insights

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JOBS ACT

Jumpstart Our Business Startups Act

By Regina M. Joseph

By Thomas C. Blank

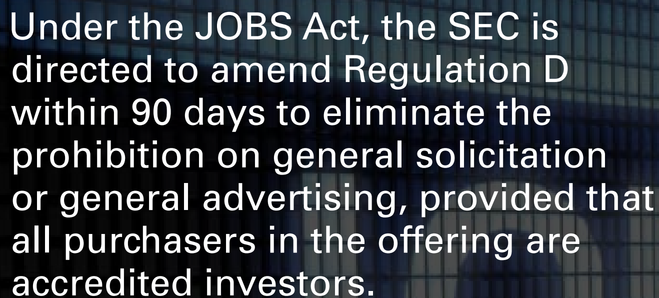
In March 2012, Congress enacted the JOBS Act, which was signed into law by President Obama on April 5, 2012. The JOBS Act combined a cluster of legislative proposals designed to facilitate the capital raising ability of "emerging growth companies," with the "crowdfunding" proposal receiving the most notoriety. Among other items, noted below, the JOBS Act raised the 500-shareholder trigger to enter the public reporting company system for private companies and community banks.

To many experienced practitioners, passage of the JOBS Act was surprising, because it was swimming against the tide in favor of tightening capital raising rules. The United States Securities and Exchange Commission ("SEC"), for example, in fulfilling its mandate under the Dodd-Frank Wall Street Reform and Consumer Protection Act, last autumn tightened the definition of "accredited investor" under its private offering rules in Regulation D to prohibit an individual using his or her primary residence's value to achieve a net worth in excess of $1 million. Recently, the Financial Industry Regulatory Authority ("FINRA"), a self-regulatory agency charged with oversight of broker-dealers, adopted a rule increasing a broker's due diligence requirements in private placements. Moreover, the SEC, North American Securities Administrators Association (i.e., state securities regulators),

Counting of Shareholders under the JOBS Act for Community Banks

As noted in the adjacent JOBS Act article, the number of shareholders required for a company to become a public reporting company under Section 12(g) was further amended to specifically grant community banks relief from 1934 Act reporting. There was a significant amount of lobbying by banking groups for such relief, since banks already are heavily regulated. For an issuer that is a bank or bank holding company, Section 12(g) becomes applicable not later than 120 days after the last day of its fiscal year in which the issuer has total assets exceeding $10 million (which threshold is met by all but the smallest banks) and a class of equity security (other than an exempt security) held of record by 2,000 or more persons. Note that banking entities will not be required to commence reporting if they have more than 500 non-accredited investors as is true for non-banking entities so long as they have less than 2,000 total shareholders. Additionally, a bank or holding company that already is reporting may terminate reporting obligations under Section 12(g) if the number of holders of record drops to less than 1,200. Thus, community banking organizations may wish to consider whether continued SEC registration is an appropriate cost for their shareholders. Rather than the current method of engaging in a costly "going private" transaction, "going dark" would be a relatively simple matter of terminating registration. Reporting banking companies also should keep in mind the fact that if they have filed a registration statement under the Securities Act of 1933 and are thus a reporting company under Section 15(d) of the 1934 Act, the duty to report is "suspended," not terminated and can spring back to life if the number of shareholders again exceeds 1,200. Note that the SEC has up to one year to adopt implementing regulations for these new "counting rules."

the Council of Institutional Investors and other prominent constituencies had criticized certain aspects of the bills, especially crowdfunding. Nevertheless, with each political party desiring to appear to be promoting job growth, both Congressional houses passed the JOBS Act, with an amendment addressing investor protection concerns. Highlights are below.



Under the JOBS Act, the SEC is directed to amend Regulation D within 90 days to eliminate the prohibition on general solicitation or general advertising, provided that all purchasers in the offering are accredited investors.

- **Enhanced Solicitation Capability in Private Placements.** Under the securities laws, each sale of a "security" must be registered or exempt from the registration requirements. A commonly used exemption (Rule 506 of Regulation D) is a privately placed sale to certain sophisticated, high-net worth investors called "accredited investors." Currently, Regulation D contains a prohibition against "general advertising and solicitation," and violation of that prohibition results in an issuer being engaged in the unlawful sale of securities. So, for example, posting an offering memorandum or referring to it on an issuer's website or in a news story means that the issuer is engaged in the unlawful sale of unregistered securities. The usefulness of the private placement exemption is further limited by the SEC's interpretation that the "no general solicitation" requirement means that the issuer or its broker must have an existing relationship before a solicitation is made, even if the proposed investor's status as an accredited investor is well known. Under the JOBS Act, the SEC is directed to amend Regulation D within 90 days to eliminate the prohibition on general solicitation or general advertising, provided that all purchasers in the offering are accredited investors – this is not a belief or knowledge standard, they must in fact be accredited investors. Therefore, using such general advertising or solicitation would preclude an issuer from selling securities in a Rule 506 offering to any non-accredited investor. Stated differently, if the issue is marketed through general solicitation and an investor turns out not to be accredited, the issuer will have engaged in the unlawful sale of unregistered securities. The issuer is required to take reasonable steps to verify that each purchaser meets the Regulation D definition of "accredited investor," using methods specified in future rulemaking by the SEC. Currently, issuers typically rely upon an investor's self-certification that it falls within one of the subsections of the accredited investor definition. If an issuer uses a FINRA-registered broker to facilitate its private offering, the broker will be required to comply with all FINRA requirements concerning due diligence and offering procedures.
- **The SEC is directed to adopt a similar amendment to 144A, which is a safe harbor for resales to institutional investors.** However, the issuer need only have a reasonable belief that the purchaser is an institutional investor.

The proposal to eliminate "no general solicitation" was previously made by the Middle Market and Small Business Committee of the American Bar Association's Business Law Section, which is chaired by Shumaker's Gregory C. Yadley, who also serves as 1 of 21 members of the SEC's Advisory Committee on Small and Emerging Businesses. The SEC Advisory Committee in February recommended to the SEC that it eliminate the prohibition on general solicitation and advertising in sales of privately-placed securities to accredited investors.

The Act's provisions permitting general solicitation and advertising do not take effect until the SEC amends its rules. It is possible that the SEC will impose additional requirements. Therefore, an issuer conducting a private offering is advised to follow current practices under the present text of all the private offering rules, as well as SEC interpretations thereof.

- **CROWDFUND Act.** This portion of the JOBS Act is so named because the title's complete name is the "Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012." The Senate amended this title through the Merkley Amendment, which was accepted by the House. Crowdfunding provides an informal approach for startup ventures to pitch their ideas to prospective investors. Selected highlights regarding this new concept are set forth below.

  - An amendment to Section 4(6) of the Securities Exchange Act of 1933, (the "1933 Act"), was created to permit a domestic, private issuer to offer up to $1 million of securities in a twelve-month period through a broker-dealer or funding portal that is registered with the SEC and any applicable self-regulatory organization, unless a portal is exempted by the SEC. A "funding portal" is defined as any person acting as an intermediary in a transaction involving the offer or sale of securities for the account of others, solely pursuant to Section 4(6) of the 1933 Act that does not: (a) offer investment advice or recommendations; (b) solicit purchases, sales, or offers to buy the securities offered or displayed on its website or portal; (c) compensate employees, agents, or other persons for such solicitation or based on the sale of securities displayed or referenced on its website or portal; (d) hold, manage, possess, or otherwise handle investor funds or securities; or (e) engage in other activities prescribed by the SEC.

  - The aggregate amount sold to any investor during the twelve-month period may not exceed the greater of $2,000 or five percent of the investor's annual income or net worth, if either is less than $100,000. For investors with annual income or net worth in excess of $100,000, investment is limited to ten percent of annual income or net worth and a maximum of $100,000. Investors will be required to make affirmations and respond to questions prescribed by the SEC as to their qualification level.

  - With specified exceptions, investors must hold the securities for at least one year.

  - Sale proceeds may not be released to the issuer until the target offering amount has been attained.

  - The issuer must give to each investor education materials and specified disclosure prescribed by the Act and as to be further required by the SEC. To note a few examples, for offerings of less than $100,000, the financial statements must be certified by the issuer's principal executive officer. For offerings between $100,000 and $500,000, the financial statements must be reviewed by an independent public accountant using professional standards or standards prescribed by the SEC. For offerings in excess of $500,000 (or such other amount established by the SEC), audited financial statements are required.

  - The broker-dealer or funding portal must take measures to reduce fraud risk, including obtaining a background and securities enforcement regulatory history check on each officer, director and person holding twenty percent of its outstanding equity.

  - Subject to any additional requirements to be prescribed by the SEC, offering materials must be filed with the SEC not later than twenty-one days prior to the first sale.

  - Issuers must file with the SEC and provide to investors annual reports of the results of operations and financial statements, and such other matters as the SEC shall prescribe.

- The CROWDFUND Act also contains a new liability section for material misstatements and omissions.

- The CROWDFUND Act preempts the registration, documentation and offering requirements of state law, although state securities administrators retain the right to require notice filings or to take enforcement action, especially with respect to fraud or deceit and other unlawful conduct. Fees relating to a notice filing may be charged only by the state of the issuer's principal place of business or any state in which investors of fifty percent or more of the offering are residents.

- **Eases the Path for Emerging Growth Companies.** Growing companies that desire to go public through an initial public offering ("IPO") will have an easier path under the new category of an "emerging growth company," which is defined as a company with less than $1 billion in annual gross revenues during its most recently completed fiscal year. The status will last until the earliest to occur of: (a) the last day of the fiscal year in which it had total annual gross revenues of $1 billion or more (as adjusted for inflation); (b) the last day of the fiscal year following the fifth anniversary of its first sale of common equity securities under a registration statement; (c) the date on which it has, during the previous 3-year period, issued more than $1 billion in non-convertible debt; or (d) the date on which it is deemed to be a "large accelerated filer," under the SEC's regulations under the Securities Exchange Act of 1934, as amended (the "1934 Act"). Being an emerging growth company confers benefits in the IPO registration process, such as presenting two, rather than three, years' of audited financial statements, and a two, rather than three, year period for presenting disclosure as to selected financial data and Management's Discussion and Analysis. Market participants, however, might expect financial statements for the longer period.

Relaxation of certain IPO rules was criticized after passage of the JOBS Act when Groupon's IPO revealed accounting irregularities. Under the new procedures, an emerging growth company could privately submit its draft IPO registration statement to the SEC and correct issues raised by the SEC without public disclosure of the corrections.

Additionally, the reduced executive compensation disclosure requirements applicable to smaller reporting companies would be applicable. After the initial public offering, certain requirements would be phased in, such as the Sarbanes-Oxley requirement to have independent auditors attest to the issuer's internal control over financial reporting. While it is an emerging growth company, the issuer would be exempt from the rules on say-on-pay voting, application of new accounting principles that are not applicable to non-reporting companies and mandatory auditor rotation requirements.

- **1934 Act Thresholds.** Under Section 12(g) of the 1934 Act and SEC rules, a company with more than 500 shareholders of record and $10 million in assets must comply with all the public company requirements, including annual and quarterly reporting, as well as compliance with the Sarbanes-Oxley requirements. The 500-shareholder requirement has not been updated since it was originally adopted in 1964, but the JOBS Act increases this threshold. Under the JOBS Act, the 1934 Act requirements will become applicable within 120 days after the last day of the fiscal year in which the issuer has total assets exceeding $10 million and a class of equity security (other than an exempted security) held of record by either (a) 2,000 persons, or (b) 500 persons who are not "accredited investors." Additionally, the definition of "held of record" does not include securities held by persons who received the securities pursuant to an employee compensation plan in transactions exempted from the 1933 Act, and the SEC is directed to adopt safe harbor provisions for determining when this definition has been satisfied. The CROWDFUND Act directs the SEC to adopt a rule exempting crowdfunding investors from the Section 12(g) threshold

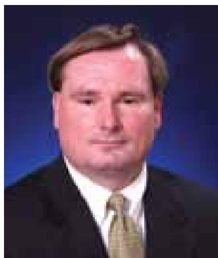
numbers on either a conditional or an unconditional basis. Importantly, the JOBS Act does not require the amendment of the shareholder counting rules under section 12(g)(5) to include "beneficial holders," but it is possible that this issue will be revised when the SEC reviews the counting rules. While the increase in the number of shareholders necessary to trigger the public reporting obligations is welcome, how and when the "accredited investor" test is applied and the impact of shares issued under employee benefit plans and crowdfunding offerings will complicate this relief. Community banks and bank holding companies faired better in the legislation in the context of counting shareholders (see page 1 text box). Note that the legislation did not increase the 300 shareholder threshold for deregistration as was done for banking entities.

• **Regulation A.** Regulation A is an alternative exempt offering process that is rarely used due to its limited offering amount and required filing of a detailed disclosure document with the SEC for review prior to commencing an offering. Congress hopes to enhance the utility of Regulation A by increasing the offering threshold from $5 million to $50 million. Interestingly, the law requires that companies using the revised Regulation A file financial statements with the SEC after the offering and allows the SEC to adopt such other requirements as it "may deem necessary in the public interest."

• **Regulations.** As is frequently the case with new securities laws, Congress has left much to be done by the SEC through the adoption of regulations. Even though time lines are set for these regulations, the SEC still is digging out from under the regulations required by Dodd-Frank and it is unclear if the required time lines can be met.

Ohio's New Oil and Gas Boom Raises Environmental Legal Issues

A recent headline in the *Washington Post* asked: "Can the Shale Gas Boom Save Ohio?"[1] The headline reveals the economic potential of the oil and gas boom that has swept Ohio in recent years, as major energy producers position to tap natural gas and oil reserves in the Utica Shale formation a mile and a half below the surface of a large swath of Ohio. Estimates of the scale of the economic impact the oil and gas rush could have on Ohio vary, but one recent study found that the industry will spend $34 billion on exploration and development alone over the next five years and more than 200,000 jobs could be created.[2]


By Joseph S. Simpson

Production of oil and natural gas from shale relies upon hydraulic fracturing or "fracking." The process involves drilling deep wells and one or more horizontal shafts from each vertical well. By pumping a mixture of water, sand and chemicals under pressure into the horizontal borings, the shale is fractured, releasing oil and gas, which is then produced through the vertical well.

The fracking process has raised environmental concerns that have triggered significant legal disputes in states where development of other major shale formations is more advanced. For instance, regulatory agencies and citizens have claimed that fracking operations have polluted groundwater, contaminated drinking water wells, fouled surface waters or created nuisance conditions.[3] As explained below, development of the Utica Shale in Ohio will likely raise similar disputes.

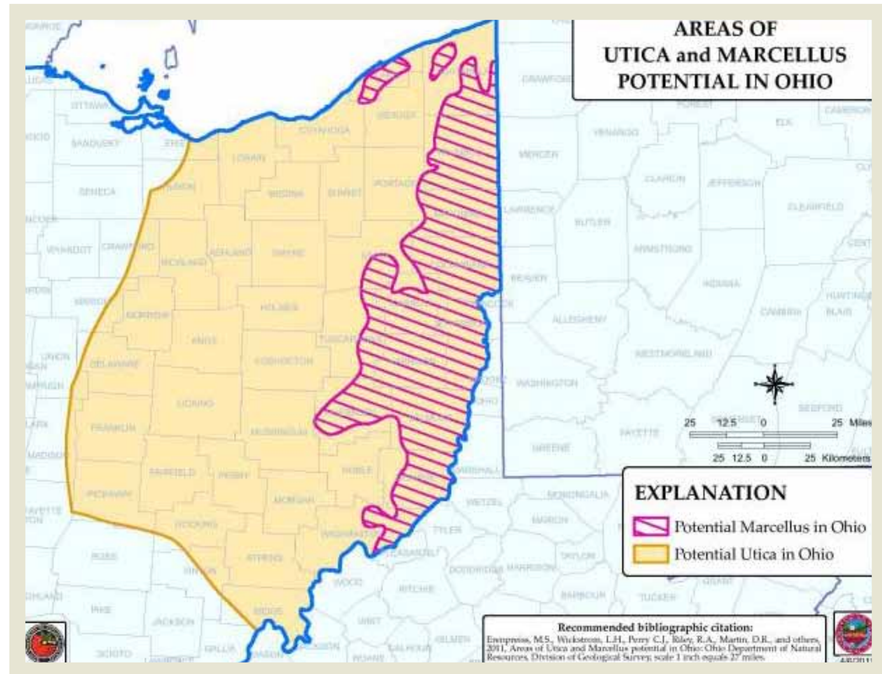
Ohio's History as an Oil and Gas Giant

Ohio's rich history of oil and gas production dates back nearly two centuries. Two men drilling for salt in Noble County cursed their luck when they encountered a black liquid oozing into their pit at a depth of 475 feet.[4] The year was 1814, and Silas Thorla and Robert McKee had unwittingly produced America's first crude oil from a drilled well near Caldwell, Ohio.[5] The find meant little to them beyond the nuisance it caused to their quest for food-preserving salt.[6] At the time, whale oil was Ohio's burning fluid of choice, and would remain so until at least 1860, when perfection of oil refining greatly enhanced the value of crude.

Ohio's first commercial oil well was placed in production in 1860 in Macksburg, Washington County, around the same time that Colonel Drake drilled his historic well in Titusville, Pennsylvania in 1859.[7] Subsequently, discovery of oil in the Trenton limestone near Lima in northwestern Ohio triggered a 20-year oil and gas boom beginning in 1884.[8] That period saw Ohio transformed into the leading oil producing state in the nation and a world leader from 1895-1903. In 1896 alone, Ohio produced nearly 24 million barrels of oil.[9] Natural gas was initially a by-product of oil production, but by 1884 was being commercially produced.[10]

Ohio has never again reached the production level of 1896. By comparison, in 2011[11] a little less than 5 million barrels of crude were produced in Ohio. Nevertheless, Ohio has continuously produced oil and gas, even decades after the focus of the industry shifted to the mid-continent oil fields in Kansas, Oklahoma, Texas and Louisiana in the early 1900s. Oil and gas has been found and produced in 76 of Ohio's 88 counties.[12] There have been over 275,000 wells drilled in Ohio to date, second only to Pennsylvania. Today, there remain 64,378 oil and gas wells in production in Ohio.[13] Many are "stripper wells" with very low production (e.g. less than 10 barrels per day or 60 thousand cubic feet (mcf) of natural gas

per day).[14] Ohio's oil and gas industry has persevered through major "boom and bust" cycles, each focusing on a geologic oil or gas play and tied to commodity prices and technology.



Hydraulic Fracturing and the Major Shale Formations

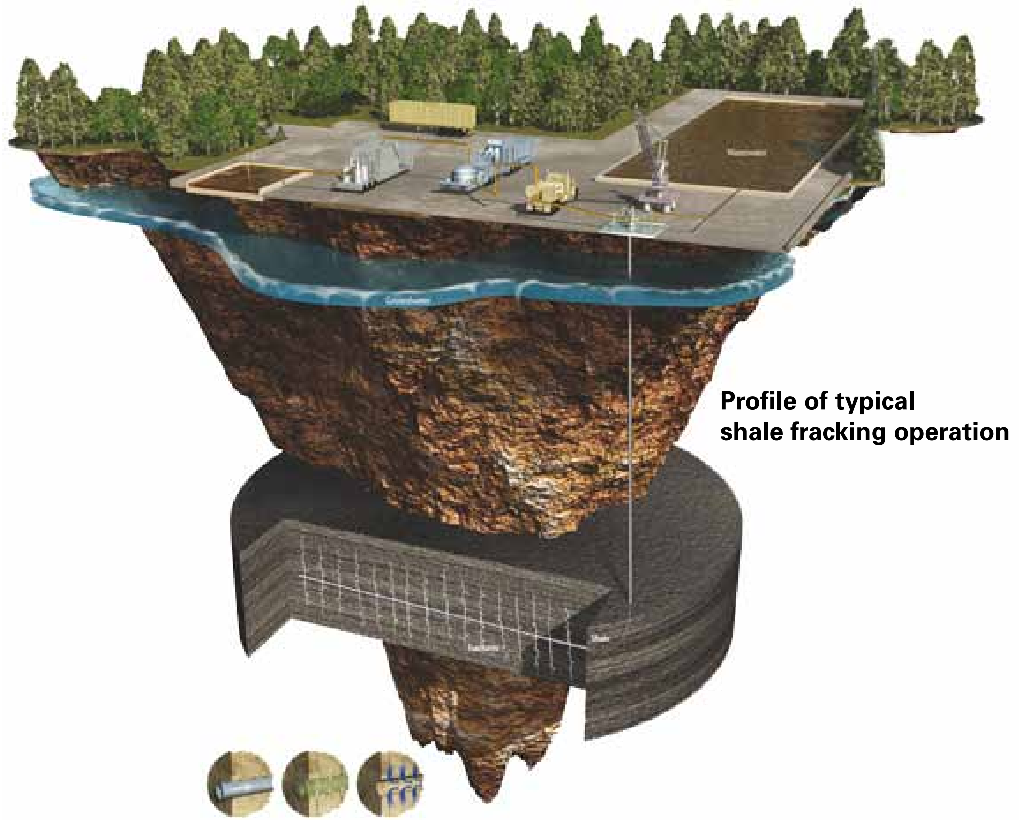
Over the last decade, the innovation of directional (horizontal) drilling, in combination with hydraulic fracturing, has opened up shale formations for production of oil and gas that had not previously been considered economically viable. These shale "plays" -- now prevalent in the news -- include the Barnett Shale (central and west Texas), the Haynesville Shale (east Texas and Louisiana), the Eagle Ford Shale (south Texas), the Bakken Shale (North Dakota) and the Marcellus Shale (West Virginia, Pennsylvania, Ohio, New York).[15] Geologic formations, like the shale plays noted above, may contain large quantities of oil or gas, but suffer from a poor flow rate due to low permeability. This is true for shales, tight sands, and coalbed methane formations, among others. Use of horizontal directional drilling and hydraulic fracturing has made extraction of oil and gas economically feasible from such formations, where in the past it would have been cost prohibitive. Fracking is not new, but has been used since at least the 1950s to stimulate poorly producing vertical wells in Ohio and elsewhere.

The Utica and Point Pleasant Shale Beneath Ohio

While a relatively modest portion of the Marcellus Shale runs beneath eastern Ohio, a considerably larger swath of Ohio lies above the Utica and Point Pleasant Shale formations.[16] It is the Utica Shale which experts believe has the potential to return Ohio to its former status as a major oil and gas producing state. The Utica runs considerably deeper than the Marcellus (2,000 to 3,000 feet deeper in eastern Ohio).[17] However, the Utica Shale underlies a much larger portion of Ohio than the Marcellus, and is considerably thicker (87 to 350 ft. thick vs. 0 to 91 ft. thick).[18] Further, the Utica Shale is believed to contain significant quantities of both oil and wet gas,[19] in addition to dry gas. Due to the current low market price of natural gas, both oil and wet gas are considerably more valuable than dry gas. Conversely, the Marcellus Shale is primarily a dry gas play. As a result, the Utica Shale is better positioned to weather any downturn in drilling for low priced natural gas due to the attractiveness of the potential oil and wet gas present in the formation. The Ohio Department of Natural Resources ("ODNR") has estimated that, if 1.2% of the Utica/Point Pleasant reserve is recoverable, the formations would yield 3.75 trillion cubic feet of gas and 1.31 billion barrels of oil.[20] If 5% of the reserve can be recovered from the formations, they would yield 15.7 trillion cubic feet of gas and 5.5 billion barrels of oil.[21]

Not surprisingly, the Utica Shale has attracted the attention of numerous leading energy companies who have already invested, or plan to invest billions of dollars into their efforts to produce oil and gas from the Utica/Point Pleasant Shale beneath Ohio. Shell, ExxonMobil, Anadarko, Chesapeake, Hess, BP, Chevron, Total, Range Resources and others have all assembled

significant leasehold positions to take advantage of the potential of the Utica Shale. On April 2, 2012, Chesapeake Energy, a major player in the Utica Shale, announced initial results for production from several test wells in Ohio. While the overall results were open to interpretation, one well produced 1.52 billion cu. ft. of natural gas, equating to 2% of the total production for the State of Ohio in just 198 days of drilling. [22]



Profile of typical shale fracking operation

Hydraulic Fracturing: How it Works

The process of fracking begins with building the necessary infrastructure at the well site, including well construction. Production wells in shale gas are typically drilled in the vertical direction with horizontal or directional sections. Vertical well sections may be drilled hundreds to thousands of feet below the land surface and lateral sections may extend up to a mile or so away from the well. The advantages of horizontal drilling and hydraulic fracturing are significant. Historically, to develop a one square mile (640 acre) parcel, about 16 vertical wells, each with a two-acre drill site would have been required to produce the parcel.[23] Utilizing horizontal drilling and fracking, the same one square mile parcel can be produced with 5 to 6 horizontal wells from a single 3 to 6 acre drill site. Minimally optimal lease tracts today would encompass roughly two contiguous square mile tracts to permit horizontal drilling in two directions from a centrally located pad. [24]

After the well has been drilled, steel casing is installed in the well. The casing is perforated within the target zones that contain oil or gas. When the fracturing fluid is injected into the well it flows through the perforations into the target zones. Fluids, commonly made up of water and chemical additives, as well as a propping agent (typically sand) are pumped into the shale at high pressure (7,000 to 10,000 psi) during hydraulic fracturing. When the pressure exceeds the rock strength, the fluids open or enlarge fractures that can extend several hundred feet away from the well. The propping agent lodges within the fractures to keep them from closing when the pumping pressure is released. The fractures permit natural gas or oil to escape the shale and flow into the well. When fracturing is complete, the internal pressure of the shale formation causes a portion of the injected fracturing fluids to rise to the surface. The recovered fracking fluids are referred to as flowback. An informative video of the hydraulic fracturing process can be viewed at: http://www.epa.state.oh.us/shale.aspx.

Up to four million gallons of fresh water may be required to fracture a single well.[25] The water used in the fracking process typically comes from a stream, river, reservoir or lake near the drill site.[26] Generally, a large percentage of the fracking fluid (up to 85%) remains underground, while the remainder (15-20%) returns to the surface as flowback. Flowback water is typically stored temporarily at the drill site in lined pits or steel tanks. Ultimate options for disposing of flowback include discharge into surface water after treatment, recycling, or underground injection.

Potential Environmental Issues Associated With Fracking

As noted above, the rise of hydraulic fracturing of shale for gas and oil has been accompanied by significant controversy, as critics have questioned its impact on the environment. There is no question that hydraulic fracturing raises the specter of legal disputes pertaining to environmental issues.

Groundwater

Contamination of groundwater is perhaps the highest profile concern raised with regard to hydraulic fracturing. Ohio EPA and ODNR, as well as other technical experts in hydraulic fracturing, have stated that they have no data showing a risk of groundwater contamination from flowback water migrating thousands of feet from the Marcellus or Utica Shale formations into drinking water aquifers much closer to the earth's surface. Those agencies do acknowledge, however, that:

"There is the potential, although unlikely, for contamination of drinking water wells because of problems occurring closer to the surface. Gas and oil can migrate from a production well into an aquifer if a well casing is damaged, leaking or poorly constructed. Natural gas can also enter aquifers from old, abandoned oil and gas wells that are unplugged or poorly plugged. A new water well that is drilled can penetrate gas-rich organic shales or coal seams at shallow depths, allowing gas to enter the well. Buried organic deposits from old swamps or landfills may also release natural gas into soils overlying aquifers."

See, e.g. Ohio EPA, "*Drilling for Natural Gas in the Marcellus and Utica Shales: Environmental Regulatory Basics*," July 2011, p. 6. Importantly, Ohio EPA and ODNR go on to stress that "there have been thousands of oil and gas production wells drilled throughout Ohio without significant adverse impacts to drinking water resources." Id at 6.

Other risks are posed to groundwater from potential leaks or spills at or near the surface of drilling operations from tanks, trucks, equipment or brine/flowback pits. Contaminants that could potentially threaten groundwater include BTEX (benzene, toluene, ethylbenzene, xylene) compounds, VOCs, and other materials. Groundwater litigation has generally accompanied hydraulic fracturing in states where development of shale is ongoing. See e.g. *Becka v. Antero Resources, LLC,* Case No. 2:11-CV-1040, U.S. District Court (W.D. Pa. 2011) (alleging contamination of groundwater with fracking chemicals); *Harris v. Devon Energy Production Co.*, Case No. 4:10-CV-708, U.S. District Court (E.D. Tex. 2011) (alleging groundwater contamination); *Berry v. Southwestern Energy Co.*, Case No. 1:11-CV-0045, U.S. District Court (E.D. Ark. 2011) (alleging contamination of groundwater with methane, hydrogen sulfide and other contaminants).

Wastewater Disposal

Because a typical fracking operating may use up to 4 million gallons of fracking water and fluids, proper disposal of flowback water remains a primary environmental concern with regard to fracking. Flowback water generally includes, salts, hydrocarbons, and additives, as well as barium, strontium and low levels of naturally occurring radioactive materials ("NORM") in the form of radon and radium. As of May 16, 2011, Ohio has prohibited discharge of flowback water into surface waters or sending it to publicly owned treatment works ("POTWs"). As a result the primary means for disposal of flowback water in Ohio is injection into Class II Underground Injection Wells, or recycling. Use of POTWs for treatment of flowback water has triggerred litigation in other states. See e.g. *Clean Water Action v. City of McKeesport*, Case No. 2:11-CV-00940 (W.D. Pa. 2011).

Nuisance

Fracking of shale for oil and gas raises a number of different nuisance issues that can potentially lead to litigation or other responses. Such nuisance conditions include noise, odor, and vibrations associated with drilling and fracking activities. Additionally, drilling operations frequently involve heavy truck traffic, with associated traffic, dust and road damage issues. All of these disturbances raise the threat of litigation from private citizens against operators for nuisance conditions. Such claims have been common in States where fracking has been ongoing. See e.g. *Maring v. Nalbone*, Case No. K12009001499 (N.Y. Sup. Ct. 2009) (nuisance due to contamination of drinking water wells with methane); *Zimmerman v. Atlas America, LLC*, Case No. 2009-7564 (Pa. Ct. Cm. Pls. 2009)(nuisance due to pollution of aquifer with fracking chemicals); *Fiorentino v. Cabot Oil and Gas Corp.*, Case No. 3:09-CV-2284, U.S. District Court (M.D. Pa. 2009) (nuisance due to methane in water wells, explosions, pollution of soils with diesel fuel, combustible gas in well headspaces); *Berry v. Southwestern Energy Co.*, Case No. 1:11-CV-0045, U.S. District Court (E.D. Ark. 2011) (alleging odors from fracking operation, as well as contamination of groundwater with methane, hydrogen sulfide and other contaminants).

Air Emissions

Production of oil and gas through hydraulic fracturing raises issues with regard to air emissions from drilling, fracking, compressor stations, generators and other equipment. Other potential air emissions issues include volatilization of contaminants from the flowback water pits as well as flaring from natural gas. Potential air contaminants include: BTEX compounds, PAHs (polycyclic aromatic

hydrocarbons), formaldehyde, NOx, SO2 and CO. Although fewer in number than lawsuits alleging groundwater contamination, numerous cases have been filed alleging air pollution from oil and gas production through fracking. See e.g. *Citizens for Pennsylvania's Future v. Ultra Resources, Inc.*, Case No. 4:11-CV-01360, U.S. District Court (M.D. Pa. 2011) (citizen suit under Clean Air Act alleging air pollution in the form of NOx and other emissions from fracking operation); *Strudley v. Antero Resources Corp.*, Case No. 2011-CV-2218 (Colorado Dist. Ct. 2011) (alleging discharges of hydrogen sulfide, hexane, toluene, propane butane and other pollutants into air and water); *Tucker v. Southwestern Energy Co.*, Case No. 1:11-CV-0044, U.S. District Court (E.D. Ark. 2011) (class action alleging water and air contamination); *Ginardi v. Frontier Gas Services, LLC*, Case No. 4:11-CV-0420, U.S. District Court (E.D. Ark. 2011) (alleging pollution of air and water, as well as noise nuisance).

Surface Water and Soils

Production of oil and gas through fracking raises significant potential surface water and soil contamination issues. In some instances, fracking activities may result in contamination of surface waters due to stormwater runoff from drilling pads and sites. The storage of chemicals and materials on pads and drill sites creates potential exposure to leaks, spills and other events that may result in contamination of surface waters or site soils. Further, holding pits or containers pose a risk of leaks into surface waters and soils. Trucks or equipment maintained at drilling sites also bring the potential for leaks and spills of fuel and other materials. Potential contaminants include total dissolved solids, total suspended solids, VOCs, methane and BTEX compounds. Contamination of soils and surface water have also engendered litigation in other jurisdictions where fracking operations are prevalent. See e.g. *Fiorentino*, Case No. 3:09-CV-2284, U.S. District Court (M.D. Pa. 2009) (nuisance due to methane in water wells, explosions, pollution of soils with diesel fuel); *Berry*, Case No. 1:11-CV-0045, U.S. District Court (E.D. Ark. 2011) (alleging pollution of soil, as well as contamination of groundwater with methane, hydrogen sulfide and other contaminants).

It should be noted that the lawsuits identified above are, in most respects, in the early stages of winding their way through the courts. As a result it is far too early to draw significant conclusions about the effect such litigation may have, if any, on hydraulic fracturing in the major shale plays. However, it appears certain that litigation over hydraulic fracturing operations will accompany development of the Utica Shale in Ohio.

Regulation of Drilling and Fracking in Ohio

Overview of Regulatory Structure

ODNR, through its Division of Oil and Gas Resources Management ("DOGRM"), has primary regulatory authority over oil and gas drilling in Ohio. ODNR's authority encompasses issuing permits for oil and gas wells; regulating well construction, siting, design and operation; disposal of brine and drilling fluids; and regulation of transporters of such fluids. See generally, Ohio Rev. Code, Chapter 1509.

Ohio EPA shares responsibility for regulation of fracking activities with ODNR. Ohio EPA's authority extends to approval of drilling construction activity that may impact wetlands, streams, rivers or other waters of the state. Ohio EPA also regulates sources of air emissions, and recently promulgated a general permit requirement for Oil and Gas Well-Site Production Operations. See Ohio Rev. Code §3745-31-29 (GP12). The general permit streamlines the permitting process and provides emissions limits for various contaminants from: glycol dehydration units, diesel engines, fixed tanks, flares, and other equipment. Id. Finally, any solid waste sent off-site for disposal must be properly managed, either at a solid waste landfill, or beneficially reused, as authorized by Ohio EPA's Division of Materials and Waste Management ("DMWM"). Table 1 below illustrates the substance of the shared regulatory authority of ODNR and Ohio EPA over oil and gas drilling.

Ohio's regulatory response to environmental concerns associated with hydraulic fracturing for production of oil and gas in the Marcellus and Utica Shale formations has been significant. In 2010, the General Assembly passed Senate Bill 165, overhauling the State's oil and gas laws as set forth in Ohio Rev. Code, Chapter 1509. The S.B. 165 legislation, which was intended to provide a firm foundation for proper oversight of the oil and gas industry in Ohio, became effective on June 30, 2010. Currently, ODNR and Ohio EPA are engaged in drafting regulations to implement the provisions of S.B. 165 in the Ohio Administrative Code.

TABLE 1

	ODNR	OHIO EPA
Horizontal oil and gas drilling in shale formations	• Issues permits for drilling oil and gas wells. [Ohio Rev. Code § 1509.05]. • Sets requirements for location, design and construction of oil and gas wells. [Ohio Rev. Code §1509.021, §1509.022, §1509.24]. • Inspects and oversees drilling, stimulation, and production. [Ohio Rev. Code § 1509.09]. • Requires controls to prevent discharges and releases. • Requires that wells no longer capable of production are properly plugged and abandoned. [Ohio Rev. Code § 1509.13-1509.151]. • Requires registration and/or permitting for operators with capacity to withdraw water at a quantity greater than 100,000 gallons per day. [Ohio Rev. Code § 1521.16]	• Requires authorization for construction activity where there is an impact to a wetland, stream, river or other water of the state. [Ohio Rev. Code §6111.041; Ohio Admin. Code §3745-1]. • Requires an air permit to install and operate (PTIO) for units or activities that have emissions of air pollutants. [Ohio Admin. Code, §3745-31]. • Involved in emergency response activities related to spills, or releases, in coordination with ODNR and other emergency response authorities. [Ohio Rev. Code, Chapter 3750].
Fracking fluids and drill cuttings at drill sites	• Sets design requirements for on-site pits used to store drill cuttings and fracking fluids. [Ohio Rev. Code § 1509.21]. • Requires closure of on-site pits after drilling operations are completed. • Sets standards for managing drill cuttings and derived sediments left at drill site. [Ohio Rev. Code §1509.22].	• Requires contaminated drill cuttings shipped off-site be taken to a licensed solid waste facility for disposal. [Ohio Admin. Code §3745-27]. • Reviews and approves proposals for beneficial reuse of cuttings off-site.
Fracking fluids disposal	• Regulates disposal of brine and other fluids. [Ohio Rev. Code §1509.22]. • Oversees permitting and operation of Class II injection wells used to dispose of waste fluids from oil and gas drilling. [Ohio Admin. Code §1501:9-3]. • Issues permits for Class II injection wells. [Ohio Admin. Code §1501:9-3].	
Transport of fracking fluids	• Registers transporters hauling brine and other oil and gas waste fluids in Ohio. [Ohio Rev. Code §1509.222].	• Involved in emergency response activities related to spills and releases, in coordination with ODNR and other emergency response authorities. [Ohio Rev. Code, Chapter 3750].

Some of the more significant changes to Ohio's oil and gas laws stemming from S.B. 165 are:

- Modified definitions to more clearly include well stimulation, including fracturing. [Ohio Rev. Code §1509.01].
- Significantly expanded ODNR's regulatory authority to allow more protection of public health and safety and the environment. [Ohio Rev. Code §1509.04].
- Authorized ODNR to expend agency monies to initiate corrective actions where necessary; allows the agency to compel a company to reimburse for monies expended. [Ohio Rev. Code §1509.071].
- Requires drillers to submit wireline electronic logs and well completion records, including those associated with hydraulic fracturing; includes reporting of type and volume of materials used; the methods used to contain such fluids; and data (such as pumping pressures and return volumes). [Ohio Rev. Code §1509.10].
- Requires submission of MSDS sheets; and rulemaking may require the inclusion of CAS (chemical abstract service) information. [Ohio Rev. Code §1509.10].
- Expands the agency's authority to require the plugging of wells with defective casing or well construction. [Ohio Rev. Code §1509.12].
- Expands well construction requirements expressly for the protection of underground sources of drinking water. [Ohio Rev. Code §1509.17].
- Authorizes the agency to require remedial testing to assure construction requirements have been met and mandates plugging of wells that are irreparably damaged. [Ohio Rev. Code §1509.17].
- Addresses well stimulation, agency notification, and well integrity testing. [Ohio Rev. Code §1509.17].
- Clarifies the definition of contamination to include those activities that may be associated with hydraulic fracturing. [Ohio Rev. Code §1509.22].

- Prohibits surface application of fluids associated with well stimulation. [Ohio Rev. Code §1509.226].
- Authorized the agency to promulgate rules to further enhance these statutory changes. [Ohio Rev. Code §1509.23].[27]

ODNR has asserted that Ohio has strong rules in place to regulate extraction of oil and natural gas from the Utica Shale based on changes made by S.B. 165 and existing regulations. Carlo LoParo, spokesman for the agency, stated that:

We're confident that those [S.B. 165] reforms, plus others we're looking at, will make Ohio one of the most carefully monitored and regulated states in the nation regarding well-construction and natural gas extraction.

Marietta News & Sentinel, March 4, 2012.

Emerging Federal Regulations

Regulation of hydraulic fracturing has thus far been an issue primarily for the states. The federal government has moved with caution in seeking to regulate natural gas production through fracking. Nevertheless, federal activity concerning regulation of fracking is emerging. Three recent initiatives of the federal government are notable.

First, in 2010, Congress directed U.S. EPA to undertake a comprehensive "study on the relationship between hydraulic fracturing and drinking water, using a credible approach that relies upon the best available science, as well as independent sources." U.S. EPA "Plan to Study the Potential Impacts of Hydraulic Fracturing on Drinking Water Resources," November 2011, p. 1. U.S. EPA released its plan for the study in late 2011 and is expected to release an initial report by late 2012. The full study is not expected to be complete before late 2014. Id. The study will examine all stages of hydraulic fracturing, including, acquisition of water, mixing of chemicals, injection and fracturing, post-fracturing production, management of flowback waters and treatment and disposal of the same. Id. at 1-2.

Second, on April 17, 2012, U.S. EPA issued modifications to its New Source Performance Standards ("NSPS") and National Emissions Standards for Hazardous Air Pollutants ("NESHAPs") under the Clean Air Act for the oil and natural gas sector. The modified rules include provisions to regulate air emissions from natural gas fracking operations.[28] These provisions represent the first significant federal regulation imposed on fracking operations. In essence, the new standards target VOCs (and indirectly methane) emissions from fractured wells that are ready for production by requiring "reduced emissions completions" also known as "green completions" during flowback. A reduced emissions completion is accomplished through use of portable equipment to separate gas and hydrocarbons from flowback water generated when a well is fracked. The gases and hydrocarbons can then be treated and utilized on-site or sold. In a concession to industry, U.S. EPA delayed requiring "green completions" until January 1, 2015, when necessary equipment is expected to be more widely available. In the interim, operators may comply through use of flares designed to reduce at least 95% of VOC emissions. Id.

Third, on May 4, 2012, the Department of Interior promulgated rules governing fracking on federal lands that are intended, in part, to provide a model for state regulation of fracking on non-federal lands.[29] Those rules provide for: (1) public disclosure of chemicals used in hydraulic fracturing on public land; (2) enhanced regulation concerning well-bore integrity of wells; and (3) enhanced management of flowback water, Id. These proposed rules will undergo public comment and response before final promulgation.

Outlook for Development of Oil and Gas in Utica Shale in Ohio

Development of the Utica Shale in Ohio is in its infancy. As a result, it is too early to tell whether the legal disputes that have marked oil and gas production by fracking in other states will emerge on the same scale and with the same intensity in Ohio. Nevertheless, given the scale of the fracking operations likely to occur in Ohio, there is every reason to think that there will be significant litigation in Ohio concerning hydraulic fracturing operations, as there has been in virtually every other state with a major shale play. Likewise, operators seeking to develop the Utica Shale in Ohio have a significant regulatory structure to navigate in order to ensure compliance in their fracking operations, and this too, can engender litigation in the event of compliance failures.

Already, Ohio has seen early signs of the legal battles and that may play out ahead. At least two related lawsuits have already been filed in Ohio by landowners alleging that fracking activities and poorly constructed wells resulted in groundwater contamination. See e.g.

Mangan v. Landmark 4, LLC, Case No. 1:12-CV-00613, U.S. District Court (N.D. Ohio 2012) (alleging contamination of groundwater by fracking operations due to improper cement job on wells); *Boggs v. Landmark 4, LLC*, Case No. 1:12-CV-00614, U.S. District Court (N.D. Ohio 2012) (asserting similar claims to *Mangan* case). Similarly, a group of landowners has filed suit against an operator, contending that, in securing leases from the landowners, the operator concealed and misrepresented the environmental disruptions that would be caused by fracking. *Koonce v. Chesapeake Exploration, LLC,* Case No. 4:12-CV-0736, U.S. District Court (N.D. Ohio).

Further, in 2011, Youngstown, Ohio experienced 12 separate low-magnitude earthquakes ranging from 2.1 to 4.0 on the Richter scale. The quakes triggered significant controversy based upon speculation that they may have been triggered by injections of fracking wastewater into the nearby Northstar 1 Class II underground injection well. A subsequent study conducted by ODNR concluded that the seismic events *were* likely caused by the injection operations near a previously unknown underground fault system.[27] The finding resulted in a moratorium on drilling of deep injection wells pending further study. Id. Class action litigation has been threatened by persons affected by the Youngstown earthquakes.

In summary, Ohio's oil and gas boom associated with the Utica Shale seems likely to have an enormous impact on Ohio's economy. Along with its economic impact, the oil and gas boom will undoubtedly engender a number of significant legal disputes concerning the potential environmental issues associated with fracking.

[1] *"Can the Shale Gas Boom Save Ohio?,"* Washington Post, March 3, 2012.

[2] "Ohio's Natural Gas and Crude Oil Exploration and Production Industry and the Emerging Utica Gas Formation, Economic Impact Study," September 2011, prepared for the Ohio Oil and Gas Energy Education Program. A separate study projected that by 2014, more than 65,000 jobs would be created and that Ohio's Gross State (Domestic) Product would increase by more than $4.9 billion in 2014. See, "An Analysis of the Economic Potential for Shale Formations in Ohio," 2011, prepared for the Ohio Shale Coalition by Ohio State University, Cleveland State University and Marietta College.

[3] See e.g. *Maring v. Nalbone*, Case No. K12009001499 (N.Y.Sup. Ct. 2009)(contamination of drinking water wells with methane); *Zimmerman v. Atlas America, LLC*, Case No. 2009-7464 (Pa. Ct. Cm. Pls. 2009) (alleging pollution of aquifer with fracking chemicals); *Fiorentino v. Cabot Oil and Gas Corp*., Case No. 3:09-CV-02284, U.S. District Court (M.D. Pa. 2009) (alleging methane in water wells, explosions, pollution of soils with diesel fuel, combustible gas in well headspaces); *Berish v. Southwestern Energy Production Co.,* Case No. 3:10-CV-01981, U.S. District Court (M.D. Pa. 2010) (alleging diesel fuel, barium, strontium, and manganese in drinking water wells due to improper well construction); *Ginardi v. Frontier Gas Services, LLC*, Case No. 4:11-CV0420, U.S. District Court (E.D. Ark. 2011) (alleging pollution of air and water, as well as noise nuisance).

[4] Ohio Geology, Spring 1993, ODNR.

[5] Id.

[6] Thorla and McKee contemplated a use for the oil, but efforts to burn it by local residents in lamps resulted in a foul odor and heavy soot. As a result, Thorla and McKee bottled some crude and sold it for medicinal purposes as "Seneca Oil". Id.

[7] ODNR: http://ohiodnr.com/mineral/program/tabid/17865/default.aspx.

[8] Id.

[9] Id.

[10] *"Ohio Crude Oil and Natural Gas Producing Industry,"* Ohio Oil and Gas Association: http://burchfieldcraig.org/FamLib/FamBus/OilGasGeneral/OhioOilandGasIndustryOverview-OOGA.pdf.

[11] ODNR: http://ohiodnr.com/mineral/production/tabid/15389/Default.aspx.

[12] ODNR, Division of Geological Survey.

[13] Id.

[14] Despite their minimal individual production, the large number of "stripper wells" or "marginal wells" render them a significant source of overall production. Collectively U.S. stripper oil wells produce 20 percent of the country's oil or 1.2 million barrels per day – as much as the U.S. imports from Saudi Arabia. National Stripper Well Association: http://nswa.us/dyn/showpage.php?id=16.

[15] "Review of Emerging Resources: U.S. Shale Gas and Shale Oil Plays", U.S. Energy Information Administration, July 2011.

[16] The Utica Shale overlies the Point Pleasant formation, an interlayered limestone and shale formation that is actually "thicker and higher in total organic content" than the Utica proper. "Vast Resource Potential Has Operators Gearing Up to Test Utica Shale Formation", The American Oil and Gas Reporter, November 2011: http://www.aogr.com/index.php/magazine/editors-choice/vast-resource-potential-has-operators-gearing-up-to-test-utica-shale-format.

[17] See, http://geology.com/articles/utica-shale.

[18] ODNR, "The Marcellus and Utica Shale Plays in Ohio", presented March 11, 2011 to Ohio Oil and Gas Association.

[19] "Wet gas" generally contains natural gas liquids with appreciable quantities of non-methane hydrocarbons such as propane, butane, and ethane. These heavier hydrocarbons increase the value of "wet gas" over "dry gas" which is comprised predominantly of methane.

[20] Id.

[21] Id.

[22] ODNR, 2011 Utica Shale Production Report.

[23] ODNR Presentation: *The Utica-Point Pleasant Shale Play of Ohio*, 2012.

[24] Id.

[25] Ohio EPA, "Drilling for Natural Gas in the Marcellus and Utica Shales: Environmental Regulatory Basics", July 2011, p. 2.

[26] Id.

[27] Pending legislation (S.B. 315) in the Ohio General Assembly would impose further regulations concerning fracking, including: (1) additional reporting requirements concerning chemicals used to drill or fracture a well; (2) requirements to sample water within 1500 feet of a proposed well and disclose the sampling results in the drilling permit application; (3) requirements to disclose the source of water to be used in well stimulation process; (4) encouragement for well operators to enter into a Road Use Maintenance Agreement with local governments; and (5) authorization for cooperative agreements between ODNR and other state agencies concerning fracking operations.

[28] http://www.epa.gov/airquality/oilandgas/pdfs/20120417finalrule.pdf

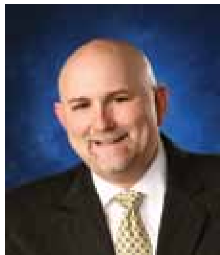
[29] http://www.doi.gov/news/pressreleases/loader.cfm?csModule=security/getfile&pageid=293916

[30] "Preliminary Report on the Northstar 1 Class II Injection Well and the Seismic Events in the Youngstown, Ohio Area", ODNR, March 2012.

ESTATE PLANNING IN 2012 AND BEYOND

Navigating through the fog

For the last several years, Americans have faced an uncertain environment for estate and gift planning that is likely to continue as we slog through this election year. The estate and gift tax landscape is clouded by a Congress that seems unable to make up its mind about taxing the transfer of wealth. Despite all of the uncertainty, two things remain certain--death and taxes. We cannot avoid the first, but by taking steps today, most of us can dodge the second. To help you navigate through the fog, what follows explains where we are, where we are headed, where we want to be and how to get there.



By Stephen A. Rothschild

Where are we?

On December 17, 2010, the President signed into law a new Act (the "2010 Tax Act") that creates extraordinary opportunities for trust, estate and gift planning. Among the highlights of the 2010 Tax Act are the following:

1. An increase in the estate, gift and generation-skipping tax ("GST") exemptions to $5.12 million in 2012;
2. The reunification of the estate and gift tax exemptions so that a person can give away during life or at death up to $5.12 million free of estate or gift tax;
3. A reduction in the estate tax, gift tax and GST rates to 35%; and
4. Portability, which gives the second spouse to die the ability to use the unused portion of the first spouse's estate and/or gift tax exemption during their lifetime or at their death to reduce the size of their estate that might be subject to tax.

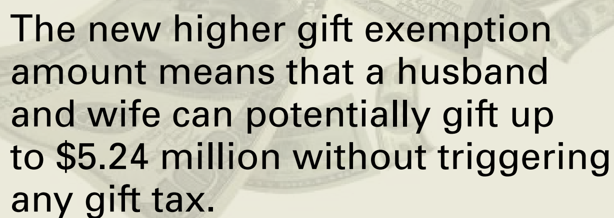
The new higher gift exemption amount means that a husband and wife can potentially gift up to $5.24 million without triggering **any** gift tax. And, using other techniques, taxpayers can gift appreciating assets and protect even a greater amount of assets from future estate taxes. In addition, during 2012, each taxpayer continues to have the ability to gift up to $13,000 per year without using up any of their gift exemption amount. Husbands and wives can split their gifts and give up to $26,000 to a single recipient without triggering any gift tax.

The ability to use portability is not automatic but must be elected. In other words, the executor of the first spouse decedent's estate must make an affirmative election to preserve the unused exempt amount on a timely filed estate tax return. Therefore, even if an estate tax return is not required because the first spouse to die does not have a taxable estate, it may be prudent to file an estate tax return for those spouses dying in 2012 in order to preserve that spouse's unused exemption for the second spouse.

Where are we headed?

Without some action by Congress, when the clock strikes midnight on December 31, 2012, the golden carriage that allows married couples to deliver over $10 million to their beneficiaries and heirs tax free will turn back into a pumpkin. On January 1, 2013, estate, gift and GST tax rates will all return to the amounts set by the 2001 Tax Act. Simply put, that means that the $5.12 million estate, gift and GST exemptions will disappear, the exemption amounts will return to just $1 million and portability vanishes too. Worse yet, the estate and gift tax rate will increase from 35% to 55% (or more for larger estates).

Adding to the confusion, the President has released 2013 revenue proposals that would vastly change the estate planning landscape if enacted. Virtually, all of the President's proposals are aimed at increasing federal revenue. First, the President has proposed a return to the unified 2009 estate tax and GST exclusion amounts of $3.5 million with a maximum estate, gift and GST rate of 45%. Further, the lifetime gift exemption amount would drop to just $1 million but portability would be made permanent.



The new higher gift exemption amount means that a husband and wife can potentially gift up to $5.24 million without triggering any gift tax.

Second, the President's proposal would eliminate valuation discounts in connection with transfers of interests in family-controlled entities like closely held corporations, limited liability companies and partnerships. These valuation discounts are currently used to reduce the value of current gifts while transferring assets that are anticipated to appreciate in value outside of the donor's estate. With such discounts currently ranging between 20-40%, the tax savings on transferred value can be substantial. Of even greater concern, the IRS has hinted that it might pass regulations immediately that would prohibit the use of such discounts.

Third, the President's proposal would eliminate the GST exemption after GST exempt trusts have been in existence for 90 years. In those states that have abolished the rule against perpetuties or that permit trusts beyond 90 years, such a proposal would eliminate some of the benefits of dynasty trust planning.

Fourth, the President's proposal would require a grantor of an intentionally defective grantor trust ("IDGT") to include in their estate the value of the trust. Currently, an IDGT is an irrevocable trust that allows the grantor to remove assets from the grantor's estate while allowing the grantor to continue to pay income tax on the trust's income. The payment of taxes by the grantor is not considered a gift and allows the grantor to further reduce their own taxable estate by using the grantor's assets to pay the taxes. The President's proposal would create estate tax inclusion for all grantor trusts and could eliminate the tax-favored status of asset sales to IDGTs.

Where do we want to be and how do we get there?

In this uncertain environment, existing estate plans need to be as flexible as possible. Presumably, everyone wants an estate plan that meets their tax and non-tax planning intentions. Generally, this means planning that reduces taxes while providing reasonable "no-strings" control over assets for spouses and future beneficiaries. Current plans need to be reviewed to consider the impact of the current and potential laws on tax formula funding clauses to make certain that credit shelter, marital and/or family trusts are funded in accordance with intentions and expectations. Formula clauses that were drafted when the exemption amounts were $3.5 million as in 2009, $1 million or less, could leave trusts under or over-funded.

Moreover, even for those clients with assets under $5 million, appropriate estate planning including the use of trusts remains a necessity to protect loved ones from potentially unnecessary taxes and estate administration expenses. This is especially the case if exemption amounts automatically revert to the $1 million level.

In conclusion, the current fog of our transfer tax system should not be used as a excuse to avoid planning all together. A proper estate plan includes more than just a will and a trust. Regardless of the taxable or non-taxable status of an estate, everyone should meet with their estate planner to discuss appropriate wills, trusts, living wills, durable powers of attorney for healthcare and the nomination of appropriate guardians. With appropriate planning and flexibility, plans can be developed now to fulfill your goals.

American Airlines:

Who's flying the plane?

American Airlines' Chapter 11 filing on November 29, 2011 may signal the reality that a formal insolvency proceeding is part of the airline industry business cycle. The U.S. airline industry has experienced substantial consolidation and many carriers have reorganized in Chapter 11. The U.S.'s largest carriers, United/Continental, Delta/Northwest, and American Airlines, each filed for Chapter 11 at least once. Southwest Airlines is the only major U.S. carrier that has not filed for Chapter 11 protection. Typically a primary motivator for an airline bankruptcy is to cut defined benefit pension plans ("Pension Plans") for employees and/or to reject or modify collective bargaining agreements. Although jet fuel spot prices have risen 110% from January 2001 to December 2006, and 133% from January 2007 to July 2008, there is little airlines can do to reduce cost of this essential commodity, other than pass along those price increases to the passengers in the form of various surcharges.

By David H. Conaway

In American Airlines' case, it has reported $4 billion of net operating losses in 2009 and 2010 (2011 numbers are not yet released). Moreover, citing an $800 million cost disadvantage to other U.S. carriers, American Airlines' stated goal is to reduce operating costs by $2 billion per year. Of that number, American Airlines seeks to save $1.25 billion by terminating its Pension Plans. It has four Pension Plans, one for pilots, flight attendants, agents, and ground crew, covering almost 130,000 employees and retirees. The Pension Benefit Guaranty Corporation ("PBGC") estimated that the combined assets in the Pension Plans are $8.3 billion as of American Airlines' filing date and the combined liabilities are $18.5 billion, leaving the Pension Plans "underfunded" by approximately $10.2 billion. By comparison the Chapter 11 "underfunding" for the Pension Plans of other major airlines was as follows:

United Airlines
$7.4 billion - 2005

U.S. Airways
$2.7 billion - 2003/05

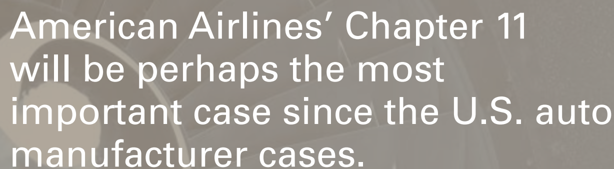
Delta Airlines - $1.6 billion - 2006

American Airlines' pension bust would be the largest in U.S. History.

The PBGC has publicly opposed American Airlines' proposed termination of its Pension Plans. The PBGC is a quasi-governmental U.S. agency (analogous to the FDIC) created to guaranty the benefits granted in Pension Plans to employee and retirees of U.S. corporations who sponsor such plans. In cases of underfunding, if a Pension Plan is terminated, the PBGC is obligated to honor most of the obligations owed under the Pension Plan. Unfortunately, the PBGC currently estimates its deficit, prior to American Airlines, at $23 billion. Ultimately, the PBGC is backed by the full faith and credit of the U.S. Government. A termination of American Airlines' Pension Plans would increase the PBGC deficit by 50%, a burden which may be eased by increasing the premiums on other Pension Plans, but which is ultimately borne by the American taxpayer. The PBGC has brought political pressure to bear in its effort to oppose terminations of the American Airlines' Pension Plans. Specifically, George Miller, a Democratic member of the U.S. House of Representatives from California, and ranking member of the House Committee on Education and the Workforce issued a public letter to Joshua Gotbaum, Chairman of the PBGC, to do everything in its power to avoid the pension plan termination by American Airlines. There has been historical perception that the PBGC has generally "rolled over" and accepted corporate Pension Plan terminations.

Clearly the stakes are high for American Airlines, the airline industry in general, and the U.S. government and the American taxpayer. This presages a legal battle over American Airlines' ability to terminate its Pension Plans, which will play out in the United States Bankruptcy Court. Under the Employee Retirement Income Security Act of 1974 (ERISA), an employer seeking reorganization in Chapter 11 bankruptcy may petition the bankruptcy court for termination of a Pension Plan. The debtor is required to show that unless the Pension Plan is terminated, it will be unable to pay all its debts pursuant to a reorganization plan and will be unable to continue in business outside the Chapter 11 reorganization process. However, if the termination would violate the terms and conditions of an existing collective bargaining agreement, a debtor seeking a distress termination may also need to obtain the bankruptcy court's approval to unilaterally reject or modify the collective bargaining agreement pursuant to section 1113 of the Bankruptcy Code. Section 1113 requires that the debtor make a proposal to the union "which provides for those necessary modifications in the employees benefits and protections that are necessary to permit the reorganization of the debtor and assures that all creditors, the debtor and all affected parties are treated fairly and equitably." If history repeats itself, American Airlines will likely be able to terminate most or all of its Pension Plans, thus reducing its financial obligations by $1.25 billion per year.

Assuming American Airlines is successful in its goals, what's next for American Airlines? On February 9, 2012, Reuters reported that American Airlines' creditors' committee wants a merger explored, contrary to American Airlines' management's goal to stay independent. The members of American Airlines' creditors' committee include the PBGC, American Airlines' labor unions, the banks representing American Airlines' bondholders and Boeing. Both Delta and US Airways have announced they have engaged financial advisors to explore acquisitions of or mergers with American Airlines. Many industry analysts believe a Delta merger is unlikely given potentially insurmountable antitrust hurdles and over-lapping U.S. east coast routes. Most analysts have not ruled out a US Airways combination but do not believe it would be the dream alliance such as the United and Continental combination created. However, US Airways has been a champion of industry consolidation and has managed to post a $447 million profit in 2010. With growing political pressure and creditor support for a merger, American Airlines may be forced to consolidate by combining with another airline.



Whether American Airlines is able to succeed in staying independent or forced to consolidate will again be played out in Bankruptcy Court and may hinge on who controls the bankruptcy process. A key component will be determining who may propose and file a plan of reorganization, which is the court-approved contract to pay creditors that allows a Chapter 11 debtor to emerge from bankruptcy protection. In Chapter 11, American Airlines retains the exclusive right to propose a plan of reorganization and to solicit votes in favor of such plan for a period of 120 days after filing to file a plan, and another 60 days to gain acceptance of its plan. In a case of the size and complexity of American Airlines, it is likely the Bankruptcy Court will exercise its discretion to extend that right to 18 months. Very often in Chapter 11 cases, creditors, through the officially appointed committee of creditors, will support extensions of such debtor's exclusivity provided the debtor is making progress. In this case, "progress" will be measured by reductions in operating costs and a satisfactory business strategy to successfully emerge from Chapter 11 and deliver value to creditors, perhaps through an acquisition or merger. We anticipate that the Bankruptcy Court will extend American Airlines' exclusivity until as late as September, 2013.

It is also likely that creditors including the bondholders, the PBGC, and vendors will own a significant stake in a reorganized American Airlines, or in the surviving entity in any American Airlines merger. This is because under the provisions of the U.S. Bankruptcy Code, the "absolute priority rule" prohibits any junior class of creditors from receiving value on account of its claims or interests unless and until all superior classes are satisfied in full. Clearly, the current American Airlines equity is "out of the money" and thus the new equity will be distributed in part to American Airlines' existing unsecured creditors on account of their debt claims.

American Airlines' Chapter 11 will be perhaps the most important case since the U.S. auto manufacturer cases. The PBGC is positioned to backstop American Airlines as "too big to fail" but the cost will be enormous … to American Airlines, to its creditors, to its employees and retirees, to the airline industry and ultimately to the American taxpayer. This chapter of American Airline's history will play out in 2012 and 2013. The future of the global airline industry will unfold over many years.

In an era of above $100 per barrel oil prices, exacerbated by continued unrest in the Middle-East, lagging economies in the U.S., EU and Asia, constricted lending conditions and potentially rising interest rates in global capital markets, U.S. and global carriers must find ways to gain operating efficiencies and maximize revenue opportunities. Many believe that growth in emerging markets will be critical to enhancing profitability. At some point, global consolidation, beyond current global "alliances," may need to play a role in the industry's future. However, many carriers are state-owned, and "open skies agreements" limit foreign investment to 25%, both hurdles to global consolidation. Perhaps American Airlines' Chapter 11 proceeding will spur a global debate about the future of the global airline industry.

Labor Law **Update**

Criminal Background Checks and Hiring

The Equal Employment Opportunity Commission ("EEOC") recently released guidance on the use of criminal records in hiring. While this guidance does not carry the same rule of law as a regulation, courts will consider the guidance as persuasive, and it will dictate the EEOC's investigations into discrimination charges. Accordingly, employers need to be aware of the guidance.

By Serena L. Lipski

Background

The EEOC's reasoning behind issuing this guidance is that employers' use of criminal background checks has a disparate impact on members of protected classes, meaning that they are more likely to be screened out based on criminal background checks. In cases where plaintiffs can demonstrate such a disparate impact, employers then must demonstrate that the practice in question—the criminal background check—is job related and consistent with business necessity.

The use of criminal background checks can also be discriminatory under a disparate treatment theory, which occurs where an employer screens out a member of a protected class based on the results of a criminal background check, but does not screen out similarly situated candidates based on similar results.

Targeted Screens Required

The EEOC's guidance, therefore, is aimed at preventing these types of discrimination. Employers are urged to develop a targeted screen that considers the following factors before using criminal background checks to exclude candidates:

- The nature and the gravity of the offense or conduct;
- The time that has passed since the offense or the conduct and/or the completion of the sentence; and
- The nature of the job held or sought.

Employers Must Follow Up With Individualized Assessments

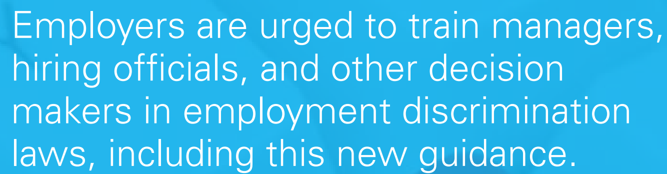
Even after candidates are excluded based on the targeted screen, the EEOC guidance requires the employer to perform an individualized assessment of each of the excluded candidates to further analyze whether the exclusion of that candidate based on his or her criminal history is consistent with business necessity and that the exclusion is job related.

To perform an individualized assessment, the EEOC guidance recommends that the employer consider the following information, including contacting the candidate to confirm the accuracy of the criminal history report or to provide additional information where necessary:

- The facts or circumstances surrounding the offense or conduct;
- The number of offenses for which the individual was convicted;
- Age at the time of conviction, or release from prison;
- Evidence that the individual performed the same type of work, post conviction, with the same or a different employer, with no known incidents of criminal conduct;
- The length and consistency of employment history before and after the offense or conduct;
- Rehabilitation efforts, e.g., education/training;
- Employment or character references and any other information regarding fitness for the particular position; and
- Whether the individual is bonded under a federal, state, or local bonding program.

Focus on Convictions and Not Arrests

The EEOC guidance cautions employers from considering arrest records in making employment decisions: "The fact of an arrest does not establish that criminal conduct has occurred, and an exclusion based on an arrest, in itself, is not job related and consistent with business necessity. However, an employer may make an employment decision based on the conduct underlying an arrest if the conduct makes the individual unfit for the position in question."



Best Practices

Employers are urged to train managers, hiring officials, and other decision makers in employment discrimination laws, including this new guidance. The EEOC's guidance provides additional "best practices" that employers should follow. First and foremost, employers should not have a blanket exclusion eliminating candidates for consideration based solely on the results of a criminal background check. Instead, employers should develop a new, narrowly tailored, written policy incorporating the targeted screen and individualized assessment as follows:

- Identify essential job requirements and the actual circumstances under which the jobs are performed.
- Determine the specific offenses that may demonstrate unfitness for performing such jobs.
  - Identify the criminal offenses based on all available evidence.
- Determine the duration of exclusions for criminal conduct based on all available evidence.
  - Include an individualized assessment.
- Record the justification for the policy and procedures.
- Note and keep a record of consultations and research considered in crafting the policy and procedures.

Exceptions

Note that this process does not apply to industries where a federal law requires criminal history checks, such as banking.

Next Steps

If you have any questions on what type of policy your business should have for conducting criminal history checks on applicants, please contact us.

Update to NLRB Posting Rule

By Serena L. Lipski

The D.C. Circuit Court of Appeals recently issued an injunction against the National Labor Relations Board ("NLRB") posting rule, meaning employers do not have to comply with the rule.

Last fall, the NLRB issued a final rule requiring employers to post a notice informing employees of their rights under the National Labor Relations Act ("NLRA"). Under the rule, both unionized and non-unionized employers were required to post the notice beginning April 30, 2012, several months later than the rule originally provided. An employer's failure to post the notice is an unfair labor practice under the rule, and results in the extension of the statute of limitations governing all unfair labor practices against the employer. Thanks to the injunction, however, the NLRB cannot enforce the rule.

The injunction stems from an action that the National Association of Manufacturers ("NAM") filed against the NLRB in the U.S. District Court for the District of Columbia. The NAM claims that the NLRB exceeded its authority under the NLRA in promulgating this new rule and is seeking an injunction against the implementation of the rule. The district court issued a ruling partially overturning the rule. The court upheld the posting requirement, but found that the rule's penalty provisions exceeded the NLRB's rulemaking authority. The NLRB has filed an appeal of the district court's order in the D.C. Circuit Court of Appeals, and the Court of Appeals issued the injunction pending appeal. The appeal is set for hearing in September.

Meanwhile, in a separate action, the U.S. and South Carolina Chambers of Commerce sued the NLRB in the District of South Carolina. The district judge in that case held that the NLRB overstepped its authority and invalidated the posting rule.

We will continue to watch these two cases closely. While employers are not currently required to comply with the posting rule, you should stay informed of any future developments.

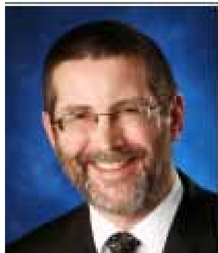
H-1B FISCAL YEAR 2013 CAP SEASON

U.S. businesses use the H-1B program to employ foreign workers in specialty occupations that require theoretical or technical expertise in specialized fields, such as scientists, engineers, or computer programmers. Each fiscal year, the U.S. Citizenship & Immigration Services ("USCIS") issues a limited number of new H-1B visas, which is known as the "H-1B visa cap." The cap does not apply to those individuals who have previously been granted H-1B status and who are seeking to change an employer or extend their stay, nor does it apply to certain employers who are exempt from the cap.

For Fiscal Year ("FY") 2013, which begins on October 1, 2012, the USCIS will issue 85,000 H-1B visas, 20,000 of which are set aside for those individuals who have obtained advanced degrees from U.S. colleges and universities.

The FY 2013 filing period opened on April 1, 2012. As of April 13, 2012, approximately 20,600 H-1B cap-subject petitions were receipted. Additionally, USCIS has receipted 9,700 H-1B petitions for aliens with advanced degrees. Given the increase in H-1B filings over the previous year, we anticipate that the H-1B cap will be reached by early summer. We thus advise that you file any anticipated H-1B visa petitions as early as possible. For assistance, please contact Mechelle Zarou (Toledo) at 800.444.6659 or Maria del Carmen Ramos (Tampa) at 800.677.7661.

Recent Cases Highlight Importance of Observing Requirements and Restrictions Imposed on S Corporations



By Thomas A. Cotter

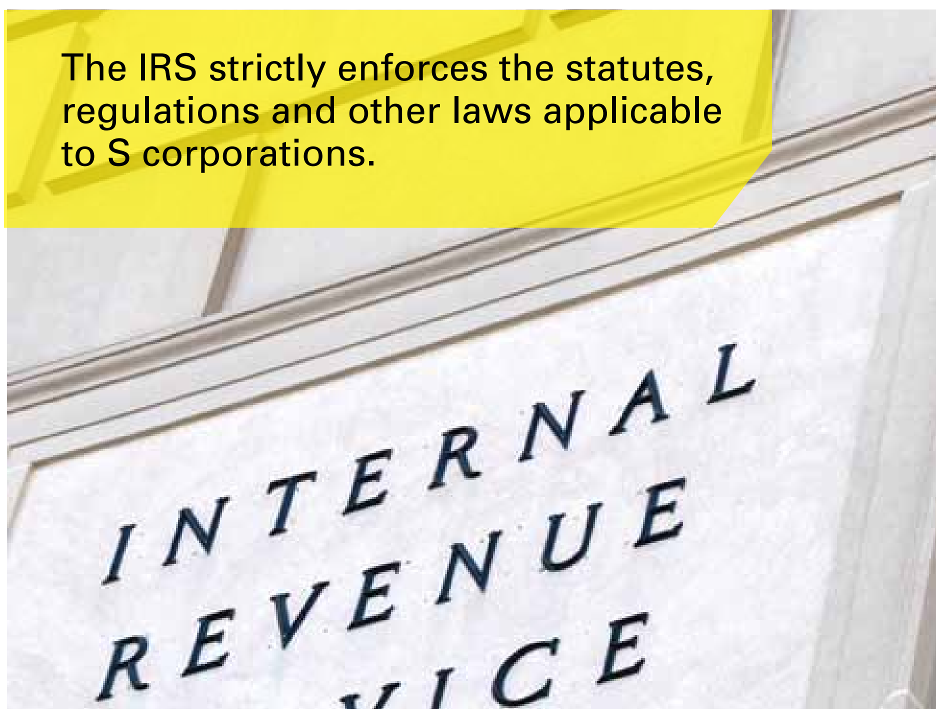
An S corporation is a popular form of business entity that is not itself subject to taxation. Instead, items of income, gain, loss and deduction "pass through" and are taxed directly to the corporation's shareholders. As a result dividend distributions from an S corporation to shareholders are not subject to tax. In contrast, a regular C corporation is itself subject to tax at the corporate level, and then dividend distributions from the corporation are subject to tax at the shareholder level.

Given the considerable benefit of being subject to only one level of taxation, the IRS strictly enforces the statutes, regulations and other laws applicable to S corporations. Two recent cases highlight this and illustrate that S corporation shareholders must exercise caution in structuring the ownership and operation of the corporation if tax benefits are to be preserved.

The first of these cases involved the issue of whether compensation paid to the shareholder/employees of an S corporation was reasonable. *David E. Watson, PC v. U.S.*, 668 F.3d. 1008 (8th Cir. 2012). Generally speaking, it is preferable to receive cash distributions from an S corporation as a shareholder dividend rather than as compensation for services, because the income supporting the dividend is not subject to employment taxes such as Social Security, Unemployment and Medicare Tax. As a result, shareholder/employees have an incentive to minimize compensation as employees and instead receive cash from the corporation in the form of dividends. Knowing this, when auditing an S corporation, the IRS will review compensation paid to shareholder/employees to ensure that the compensation is reasonable based on such factors as the qualifications and experience of the shareholder/employee, the nature and amount of the services performed for the corporation, the profitability of the corporation at issue and the amount of compensation paid to similarly situated employees who are not shareholders in a position of control over their employer-corporation. If the IRS finds that compensation paid is not reasonable, it has the power to recharacterize an appropriate amount of the dividends paid to a shareholder/employee as compensation for services and subject such amount to employment tax.

Watson involved just this type of situation. The taxpayer in question was an accountant and shareholder in a professional corporation with other accountants. The corporation had elected to be taxed as an S corporation. During 2002 and 2003, the corporation paid the taxpayer an annual salary of $24,000. The corporation paid the taxpayer $203,651 in dividends in 2002, and in 2003 it paid the taxpayer $175,470 in dividends. The IRS brought in one of its experts to review whether the compensation paid to the taxpayer for his services was reasonable under the circumstances. The expert reviewed several accountant compensation studies, relying in particular on one prepared by the American Institute of Certified Public Accountants. The latter survey indicated that an owner/employee would have received a total of compensation and return on investment of approximately $176,000 annually during the years in questions. The same survey indicated that a non-owner employee with similar experience would have earned approximately $70,000 in compensation. However, such an employee would on average have a billing rate 33% lower than a comparable owner-employee. Thus, the IRS expert increased the $70,000 compensation figure by 33% and arrived at a reasonable compensation figure for the taxpayer of $91,000 per year for 2002 and 2003, meaning an additional $67,044 was subject to employment tax.

The taxpayer argued that there is no statute, regulation or rule requiring that an employer pay a minimum amount of compensation for tax purposes. As such, what mattered was the intent of



the corporation in making payment to the taxpayer. Since it intended to pay $24,000 in compensation, that was the amount that should be subject to employment tax. The court disposed of this argument by citing to a considerable body of case law confirming that the Internal Revenue Code is intended to tax the substance, not the form of the transaction. It was necessary to dig deeper and tax the true nature of a transaction rather than allow self-serving labels to control the outcome. This meant determining what a similarly-situated employer would reasonably be expected to pay a similarly-situated employee in an arm's length situation. The court found the IRS expert's analysis of this question persuasive and ruled in favor of the IRS.

While what constitutes "reasonable compensation" can be subject to debate, the types of shareholders that are eligible to hold S corporation stock is not. The Internal Revenue Code limits eligible shareholders to individual U.S. citizens and residents, domestic estates, certain trusts and certain tax-exempt entities. Notwithstanding these relatively well-defined categories of eligible shareholders, the 9th Circuit Court of Appeals was recently called upon to determine whether a Roth IRA may hold S corporation stock. *Taproot Administrative Services, Inc. v. Commissioner*, ___ F.3d ____, Dkt. No. 10-70892 (9th Cir. March 21, 2012). This question is a critical one because if S corporation stock is transferred to an ineligible shareholder, the S corporation's status as such immediately terminates and it is taxed as a C corporation. Unfortunately, for the Roth IRA shareholder in *Taproot*, the court held that it was not eligible to hold S corporation stock and therefore the corporation was not entitled to S corporation status.

In *Taproot* the corporation in question was created in 2002 and all of its shares were from the outset held in a custodial Roth IRA. A Roth IRA is similar to a traditional IRA in that income and gains recognized by a Roth IRA are not subject to tax. However, unlike a traditional IRA, a Roth IRA is funded with after-tax contributions and distributions received from it are not subject to tax. The taxpayer who was the owner and beneficiary of the Roth IRA argued that it should qualify as an S corporation shareholder on one of two grounds: (1) it should be viewed as a "grantor" trust, which is one of the types of trusts that is an eligible S corporation shareholder under the Internal Revenue Code or (2) that as the individual beneficiary of a custodial account that also was a Roth IRA the taxpayer should be considered the owner of the shares for purposes of determining eligibility for S corporation status.

A "grantor" trust is a specific type of trust that is essentially disregarded for income tax purposes under the Internal Revenue Code. All of the assets held by a grantor trust are treated as if they are owned directly by the individual

grantor who created or transferred property to the trust. Thus a grantor trust is not recognized as a separate entity for income tax purposes. Given this, the Internal Revenue Code allows a grantor trust to hold S corporation stock so long as the individual who is treated as the owner of the trust assets is qualified to hold S corporation stock. The taxpayer argued that a Roth IRA should be given the same treatment and the taxpayer should be treated as owning the Roth IRA assets. Since the taxpayer qualified to hold S corporation stock, it followed that the corporation in question should be accorded S corporation status.

Nearly 20 years ago the IRS issued a Revenue Ruling that concluded a traditional IRA was not an eligible S corporation shareholder in the same manner as a grantor trust. The IRS' rationale was that the person who was treated as the owner of a grantor trust's assets was taxed directly on income from the S corporation just as if such person owned the stock. In contrast, the owner of a traditional IRA was not taxed on income from the IRA. It was a separate, tax-exempt entity for income tax purposes. Based on the same rationale, the IRS argued that a Roth IRA should not be eligible to hold S corporation shares on the premise that it was a grantor trust. The court agreed, noting that both traditional and Roth IRAs were expressly created by Internal Revenue Code provisions that gave them existence separate from their owners, while grantor trusts were expressly denied an existence separate from their owners.

Turning to the argument that the individual beneficiary of a custodial Roth IRA should be treated as the owner of the Roth IRA, the court noted that the Treasury Regulations did provide that a person for whom stock is held by a guardian, nominee, custodian or agent is considered to be the shareholder for S corporation purposes. However, the court again reasoned that intent of the regulation was to tax S corporation income to the true, beneficial owner of the shares. So long as the true beneficial owner was eligible to hold S corporation stock, this was consistent with the restrictions on ownership imposed by the Internal Revenue Code. According a custodial Roth IRA the same treatment, on the other hand, would frustrate such ownership restrictions in that S corporation income would be received by the Roth IRA tax free as an entity separate from its owner even thought it held its assets as a custodian for the owner.

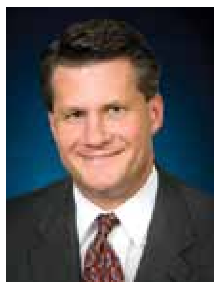
The most powerful evidence, however, against both of the taxpayer's arguments that the Roth IRA was eligible to hold S corporation shares lay in Congressional action on related matters over the past several years. The court noted that in 2004 Congress enacted a very narrowly crafted provision that allowed traditional and Roth IRAs to hold shares in S corporation banks without disturbing a bank's S corporation status. Prior to that, in 1999, Congress had directed the Comptroller General to conduct a study of possible revisions to the rules governing S corporations, including permitting shares to be held by IRAs. Congress would not have needed to pass the 2004 legislation, nor would it have directed an evaluation of whether IRAs should be allowed to own S corporation shares, if its intention had been to allow Roth IRAs to own S corporation shares in the first place. As such, the court concluded the Roth IRA was not an eligible S corporation shareholder and the corporation was therefore taxable as a C corporation from the date of its creation.

Both *Watson* and *Taproot* are examples of S corporation shareholders who did not take adequate care to follow the rules imposed on such corporations in light of their preferential tax treatment. They serve as a useful reminder that S corporation shareholders should consider and evaluate the tax consequences of various actions taken in managing the ownership and operation of the S corporation's business affairs.

Another Blow Struck to

Method Patents

On March 20, 2012, the United States Supreme Court in *Mayo Collaborative Services v. Prometheus Laboratories, Inc.* unanimously struck down a company's patents covering a method of determining the correct dosage of a specific class of drugs to give a patient. It is accepted jurisprudence that laws of nature, or natural phenomena, are not patentable. The Court in this case extended this rule to patents claiming a new way to apply natural laws, specifically the physical reactions of the human body to certain medications.



By J. Todd Timmerman

Method patents for medical diagnostic techniques and procedures have troubled both practitioners and research institutions fearing that by even routine medical practice they may unwittingly run afoul of another's patent rights. In this case, the Supreme Court expressed concern that patents might be granted in a way that would "disproportionately tie up the use of the underlying natural laws, inhibiting their use in the making of further discoveries." The patents at issue covered steps in a diagnostic process involving "well-understood, routine, conventional activity previously engaged in by researchers in the field." The Court reasoned that "[i]f a law of nature is not patentable, then neither is a process reciting a law of nature, unless that process has additional features that provide practical assurance that the process is more than a drafting effort designed to monopolize the law of nature itself." What is necessary is that the "other steps" with which the law of nature is combined must "transfor[m] the process into an inventive application of the formula." Merely adding insignificant steps to the diagnostic process, the Court found, is not "sufficient to transform the nature of the claim" beyond a mere recitation of a natural phenomenon.

This decision will surely energize the ongoing debate pitting those that maintain patents are critical to incentivizing the development of new medical diagnostic techniques and procedures against those that fear patenting technologies involving the application of natural laws will interfere with patient care and medical research. It is also likely to impact the analysis in other method patent cases involving natural laws, such as algorithms in software patents. A patent claiming software that applies an algorithm may very well be subject to the same heightened scrutiny applied by the Court in *Mayo*.

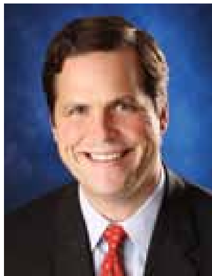
Deceptive Non-USPTO Solicitations

On February 24, 2012, the United States Patent and Trademark Office ("USPTO") issued a warning that private companies not associated with the USPTO often use information from the USPTO's databases to make deceptive trademark-related solicitations. According to the USPTO warning, USPTO has received complaints about solicitations for legal services, trademark monitoring services, recording of trademarks with U.S. Customs and Border Protection, and registering trademarks in a private registry. These companies may use names that resemble the USPTO name, including, for example, the terms "United States" or "U.S." According to the USPTO, some solicitations mimic the look of official government documents by emphasizing official government data like the USPTO application serial number, the registration number, the International Class(es), filing dates, and other information that is publicly available from USPTO records. Most require "fees" to be paid. The warning said that official correspondence from the USPTO will be from the "United States Patent and Trademark Office" in Alexandria, VA, and if by e-mail, specifically from the domain "@uspto.gov." The USPTO encourages recipients of misleading communications to contact the USPTO by emailing TMFeedback@uspto.gov.
If you have any question about suspicious communications, please feel free to contact a member of Shumaker's Intellectual Property Law Practice Group.

Amendments to Ohio General Corporation and Limited Liability Company Laws

In close consultation with the Ohio State Bar Association, the Ohio General Assembly made significant amendments to the Ohio General Corporation Law, Chapter 1701 of the Ohio Revised Code, which became effective May 4, 2012. Conforming amendments were also made to the Non-Profit Corporation Law in Chapter 1702. Key amendments to Chapter 1701 are as follows:

By Barbara G. Rivas



By Mark D. Wagoner, Jr.

• General Corporation Law and Nonprofit Corporation Law now provide that the right to indemnification or advancement of expenses arising under a provision of the articles of incorporation or the regulations of a corporation cannot be impaired or eliminated after the act or omission has occurred, unless the indemnification provision permits elimination or impairment after the act or omission has occurred.

In order to wind up affairs, a corporation that is dissolved voluntarily, has had its articles of incorporation canceled, or whose stated period of existence has expired must continue for five years after such dissolution, cancellation, or expiration unless extended by a court.

• The required number of directors has been reduced to no less than one, and that number may be changed at a shareholders meeting. In addition, directors must be natural persons at least 18 years of age.

• Dissenting shareholders are not always entitled to relief if an amendment to the articles of incorporation makes certain changes or if a corporation is authorized to dispose of all or substantially all of its assets.

• In certain circumstances, the following dissenting shareholders are not entitled to relief: (1) shareholders of a domestic corporation being consolidated or merged, (2) shareholders of the surviving corporation in a merger into a domestic corporation, and (3) shareholders of an acquiring corporation.

• Shareholders are now permitted notice before a vote on a proposal that relief is available as dissenting shareholders. A shareholder receiving such notice and electing to be a dissenting shareholder must deliver to the corporation prior to the vote a written demand for the fair cash value of the shares for which the dissenting shareholder seeks payment.

• The fair cash value of the shares of a dissenting shareholder does not include any premium associated with control of the corporation or any discount for lack of minority status or marketability. In addition, if the share is listed on a National Securities Exchange at certain times, the fair cash value must be the closing sale price on the Exchange as of the applicable date.

• A resolution for voluntary dissolution may now include the date on which the certificate of dissolution will be filed, the circumstances that will lead to the filing of the certificate, or an authorization for the officers or directors to abandon the proposed dissolution before the certificate has been filed.

• In contrast with prior law, which required the names and addresses of a corporation's directors and officers or incorporators on a certificate of dissolution, now a certificate must include the Internet address of each domain name held or maintained by or on behalf of the corporation.

• The requirements regarding evidence for filing a certificate of dissolution with the Secretary of State have been modified. In addition, the prior law on public notice requirements after the filing of a certificate of dissolution has been replaced.

• In order to wind up affairs, a corporation that is dissolved voluntarily, has had its articles of incorporation canceled, or whose stated period of existence has expired must continue for five years after such dissolution, cancellation, or expiration unless extended by a court.

• Dissolution of a corporation does not impair or eliminate any remedy available to or against the corporation or its directors, officers, or shareholders for any existing right, claim, or liability, as long as the action is brought within the required limitations period.

• The updates authorize the enforcement of any property right of a corporation that is discovered after its winding up, collection and division of assets discovered among persons entitled to those assets, or prosecution of proceedings or actions in the corporation's name.

• Section 1701.881 provides a procedure for a corporation that has given notice of its dissolution to reject any matured claim made by a claimant or to offer security to a claimant whose claim is unmatured, contingent, or conditional, including applying to the court with jurisdiction for a determination of the amount and form of insurance or other security for persons with contingent, conditional, or unmatured claims. The insurance or security must be reasonably likely to be sufficient to provide compensation for claims that have not been made known to the corporation or that have not arise but that, based on the facts known to the corporation, are likely to arise or to become known or such longer period of time as the directors or a court may determine, not to exceed ten years after the date of dissolution.

• The amendments enumerate the duties of dissolved corporations with respect to claims and offers of security.

• New Section 1701.883(B) provides that a shareholder who receives a distribution of assets from a dissolved corporation is not liable for any claim against the corporation in an amount in excess of the amount of the shareholder's pro rata share of the claim or the amount distributed to the shareholder, whichever is less. The aggregate liability of any shareholder for claims against a dissolved corporation shall not exceed the amount distributed to that stockholder after the dissolution. Pursuant to Section 1701.883(C), a shareholder may be liable for a claim against the corporation only if an action is commenced before five years after the date of dissolution or within the time limits otherwise required by Section 1701.881 or any other provision of law, whichever is less.

• The amendments modify prior law that authorized a court of common pleas to dissolve a corporation by judicial order.

Limited Liability Companies

At the same time, the Ohio General Assembly made amendments to Chapter 1705, governing limited liability companies ("LLCs"), which were also effective on May 4, 2012:

•An LLC is bound by its operating agreement whether or not it executes the agreement. In addition, an assignee of a membership interest in an LLC or a substitute member of the LLC is also bound by the operating agreement, regardless whether the assignee executes it.

• An LLC's operating agreement may not: (1) vary the rights and duties of the LLC set forth in Section 1705.04; (2) unreasonably restrict a member's right of access to the books and records of the LLC; (3) eliminate the duty of loyalty; (4) unreasonably reduce the duty of care; (5) eliminate the obligation of

good faith and fair dealing; (6) eliminate manager duties set forth in Section 1705.29, although certain refinements are permitted; (7) vary the requirement to wind up the LLC's business in cases specified in Section 1705.47; and (8) restrict the rights of third parties set forth in Chapter 1705.

• New Section 1705.161 clarifies that, when a member withdraws from an LLC, the member's right to participate in the management and conduct of the LLC terminates, as does the duty of loyalty under certain circumstances.

• Assignment of a membership interest does not give an assignee the full rights of a member, but only entitles the assignee to receive the distributions and allocations that the assignor would have been entitled to receive.

• The only remedy a creditor can seek to satisfy a judgment against the membership interest of a member or assignee is an order charging the membership interest. Such a creditor has no right to the LLC's property.

• New Section 1705.281 provides that the only fiduciary duties a member owes to an LLC and the other members are the duties of loyalty and the duty of care, which are defined therein.

• New Section 1705.282 provides that a manager who is also a member of an LLC, has been appointed in writing and has agreed in writing to serve as manager owes the duties of a manager. These duties are limited to acting in good faith and in a manner reasonably believed to be in or not opposed to the best interests of the LLC, and using the care of an ordinarily prudent person.

• Under the pre-May 4, 2012 statute, a member could petition the court of common pleas to dissolve the LLC if it was not reasonably practicable for the LLC to carry on business in conformity with its articles of organization and operating agreement. The amendments expand reasons for a dissolution and permit the matter to be submitted to a "tribunal," defined as "a court or, if provided in the operating agreement or otherwise agreed, an arbitrator, arbitration panel, or other tribunal." As amended, Section 1705.47 provides that, upon petition of a member, the tribunal may declare an LLC dissolved, and the LLC's business shall be wound up, upon the occurrence of any of the following: (1) an event makes it unlawful for all or substantially all of the LLC's business to be continued, unless cured within ninety days; or (2) a determination by the tribunal that any of the following is true: (a) the LLC's economic purpose is likely to be reasonably frustrated; (b) another member has engaged in conduct relating to the LLC's business that makes it not reasonably practicable to carry on the business with that member; (c) it is not otherwise reasonably practicable to carry on the LLC's business in conformity with its operating agreement.

welcome

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C. Victoria Knight
Tampa, Health

Elena A. Kohn
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Shumaker's Sarasota office was named "Best Law Firm" in the *Herald-Tribune* 2011 Readers' Choice Awards for the second year in a row. 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, Florida.

Shumaker, Loop & Kendrick, LLP received Metropolitan First-Tier rankings in the 2011 – 2012 *U.S. News Media Group* and *Best Lawyers®* rankings and was also selected by Martindale-Hubbell® as a 2012 "Top Ranked Law Firm."

Shumaker was recognized as a 2012 "Go-To" Law Firm and was featured in the ninth annual edition of *Corporate Counsel's* "In-House Law Departments at the Top 500 Companies."

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slknews

Tony Abate and Christopher Staine presented "The Emerging Dilemma: Surety's Obligations on Green Building Projects" at the Northeast Surety and Fidelity Claims Conference in September 2011, in Atlantic City.

Erin Aebel has been named Walk Chair of the American Diabetes Association's Step Out to Stop Diabetes Walk which will take place on November 10, 2012 at the University of South Florida Tampa Campus. In addition, Erin was named Vice Chair and Chair-Elect for the American Diabetes Association Tampa Bay Community Leadership Board. Erin presented a CLE webinar for the Florida Bar Health Law Section and participated in a panel discussion at Stetson University College of Law in March.

Jeni Belt was a presenter for the Toledo Bar Association Common Pleas Court seminar in November on "Practicing Law in a Time of Change: Current Technology and Practical Issues Affecting Lawyers in Lucas County Common Pleas Court" on the topic of "Social Networks--A Start on What you Need to Know."

Steve Berman has been appointed to the American Bankruptcy Institute Battleground West's Advisory Board and was a panelist at the 20th Annual Bankruptcy Battleground West in March in Los Angeles. Steve spoke at the 36th Annual Judge Alexander L. Paskay Seminar on Bankruptcy Law and Practice in March in Tampa.

Mike Born addressed the Air & Waste Management Association at its "All Ohio" meeting on April 25, 2012, on the topic of regulatory and enforcement initiatives under the federal and Ohio clean air acts. AWMA is a non partisan, non profit organization of environmental professionals and the "All Ohio" meeting features participants from all chapters within the state of Ohio.

Mike Briley has been appointed Secretary of the Antitrust Law Section of the Ohio State Bar Association and has been reappointed to another three-year term on the Board of Governors of the OSBA Antitrust Law Section. Mike will be teaching the antitrust law course at the University of Toledo College of Law every year in the future, commencing with the Spring Term in 2012. Mike will present a three-week lecture series at the London School of Economics in London in July of 2013 entitled: "The History and Influence of United States Antitrust Policy on Global Antitrust Enforcement Initiatives." Additionally, Mike presented a webcast for the American Bar Association Antitrust Law Section in November.

Doug Cherry presented "E-Discovery" as part of a seminar titled "Basic Discovery 2012" hosted by The Florida Bar CLE Committee in conjunction with the Young Lawyers Division of The Florida Bar in March. Doug was a panelist at the Gulf Coast Venture Forum Due Diligence Seminar in December and was a presenter at the Sarasota Manatee Area Manufacturers Association Dinner Meeting in October and spoke about Protecting IP in a Global Market.

Ron Christaldi was named Co-Chair of the Tampa Chamber of Commerce's Public Policy Committee. Ron has been elected to serve as chair of the Tampa City Council's Citizens Advisory Committee on the Economic Impact of Cultural Assets and has been elected to the Board of Directors of the Tampa Club.

Jason Collier made a presentation before the HFTP Florida Manasota Chapter in January and presented "The Principles of Hiring, Firing, and Performance Appraisals: Common Mistakes Managers Make" at Critical Care & Veterinary Specialists of Sarasota in November.

Jamie Colner is on the Board of the Ohio Chapter of ABOTA, the American Board of Trial Advocates. He is coordinating the annual ABOTA Masters of Trial seminar on September 7, 2012. The topic will be Direct and Cross-Examination of Expert Witnesses. He is also an active member of the Kairos Prison Ministry at Marion Correctional Institute and has served on its Advisory Council. Kairos is an ecumenical Christian ministry. Jamie continues to be involved in the ground breaking case involving Charter Schools in Ohio. The trial court ruled in our client's favor and held that for profit operators of the schools are public officials that must account for how the public monies are spent. That ruling is on appeal before the Franklin County Court of Appeals and should be decided this fall.

Jennifer Compton was elected to the Board of Girl's Inc. Jennifer will also Chair the Workforce Innovation and Talent Development Council for the Greater Sarasota Chamber of Commerce.

David Conaway was a panelist on "Creditor Participation Rights in Insolvency Proceedings" for the University College London, 6th Insolvency Research Conference, at the UCL Faculty of Laws in April. David

presented "Cross-Border Insolvency, Chapter 15, and Comparative Analysis of Foreign Countries Insolvency Laws" before the National Paper Packaging Credit Group in San Antonio in March, and also made a presentation to the National Steel Mill Credit Group in Atlanta, Georgia in November.

Dave Coyle was a presenter at the Advocates for Basic Legal Equality, Inc. (ABLE) "Access to Justice Awards Dinner" on April 30, 2012, and **Steve Rothschild** was the Co-Chair and MC of the event.

Tom Dillon was selected as a Fellow of the Litigation Counsel of America.

Julio Esquivel, Greg Yadley and Bill Swindle participated in a joint seminar entitled "Maximizing Returns in M&A Transactions" in Tampa in February.

Julio Esquivel spoke to the Association of Corporate Counsel-West Central Florida (ACC-WCFL) in November.

Tim Garding spoke at the Hillsborough County Bar Association Labor & Employment Luncheon in December on "Clones, Drones and Animatrons: GINA's Impact on the American Workplace One Year Later."

Jack Gillespie is active with the Board of Trustees of the Homeless Families Foundation.

Rachel Goodman was appointed to the Signage Committee of the Raymond James Gasparilla Festival of the Arts.

Bruce Gordon moderated a panel discussion on recent developments and hot topics for the 14th Annual All Children's Hospital Estate, Tax, Legal and Financial Planning Seminar held in February in St. Petersburg.

Bonnie Keith Green was a panelist at the Piedmont Construction and Design Symposium on "The New Regulatory Landscape," at Winston-Salem State University in October.

Dan Hansen has been elected to a three-year term on the Law Alumni Association Board of Directors for Case Western Reserve University School of Law. Dan was also a co-lecturer at a Lorman construction law seminar in February in Charlotte.

Victoria Knight was named to the Development Council of The Spring of Tampa Bay.

Richard Lewis gave a presentation to financial advisors and MetLife Customers entitled "The Essentials of Successful Estate Planning" at MetLife Insurance Company in Sarasota in November.

Greg Lodge was a Contributing Editor, *"How to Take A Case Before The NLRB"* (BNA, 2011).

Moses Luski was named to the Board of Directors of the Central Piedmont Community College Foundation. Moses will again be part of the Selection Committee for the Arts and Science Council Honors Program for Lifetime Achievement in the Arts. Moses was a featured speaker at Charlotte Country Day School in December and also spoke at the Hance Fine Arts Center on the Cuban artist Cundo Bermudez in conjunction with an exhibit of the artist's works.

Ernie Marquart has been appointed to the Board of Trustees of the Florida Hospital Wesley Chapel Foundation.

Brandy Milazzo presented a CLE webinar for the National Business Institute in April. She also presented "Outsourcing and Offshoring," at a Mecklenburg County Bar CLE Seminar in February, and to the National Business Institute in December.

Christina Nethero named to the Development Council of The Spring of Tampa Bay.

Mike Pitchford has been certified by the Florida Bar as a Program Arbitrator for the Bar's Grievance Mediation and Fee Arbitration Program.

Tom Pletz was a speaker the Shumaker, Loop & Kendrick Student Lounge at the University of Toledo College of Law for the Student Mentoring Kick-Off Program on the subject of "The Mentoring Relationship" in November.

Dick Rogovin has been elected Chairman of the Board of Directors of the Edison Welding Institute of Columbus, Ohio (EWI). Dick also serves as Chairman of EWI's Strategic Growth Committee.

Brian Schaffnit has been elected to the Board of Directors of the Tampa Bay Seminole Club.

Mike Snyder became a member of the Development Board for Nationwide Children's Hospital in Columbus, Ohio. In the Fall of 2011, Mike attended the Air & Waste Management Association's Clean Air Act New Source Review Conference in Seattle, Washington and spoke to a group of refining industry environmental managers and attorneys on topics that included objections to Title V operating permits and U.S. EPA's aggregation policy.

Greg Yadley spoke at the American Bar Association's Business Law Section Spring Meeting in Las Vegas in March. Greg was principal Co-Chair of the 30th Annual Federal Securities Institute in Miami Beach in February. In addition to his presentation on new securities regulations affecting smaller public companies, Greg participated in a Legal Ethics panel.

Mechelle Zarou is a Master in The Morrison R. Waite American Inns of Court of Toledo.

A Newsletter from Shumaker, Loop & Kendrick, LLP

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