of the agreement, and the assignment rights of the target. Conversely, the buyer should also inquire as to any confidential information of a third party that has been acquired by the target that is subject to an NDA and what obligations the buyer will have to maintain such information following the transaction.

Online IP Due Diligence Considerations

Websites and social media profiles like Facebook, Instagram, X, YouTube, or LinkedIn have become key assets of most businesses to market the company's goods and services. When conducting a due diligence review of a target's website, the buyer should confirm ownership of the domain name, review the posted terms of use for the website and social media accounts, and confirm that the target is acting in accordance with the posted policies. Various privacy and data security laws continue to be enacted throughout the country and internationally which could impact the target, including, but not limited to, California's Online Privacy Protection Act (COPPA)[1] and Consumer Privacy Act of 2018 (CCPA)[2] and the European Union's General Data Protection Regulation (GDPR). M&A counsel should note that there are a number of U.S. states that have enacted privacy laws that will become effective within the next few years and these laws may be applicable to the target and any information that the target has gathered from its website or social media sites. A buyer should review the privacy policy that is posted on the target's website along with the target's actions related to the protection of consumer data to determine compliance and any risks involved with acquiring the online assets of the target.

IP Agreements

A diligent buyer would request copies of all contracts related to the target's IP. This would include licenses that the target has granted to and received from third parties, such as licenses for software, use of copyrighted images, patents, trademarks or trade secrets. Additionally, it may include development agreements, independent contractor agreements, domain agreements, and non-disclosure agreements. The buyer should carefully review the terms and conditions of these agreements to consider assignability, the duration of the rights, required consents or notices and confirm that the agreements provide the buyer with the necessary rights for its intended use of the IP.

IP Representations and Warranties

Upon the completion of the buyer's IP due diligence, it should begin crafting the representations and warranties that it will request from the target. These statements by the target will be critical to the buyer in its ability to allocate the risk of acquiring the IP assets and will provide a basis for any future indemnification claims related to the IP. The target's representations should confirm at a minimum ownership of both registered and unregistered IP, conformance with all applicable laws, confirm maintenance of all registrations and provide informational disclosures relating to the development of any IP and all IP agreements entered into by the target. If the target company collects consumer data, personal information or protected health information, privacy and data security representations and warranties should be well crafted to confirm compliance with all laws. The level of specificity surrounding the IP representations and warranties is often directly tied to the nature of the business and its dependence on the IP assets in the operation of the business.

Conclusion

In today's digital age, IP assets are often a critical component to the business operations of a target. We have highlighted some of the considerations for a buyer when acquiring IP assets of a target but would note that each diligence review is unique and that new laws impacting this area are forthcoming in various states. To maximize the value of the assets to be acquired, a buyer should carefully analyze the intellectual property of the target during its due diligence phase of the M&A transaction and remain informed regarding the laws and regulations impacting the activities of the business. ■

Endnotes

1. Cal. Bus. & Prof. Code §22577
2. Cal. Civ. Code §1798.100 to 1798.199.100

Mitigating Cybersecurity Risks in Mergers and Acquisitions

The Importance of Due Diligence and Regulatory Compliance

By Karen Painter Randall, Joshua P. Previl, and Adam J. Salzer

With cybersecurity threats to both public and private companies becoming a daily occurrence, it has never been more important for venture capital, mergers and acquisitions (M&A) and private equity firms to conduct substantive due diligence on the organizational cybersecurity infrastructure of their target investments. Organizations of every size, across all industries, are constantly facing threats to their proprietary business data and the personal information of their investors, clients and employees through phishing emails, ransomware, spyware, and a myriad of other nefarious tactics. Despite employee cybersecurity training and the use of third-party specialists to manage company security and data systems, billions of dollars are lost each year due to data security breaches causing some enterprises to go out of business. This ever-evolving threat compels potential suitors to conduct extensive due diligence relevant to a target's security infrastructure, posture and culture during M&A to avoid having the acquiring firm inherit the security issues of its acquisition.

...[The] Securities and Exchange Commission (SEC) recently adopted new rules to enhance and standardize public companies' disclosures regarding cybersecurity, risk management, strategy, governance and incidents. Additionally, the Federal Trade Commission (FTC) recently approved amendments to the Standards for Safeguarding Customer Information Rule requiring non-banking financial institutions regulated by the FTC to report certain data breaches.

Government regulators have begun to take notice of the relentless threat landscape. Most notably, the Securities and Exchange Commission (SEC) recently adopted new rules to enhance and standardize public companies' disclosures regarding cybersecurity, risk management, strategy, governance and incidents. Additionally, the Federal Trade Commission (FTC) recently approved amendments to the Standards for Safeguarding Customer Information Rule requiring non-banking financial institutions regulated by the FTC to report certain data breaches. As recently as Dec. 18, 2023 (the effective date of the new SEC reporting requirements), VF Brands, a publicly traded company, filed an SEC report indicating that "attackers" stole personal data from the company, and that the incident would likely continue "to have a material impact on the Company's business operations..."[1]

In light of this high-risk environment and the new regulatory reporting standards, company executives are under increasing pressure to: (1) ensure that business, client and investor data is adequately protected, and (2) accurately and promptly disclose known cybersecurity risks and vulnerabilities. Failure to do so is a recipe for a crippling data breach, costly litigation and regulatory enforcement claims, and in the case of mergers and acquisitions, post-closing indemnity claims. The Oct. 30, 2023, complaint filed by the SEC in the Southern District of New York against SolarWinds, Inc., a publicly-traded software company, and its chief information security officer (CISO), Timothy Brown provides a cautionary tale.

The SEC's complaint charged SolarWinds with violations of the antifraud provisions of the Securities Act of 1933 and of the Securities Exchange Act of 1934 related to "misstatements, omissions, and schemes that concealed both the Company's poor cybersecurity practices and its heightened—and increasing—cybersecurity risks."[2] The SEC alleged that despite the company's known cybersecurity vulnerabilities, SolarWinds and Brown made false public statements and failed to disclose known risks related to the quality of its cybersecurity practices. Those vulnerabilities only came to light following the 2019 and 2020 SUNBURST cyberattack that exploited the vulnerabilities of SolarWinds' Orion product. By inserting a malicious code into the Orion product, the threat actor ultimately gained access to SolarWinds' customers data.

In December 2020, SolarWinds disclosed to the SEC that it was affected by the SUNBURST attack. Following its disclosure, SolarWinds' share price dropped 35% in approximately two weeks. At the same time, it came to light that numerous employees,

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including Brown, knew that the company had "serious cybersecurity deficiencies," as described in numerous internal statements. Those statements "dramatically contradict SolarWinds' public disclosures…"[3]

SolarWinds' failures to adequately address its cybersecurity policies, along with its materially false statements to the public and regulators regarding its cybersecurity practices, led to millions of dollars in investor losses and exposed SolarWinds to liability resulting from violations of a litany of regulatory issues and litigation. SolarWinds' counsel will move for dismissal of the SEC complaint.[4] They argue that the SEC's actions overstepped the agency's legislative authority since "the SEC is not a cybersecurity regulator."[5]

In an effort to promote accurate and complete cybersecurity disclosures and assist investors in making informed decisions, the SEC has adopted new rules that standardize the disclosure practices surrounding cybersecurity and hold boards of directors more accountable for the oversight of a registrant's cybersecurity protections. Effective December 2023, registrants are required to report on Item 1.05 of their Form 8-K the following information regarding a material cybersecurity incident:

1. When the incident was discovered and whether it is ongoing;
2. A brief description of the nature and scope of the incident;
3. Whether any data were stolen, altered, accessed, or used for any other unauthorized purpose;
4. The effect of the incident on the registrant's operations; and
5. Whether the registrant has remediated or is currently remediating the incident.[6]

With a limited exception for threats to national security or public safety, the Form 8-K detailing a cybersecurity incident must be filed within four (4) business days of the registrant's determination that the incident is considered material to the company. This determination does not necessarily coincide with the date of the incident.[7] The new rules maintain the current definition of "material" in securities law: An incident is material if "there is a substantial likelihood that a reasonable shareholder would consider it important."[8] Furthermore, the rules require foreign private investors to report similar incidents on a Form 6-K whenever they report such incidents in a foreign jurisdiction.

Already under a spotlight, the new SEC disclosure and governance rules will make a CISO's life even more complicated. Not only will the CISO be responsible for detecting and responding to a cybersecurity incident, but he will play an important role working with key stakeholders to determine whether the incident rises to the level of being material to the company's financial performance requiring regulatory notification. Legal and regulatory bodies have been proactive in this space including convicting the Uber Chief Security Officer in a federal court action, conducting a SEC civil investigation of the Solar Winds CFO and ordering Drizly's CEO to implement a data security program.

According to the new rules, registrants are also required to disclose on Item 106 of Form 10-K their current systems and policies for managing cybersecurity threats, including whether a third-party is engaged to manage such threats, procedures for identifying and addressing threats that are in place, and contingencies for recovering data after a breach. Registrants are also required to report on the company's cybersecurity practices to the board of directors' management and oversight committee.

The SEC's new disclosure rules will give investors the ability to gain more insight into a potential target's cyber risk and resiliency plan. In the context of M&A, this can provide investors with information that they may not have otherwise received or requested during the due diligence process. Although cybersecurity continues to be a minefield, investors request varying levels of detail from targets in this area. Some request high-level information on a target's information systems, while others have a team of specialists dedicated to gathering details about the target's cybersecurity posture. The new rules can also make investors aware of areas that might warrant follow-up or a deeper dive especially if the investor requests broader disclosures during the due diligence process than the target is required to report in its SEC filings. In today's data privacy landscape, it is crucial for investors to conduct a cybersecurity risk assessment to gain as much information about a target's security infrastructure as reasonably possible before deciding to consummate an acquisition. Without the proper vetting, gaps in data security can go undetected until post-acquisition. Without proper due diligence, an acquirer may find that it purchased the target without detecting an ongoing attack impacting its system. For example, just two years after it acquired Starwood Hotels & Resorts Worldwide, Inc. in 2016, Marriott Hotels & Resorts suffered a data breach caused by a Trojan malware placed on Starwood's servers.[9] Starwood's systems were not sufficiently secure, and it had suffered multiple data breaches even before it was acquired, including a successful attack in 2015.[10]

From the target's standpoint, the new rules reinforce the importance of conducting regular risk assessments and making sure that best practices are used across the enterprise using applicable frameworks as guidance. Ensuring that an incident response plan with different playbooks and tabletop exercises are practiced is crucial under the new rule. Cyber policies and procedures will need to be tested and updated as well to ensure compliance with new laws and regulations. Security awareness training, third-party vendor management, patch management, multifactor authentication, endpoint detection and response (EDR) are just a few measures to be focused on in order to fortify an enterprise's cybersecurity. Companies should also keep abreast of changes in applicable privacy laws and update their privacy policies and practices accordingly. The new rules also put a spotlight on directors, emphasizing the importance of sufficient oversight of the inner workings of the company's data security.

Although the new rules seek to help investors to be more informed about their potential targets, attackers have found ways to use the new rules to their own benefit. On Nov. 7, 2023, ALPHV/Black Cat, a notorious ransomware-as-a-service operator, launched a successful ransomware attack on MeridianLink, Inc., a publicly-traded software company that provides digital solutions to financial institutions.[11] When MeridianLink refused to pay the ransom, Black Cat applied more pressure by filing a complaint with the SEC alleging that its victim failed to disclose the ransomware attack as required by the new rules. Although the new rules were not in effect at the time the complaint was filed, this tactic used by Black Cat serves as a warning for current registrants. In addition to enforcement actions by the SEC for failure to disclose material cybersecurity threats and processes, registrants may now face additional threats and pressure from groups like Black Cat. SolarWinds' counsel has also expressed its frustrations with the new rules, particularly the addition of Item 106 to Form 10-K. They argued that "it's unreasonable for the SEC to expect publicly available investor disclosures to spell out the specific vulnerabilities in a company's cybersecurity infrastructure, and in so doing, "giving a roadmap to fraudsters."[12]

The threat of a cyberattack may be increased during M&A transactions, especially as it pertains to publicly-traded companies. Due to the visibility associated with such a transaction, it is a prime opportunity for cybercriminals to launch ransomware attacks, phishing scams, and other data breaches. Cybercriminals can also play the long game by breaching the target company and waiting for it to be acquired by a larger entity, thereby circumventing the cyber protections established at the larger entity.[13] The creative tactics employed by cybercriminals require companies to conduct extensive diligence of their potential target. The SEC Commission Chair, Gary Gensler, has warned companies against "AI washing," the practice of overstating or misrepresenting the amount of AI or the level of sophistication of AI used in a company's operations.[14] Although companies may AI wash in an effort to assure investors that the company has the latest technology and cybersecurity protections, the deficiencies would be exposed if the company suffers a cybersecurity attack or data breach. With the increasing prevalence of cyber threats in a world dependent on information technology, companies' cyber protections will almost definitely be tested.

The new SEC rules aim to increase transparency between companies and their current and potential shareholders. The rules, along with the constant threat of cyberattacks, urge registrants to improve their cybersecurity processes and policies consistently. Making the required disclosures not only ensures compliance with the SEC, it also facilitates more seamless due diligence in M&A transactions.

Whether a company is selling or looking to acquire and expand, it is imperative that legal and security vendors work collaboratively with the client and counter-parties to ensure that sufficient, responsive information is disclosed during the due diligence process. Companies put themselves at risk when material information is concealed or omitted. Cybersecurity due diligence will continue to be a mainstay in M&A transactions. Investors and targets require proper counsel to guide them through this heavily regulated area to limit respective risks and liability. ■

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Time for a Trade Secret Audit as Non-Competes Under Attack?

By Galit Kierkut

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It is no secret that non-competes have been under attack in the last several years. There are numerous states that have recently passed or seem to be on the verge of passing much more stringent laws restricting the ability of companies to impose broad non-competes on their workforces. According to the U.S. Government Accountability Office (GAO), as of May 16, 2023, "two recent nationally representative studies GAO reviewed estimated that 18 percent of workers were subject to non-compete agreements (NCAs), and one of the studies estimated that 38 percent of workers had been subject to an NCA at some time in their careers. Over half of the 446 private sector employers responding to GAO's survey reported that at least some of their workers had NCAs."[1]

Federal Attempts at Non-Compete Regulation

In 2021, in an attempt to curtail the use of non-competes nationwide, President Biden signed an executive order (Biden Executive Order) stating an intent to prohibit all non-compete agreements, except those essential to protecting a narrowly defined category of trade secrets. The order issued a directive to the Federal Trade Commission

(FTC), which encourages the FTC to use its rulemaking authority to restrict and reduce—and even ban—certain types of non-compete agreements. Specifically, it provides that "the Chair of the FTC is encouraged to consider working with the rest of the Commission to exercise the FTC's statutory rulemaking authority under the FTC Act to curtail the unfair use of non-compete clauses and other clauses or agreements that may unfairly limit worker mobility."[2]

Responding to the Biden Executive Order, on Jan. 5, 2023, the FTC took a significant step towards banning non-compete agreements between companies and workers. The FTC proposed a broad rule that would effectively ban all non-compete clauses entered into in the employment context. It would also require companies to rescind existing non-compete agreements. The scope of the rule could also implicate other restrictive covenants, like nondisclosure and non-solicitation agreements.[3]

The proposed rule defines a "non-compete clause" as "a contractual term between an employer and a worker that prevents the worker from seeking or accepting employment with a person, or operating a business, after the conclusion of the worker's employment with the employer."[4] The definition expressly includes a broad clause that "*has the effect* of prohibiting the worker from seeking or accepting employment with a person or operating a business after the conclusion of the worker's employment with the employer" under a so-called "functional test." "Worker" is broadly defined. It includes paid and unpaid individuals who work for an employer, including individuals "classified as an independent contractor, extern, intern, volunteer, apprentice, or sole proprietor who provides a service to a client or customer."[5]

The proposed rule also provides two examples of "de facto" non-competes under the "functional test": (1) a nondisclosure agreement "written so broadly that it effectively precludes the worker from working in the same field after the conclusion of the worker's employment with the employer" and (2) a contractual term requiring the worker to repay training costs where such payment "is not reasonably related to the costs the employer incurred for training the worker." The proposed rule includes only a single exception, for a non-compete clause entered into in the context of a sale of a business provided the clause applies to an individual who owned more than 25% of the business being sold.[6]

The proposed rule would apply retroactively and provides that it is an unfair method of competition for an employer to "maintain" an existing non-compete agreement or represent to a worker that the worker is subject to a non-compete clause. To comply with that restriction, the proposed rule would require employers to "rescind the non-compete clause no later than the compliance date" and provide "individualized communication" to the affected worker regarding the rescission.[7] The proposed rule also provides that it "shall supersede any State statute, regulation, order, or interpretation to the extent that such statute, regulation, order, or interpretation is inconsistent" with the proposed rule. Any State statute, regulation, order, or interpretation offering greater protection to the worker would not, however, be superseded.[8]

The Notice of Proposed Rulemaking (NPRM) provides a great deal of background information regarding the proposed rule, and, in Section VI, it also highlights two potential alternatives to the FTC's proposed rule.[9] First, the NPRM suggests the FTC could impose a "rebuttable presumption of unlawfulness instead of a categorical ban." If the FTC were to take this approach, non-compete agreements would be presumptively unlawful, but an employer would be permitted to show that the clause should be enforceable under particular circumstances. The NPRM notes that such an approach would be similar to most existing state law where non-compete agreements are "disfavored" but permissible when used to protect "legitimate business interests" like confidential information or goodwill. However, the NPRM says that if the FTC were to ultimately adopt the rebuttable presumption approach, its rule would be more restrictive than current law.[10]

Second, the NPRM suggests that rather than a categorical ban, the FTC "could apply different rules to different categories of workers." Under that approach, the FTC could promulgate a rule with a categorical ban for some workers (e.g., low-paid workers) but impose a rebuttable presumption of unlawfulness for others (e.g., "highly paid, highly skilled workers such as executives"). The NPRM notes that there is no accepted definition for "executives" under federal law, but points to U.S. Securities and Exchange Commission reporting requirements as a potential source for such a definition.[11]

The FTC held a public forum and extended the public comment period, and it has received extensive public comments—in support of and in opposition to—in response to its proposed rule. Given the number of comments, the FTC is not expected to vote on its proposed ban, or some version of it, until April 2024. Any final rule will take effect 180 days after its publication and then will be subject to legal challenge, so the reality for employers is that the version of the law that is passed will likely not take effect until the challenges are resolved (assuming a nationwide stay is put in place). So, the federal law prohibition on non-competes will begin to take shape this spring but will likely not be fully resolved until at least 2025.

Recent State Attempts at Non-Compete Restrictions

Several states have also recently enacted or strengthened laws (e.g., Massachusetts, Colorado, Illinois and California) or are considering new laws (e.g., New York, New Jersey) significantly restricting the use of non-compete agreements. In New York, Governor Hochul has recently vetoed a very broad New York Senate bill that would have effectively banned most non-competes in the state. A form of the legislation is likely to be reintroduced in 2024. In New Jersey, the Assembly's Labor Committee passed bill A3715A in 2022, however the bill has not yet been acted upon. The most recent Appellate Division case regarding non-competes, *ADP v. Kusins*, validated the use of both non-competes and non-solicit agreements in New Jersey[12], and at the moment, employers can certainly continue complying with the construct that has been approved by the courts, a narrowly drawn agreement tailored to protect relationships and confidential information that is not unduly restrictive on employees. However, employers do need to be prepared to address potential changes in the law in New Jersey, in the states where they have employees (whether in offices or remote) and potentially soon nationwide. A company's restrictive covenants may be deemed unenforceable overnight leaving employers with little protection of their most important assets—their customer relationships and their confidential information.

Strengthening Confidentiality Protections and Non-Solicits as Best Practices for Employers

Due to the proposed federal rule, and to the growing trend of states to limit non-competes, now is a good time to take a fresh look at agreements, particularly for new employees, and ask the following questions: Is this restriction necessary for this particular type of employee? Can it be narrowed in scope or time? Does a non-solicit really suffice to protect our interests? With respect to salespeople, often a narrow and specific non-solicit can accomplish the employer's goal of protecting actual customer relationships that the company provided to or helped develop for the salesperson. Under current law in most states, those clauses tend to be far more enforceable than broad non-competes.

Often non-competes are used to protect confidential information from getting into the hands of a competitor. If non-competes become unenforceable, employers must still ensure that they are safeguarding their interests with respect to their confidential information. Trade secret statutes, both federally and in most states, will not be impacted by this trend in non-compete restrictions. Those protections are therefore the employer's best tool to protect confidential information if a key employee departs to a competitor and the non-compete becomes unenforceable under federal or state law. Even for employers located in states without non-compete restrictions who determine that they are not worried about the federal rules until they actually go into effect, their workforces likely have many remote only employees who live in states with greater protections than the employer's home state. The protection of trade secrets will be more important than ever in order to ensure a legal right to take action against an employee who takes those secrets to a competitor. In order for trade secrets to be protected under most statutes, including the under the Defend Trade Secrets Act of 2016 (DTSA)[13] the following test must be met:

1. The information must have economic value by being secret;
2. The information must not be readily discoverable by others who also can profit from it; and
3. The company must take reasonable steps to protect its secrecy.

The best way to ensure that this test is met for companies with significant confidential information is to put into place a trade secret protection plan. That plan must at a minimum ensure that the company has agreements with all employees regarding confidential information and has agreements with third parties to whom confidential information is disclosed. The plan should also implement written policies regarding how that information is protected, limit access to confidential information, train employees on those policies, and enforce the policies. When an employee who has been exposed to significant confidential information joins a competitor, the company should also have specific plans in place as to how to address that departure, including preservation of equipment, assessing whether employees actually took information with them and potentially the conducting of forensic examinations by qualified third party examiners who can ultimately testify if a matter goes to litigation. A narrowly drawn non-solicit agreement for salespeople and a robust trade secret plan that is consistently applied and enforced can be the answer to the changing landscape of non-competes. ■

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A Litigator's Plea

A Little Planning When Drafting an Arbitration Clause Can Save a Lot of Time, Money and Headache

By Robert Bartkus and James Harry (JH) Oliverio

As an arbitrator assigned to commercial cases and "recovering" litigator, an attorney who routinely litigates issues of arbitrability, and regular readers of current New Jersey federal and state court opinions, we routinely see arbitration clauses with fatal defects. Although arbitration, especially among sophisticated commercial parties, is intended to provide a private, less expensive, and quicker alternative to litigation, the intent of the parties can be frustrated by easily avoided drafting errors. Even the most experienced transactional attorney can fall into traps when the unique aspects of arbitration are involved. To cite Justice Pashman, arbitration is "meant to be a substitute for and not a springboard for litigation.'"[1]

Checklists—familiar to airplane pilots and other mechanical equipment operators—have been adopted for legal matters. Once the transactional attorney becomes familiar with the client's business, the nature of the business-to-business (B2B) transaction, and the possible points of friction in the client's soon-to-be relationship, a few checklist suggestions may ease the steps for drafting and implementing the dispute resolution clause:

- **NEVER** simply pull an old arbitration or other alternative dispute resolution (ADR) clause from another contract, form book, or the internet. Arbitration law, especially related to the enforceability of clauses, is subject to frequent, often significant statutory and case law changes. Just as one would consider changes in the relevant tax law or trade regulations, one should do the same for any ADR clause.

Calling in a litigator or arbitration specialist should be second nature, just as consulting with tax or trade specialists. As a painful example, in 2014 the New Jersey Supreme Court in *Atalese v. U.S. Legal Servs. Grp. L.P.*[2] clarified that waivers of the right to a jury or court determination must be set out clearly and unambiguously in an arbitration clause. Since then, countless thousands of lawyer hours and client fees have been spent litigating whether an ADR clause meets the *Atalese* standard, when it might have been easier, certainly for contracts drafted post *Atalese*, to include appropriate waiver language, even if not strictly required for business transactions.[3] While the proliferation of litigation over this issue may be, in part, due to the *Atalese* Court's recognition that there is no magic language that qualifies as a clear and unambiguous waiver of rights, subsequent case law is replete with examples that have been held valid, as well as terms found to be improper resulting in the denial of arbitration.[4]

- **AVOID BOILERPLATE** in the rest of the contract that might affect the client's arbitration rights, or at least be aware of the potential interaction between standard transactional language and arbitration, so one may work around any potential conflict. Jurisdictional, third-party beneficiary, assignment, and integration clauses regularly create issues. For example, in a case between Re/Max fanchisees, a panel of the New Jersey Appellate Division held the defendant franchisee had no right to compel the plaintiff franchisee to arbitrate its claims under the plaintiff's franchise agreement that required mediation and, if unsuccessful, arbitration of disputes between Re/Max franchisees because the contract also contained a clause barring a third-party beneficiary's reliance on the agreement.[5] In another case, the Third Circuit held a plaintiff was not required to arbitrate his claims where the parties' operating agreement contained a jurisdictional clause vesting exclusive jurisdiction of disputes in the federal and state courts of Delaware because the ADR provision applied to disputes "except as otherwise provided in [the agreement]." The Third Circuit reasoned the ADR clause could not be given its plain-meaning effect without rendering the jurisdictional clause superfluous.[6]
- **ALWAYS** be aware of the consequences of the arbitration law, forum and forum rules inserted in the clause. Just as one would not blithely choose New York law to govern the business aspects of the transaction without knowing the effect of General Obligations Law sections, such as interest rates, so one should be aware that choosing New Jersey arbitration law or the Federal Arbitration Act (FAA) may affect the client's rights.[7] Remember that New Jersey's arbitration law is the default absent a specific election (unless there is FAA preemption). Likewise, different arbitration forums may have different or unexpected rules and protocols. An often-overlooked provision of the American Arbitration Association (AAA) Commercial (and other) Rules permits an arbitrator to award legal fees when the parties request fees in their demand—even though not otherwise available. As another example, does the client really want the hearsay or court discovery rules to apply, despite the effect that choice will have on the arbitration—*i.e.*, delay. Where the client's expressed preference for a particular procedure, *e.g.*, federal rules of evidence or discovery, conflicts with the rules of the forum, the arbitrator may have discretion to choose between them unless the choice is restricted.
- **REMEMBER** that even in a B2B transaction the buyer may be considered a "consumer" under the CFA or designated arbitral forum's rules. If so, an unconscionable provision, *e.g.*, limitations on statutory rights or remedies, time-limitations, and certain fee-shifting provisions, may be stricken or (if egregious) result in arbitration being denied by the court or refused by the forum (for disapproved provisions). Such "consumer" B2B Terms and Conditions may be submitted to some forums in advance to be sure they do not run afoul of the forum's protocols.
- **CONSIDER** whether to exclude arbitration for some issues, *e.g.*, litigating collections in small claims court, or to elect the forum's internal appellate panel rules when a party considers requiring a three-person arbitration panel. Consider having only one arbitrator at the first arbitration as it may be more economical and expeditious than three. Designating a non-existent forum, or imposing impossible qualifications for the arbitrator, or an unrealistic timeframe for arbitrator selection can lead to disaster. While an arbitration provision need not designate a specific arbitrator, forum and rules,[8] the failure to do so can lead to court action and unwanted delay. A short sentence providing for jurisdiction and a means of service of a demand, if not indicated in a forum rule, can avoid the loss of one benefit of arbitration: cooperation and informality rather than strict procedural rules.
- **RECOGNIZE** that there remain questions regarding many arbitration issues. For example, most courts have held that the forum's rules control such issues as who—judge or arbitrator—decides arbitrability and jurisdictional issues. Where, however, an ADR clause references a forum's rules as controlling the arbitration, the issue

as to whether that reference itself qualifies as an enforceable delegation provision remains debatable and has not been finally decided. Thus, a full delegation clause may be worth the extra ink.

- **CLARITY** is just as important in drafting the ADR clause as in any other aspect of the document. Although arbitration may be viewed by courts as a favored means of dispute resolution for business disputes, these clauses still are governed by ordinary contract principles (and in the context of consumer contracts, The Plain Language Review Act).[9] Thus, one court held that a two-step clause (mediation then arbitration) failed because the language confused mediation rules with arbitration rules.[10] In other cases, the use of convoluted multi-clause sentences led to confusion—and the entire clause not being enforced.[11]
- **COMPLEXITY** is the enemy. Once a dispute arises, the other party may not be as enthusiastic about arbitration! Therefore, it is imperative to avoid a complex clause with long sentences and clauses; multiple steps; and overly detailed provisions that may give rise to enforcement issues. While complex, long-term joint venture and similar relationships may warrant complex ADR provisions—because the parties have a shared interest in having the relationship continue—most business-to-business contracts and Terms and Conditions do not warrant the same treatment. The major arbitration forums have basic provisions that can be tailored to specific needs without increasing enforcement problems. In *Achey v. Cellco Partnership,*[12] the court threw out a tailored bellwether arbitration process which was used in the consumer context, in lieu of class actions or the forum's own Mass Arbitration Rules, because it was found to be unfair and overly complex. Forum rules are usually drafted with both claimants and respondents at the table, and are issue-tested to avoid the *Achey* problem.
- **DOUBLE-CHECK** the ADR provision's scope language. Using the term "under this agreement" may be interpreted as limiting arbitration to contract disputes and preclude arbitration of statutory or termination issues.[13]
- **MULTIPLE** documents in a transaction, or series of transactions, regularly create problems for drafters. Where a relationship begins with a "master agreement"—whether named as such—the application of the arbitration clause in the standard terms and conditions should be clearly cross-referenced in the subsidiary documents, such as purchase orders, confirmations, or indemnification agreements. Multiple contracts with disparate dispute-resolution provisions may result in the denial of arbitration.[14] Failing to reference the initial "master" or "intake" agreement in the ancillary documents may doom arbitration, where only the first contained the arbitration clause.
- **CONFIDENTIALITY** is considered a benefit of arbitration, but absent specific agreement on confidentiality in the arbitration clause or later agreement, normal (less protective) privacy rules will govern.
- **AWARD:** The ultimate result of the arbitration may require enforcement in court. Therefore, jurisdiction waivers or other protective clauses may be appropriate. Do not be surprised that any court action may require public disclosure of the award; specifying a summary or simple award may assist if that is a problem for the client.

By using a simple checklist, the extra time spent carefully reviewing your arbitration clauses—or updating them as changes in the law occur—will be well worth it. And your client will thank you. ■

Endnotes

1. *Barcon Assocs., Ins. Co. v. Tri-County Asphalt Corp.*, 86 N.J. 179, 187 (1981) (quoting *Korshalla v. Liberty Mut. Ins. Co.*, 154 N.J. Super. 235, 240 (Law Div. 1977)).
2. *Atalese v. U.S. Legal Servs. Grp., L.P.*, 219 N.J. 430 (2014).
3. *See Cnty. of Passaic v. Horizon Healthcare Servs., Inc.*, 474 N.J. Super. 498 (App. Div. 2023) (sophisticated parties to a lawyer-negotiated contract exempt from *Atalese*).
4. *See, e.g., Flanzman v. Jenny Craig, Inc.*, 244 N.J. 119 (2020) (valid waiver language found in arbitration clause); *Guc v. Raymours Furniture Co.*, No. A-3452-20, 2022 N.J. Super. Unpub. LEXIS 395 (App. Div. Mar. 11, 2022) (time-limitation provision in arbitration agreement rendered agreement unconscionable and unenforceable).
5. *Castle Realty Mgmt. v. Burbage*, No. A-5399-15T4, 2017 N.J. Super. Unpub. LEXIS 1748 (App. Div. Jul. 13, 2017).
6. *Pei Chuang v. OD Expense LLC*, 742 Fed. Appx. 670 (3d Cir. 2018).
7. *See Strickland v. Foulke Mgmt. Corp.*, 475 N.J. Super. 27, 290 A.3d 1259 (App. Div. 2023) (selection of FAA to govern the arbitration frustrated the parties' intention to impose a strict standard of review over the arbitrator's legal determinations).
8. *See Flanzman*, 244 N.J. at 134-35.
9. N.J.S.A. 56:12-1, et seq.
10. *See Kernahan v. Home Warranty Adm'r of Florida, Inc.*, 236 N.J. 301 (2019).
11. *See NAACP of Camden County East v. Foulke Mgmt. Corp.*, 421 N.J. Super. 404 (App. Div. 2011) (multiple documents with inconsistent arbitration terms; motion to compel denied).
12. *See Achey v. Cellco Partnership*, 475 N.J. Super. 446 (App. Div. 2023).
13. *See Moon v. Breathless Inc.*, 868 F.3d 209 (3d Cir. 2017).

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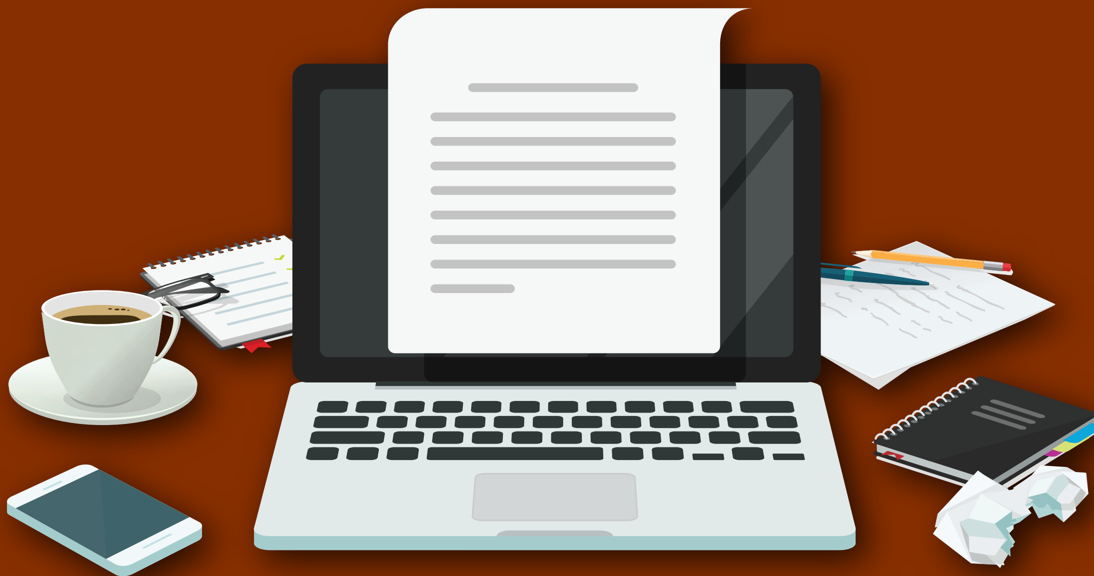

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