insights

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Shareholder Votes on Executive Compensation – SEC Say-on-Pay Rules

By Eric Britton

One of the biggest challenges public companies and their attorneys face during the 2011 proxy season is the new "say-on-pay" requirement. For the first time, most publicly-traded companies must offer their shareholders an opportunity to vote on executive pay. This article will summarize the Securities and Exchange Commission's new say-on-pay rules and discuss a few key implications.

As part of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), Congress imposed new shareholder voting requirements on listed companies and other companies subject to the proxy rules under the Securities and Exchange Act of 1934. The Dodd-Frank Act added a new Section 14A to the Securities Exchange Act of 1934.

This new Section 14A requires reporting companies:

- to include a resolution in their proxy statements at least once every three years, asking for a shareholder advisory vote to approve the compensation of executive officers, as disclosed in the proxy statement;
- to conduct a separate shareholder advisory vote to determine how often the company should offer the shareholders a vote on executive pay; and
- if the reporting company is soliciting the shareholders to approve a merger or other major corporate transaction, to provide more extensive disclosure of golden parachute arrangements for executives, and, in certain circumstances, to ask for a separate shareholder advisory vote to approve the "golden parachute" arrangements.

On January 21, 2011, the Securities and Exchange Commission published new SEC Exchange Act Rule 14a-21 to control how these say-on-pay and say-on-frequency votes should be conducted, and also expanded its executive compensation disclosure requirements in SEC Regulation S-K Item 402.

Say-on-Pay Votes

The SEC's existing proxy statement rules already call for reporting companies to provide very specific and detailed disclosure on the compensation of the company's chief executive officer and other named executive officers in any proxy statement for an annual meeting at which directors will be elected. Under the new say-on-pay rule, reporting companies are also required to include in their proxy statements at least once every three years a resolution asking their shareholders to cast an advisory vote on this executive compensation program.

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Under the new SEC Rule, the required shareholder vote is only advisory, and is not binding on the company's Board of Directors or Compensation Committee. Companies required to file reports with the SEC under the 1934 Act (so-called "reporting companies") are, however, required to disclose how the shareholders voted. The new SEC rules now expressly require this disclosure to be filed with the SEC on a Form 8-K report promptly after the shareholders' meeting. Further, the Compensation Discussion and Analysis, which the company includes in its future proxy statements, must discuss whether the company has considered the results of the most recent shareholder advisory vote on executive pay, and how (if at all) the company's compensation policies and practices have been modified in response.

The SEC Rule does not require a specific format or wording for the shareholder proposal. The SEC has provided an example of a say-on-pay resolution that it believes will satisfy the Rule 14a-21 requirements.

For companies with stock listed on a national exchange, the broker discretionary voting rules will not permit a broker to vote shares for which no instructions have been received on the say-on-pay issue.

Note that reporting companies are not required to file a preliminary proxy statement with the SEC merely because the proxy statement includes a say-on-pay proposal or a say-on-frequency proposal (discussed below).

Which Companies are Subject to the Say-on-Pay Requirements?

The say-on-pay rules apply only to companies that have stock listed on a stock exchange or are otherwise registered with the Securities and Exchange Commission under the 1934 Act and subject to the SEC rules regulating proxy statements for shareholder votes. There are, however, a number of exceptions:

- "Smaller reporting companies" (i.e., those with public float of less than $75 million) will not need to comply with the say-on-pay requirements in 2011. Instead, they will only have to comply when preparing proxy statements for annual meetings that will be held on or after January 21, 2013. Some experts believe that the SEC may ultimately decide to waive this requirement for such smaller reporting companies.
- Banks and other financial institutions that received financial assistance from the federal government under the TARP program must still follow the special TARP rules requiring an annual shareholder vote on executive compensation, but do not need to also comply with the new SEC rules until they have repaid their TARP funds.

Say-on-Frequency Vote

The new rules also require a shareholder advisory vote on whether the reporting company's say-on-pay votes will occur every 1, 2, or 3 years. For reporting companies subject to the say-on-pay vote, this vote on frequency must be included in the 2011 proxy statement. Shareholders must be given four choices on the proxy card, whether the shareholder vote on executive compensation will occur every 1, 2, or 3 years, or to abstain from voting on this issue.

The SEC does not require companies to use any specific form of proposal or resolution for a say-on-frequency vote, and has not provided a sample resolution.

The new SEC Rule allows a reporting company to make a recommendation on the frequency of the say-on-pay vote but this recommendation is not required. The Board may voluntarily include a recommendation in the proxy statement soliciting shareholders to follow the company's preferred alternative, but the proxy card must include all four choices.

Many of the 2011 proxy statements that we have seen have included company recommendations, taking a variety of approaches. Note that ISS and Glass Lewis (firms which provide guidance on proxy voting to institutional investors) have recommended annual say-on-pay votes, and many institutional investors have expressed a similar preference for an annual vote.

After the annual meeting, the company must promptly file a Form 8-K with the SEC to disclose the result of the shareholder vote. In the future, the company's decision as to how frequently the company will conduct say-on-pay votes must be disclosed in an amended Form 8-K filed within 150 days after the stockholders meeting.

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The say-on-pay rules apply only to companies that have stock listed on a stock exchange or are otherwise registered with the Securities and Exchange Commission.

Say on Parachute Payment Votes

The new SEC Rules require a separate shareholder vote on golden parachutes for senior executives and more detailed disclosure on these golden parachute arrangements, whenever a reporting company seeks shareholder approval of a merger, acquisition, sale of assets or other major corporate transaction.

The SEC has modified its disclosure rules in Regulation S-K to require detailed disclosure of named executive officers' golden parachute arrangements, including a new table labeled "Golden Parachute Compensation," as well as a narrative explanation of the plans or agreements under which the golden parachute payments might be paid. This additional disclosure is only required in proxy statements for mergers or similar corporate transactions requiring shareholder approval. The prior SEC rules for disclosure of golden parachute arrangements may still be relied on in regular annual proxy statements not involving a corporate transaction.

A separate shareholder vote on the golden parachute compensation payable to named executive officers in connection with a merger or other corporate transaction is required if the company seeks shareholder approval of the transaction. This vote is required only when the golden parachute arrangements must be disclosed in the proxy statement, and therefore does not apply to arrangements for employees who are not executive officers.
It also does not apply to the proposed golden parachute agreements (if any) between the executives and the acquiring company (that is, the other party to the merger or acquisition).

Under another limited exception, a shareholder vote is not needed for golden parachute arrangements that have been subject to a prior shareholder vote (after providing the full detailed level of disclosure under the new rules) and have not subsequently been modified in any significant manner.

Like the say-on-pay vote, this shareholder vote on golden parachute payments is advisory, and is not binding on the company or its board of directors. Our initial reaction is that most reporting companies will typically not want to seek a shareholder vote approving parachute payments until they are presented with a specific transaction.

Effective Date and Transition Rules for Say-on-Pay Requirements

Reporting companies will need to include a say-on-pay proposal and a say-on-frequency proposal in the proxy statement for their first annual meeting of shareholders to be held after January 21, 2011. In most cases, this will be the 2011 proxy statement for the 2011 shareholders meeting.

In future years, a reporting company will have to include the say-on-pay proposal at least once every three years, and a say-on-frequency proposal at least once every six years.

Smaller reporting companies do not have to comply with the full say-on-pay rule immediately in 2011. Instead, the new rules for say-on-pay and say-on-frequency votes do not apply to a smaller reporting company until the proxy statement for the first stockholders meeting to be held after January 21, 2013. However, since the effective date for the shareholder vote on golden parachutes is not delayed until 2013, a smaller reporting company seeking a shareholder vote on a corporate merger or acquisition will need to include a separate shareholder proposal covering its golden parachute arrangements.

The SEC has also provided several helpful transition rules for 2011 proxy statements:

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- The SEC will not object if a reporting company does not file its 2011 proxy statement in preliminary form if the only matters that would require the filing in preliminary form are the say-on-pay vote and the say-on-frequency vote.
- The SEC understands that some reporting companies may have problems reprogramming their proxy cards to offer the 4 choices required by the new say-on-frequency rule. Until the end of 2011, the SEC will not object if the format used in the proxy card for a say-on-frequency vote provides the opportunity to specify by boxes a choice among 1, 2 or 3 years, without discretionary authority to vote proxies on the say-on-frequency vote if the shareholder does not affirmatively select one of these three choices.
- If a reporting company is a bank or other financial institution that has received TARP assistance and is subject to the special TARP rules on executive compensation, it will not need to comply with the new say-on-frequency vote requirements.

Implications

Although the say-on-pay votes required by these new rules are non-binding, the shareholder vote by itself will put significant additional pressure on some reporting companies' executive compensation practices. In particular:

- Both Compensation Committee members at reporting companies with generous pay packages for their executive officers and the attorneys working with the Compensation Committee on proxy disclosure should be putting significant time and effort into making sure the executive compensation disclosure in this year's proxy statement puts the company's compensation plans and practices in the best possible light. We believe 2011 is not a good year to mechanically update last year's discussion.
- Companies may want to review their stock plans, golden parachute agreements and other executive compensation programs to identify any features which ISS and its peers have said they are likely to object to – such as single-trigger golden parachutes or tax gross-up payments – and consider whether they want to retain these features.
- Reporting companies with large blocks of stock held by institutional investors (e.g., a single mutual fund family) or other large minority investors may want to reach out to these shareholders to hear about any concerns with executive compensation issues early, before they finalize the Compensation Discussion and Analysis section of the proxy statement.

This is a short summary of a complex topic. If you have specific questions about your company's circumstances, or need help with particular issues you are facing with your proxy statement, we would be happy to work with you to address how these rules should be applied to your specific issues.

For additional information, contact Eric Britton, who is a member of the Employee Compensation and Benefits Practice Area. He can be reached at ebritton@slk-law.com or 419.321.1348.

tax update

The Ohio Department of Taxation (the "Department") has launched a use tax education program with two goals in mind: (i) to raise awareness of the use tax and help businesses understand how it works so they can comply with the law; and (ii) to encourage businesses to register and pay the use tax they owe by, in part, offering incentives that can reduce the amount of tax potentially due. The Department is providing two time periods in which to participate in the program. The first is open now through August 1, 2011. Any business that comes forward during the first time period, signs a voluntary disclosure agreement and pays the use tax bill will only be liable for up to three years back tax and interest.

The second window will open when the Department begins sending out letters to the targeted businesses advising them about the program and encouraging them to come forward. Any business that receives a letter and contacts the Department will have its use tax liability limited to no more than four years back tax and interest. Any business that receives a letter and fails to respond will be audited or sent a bill that estimates how much tax it may owe, and could be liable for up to seven years back tax plus penalty and interest.

For additional information, contact Tom Cotter, Co-Chair of the Tax and Employee Benefits Practice Areas, at tcotter@slk-law.com, 419.321.1385, or John Staler, member of the Tax and Corporate Practice Areas, at jstaler@slk-law.com, 419.321.1327.

What's Due Process Got to Do With It?

The True Danger of "Robo Signings" and "Rocket Dockets"

The recent reports of "Robo Signing" of affidavits where evidentiary proof intended for foreclosure proceedings is prepared under oath without scrutinizing the evidence that is being attested to or "Rocket Dockets" where foreclosure cases are rushed through the courts with minimal scrutiny are disturbing and should be closely monitored – but not for the reason that one might think. The chief concern raised by these cases is not the ultimate substantive result. There is no question that in the vast majority of the cases the debt is owed to the lender, the lender will be entitled to the collateral and should, in fact, be able to obtain control of the collateral with reasonable dispatch. Nor need one be concerned with the existing procedure for the foreclosing of mortgages. Even the procedures for non-judicial foreclosure have been well-tailored to harmonize the requirements for swift action with the constitutional imperative of procedural due process. *See e.g., Turner vs. Blackburn, 389 F. Supp. 1258 (W.D.N.C. 1975)*

By Moses Luski

The chief concern raised by the above practices is no less than the integrity of the judicial system. To state that the money is clearly owed by the borrower and that subsequent procedures to enforce borrower's obligations to lenders can therefore be loosened ignores the profound risk to the social fabric, ultimate social order, that such a lax attitude will create. Just as one may be justly concerned about the consequences of the recent severe recession (of which the housing bubble is a major part) on the future economic standing of the United States, one should be similarly concerned as to whether the United States can continue to function as a world leader, both economically and otherwise, with a compromised and opaque judicial system.

So what does due process have to do with it? In essence, in the English law system, due process is the mediating concept which prevents the sovereign from declaring itself a law unto itself and depriving its subjects of freedom and property. Thus, Clause 39 of the 1297 Magna Carta, which is still valid English law, states:

No Freeman shall be taken or imprisoned, or be disseised of his Freehold, or Liberties, or free Customs, or be outlawed, or exiled, or any other wise destroyed; nor will We not pass upon him, nor condemn him, but by lawful judgment of his Peers, or by the Law of the Land. We will sell to no man, we will not deny or defer to any man either Justice or Right.

English law, as subsequently influenced by the monarchial tradition, was not necessarily hospitable to the full flowering of due process of law as a core jurisprudential concept and it took force of arms and a revolution on new soil to firmly establish the concept at the United States Constitutional Convention. *See* U.S. Const., amend V, amend XIV. *See generally*, John V. Orth, Due Process of Law, A Brief History (University Press of Kansas 2003). It may be said that procedural due process, at minimum, is embedded in the United States Constitution and has become an immutable concept of American jurisprudence. The doctrine of judicial review established in the seminal case of *Marbury vs. Madison*, 5 U.S. 137 (1 Cranch) (1803), further encroached on the power of the legislative and executive branches to curtail these hard won freedoms.

The quotation to the magisterial language of the Magna Carta and the brief history lesson are designed to remind us of what is at stake when participants play fast and loose with hard-won procedural protections. Procedural due process is nothing less than one of the bedrock principles of our society. To give short shrift to procedural requirements in foreclosure proceedings is to erode the constitutional doctrine of procedural due process upon which these procedures are based. To erode this doctrine brings us one step closer to lawlessness and either tyranny, anarchy, or both.

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Thus, Robo Signing and Rocket Dockets have everything "to do" with due process in that these practices encourage a lack of adherence to and respect for one of our most basic societal protections. The issue being raised in this article is not that the legal system has failed to establish a procedure to protect a borrower, but that the alleged unwillingness to administer these procedures puts the fabric of society at risk. To paraphrase the popular song referenced in the title of this article, due process should not be treated as the equivalent of a "second-hand emotion." As stated in *Louk vs. Haynes*, "[d]ue process requires that the appearance of justice be satisfied." 159 W.Va. 482, 499, 223 S.E. 2d 780, 791 (1976) (holding that a judge's failure to perform his duty in recusing himself where a personal conflict existed was a denial of plaintiffs due process rights). "A fair trial in a fair tribunal is a basic requirement of due process." *Id*. (citing *Tumey vs. Ohio*, 273 U.S. 510, 532, 47 S. Ct. 437, 444, 71 L.Ed. 749 (1927)).

In times of crisis it is very tempting to subvert our hard-won freedom and reach for easy solutions which bypass well established procedural norms. Ironically, it would appear that the sloppy procedures allegedly being used to administer foreclosure cases mirror the sloppy underwriting that created the foreclosure crisis. Ignoring procedural requirements embarks on a slippery slope which risks not only the unique liberties we enjoy as Americans but risks our economic system falling into chaos and illiquidity because our superior and world changing capitalist free market system owes much to the predictability, transparency and integrity of our legal institutions. *See e.g.*, Hernando de Soto, The Mystery of Capital: Why Capitalization Triumphed in the West and Fails Everywhere Else (Basic Books 2000). Thus, to encourage shoddy and unprincipled adjudications in the foreclosure arena in the name of expediency surely will have a devastating effect (with broad unintended consequences) on the ability of our nation to heal itself from the economic calamity that has befallen it. It will also compromise one of our key competitive advantages: the persistent dynamism of free market capitalism. The recent recriminations in the press and the concerted actions of the State Attorneys General and other governmental agencies are to be welcomed to the extent they help right the constitutional ship. On the other hand, one sincerely hopes that these enforcement actions are not used as populist fodder to denigrate and dismantle our financial system. Throwing the baby out with the bath water and dismantling the financial system is not an option. We do not have the luxury of mishandling this issue. The economic stakes are too high and we now have international competition that will immediately seize on our missteps.

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update

The recent case of *U.S. National Bank Association v. Antonio Ibanez, 458 Mass. 637 (2011)* decided by the Supreme Judicial Court of Massachusetts upholds the proposition that lenders in foreclosure proceedings should not be allowed to take shortcuts in their proof of the underlying note and mortgage simply because these instruments are part of a securitized pool of instruments. In so holding, the *Ibanez* Court confirms the arguments made in this article that procedural due process in the foreclosure setting is not a mere inconvenience that can be ignored, but, rather, a bedrock principle that must be respected.

What does a Bank Regulatory Order Mean and why are Regulatory Orders Issued?

Enforcement actions by bank regulatory agencies have become increasingly prevalent in the financial services industry since the onset of the economic downturn. Regulatory enforcement actions generate important challenges, issues, and problems for institutions, particularly when the enforcement actions become public. The impact of regulatory enforcement actions on financial institutions and their directors, executive officers, shareholders, customers and other constituencies can be significant.

By Greg Yadley

By David Mack

The enforcement action process often starts with bank examinations conducted by the State or Federal bank regulatory agencies, which include the FDIC, the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS) and the Federal Reserve System. Bank examinations are conducted periodically (usually on 12 month cycles) and range from consumer protection areas such as truth-in-lending and community reinvestment regulations, to trust operations and the adequacy of data process systems. The most significant review is the "safety and soundness" examination, usually conducted collaboratively among applicable Federal and State regulators (e.g., the FDIC and the Florida Office of Financial Regulation, Ohio Division of Financial Institutions, and North Carolina Office of the Commissioner of Banks), which examination results in the issuance of the bank's "CAMELS" rating. The acronym "CAMELS" refers to the six components of a bank's condition that are assessed during the exam. They include ***C***apital adequacy, ***A***sset quality, ***M***anagement, ***E***arnings, ***L***iquidity, and ***S***ensitivity to market risk. Ratings are assigned for each component on a scale from 1 to 5, and a "composite" rating of a bank's overall condition is assigned as well. Banks with composite ratings of 1 or 2 generally exhibit the strongest performance and risk-management practices relative to their size, complexity, and risk profile, and give no cause for supervisory concern. Banks with a composite rating of 3 have a combination of moderate to severe weaknesses. Banks with a composite rating of 4 may fail if the problems and weaknesses are not satisfactorily addressed and resolved. Banks with a composite rating of 5 generally exhibit performance inadequacies so significant that failure is more likely, making them the greatest supervisory concern to regulators.

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In general, bank customers, including deposit and loan customers, are rarely hurt by increased regulatory control and the imposition of regulatory enforcement orders on their bank. Even in those instances where a bank fails outright and the FDIC is appointed to take over as receiver, depositors rarely lose anything. FDIC Chairman Sheila Bair has repeatedly stated that *"No insured depositor has ever lost a penny of insured deposits — and none ever will. The FDIC was created specifically for times like these. Our resources are strong. Your insured deposits are absolutely safe."* This is true – the FDIC is funded primarily through the assessment of insurance premiums which are based on the level of risk a particular institution poses to the deposit insurance fund. In addition, the FDIC has immediate access to a $100 billion line of credit at the U.S. Treasury. Although deposit insurance generally only covers savings accounts and time deposits up to a maximum of $250,000, transaction accounts, such as checking and money market accounts, currently have unlimited coverage. Practically speaking, however, when the FDIC comes in and closes a failed bank, all deposit obligations of the failed institution are generally assumed by a successor institution. Loans held by the failed bank are generally sold by the FDIC to other institutions as well, although many of the worst of such assets are held for later disposition by the FDIC. So while the identity of a borrower's creditor may change as a result of the failure, the general terms of loan will not. The biggest problem is often the delay in reaction for a borrower whose loan is held by the FDIC.

Having a composite rating of 3 or below often exposes the subject bank to enhanced monitoring, which often includes the imposition of a regulatory enforcement action. Bank regulatory enforcement actions come in two general varieties; "formal" and "informal." The primary distinction is that "informal" actions are generally not enforceable in court by the agencies, while "formal" actions (specifically those issued under 12 U.S.C. §1818) are enforceable by the agencies through the courts. In addition, banks subject only to informal regulatory enforcement actions are required to keep that fact confidential, while the entry into any formal regulatory action is required to be publicly disclosed pursuant to federal statute. As a consequence, institutions which are publicly traded may need to address difficult, and potentially divergent, disclosure concerns pursuant to the requirements of state and federal securities laws. Such disclosures can have an impact on trading in the company's stock and make the company more vulnerable to takeover by unaffiliated institutions.

Each of the federal regulatory agencies has its preferred forms for both informal and formal regulatory actions. Informal regulatory actions generally take the form of a "Memorandum of Understanding" (or "MOUs") and "Voluntary Board Resolutions." The most typical formal regulatory enforcement actions generally include "Formal Written Agreements," "Consent Orders," and "Cease and Desist Orders." The level and specific terms of both formal and informal enforcement actions vary depending on the target institution and the nature and extent of the regulatory concerns. Enforcement actions typically require the institution to undertake certain designated corrective actions, and may also include restrictions on the institution from engaging in certain other activities and actions. Potential enforcement subjects include: improving the bank's loan loss reserve adequacy, liquidity, capital adequacy, and asset quality; restricting or eliminating the payment of dividends; hiring new officers for certain positions; strengthening risk management, compliance or oversight functions; requiring a forensic audit; hiring outside experts to draft or revise bank policies and procedures; prohibiting or restricting lending to insiders; suspending pending acquisition transactions; and prohibiting payments under change in control or "golden parachute" agreements. Enforcement actions also generally require periodic progress reports to the agencies regarding the institution's efforts to implement the requirements of the enforcement action.

Enforcement actions also result in heightened personal liability concerns for directors and other bank-affiliated parties, including the potential of the imposition by the regulatory agencies of civil money penalties. The category of individuals subject to enforcement actions (referred to generally as "institution-affiliated parties") includes directors, officers, employees and controlling shareholders, and can also include independent contractors such as attorneys, appraisers and accountants who participate in inappropriate activities. With respect to directors in particular, in today's environment board activities are under intense regulatory scrutiny. Following good corporate processes, keeping complete and accurate minutes, making decisions free from conflicts of interest and on the basis of sound credit underwriting, and closely monitoring the activities of management are all highly recommended components of good board oversight. Importantly, the potential for personal liability is not eliminated by resigning from the institution if the issues giving rise to potential liability are already in existence, and institution-affiliated parties remain subject to the imposition of civil money penalties for a significant period of time following termination of their involvement.

Regulatory enforcement actions can present significant challenges to financial institutions and their management teams. Consequently, when faced with the potential of either an informal or formal regulatory action, a proactive approach to addressing the underlying issues is usually best. In this respect, institutions are strongly advised to retain a team of financial and legal advisors who have experience in dealing with bank regulators and the issues that confront these "troubled" institutions.

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Does LinkedIn Kill the Restrictive Covenant?

Founded in 2003, LinkedIn has exploded to include 100 million members in over 200 countries. A new member joins LinkedIn every second and executives from every single Fortune 500 company are members. Along with other professional and business networking sites, LinkedIn can be an excellent communication and business development tool. It can assist with both development and maintenance of business contacts within a vast network of social contacts with ease and little to no cost.

For this reason, many companies are encouraging and even requiring their employees to sign up with LinkedIn and foster relationships with clients, customers and prospective customers through the site, not realizing that they may be unwittingly waiving their right to enforce certain restrictive covenants against that employee should the employment relationship terminate.

By Jarrod Malone

Consider the following hypothetical: ABC Co., a national widget manufacturer, decides to encourage its employees to network existing and prospective customers through LinkedIn in order to develop and maintain those contacts and generate business. ABC Co. also requires its sales managers to enter into a confidentiality agreement protecting the confidentiality of client identities and prospect lists, as well as a covenant not to compete and a covenant not to solicit.

Jonathan, a top sales manager for ABC Co., decides he will leave ABC Co. and join a direct competitor, XYZ Corp., as vice president of sales. Jonathan had followed ABC Co.'s marketing directive and over the past year linked hundreds of his top customers and prospects into his LinkedIn network.

A month after Jonathan's resignation, ABC Co. learns that Jonathan updated his LinkedIn profile when he changed employment. Jonathan updated his new employment information along with a description of his new duties and a statement that "I'm proud to work for XYZ Corp., the nation's top widget manufacturer. Our customers are amazed at the top quality and competitive pricing of our widgets. Satisfaction Guaranteed."

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LinkedIn then automatically sent this updated profile and new employment information to everyone in Jonathan's network, which included hundreds of customers and prospects of ABC Co. Subsequently, over a dozen top customers terminated their relationship with ABC Co. and switched their accounts to Jonathan at XYZ Corp.

Did Jonathan breach his restrictive covenants with ABC Co.? Jonathan has an argument that he did not. By encouraging or even permitting Jonathan to maintain a client and prospect network on LinkedIn, a publicly available internet site, ABC Co. may have waived the confidentiality of such client identities. It may be precluded from arguing that such clients and their identities are trade secrets because its employment handbook and restrictive covenants did not include language to address this potential loophole. Further, Jonathan may argue he did not actively communicate with or solicit ABC Co. customers when LinkedIn sent out the update notice to his profile.

What ABC Co. failed to realize in the hypothetical above is that professional networking sites, particularly for those businesses involved in sales, operate much like a modern day souped-up Rolodex. Professional networking sites not only allow members to store all kinds of information about themselves, they also connect members with other members into a network. Any person in such network can readily see another member's profile information, as well as photos, current employment information, work histories, contact information, education, and most importantly, a list of that other member's connections and network. LinkedIn even allows its members to easily export their connections to a Microsoft Outlook file.

Departing employees can with a click of a button instantaneously communicate with hundreds or thousands of people at no cost, many of whom are likely existing customers of the former employer and subject to restrictive covenants. The employee may claim that client information on LinkedIn is publicly available information and thus cannot, as a matter of law, be considered a trade secret. Thus, a departing employee who might otherwise be restricted from contacting or soliciting customers may possibly take confidential client information and trade secrets and unwittingly solicit without violating any governing restrictive covenant.

It is unsettled whether an updated LinkedIn profile containing new employment information that is sent to existing customers of the old employer would be considered a solicitation or violation of a restrictive covenant. More disturbing, any person can easily join the network of a competitor to mine that network for the contacts and customers such competitor built up over years of hard work.

Astonishingly, no known court in the United States has answered these questions, even though social and professional networking sites have been in existence for nearly a decade. While an employer may claim that solicitation online is solicitation nonetheless, without adequate protection and contract language to address this issue, it is possible such employer has waived its right to assert that client identities are confidential information when such identifying information has been published online by an employee with the consent of the employer.

As with any restrictive covenant matter, the answer will likely vary on a case by case basis and will require a closer examination of the covenant language in light of such facts. Attorneys who practice labor and employment law should recognize that social and professional networking on the internet can gut even the strongest restrictive covenant if such restrictive covenant and the employer's employment contracts, policies and procedures do not include language to address this emerging issue.

For additional information, contact Jarrod Malone at jmalone@slk-law.com or 941.364.2715.

legalupdate

Exporting Certification in Immigration Petitions

Beginning February 20, 2011, an employer submitting a visa petition under the H, L, or O classifications for a prospective foreign employee who will work in the United States must complete a "Certification Regarding the Release of Controlled Technology or Technical Data to Foreign Persons in the U.S." Companies regularly engaged in the exporting process are knowledgeable that certain products may require a license to be generally exported or exported to specified countries. Although high technology for military applications and advanced encryption software are products readily recognizable as subject to export restrictions, many less obvious products require a special export license, particularly if they are deemed to have a dual use. (*See* the U.S. Commerce Department's "Commerce Control List" set forth in the Export Administration's Regulations, http://www.gpo.gov/bis/ear/ear_data.html.) The federal government takes the position that controlled technology or technical data is "deemed" to be exported if its essential details are disclosed to a foreign person working within the United States. An example would be the disclosure to a computer programmer of the source code of highly encrypted software requiring an export license. If a license is required to export a product, then a license is required to disclose the fundamental properties of such technology to the visa holder. This "deemed exporting" position may ensnare those who are not otherwise engaged in the practice of exporting the product and who have not had occasion to contemplate whether an exporting license is required. The new Certification in visa petitions also places a burden on a potentially unknowledgeable person – it is common practice at many large companies that the person executing a visa petition is a Human Resources professional. Such person is unlikely to have personal knowledge about the complex rules governing export licenses, technological intricacies that could require a license, and whether the employer will continue to comply with those rules if the H, L, or O visa is granted and the beneficiary commences the proposed employment duties. Therefore, it is advisable to institute procedures before a visa petition is executed to determine if the proposed job duties will expose the foreign worker to controlled technology.

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Changes in State Capitol will Affect Rule-Making Process

Political change once again swept the country with the 2010 election cycle. Ohio was not left out. With the election of Governor John Kasich, along with a full slate of new statewide officers – including Mike DeWine as Ohio's new Attorney General – widespread change has come to state government in Columbus.

While many of the issues are now spread upon the front pages of Ohio's newspapers, some significant changes that effect how individuals and businesses relate with state agencies have not received as much attention. Those significant changes have come about through the adoption of Senate Bill 2 – Governor Kasich's "Common Sense Initiative." Often times, the most complex and challenging issues presented to an individual or business are not based on statute in the Ohio Revised Code, but rather are a product of regulations contained in the Ohio Administrative Code. The Common Sense Initiative provides another tool in handling problems created by unreasonable regulations.

By Mark Wagoner

The number of rules in Ohio are more extensive – and often times more complex – than the Ohio statutes themselves.

When the subject of a statute is technically complex, the Ohio General Assembly often creates or authorizes an administrative agency to implement the statute. An important technique by which agencies are empowered to implement statutes is by rulemaking. That is, in enacting an agency-empowering statute, the Ohio General Assembly often directs the agency to adopt rules for particular purposes. A rule is a formal, written statement of general principles of law, as a statute. For example, in a public utilities statute that entitles the public utility to a "fair and reasonable return on its investment," the Ohio General Assembly might direct the agency to then adopt rules stating the criteria by which a "fair and reasonable return" can be determined.

An administrative rule can be effective in Ohio only after its adopting agency has taken it through a statutorily-prescribed rulemaking procedure. Here is where, among other places, the Common Sense Initiative will have some impact. Currently, the majority of rules adopted in Ohio are done through the Ohio Administrative Procedures Act, O.R.C. Chapter 119. There are several steps that are followed in enacting any new rule in Ohio. The steps are:

1. the agency gives public notice of its intention to adopt the rule in the Register of Ohio at least 30 days before a scheduled hearing on the rule (the Register of Ohio is a website where all proposed rules are posted. The website address is www.registerofohio.state.oh.us.);
2. at least 65 days before adopting the rule, the agency files a notice with the appropriate state agencies;
3. the agency holds a public hearing on the proposed rule not earlier than the 31st but not later than the 40th day after registering the regulation;
4. 66 days after the filing of the proposed rule, if not invalidated by the Legislative Joint Commission on Agency Rules and Regulations (JCAR), the agency may adopt the rule; and
5. the agency must make a reasonable effort to promulgate the rule.

The number of rules in Ohio are more extensive – and often times more complex – than the Ohio statutes themselves. And, in many instances, a rule has a more profound impact than a statute might. Over time, many feel that the depth and complexity of regulations has caused unnecessary challenges to individuals and businesses.

One of the biggest hurdles is that individuals and businesses are not aware that the rulemaking process is proceeding. In order to address those issues, the Common Sense Initiative establishes a new process to evaluate whether administrative rules proposed by state agencies have an adverse impact on individuals or businesses and, if so, to reduce or eliminate the impact. In that way, the Common Sense Initiative hopes to avoid potential problems before a rule is enacted. The Common Sense Initiative creates an office within the Governor's office, the "Commonsense Initiative Office" (the "CSIO"), to evaluate rules that may have an adverse impact on businesses.

CSIO must create a system through which any person can comment to the CSIO about the adverse impact on businesses that a draft or current rule has or might have. Finally, state agencies must develop a customer service standard for its employees and its compliance would be evaluated as part of the state budget-making process.

The Common Sense Initiative presents another avenue to work through issues and problems caused by unreasonable regulations in Ohio. Rather than incurring the cost of an unreasonable rule, the initiative allows businesses to be proactive and explore changing the rule before it becomes a problem.

Proposed changes to an unreasonable regulation can be submitted through the Common Sense Initiative website: http://governor.ohio.gov/csi.

Should you be aware of any potential issues with rules, please contact Shumaker, Loop & Kendrick, LLP, and we will help you develop a strategy to deal with those issues.

Mark D. Wagoner, Jr. is a an Ohio State Senator and Chair of The Ohio Senate Judiciary Committee. He can be reached at mwagoner@slk-law.com or 419.321.1412.

Lehman Brothers: 5 Days in September

By David Conaway

In September 2008 Lehman Brothers Holdings Inc. and Lehman Brothers Inc. (collectively, "Lehman") sold their historically coveted brokerage business to Barclays Capital Inc. Many believe the sale was necessary to prevent a worldwide economic meltdown given Lehman's tentacles throughout the global economy. In fact, Lehman's Chapter 11 filing on September 15, 2008 was valued at $639 billion, the largest Chapter 11 in U.S. history. It involved 7,000 legal entities and spawned 75 related insolvency proceedings throughout the world. Despite (or perhaps because of) the enormity of the Lehman Chapter 11, the sale of Lehman's brokerage business was accomplished in 5 days, an unprecedented accomplishment given the size, importance and complexity of the assets being sold and the transaction itself. Lehman proceeded under Section 363 of the U.S. Bankruptcy Code (regarding sales of assets) to effect this transaction. However, the sale had none of the usual procedures and protections normally associated with a Section 363 sale. The sale followed an extremely truncated process involving only 5 days from Lehman's Chapter 11 filing to the closing of the sale. While the sale order referenced "competitive bidding" and other "qualified bids," Barclays was the only realistic buyer.

This "sale of the century" has spawned litigation and commentary around the globe. The most significant litigation that emerged from the sale was Lehman's own motion to have the terms of the sale modified, which is currently pending before the United States Bankruptcy Court in the Southern District of New York. The business and legal communities are closely watching the outcome of this litigation on the efficacy of the Section 363 sales process and the finality of Section 363 sale orders. Is Lehman trying to renegotiate the deal after the fact, or does the unprecedented magnitude and speed of this sale warrant a modification to the sale order to insure the original intent of the transaction?

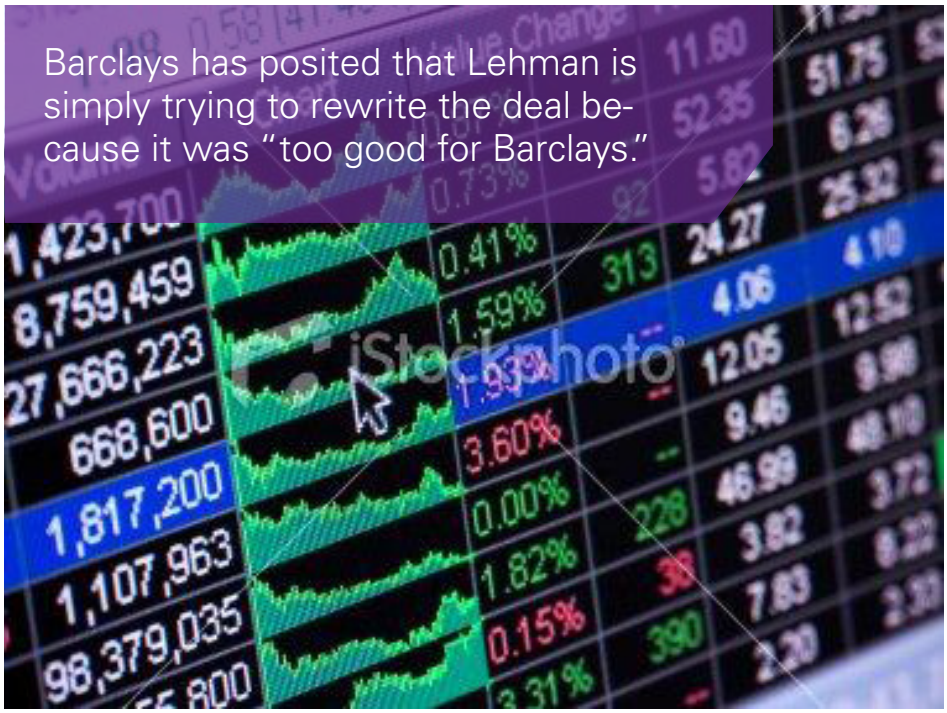
According to Lehman's motion to modify the Section 363 sale order, there were material components of the transaction that were not disclosed to the Bankruptcy Court and the sale transaction that closed differed materially from the transaction approved by the Bankruptcy Court. Lehman's motion indicates that the original intent of the sale was a "wash" whereby Barclays would pay fair value for the assets it was acquiring, when in fact the deal was actually structured to give Barclays an immediate and enormous windfall of approximately $11 billion. This was accomplished because the key Lehman negotiators were also key employees who were transferring to Barclays as a result of the sale.

A controversial component of the transaction was the "Clarification Letter" which was signed after the sale order was entered. The "Clarification Letter," among other things, terminated a Repurchase Agreement between Lehman and Barclays where Barclays transferred $45 billion cash to Lehman in exchange for $50 billion of securities, subject to Lehman's repurchase of the securities at a later date for $45 billion. By terminating this agreement, Barclays received an undisclosed $5 billion discount. Lehman asserted that under Section 559 of the Bankruptcy Code (dealing with Repurchase Agreements), the excess of market prices over stated repurchase prices are property of Lehman's estate, and thus termination of the Repurchase Agreement violated the Bankruptcy Code. The terms of the "Clarification Letter" allegedly were not disclosed, and constituted a material alteration to the transaction approved by the Court.

In addition to the $5 billion discount, and due to the fear that the value of Lehman's assets were rapidly deteriorat-

ing, Lehman asserted that there was a scramble within Lehman to deliver to Barclays $5 billion of other assets without consideration or disclosure to the court. The additional assets included approximately $800 million of the so-called "15c3-3 assets," at least $1.9 billion of unencumbered assets in so-called "clearance boxes," and approximately $2.3 billion of additional assets. Lehman further alleged that Barclays was to assume $2 billion in 2008 bonus liabilities to Lehman employees who transferred to Barclays, and another $1.5 billion for cure payments for assumed executory contracts. Lehman maintained that Barclays actually assumed no more than about $1.7 billion in liabilities, compared to the $3.5 billion it had agreed to assume. Lehman also highlighted that Barclays publicly announced in February, 2009 that it had enjoyed a gain of $4.2 billion "on acquisition" of Lehman assets. This immediate gain was attributable to "the excess of the fair value of net assets acquired over consideration paid … on acquisition." Lehman maintained the "gain on acquisition" was understated by at least $6 billion because of various post-closing asset and valuation adjustments. The immediate gain for Barclays was never disclosed to or approved by the Bankruptcy Court.

In response to Lehman's various assertions, Barclays has posited that Lehman is simply trying to rewrite the deal because it was "too good for Barclays." Moreover, Barclays maintains that Lehman's assertions are "a gross distortion" about the complex negotiations over the sale of Lehman's broker-dealer business, where once an agreement was struck, both sides continued to negotiate terms as Lehman's assets continued to deteriorate in the wake of its collapse.



Barclays asserted that it received far less than the $50 billion in securities it was supposed to get in exchange for $45 billion in cash it advanced to Lehman. This short fall created "massive uncertainty and risk" for Barclays that was not resolved for months. Because the securities were actually worth only slightly more than $45 billion, the embedded gain of almost $5 billion was a fiction. Barclays' court filings asserted that had the deal turned out differently such that Barclays incurred a loss because the assets were worth less than anticipated, Barclays would not have the right to come back to court a year later to change the deal.

Lehman's legal arguments included the following: (1) the sale failed to maximize the value of the Lehman bankruptcy estate and the return to creditors, (2) under Section 549 of the Bankruptcy Code, there were unauthorized post-petition transfers of the debtor's assets of at least $8.2 billion, based on "secret agreements" which are unacceptable in bankruptcy as they deprive sellers of full market value, (3) Lehman executives colluded with Barclays to create a sweetheart deal for Barclays, and (4) through mistake, misrepresentation and newly discovered evidence, it is clear that Barclays received an $11 billion discount and failed to assume liabilities for borrowers and executory contract cure payments.

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The trial on Lehman's motion to modify the sale order, including Barclay's defenses, concluded in October, 2010. A ruling by the Bankruptcy Court is expected in the first quarter of 2011. Given the $11 billion at stake, there will undoubtedly be appeals to the United States District Court, the United States Second Circuit Court of Appeals and perhaps the U.S. Supreme Court. The business and legal communities are closely watching the outcome of the Lehman-Barclays trial due to the potential impact on the sanctity of Section 363 sale orders. The Bankruptcy Court has a delicate balance of preserving the finality of sale orders and insuring the process, including adequate disclosure, generates the maximum value for creditors. If the Bankruptcy Court modifies the sale order as Lehman requests, many will use the Court's modification to challenge future Section 363 sale orders. While such a ruling would surely create some level of uncertainty for future Section 363 sales, perhaps Lehman will be "limited to its facts," and viewed as an extraordinary ruling regarding an extraordinary transaction in an extraordinary time in our economic history. In the Lehman case itself, a modification to the sale order is estimated to create a nearly 16 cents per dollar recovery for Lehman's creditors.

A fundamental policy of Chapter 11 is to preserve asset values for the benefit of the debtors' estates and their creditors. Bankruptcy Courts in the United States are accustomed to quick Section 363 sales to accomplish this purpose. What made the Lehman sale unique is that it was the largest such sale in bankruptcy history, and it occurred in only 5 days, in an effort to stabilize the United States' economy and world markets. It is impossible for a sale of this enormity to have all details resolved prior to sale approval or closing. Necessarily, the Bankruptcy Court approved a transaction with many details left for further negotiations. The Bankruptcy Court clearly gave Lehman and Barclays virtual carte blanche to consummate a deal to save Lehman's brokerage business and prevent a feared catastrophe in the global economic markets. While this strategy allowed a truly titanic Section 363 sale to be negotiated, approved and closed in warp speed, the sale has predictably precipitated an $11 billion lawsuit challenging the terms of the transaction, and may alter Section 363 sales in the future.

For additional information, contact David Conaway who is a member of the Bankruptcy and Creditors' Rights Practice Area. He can be reached at dconaway@slk-law.com or 704.945.2149.

update

Lehman Sale to Barclays Upheld:

On February 22, 2011, the United States Bankruptcy Court in New York City ruled that Lehman Brothers Holdings Inc.'s and Lehman Brothers Inc.'s Section 363 sale of their brokerage business to Barclays Capital Inc. days after Lehman's Chapter 11 filing on September 15, 2008 was proper. In a 103-page opinion, Judge Peck denied Lehman's motion to modify the Section 363 Sale Order and ruled that the "sale process may have been imperfect, but it was still adequate under the exceptional circumstances" of the Lehman case. The Court noted that there was an "undeniably correct" perception that the sale "mitigated systemic risk" and avoided "an even greater economic calamity." This ruling, which will likely be appealed, will be viewed as a victory for the sanctity of Section 363 sale orders. With almost $11 billion of value at stake, the ruling will materially diminish the potential dividend to creditors.

congratulations

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Employment and Labor

Corporate Counsel Magazine: Best Lawyers: Annual Guide to Construction Law

Steele B. Windle, III

Shumaker's Sarasota office was named "Best Law Firm" in the *Herald-Tribune* 2010 Readers' Choice Awards. The Readers Choice awards are one of the most prestigious awards bestowed on a local business because the awards are a readers' poll that distinguishes fine products and services in Sarasota.

slknews

Erin Aebel was appointed to the Community Leadership Board of the American Diabetes Association (ADA) in Tampa Bay and Southwest Florida. In March, Erin joined more than 200 diabetes advocates from across the country in Washington, D.C. for the American Diabetes Association's Call to Congress.

Erin Aebel, Malinda Lugo, and Ed McGinty were invited to speak to medical residents/fellows at the University of South Florida to prepare physicians for practice.

Chad Baker serves as an adjunct professor of law at the University of Toledo College of Law teaching the Law of Nonprofits, Tax Exempt Organizations and Charitable Gifts.

Steve Berman was a speaker at the 35th Annual Judge Alexander L. Paskay Seminar on Bankruptcy Law and Practice. Steve was also a panelist at the San Diego Bankruptcy Forum's "Bankruptcy Appellate Practice: Putting the Appeal Back in Appeals" program.

Graham Carothers was elected to the Boards of Directors for 1Voice Foundation and The Seminole Torchbearers.

Doug Cherry spoke at the Suncoast Technology Forum (STF) Techbyte Luncheon in November regarding "Avoiding Legal Pitfalls in Social Networking, Open Source Software and Records Retention." Doug was also a presenter at a seminar sponsored by AAF Suncoast and the EDC of Sarasota County, in November on "How to Make Intellectual Property and Copyright Law Work for You."

David Conaway was a panel speaker at the International Credit and Trade Financial's Global Credit Symposium held in Chicago in April. He also spoke before the Juvenile Products Credit Group in Las Vegas, as well as the National Association of Credit Management - Credit & Financial Development Division in Charlotte, in October.

Dave Coyle has been elected to serve as the President of the Boards of Trustees of Legal Aid of Western Ohio, Inc. (LAWO) and Advocates for Basic Legal Equality, Inc. (ABLE).

Mary Li Creasy was elected to the Board of Directors of Brookwood Florida.

Brad deBeaubien spoke to a credit group with the National Association of Credit Management in February. His topic was "Dealing with Debtors: A Bankruptcy Primer for Trade Creditors."

Julio Esquivel was named to the Board of Directors of Tampa Theatre Foundation.

Tim Garding received the *Tampa Bay Business Journal's* 2010 Up & Comers Award, which celebrates the accomplishments of rising professionals throughout the Bay area. Tim was also elected to serve on the Board of Directors of the Tampa Bay Businesses for Culture and the Arts.

Tammy Giroux was one of the presenters at the American Bar Association Tort Trial & Insurance Practice Section Fidelity and Surety Law Committee's Mid-Winter Meeting Program held in New York City.

Bruce Gordon was elected to the Planning Committee for the All Children's Hospital Annual Estate, Tax, Legal and Financial Planning Seminar, which was attended by more than 250 professionals.

Bonnie Keith Green was the Co-Planner and Facilitator for the American Bar Association, The Woman Advocate Committee, "Gender-Based Impediments to Rainmaking and How to Overcome Them," held in Charlotte in March. Bonnie was also a panelist at the North Carolina State Construction Conference held in Raleigh.

Ben Hanan was named Vice-Chair of the Economic Development Corporation of Sarasota County.

Brian Lambert was appointed to the Board of Directors of Tampa Bay Beautification Committee, f/k/a the Mayors Beautification Committee.

Brian Lambert and Christopher Staine were invited to speak to the Florida Gulf Coast Chapter of Associated Builders and Contractors, Inc., in February, and they presented the "ABC's of Florida Construction Lien Law."

Richard Loudermilk was a presenter at a debt collection seminar entitled "Collections: Seeking and Collecting a Judgment," sponsored by the National Business Institute in Tampa in November. He also presented an online seminar for Lorman Education Services in November on "Essentials of Florida Garnishment Laws."

Moses Luski presented the "Legal Minute" at the February meeting of the Latin American Chamber of Commerce in Charlotte on the topic of "How To Effectively Communicate With Your Commercial Banker".

Moses Luski and Jack Santaniello were speakers at the National Hispanic Entrepreneurs Association ("NHEO") Talks Charlotte Conference "Are You Ready for the Future? - Building a Shared Vision for 2020" held in Charlotte in December.

Steve Meckler was a featured guest on CNN in October and was interviewed regarding the foreclosure crisis.

Scott Newsom spoke at the International Employee of Employee Benefit Plans' 56th Annual Employee Benefits Conference on two topics, "Withdrawal Liability: From Start to Finish", and "Health Care Reform for Attorneys" in November in Honolulu.

Scott Newsom and Dennis Witherell spoke in December at the University of Toledo Center for Family & Privately-Held Business on "Healthcare Reform Distilled – What You Won't Hear on Fox or MSNBC."

Malcolm Pitchford was appointed to the Real Estate Certification Committee of the Florida Bar for a three year term.

Tom Pletz was presented with the "Distinguished Toledo Lawyer Award" at the Toledo Bar Association's luncheon in April celebrating Law Day 2011. Tom spoke on "Professionalism In Dealing With The Media" at the Toledo Bar Association's December seminar on "Managing The Media: Lawyers And The Press."

Melissa Register presented "Florida Law Update" to the Suncoast Estate Planning Council in December. In January, Melissa presented "Summary of the Transfer Tax Provisions of the 2010 Tax Relief Act" to the Society of Financial Service Professionals, "Selecting the Right Estate Plan for You and Your Family" to the Tampa Bay Paralegal Association, and "Estate Planning in 2011 and Beyond: How Recent Changes to Federal and Florida Law Will Affect You and Your Clients," at the Pinellas County Estate Planning Council.

Jack Santaniello was a participant in the Entrepreneur's Source "Discovery Day and Franchise/Expo" in January held in Greensboro.

Shumaker is ranked #192 among the nation's 250 largest law firms in the United States, based upon *The National Law Journal's* annual survey.

Pete Silverman was appointed a commissioner on the Ohio Casino Control Commission.

Greg Yadley played a major role at the Securities and Exchange Commission's November forum on small business capital formation at the Washington, D.C., headquarters. In addition to participating on two panels regarding the new provisions of the Dodd-Frank Act, Greg was the Moderator of one of the Forum's three Breakout Groups and oversaw the afternoon's Plenary Session to develop the final Forum report to the SEC Commissioners. Greg also participated in a panel presentation at the American Bar Association's Business Law Section Fall Meeting in Washington, D.C. in November.

Greg Lodge and Neema Bell spoke at the Employers' Association 2011 Employment Law Conference in March.

Mark Wagoner was appointed Chairman of The Ohio Senate Judiciary Committee. The Judiciary Committee is charged with addressing changes to Ohio commercial and business law, along with overseeing potential changes to the operation of Ohio courts.

Mark Wagoner and Pete Silverman represented a beer and wine distributor in fighting an attempt by MillerCoors to terminate the distributorship. In a landmark summary judgment decision, written up in national trade journals, the court ruled in favor of the distributor and other distributors in finding that MillerCoors lacked any lawful basis for the termination.

insights

A Newsletter from Shumaker, Loop & Kendrick, LLP

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