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Please contact
Professor John Duggan
jduggan2@stonehill.edu

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TABLE OF CONTENTS

Massachusetts' New Non-Compete Law: A Favorable Advancement, Protecting Sensible Categories of Workers and Enhancing the State's Innovation Economy
David P. Twomey 1

Gauging the Effectiveness of the Massachusetts Benefit Corporation Statute (M.G.L. 156E)
John B. Duggan, Katherine Marsland, Hannah Baxter, and Molly Jones 13

New Big to Fail: An Antitrust Analysis of Content-Internet Mergers Absent Net Neutrality
William Murphy 27

Federal Opportunity Zone Rules Remain Unclear for Municipal Governments: Where Do We Go From Here?
Brien C. Walton 43

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MASSACHUSETTS' NEW NON-COMPETE LAW: A FAVORABLE ADVANCEMENT, PROTECTING SENSIBLE CATEGORIES OF WORKERS AND ENHANCING THE STATE'S INNOVATION ECONOMY

by David P. Twomey*

I. BACKGROUND

Derived from the U.S. Department of the Treasury's 2016 report entitled "*Non-Compete Contracts: Economic Effects and Policy Implications*,"[1] a May 5, 2016 White House paper summarized the position that noncompete agreements can affect the mobility of workers, clearly affecting a region's growth as follows:

> When firms in a given industry are clustered, it makes it easier for their workers to share expertise and discoveries, some of which may not be protected by trade secret or intellectual property legal provisions. Economists refer to geographic clustering effects of factors like a large, deep pool of skilled workers, a more competitive market of suppliers, and information spillovers across workers and firms as "agglomeration effects."
>
> While not necessarily in the interest of an individual firm, more rapid dissemination of ideasand technology improvements can have significant positive impacts for the larger regional economy in terms of innovation, entrepreneurship, and attracting more businesses and jobs to a region. Non-competes that stifle mobility of workers who can disseminate knowledge and ideas to new startups or companies moving to a region can limit the process that leads to agglomeration

* Professor of Business Law, Carroll School of Management, Boston College.

[1] Office of Economic Policy, U.S. Department of the Treasury, "*Non-Compete Contracts: Economic Effects and Policy Implications*" www.treasury.gov, p. 6 (March 2016).

> economies. Overly broad non-compete provisions could prevent potential entrepreneurs from starting new businesses in similar sectors to their current employer, even if they relocate.[2]

The research history for the positions set forth in this White House paper on information spillovers across workers and firms as "agglomeration effects" goes back to Professor Ronald Gilson's 1999 article comparing the growth of California's Silicon Valley and the Route 128 corridor outside of Boston.[3] California did not and now does not follow the general rule that covenants not to compete are valid if they are reasonable in purpose and scope.[4] The post-employment noncompete agreements applicable to Massachusetts employees presented a barrier to the second-stage agglomeration economy that sustains a high technology district by allowing it to reset its product life cycle, an economy that did not develop on Route 128 but did in Silicon Valley.[5]

The White House paper also listed seven areas that highlight how workers may be disadvantaged by non-competes, as follows:

1. Workers who are unlikely to possess trade secrets (in particular, low wage workers) are nonetheless compelled to sign non-competes.[6]
2. Workers are asked to sign a non-compete only after accepting a job offer, when they have already declined other offers and thus have less leverage to bargain.[7]
3. Non-competes, their implications, and their enforceability are often unclear to workers.[8]

[2] "*Non-compete Agreements: Analysis of the Usage, Political Issues and State Responses*" The White House, May 5, 2016, p. 7.

[3] Ronald J. Gilson, "*The Legal Infrastructure of High Technology Industrial Districts: Silicon Valley, Route 128, and Covenants Not to Compete*", 74 N.Y.U.L. REV. 575 (1999).

[4] CAL. BUS. & PROF. CODE §16600 (2019). The policy behind California's rule as expressed by the California Supreme Court states:

> Every individual possesses as a form of property the right to pursue any calling, business or profession he may choose. A former employee has the right to engage in a competitive business for himself and to enter into competition with his former employer provided such competition is fairly and legally conducted.

Cont'l Car-Na-Var Corp. v. Mosely, 24 Cal.2d 104, 110 (Cal. 1944). Agreements not to disclose an employer's trade secrets during or after the term of employment are fully enforceable. *See, e.g*. Muggill v. Reuben H. Donnelly Corp. 62 Cal.2d 239 (Cal. 1965).

[5] *Gilson*, *supra* note 3, at 607.

[6] *White House* paper, supra note 2, at 8.

[7] *Id*. at 9.

[8] *Id*. at 10.

4. Employers often write non-compete agreements that are overly broad or unenforceable.[9]
5. Employers requiring non-competes often do not provide "consideration" that is above and beyond continued employment.[10]
6. In some cases, non-competes can prevent workers from finding new employment even after being fired without cause.[11]
7. In some sectors, non-competes can have a detrimental effect on health and well-being by restricting consumer choice.[12]

With the idea of becoming more competitive with California in terms of venture capital investments in new high tech enterprises and to invigorate its start-up community, and to correct the abuses by employers of noncompete agreements, Massachusetts legislators set out to enact comprehensive legislation relating to noncompete agreements in the summer of 2016. A "garden leave"[13] provision in the legislation turned out to be a concept that was difficult for employers and some legislators to accept, and the legislation was put over to a subsequent legislative session.[14]

On August 10, 2018 Governor Baker signed into law the Massachusetts Noncompetition Act of 2018,[15] limiting the use of noncompetition agreements in Massachusetts and correcting many of the abuses identified in the White House paper. While not adopting

[9] *Id.* at 11.
[10] *Id.* at 12.
[11] *Id.* at 13.
[12] *Id.* at 14.
[13] In a "garden leave clause" in an employment contract, the employee must give a certain amount of notice to the employer in advance of the employee's resignation from employment. In exchange, the employer does not require the employee to come into work during the period of the leave, and the employee will receive full wages and benefits, and can spend his or her time "in the garden". During the leave the employee cannot work for a competitor. However, on leave the employee also cannot access confidential records and will be unable to directly solicit clients or co-workers. *See* Jeffrey S. Klein and Nicholas Pappas, "*Garden Leave" Clauses in Lieu of Non-competes*, www.NYLJ.com, vol. 241 No. 24 (Feb 5, 2009). Given the costs to the employer of paying salary and benefits during the period of garden leave, the employer must carefully identify the type of employee that warrants a garden leave, such as senior executives, key technical employees and employees who have access to confidential information.
[14] The chief executive of the Greater Boston Chamber of Commerce, Jim Rooney commented, "It creates a dynamic in which one employer would have to basically pay someone for not working… this does not feel right." See Jon Chesto, "Bill to Limit Non-compete deals includes a surprise catch". Boston Globe, May 16, 2016, https://www.bostonglobe.com/business/2016/05/16/bill-limiting-noncompete-agreements-advances-with-contentious-provision/bfGSYp0oCW6UVSQH4LMaBM/story.html
[15] Massachusetts Noncompetition Agreement Act, G.L. c.149, s.246 (August 10, 2018).

California's approach to noncompete agreements, nevertheless with its protectable employee provisions and employer economic obligations, and the foundational recognition that noncompetition agreements do serve legitimate business purposes, Massachusetts' new law is structured to enhance the state's innovative economy.

II. THE NEW LAW: SELECTED DEFINITIONS AND EXCLUSIONS FROM COVERAGE

Under the new act a "noncompetition agreement," is an agreement between an employer and an employee, or otherwise arising out of an existing or anticipated employment relationship, under which the employee or expected employee agrees that he or she will not engage in certain specified activities competitive with his or her employer after the employment relationship has ended. The term "employee" as used in this section also includes independent contractors.[16] The law applies to employee noncompetition agreements entered into on or after October 1, 2018 by Massachusetts workers or residents[17] All prior agreements continue to have full force and effect and are not altered by the new law.

Under the law, noncompetition agreements do not include the following covenants, clauses or agreements:

(i) covenants not to solicit or hire employees of the employer;
(ii) covenants not to solicit or transact business with customers, clients, or vendors of the employer;
(iii) noncompetition agreements made in connection with the sale of a business entity or substantially all of the operating assets of a business entity or partnership, or otherwise disposing of the ownership interest of a business entity or partnership, or division or subsidiary thereof, when the party restricted by the noncompetition agreement is a significant owner of, or member or partner in, the business entity who will receive significant consideration or benefit from the sale or disposal;
(iv) noncompetition agreements outside of an employment relationship;
(v) forfeiture agreements;
(vi) nondisclosure or confidentiality agreements;
(vii) invention assignment agreements;
(viii) garden leave clauses;
(ix) noncompetition agreements made in connection with the cessation of or separation from employment if the employee is expressly given seven business days to rescind acceptance; or

[16] §24L(a).
[17] §24L(c).

(x) agreements by which an employee agrees to not reapply for employment to the same employer after termination of the employee.[18]

III. AGREEMENT FORMATION PROCEDURES

Mindful of how workers may be disadvantaged by non-competes, as stated in the White House paper and in testimony before the Massachusetts Joint Committee on Labor and Workforce Development, including workers disadvantaged when asked to sign a non-compete only after accepting a job offer when they had declined other offers and then have less leverage to bargain; or workers who are unclear about noncompetes' implications and enforceability; or are not provided proper "consideration," the new law provides protective procedural and substantive requirements as follows:

(i) For a noncompete agreement entered into in connection with the commencement of employment, it must be in writing and signed by both the employer and employee and expressly state that the employee has the right to consult with counsel prior to signing the document. The agreement must be provided to the employee by the earlier of a formal offer of employment or 10 business days before the commencement of the employee's employment.[19]

(ii) For a noncompete agreement entered into after the employment relationship is started, but not in connection with the separation from employment, the agreement must be supported by fair and reasonable consideration independent from the continuation of employment. The proposed notice of the agreement must be provided at least 10 business days before the agreement is to be effective. Moreover, the agreement must be in writing and signed by both the employer and employee and expressly state that the employee has the right to consult with counsel prior to signing.[20]

IV. PRECLUDING ENFORCEMENT AGAINST LOW WAGE AND OTHER CATEGORIES OF WORKERS

Reflecting a national dialog on the misuse of noncompetes by employers of at-will low wage workers including misuse by Jimmy John's Sandwich Shops in Illinois;[21] and the misuse of noncompete

[18] §24L(a).
[19] §24L(b)(i).
[20] §24L(b)(ii).
[21] Illinois Attorney General Lisa Madigan filed a lawsuit on June 8, 2016 against Jimmy John's Sandwich Shops seeking injunctive and other equitable relief contending:

> … that Jimmy John's use of non-compete agreements for at-will, low wage workers limits the ability of employees to find new employment, … hinders upward mobility of workers looking for higher wages or advancement with new employment using skills obtained in their current employment, and suppresses wages for employees who have limited negotiating power with both current and potential new

agreements by a summer camp in Massachusetts applicable to high school age counselors;[22] and the abuse of other low wage workers in the state with no exposure to company trade secrets or confidential information, the new law precludes enforcement against the following categories of workers:

> (i) an employee who is classified as nonexempt and entitled to overtime pay under the Fair Labor Standards Act; (ii) undergraduate or graduate students that partake in an internship or otherwise enter a short-term employment relationship with an employer, whether paid or unpaid, while enrolled in a full-time or part-time undergraduate or graduate educational institution… and (iv) employees age 18 or younger.[23]

The law also precludes enforcement of noncompete agreements against employees who have been terminated without cause or laid off.[24]

employers when they are limited by a non-competition agreement. … Complaint, *Illinois v. Jimmy John's Enterprise, LLC.*, 2016 CCH 07746 at 17.

All store employees are employees at-will, and all store employees in Illinois were required to sign a non-competition covenant, which stated in part:

> **Non-Competition Covenant.** Employee covenants and agrees that, during his or her employment with Employer and for a period of two (2) years after… he or she will not have any direct or indirect interest in or perform services for (whether as an owner, partner, investor, director, officer, representative, manager, employee, principal, agent, advisor, or consultant) any business which derives more than ten percent (10%) of its revenue from selling submarine, hero type, deli- style, pita and/or wrapped or rolled sandwiches and which is located within three (3) miles of either (1)_________[Insert address of employment], or (2) any such other JIMMY JOHN'S Sandwich Shop operated by JJF, one of its authorized franchisees, or any of JJF's affiliates....
>
> **Costs and Attorney's Fees.** Employee agrees to reimburse Employer and JJF for all costs and expenses, including attorney's fees, that Employer or JJF incur to enforce this Agreement against Employee.Id. at Exhibit A.

On December 7, 2016 the parties announced a settlement with Jimmy John's, in which the company, among other things, is required to notify all current and former employees that their non-compete agreements are unenforceable and that Jimmy John's does not intend to enforce them. "*Illinois Attorney General Madigan Announces Settlement With Jimmy John's For Imposing Unlawful Non-Compete Agreements*," http://www.illinoisattorneygeneral.gov/pressroom/2016_ 12/20161207

[22] Adam Vaccaro, *A Massachusetts Summer Camp Uses Noncompete Clauses*, boston.com (June 9, 2014).

[23] §24L(c)(i)(ii) and (iv).

[24] §24L (c)(iii).

V. GENERAL ENFORCEMENT PRINCIPLES

The Restatement (Second) of Contracts sets forth the general principles for states to enforce non-compete agreements considering: (1) whether "the restraint is greater than needed to protect the [employer's] legitimate interests; (2) the hardship to the [employee]; and (3) the likely injury to the public."[25] The employer's legitimate business interests may include confidential information, trade secrets and customer good will.[26] Overly broad geographic and time restrictions are unenforceable.[27] The Noncompetition Act codifies and carries forward these common law principles regarding scope, duration, geographic reach and proscribed activities.

A. Breadth

The agreement must be no broader than necessary to protect the legitimate business interests of the employer: such as the employer's trade secrets; the employer's confidential information that otherwise would not qualify as a trade secret; or the employer's goodwill.[28] Thus, existing case law, not in conflict with the act, protecting confidential business information will continue under the new act, as seen in the pre-act *SimpliVity Corp. v. Moran.* In the *SimpliVity* case the court allowed a preliminary injunction against Keith Moran, enjoining him from working for a competing start up, Nutanix, or any other firm in the data storage industry for a year even though he promised not to solicit the customers of his former employer, SimpliVity.[29] The court determined that he would inevitably use the SimpliVity confidential information in his brain memory in selling Nutanix's products and competing against SimpliVity. [30]

Also, existing case law refusing to enforce a noncompete agreement broader than necessary to protect the legitimate business interest of the employer will continue under the new act. The pre-act case *Elizabeth Grady Face First, Inc. v. Garabedian* demonstrates that decision where the employer was not entitled to a preliminary injunction on a non-compete agreement against two former employees who operated a day spa nine miles from the plaintiff's shop.[31] The court

[25] Restatement (Second) of Contracts § 188 (1981).

[26] DAVID TWOMEY, MARIANNE JENNINGS & STEPHANIE GREENE, BUSINESS LAW, PRINCIPLES FOR TODAY'S COMMERCIAL ENVIRONMENT. pp. 277, 278 (5th ed. 2017).

[27] *Id.*

[28] §24L(b)(iii).

[29] SimpliVity Corp. v. Moran, 2016 Mass. Super. LEXIS 297 at *33. (Aug. 14, 2016).

[30] *Id.*

[31] Elizabeth Grady Face First Inc. v. Garabedian et al, 2016 Mass. Super. LEXIS 34 at *13.

found that there was no evidence that the defendants were possessed of or exploiting bona fide trade secrets, confidential information, or customer good will belonging to the company, rather the court stated it was evident that Elizabeth Grady's true motivation was to thwart ordinary competition from conventionally skilled service providers. The court determined that this was not permissible under Massachusetts law.[32]

B. Duration

The new law limits the restricted period of a non-compete twelve months from the date of cessation of employment.[33] However, should an employee breach his or her fiduciary duty to the employer such as obtain secret profits made in connection with the employer's business, or the employee has unlawfully taken, physically or electronically, property belonging to the employer, such as customer lists or business plans, then the duration may not exceed two years from the date of cessation of employment.[34]

C. Geographic Reach

Under the new law, the noncompete agreement must be reasonable in geographic reach. A geographic reach that is limited to only the geographic areas in which the employee, during any time within the last two years of employment, provided services or had a material presence or influence is presumptively reasonable.[35] The statutory language "had a material presence or influence" not being defined in the law may lead to future litigation leading to the development of a body of case law to resolve each controversy as the courts exercise their discretion to reform noncompete agreements under Section 24 L(d) of the act.

D. Proscribed Activities Related to Services Performed by the Employee

Under the law, the agreement must be reasonable in the scope of proscribed activities in relation to the interests protected. A restriction on activities that protects a legitimate business interest and is limited to only the specific types of services provided by the employee at any

(Mar. 25, 2016).

[32] *Id.* at *11.

[33] §24L(b)(iv).

[34] *See id.*

[35] §24L(b)(v).

time during the last two years of employment is presumptively reasonable.[36]

VI. THE GARDEN LEAVE CLAUSE

The agreement not to compete with an employer after the employment relationship ends must be supported by (a) a garden leave clause; or (b) other mutually agreed upon consideration between the employer and employees, provided that such consideration is specified in the noncompetition agreement.[37] The garden leave clause must provide for the payment, on a pro-rata basis during the entirety of the restricted period (up to one year), of a least 50 percent of the employee's highest base salary over the two years preceding the employee's termination.[38] The employer may waive the restrictions upon post-employment activities and be relieved of its contractual obligations to make the garden leave payments.[39]

The agreement not to compete for the one year restriction period may alternatively be supported by "other mutually-agreed upon consideration," between employer and employee specified in the noncompete agreement.[40] The statutory language provides a loophole clearly allowing the employer to negotiate with new employees pragmatic compensation packages based on market conditions, including stock options or signing bonuses in lieu of a garden leave provision. Fear that "other mutually agreed upon consideration" must be equivalent to the 50% garden leave pay rate is unsupported by the statutory language and legislative history.

VII. LITIGATION ISSUES

A. Reformation

The White House paper references the disadvantages faced by workers when employers require non-compete agreements that are overly broad. While states such as Nebraska, Virginia and Wisconsin refuse to enforce noncompete contracts that contain overly broad

[36] §24L(b)(vi). *See* the Virginia Supreme Court decision in *Home Paramount Pest Control v. Shaffer,* 282 Va. 412, 416 (2011) where the noncompete provision prohibited Shaffer from "engag[ing] indirectly or concern[ing] himself… in any manner whatsoever" in pest control "as an owner, agent, servant, representative, or employee and/or as a member of a partnership and/or as an officer, director or stockholder of any corporation, or in any manner whatsoever."… Because the non-compete provision did not confine the function element to those activities Shaffer actually engaged in for the employer, the court found the noncompete provision was overbroad and unenforceable.

[37] §24L(b)(vii).

[38] Id.

[39] §24L(a).

[40] §24L(b)(vii).

provisions,[41] the new Massachusetts law allows a court, in its discretion, to reform or otherwise revise a noncompetition agreement so as to render it valid and enforceable to the extent necessary to protect the applicable legitimate business interests.[42]

B. Court Venue

All civil actions relating to employee noncompetition agreements must be brought in the county where the employee resides or, if mutually agreed upon by the employer and employee, in Suffolk county.[43] If the action is brought in Suffolk county, the superior court or the business litigation session of the superior court shall have exclusive jurisdiction.[44]

C. Choice of Law Restrictions

No choice of law provision in any contract that would have the effect of avoiding the requirements of the law will be enforceable if the employee is, and has been for at least thirty days immediately preceding his or her cessation of employment, a resident of or employed in Massachusetts at the time of his or her termination of employment.[45]

VIII. CONCLUSION

The vibrancy of California's Silicon Valley innovation economy due in part to information sharing facilitated by worker mobility unfettered by non-compete agreements is well established.[46] It has been encumbered somewhat however, by practices where major employers including Google and Apple allegedly agreed with each other not to hire away each other's employees, a factor contradicting the mobility of employees in high tech firms in Silicon Valley.[47]

[41] See RUSSELL BECK, EMPLOYMENT NONCOMPETES A STATE BY STATE SURVEY (Jan. 13, 2019).

[42] §24L(d).

[43] §24L(f).

[44] *Id.*

[45] §24L(f). In *Oxford Global Resources, LLC v. Hernandez*, 480 Mass. 462 (2018) the Massachusetts Supreme Judicial Court refused to enforce a noncompete – nonsolicitation agreement, with a choice of law provision expressly governed by Massachusetts law, involving a California-based former employee because, in part, California was the most appropriate forum for the resolution of the controversy and California's public policy prohibits such agreements.

[46] *Non-compete Agreements: Analysis of the Usage, Political Issues and State Responses,"* The White House, May 5, 2016. p. 7.

[47] *See* U.S. v. Adobe Systems, Inc.; Apple Inc.; Google Inc.; Intel Corp.; Intuit Inc. and Pixar, 2011 U.S. Dist. LEXIS 83756 at *5 (D. D.C. Mar. 17, 2011) where defendants agreed that they participated in at least one agreement in violation of the Sherman Act and each defendant was enjoined from attempting to enter into, any agreement with any other person to in any

The role of broad-based employee stock options in California may be used to handcuff valuable employees of successful private firms as surely as if they were locked into powerful noncompete contracts. The employee retention function of stock options is undepreciated in the literature on employee mobility and innovation according to a recent note by Yitfat Aran, published in the *Stanford Law Review*.[48] She contends that the payoff structure of stock options binds employees to the startup when the startup prospers, but pushes them away when the startup stumbles, steering talent to where it is most valuable.[49]

Metropolitan Boston has enormous core strengths in technology derived from MIT, Harvard, its other major universities and its world class research based hospitals. Boston leads the world in start-up activity in biotech, and there is solid growth in tech industries as well.[50] Moreover, there is a surge in innovation in Intelligent Systems, where start-ups are building out infrastructure for practical applications of such systems.[51]

The very appropriate adjustment to Massachusetts' noncompete legal infrastructure set forth in the state's 2018 law, with noncompete restrictions generally for just one year, coupled with garden leave payments or other mutually-agreed upon consideration will sustain and retain innovation talent in the region, with the existing stock option structure in private firms also very much present in the Massachusetts economy, locking in highly skilled employees to successful firms and steering other talent to where it is most valuable.

way refrain from soliciting, cold calling, recruiting, or otherwise competing for employees of the other person. *See also* Steve Musil "Apple/Google offer $415 million to Settle Anti- pouching Suit – SNET", Jan. 15, 2015, www.CNET.com.

[48] Yifat Aran, *Beyond Covenants Not to Compete: Equilibrium in High-Tech Start Up Labor Markets*, 70 Stan. L. Rev. 1235 (April, 2018).

[49] *Id.* at 1238, 1239. The author points out that an initial public offering allowed vested employees to cash out their stock options releasing the company's grip on the entrepreneurial talent, but todays companies are able to raise growing sums of money in private markets avoiding IPOs and impeding the departure of much needed entrepreneurial talent.

[50] Todd Hickson "The Boston Tech Startup Ecosystem Is Making a Strong Comeback", April 8, 2016, www.forbes.com.

[51] *Id.*

GAUGING THE EFFECTIVENESS OF THE MASSACHUSETTS BENEFIT CORPORATION STATUTE (M.G.L. 156E)

by John B. Duggan*, Katherine Marsland**, Hannah Baxter***, and Molly Jones****

Abstract: This paper seeks to evaluate the effectiveness of the Massachusetts Benefit Corporation statute, M.G.L. 156E (hereinafter "the Act"), after 6 years of implementation. When the Act was adopted in 2012, proponents sought to provide an opportunity for socially conscious entrepreneurs and investors to ingrain Corporate Social Responsibility ("CSR") into the foundation of the corporation. The Act faced criticism from legal scholars[1] who questioned the enforcement mechanisms of the statute and the effectiveness of the "third-party standard."

This paper looks at the results of the legislation, inquires if its potential was realized, and if the problems prophesized have come to pass. The authors draw on available public records, public records requests, interviews with Benefit Corporation management, survey

* John B. Duggan, J.D. is an Assistant Professor of Business Law, and Chairperson of the Department of Business Administration in the Leo J. Meehan School of Business at Stonehill College.

** Katherine Marsland, J.D. is an Adjunct Faculty member at Stonehill College and Emmanuel College.

*** Hannah Baxter (Stonehill College class of 2019).

**** Molly Jones (Stonehill College class of 2019).

[1] David Houlihan, *Who Benefits?: Why the Massachusetts Benefit Corporation Falls Short*, NORTHEASTERN LAW REVIEW EXTRA LEGAL (APR. 23, 2014), http://nulawreview.org/extralegalrecent/who-benefits-massachusetts-benefits-corporations-fall-short.

results from current and former Benefit Corporation managers, and other legal scholarship in the area.

Section 7 of the Act requires that companies advertising themselves as Benefit Corporations fully comply with the requirements of the Act and, by reference, M.G.L. chapters 156 A and D. Based on the authors' investigation, 2.5% (n=78) of Massachusetts Benefit Corporations fully comply with these requirements. The authors propose multiple recommendations to address their assessment of the causes of noncompliance: 1) a lack of state administrative support, 2) incorporator disengagement, and 3) numerous, and overly specific, statutory requirements.

IN THE "B"EGINNING

The Model Benefit Corporation Act (hereinafter "MBC") was created by the Pennsylvania non-profit B-Lab.[2] The founders of B-Lab approached the formation of the MBC with a perspective of personal experience. Jay Coen Gilbert and Bart Houlahan founded And1, a basketball shoe, equipment, and apparel company – soon growing to the number two basketball shoe brand in the United States.[3] And1 encountered problems after their rapid growth resulting in the sale of the company by Gilbert and Houlahan in 2005.[4] They saw the culture of social responsibility they had built at the company wiped away soon after the sale of And1.[5]Moving forward, Gilbert and Houlahan sought to create a new business entity that would match an incorporator's desire to found a "good company" forming B-Lab in 2006.[6]

[2] William H. Clark & Larry Vranka, *The Need and Rationale for the Benefit Corporation: Why it is the Legal Form that Best Addresses the Needs of Social Entrepreneurs, Investors and Ultimately the Public* at 27 (Jan. 18, 2013), https://benefitcorp.net/sites/default/files/Benefit_Corporation_White_Paper.pdf

[3] Ryan Honeyman and Tiffany Jana, *The B Corp Handbook – How You Can Use Business as a Force for Good*, 22 (Second Edition 2019).

[4] *Id.* at 23.

[5] *Id.*

[6] *Id. See also* Kyle Westaway & Dirk Sampselle, *The Benefit Corporation: An Economic Analysis With Recommendations To Courts, Boards, And Legislatures*, 62 EMORY L.J. 999, 1010-1011 (2013) (citing *Introducing the B Corporation, B Revolution Consulting 4* (May 15, 2012)).

Since 2010 the MBC has been adopted in thirty-four states with legislation pending in six states.[7] The purpose of the MBC[8] and Benefit Corporation Law [9] is well documented as are its potential problems.[10]

The problems with the legislation after implementation are less well known.[11] Each state's modification of the MBC[12] and the realities of implementation of the MBC under each specific state's statute creates an array of functional issues.

Maryland provided the first analysis of the actual implementation of the MBC.[13] This research presented several short falls and proposals for correction aimed at supporting the nascent entity type. Much of the scholarship surrounding Benefit Corporations recently has attempted to address the practical considerations of the implementation of the MBC variants in particular states[14] and compliance in general.[15] Researchers[16] have attempted to evaluate compliance rates for sample states [Minnesota, Delaware, Oregon, Colorado] that have adopted the most common variants of social enterprise statutes (MBC and Delaware statutory framework). This research extrapolates compliance for annual benefit reports to overall Benefit Corporation compliance.[17]

It has been noted that the MBC itself, and the relatively wide adoption of MBC variants, provides an opportunity for standardization of the Social Enterprise model.[18] The Social Enterprise model attempts to use capitalism's wealth to rectify problems capitalism itself has

[7] B-Lab, http://www.benefitcorp.net/policymakers/state-by-state-status (last visited 4/8/19).

[8] *See generally* Clark, Westaway; *see also* Kathryn Acello, *Having Your Cake and Eating It, Too: Making the Benefit Corporation Work in Massachusetts,* 47 SUFFOLK U. L. REV. 91, (2014).

[9] Mark J. Loewenstein, *Benefit Corporation Law,* 85 U. CIN. L. REV. 381 (June, 2017).

[10] Houlihan, *supra*, note 1; *see also* Acello.

[11] Ellen Berrey, *Social Enterprise Law in Action: Organizational Characteristics of U.S. Benefit Corporations*, 20 TRANSACTIONS 21, 26 (FALL 2018).

[12] See: smithmoorelaw.com/webfiles/BCorpWebMap.pdf – visited 8/8/18 and B CORP statutory evaluation http://benefitcorp.net/sites/default/files/documents/State%20by%20State%20Analysis_0.pdf.

[13] Acello, *supra* note 6, at 106.

[14] John Rappa, *Benefit Corporations*, OFFICE OF LEGISLATIVE RESEARCH (Aug. 30, 2018), https://www.cga.ct.gov/2018/rpt/pdf/2018-R-0110.pdf.

[15] Maxime Verheyden, *Public Reporting by Benefit Corporations: Importance, Compliance, and Recommendations,* 14 HASTINGS BUS. L.J. 37, 94 (Winter, 2018).

[16] *See generally Id. see also* Berrey, *supra* note 9.

[17] Verheyden, *supra* note 13, at 41.

[18] Kayleen Asmus, *Finding the Benefit in a New Administration: A Uniform B Corporation Legislation*, 43 IOWA J. CORP. L. 375, 376 (2017-2018).

created.[19] With the design of a new corporate format, the Benefit Corporation, entities can prioritize both profits and social missions and even choose to promote the social mission over profits[20] without fear of repercussion from stockholders.

The underlying assumption in these arguments is that states across the country have a common motivation and economic connection in implementing their Social Enterprise statutes and methodology for corporate compliance.

MASSACHUSETTS STATUTE

Massachusetts has implemented what appears to be a unique variant of the MBC – adding the additional requirement that an entity, formed under the Act, must be in full compliance with the Act in order to hold itself out as a Benefit Corporation.[21] The Act's unique feature creates a need for vigilance by the entities and the Commonwealth. However, the realities of the enforcement of the statutory requirements of the Act, and the consequences of compliance failure, have been less clear.

Legislative History

The Act, M.G.L. Ch 156E, was enacted as part of H4352 – *An Act Relative to Infrastructure Investment, Enhanced Competitiveness and Economic Growth In the Commonwealth* – and is an adaptation of the MBC.[22]

H4352 contained a variety of projects aimed at sparking economic growth in the Commonwealth in the midst of the Great Recession.[23] As such, the legislative history of the specific "Benefit Corporation" provision is difficult to discern from publicly available documents.

A fair reading of the bills that were recommended favorably from the *Committees on Economic Development and Emerging Technologies, Ways and Means, and Bonding, Capital Expenditures, and State Assets* in May of 2012 shows very little change to the Benefit Corporation sections.[24] An amendment to strike the Benefit Corporation section from the final House bill failed (no vote recorded).[25]

[19] Berrey, *supra* note 9, at 4.

[20] *Id.* at 5.

[21] Michael A. Hacker, *"Profit, People, Planet" Perverted: Holding Benefit Corporations Accountable to Intended Beneficiaries*, 57 B.C. L. REV. 1747 at FN 43 (2016).

[22] H. 4352, 187th Leg. (Ma. 2012).

[23] MASS. GEN. LAWS ch. 238 (2012).

[24] H. 4093, 187th Leg. (Ma. 2012).

[25] See: Amendment #42 by Sen. Kennedy, 5/23/12 https://malegislature.gov/Bills/187/S2350/Amendments/Senate.

Despite the scope of the legislation, the Massachusetts legislature passed H4352 on July 31, 2012 (the last day of the legislative session[26]). The majority of the bill was signed by Governor Deval Patrick on August 7. 2012. (Twenty-one sections, unrelated to Benefit Corporations, were vetoed by the Governor and returned to the House Ways and Means Committee).[27]

Massachusetts Distinctions from the MBC:

The Act created two (2) distinct provisions that differ from the MBC:

- A shareholder right of appraisal at conversion from Corporation to Benefit Corporation[28]
- A prohibition on Massachusetts entities holding themselves out as Benefit Corporations *unless* they are A) organized under the Act **and** B) are in full compliance with the Act.

These provisions clearly aim at consumer protection; legislators attempted to protect shareholders reluctant to switch to Benefit Corporations and consumers defrauded by non/noncompliant Benefit Corporations.[29] However, as the statute is lacking other enforcement provisions, the attempt to protect consumers is essentially useless. The authors know of no instance of these provisions being utilized in litigation.

Compliance and Entity Failure

Our first analysis of Benefit Corporations in Massachusetts sought to determine the continued legal existence of entities that filed articles of incorporation as Benefit Corporations: How many Massachusetts Benefit Corporations "exist"?

This research began by searching the public listings of Benefit Corporations on B-Labs website. This was an unreliable list, devolving into a confusing spiral of vocabular pedantry – a Benefit Corporation is *not* a B-Corp and a B-Corp *may or may not* be a Benefit Corporation.[30] The list also included LLCs, Partnerships, and entities which were not incorporated in Massachusetts (e.g. Boloco – a Massachusetts restaurant chain incorporated in New Hampshire and Delaware).

[26] https://www.massbar.org/advocacy/legislative-activities/the-legislative-process.
[27] *See* H. 4352, *supra* note 22.
[28] *See* Acello, *supra* note 6 at 107.
[29] *Id.* at 114.
[30] *See* Verheyden, *supra* note 13, at 40.

This list was necessary in order to determine whether an entity that "held itself out" as a Benefit Corporation, incorporated in Massachusetts, was compliant with the Act.

A search of the Massachusetts Secretary of the Commonwealth (hereinafter "the Secretary") Corporations Division's Public Database also proved unfruitful.[31] Unfortunately, Massachusetts does not distinguish between Domestic For-Profit Corporations and Domestic For-Profit Benefit Corporations on its public website.

The next step was to seek internal data and tracking from the Secretary through multiple public records requests with the Secretary. The records requests were promptly acted upon by the Secretary's office, often with responses occurring in under twenty-four (24) hours. Much of the reason for filing multiple records requests was confusion by the authors about how the data was stored, coded, and accessible.[32]

Records obtained via the Secretary's database and public records requests allowed the authors to determine 1) if the entity maintained its legal existence and 2) if the entity complied with basic filing requirements (Annual Report and Benefit Report).

In the Commonwealth of Massachusetts from December 2012 through March 19, 2019 eighty-six (86) entities filed as Benefit Corporations.

- Thirteen (13) were filed within the past year and thus have had no chance to comply with the annual statutory filing requirements;
- Three (3) converted to another entity;
- Five (5) were voluntarily dissolved;
- Forty (40) have never filed an annual report or annual benefit report yet remain in good standing;
- Twenty-Five (25) are more than one year old and remain in existence and good standing with the Secretary of the Commonwealth's Office and have filed their required annual reports.[33]

[31] William Francis Galvin, Secretary of the Commonwealth of Massachusetts, *Corporations Division Search the Corporate Database,* http://corp.sec.state.ma.us/corpweb/CorpSearch/CorpSearch.aspx.

[32] For example, different data was provided when the request included "all entities that were dissolved" versus when the request stated "all entities that were voluntarily dissolved".

[33] Benefit Corporations in Massachusetts must file their annual benefit report with the Secretary of the Commonwealth. It is unknown at this time if the Secretary of the Commonwealth's office monitors the separate filing of an annual report and a benefit report as grounds for administrative dissolution.

COMPLIANCE WITH BENEFIT REPORT REQUIREMENTS UNDER THE MBC

While each state that uses the MBC has its own idiosyncratic implementation, the requirements of what makes up the Annual Benefit Report for a Benefit Corporation in many states are notably similar. The MBC requires that a Benefit Corporation's Annual Benefit Report "shall" contain the following (variations shown in footnotes where necessary):

1) The Entity's Pursuit of General Public Benefit
2) The Entity's Pursuit of Specific Public Benefit [34] (if applicable)
3) The Entity's Headwinds for achieving Benefit
4) The Entity's reasons for selecting particular third party standard
5) An Assessment of Social Impact
   a. Consistent with third party standard
   b. Explanation for inconsistency (if applicable)
6) An Assessment of Environmental Impact
   a. Consistent with third party standard
   b. Explanation for inconsistency (if applicable)
7) The Address of Benefit Director and Benefit Office (if applicable) for correspondence
8) The Compensation of Benefit Director (as Benefit Director only)
9) Names of each person (or beneficiary) if knowable owning >5% of stock[35]
10) Statement of the Benefit Director
    a. That the entity acted in accordance with the stated benefit
    b. Directors complied with the requirement to consider all stakeholders in decisions
    c. Why and how the company and/or directors failed to comply with the stated benefit
    d. Impact of Benefit Corporation status on Business (client/consumer opinion, ROI), impact on shareholders, and impact on employees
11) Conflicts of interest with the 3rd party standard provider (if any)
12) Board Substitute (if applicable) for close corporations.

Compliance with these standard requirements among Benefit Corporations is the essential mode of transparency as envisioned by the creators of the MBC.

Massachusetts

A Massachusetts business cannot claim to be a Benefit Corporation "unless it was organized under and in full compliance with this chapter."[36] The Secretary of the Commonwealth requires two separate

[34] Westaway, *supra* note 6, at 1039.
[35] M.G.L. 156E § 15(a)(5).
[36] *Id.* at §7.

filings, an annual report and an annual benefit report. There are no standard forms provided.

An analysis of public records requests received from the Secretary of Commonwealth shows that 32.05% - twenty-five (25) out of seventy (78) entities filed either an Annual Report and/or an Annual Benefit Report.

However, over the last six years in Massachusetts, the compliance rate of Benefit Corporations following all reporting requirements [thus able to actively hold themselves out in Massachusetts as a Benefit Corporation] has been only 2.5% - two (2) out of seventy-five (78) entities.

Completing the annual benefit report is, theoretically, an involved process.[37] Companies are expected to keep records of their social impact, comparing their requirements to the third party standard, discussing their adequacy, and creating their report to be transparent and thorough. This information is variable from year to year, unique to each company (choice of third party standard, General Benefit, Specific Benefit, etc.). This is made more complicated by the lack of standardization and guidance from the Commonwealth.[38]

However, for all practical purposes, a Benefit Corporation in Massachusetts could file a three sentence statement on company letterhead as its Annual Benefit Report and remain, at least from a cursory inspection, compliant with the annual filing requirements for the Commonwealth.[39] For example a company, incorporated as a Benefit Corporation in Massachusetts and currently in good standing, provided the following opening as the majority of its benefit reports for 2015 and 2016:

> 2015
> [*********] *(Company)* was incorporated [in 2014] and has afiscal year that ends on December 31. The Company's primary function is to assist local governments and organizations with developing and implementing plans and programs to make them more sustainable.
>
> 2016
> [*********] *(Company)* was incorporated [in 2014] and has a fiscal year that ends on December 31. The Company's primary function

[37] *See* Verheyden, *supra* note 13 at 59.

[38] Secretary of the Commonwealth of Massachusetts, MEMORANDUM: NEW LEGISTATION, MASSACHUSETTS GENERAL LAWS CHAPTER 156E, EFFECTIVE DECEMBER 1, 2012, *available at* https://www.sec.state.ma.us/cor/corpdf/Notice%20regarding%20Benefit%20Corporations.pdf.

[39] This is actually the case with multiple Massachusetts entities still in existence and in good standing.

> is to assist local governments and organizations with developing and implementing plans and programs to make them more sustainable.[40]

From 2015 to 2016 the company changed a total of seventeen (17) words, constituting one half of one sentence, in their benefit report. The company's statements did not change substantially in 2017 and 2018.

It is unclear whether the Secretary has or would inspect Benefit Report filings for statutory compliance.

This paper addresses this shortfall.

Failure to comply with all the provisions of MGL Ch. 156E, including all of the requirements in the Annual Benefit Report in section 15, means that the corporation cannot hold itself out as a Benefit Corporation. In addition, the statute incorporates, by reference, the compliance requirements of MGL 156A– the underlying Corporations statute in Massachusetts.[41]

This standard may be a true impediment to the growth of Benefit Corporations in Massachusetts.[42] It also creates an increased level of liability for corporations, in violation of the statutory compliance, to clients, customers, business partners, and possibly state entities that enter into contracts with Benefit Corporations relying on their representation that the corporation is a social enterprise.[43] Though, to be fair, Massachusetts has the second most entities incorporated as Benefit Corporations in New England.[44]

The practical implication of the requirements has been to make the "Massachusetts Benefit Corporation" that is statutorily allowed to call itself a "Benefit Corporation" exist on the edge of extinction.

Compliance and Data:

M.G.L. 156E §7 states that a business cannot claim to be a Benefit Corporation "unless it was organized under and in full compliance with this chapter."[45] However, over the last six years in Massachusetts, the compliance rate of Benefit Corporations following all reporting requirements has been only 2.5%. This conclusion was reached by analyzing records received from the Secretary of the Commonwealth through records requests, investigating publicly available records on

[40] Italics and brackets not in original.

[41] M.G.L. Ch. 156E s. 3.

[42] Acello, *supra* note 6, at 113-114.

[43] Houlihan, *supra* note 1, at FN 13.

[44] CT – 123; MA – 75; NH – 58; VT – 59; RI – 17. With the exception of Maine which does not have a Benefit Corporation Statute (as of December 2018).

[45] M.G.L. Ch. 156E s. 7.

the internet, surveying Massachusetts Benefit Corporation officers, and interviewing two of those officers for further information.

Eighty-Six (86) businesses have incorporated as Massachusetts Benefit Corporations under M.G.L. 156E since the implementation of the statute in 2012. Two (2) companies converted to Nonprofit Organizations - deciding this structure was better suited for their purposes. One (1) business converted to a Domestic for Profit Corporation from a Benefit Corporation.[46] Five (5) entities have been dissolved.

Of the remaining Seventy-Eight (78) entities:

A) Thirteen (13) businesses are too new to analyze, as they filed their articles of incorporation within the past twelve (12) months and are not yet required to file any annual reports;

B) Sixty-Five (65) remain in good standing with the Secretary's Office

   a) Forty (40) of the Benefit Corporations have not filed Annual Reports during their existence.

   b. Twenty-Five (25) Benefit Corporations have filed Annual reports after their initial Articles of Incorporation.

      1. Only sixteen (16) of these Benefit Corporations have filed Annual Benefit Reports, which are required attachments to the Annual Reports.

Considering Benefit Reports are required annually for all Benefit Corporations, a filing compliance rate of 20.5% [sixteen (16) out of seventy-eight (78)] should be cause for concern alone. An analysis of every Benefit Report available for each of the sixteen (16) complying businesses showed that only two (2) Benefit Corporations acted in accordance with the specific requirements, as their officers and benefit directors addressed every element required by statute. Therefore, the actual compliance rate for sufficient Benefit Reporting in Massachusetts is only 2.5%, or, in other words, only two (2) out of seventy-five (78) corporations in the Commonwealth can legally call themselves Benefit Corporations.

Our quantitative analysis results described above involved a simple checklist for the various elements required in Benefit Reports. If an element was addressed, the report was given a "Yes," if not, a "No," and if the element did not apply to the business and was only required to be addressed if applicable, it was given "Not Applicable." Those reports

[46] Going forward in the analysis, we include these three (3) converted organizations in the total because they never complied with the reporting requirements when they were active Benefit Corporations.

with even a single "No" could not be considered in accordance with the legislation, no matter how minor the forgotten element seemed. Multiple businesses, however, had many missing elements or provided extremely brief Benefit Reports that did not successfully represent the business, explain the General or Specific Public Benefit, or give enough information to provide the consumer protection sought by the Act.

Complying with the "Spirit" of Transparency

Aside from the required elements above, for the purpose of this study high quality Benefit Reports were considered to be those including a description of the benefit created throughout the year, stating clear goals for the years ahead, detailing any difficulties it had faced in achieving the benefit or anticipated facing in the future, adhering to transparency, utilizing a third party standard, and attaching a substantive Benefit Director statement.

Clear goals are those that include both broad intentions to cover the entire scope of the business and smaller, more specific objectives. Also, goals were deemed clear if they included an ideal timeline to strive for, regardless of whether or not the businesses claimed, in later reports, to have successfully accomplished their goals in the given time. Unclear goals were those that were vague or not directly stated.

When qualitatively analyzing Benefit Director statements, those deemed "substantive" formally introduced the Benefit Director, explained his or her relevance to the company, described the highlights of the benefit the corporation created within the year, discussed any issues or other important details about the selected third party standard, and, most importantly, signed off that the business was acting in accordance with its stated benefit. Those that contained only a brief explanation that he or she was the Benefit Director and the business acted appropriately were not deemed substantive.

No company was determined to have filed a "quality" Benefit Report if it copy/pasted its annual reports changing only the dates on the reports.

Of the sixteen companies, incorporated as Benefit Corporations in Massachusetts that had filed annual benefit reports six (6) filed "quality" benefit reports. This analysis is not a determination of compliance. However, these six companies included clear and transparent goals as well as statements of benefit directors that were not cursory. These six (6) companies intended to comply with the requirements of the Act.

The most common technical violations of the Act were a failure to address headwinds to success in achieving the General and Specific Public Benefit. Companies may not want to confront the challenges that they face. However, any reasonable reading of the Act for what an

Annual Benefit Report must contain – or merely a Google search of "Annual Benefit Report" would show the producer of the report that any hindrances must be included.[47] While it is entirely possible that a company feels as though it did not face any hindrances to its Public Benefit, it must still address this area in the Benefit Report at some point in order to fully comply with the statutory requirements.

RECOMMENDATIONS

Based on these findings, below are five (5) ways to make the act of complying with reporting requirements more straight-forward for the Massachusetts Benefit Corporation. While some companies are putting in the effort to comply with the standards, they often fall short due to missing technical requirements of the statutory details in their reports. For example, companies commonly leave out a discussion of any problems they faced achieving their General or Specific Public Benefit over the last year.[48] The statute includes this requirement as a part of the "narrative description" that all Annual Benefit Reports must include.

First, the Commonwealth should create a required form which serves as the basis for all Benefit Reports. This is a model that has been effective in the State of Rhode Island, where one form serves as an Annual Report and an Annual Benefit Report.[49] This is a simple way to ensure that all statutorily required information is included in the report. It must include all of the details the Commonwealth requires but present it in a way that allows the company to focus on the quality of the information they provide, rather than worrying about which information is necessary.

B-Labs recently changed their B Impact Report form, after a period of public comment, to reflect the required elements of the MBC annual benefit report requirements.[50] This is a step in the right direction as many companies, in the Commonwealth and in other states, use this report as their Annual Benefit Report.[51] This may have the effect of mitigating a small number of non-compliant Benefit Reports.

[47] *Id.* see also B Lab, https://benefitcorp.net/businesses/benefit-corporation-reporting-requirements.

[48] M.G.L. Ch. 156E § 15(a)(1)(iii).

[49] Nellie M. Gorbea, Secretary of State of Rhode Island, *File Your Annual Report*, http://sos.ri.gov/assets/downloads/documents/633-benefit-corporation-annual-report.pdf.

[50] Ana Citlalic Gonzalez-Martinez, *Version 6 of the B Impact Assesment, scheduled for launch January 2019, is now available for public comment!* B-Lab (last visited Apr. 22, 2019) https://bcorporation.net/news/version-6-b-impact-assessment-available-public-comment (link to Version 6 is in paragraph 3 follow the "here" hyperlink).

[51] Verheyden *supra* note 13, at 84.

Second, Benefit Corporations should attach a Table of Contents to their Benefit Report. This could provide an easy reference sheet for the Secretary of the Commonwealth to analyze nominal compliance for the content of Benefit Reports. Over time rejection of filings by the Secretary and corrected filings from the entity could move towards compliance. This would also serve as a checklist while creating the Benefit Report, while leaving freedom for each individual company to structure the report in a way that works best for them.

Keene Advisors, Inc. currently provides a Table of Contents in the early pages of its Benefit Reports and is the second of the two fully compliant Benefit Corporations. The Table of Contents helps make Keene Advisors, Inc.'s Benefit Report easy to follow. Utilizing this format for all Benefit Reports has the potential to allow companies to focus more on the quality of the content they are providing while still ensuring that they fulfill each statutory requirement.

Perhaps the most important change that must be made is to implement real consequences for failure to comply with the Act. The Secretary of the Commonwealth must be empowered to revoke the Benefit Corporation status of any corporation that fails to file the required Annual and Benefit Reports, or any corporation that fails to provide the required information in their Benefit Report. Admittedly, this will require oversight and vigilance from the Office of the Secretary of the Commonwealth. However, the implementation of a standard Benefit Report form, required to be fully completed by each Benefit Corporation, would streamline the process.

Alternatively, the Secretary of the Commonwealth mustimplement fines for those Benefit Corporations that fail to report accurately or completely on their Annual Benefit Report. This should be a first step when a Benefit Corporation does not comply with reporting statutes, with chronic offenders being subjected to the loss of their status as a Benefit Corporation.

The Commonwealth must also reassess exactly what needs to be provided in Benefit Reports and make any adjustments necessary to the legislation. This method would yield a higher compliance rate among Massachusetts Benefit Corporations, while also setting penalties for failure to comply. While it is important to continue setting high standards for what qualifies a company as creating a Public Benefit, making the reporting side of compliance more user-friendly would have multiple, wide ranging advantages. First, user-friendly compliance regulations would further one of the goals of the Act - to provide consumer protection. Confusing reporting and compliance standards prevent consumers from obtaining the information needed to make an informed purchasing or investment decision. Second, the assessment of whether a Benefit Corporation is compliant would be

straightforward with clearer reporting standards. While increased oversight is needed from the Secretary, simple and uniform reporting standards would reduce that burden. Finally, foreign and domestic Benefit Corporations would be encouraged and assisted in achieving successful compliance.

Both compliance and the Public Benefits that are the goal of each Benefit Corporation are important. Massachusetts must make the compliance piece clearer and easier to follow, to aid Benefit Corporations in spending the bulk of their time on achieving their stated goals and to assist consumers in educating themselves about specific Benefit Corporations, as the MBC and the Act intend.

NEW BIG TO FAIL: AN ANTITRUST ANALYSIS OF CONTENT-INTERNET MERGERS ABSENT NET NEUTRALITY

by William Murphy*

I. INTRODUCTION

The disruptive rise of streaming services has violently altered the home entertainment industry. The option to consume media from outside the traditional cable model attracts viewers overpaying for television packages in droves. As of 2018, 33 million Americans replaced traditional television services with online streaming and this mass exodus shows no signs of slowing down[1]. According to Nielsen Media, 58.7% of homes in the United States own at least one internet-enabled device capable of streaming to a television set.[2] Additionally, of those homes with an enabled multimedia device, game console, or smart TV, nearly 10% possess all three.[3] The emergence of such devices is indulging consumers' desire to access content with the press of a button. Services such as Netflix and Hulu have dramatically altered the media habits of Americans, especially young ones. Sixty-one

* Assistant Professor, College of Professional Studies, St. John's University, Queens, New York.

[1] *Exodus from Pay TV Accelerates Despite OTT Partnerships*, eMarketer (Jul. 24, 2018), *available at* https://www.emarketer.com/content/exodus-from-pay-tv-accelerates-despite-ott-partnerships.

[2] *Streamer Things: Internet-Enabled TV Connected Devices Found in Nearly 60 Percent of U.S. TV Homes*, Nielsen Media (Nov. 16, 2017), *available at* https://www.nielsen.com/us/en/insights/news/2017/streamer-things-internet-enabled-tv-connected-devices-found-60-percent-us-tv-homes.html.

[3] *Id.*

percent of those ages 18 to 29 report the primary way they watch television now is with streaming services on the internet, compared with 31% who report watching mostly via a cable or satellite subscription and 5% who watch mainly with a digital antenna.[4] The younger the consumer, the more prevalent streaming video is. It reaches 87% of children ages 2-11, more than any other age group, but teens and young adults spend the most time streaming.[5]

Simultaneously, content streaming services are also developing into economic powerhouses. Over-the-top, or "OTT," content streaming services generated an estimated $20.1 billion in revenue domestically during 2017 on 15.2% growth year-over-year.[6] According to the PricewaterhouseCoopers Entertainment & Media Outlook for 2018-2022, it is estimated that streaming video on demand services account for almost 80% of home entertainment sector revenues and that the sector will grow to $30.6 billion by 2022, an annual growth of about 8.8%.[7] Significant growth notwithstanding, the report acknowledges that individual streaming services may suffer as competition and customer choices continue to grow.[8] The recent trend of content providers abandoning partnerships with established streaming services to forge their own streaming services, most notably Disney's departure from Netflix to launch Disney+, demonstrates this harsh new reality for providers and consumers alike.[9] Through 2018, Netflix subscribers received access to both popular Netflix and Disney produced content but now must subscribe to both Netflix and the new Disney+ service in order to continue consuming both content libraries.[10] Essentially, this scenario forces consumers into purchasing two services where they previously purchased only one to view the same general inventory of content. With fellow major production studios poised to follow Disney's lead and digital streaming services creating ever-increasing surpluses of their own "can't miss"

[4] *About 6 in 10 Young Adults in U.S. Primarily Use Online Streaming to Watch TV*, Pew Research Center (Sep. 13, 2017), *available at* http://www.pewresearch.org/fact-tank/2017/09/13/about-6-in-10-young-adults-in-u-s-primarily-use-online-streaming-to-watch-tv/.

[5] *Streamer Things*, *supra* note 2.

[6] *Global Entertainment & Media Outlook 2018-2022*, PricewaterhouseCoopers (Jun. 5, 2018), *available at* https://www.pwc.com/gx/en/industries/tmt/media/outlook.html.

[7] *Id.*

[8] *Id.*

[9] Michelle Castillo, *Disney will Pull its Movies from Netflix and Start its own Streaming Services*, CNBC (August 8, 2017), *available at* https://www.cnbc.com/2017/08/08/disney-will-pull-its-movies-from-netflix-and-start-its-own-streaming-services.html.

[10] *Id.*

programming, subscription costs for multiple services may soon surpass the bloated traditional cable bills of yore in order to access a given consumer's holistic content preferences.

With finite disposable income, consumers will inevitably make choices, forcing streaming services into precarious positions as well. Increased competition for subscribers already drives the proliferation of "bundling" services as a market compromise, where multiple services unite offering consumers a combined "bundle" of content at one reasonable price.[11] Where bundling may ensure survival for some, lone streaming services left without dance partners and lacking the influence of industry giants like Netflix, Amazon Prime, YouTube, and Hulu may face extinction. More troubling for healthy market competition, consumer choice, and even perhaps free speech long-term however, is the invasion of internet providers and vertical integration onto the digital content streaming battlefield. Vertical integration is the growth of a business enterprise through the acquisition of companies that produce the intermediate goods needed by the business or provide marketing and distribution for an internally produced good.[12] In this specific scenario, internet providers, entities controlling the means of distribution for digitally streamed content, are acquiring content providers, entities creating digitally streamed content, potentially spawning anticompetitive practices for the broad spectrum of contemporary content providers as well as consumers. The most prominent and current example of internet provider-content provider mergers is the pairing of bandwidth behemoth AT&T with the Time Warner media and content kingdom unsuccessfully appealed by the United States Department of Justice in the United States Court of Appeals for the D.C. Circuit.[13] The Justice Department argued that approval of this merger would allow the resultant AT&T-Time Warner empire to raise bandwidth costs for digitally streamed content outside of its own library drastically or, worse yet, blackout outside content altogether.[14] Essentially, by vertically integrating, the proposed AT&T-Time Warner would control both an essential means of distribution, internet service, and maintain its own product, an

[11] Paul Bond, *One Fee for Netflix, Amazon and Hulu? Digital TV re-bundling gains momentum*, HOLLYWOOD REPORTER, Jan. 10, 2015, at 9.

[12] Gregory S. Crawford, Robin S. Lee, Michael D. Whinston and Ali Yurukoglu, *The Welfare Effects of Vertical Integration in Multichannel Television Markets*, 86 ECONOMETRICA 891 (2018).

[13] Richard Levick, *The AT&T-Time Warner Merger: Is Bigger Better?*, Forbes (Jul. 10, 2018), *available at* https://www.forbes.com/sites/richardlevick/2018/07/10/the-att-time-warner-merger-is-bigger-better/#73f9027469b4.

[14] Hamza Shaban, *It's Not Looking Great for the Justice Department's Appeal of the AT&T-Time Warner Merger*, WASH. POST, Dec. 6, 2018, at G4.

internal collection of digitally streamable content, allowing for anticompetitive practices harming rival content creators and consumers alike.

Little more than one short year ago, the Justice Department's concerns would have been wholly unfounded. The policy and enforcement of Net Neutrality safeguarded against the possibility of online content monopolies until its repeal by the Federal Communications Commission in late 2017.[15] Absent Net Neutrality, judicial interpretations of United States antitrust law serve as a final line of defense. This study examines the market protections lost in the wake of Net Neutrality's demise and the potential outcome of courts applying established antitrust precedent to the emerging phenomena of internet provider-content provider mergers through the lens of AT&T-Time Warner, a current case study carrying significant economic and cultural weight.

II. NET NEUTRALITY

Net Neutrality is the principle that internet service providers should enable access to all content and applications, regardless of the source, and without favoring or blocking particular products or websites.[16] As Marsden documents, in 2005 the Federal Communications Commission ("FCC") adopted network neutrality principles "to preserve and promote the vibrant and open character of the internet as the telecommunications marketplace enters the broadband age."[17] Subsequently, between 2005 and 2012, five attempts to pass bills in Congress containing net neutrality provisions failed.[18] The FCC ultimately promulgated a regulation in the form of its "Open Internet Order" in 2015, granting the agency authority to enforce net neutrality.[19] Reclassifying broadband services as telecommunications services subject to regulation under the Federal Communications Commission Act of 1934, the Order focused on three specific rules for internet service: no blocking, no throttling, and no paid prioritization.[20] "A person engaged in the provision of broadband internet access service, insofar as such person is so engaged, shall not impair or degrade lawful internet traffic on the basis of internet content,

[15] Florian Schaub, *The Implications of the FCC's Net Neutrality Repeal*, 6 MEDIA AND COMMC'N 69 (2018).

[16] Christopher T. Marsden, *Network Neutrality: From Policy to Law to Regulation* § 1 (2017).

[17] *Id.*

[18] *Id.*

[19] 30 FCC Rcd. 5601.

[20] *Id.* at 5607-08.

application, or service, or use of a non-harmful device, subject to reasonable network management," the Order outlined regarding blocking and throttling.[21] The Order identified paid prioritization as "the management of a broadband provider's network to directly or indirectly favor some traffic over other traffic, including through use of techniques such as traffic shaping, prioritization, resource reservation, or other forms of preferential traffic management, either (a) in exchange for consideration (monetary or otherwise) from a third party, or (b) to benefit an affiliated entity."[22] Violations of these provisions were punishable by mandatory fines imposed by the FCC.[23]

The domestic telecommunications industry abruptly contested the FCC's new regulatory framework in *United States Telecommunications Association v. FCC*.[24] The primary issue before the court was whether the FCC properly classified broadband service as a telecommunication service.[25] The FCC had properly focused on consumer perception of what broadband service providers "offer" the product they sell to consumers.[26] The Court provided the FCC with authority to enforce Net Neutrality by concluding that broadband services provide the unadulterated transmission of messages via computer processing, in that they connect users to third party content.[27] Content from edge providers like Netflix, YouTube, and MLB.tv have "transformed nearly every aspect of our lives, from profound actions like choosing a leader, building a career, and falling in love to more quotidian ones like hailing a cab and watching a movie."[28] As such, a broadband service provider makes a "stand-alone offering of telecommunications," and are within the definition of a "telecommunications service" as determined by the FCC, and properly classified and regulated as such.[29]

Shortly after his inauguration in January 2017, President Donald Trump appointed Ajit Pai, a known objector to the 2015 Open Internet Order, as the new chairperson of the FCC.[30] That April, Pai put forth the Restoring Internet Freedom Order effectively repealing the policy

[21] *Id.* at 5651-52.
[22] *Id.* at 5608.
[23] *Id.* at 5971-72.
[24] 825 F.3d 674 (D.C. Cir. 2016).
[25] *Id.* at 700.
[26] *Id.* at 714-16.
[27] *Id.* at 698-700.
[28] *Id.*
[29] *Id.*
[30] Jeff Dunn, *Trump Just Made a Vocal Opponent of Today's 'Open Internet' Laws the Next FCC Boss*, Business Insider (Jan. 23, 2017), *available at* https://www.businessinsider.com/trump-net-neutrality-fcc-chairman-ajit-pai-2017-1.

of Net Neutrality and its enforcement by the FCC.[31] Pai claimed in his official statement supporting this new Order that:

> …[T]hese unnecessary and harmful internet regulations will be repealed and the bi-partisan, light-touch approach that served the online world well for nearly 20 years will be restored…[W]e will have a framework in place that encourages innovation and investment on our nation's networks so that all Americans, no matter where they live, can have access to better, cheaper, and faster internet access and the jobs, opportunities, and platform for free expression that it provides.[32]

After introducing the 2017 Restoring Internet Freedom Order, the FCC received over 20 million comments voicing disapproval and opposition. It was nevertheless approved and in effect as of June 2018 resulting in a joint lawsuit filed by 22 states against the FCC[33] and California's passage of its own Net Neutrality protections currently under challenge by the federal government.[34]

III. THE AT&T-TIME WARNER MERGER

AT&T announced its agreement to acquire Time Warner for $85.4 billion in October 2016.[35] As the second largest U.S. wireless carrier, trailing only Verizon, AT&T serves more customers than the third and fourth largest carriers, Sprint and T-Mobile, combined and completed its purchase of satellite TV giant DirecTV for $48.5 billion mere years earlier in 2015.[36] After spending much of the preceding decade divesting itself of AOL, several Time Inc. publications, and Time Warner Cable, Time Warner retains a highly desirable content library including HBO with its blockbuster original programming like "Game of Thrones" and "Westworld," the Warner Bros. Movie Studios which holds licenses to the popular "Wizarding World of Harry Potter" and

[31] 33 FCC Rcd. 311.

[32] *See* Press Release, Federal Commc'ns Comm'n, Chairman Pie Statement on Restoring Internet Freedom Order Taking Effect (May 10, 2018) *available at* https://transition.fcc.gov/Daily_Releases/Daily_Business/2018/db0510/DOC-350643A1.pdf.

[33] David Shepardson, *Twenty-Two States Ask U.S. Appeals Court to Reinstate 'Net Neutrality' Rules*, Reuters (Aug. 20, 2018), *available at* https://www.reuters.com/article/us-usa-internet/twenty-two-states-ask-u-s-appeals-court-to-reinstate-net-neutrality-rules-idUSKCN1L605W.

[34] Cecilia Kang, *Justice Department Sues to Stop California Net Neutrality Law*, N.Y. TIMES, Sep. 30, 2018.

[35] Greg Roumeliotis and Jessica Toonkel, *AT&T to Pay $85 Billion for Time Warner, Create Telecom-Media Giant*, Reuters (Oct. 22, 2016), *available at* https://www.reuters.com/article/us-time-warner-m-a-at-t-source-idUSKCN12M0SI.

[36] Michael J. de la Merced, *AT&T Agrees to Buy Time Warner for $85.4 Billion*, N.Y. TIMES, Oct. 22, 2016, at A1.

D.C. Comics franchises, as well as CNN, TNT, TBS, and Turner Sports among other tent pole cable outlets.[37] The conglomeration of Time Warner content primed specifically for digital streaming to AT&T's significant internet subscriber base represents a vertical integration scheme with the potential of blocking, throttling, or gouging content competitors at consumers' expense absent the FCC's enforcement of Net Neutrality.[38]

Given its recent about-face on Net Neutrality, the FCC, under chairman Ajit Pai, initially declined review of the merger, leaving only the Trump Justice Department standing between it and judicial approval.[39] Unexpectedly, the DOJ did contest the merger in federal court cautioning against "an appreciable danger" of raised prices for consumers and arguing that AT&T-Time Warner's "FCC filings acknowledged that the vertical integration of a high-value programmer with a large distributor in the MVPD industry leads to higher fees for rival distributors," though some suggest the DOJ's challenge derived directly from President Trump's personal disdain for Time Warner-owned CNN.[40] In June 2018, the merger was approved by U.S. Federal District Court Judge Richard Leon finding that it could offer better and cheaper options to customers and that vertically integrating content production and distribution would let producers gather more data about what customers liked and sell more valuable targeted ads instead of charging subscribers more.[41]

Almost immediately after its merger approval, AT&T Time Warner began contradicting Judge Leon's findings as the Justice Department alleged, raising subscription fees for DirecTV Now and adopting new approaches to content development at HBO.[42] The DOJ eventually appealed the matter to the United States Court of Appeals for the D.C.

[37] *Id.*

[38] Walt Mossberg, *Why the AT&T-Time Warner Merger is Dangerous*, The Verge (Dec. 15, 2016), *available at* https://www.theverge.com/2016/12/14/13941266/walt-mossberg-att-time-warner-merger-deal-danger.

[39] Jacob Kastrenakes, *FCC Chief Doesn't Plan to Review AT&T-Time Warner Merger*, The Verge (Feb. 27, 2017), *available at* https://www.theverge.com/2017/2/27/14751082/fcc-att-time-warner-merger-no-review-plans-ajit-pai.

[40] Nathan Reiff, *AT&T and Time Warner Merger Case: What You Need to Know*, Investopedia (updated Dec. 7, 2018), *available at* https://www.investopedia.com/investing/att-and-time-warner-merger-case-what-you-need-know/.

[41] Ted Johnson, *AT&T-Time Warner Merger Approved*, VARIETY, Jun. 12, 2018, at 1.

[42] Makena Kelly and Adi Robertson, *Why Yesterday's AT&T and Time Warner Merger Appeal Matters – and Why It's a Long Shot*, The Verge (Jul. 13, 2018), *available at* https://www.theverge.com/2018/7/13/17566326/justice-department-att-time-warner-merger-ruling-appeal-explainer.

Circuit and arguments were heard in early December 2018 with a majority of commentators agreeing that AT&T-Time Warner retained the upper hand.[43] In February 2019, the D.C. Circuit officially affirmed Judge Leon's ruling,[44] opening the door for future internet provider-content provider mergers of this scale, and leaving a possible appeal to the U.S. Supreme Court as the last and only recourse.[45]

IV. *UNITED STATES V. PARAMOUNT PICTURES, INC.*

The U.S. Supreme Court encountered an alarming similar scenario to the current AT&T-Time Warner merger back in 1948 when it decided *United States v. Paramount Pictures*.[46] The case, a product of a very different era, involved major movie studios owning their own theaters and holding exclusivity rights on which theaters would show their films.[47] Through vertical integration, the major studios established a monopoly on the movie business in the United States.[48] Each studio maintained exclusive contracts with actors and directors, owned the theaters where their movies played, and controlled the availability of their films to independent theaters.[49] At the time, the seven major studios controlled nearly all of the nation's movie theaters.[50] Resultantly, specific theater chains ran only the films produced by the studio that owned them and additionally engaged in the process of "block booking," through which independent theater owners entered contracts with the major studios requiring the showing of a specified number of studio-produced films or else risk losing access to the content altogether.[51] Despite nearly two decades worth of opposition, legal challenges, and agreements routinely breached or circumvented by the major studios, these practices persisted until challenged by the Justice Department in the U.S. Supreme Court.[52]

The Department of Justice argued that the major studios' conduct violated Sections 1 and 2 of the Sherman Anti-Trust Act as amended in 1937 and demanded that the Court order the studios to end block

[43] Dade Hayes, *AT&T Gains Upper Hand on DOJ in Appeals Court Arguments of Lawsuit over Time Warner Deal*, Deadline (Dec. 6, 2018), *available at* https://deadline.com/2018/12/att-department-of-justice-time-warner-lawsuit-appeals-court-argument-1202515135/.

[44] *See* United States v. AT&T, Inc., 916 F.3d 1029 (D.C. Cir. 2019).

[45] Kelly & Robertson, *supra* note 37.

[46] 334 U.S. 131.

[47] *Id.* at 140.

[48] *Id.* at 173-74.

[49] *Id.* at 143.

[50] *Id.*

[51] *Id.* at 156-57.

[52] *Id.* at 140-41.

booking and divest of their theaters as a means of distribution.[53] In a 7-1 ruling, the Court sided with the government, forcing the major studios to divest themselves of their movie theater chains and end the practice of block booking by requiring that all films be sold on an individual basis.[54] The Court's majority opinion, delivered by Justice William O. Douglas, considered five different trade practices in justifying its ruling was "incontestable."[55] He added:

> Our doubts concerning the competitive bidding system are increased by the fact that defendants who own theatres are allowed to pre-empt their own features. They thus start with an inventory which all other exhibitors lack. The latter have no prospect of assured runs except what they get by competitive bidding. The proposed system does not offset in any way the advantages which the exhibitor-defendants have by way of theatre ownership. It would seem in fact to increase them.[56]

With this decision, independent producers could finally compete with the major studios for audiences and actors, and studio heads began selling off their respective theater chains.

In the decades since *United States v. Paramount Pictures, Inc.* was decided, the federal government has not applied the precedent to studio control in other media, primarily because the emergence of TV networks, and now streaming services, relied on the licensing of content by one studio from other rival studios in addition to utilization of its own.[57] The AT&T-Time Warner merger, however, eerily recalls the circumstances of 1948 in a manner potentially providing significant, and possibly unlawful, advantages to this new media conglomerate. AT&T, one of the largest providers of internet access in America, could allow its subscribers access to a Time Warner streaming service at a discount and not count time watched against a data cap, for example. More severe still would be if AT&T charged subscribers higher rates for internet access allowing for streaming competitors' content or a blackout of non-Time Warner content on AT&T bandwidth altogether. Until 2018, Net Neutrality guarded against the possibility, but now, with its recent repeal, *United States v. Paramount Pictures, Inc.* stands alone as established law prohibiting such a scenario. Any faithful application of the 1948 ruling in the courts should undermine and dissolve the intentions of AT&T and Time Warner and dissuade future internet provider-content provider pairings.

[53] *Id.* at 153-54.
[54] *Id.* at 156-57.
[55] *Id.* at 144-45.
[56] *Id.* at 166-65.
[57] *See U.S. Philips Corp. v. Int'l Trade Comm'n*, 424 F.3d 1179 (Fed. Cir. 2005).

V. EXEMPTIONS FROM UNITED STATES ANTITRUST LAW

A different, and more likely, possible outcome of U.S. Supreme Court review of the AT&T-Time Warner merger is that, given the major economic and cultural consequences of finding an antitrust violation, a recognized exemption to Sections 1[58] and 2[59] of the Sherman Anti-Trust Act as currently amended may be applied. Moen, Roberti, and Steenholdt identify three distinct situations where application of an exemption is appropriate.[60] First, where facially anti- competitive activity is actually pro-competitive or beneficial.[61] The classic example of a pro-competitive restraint involves professional sports leagues where otherwise competitive teams join together to create a common organization that sets rules, organizes events, and excludes other potential entrants. Second, when a value deemed greater than antitrust is at play:

> For instance, it would not be illegal for an industry group to lobby Congress to create a new exemption allowing competitors within the industry to agree on common prices, even though it would clearly be illegal for these entities to form such agreements themselves. The immunity lies in the citizens' constitutional rights to petition their government to change its laws under the First Amendment.[62]

Third, where, in certain industries, regulation was preferable to competition or there were natural monopolies that needed to be controlled.[63] For example, "the railroads, insurance companies, ocean shippers, and certain agricultural cooperatives have been granted special statutory immunities to do things like set prices, agree to common terms of service, and form joint ventures as an industry."[64] This section will discuss the most prominent antitrust exemptions established by the U.S. Supreme Court, professional sports leagues, media, and utilities, and consider the effect of their applicability to the AT&T-Time Warner Merger.

A. *Antitrust Exemptions for Professional Sports Leagues*

Professional sports leagues enjoy a number of exemptions from United States antitrust law as recognized by the courts. Most notably,

[58] 15 U.S.C. § 1 (1937).

[59] 15 U.S.C. § 2 (1937).

[60] Kelse Moen, John Roberti and Jana Steenholdt, *The Role and Relevance of Exemptions and Immunities in U.S. Antitrust Law*, U.S. Dep't of Justice (Mar. 14, 2018), *available at* https://www.justice.gov/atr/page/file/1042806/download.

[61] *Id.* at 1.

[62] *Id.* at 2.

[63] *Id.*

[64] *Id.*

Major League Baseball was held to be broadly exempt from antitrust law in *Federal Baseball Club v. National League*.[65] That case involved the owner of a professional baseball franchise from the defunct Federal Baseball League alleging that rival league, Major League Baseball, conspired to monopolize baseball through offering many Federal League owners compensation for folding their teams in violation of the Clayton Antitrust Act, 15 U.S.C. §13 (1914), and thus destroying the Federal League.[66] In a unanimous decision, the U.S. Supreme Court ruled in favor of Major League Baseball, explicitly exempting the entity from antitrust law.[67] Writing on behalf of the Court, Justice Oliver Wendell Holmes held that:

> The business is giving exhibitions of baseball, which are purely state affairs. It is true that, in order to attain for these exhibitions the great popularity that they have achieved, competitions must be arranged between clubs from different cities and states. But the fact that, in order to give the exhibitions, the Leagues must induce free persons to cross state lines and must arrange and pay for their doing so is not enough to change the character of the business.[68]

Applying a similar framework to the AT&T-Time Warner merger, one could argue that the coalescence of independent content through one internet distributor serves essentially the same premise as independent professional baseball franchises uniting to form a singular league. The conduits, bandwidth and league organization, do not alter the intents and purposes of the businesses, providing content and staging baseball exhibitions. However, subsequent jurisprudence casts doubt and disfavor on the holding in *Federal Baseball Club* making it unlikely the U.S. Supreme Court would extend the precedent to encompass AT&T and Time Warner. In 1972, the Court in *Flood v. Kuhn* upheld Major League Baseball's antitrust exemption but declined to extend it and claimed it a regrettably irreversible "anomaly" in determining players did not constitute property of their respective teams in perpetuity.[69] Moreover, the Court in *United States v. International Boxing Club of New York, Inc.*[70] and *Radovich v. National Football League*[71] rejected attempts by both professional boxing and professional football to avail themselves of similar exemptions to antitrust law as enjoyed by professional baseball.

[65] 259 U.S. 200 (1922).
[66] *Id.* at 207.
[67] *Id.* at 208-09.
[68] *Id.*
[69] 407 U.S. 258.
[70] 348 U.S. 236 (1955).
[71] 352 U.S. 445 (1957).

B. Antitrust Exemptions for Media

Antitrust exemptions also exist where the media and free speech are at issue. Specifically, the *Noerr-Pennington* doctrine exempts private entities when attempting to influence the passage or enforcement of laws despite potentially anticompetitive consequences.[72] Derived from the U.S. Supreme Court cases *Eastern Railroad Presidents Conference v. Noerr Motor Freight, Inc.*[73] and *United Mine Workers v. Pennington*,[74] the doctrine stands for the differentiation of free speech made in public and private spheres under the First Amendment where antitrust law is implicated.[75] *Noerr* presented the Court with an anticompetitive propaganda campaign by colluding railroad companies resulting in Pennsylvania's vetoing of a law permitting increased trucking loads.[76] Exempting the railroads' conduct from antitrust law in a unanimous decision premised on established First Amendment protections, Justice Hugo L. Black noted that violations of the Sherman Act could not "be predicated upon mere attempts to influence the passage of enforcement of laws…it is a code that condemns trade restraints, not political activity."[77] Subsequently, in *Pennington*, the Court was faced with a small coal producer alleging that the coal miners' union and certain large coal producers entered into an agreement to drive small coal producers out of business in violation of the Sherman Act by successfully lobbying for increased coal miner wages financially absorbable by only the larger coal producers.[78] Finding in favor of the joint large coal producer-coal miners' union coalition, the Court affirmed its First Amendment-supported ruling in *Noerr*, holding that "joint efforts to influence public officials do not violate the antitrust laws even though intended to eliminate competition. Such conduct is not illegal, either standing alone or as part of a broader scheme itself violative of the Sherman Act."[79]

Considering the impact of the *Noerr-Pennington* doctrine on the AT&T-Time Warner merger, it could be argued that the potentially anticompetitive combination of content production and internet distribution is a protected form of speech exempted from antitrust law under the First Amendment. It is well established that "motion pictures are a significant medium for the communication of

[72] Moen, Roberti, & Steenholdt, *supra* note 59 at 2.
[73] 365 U.S. 127 (1961).
[74] 381 U.S. 657 (1965).
[75] Moen, Roberti, & Steenholdt, *supra* note 59 at 2.
[76] 365 U.S. at 129-31.
[77] *Id.* at 135-36.
[78] 381 U.S. at 658-61.
[79] *Id.* at 670.

ideas…affect[ing] public attitudes and behavior in a variety of ways, ranging from direct espousal of political or social doctrine to the subtle shaping of thought which characterizes all artistic expression." [80] More recently, in *Reno v. American Civil Liberties Union,*[81] the Court expanded First Amendment free speech and expression protections to the internet declaring specifically: "Through the use of chat rooms, any person with a phone line can become a town crier with a voice that resonates father than it could from any soapbox. Through the use of Web pages, mail exploders, and newsgroups, the same individual can become a pamphleteer." Nevertheless, an extension of the *Noerr-Pennington* doctrine to the ATT-Time Warner merger proves problematic for two reasons. First, the nature of content to be distributed cannot, in its entirety, be considered political speech or expressions that comment on government action rather than the private conduct of an individual. Although some scholars may espouse the subtle political machinations of Harry Potter's Wizarding World, a similar theory premised on D.C. Comics' 2016 film Suicide Squad would be objectively less compelling. Second, the *Noerr-Pennington* doctrine presumes all voices, even if not heard equally, may at least still be heard. Modern internet provider-content provider mergers like AT&T-Time Warner possess the power, without Net Neutrality regulations in place, to silence rival and independent content providers through price increases, diminutive bandwidth, or complete blackout undermining the framers' intent behind the First Amendment altogether.

C. Antitrust Exemptions for Public Utilities

Throughout the United States, "public utilities" function as government-granted monopolies immune to antitrust liability.[82] A "public utility" is defined generally as "a business organization which regularly supplies the public with some commodity or service which is of public consequence or need, such as electricity, gas, or water."[83] As is the case with many "public utilities," the government exclusively appoints a private enterprise as the sole provider of a good or service excluding competitors from the market where the infrastructure required to produce and deliver a product is economically impractical or unfeasible to create and maintain.[84] As concluded by Blum, Oaks, and Surrette:

[80] See *Burstyn v. Wilson*, 343 U.S. 495 (1952).

[81] 521 U.S. 844, 870 (1997).

[82] Moen, Roberti, & Steenholdt, *supra* note 59 at 2.

[83] *See United Parcel Serv. of Am. v. Huddleston, 981 P.2d 223 (Colo. App. 1999).*

[84] George Blum, Karl Oaks and Eric Surette, 73B C.J.S. *Public Utilities* §§ 1-3 (2019).

> …[P]articular businesses or enterprises may be declared by constitution or statute to be public utilities, and while the submission by a business or enterprise to regulation by the public implies that it is a public utility, the question whether or not it is such does not necessarily depend on whether it has submitted to the regulatory jurisdiction of the state.[85]

The absence of a definitive U.S. Supreme Court precedent identifying a precise scope for what constitutes a public utility and what benefits it should be afforded historically creates inconsistent applications of antitrust law to these government-granted monopolies in the lower courts.[86] Further, without judicial clarity, so-called or presumed "public utilities" freely employ anticompetitive strategies to the detriment of competitors and consumers without consequence.[87]

Distinct from other established antitrust exemptions, the consideration of whether internet service constitutes a "public utility" through the lens of the AT&T-Time Warner merger presents a ripe issue for U.S. Supreme Court review and an opportunity for providing clear judicial guidance and economic stability given the financial gravity of the $85 billion purchase and the consumer markets involved. Without necessity for any reference or discussion, it is blatantly obvious that an internet service company provides a product of the highest public importance otherwise impractically or unfeasibly operated by the government. The documented failures of municipal broadband across the nation further bolster this argument.[88] Concerning any legal requirement for regulation, the FCC, notwithstanding its recent approach under Chairman Pai, retains its authority and could reemerge as an internet regulator under new leadership during a future presidential administration. Given the perpetually evolving and growing nature of ecommerce, the internet may now actually fall under the purview of a different regulatory body altogether.[89] The rampant consumerism consuming the overwhelming majority of bandwidth may dictate regulation not by the FCC but

[85] *Id.*

[86] David Elkind, *State Action: Theories for Applying Constitutional Restrictions to Private Activity*, 74 COLUM. L. REV. 656, 669-71 (1974).

[87] William Pentland, *Investor-Owned Utilities: Asleep at the Switch or Above the Law?*, Forbes (Sep. 18, 2011), *available at* https://www.forbes.com/sites/williampentland/2011/09/18/investor-owned-utilities-asleep-at-the-switch-or-above-the-law/#7b5107975c2d.

[88] *See* Tom Reynolds, *The Failures of Government-Owned Internet*, Forbes (Apr. 26, 2016), *available at* https://www.forbes.com/sites/realspin/2016/04/26/government-owned-internet-failure/#39ecd0e555e2.

[89] Keith Collins, *Net Neutrality has Officially been Repealed. Here's how it could Affect you*, N.Y. TIMES, Jun. 11, 2018, at B3.

instead by the Federal Trade Commission ("FTC").[90] In fact, during late 2017, the FCC and FTC outlined an agreement under which the FTC would assume at least some authority over internet regulation on consumer protection grounds signaling a shift in regulatory promulgation and enforcement.

VI. CONCLUSION

Without the blocking, throttling, and paid prioritization protections afforded by Net Neutrality, the vertical integration of AT&T's internet service with Time Warner's content library presumably violates the Sherman Anti-Trust Act under *United States v. Paramount Pictures, Inc.*. Should the U.S. Supreme Court grant certiorari pending the outcome of the current appeal, it is unlikely the Court will strictly apply its 1948 precedent however due to factors including the financial enormity of the merger and its potential impact on the growing cultural importance and norms of evolving digital streaming technology trending infinitely upward in utilization. Instead, the Court may seek to immunize internet provider-content provider mergers from antitrust law under an established exemption. Exemptions recognized for professional baseball and media would not apply with the former labeled an "anomaly" and the content at issue not equating to "political speech" required to invoke the latter. Conversely, labeling the AT&T-Time Warner merger a "public utility" exempt from antitrust law due to its providing of internet service to the public permits the Court to uphold the economically significant deal without overturning precedent while also offering clearer guidance on a largely unsettled legal issue to lower courts nationwide. The absence of a viable, government provided alternative to the resource of internet access, dormant FCC regulatory authority, and emerging FTC regulatory authority further support this conclusion.

[90] Brent Kendall and John D. McKinnon, *Is the FTC Up to the Task of Internet Regulation?*, WALL ST. J., Dec. 15, 2017, at A15.

FEDERAL OPPORTUNITY ZONE RULES REMAIN UNCLEAR FOR MUNICIPAL GOVERNMENTS: WHERE DO WE GO FROM HERE?

by Brien C. Walton, J.D., LL.M., A.L.M., MS.Ed., Ed.D.*

I. INTRODUCTION

If someone asked you "who could better invest in the most economically distressed communities in your state – a resident billionaire or the federal government?" who would you choose? This is similar to the question, and challenge, that was presented to political leaders on Capitol Hill in early 2016, by Silicon Valley billionaires, who believed their business acumen and ties to local and regional communities gave them unique insights as to the best ways to grow businesses in their communities.[1] In April 2016, with bipartisan support at the end of the Obama administration, Senators Tim Scott (R-South Carolina) and Cory Booker (D-New Jersey) introduced a bill on the Senate floor while Congressmen Pat Tiberi (R-Ohio) and Ron Kind (D-Wisconsin) introduced the bill in the House, that became the "Tax Cuts and Jobs Act" and promised to pump a massive amount of cash into America's most impoverished communities by offering wealthy investors and corporations a chance to erase their tax obligations.[2] The rationale behind the law is persuasive – there is an

* Assistant Professor of Entrepreneurship, College of Business, Husson University, Bangor, Maine.

[1] Steven Bertoni, *An Unlikely Group of Billionaires and Politicians Has Created the Most Unbelievable Tax Break Ever*, Forbes, July 17, 2018, www.forbes.com/sites/forbesdigitalcovers/2018/07/17/an-unlikely-group-of-billionaires-and-politicians-has-created-the-most-unbelievable-tax-break-ever/.

[2] *Id.*

astounding $6.1 trillion in paper profits (capital gains) currently held by taxpayers that, theoretically, could be directly invested into revitalizing economically distressed communities throughout the United States, called "Qualified Opportunity Zones," hereinafter "Opportunity Zones." [3]

On December 22, 2017, the *Tax Cuts and Jobs Act* created a new section of the Internal Revenue Code (26 U.S. Code § 1400Z) that provides tax incentives for investments in targeted areas in the United States through investment vehicles called "Qualified Opportunity Zone Funds," hereinafter "Opportunity Zone Funds."[4] The purpose of an Opportunity Zone Fund is to promote economic development in Opportunity Zones by offering investors substantial federal tax advantages that are only available through the new program. There are currently more than 8,700 such Opportunity Zones throughout the United States, which means that each Opportunity Zone, assuming a proportionate distribution across all Opportunity Zones, could receive at least $701 million in capital to support scalable businesses and expedite economic growth.[5] The key to the success of this plan for revitalizing communities is recognizing the power of "capital assets" that are generally defined under §1221(a) of the Internal Revenue Code ("IRC"), as property held by the taxpayer (whether or not connected with his trade or business) for 12 months or more.[6]

Specifically, the goal is to encourage wealthy individuals and entities that have held appreciated assets for 12 months or more, to sell that asset. Prior to this new law, upon the sale of a capital asset, taxpayers were required to immediately send 20% of the net proceeds (capital gain[7]) to the Internal Revenue Service ("IRS") as a tax. Today, however, these Opportunity Zones allow the taxpayer to directly invest that 20% of net proceeds into economically-distressed communities. Essentially, the U.S. Senate recognized that navigating a bureaucratic infrastructure may not be the best way to support low-income communities, so they removed the "middleman." This has created an incentive for those with the capital to decide exactly where that capital goes and for what purpose - as long as the "where" is a federally-recognized low-income census tract and the "purpose" is to help

[3] *Id.*

[4] 26 U.S. Code § 1400Z–1 - Designation. (Westlaw through P.L. 115- 97).

[5] 26 U.S. Code § 1400Z–1 - Designation. (Westlaw through P.L. 115- 97). A complete list of designated qualified opportunity zones is found in Notice 2018-48, 2018-28 I.R.B. 9.

[6] 26 U.S. Code § 1221 - Capital asset defined. (Westlaw through P.L. 115- 97).

[7] 26 U.S. Code § 1222 - Other terms relating to capital gains and losses. (Westlaw through P.L. 115- 97).

stimulate economic growth in that community. Unfortunately, the law was enacted with guidance only on how the Opportunity Zones would be chosen in the respective states, but little to no guidance on what qualifies as "tangible business property," the structural requirements in forming Opportunity Zone Funds, or how taxpayers can ensure their investments and development projects supported by the Opportunity Zone Fund will meet regulatory compliance standards, such as monitoring and tracking protocols that can be more art than science.

This article explains the key provisions under the Opportunity Zones' statute, reviews the key ways to maximize Opportunity Zone benefits in use throughout the nation, and explores an innovative approach that enables the creation of Mega-Opportunity Zone Funds to leverage multiple investors and multiple developers under single fund, which has the potential to transform economic development and business resiliency in disaster-stricken and severely distressed communities.

II. THE NEW STATUTE: 26 U.S. CODE § 1400Z

Under §1400Z-1(a) of the Internal Revenue Code (IRC), an Opportunity Zone is simply a population census tract that is a low-income community designated as a "qualified opportunity zone."[8] From that simple definition, however, the low-income communities so designated have incredible leverage that enables them to receive private investments through an Opportunity Zone Fund. Under the original drafting of the statute, an Opportunity Zone Fund was generally defined under IRC §1400Z-2(d)(1) as *any* investment vehicle organized as a corporation or partnership for the purpose of investing and holding at least 90% of its assets in qualified opportunity zone property (e.g., capital assets held for 12 months or more by the taxpayer).[9]

IRC §1400Z-2(d)(2) further distinguishes qualified opportunity zone property as consisting of either stock, partnership interests, or tangible property used in a trade or business.[10] It may be readily apparent to business-minded taxpayers what corporate stock or partnership interests are, which generally reflect any documents that represent a taxpayer's ownership interest in a business entity engaged in activities designed to earn a profit. It is much less apparent, however, what constitutes "tangible business property" for the purposes of Op-

[8] 26 U.S. Code § 1400Z–1 - Designation. (Westlaw through P.L. 115- 97).

[9] 26 U.S. Code § 1400Z-2 - Special rules for capital gains invested in opportunity zones. (Westlaw through P.L. 115- 97).

[10] 26 U.S. Code § 1400Z-2 - Special rules for capital gains invested in opportunity zones. (Westlaw through P.L. 115- 97).

portunity Zone investment, e.g., does residential real estate qualify, or does commercial real estate, or a startup business, or an existing business, etc.? The distinction of what constitutes business property is critically important because investors are required to leave their capital in the Fund for at least five years in order to receive minimal benefits of tax deferral - at least 10 years for the full benefit of 100% elimination of capital gains tax.

Typical Examples of an Opportunity Zone Fund

Under IRC §1400Z-2(d), an Opportunity Zone Fund is a privately managed investment vehicle organized to help direct resources to low-income communities, and Opportunity Zone Funds invest in U.S. company stock and partnership interests; and tangible property used to substantially improve business operations. The incentives built into the Opportunity Zone program appear to be specifically designed to reward long-term investments in distressed communities, and on an after-tax basis could mean a two times (2x) higher return on investments vs. a traditional stock portfolio because the investor is able to use the 20% of "found money" to not only invest initially, but any appreciation in asset value can also be deferred.

For example, if Ms. Taxpayer, sells her real estate investment in California for a $1 million profit and the investment was held for more than one year, then the capital gains tax at 20% would be $200,000. Ms. Taxpayer, instead of sending the $200,000 to the Internal Revenue Service, can then invest that $200,000 into a promising startup manufacturer in a New England Opportunity Zone. Ms. Taxpayer is already ahead because she has full use of an additional $200,000 that was not available otherwise, but if that $200,000 investment grows to $2 million during the 10-year holding period in the Opportunity Zone Fund, then upon sale of the $2 million asset in Year 11, there is still zero tax due to the Internal Revenue Service. Instead of paying $200,000, Ms. Taxpayer earns $2 million, which is a powerful incentive.

Typical examples of an Opportunity Zone Fund include:

- $100 MM national private equity fund providing capital to growth-stage manufacturing companies.
- $50 MM regional, disaster relief fund that develops and leases new, affordable housing for people displaced by the 2018 natural disasters.
- $20 MM local fund providing equity for a $100 MM conversion of a shopping mall into a mixed-use development that includes new retail stores and workforce housing.

Opportunity Zone Benefits for Investors

Through Opportunity Zones, investors receive five (5) key tax benefits on unrealized capital gains reinvested in Opportunity Zone Funds. Under IRC §1400Z-2(b)(2)(B), which details the determination of the basis for taxpayers that invest in an Opportunity Zone Fund, the following benefits are illustrated:

- Investors can roll over existing capital gains into Opportunity Zone Funds, with $0 up-front tax bill.[11]
- Investors can temporarily defer their original tax bill until ten (10) years after initial investment into the Fund, or when the Opportunity Zone Fund investment is sold.[12]
- A step-up in basis for capital gains reinvested in an Opportunity Zone Fund. Specifically, the basis is increased by 10% if the Opportunity Zone Fund investment is held by the taxpayer forat least five (5) years. This means the investor will only owe taxes on 90% of the rolled-over capital gains, and by an additional 5% (15% total) if held for at least seven (7) years.[13]
- A permanent exclusion from taxable income of capital gains from the sale or exchange of an investment in an Opportunity Zone Fund, if the investment is held for at least 10 years. In other words, capital gains = $0 after 10 years.[14]
- There is no upper limit on how much can be invested in Opportunity Zone Funds, but at least 90% Opportunity Zone Fund assets must be invested in Opportunity Zones.[15]

These benefits are unique to this program and will likely evolve as legislators review feedback from municipalities, investors, and developers, but being able to save 20% as a foundational principle makes this program a viable incentive for any project that requires equity because it can be obtained relatively inexpensively compared to other equity sources. For example, if an investor must divert cash from their savings to make an investment, the opportunity cost (or risk of loss) will be higher than if the same investor can use cash that they would normally not think twice about missing - the capital gains tax. For lenders and investors concerned with risk mitigation, this program will facilitate those objectives.

[11] *Id.*
[12] *Id.*
[13] *Id.*
[14] *Id.*
[15] *Id.*

III. THE RULES HAVE SLOWLY EVOLVED: TWO ROUNDS OF GUIDANCE

Round 1: October 19, 2018

Subsequent to the enactment of the *Tax Cuts and Jobs Act on* December 22, 2017, there have been two rounds of additional guidance provided that attempted to clarify and expand upon the original rules regarding the deferral of capital gains associated with investments in Opportunity Zones. On October 19, 2018, the U.S. Treasury Department (hereinafter, "Treasury") published Revenue Ruling 2018-29,[16] (hereinafter, "Revenue Ruling") and issued Proposed Regulations § 1.1400Z-2 (2018) under IRC § 1400Z-2.[17]

The proposed regulations clarified a key distinction in the type of gains that can be deferred under the program, which is exclusively capital gains and not ordinary gains.[18] The proposed regulations also significantly expanded the number of eligible properties that can be invested in by taxpayers by excluding the value of land from a property's adjusted basis for the purpose of meeting the "30% Substantial Improvement" test,[19] a provision that essentially requires an investment in Opportunity Zone property to add at least 30% to the original value of the Opportunity Zone property, after acquisition or investment. The proposed regulations also provided guidance on the timing of investments into an Opportunity Zone Fund after the sale of an original capital asset (e.g., taxpayers have six months from the sale of a capital asset to place the proceeds into an Opportunity Zone Fund), and rules for self-certification of an Opportunity Zone Fund.[20] The "self-certification" of an Opportunity Zone Fund is what has created much of the concern and confusion amongst legal and tax professionals, and has slowed adoption of the program.

Because the context in the proposed regulations is "self-certification," without any guidance aside from stating that taxpayers will need to make deferral elections on Form 8949, which is to be submitted with the taxpayer's federal income tax returns for the taxable year in which the gain would have been recognized, if it had not been deferred,[21] the result has been confusion on many important issues required to encourage investment. For example, there was no guidance as to the type of fund structure, e.g., what fund structure is

[16] Rev. Rul. 2018-29, 2018-45 I.R.B. 765.
[17] Prop. Treas. Reg. 1.1400Z-2 (2018).
[18] *Id.*
[19] *Id.*
[20] *Id.*
[21] *Id.*

most appropriate (corporation vs. limited partnership vs. limited liability company), does the Opportunity Zone Fund have track each investor separately or can they grouped under a single filing, or even *how* the Opportunity Zone Fund should track investors and other participants in the capital stock of a project, e.g., appropriate methods of monitoring and tracking of investment impact and job growth. When you consider that much of the publicity around Opportunity Zones have been focused at real estate developers, without distinguishing between residential versus commercial development, the potential problem becomes clear.

Specifically, if a residential real estate developer believes they are helping a community by building apartments and condos, creates an Opportunity Zone Fund to support the development, but the final rules stipulate that because the mission of the program is to ensure investment capital circulates *within* a low-income community for at least five years, then unless the residential real estate developer lives in that low-income community, the investment is being exported out of the Opportunity Zone to the developer's own community, which likely is in contravention of the program's mission. Similarly, if a commercial developer builds retail space, it is unclear whether they also must invest in the business that occupies the commercial space to receive the benefit, because simply building a structure does not generate and circulate investment throughout the community if the building remains vacant, etc. To further exacerbate the problem – there is still the outstanding issue of what happens when there is an investor for the construction of the building that is different from the investor in the business that will occupy the building, e.g., do both, mutually exclusive investors receive the tax deferral benefits or does one…and which one?

Although the guidance was helpful in clarifying some issues, additional issues resulted that have further stymied adoption of the program for taxpayers without extensive experience in both venture capital and real estate taxation, which makes the Opportunity Zone regulations some of the most complex in the economic development industry. To address the complexity, however, Treasury issued Proposed Regulations § 1.1400Z-2 (2019) under IRC § 1400Z-2,[22] that presented additional guidance while repealing and clarifying portions of the "2018 Proposed Regulations."

[22] Prop. Treas. Reg. 1.1400Z-2 (NPRM, 2019).

Round 2: April 17, 2019

The second round of Opportunity Zone rules issued on April 17, 2019, by the U.S. Treasury Department does make the tax incentive program aimed at increasing development in underserved areas more accessible for investors and communities that want to set up Opportunity Zone Funds, but there are still critical gaps that have caused some economic development projects to stop altogether, until further guidance is released. Proposed Regulations § 1.1400Z-2 (2019) is a two-part document and many real estate professionals have focused solely on the 169-page, core document entitled, "Investing in Qualified Opportunity Funds," which is a "Notice of Proposed Rulemaking" (hereinafter, "NPRM"). This is an important distinction because, under Treasury's Internal Revenue Manual, an NPRM simply announces to the public that Treasury is considering modifying published regulations or is issuing rules on matters not addressed in the existing regulations.[23]

The second part of the document release, however, was a "Notice and Request for Information" (hereinafter, "RIF") that seeks public input regarding exactly what type of public information is required to track investments in an Opportunity Zone Fund, and exactly how that monitoring and tracking process should be implemented and regulated. Specifically, the RIF is entitled "Request for Information on Data Collection and Tracking for Qualified Opportunity Zones," and it is this document that has legal and tax professionals scrambling to restructure existing Opportunity Zone Funds to ensure taxpayers avoid the wrath of the Internal Revenue Service.[24]

"Notice of Proposed Rulemaking" (NPRM):

Proposed revisions in the 169-page NPRM are numerous and have relative importance that will vary greatly, depending upon the specific needs and objectives of the taxpayer, so for the purposes of this article, the broad categories are addressed and a few key provisions are highlighted that provide critical clarity for an innovative approach to leveraging Opportunity Zone Funds that directly supports city managers, town managers and economic development directors, who rarely have the time, resources, or in-house expertise to proactively create, market, and manage an Opportunity Zone Fund.

Three broad categories of guidance in the NPRM pertain to the classification and treatment of various forms of Real Estate, treatment of Operating Business income, and Opportunity Fund Management.

[23] IRM 32.1.1.2.2 refers to Notice of Proposed Rulemaking.
[24] Prop. Treas. Reg. 1.1400Z-2 (RIF, 2019).

Regarding real estate, amongst other details, under § II of the NPRM, application of IRC § 1400Z-2(d)(2)(D)(i) is clarified regarding how Opportunity Zone property is no longer required to be purchased to meet the 70% (substantially all) test to qualify, e.g., the proposed regulations will permit leased properties to also qualify under certain circumstances. [25] Regarding business income, amongst other details, under § III(B) of the NPRM, application of IRC § 1397C(b)(2) is clarified regarding how an Opportunity Zone business must have at least 50 percent of its total gross income "from the active conduct of such business," and provides details on *how* taxpayers can ensure that they meet the requirement.[26] Before this clarification, it was unclear whether the 50% was based upon time expended, revenue generated, or the physical location of the resources used in the businesses, etc. There is also guidance on the type and aggregation of assets to qualify for tax deferral.

Two (2) impactful changes for economically-distressed communities under the NPRM, however, that those communities can immediately benefit from, I would note the following:

1. Under § III(A) of the NPRM, the application of IRC § 1397C(b)(2) is clarified under the section entitled, "Real Property Straddling a Qualified Opportunity Zone," where the Treasury Department and IRS will now permit real property straddling the boundaries of an Opportunity Zone, e.g., 49% outside of the Opportunity Zone, but 51% in the Opportunity Zone, to qualify for the Opportunity Zone's tax deferral benefits.[27]

This provision should be welcome news to any business whose land is on the census-tract line that defines the Opportunity Zone and it provides a great opportunity for real estate investors. Essentially, owners of those parcels should be able to enjoy an increase in value because businesses no longer have to be 100% within an Opportunity Zone, e.g., 51% is sufficient. A potential strategy for investors and developers might be to partner with a landowner on the Opportunity Zone line to launch your business using the 20% in capital gains saved under the Opportunity Zone rules. In other words, there are very few Opportunity Zones relative to the number of communities that can benefit from them, so this provision enables savvy taxpayers and their financial professionals to look for opportunities that are immediately adjacent to the increasingly valuable Opportunity Zones, to effectually have many more economic development projects qualify that would not have been possible under the original rules. This could mean tens,

[25] Prop. Treas. Reg. 1.1400Z-2 (NPRM, 2019).
[26] *Id.*
[27] *Id.*

or even hundreds of millions of dollars, in additional regional economic impact.

The second provision that town managers and economic development directors should find particularly useful in the NPRM is illustrated in Proposed Regulations §1.1400Z-2(c)(4)(i)(B)(6), which pertains to "Original use of leased tangible property."[28] Several town managers have anecdotally told me would be very beneficial to their communities if they had the ability to demolish or rehabilitate abandoned, dilapidated, or obsolete buildings, that effectively deter growth around them. For example, it would not be too difficult to find a once beautiful historic building on an Opportunity Zone's Main Street, that has been abandoned for more than five years and is now an eyesore on the verge of collapse due to its state of disrepair. If no taxes on the property have been paid in years, the town might actually own the building after a foreclosure or tax lien default, but economically distressed towns are unlikely to have the resources to rehabilitate every building they had to reclaim from absentee or delinquent owners.

As previously mentioned, the guidance provided on October 19, 2018, left serious gaps in defining exactly what qualified Opportunity Zone business property comprises, and no distinction was drawn between the purchase and ownership of business property in contrast to the leasing of tangible business property. This distinction is important because a significant percentage of land in an economically-distressed community may be owned by absentee owners, which may explain a potential reason for the lack of development, e.g., if the owner lives in a different state, they may not be actively pursuing development in a distant community that might be cost prohibitive, or they may not be closely tied to the community. Similarly, there may be dilapidated commercial properties, owned by private individuals or held by the municipality, that have remained unleased for years or even decades as the community declined, and the owners in possession were unable to identify an incentive to bring the properties up to code. These potentially leasable properties can provide the impetus for growth by creating the "flagship" rehabilitation project.

For purposes of Proposed Regulations §1.1400Z-2(d)(2)(i)(B)(6), "if property has been unused or vacant for an uninterrupted period of at least 5 years, original use in the qualified opportunity zone commences on the date after that period when any person first uses or places the property in service in the qualified opportunity zone […and used tangible property satisfies the original use requirement if the property

[28] *Id.*

has not been previously so used or placed in service in the qualified opportunity zone]."[29]

A town manager with entire blocks of vacant buildings may want to pursue rehabilitating those vacant buildings to jump-start the local economy, but they struggle to find banks or developers willing to take the chance. Because the Opportunity Zone's primary purpose is to support scalable businesses and keep investment dollars circulating in the community for at least ten years, the Treasury Department has relaxed the rules that govern the holding period of Opportunity Zone investments. Specifically, property that has been unused or vacant for at least 5 years prior to being used in the Opportunity Zone, can now have a "start date" of the first day any person first uses or places the property in service in the Opportunity Zone. As a result, this provision should make it much easier for towns to attract investment in their most devastated neighborhoods, e.g., investors can use capital gains they would not otherwise miss. Next, we will review the notice and request for information that has focused on operational requirements for Opportunity Zone Funds, that were not previously addressed in the original law or the October 2018 guidance.

"Notice and Request for Information" (RIF):

The RIF is only a seven-page document, but two sentences on the first page have resulted in dozens of usually stoic real estate and tax attorneys scrambling for guidance because the original rules did not appear, from their perspective, to so clearly reflect the program's purpose of encouraging investment in active, scalable businesses (for permanent job creation), as opposed to any type real estate investment, e.g., the building of apartments, condos, commercial office space, etc., which do not usually create permanent jobs and may only indirectly support the creation of jobs for the businesses that may occupy their buildings. Specifically, the RIF states "Sections 1400Z-1 and 1400Z-2 seek to encourage economic growth and investment in designated distressed communities (qualified opportunity zones) by providing Federal income tax benefits to taxpayers who invest in businesses located within these zones through a QOF. The purpose of information collection and tracking is to measure the effectiveness of the policy in achieving its stated goals, and ensure that this investment opportunity remains an attractive option for investors to use."[30]

There are several issues covered in the RIF, but the key item fueling uncertainty pertains to the question presented in the document that

[29] *Id.*
[30] Prop. Treas. Reg. 1.1400Z-2 (RIF, 2019).

asks, "What data would be useful for tracking the effectiveness of providing tax incentives for investment in qualified opportunity zones to bring economic development and job creation to distressed communities?"[31] The expectation of Treasury is that they will receive input regarding:

1. Measures that would signal improved economic development in local target markets as well as spillover to neighboring areas;
2. Measures of job creation specific to the distressed community;
3. Who would collect the data;
4. Frequency of data to be collected; and
5. Sources from which to collect data.[32]

The second item in the list – tracking job creation specific to the distressed community – is where real estate developers should be concerned if they are only constructing a building (e.g., temporary jobs), but not investing directly into an actual business that can create permanent, full-time jobs that can sustain a community into the next generation. The mission of the Opportunity Zone program appears to be the creation of permit full-time jobs to raise the standard of living in economically distressed communities, so that ideally, in 10 years when the next batch of zones is identified, current Opportunity Zones will no longer qualify because of sustained economic growth. Since the rules were first announced, there has been rampant "groupthink" that has led many reporters, legal, financial, and real estate professionals, to not carefully read IRC §1400 to understand how the related provisions emphasize the intent of Congress to keep cash generated in Opportunity Zones circulating in that community for several years, instead of exporting the cash out of the community to a developer's non-Opportunity Zone community.[33] For attorneys and financial professionals with regional economic growth as a primary goal, there are opportunities, some direct and some indirect, in the Opportunity Zone guidance that can greatly support all investors and developers in a distressed community, with a Treasury-compliant Fund that provides a cost-effective pathway to economic growth that can be safely launched today, under the existing rules, without the need to delay months or years for the final rules.

[31] *Id.*
[32] *Id.*
[33] *Id.*

IV. WHERE DO WE GO FROM HERE?

The Birth of "Mega" Opportunity Zone Funds

To their credit, the U.S. Treasury Department has sought strategic advice from a few corporate real estate tax attorneys with venture-capital experience, who have been working very closely with the Treasury Department since the Opportunity Zone rules were first announced, and have continued to work with other federal agencies, such as the U.S. Small Business Administration, U.S. Department of Agriculture's Rural Development division, and U.S. Department of Homeland Security's Federal Emergency Management Agency, with a "mandate" to proactively identify, create, and validate, innovate ways to maximize Opportunity Zone Fund benefits and directly support town managers and economic development directors in the most severely distressed communities, and economic development professionals have been actively supporting those federal initiatives for the past year throughout New England, and in disaster areas in the Midwest and on the West Coast.[34]

The State of Maine, however, is unique among the 50 states, and not just because it is the only state in the U.S. whose name has one syllable. As of the Summer of 2019, Maine is the only state in the U.S., where forward-thinking, business-friendly towns have taken the initiative to create their own Opportunity Zone Funds to attract investors to the *entire* town – not just a single project. Maine has three such funds, in Lincoln, Calais, and Baileyville, and their respective economic development directors were some of the few that were almost giddy over the new Opportunity Zone rules released on April 17, 2019.[35]

The proposed rules comprise 169-pages full of acronyms and legalese that could easily overwhelm public administrators without legal training or experience in complex structured finance, but the impact of the guidance in those pages is something any conscientious public administrator should find exciting. Specifically, the April 17, rules allow an Opportunity Zone Fund to invest in multiple businesses or development projects, provided the Fund has established "appropriate" monitoring and tracking protocols, as determined by the IRS. A potential strategy for a town manager or economic development director is to take the initiative to create their own Opportunity Zone

[34] Brien Walton, *Navigate the new rules for Opportunity Zones*, Mainebiz, May 13, 2019, www.mainebiz.biz/article/navigate-the-new-rules-for-opportunity-zones.

[35] Maureen Milliken, *Lincoln, Calais, Baileyville Jumping on Opportunity Zones to Ignite Development*, Mainebiz, May 22, 2019, www.mainebiz.biz/article/lincoln-calais-baileyville-jumping-on-opportunity-zones-to-ignite-development.

Fund to support the entire community, not just a single parcel, e.g., multiple projects aggregated under one Fund has substantial economies of scale. To date, three towns in Maine correctly predicted how the rules would evolve, so it is reasonable to expect other Opportunity Zones to soon maximize this innovative approach as well.[36]

It is also important to note that the Opportunity Zone program is governed, in part, by the Treasury Department's Community Development Financial Institution Fund (CDFI Fund), which has established appropriate tracking protocols routinely used by Community Development Entities (CDEs) in the federal NewMarkets Tax Credit program.[37] This means that financial professionals experienced with the CDFI Fund may have more insights into the Opportunity Zone program than most professionals, but because the rules are constantly evolving, reliance upon the way the CDFI Fund may have operated in the past is no guarantee of how the new, Opportunity Zone program will be managed. In fact, the CDFI Fund specifically states that they are "supporting the IRS with the Opportunity Zone nomination and designation process under IRC §1400Z-1 only," which excludes the Opportunity Zone Fund operation guidelines under IRC §1400Z-2.[38] As a result, attorneys should not assume the rules for federal New Markets Tax Credits will be transferred verbatim into the Opportunity Zone rules.

In fact, real estate vision and creativity are woefully insufficient in understanding how different venture capital fund structures can adversely impact certain real estate investment vehicle structures, both operationally and from a tax perspective, so receiving guidance from experts in all three fields (corporate taxation, real estate, and venture capital, is prudent). The first town in the U.S. to receive that guidance and take the initiative to launch their own Opportunity Zone Fund for the use and benefit of every investor and developer considering Central Maine for business, was Lincoln, Maine.[39]

[36] *Id.*

[37] *Opportunity Zones Resources*, Community Development Financial Institutions Fund, U.S. Department of the Treasury, www.cdfifund.gov/Pages/Opportunity- Zones.aspx. (last visited June 8, 2019).

[38] *Id.*

[39] Charles Eichacker, *To Lure Business, Lincoln Moves Quickly to Take Advantage of New Federal Tax Break Program*. Bangor Daily News, December 5, 2018, bangordailynews.com/2018/12/05/news/penobscot/to-lure-business-lincoln-moves-quickly-to-take-advantage-of-new-federal-tax-break-program/.

1st "Mega" Opportunity Zone Fund: Lincoln Lakes Opportunity Zone Innovation Fund

An Opportunity Zone designation is nothing more than a census-tract, providing as much clarity as a zip code. The designation itself does not provide particular benefits to either investors or businesses unless there is an attendant Opportunity Zone Fund created to be the conduit for equity investment capital, produced from the sale of a capital asset. It is the Fund, operating according to Treasury Department guidelines and providing the necessary oversight and reporting that will ensure that all of the investments and activities carried out within the Opportunity Zone will meet the rigorous requirements of the federal government and other federal and state regulatory agencies. Without a properly established and managed Opportunity Zone Fund, however, the tax benefits which will drive this new investment cannot be tracked and monitored appropriately to ensure compliance with the IRS regulations. It is safe to say that all taxpayers want to stay on the good side of the IRS, so adopting appropriate tracking and monitoring protocols for each investor, each developer, each project, and each related financial incentive used by the stakeholders involved in the project is critical to achieving permanent tax deferral.

In December 2018, the town of Lincoln, Maine, established the "Lincoln Lakes Opportunity Zone Innovation Fund" – the first such fund in Maine and the first fund in the nation that has been established by a municipality in order to promote investments within a rural community. Lincoln's Economic Development Director, Jay Hardy, who was a co-author of Maine's Tax Increment Financing legislation and veteran public administrator, extensively vetted the potential strengths, weaknesses, opportunities, and threats of the Opportunity Zone program, and after interviewing dozens of attorneys, accountants and real estate brokers, received unanimous approval from Lincoln's town council to create the Lincoln Lakes Opportunity Zone Innovation Fund, in partnership with an external fund manager. Because Lincoln is a relatively small town, a key purpose of the Fund to facilitate and aggregate smaller projects, thus spreading the risk and encouraging projects that are a better match, in terms of scale, with typical economic expansion in a smaller rural Maine community. The town of Lincoln's approach is directly aligned with the mission and objectives of the U.S. Treasury Department, which makes them an excellent "flagship" for the Opportunity Zone program's allowance of larger Funds that create a single community pipeline for multiple investors and multiple projects, to facilitate a comprehensive economic

development strategy for the entire region around the Opportunity Zone. [40]

V. CONCLUSION

There are more than 8,700 Opportunity Zones in the U.S. that provide an excellent opportunity to expedite a community-based approach to economic development designed to leverage options both in and outside of the designated Opportunity Zones. Most projects are "one-off" real estate developments, although some may be taking a huge risk by assuming residential real estate is consistent with Opportunity Zone program incentives. The rules on IRC § 1400 clearly explain that the mission is to directly promote business growth, and while residential homes might be an obvious inconsistency with the rules, the rules are unclear about "workforce housing" that can, theoretically, directly promote business growth, using a broad interpretation. It is these vagaries in the language that make the full intention of the Opportunity Zone guidelines unclear.

The lack of clarity is understandable because it does take time to gauge impact, adjust accordingly, then re-issue guidance, but until the final rules are published, many attorneys, accountants, and real estate professionals may sit on the sidelines to wait in safety. Economic development is not for the faint of heart, however, and some risk is inherent in this industry, no matter how much guidance is provided. The primary premise IRC § 1400Z-2 is to facilitate and expedite attracting capital to areas where capital is scarce, then committing to keeping that capital in that community to circulate for at least 10 years. To maximize that benefit, it makes more sense to have a "Mega" Opportunity Zone Fund that can leverage more regional resources in collaborative, public-private partnerships, instead of chasing "one-off" developments. This is not to discourage small developments, but in terms of maximizing impact - economically-distressed communities can usually do more when they have more capital behind them to encourage others to move forward.

Towns, such as, Lincoln, Calais, and Baileyville have already launched their "Mega" Opportunity Zone Funds that, respectively, are not focused on a single project, but aggregate all development projects in the municipality. When you consider that the U.S. Treasury Department estimates there is $6.1 trillion available to fund the 8,700+ Opportunity Zones, which equates to $701 million per Opportunity Zone, if distributed proportionately, and a small state, such as Maine, has 32 Opportunity Zones, the potential is more than $22 billion for

[40] *Id.*

state of only 1.3 million people (~$17 million per person).[41] Of course, the $6.1 trillion will not be distributed proportionately across each Opportunity Zone, e.g., some Zones many never create a Fund, while other Zones in crowded areas may receive several billion dollars. One thing is fairly certain, however, and that is Opportunity Zone Funds that have figured out what the U.S. Treasury wants first, and proactively took steps to leverage collateral benefits for potential investors and developers, e.g., community banking partners, local political support, state/local tax abatement, etc. - those Opportunity Zones will be getting the most attention, and likely, more of the available investment capital.

[41] Steven Bertoni, An Unlikely Group of Billionaires and Politicians Has Created the Most Unbelievable Tax Break Ever, Forbes, July 17, 2018, www.forbes.com/sites/forbesdigitalcovers/2018/07/17/an-unlikely-group-of-billionaires-and-politicians-has-created-the-most-unbelievable-tax-break-ever/.