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RETAIL INDUSTRY

YEAR IN REVIEW

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DEAR CLIENTS AND FRIENDS,

It has been another extraordinary and challenging year for the retail industry. New and exciting technologies such as blockchain are enabling retailers to improve their customers' experiences, while threats such as ransomware and increasing class action lawsuits related to deceptive pricing and the use of gift cards remain as challenging as ever. Merger and acquisition activity is still on the rise in the US, the election of President Donald Trump has resulted in many significant changes at the NLRB that have impacted retail employers, and the Federal Trade Commission (FTC) is getting closer to enforcing privacy regulations against marketers of kid-directed connected devices.

Our *2017 Retail Industry Year in Review* provides a comprehensive overview of developments and issues that retailers faced in the past year, as well as a glimpse into what they can expect in 2018. Hunton & Williams LLP's retail team remains at the forefront of these issues and achieved numerous successes on behalf of our retail clients in the past year. Recent highlights include:

- We represented a major retail chain in connection with its acquisition of a leading distributor of maintenance, repair and operations products to the multifamily housing industry, for a total transaction value of \$512 million.
- We scored a significant victory for a food manufacturer by recovering the maximum amount of insurance available for the company's extensive losses following a November 2016 product recall. We were able to secure the full amount of coverage from each insurer.
- We won a major victory for a products manufacturer when the court denied the plaintiffs' request to file a renewed motion for class certification of a nationwide class comprising all owners of branded microwave ovens manufactured since 2000, plus numerous state-wide classes. The court denied certification of any of the proposed classes, closing the door on what would have been one of the largest consumer-product class actions ever.
- We advised numerous major retailers on a variety of privacy, cybersecurity, data security and outsourcing matters.

We were also pleased to be recognized again by *Chambers USA* as one of the top retail groups in the country, which reflects our efforts and accomplishments on behalf of our retail clients across practices and our deep understanding of issues facing the retail industry.

I hope that our *2017 Retail Industry Year in Review* will be a valuable guide to the unique challenges and developments that faced the retail industry this past year. I am certain you will benefit from the analyses and reports in the pages that follow.

Wally Martinez
Managing Partner

BLOCKCHAIN'S GROWING IMPACT ON THE RETAIL SECTOR

Scott Kimpel and Mayme Beth Donohue

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This was a breakout year for blockchain, the technology providing the platform for cryptocurrencies and the emerging market for initial coin offerings (ICOs) and token sales. With Bitcoin capturing headlines because of its soaring price, blockchain's impact is often misunderstood as narrowly impacting the financial sector. In fact, the retail sector is among the early adopters of this disruptive technology and retailers are actively implementing blockchain solutions to improve inefficiencies and enhance consumer experiences. Retail and consumer products companies can no longer afford to ignore blockchain as a passing trend; rather, blockchain should be thought of as a potentially valuable tool.

Blockchain 101

Blockchain is a technology that allows for the immediate and secure transfer of assets on a distributed ledger that records and settles transactions through the participation and verification of the participants in the blockchain. Each participant in a blockchain has an identical record of all the transactions related to the assets being traded within that blockchain. When a new transaction is initiated, rather than rely on a central intermediary (like a bank or trustee) to validate and settle the transaction, each participant's ledger is matched and the consensus of the group authorizes the transaction. After each new transaction, every participant's ledger is updated to reflect the new ownership of the assets within the blockchain.

Blockchain is disruptive because it has the potential to lower the cost of transactions and make transactions more secure. By eliminating the need for central intermediaries

to settle transactions, blockchain reduces the cost of transactions as third-party fees are erased from the process. Additionally, because the record of each transaction on a blockchain is maintained in so many identical copies among the participants, any security breach that manipulates any one record will not have an impact. In order to manipulate the history of transactions in a blockchain, enough copies of the distributed ledger would need to be manipulated in the exact same way to create a consensus around the manipulated record.

Blockchain stands to revolutionize not only the process of doing business in the retail sector, but also the fundamental structure and corporate governance of retail companies.

Attempting to understand what exactly blockchain is, is far less important than understanding what blockchain can do. Taking the internet as an example, understanding how a technology works is not a prerequisite for the widespread implementation of that technology. In fact, an analogy has been made that blockchain will do for the transaction of assets what the internet did for communications.

Supply Chain and Inventory Management

Leading retail companies are rushing to implement blockchain solutions for supply chain and inventory management. For example, in partnership with IBM, Walmart is developing a blockchain solution that tracks its inventory

from source to consumer with an eye toward product safety. By creating a digital record of each product and maintaining a record of the transfer of the products on a distributed ledger, the source of a product can be verified almost instantaneously. In marketing this blockchain, Walmart has indicated that the time it takes to track the source of a contaminated food product has decreased from roughly a week to 2.2 seconds. Similarly, IBM is also working on an international supply chain solution in partnership with shipping giant Maersk. This blockchain is being tested with retailers and has the potential to eliminate some of the costly inefficiencies of international trade, particularly related to the regulatory and paperwork burdens of shipping across borders.

Consumer Trust

By tracking the source of a product, blockchain is also being used to enhance consumer trust by verifying the authenticity of rare and expensive products. Diamonds are being tracked on Everledger, a blockchain that verifies both the authenticity of a diamond and its status as conflict free. The authenticity of rare art, expensive wines and even Sashimi-grade tuna are being verified on blockchains and enhancing a consumer's trust in the value of an asset. Retailers that implement blockchain to verify the authenticity of their products may begin to see a competitive advantage in the market.

Consumer Rewards

Underutilized and administratively burdensome consumer loyalty programs are missing opportunities to enhance consumers' relationships and loyalty to a brand. Companies like loyyal are building blockchain solutions that address the reasons consumers abandon loyalty programs, while simultaneously easing the administrative burdens associated with running a loyalty program. Loyalty reward points are already a form of digital currency, so the evolution of issuing and redeeming loyalty reward points on a blockchain is a natural application of the technology. By maintaining loyalty programs on a blockchain, the frictions involved in earning and redeeming rewards will ease and companies can better track consumers' behaviors as they earn and redeem their rewards. By enhancing the experience

of consumer reward programs, companies can enhance their brand loyalty and take advantage of the additional data gathered through the programs.

Blockchain's Broader Impact

The retail sector will also be impacted by the broader impact blockchain is having, and will continue to have, on securities offerings, securities trading and corporate governance. Major players in the financial industry, including the Nasdaq, the DTC and major banks, are all working toward the digitization of securities on blockchain. This transition will allow for faster trading and more accurate and less expensive recordkeeping for trades. In addition, corporate governance is also being impacted by blockchain. This year, Delaware amended its corporate code to affirmatively allow the use of blockchain technology to create and maintain a corporation's stock ledger and to communicate electronically with stockholders. These changes open up the possibility of issuing stock and distributing stockholder communications on a blockchain.

Blockchain stands to revolutionize not only the process of doing business in the retail sector, but also the fundamental structure and corporate governance of retail companies. Investment in blockchain technology is growing rapidly, and the retail sector is among the first industries to experience the practical applications of this new technology. Blockchain has the potential to become a necessary, rather than novel, tool and the retail sector is already seeing the impact of its implementation.



THE NLRB ENDS 2017 WITH A BANG

Ronald Meisburg and Robert Dumbacher

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When President Trump was inaugurated in January 2017, he was given the opportunity to appoint a new majority of National Labor Relations Board (the Board) members and the Board's General Counsel. By the end of the year, President Trump's appointments were confirmed by the Senate, resulting in Republican control of the Board for the first time in a decade. Immediately thereafter, the Board began taking concrete steps to address changes desired by the business community. Indeed, 2017 ended with a bang when the Board issued major decisions of particular importance to the retail industry. We summarize key changes below.

Overruling the Relaxed Joint Employer Test

The new Board majority overruled the relaxed joint employer test announced two years ago in *Browning Ferris Industries of California, Inc.*, 362 NLRB No. 186 (2015). In *Browning-Ferris*, the Board departed from decades of settled law and announced that it would find a joint employer relationship based on (1) *indirect conduct* by one company affecting the terms and conditions of employment of an unrelated company's employees; and (2) *retained but unexercised control* contained in service contracts, franchise agreements and the like, between otherwise unrelated companies.

This new joint employer test was especially troubling for the retail industry. It was particularly threatening to franchising, which is an important retail business model. Further, retail establishments routinely rely on myriad other business relationships to supply shipping, warehousing, food service, specialty product marketing, technology and other aspects of the retail enterprise. All these relationships could, to one degree or another, be susceptible to a joint employer finding.

On December 14, the Board returned the joint employer test to the one existing for decades before: (1) joint employer status would not be found in the absence of *direct and immediate control* exercised over another employer's employees; and (2) even then, joint employer status would not be found where such control was *limited and routine and not accompanied by any other normal indicia of employment*, such as the ability to hire, fire or discipline. *Hy-Brand Industrial Contractors, LTD*, 365 NLRB No. 156 (2017).

In *Hy-Brand*, the Board announced that the restored joint employer test will be applied to pending cases. This means that the pending high-profile *McDonald's* franchisee joint employer cases are subject to the Board's ruling. It remains to be seen how the restored test will play out in those and other pending cases, and it is something to keep an eye on in 2018.

Overruling "Micro" Units

In *Specialty Healthcare and Rehabilitation Center*, 357 NLRB 934 (2011), the Board announced a controversial new test for the determination of bargaining units, resulting in so-called "micro" bargaining units.

Before *Specialty Healthcare*, bargaining units in the retail industry were generally "wall to wall," meaning all covered employees in an entire store were made part of a single bargaining unit for union representation and collective bargaining. Occasionally, there would also be multistore units.

In *Specialty Healthcare*, the Board instituted a new test allowing a union to successfully petition for a smaller "identifiable group" of employees. If those in the identifiable group shared a community of interest among themselves (for

instance, common job duties, hours, supervision and work locations), a union election would be held among that group. The most dramatic examples of micro units in the retail industry were a women’s shoe department’s and a cosmetics department’s being carved out of large retail department stores as standalone “micro” units. Under the *Specialty Healthcare* test, the fact that the rest of the employees in the store shared a community of interest with the employees in the union’s requested unit was irrelevant, unless they shared an “overwhelming community of interest.”

Specialty Healthcare created several negative ramifications for retail employers. First, the “overwhelming community of interest” standard for adding employees to a union’s proposed unit proved virtually impossible to meet. Second, a store or warehouse could become balkanized with different bargaining units and unions representing various departments. Third, because each balkanized unit could have its own contract and union representative, facilities could become very difficult to manage. Finally, implementing storewide policies would require bargaining with each separate union, with yet more carve-outs for nonrepresented groups of employees.

Fortunately, the Board overruled *Specialty Healthcare* in *PCC Structurals, Inc.*, 365 NLRB No. 160 (2017), and returned to the pre-*Specialty Healthcare* rules. The Board will now not only look at whether the group proposed by the union

shares a community of interest, but also will ask whether the community of interest factors apply to the other employees at the facility.

The Board’s return to pre-*Specialty Healthcare* standards will promote efficiency because all employees who share a community of interest will be in the unit.

Action on “Quickly” Election Rules

The Obama-era Board engaged in a controversial revision of the election rules, adopting the so-called “quickly election rules” that became effective in April 2015. Those rules impose undue burdens on employers, who are required to respond to an election petition within seven days of its filing and provide the union with a list of employees in the unit (including their telephone numbers and personal email addresses) in only two days following an order directing an election or an election agreement. Further, employers are prohibited in nearly all cases from challenging at a hearing the status of persons the union has chosen to include in the petitioned-for unit (e.g., the supervisory status of particular employees).

These artificial deadlines and limitations on what may be contested at a hearing have cut the time between the filing of a petition and the election from a median of 38 days before the new rules to a median of 23 days.

We submit this was the real goal of the Obama Board’s quickly election rules—to shorten the time that an employer



has to campaign and provide information countering the union's one-sided messaging. This is a great disadvantage to employers (and the employees), because unions have unlimited time to plan their organizing strategy and engage in organizing before ever filing an election petition.

Retail employers are especially hit hard because a large percentage of employees are on the retail sales floor. Educating the workforce on the realities of unionization is a challenge even under a more traditional 35- to 40-day election period. Further, unlike a factory or warehouse, it is difficult, if not impossible, for retail supervisors to "spread the word" as part of the ordinary back and forth conversations throughout the workday, because of the interference with customer service.

On December 12, 2017, signaling its intent to revisit the "quicky" election rules, the new Board majority published a Request for Information, 82 FR 58783-01, in which it requested that interested persons provide the Board with their views on whether the quicky election rules should be retained or revised in whole or in part. The Board will receive submissions from interested parties until February 12, 2018, and we encourage interested employers to submit their views on this important issue.

Revising Work Rules Test

On December 14, the Board issued its decision revising the test used to evaluate the validity of employer work rules. In *The Boeing Company*, 365 NLRB No. 154 (2017), the Board overruled its "reasonably construe" standard for evaluating employer work rules.

The "reasonably construe" standard provided that a work rule would be deemed unlawful if employees would reasonably construe facially neutral rules to prohibit protected activity.

Unfortunately, this standard transmogrified into one that proved extremely difficult to apply in practice, and produced results that were confusing, inconsistent and difficult to harmonize with one another.

Further, under this test dozens of commonsense rules were invalidated, such as rules that simply required employees to treat one another with respect. This led to NLRB regions routinely turning unfair labor practice charges into cases about the validity of the employer's handbook, even when the handbook was unconnected to the alleged underlying conduct at issue.

In order to eliminate these shortcomings, the Board in *Boeing* announced a new standard in which it will no longer apply the "reasonably construe" test but rather balance two interests: the nature and extent of a rule's impact on NLRA rights, and an employer's legitimate justifications for the rule.

Although it remains to be seen, we are hopeful that this new test will result in less fishing expeditions, more predictability in outcome and the upholding of commonsense employer rules.

* * * * *

All these developments are welcome news to retailers, but the situation is dynamic. The term of Republican Chairman Philip Miscimarra expired on December 16, 2017. This leaves the Board in a 2-2 deadlock until a new Board member is nominated by President Trump and confirmed by the Senate. This process could drag on through the first quarter of 2018, and perhaps beyond. In the absence of a recess appointment, it is unlikely that any major changes in the law can be made by the Board until a fifth member is nominated and confirmed.

BACK TO THE FUTURE: ANTITRUST MERGER ENFORCEMENT IN THE TRUMP ADMINISTRATION

Amanda Wait and Andrew Eklund

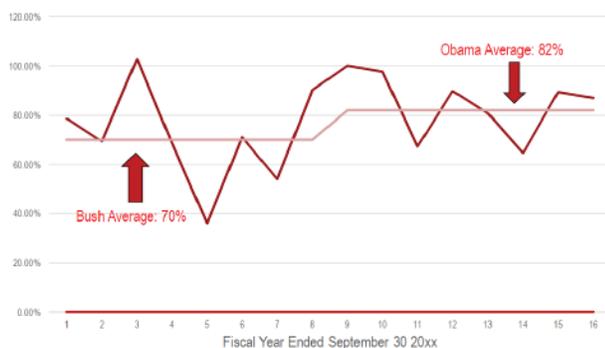
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Early indications from the Trump administration suggest a merger review environment for retail and consumer products deals that may be more favorable than we saw during the Obama administration years.

In 2008, then-candidate Barack Obama pledged to “reinvigorate” antitrust enforcement after perceived lax enforcement during the George W. Bush administration. As a result, from 2008 until 2016, antitrust merger investigations, on average, took longer and were more onerous, and more deals were challenged. For example, a merger that was subject to a Second Request was 12 percent more likely to be challenged under the Obama administration than under the prior Bush administration.

Merger Challenges as a Percentage of Second Requests



Source: Fed. Trade Comm'n & US Dep't of Justice, Antitrust Division, Hart-Scott-Rodino Annual Reports, FY2001-FY2016, available at <https://www.ftc.gov/policy/reports>
policy-reports/annual-competition-reports.

Eleven months into the Trump administration, there have been few public pronouncements about this administration's intended treatment of merger review by the two federal antitrust agencies—the Federal Trade Commission and the Antitrust Division of the US Department of Justice. However, key political appointments and recent merger enforcement decisions, including those in the retail and consumer products space, suggest that this administration may dial back some of the Obama administration's “reinvigorated” merger enforcement.

The theme for the Trump administration's antitrust appointments appears to be “Back to the Future.” Many of the selected individuals held leadership positions at the antitrust agencies during the Bush administration. For example, at the Antitrust Division, the recently confirmed assistant attorney general, Makan Delrahim, and four of his six deputies all served in key antitrust positions under President Bush. A few blocks down Pennsylvania Avenue at the FTC, a permanent chair has yet to be nominated by President Trump but the president has indicated an intention to nominate Joe Simons, who formerly served as the director of the Bureau of Competition at the FTC under President Bush. Several key staff positions have also been filled at both agencies by former enforcers from the Bush administration.

Current antitrust officials appear to signal a return to a more favorable merger review environment for retail and consumer products deals. The president's intended nominee to chair the FTC has been a vocal critic of some of the analyses used by the Obama administration to block retail deals involving supermarkets and other retailers.

Moreover, both the FTC and the Antitrust Division are implementing changes to ensure that merger reviews are shorter and less expensive under this administration. In April 2017, the FTC issued a statement detailing process reforms under which the FTC would “streamline demands for information in investigations to eliminate unnecessary costs to companies and individuals who receive them.”¹ Similarly, a senior DOJ official stated that “[t]he Antitrust Division . . . wants to reverse the trend by increasing the speed and reducing the burden of merger reviews.”²

The few retail and consumer products deals reviewed in 2017 seem to show early signs of these expected trends.

- In 2017, many retail and consumer products deals were cleared without significant review, including Michael Kors’ acquisition of the Jimmy Choo shoes company, Church & Dwight’s acquisition of Water Pik and Coach’s acquisition of Kate Spade.
- Others received significant review, but were ultimately cleared without divestitures or other remedies, such as Bass Pro Shops’ acquisition of Cabela’s and Amazon’s acquisition of Whole Foods Market.

Key takeaways from these matters include:

- Local markets still matter in brick-and-mortar retailer transactions. In Alimentation Couche-Tard/Jet Prep, Bass Pro Shops/Cabela’s, and Walgreens/Rite Aid, the FTC focused on local area geographic overlaps as a significant part of its investigation and required divestitures in local markets that it believed would face likely price increases from the combinations.
- But online shopping matters too. The role of online shopping likely played a significant role in the FTC’s reviews of both Bass Pro Shops/Cabela’s and Amazon/Whole Foods. Looking forward, we expect online

shopping to play an increasing role in the antitrust review of retail and consumer products mergers.

- The FTC will carefully consider impacts of a deal on the supply chain. In Danone/WhiteWave, the Antitrust Division raised the prospect that the combined company could exercise market power over suppliers of raw organic milk, a key input into the production of organic yogurt and other dairy products.

We describe highlights of several notable retail and consumer products deals below.

Alimentation Couche-Tard/Jet Pep: In August 2017, Alimentation Couche-Tard (owner of Circle K and other convenience store brands) announced its intention to acquire over 100 Jet Pep retail sites, in addition to a fuel terminal and other assets. Due to concerns over lack of competition in three Alabama towns, the FTC required ACT to divest one convenience store in each of the three towns of concern. The settlement was announced in late November, with ACT acquiring a total of 120 convenience store locations.

Amazon/Whole Foods: In June, online retailer Amazon announced that it intended to acquire Whole Foods for \$13.7 billion. The deal closed on August 28. On August 23, 2017, the FTC’s Bureau of Competition issued a short statement that read, in its entirety: “The FTC conducted an investigation of this proposed acquisition to determine whether it substantially lessened competition under Section 7 of the Clayton Act, or constituted an unfair method of competition under Section 5 of the FTC Act. Based on our investigation we have decided not to pursue this matter further. Of course, the FTC always has the ability to investigate anticompetitive conduct should such action be warranted.”

Bass Pro Shop/Cabela’s: The two retailers of outdoor lifestyle products originally announced their intent to merge in a deal worth \$5.5 billion in October 2016. The parties pulled and refiled their HSR filings to address concerns raised by the FTC, but reported receiving Second Requests at the end of December 2016. The parties announced a new agreement in April 2017 revising the value of the transaction. Further, Cabela’s announced it would divest its wholly owned

¹ Fed. Trade Comm’n, Press Release, Process Reform Initiatives Are Already Underway at the Federal Trade Commission, April 17, 2017, at <https://www.ftc.gov/news-events/press-releases/2017/04/process-reform-initiatives-are-already-underway-federal-trade>.

² Don Kempf, Deputy Assistant Attorney General, Antitrust Division, US Dep’t of Justice, Remarks at the ABA Fall Forum, Nov. 16, 2017, at <https://www.justice.gov/opa/speech/deputy-assistant-attorney-general-donald-g-kempf-jr-delivers-remarks-american-bar>.



subsidiary bank to Synovus Financial Corp., and Capital One would purchase the Cabela's credit card program. The final acquisition price was reportedly about \$4 billion, or \$1.5 billion less than originally contemplated by the parties. This revised acquisition structure appears to have allayed any concerns the FTC had, as there was no statement from the agency regarding the final transaction.

Danone/WhiteWave: Danone announced in July 2016 its intention to acquire organic yogurt producer WhiteWave. After a lengthy investigation, the \$12.5 billion acquisition was allowed to go through on the condition that Danone divest its Stonyfield Farm business. According to the DOJ, without the divestiture, the combined company would have had unfair buying power in the market for raw organic milk. Danone sold Stonyfield Farm to Lactalis for \$875 million, and closed the WhiteWave transaction in April 2017.

Sherwin-Williams/Valspar: Sherwin-Williams completed its acquisition of Valspar in June 2017. After announcing their proposed deal in March 2016, the two paint and coating manufacturing companies announced that they received Second Requests in May 2016. The value of the required divestiture package may have been a sticking point between the merging parties and the FTC. According to the merger agreement, if the value of the divestiture package exceeded \$650 million, then the purchase price for Valspar would have

dropped from \$113 per share to \$105 per share. Ultimately, the parties agreed to divest Valspar's North American Industrial Wood Coatings business to Axalta Coating Systems, for less than the \$650 million threshold contemplated in the merger agreement, thus maintaining the \$113/share purchase price. This merger clause limiting divestitures shows one way that parties can adapt to the increased scrutiny of the antitrust regulators and provide for some level of flexibility in negotiating a resolution.

Walgreens/Rite-Aid: After two years of trying to acquire Rite-Aid, Walgreens managed to buy less than half of Rite-Aid's locations. Walgreens originally announced that it would acquire all of Rite-Aid's 4,600 stores for \$17.2 billion in October 2015, but years of scrutiny caused Walgreens to set its sights significantly lower. After a yearlong Second Request review, Walgreens and Rite-Aid announced an amended agreement in January 2017 and offered to divest 865 locations to Fred's, Inc. That revised deal structure was still too much for the FTC, so Walgreens proposed to acquire only 2,186 Rite-Aid locations in June 2017 for \$5.175 billion. When the deal finally cleared in September, Walgreens ended up paying \$4.4 billion for 1,932 stores, and Walgreens announced in October that it will be closing about 600 stores (mostly Rite-Aids) in early 2018 due to overlapping geographies with other Walgreens-owned locations.

GIFT CARD AND DISCOUNT VOUCHER PROGRAMS CAN LEAVE RETAILERS VULNERABLE TO CLASS ACTIONS

Thomas Waskom and Elizabeth Reese

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The most innovative retailers constantly look for new ways to market their products and services. But in doing so, they should be aware that those efforts are subject to an increasingly complex web of federal and state laws regulating gift card practices. These laws can apply even where companies are not issuing traditional gift cards. New laws governing advertising, redemption and expiration of gift cards, discount vouchers and similar products have been on the rise in recent years, and retailers doing business in multiple states—including online retailers—have been forced to defend their practices in class actions filed in courts across the country.

Earlier this year, Sears settled class action claims brought in California state court in *Saunders v. Sears Holdings Management Corporation*, No. 17-cv-000034 (Calif. Super. Ct., Napa Cnty., 2017), in which the plaintiffs claimed that Sears failed to redeem store gift cards with balances under \$10 for cash at the consumer's request and as required by California law. As part of the settlement agreement, Sears agreed to provide claimants with new gift cards, to overhaul its in-store procedures to include training requirements for employees and to post notices regarding California's gift card law both in its stores and on its websites.

This is not to say that these cases are a new phenomenon. On the contrary, *Saunders* is just the latest iteration of an ongoing trend. In *Stern v. Sunoco, Inc., et al.*, No. 2:14-cv-04061 (E.D. Pa. 2014), Sunoco faced allegations that it had engaged in deceptive trade practices by advertising that its gift cards could be used at Sunoco stations "just like cash." The putative class of consumers claimed that—unbeknownst to them—when they used gift cards to make purchases, Sunoco, which offers a discount on gasoline purchases for customers using cash, charged them the higher, undiscounted price charged to customers using debit or credit cards.

Brick-and-mortar retailers issuing traditional gift cards are not the only companies at risk of class action litigation. Companies who have broken into the retail sector using nontraditional business models have also been forced to defend their practices against classwide allegations in recent years. In 2016, a federal court granted final approval to an \$8.5 million settlement in *In re Groupon Marketing and Sales Practices Litigation*, Case No. 3:11-md-02238, a multidistrict litigation action in which the plaintiffs claimed that Groupon's discounted vouchers for third-party products and services were subject to laws governing the sale and use of gift cards,

The framework governing the advertising, sale and redemption of gift cards and related product marketing practices is complicated, but failure to bring marketing practices into compliance exposes companies to significant risk, with respect to both financial costs and consumer goodwill.

rendering its expiration date policy illegal. This year, Audible was hit with a consumer class action in *McKee v. Audible, Inc., et al.*, No. 2:17-cv-01941 (C.D. Cal. 2017), claiming that its model of allowing subscribers to earn “credits” redeemable for audiobooks through Audible’s service concealed what the putative class called an “illegal gift card scheme” because Audible allegedly allowed the credits to expire. And in June 2017, SoulCycle agreed to pay up to \$9.2 million into a settlement fund to resolve *Cody v. SoulCycle Inc.*, No. 15-cv-6457 (C.D. Cal. 2015), a class action brought by consumers who claimed that SoulCycle required consumers to purchase gift certificates redeemable for a “series” of exercise classes, rather than allowing them to use cash or credit cards to purchase those classes. The *Cody* plaintiffs claimed that SoulCycle’s practice of imposing short expiration windows on the purchased certificates and retaining all

unused balances resulted in more than \$25 million in profit to the company while defrauding consumers under both federal and California state law.

Retailers who either already have gift card or similar credit policies, or who are looking for new marketing concepts to attract consumers, should carefully evaluate those programs. Expanding interpretations of what constitutes a “gift card”—and the corresponding increase in class actions filed against retailers who rely on those concepts—raise the risks associated with key parts of some retailers’ business models. The framework governing the advertising, sale and redemption of gift cards and related product marketing practices is complicated, but failure to bring marketing practices into compliance exposes companies to significant risk, with respect to both financial costs and consumer goodwill.



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RANSOMWARE AND ITS POTENTIAL IMPACT ON THE RETAIL INDUSTRY

Ryan Logan and Jeff Dunifon

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Ransomware and Its Potential Impact on the Retail Industry

On May 12, 2017, a massive ransomware attack hit tens of thousands of computer systems in over 150 countries. The ransomware, known as “WannaCry,” leveraged a Windows vulnerability and encrypted files on infected systems and demanded payment for their release. If payment was not received within a specified time frame, the ransomware automatically deleted the files. A wide range of industries were impacted by the attack, including businesses, hospitals, utilities and government entities around the world.

Ransomware is one of the many types of recent cyberattacks that can have significant legal implications for affected entities and industries for whom data access, integrity and availability are critical. Retailers, which often process sensitive information like individuals’ credit card numbers and other payment details, are a common target of these disruptive attacks. According to NTT Security, 15 percent of all ransomware covered in its 2017 Global Threat Intelligence Report was detected in the retail industry. In preparing for and responding to ransomware attacks, retailers may need to consider certain key legal issues, which we have summarized below.

FTC Enforcement

The Federal Trade Commission has used its authority under Section 5 of the FTC Act to pursue “unfair or deceptive acts or practices” to address data privacy and security issues. The deception doctrine has been used to pursue companies that misrepresent their use of personal information or the security measures used to protect such data, while the unfairness doctrine has been used to bring actions against companies

that fail to employ adequate safeguards prior to a security incident (regardless of the company’s representations). In a November 2016 blog entry, the FTC stated that “a business’ failure to secure its networks from ransomware can cause significant harm to the consumers (and employees) whose personal data is hacked. And in some cases, a business’ inability to maintain its day-to-day operations during a ransomware attack could deny people critical access to services like health care in the event of an emergency.” The FTC also indicated that “a company’s failure to update its systems and patch vulnerabilities known to be exploited by ransomware could violate Section 5 of the FTC Act.” Nearly all data security actions brought by the FTC have been settled and have resulted in comprehensive settlement agreements that typically impose obligations for up to 20 years.

Breach Notification Laws

In the United States, 48 states, the District of Columbia, Guam, Puerto Rico and the US Virgin Islands have laws that require notification to affected individuals (and in many states, regulators) in the event of unauthorized acquisition of or access to personal information. Certain federal laws also require notification for certain breaches of covered information, and there are an increasing number of breach notification laws being adopted internationally. To the extent a ransomware attack results in the unauthorized acquisition of, or access to, covered information, applicable breach notification laws may impose notification obligations on affected entities and analyzing these varied requirements, particularly for entities like multi-state retailers, can be a daunting task.

Data Security Laws

A number of US states have enacted laws that require organizations that maintain personal information about state residents to adhere to certain information security requirements with respect to that personal information. As a general matter, these laws require businesses that own or license personal information about state residents to implement and maintain reasonable security procedures and practices to protect the information from unauthorized access, destruction, use, modification or disclosure. To the extent a ransomware attack results from a failure to implement reasonable safeguards, affected entities may be at risk of legal exposure under the relevant state security laws.

Litigation

In the event that ransomware results in a compromise of covered information, litigation is another potential risk. Despite the difficulty of bringing successful lawsuits against affected entities, plaintiffs' lawyers continue to actively pursue newsworthy breaches, as businesses are paying significant amounts in settlements with affected individuals. Affected entities also may face lawsuits from their business partners whose data is involved in the attack, and often battle insurers over coverage of costs associated with the attack. Businesses must also be cognizant of cyber-related shareholder derivative lawsuits, which increasingly follow from catastrophic security breaches.

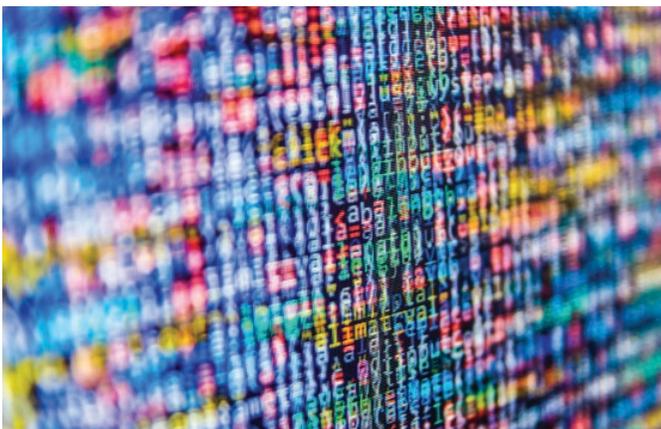
Agency Guidance

Given the evolving nature of ransomware attacks, government agencies are continuously developing recommendations to help businesses respond to such attacks. For example, the FBI has developed ransomware resources directed toward chief information security officers (CISOs) and CEOs. This guidance should be carefully considered to help retailers prevent and recover from ransomware attacks and to understand the potential criminal and enforcement implications of such attacks.

According to NTT Security, 15 percent of all ransomware covered in its 2017 Global Threat Intelligence Report was detected in the retail industry.

Conclusion

Ransomware is a growing concern, and while the recent global attack has been the most high-profile attack to date, it is part of an overall trend in the evolving threat landscape. Retailers should take into account the legal considerations discussed above in their efforts to prevent, investigate and recover from these disruptive attacks.



SEC ACTIVITY IN 2017

Scott Kimpel and Hannah Flint

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With a new administration in the White House, 2017 brought a number of changes at the Securities and Exchange Commission (SEC), including new leadership and regulatory priorities. Notably, Chairman Jay Clayton, who was sworn in on May 4, 2017, has made disclosure reform and the revival of the IPO market a central tenet of his agenda. Recognizing that some required disclosures are burdensome to generate and may not be material to the total mix of information available to investors, the SEC has indicated that it will move forward on a number of initiatives aimed at promoting capital formation by seeking to ease compliance burdens on companies while still providing for the disclosure of all required information. With upcoming confirmation hearings for nominees to the two vacant commissioner seats, it now appears as if the five-person SEC soon will be back at full strength, and we are cautiously optimistic that the SEC will be able to approve many sensible and long-overdue measures. We highlight a few trends and issues that may be of interest to publicly traded retailers.

2017 Regulatory Agenda

In the SEC's 2017 regulatory agenda, the SEC cut the number of regulations the agency expects to propose or finalize in the coming year by about half. Among the rules removed from the near-term regulatory agenda were several incomplete Dodd-Frank regulations on executive compensation, including pay-for-performance, clawbacks and hedging. Other regulatory actions moved to the SEC's long-term agenda include a proposed rule on universal proxy access and corporate board diversity disclosure.

Of the 33 actions included on the near-term agenda, several key rulemakings relate to disclosure requirements.

Among others, the proposed rule stage includes business and financial disclosure required by Regulation S-K, implementation of FAST Act report recommendations, reporting on proxy votes on executive compensation and a concept release on additional disclosure on audit committees. The final rule stage includes disclosure update and simplification, modernization of property disclosure for mining registrants and simplification of disclosure requirements for emerging growth companies and forward incorporation by reference on Form S-1 for smaller reporting companies.

These changes to the SEC's agenda, while not binding on the agency, appear to confirm a different emphasis for Chairman Clayton under this SEC. Although Chairman Clayton will remain under congressional pressure to finalize incomplete Dodd-Frank rules on pay-for-performance, clawbacks and hedging, we are cautiously optimistic that Chairman Clayton will go in a different direction given the punitive nature of some facets of the proposed rules.

Disclosure Modernization

On October 11, 2017, the SEC adopted new proposed rules under the FAST Act to modernize and simplify the disclosure requirements in Regulation S-K. The proposed rules revise Regulation S-K to, among other things, further scale or eliminate requirements of the regulation so as to reduce the burden on emerging growth companies, accelerated filers, smaller reporting companies and other smaller issuers and eliminate provisions of Regulation S-K that are duplicative, overlapping, outdated or unnecessary. We expect that this proposal will mark the first of several future rulemakings on disclosure reform to come during Chairman Clayton's term.

CEO Pay Ratio Disclosure

In early 2017, then Acting SEC Chairman Michael Piwowar issued a statement instructing the SEC staff to reconsider the implementation of the SEC's pay ratio rule, which requires registrants to disclose the ratio of the annual total compensation of the company's CEO to the median annual total compensation of all of the company's employees, and to determine whether additional guidance or relief is appropriate. Accordingly, on September 21, 2017, the SEC and the staff of the SEC's Division of Corporation Finance issued interpretive guidance, staff guidance and an updated Regulation S-K Compliance & Disclosure Interpretation to assist companies in their compliance efforts. Despite early optimism that the SEC might delay effectiveness of the rule, the additional flexibility afforded by the guidance comes as a welcome relief. Notably, the guidance encourages companies to take advantage of the flexibility provided in the rule and indicates that the SEC will seek enforcement action against a company for its pay ratio disclosures only when the disclosure was made without a reasonable basis or was not otherwise provided in good faith. Reporting companies should take comfort in the SEC's effort to encourage companies to use the flexibility provided in the rule to alleviate some of the compliance and liability concerns.

Conflict Minerals Rule

On April 7, 2017, the staff of the Division of Corporation Finance released a statement that it would not recommend enforcement action against companies that choose not to engage in the additional due diligence requirements imposed by Item 1.01(c) of Form SD and thus do not file a Conflict Minerals Report (CMR) as an attachment to the Form SD. This statement appears to be a stop-gap measure pending further action by the SEC. Despite the staff's statement, however, many Form SD filers for reporting year 2016 did not appear to take advantage of the SEC staff relief and instead completed a CMR. Whether Section 1502 of Dodd-Frank is amended by Congress and whether the SEC will make changes to the reporting regime (either by rulemaking or the issuance of further interpretive guidance of some sort) remain to be seen.

Shareholder Proposal Process

Chairman Clayton also has indicated that while he is supportive of rules that allow shareholder proposals, the SEC is searching for a way to address the concerns of various stakeholders in the shareholder proposal process. On November 1, 2017, the SEC staff issued Staff Legal Bulletin No. 14I (SLB 14I), which layers on additional requirements for companies seeking to exclude certain shareholder proposals from their proxy materials. In particular, the staff now expects boards of directors to analyze shareholder proposals before making no-action requests to exclude such proposals from proxy materials under Rule 14a-8(i)(7) (the ordinary business exception) or Rule 14a-8(i)(5) (the economic relevance exception). No-action requests should include a discussion reflecting the board's analysis and the specific processes it employed to reach a well-informed and well-reasoned conclusion. SLB 14I also requires new documentation for submissions of shareholder proposals by proxy and provides guidance on the use of images and graphs in shareholder proposals.

SLB 14I places greater responsibility on boards by encouraging them to consider shareholder proposals; however, it remains to be seen how much time and consideration boards must give to these proposals and what processes should be put in place to satisfy the new guidance. At the same time, SLB 14I's new requirements may give boards a greater opportunity to exclude proposals under the ordinary business and economic relevance exceptions. Boards will be able to give company-specific reasoning for excluding particular shareholder proposals, and the SEC staff may be more likely to defer to their management expertise. The new guidance may be especially useful in excluding the large number of proposals submitted each year to publicly held retailers when those proposals deal with a company's ordinary business matters or issues that are economically insignificant.

CYBER, HURRICANES AND RECALLS TOP THE LIST OF INSURANCE ISSUES IMPACTING RETAILERS

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Business financial losses due to social engineering, including fraudulent impersonation of legitimate vendors, clients and company executives, was the major concern for businesses in 2017. Two court decisions on that topic widened the split on whether social engineering losses are covered under traditional crime policies. The mixed case law should encourage all policyholders to play it safe and obtain specific social engineering/impersonation fraud coverage by endorsement.

- *Medidata Solutions, Inc. v. Federal Insurance Company*, No. 15-cv-907, 2017 WL 3268529, __ F. Supp. 3d __ (S.D.N.Y. July 21, 2017), *on appeal*, No. 17-2492 (2d Cir. Aug. 11, 2017). In *Medidata*, fraudsters changed code in Medidata's email system so emails appeared to come from Medidata executives, but were actually sent by the cybercriminals. The emails populated with legitimate email addresses and employee photos. Citing a confidential business acquisition which had only been publicized internally, the cybercriminals instructed accounts payable employees to make wire transfers totaling \$4.8 million. The emails were so convincing that multiple high-level employees were duped into authorizing the transfers. The insurer denied coverage under Medidata's crime policy, however, on the grounds that Medidata's computer system had not been "hacked" and the funds were transferred with Medidata's knowledge and consent. The court disagreed, finding that the manipulation of computer code that achieved the fraud was the type of "deceitful and dishonest access" envisioned by other New York precedent. The court also found that employee authorization of the transfers did not

make them valid transactions; in other words, "larceny by trick is still larceny." The *Medidata* decision is reminiscent of another federal court decision from last year, *Principal Solutions Group, LLC v. Ironshore Indemnity Inc.*, No. 1:15-cv-04130, 2016 WL 4618761 (N.D. Ga. Aug. 30, 2016), which found that innocent employee approval of the fraudulent wire transfer did not break the causal chain between the impersonation crime and subsequent loss.

- *American Tooling Center, Inc. v. Travelers Casualty & Surety Company of America*, No. 16-12108, 2017 WL 3263356 (E.D. Mich. Aug. 1, 2017). In *American Tooling*, a manufacturer was duped into paying \$800,000 in legitimate outstanding vendor invoices to a fraudulent bank account. The district court, applying a narrow interpretation of the computer fraud coverage, held that the manufacturer had not suffered a "direct" loss that was "directly caused by the use of a computer" due to intervening employee negligence. The court relied, in part, on the *Apache v. Great American Ins. Co.*, 662 F. App'x 252 (5th Cir. 2016) decision from last year, which held that the fraudulent email was merely incidental to the transfer allowed by employee negligence.

Retailers should ensure that critical departmental personnel are involved in preparing applications and renewal documents, and should provide appropriate caveats when answering application questions.



Mother Nature's Wrath Wreaked Havoc in 2017, Pushing Retailers' Insurance to Its Limits and Reminding Policyholders to Act Prudently When Tragedy Strikes

Mother Nature dealt nasty punches to the Caribbean, Texas and Florida with Hurricanes Harvey, Irma and Maria, and then turned up on the heat on the opposite coast with catastrophic, and ongoing, wildfires in California. For those affected by these events, basic property insurance should cover a variety of incurred losses, assuming insureds protect their right to recovery.

In addition to coverage for physical loss, insurance policies may also cover financial losses due to the interruption of the insured's business or another's business upon which the insured relies. Policies may also cover expenses above standard operating costs incurred to continue operations while the business is still affected by the loss event or physical damage.

- But, availability of coverage depends largely on whether the insured business has acted to protect its rights, which should include *at least* the following activities:
- **Identify All Potentially Applicable Policies:** When dealing with catastrophic losses, businesses should identify potentially applicable insurance policies promptly, keeping in mind that they may also be covered by insurance policies issued to others. For instance, an insurance policy issued to a contractor, a lessee or a

customer may provide coverage to your business as well as to the policyholder.

- **Give Prompt Notice:** After identifying potentially applicable policies, the insured should notify all insurance companies who issued potentially applicable coverage of the actual or potential losses. Notice should be provided consistent with the terms of each policy, keeping in mind that carriers may require different information.
- **Provide Reasonable Cooperation:** Following notice of the loss, insurers will usually have questions about the circumstances of the loss as well as the property damage and any lost business income. Do your best to answer questions and provide available information—it is your duty to do so. However, if you find that your carrier is making unreasonable demands, consult with a coverage lawyer right away.
- **Beware Public Adjusters:** Policyholders should also beware of so-called public adjusters. These companies and individuals purport to represent the interests of the insured in assisting with the preparation and presentation of the policyholder's insurance claim. Public adjusters charge upwards of 10 percent (or more!) of any insurance recovery obtained. Thus, if you hire a public adjuster to assist with a claim for \$10 million in property losses, plus \$2 million in business interruption losses, the public adjuster could take \$1.2 million of that recovery, leaving you with substantially less than the value of your claim.

- **Collect and Maintain Records:** Businesses should document physical damage, amounts paid to prevent further damage or remedy existing damage, and amounts lost due to the disruption of business activities for the period of time when the losses are incurred. Maintaining these records will help in later insurance negotiations.
- **Do Not Assume Your Insurer Is Correct:** As confident as they may seem, insurers are not always right when it comes to calculating insurable losses. Insurance companies handle thousands of claims each day—yours is just one of them. The process is ripe for error.
- **Be Careful What You Say:** When dealing with insurers, the rule of thumb should be, as Joe Friday would say, “just the facts.” It is important to remember that claim adjusters are trained to ask loaded questions and capture everything a policyholder says. Your speculation about facts or causation might be used to limit or deny the claim.

Application-Stage Misrepresentations and Omissions Still Lead Recall Concerns

Last year, we reported on the district court’s decision in *H.J. Heinz Company v. Starr Surplus Lines Insurance Company*, No. 15-cv-0631, 2016 WL 374307 (W.D. Pa. Feb. 1, 2016). There, the district court ordered rescission of a

recall insurance policy issued to the H.J. Heinz Company on findings that Heinz materially misrepresented its claim history when it purchased the policy, leaving a \$25 million business interruption loss uncovered. Although a jury agreed that Heinz’s errors were unintentional, the district court found that even unintentional material misrepresentations were sufficient to void the contract. In January 2017, the Third Circuit affirmed the district court’s ruling, writing that “Heinz’s misrepresentations were of such magnitude that they deprived Starr of ‘its freedom of choice in determining whether to accept or reject the risk.’” 675 F. App’x 122, 128 (3d Cir. 2017).

Emboldened by its success in the *Heinz* case, Starr has continued to rely on alleged application-stage errors to avoid paying claims. For example, Starr sued CRF Frozen Foods, LLC, in February 2017 to rescind coverage based on the allegation that CRF was aware of circumstances likely to give rise to its 2016 recall of frozen vegetables.

These recall coverage cases underscore the importance of representations made at insurance application and renewal. Retailers should ensure that critical departmental personnel are involved in preparing applications and renewal documents, and should provide appropriate caveats when answering application questions.



KIDS, PRIVACY AND THE INTERNET OF THINGS

Phyllis Marcus

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Connected toys and devices are all the rage, captivating kids and offering innovation for consumer products companies and retailers in a time of soft sales. For several years now, privacy advocates and attorneys have been watching to see if the Federal Trade Commission (FTC) will take action to enforce privacy regulations against toy makers and marketers of kid-directed connected devices. Following on the heels of notable data security incidents (see VTech and Mattel), the introduction of the augmented-reality Hello Barbie, heightened congressional inquiry and the international uproar relating to the My Friend Cayla and i-Que Intelligent Robot toys, marketers should heed longstanding advice to build in privacy and security from the outset if planning to develop kid-connected devices.

This year, the FTC has twice emphasized that the federal Children's Online Privacy Protection Act (COPPA) applies to the Internet of Things. In June of this year, the FTC issued business guidance stating that COPPA applies "not only to websites and mobile apps. The law also can apply to the growing list of connected devices that make up the Internet of Things. That includes connected toys and other products intended for children that collect personal information, like voice recordings or geolocation data." See [Children's Online Privacy Protection Rule: A Six-Step Compliance Plan for Your Business](#) (Jun. 2017). More recently in October, the FTC indicated that interactive virtual assistants, toys and smartwatches may collect audio files from children without parental consent, only so long as the child is speaking solely "as a replacement for written words" and the file is immediately deleted. See [FTC Provides Additional Guidance on COPPA and Voice Recordings](#) (Oct. 2017).

Toy makers and retailers should familiarize themselves with COPPA's requirements, which can be tricky for the

uninitiated. COPPA requires companies to notify parents and obtain verifiable consent *prior* to collecting personal information. COPPA contains a very specific definition of personal information. The list includes typical items such as full name, address, phone number, Social Security number and online contact information, and digital information such as photos, videos and audio files containing a child's image or voice, persistent identifiers used to target children with behavioral advertising or build profiles on them, and geolocation information. Companies must think through how to deliver effective notices that can be seen by parents before they link their children's devices or set up a connected toy. They also must ensure that they have effective security mechanisms in place to protect any personal information they collect from children.

Thus far, the FTC has not taken action involving connected devices. We continue to predict that it's merely a matter of time. We also have been closely watching the potential for consumer litigation involving kids and connected devices. Although COPPA does not provide a private right of action, this year has seen the rise of consumer class actions using COPPA as a predicate for asserting violations of state consumer protection and common law privacy torts. For example, in August 2017, consumers filed suit in federal court in California against two gaming app developers and a group alleged to have provided the developers with computer code used to serve behaviorally targeted ads to children without parental knowledge or consent.

Our team includes attorneys steeped in children's privacy, including [Phyllis Marcus](#), who headed the FTC's COPPA program from 2007 through 2012. We are well situated to counsel clients on the launch of connected devices, and other children's privacy and advertising initiatives.

DECEPTIVE DISCOUNT PRICING CLASS ACTIONS ON THE RISE

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There has been, in recent years, a spate of putative class action suits alleging a particular brand of deceptive pricing practices. Prominent retailers such as Michael Kors, Burberry, Coach, Neiman Marcus and Nordstrom, among others, have stood as defendants. In these suits, plaintiffs claim that retailers have misrepresented the standard price of discounted goods in order to create the illusion of a greater than actual bargain. By displaying fictitious reference prices at which items were never actually sold, the argument generally goes, retailers entice deal-hungry customers into making purchases they would not make without the belief that they are saving money.

Although the Federal Trade Commission has not set forth enforceable rules regarding this particular form of deceptive advertising, it has published relevant guidelines. The FTC's Guides Against Deceptive Pricing identify as illegitimate the use of a "former" price never in fact offered to the public as a reference point for a purported bargain. 16 C.F.R. § 233.1(a). While it is not fatal that no sales were actually made at the advertised original price, it is essential, the FTC warns, that "the price is one at which the product was openly and actively offered for sale, for a reasonably substantial period of time, in the recent, regular course of [the retailer's] business, honestly and in good faith." *Id.* § 233.1(b). "Reasonably substantial period of time" is not defined.

Because the FTC has issued only these guidelines, enforcement of this type of deceptive pricing is left to the states, the vast majority of which have enacted statutes that, at the least, codify the FTC's recommendations. Some go

further, or include more specific requirements; California, for example, requires that the advertised former price must have been the "prevailing market price ... within three months." Cal. Bus. & Prof. Code § 17204. It is therefore important that retailers keep abreast of the regulations in each state where they do business. Brief summaries of cases from opposite coasts will serve to illustrate the importance of local law as well as individual facts.

In *Belcastro v. Burberry Ltd.*, the Southern District of New York recently dismissed the complaint with leave to amend. The plaintiff in *Belcastro* purchased at an outlet store goods that Burberry advertised as discounted from their Manufacturer's Suggested Retail Price (MSRP), at which, he alleged, the goods were never sold or intended to be sold. The court rejected the plaintiff's claim of injury, holding that under New York law it was not enough that he merely, in the face of what appeared to be a bargain, "paid more than he was subjectively willing to otherwise pay." Citing the District of Massachusetts case *Shaulis v. Nordstrom, Inc.*, the court held that it is not enough for a plaintiff to allege only that he did not save as much money as the retailer's discount advertising led him to believe. Without an allegation that his goods were worth less than he paid, the court determined, the mere use of allegedly manipulative tactics by the retailer did not create a cognizable injury.

The FTC's Guides Against Deceptive Pricing identify as illegitimate the use of a "former" price never in fact offered to the public as a reference point for a purported bargain.

Given the disparate and developing law in this area, retailers must be vigilant in monitoring the situation in those states where they do business.

Belcastro and *Shaulis* are to be contrasted with the result in the Southern District of California’s *Branca v. Nordstrom, Inc.*, in which the plaintiff alleged injury from the purchase of goods advertised with a “compare at” price at which they had never in fact been sold. The court was impressed by the plaintiff’s production of a survey showing that 90 percent of shoppers interpreted Nordstrom’s “compare at” tags to mean that the relevant item had previously been offered at that price, as well as the argument that the goods in question were specifically produced for Nordstrom’s discount outlet store and therefore could never have been offered for a higher price. The court held that, under California law, the plaintiff had alleged a cognizable harm despite not showing that the goods were worth less than the purchase price.

Finally, in *Marino v. Coach, Inc.*, the Southern District of New York reaffirmed its reasoning in *Belcastro* and distinguished *Branca*. Like *Belcastro*, the case centered around the use of allegedly fictitious MSRPs at outlet stores. The court held that the use of an MSRP as a reference price was materially different from the use, as in *Branca*, of a “compare at” price, and reached the same conclusion as in *Belcastro*. This is particularly notable, and somewhat curious, because the plaintiff in *Branca* in fact produced evidence that Nordstrom’s internal documents referred, at times, to its “compare at” prices as MSRPs.

These cases demonstrate the uncertain waters surrounding the FTC’s bargain-price advertisement regulations. Given the disparate and developing law in this area, retailers must be vigilant in monitoring the situation in those states where they do business. A hard look at bargain-pricing practices, particularly in outlet stores, may be necessary.



INCREASED REGULATORY ACTION UNDER TSCA RAISES INCREASED RISK OF TORT LITIGATION

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By now, manufacturers and retailers of composite wood products—including certain floorings, furniture, cabinets, shelving, picture frames and other hardwood plywood, medium-density fiberboard and particleboard products—are well aware of the increased regulation at both the federal and state levels related to formaldehyde emissions from such products. As recently as September 2017, the Environmental Protection Agency issued a series of amendments to its Final Rule under Title VI to the Toxic Substances Control Act (TSCA). The Formaldehyde Final Rule is particularly significant because it represents the first time that the federal government has regulated formaldehyde emissions from consumer products, such as those listed above. It also includes various testing, certification, labeling and other requirements for manufacturers of covered composite wood products and record-keeping requirements for others in the supply chain—including, specifically, retailers. The EPA's September 2017 amendments to the Formaldehyde Final Rule extended the deadline for compliance for the bulk of the provisions until December 12, 2018.

Without question, new regulations such as the Formaldehyde Final Rule present risk to retailers associated with noncompliance. Retailers of covered products should be taking the necessary steps now to ensure that they will be in compliance with the rule by the December 2018 deadline. However, in the realm of tort litigation, we frequently observe increased litigation risk for retailers associated with increased regulatory action *even in the absence of regulatory noncompliance.*

Formaldehyde emissions present a case in point. Specifically, the same formaldehyde emission limits contained in the Formaldehyde Final Rule were instituted in California several years ago by the California Air Resource Board (CARB). Since the implementation of the CARB emission standards, there has been a sharp increase in claims nationally brought by plaintiffs alleging personal injury and/or property damage as a result of formaldehyde emissions in their homes. The most widely publicized litigation has involved Lumber Liquidators, a specialty retailer of hardwood flooring. Claims against the company were consolidated in multidistrict litigation in the US District Court for the Eastern District of Virginia. In October 2017, Lumber Liquidators announced a Memorandum of Understanding that, if approved, would resolve a broad group of these claims for an aggregate settlement of \$36 million.

In 2018, retailers should remain cognizant of the substances in the EPA's focus and be proactive in minimizing associated litigation risk.

Regulatory activity regarding a potential chemical or substance has a twofold impact on litigation. **First**, increased regulatory activity regarding a substance leads to an increased focus on that substance by opportunistic and entrepreneurial plaintiffs' law firms. Plaintiffs' firms begin to recruit potential litigants. **Second**, plaintiffs' counsel then attempt to assert the regulatory exposure limits as a proxy



for causation in human health effects litigation—asserting, for example, that if a product emits formaldehyde at, near or in excess of the regulatory standard, the causation element of their personal injury claim should be assumed. This theory ignores that the regulatory risk assessment process is intended to overestimate risk, and is not necessarily tied to any scientific evidence of human health effects at or above the set exposure limits. Defending against this theory proves particularly slippery in the context of a chemical substance, such as formaldehyde, that is associated with ubiquitous and nonspecific health effects. With the EPA’s focus on formaldehyde through the Formaldehyde Final Rule, this type of litigation is likely to become more widespread and has the potential to impact each member of the supply chain of the covered products at issue.

We observed a similar uptick in litigation associated with the Occupational Safety and Health Administration’s 2016 rulemaking that reduced permissible exposure limits for silica. Although tort litigation associated with silica exposure peaked in the early to mid 2000s, increased regulatory activity in this area over the last several years resulted in a renewed focus on the substance and a noticeable increase in related litigation.

Although the increased regulation of formaldehyde emissions is a clear litigation risk for retailers of composite wood products in the year ahead, the EPA’s increased regulatory activity under the 2016 amendments to the TSCA presents increased litigation risk to retailers more broadly. Specifically, the EPA is currently undertaking risk evaluations for 10 “high priority” chemical substances to determine associated

human health and environmental risks, and any regulatory steps necessary to mitigate those risks. The list of 10 includes the following:

- 1,4-Dioxane
- 1-Bromopropane
- Asbestos
- Carbon Tetrachloride
- Cyclic Aliphatic Bromide Cluster
- Methylene Chloride
- N-methylpyrrolidone
- Pigment Violet 29
- Tetrachloroethylene (also known as perchloroethylene)
- Trichloroethylene

These chemicals can be found in a wide variety of consumer products, such as cleaning and degreasing solvents, laundry and dishwashing products, furniture cleaners, plastic-based products and textiles, building materials, paints and coatings, automotive care products, arts, crafts, hobby materials (including watercolor and acrylic paints) and toys.

Again, we expect that the EPA’s increased regulatory focus on each of these chemicals has the potential to increase litigation risk for manufacturers of products containing those chemicals and others in the supply chain—including retailers. In 2018, retailers should remain cognizant of the substances in the EPA’s focus and be proactive in minimizing associated litigation risk.

MERGERS AND ACQUISITIONS IN 2017

Scott Kimpel and Candace Moss

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Overview and Trends

As of October, global M&A volume was down 8 percent YTD from 2016 to \$2.6 trillion, according to Dealogic; however, 2017 has proven to be another strong year for M&A. Despite the global decrease in deal volume, this is the fifth straight year in which reported M&A deal value involving US targets is expected to exceed \$1 trillion. In November alone, there was \$200 billion in announced M&A activity, putting it on target to be the second-biggest month on record in at least 22 years.

As of Q3, US consumer markets YTD deal value was up 72 percent and deal volume was up 20 percent over 2016, according to PwC.¹ The food and beverage subsector accounted for 39 percent of consumer markets deal value in Q3, and food and beverage M&A activity through Q3 was up 4 percent from 2016.² Also, restaurant M&A outperformed previous levels, with deals such as Darden Restaurants, Inc.'s **\$780 million purchase** of Cheddar's Scratch Kitchen Restaurants.³ Corporate acquisitions of restaurants totaled around \$11.7 billion as of November 2017 compared to an average of \$2 billion per year since 2008. Private equity firms more than tripled the amount spent on restaurant acquisitions, with an increase from \$1.4 billion in 2016 to \$4.5 billion in 2017.⁴

Appraisal Rights Developments

In the past few years, there has been an increase in appraisal proceedings brought by investment funds that engage in "appraisal arbitrage" by buying shares after the announcement of a transaction in order to seek a judicial appraisal of the fair value and potentially obtain more money. Often, they are able to negotiate settlements with buyers who desire to avoid costly and lengthy litigation. However, the effects of appraisal reform in Delaware and recent court decisions have resulted in a 33 percent decline in the number of appraisal proceedings brought in the first half of 2017, which may signal an end to this trend.⁵

Effective August 1, 2016, Delaware's governor approved legislation amending the appraisal statute. Among other changes, the amendments require dismissal of certain de minimis appraisal proceedings and allow companies subject to appraisal actions to make prejudgment payments to shareholders in order to reduce interest costs. In May 2017, the Delaware Court of Chancery ruled in *In re Appraisal of SWS Group, Inc.*, that the fair value of the stockholders' shares was almost 8 percent less than the deal price.⁶ In making this determination, the court did not rely on the deal price as evidence of the fair value and it excluded the expected synergies from the determination of fair value, instead choosing to rely on a discounted cash flow analysis. Additionally, in several other appraisal cases, the chancery

¹ <https://www.pwc.com/us/en/industries/consumer-markets/publications/quarterly-deals-insights.html>.

² <https://www.stoutadvisory.com/insights/industry-update/food-beverage-industry-update-q3-2017>.

³ <https://www.hunton.com/en/news/ma-team-advises-darden-restaurants-in-780m-purchase-of-cheddars.html>.

⁴ <https://www.cnbc.com/2017/11/15/restaurant-ma-is-making-a-comeback-here-are-some-potential-targets.html>.

⁵ <https://corpgov.law.harvard.edu/2017/09/08/the-high-cost-of-fewer-appraisal-claims-in-2017-premia-down-agency-costs-up/>.

⁶ https://www.hunton.com/images/content/3/1/v2/312017/delaware_appraisal_proceeding_results_in_fair_value_below_merger.pdf.



In the retail industry, underperformance in several subsectors may lead to more M&A intended to quickly spur growth and financial results.

court found the fair value of shares to be at or below the deal price. In August 2017, in *DFC Global v. Muirfield Value Partners*, despite acknowledging that the sale price will often be the most reliable evidence of fair value, the Delaware Supreme Court found that the chancery court is not required to defer to the sale price and that judges have discretion to consider all relevant factors when determining fair value. These recent rulings coupled with legislative changes suggest an increased risk for shareholders to pursue appraisal, as such proceedings may be more likely to result in a valuation lower than that paid to nondissenting shareholders.

Preview of 2018

Looking ahead to 2018, M&A activity is predicted to remain at the same level or increase, due to a variety of factors. More companies may look to strategic transactions in 2018 to better position themselves in an increasingly competitive market. Recent examples include Amazon’s acquisition of Whole Foods, Panera’s acquisition of Au Bon Pain and Arby’s

acquisition of Buffalo Wild Wings. We also expect more brick-and-mortar retailers will seek to expand their online presence through acquisitions, such as Walmart’s acquisition of Jet.com and PetSmart’s acquisition of Chewy.com. In the retail industry, underperformance in several subsectors may lead to more M&A intended to quickly spur growth and financial results. A Deloitte survey of corporate executives and private equity investors noted that respondents expect more deals between retailers and technology companies, with an increasing convergence between those two industries as retail sales continue moving to online channels. Companies and private equity firms still have significant cash reserves, which they are likely to use for M&A; interest rates are still relatively low for those seeking access to capital; and record high stock market levels can provide increased purchasing power for financing acquisitions. Additionally, given the current political climate, companies may anticipate benefits from deregulation and a more advantageous business environment due to tax reform. Notwithstanding these factors, M&A activity could be negatively impacted in the event of unfavorable regulatory changes, increased antitrust scrutiny of transactions under the merger review process, or changes to trade policies such as NAFTA.

UNCOVERING, FIGHTING AND SUCCESSFULLY OPPOSING A LITIGATION FUNDING GROUP'S FRAUDULENT MULTI-STATE PUBLIC ACCOMMODATIONS SCHEME



M. Brett Burns and Richard Cortez

Brett is a partner and Richard is an associate on the labor and employment team in Hunton & Williams' San Francisco and Dallas offices, respectively.

As many readers already know, one valuable service we offer our retail clients is managing national and regional dockets of public accommodation litigation. In any given year, we represent clients in hundreds of lawsuits across the country presenting issues ranging from new legal theories (website accessibility, emerging accessibility technology, new architectural designs, etc.) to traditional “brick-and-mortar” claims for violations of ADA Title III, the ADA Standards and conceptually similar state laws. Our approach is highly practical and client-focused, and we never litigate just to litigate. If there is a genuine problem, we will recommend an early verification and remediation strategy to maximize the chance of an early and inexpensive settlement. But when there is no liability, or when liability is questionable and the stakes are high, we will fight and win.

Against that background, some large retail clients for whom we manage national and regional dockets alerted us that, within a few weeks, they had been sued multiple times in Nevada and Utah. They sent us the newly filed lawsuits and asked us to assess them. We did. We noted that all the lawsuits used virtually identical form complaints and presented similar claims (alleged violations of ADA Standards regarding parking lots and aisle widths). That was a little unusual in and of itself, as most plaintiff attorneys won't file so many suits against the same clients so quickly (one of our clients was sued five times!). When we called the plaintiff's counsel at the telephone numbers listed in the lawsuits, things started to get very odd. No one answered the telephone calls; rather, we heard a recording directing

us to send any communications via email. Making this even stranger was the fact that we already had heard a strikingly similar message when consulting on a different public accommodations case filed by a different plaintiff's counsel for a different plaintiff in another state—Arizona—four months earlier. Odder still was the fact that when we sent an email to the plaintiff's counsel in Nevada, we received a response from the same paralegal who responded to us in Arizona. Something wasn't right. So we began to investigate.

What we uncovered was this:

- In early- to mid-2016, a litigation funding group called Advocates for Individuals with Disabilities (AID) paired with a local Arizona lawyer to file more than 1,700 public accommodations lawsuits in Arizona. Most businesses settled the lawsuits for nuisance value (reportedly between \$5,000 and \$7,500 per lawsuit), rather than litigate them, a fact AID surely considered when setting modest prices for their settlements.
- Things went well for AID for a while. So well that AID decided to scale its operations and expand into new states. To do so, AID created a new entity called Litigation Management and Financial Services (LMFS) to manage and fund a much larger, coordinated, multi-state effort to file hundreds of new public accommodations lawsuits in Arizona, Colorado, Nevada, New Mexico and Utah.
- How did they manage these cases? LMFS recruited lawyers in new states (sometimes using Craigslist ads) to pair with wheelchair-using plaintiffs and then arranged

for drivers to take the plaintiffs to businesses—retailers, hospitality services, restaurants, etc. They would oftentimes take a photo in front of the business, have a retained consultant locate a technical problem at the business, such as parking lot signage, soap dispenser height or aisle width, and then file a slew of federal court lawsuits. LMFS provided its lawyer network with templates for the complaints, telephone numbers and directions to communicate via email, email addresses, and centralized paralegal staffing to negotiate and process settlements. And many, many businesses settled.

But after an initial few months of aggressive filings and quick settlements, things went south for AID and LMFS, fast. Connecting some dots, we learned:

- In August 2016, following an extensive investigation, the Arizona Attorney General intervened in AID’s then-pending Arizona cases and alleged AID was “circumventing the statutorily proscribed State enforcement process by claiming to ‘investigate’ supposed violations of the [ADA], while in reality apparently engaging in ‘trolling’ litigation tactics designed to induce defendants into quick pre-suit or post-complaint settlement that merely enriches the Plaintiff.” Following the Attorney General’s intervention, approximately 1,000 of AID’s open cases were consolidated and dismissed. After initially defending against a series of motions for penalties and sanctions against its lawyers and employees, AID capitulated,

agreeing, among other things, to (1) never file another disability lawsuit in an Arizona’s state court again; (2) pay the Attorney General’s Office lawyers’ fees; (3) pay the Arizona Attorney General’s Office \$25,000 to set up a fund for an ADA education campaign and for businesses to apply to obtain funds towards ADA improvements; and (4) allow defendants in the consolidated cases to submit motions for lawyers’ fees.

- Then, in July 2017, following several days of hearings and direct questions by the court to serial-filing plaintiff Alyssa Carton and her counsel, Chief Magistrate Judge Karen B. Molzen of the United States District Court for the District of New Mexico consolidated more than 100 cases before her and entered an order finding all of the complaints “to be malicious” and recommending that they be dismissed with prejudice. See *Carton v. Carroll Ventures, Inc.*, CIV 17-0037 KG/SCY, 2017 U.S. Dist. LEXIS 107135, *1 (D.N.M. July 10, 2017). Comparing the lawsuit filings to a “carnival shell game,” Molzen found that the group deceived its plaintiff, Alyssa Carton, about how she would be paid and how the lawsuits would proceed.

Armed with the knowledge of then-recent events in Arizona and New Mexico, and connecting the dots between AID’s and LMFS’s cases in Arizona and New Mexico with the new lawsuits our clients received in Nevada and Utah, we advised our clients to fight. They did. LMFS folded. We filed motions to dismiss in all cases. Each time, plaintiff’s counsel ultimately decided to file agreed orders to dismiss



with prejudice, without receiving any payment whatsoever, rather than litigate and subject the LMFS scheme to further scrutiny. Clearly, this litigation funding group, attorneys and serial-filing plaintiffs were more interested in securing quick settlements from others than actually seeking to right any true public accommodations wrongs.

Meanwhile, the pain continues for LMFS. In Nevada, the State Attorney General recently filed a motion to intervene in one of the more than 275 pending LMFS-funded cases. Citing its “strong interest in protecting the public interest from malicious or premature lawsuits that threaten Nevada businesses owners and adversely impact Nevada’s general economy,” the Nevada Attorney General stated its belief that

“the [LMFS-funded] complaints are potentially malicious or, at best, premature and poorly drafted; failing to state a cause of action or adequately establish the plaintiffs standing to bring these suits.” Time will tell what happens next, but it doesn’t look good for LMFS or its network.

It goes without saying that there are many legitimate public accommodations lawsuits. We know many excellent plaintiff-side public accommodations lawyers and have respect for them and good relationships with them. These cases were different. And because of the national and regional docket coordination services we provide, we could connect the multi-state dots, our clients fought LMFS, and our clients won.



RETAILERS TO REAP RETURNS FROM REDUCED TAX RATE

Alex McGeoch

Alex is a partner in the tax practice in Hunton & Williams' Dallas office.



Twenty-one Percent Flat Corporate Income Tax Rate

President Trump signed the Tax Cuts and Jobs Act (the “Tax Act”) into law December 22, 2017. The Tax Act reduces the corporate tax rate from 35% to 21%. The 21% corporate tax rate is the most significant change made by the Tax Act for retail companies. Because retailers typically do not benefit from various deductions that lower the effective federal income tax rates of manufacturing corporations and other corporations engaged in non-retail businesses, many retailers actually will benefit from a 40% reduction in their federal income tax liability (35% before and 21 % after the Tax Act). Several major retail companies already have announced employee bonuses and increased wages in response to the expected cash influx resulting from the reduced tax rate.

Although the reduction in tax rates generally is effective for tax years beginning after December 31, 2017, corporations using a fiscal year for federal income tax purposes will benefit from a blended tax rate based on the portion of their fiscal year occurring before and after January 1, 2018. For example, taxable income of a corporation with a fiscal tax year ending on June 30, 2018, will be subject to a blended tax rate of 28% for its current year. Congress also took the long-awaited step of repealing the corporate alternative minimum tax.

Business Interest Deductions Limited

One detrimental provision of the Tax Act for retailers and other businesses that incur significant debt obligations is a new cap on business interest deductions. The new rule generally limits a taxpayer’s deduction of business interest

expense in excess of its business interest income to 30% of adjusted taxable income. Since the net interest deduction is limited to 30% of adjusted taxable income, the limitation is most likely to apply in years when a taxpayer’s profits are disappointingly low.

The harshness of the net interest deduction limitation is ameliorated to some extent by the Tax Act’s allowance of unlimited carryforwards of disallowed interest deductions to subsequent tax years. Disallowed interest will be taken into account, however, as an item subject to restrictions on the deduction of pre-change losses after a change in ownership of a corporation.

The limit on net interest deductions will cause taxpayers to structure transactions with a view to causing payments they make not to be treated as interest and payments they receive to be treated as interest income when possible in order to bring their net interest expense within the 30% of adjusted taxable income limit. The interest deduction limitation will increase the cost of leveraged acquisitions in which debt is incurred to finance the purchase price of the target company in an amount sufficient to cause the purchaser to incur non-deductible interest payments.

The cap on interest deductions is effective for tax years beginning after December 31, 2017, and there is no grandfather provision protecting interest deductions with respect to debt incurred prior to the effective date. Taxpayers with average annual gross receipts of \$25 million or less for the three-tax-year period ending with the prior tax year are exempt from this interest limitation.

New Net Operating Loss Limitations

The Tax Act made significant changes to taxpayers' ability to deduct net operating losses ("NOLs"). NOLs arising in tax years ending after December 31, 2017, may be carried forward indefinitely, but may be used to offset only 80% of taxable income in any year. The rationale expressed by the Senate Finance Committee is that taxpayers should pay some income tax in years in which they generate taxable income rather than being allowed to offset all of their taxable income with prior year losses. The Tax Act also eliminates the two-year carryback for losses generated in tax years ending after December 31, 2017, and the ten-year carryback with respect to specified liability losses such as product liability costs. The changes to the NOL carryback and carryforward rules apply to tax years ending after December 31, 2017.

Real Property Depreciation

The Tax Act eliminates the separate definitions of qualified leasehold improvement property, qualified restaurant property and qualified retail improvement property for property placed in service after December 31, 2017, and replaces them with the single category of qualified improvement property. Qualified improvement property will be subject to a general 15-year recovery period (utilizing a straight-line recovery method and half-year convention generally). One benefit of this change is that the general 15-year recovery period will apply regardless of whether the improvements are made to property subject to a lease, placed in service more than three years after the date the building was placed in service, or made to a restaurant building.



ABOUT US

Hunton & Williams LLP is a global law firm with more than 725 lawyers practicing from 19 offices across the United States, Europe and Asia. The firm's global experience extends to myriad legal disciplines, including corporate transactions and securities law, energy and infrastructure, international and government relations, regulatory law, privacy and cybersecurity, labor and employment and commercial litigation.

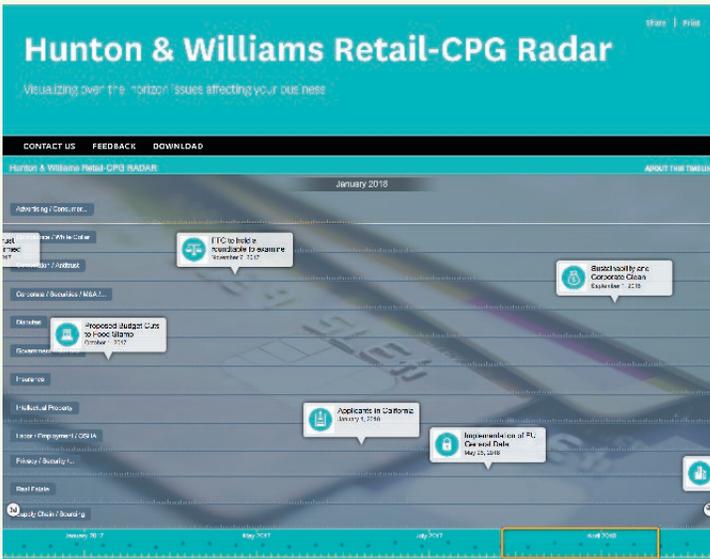
Our retail industry lawyers represent businesses at every step, from factory floor, to retail outlet, to online store. Our extensive list of international, national and regional clients includes many well-known restaurant chains, malls, home-improvement centers, supermarkets, and media and entertainment companies, as well as manufacturers and retailers of apparel, baby products, cosmetics, electronics, fine jewelry, luxury goods, toys and other merchandise. Our retail team is composed of more than 100 lawyers who represent retailers in the Fortune 500® and virtually every retail sector.

Please visit www.hunton.com for more information on our industries and practices.

CLIENT RESOURCE: HUNTON RETAIL-CPG RADAR

www.hunton.com/en/retail-cpg-radar.html

The Hunton & Williams Retail-CPG Radar tracks legal issues of importance to retail and consumer products companies, providing insights and guidance to help companies anticipate and prepare for happenings and challenges ahead.



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