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Legal Guide for Direct Brands

November 2019

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Executive Summary

This Legal Guide for Direct Brands provides a concise overview of legal issues often confronted by companies, particularly direct brands. Direct brands are companies characterized by their direct connections to consumers and are disrupting the business model of market-leading companies. This guide covers:

- Why founder and equity agreements are vital for direct brands and the documents necessary for such investment transactions.
- How commercial and intellectual property issues and privacy policies and terms can ensure companies retain all rights in the intellectual property of their businesses.
- The essentials of privacy, advertising, and marketing law for direct brands.
- The various types of product liability claims, legal defenses for product liability, and potential product liability claims for software that direct brands face.

This guide is intended to help companies spot issues that should be discussed with counsel and is not a substitute for legal advice.

Founder Agreements

The founding of a new company is a time of optimism and goodwill. It is not a time when most founders are focused on potential problems down the road and even planning for potential problems seems out of place. However, the road to success will be much smoother if the founders take the time to address in a founders' agreement issues that are common to most new businesses. The founders' agreement can be documented in several ways, but the following points should be addressed:

Who Is a Founder? Not all members of a company's founding team are actually founders. The initial team may include individuals with specific, important skills that are valuable for the launch of the venture, but that can be easily replaced as the company grows. Founders are individuals who are likely to be members of the company's core leadership for a significant period of its growth. There are ways to reward non-founder early team members, but true founders are the company's initial owners.

Allocation of Economics. Once founders are identified, they must decide on the allocation of economics between them. In the early stage, compensation and benefits are usually minimal. The most significant economic decision relates to the allocation of equity in the new company. There is a myth that founders' stock is incredibly valuable. In most cases the exact opposite is true. Most founders receive common stock, the lowest form of stock on the equity totem pole. Subsequent financial investors will often receive preferred stock that has a higher claim to dividends or asset distribution than common stock.

There is no one-size-fits-all formula for allocating founders' stock. Among the factors founders should consider are:

- The experience and skill set of each founder;
- The role of the founder at the time of allocation, as well as his or her anticipated future role;
- The pedigree of the founder — for example, a serial entrepreneur with a successful track record or a professor from a prestigious institution might receive a larger allocation; and
- Prior financial or sweat equity contributions made by the founder to the company (i.e., work by the founder on behalf of the company).

Control. A corporation requires officers and directors. Directors have more of an oversight role, while officers have day-to-day responsibilities. Control in a limited liability company (LLC) can be structured in several different ways. (New ventures are typically formed as either a C corporation or an LLC. Where appropriate this summary will highlight differences). Regardless of the mechanics of control, founders should carefully consider how control of the company will work in practice. While the control structure will often mimic the allocation of economics, it does not have to, and there are often good reasons for control to be structured differently.

When structuring control, founders should be careful to avoid structures that can result in deadlock. It is not uncommon for a company with two founders to split equity and the Board of Directors 50/50. When things are going well, this is usually not an issue because most decisions are made by consensus. When a rough patch arrives, the founders may find themselves deadlocked. Conversely, giving one founder too much control can also impede decision-making. There are several approaches to tie-breaking that founders should consider and add to their founders' agreement. Even if one founder owns a majority of the shares, it is often beneficial to construct a control structure that requires the vote of that founder and at least one other founder to approve or block a measure.

When the Team Splits Up. It is more the rule than the exception that one or more founders will depart the company at some point in a company's life. The consequences of a founder departure should be addressed in the founders' agreement. The last thing the company wants is a founder that works for the company for a short time, leaves the company, and retains a large block of stock. The circumstances of a founder's departure will usually dictate what equity the founder retains after departure. The company wants to create a disincentive for founder departure or poor performance.

Venture Employees. With venture employees, equity grants are almost always subject to vesting (discussed in more detail below). Often founders will own their shares outright. In companies where the founders own their shares, consideration should be given to making those shares subject to a restricted stock agreement that (i) limits the founders' ability to transfer the stock; (ii) gives the company a stock buy-back right that mimics vesting some or all of the shares. In two-founder situations, the founders may agree to a buy-sell agreement that defines circumstances where one founder can buy out the other.

Terms of Employment. In the U.S., all but the most senior employees, and often, even very senior employees, do not have formal employment agreements. Instead, most employees are engaged through an offer letter that usually describes:

- Job title and, sometimes, a more detailed description of the position and reporting lines
- Job location, if applicable
- Compensation
- Equity grant, subject to Board approval
- Expected hours of work. While venture employees are often expected to work irregular hours subject to the needs of the business, under recent changes to U.S. employment law, employees making under $35,308 annually are entitled to overtime pay.
- Vacation policy and sometimes key benefits. Note that it is important that vacation be on a use-it-or-lose-it annual basis because vacation time that is allowed to accrue over time can become a major liability for a venture.

In the vast majority of states, there is no statutory entitlement to severance, although in some cases company policy may provide for severance. Further, in most states, unless the terms of employment specify otherwise, employment is considered at-will. However, to ensure that nothing in the employment agreement is considered a promise of employment for any fixed period of time, the offer letter usually states clearly that

employment is at will. Check with your local counsel to verify that your state law supports at-will employment and does not require severance.

In addition to an offer letter, employees should be asked to sign a second agreement. Although this agreement may have one of a number of names, it typically includes the following provisions:

- *Confidentiality.* Particularly in early-stage companies, it is not uncommon to find that confidential information has been shared in advance of the start date so the agreement should provide that it preserves the confidentiality of information disclosed in anticipation of employment as well.
- *Assignment of Intellectual Property Developed During the Course of Employment.* This section may include a required disclosure of previously developed relevant intellectual property (IP) and a representation that the new work responsibilities will not conflict with prior contractual obligations to third parties.
- *Non-Competition.* This is a clause under which one party (usually an employee) agrees not to enter into or start a similar profession or trade in competition against another party (usually the employer). Note that these clauses are unenforceable in California and as a result are typically not found in the employment contracts of California-based employees and California-based companies. Courts prefer not to prevent individuals from working, so these clauses must be drawn up narrowly as to time (generally no more than a year), geography and scope (which requires a narrow definition of what constitutes a competing business).
- *Non-Solicitation.* Typically lasts for a year after the end of employment and covers solicitation of employees and contractors of the company, as well as solicitation of customers of the company.

Employee Compensation and Benefits — A Multilayer Approach

When onboarding employees, companies have several economic levers at their disposal, each of which serves as a different form of incentive.

Base Compensation. Startups typically can pay less than their established peers because of the equity compensation usually provided. However, it is important that this compensation be competitive with other startups in the same geography and that it meets the basic living wage requirements of recruits.

Benefits and Perks. This is often where ventures try to distinguish themselves in recruiting. Ping pong tables, beer on tap, gym memberships, etc. are viewed as relatively inexpensive ways for companies to set themselves apart. However, these benefits can often add up to substantial sums of money and are typically the first things eliminated by struggling enterprises.

Bonuses. Less common for early-stage companies (except for sales professionals who often work on a partial commission basis), bonuses are very effective in driving employees towards discrete, shorter-term goals. The basis for the payment of a bonus or commission and the timing of the payment should be clearly laid out.

Equity. Granting equity to employees and other service providers has two main goals. First, it creates long-term alignment since recipients are motivated to increase the value of the company as a whole. Second, since equity is often granted subject to multi-year vesting, it creates a cost for leaving the company, which discourages turnover.

Equity grants can take several forms. The most common are:

- *Stock Options (Incentive Stock Options (ISOs)/Non-Qualified Stock Options (NSOs).* Employees are given the option of purchasing common shares of the company upon the payment of an option strike price equal to the fair market value of the stock at the time of grant. ISOs are available only to company employees and, subject to certain conditions, option holders can benefit from capital gains treatment on the ultimate stock sale. Gains from NSOs, which can be granted to advisors and other service providers, are usually taxed at ordinary income rates. In LLCs, employees can be granted profits interests which conceptually function much like stock options, although the recipients own interests in the company, rather than the option to buy interests.
- *Restricted Stock Grants.* These are actual grants of shares in the company, usually subject to a company repurchase option (reverse vesting) and transfer restrictions. These grants are taxed immediately as income and as a result, they are usually made only when the granting company has minimal value.
- *Restricted Stock Units (RSUs).* These units are issued to an employee through a vesting plan after remaining with their employer for a particular length of time. RSUs give an employee an interest in company stock but they have no tangible value until vesting is complete. The value of the stock received after vesting will be taxed as ordinary income.

  Note that all the forms of equity grants described here pertain to corporations, however, there are equivalent grants for companies set up as LLCs.

Tax Clock. When it comes to equity grants, founders should be aware that they are working under a ticking tax clock. Assuming the company increases in value, its share price is increasing as well. This impacts both stock and option grants. If stock is granted to an employee, it must be reported as compensation to the employee. As a result, the employee will have an immediate tax liability upon receipt for the fair market value of the stock. The exercise price of a stock option must be set at the then-current fair market value of the stock, or it may be considered deferred compensation under Section 409A of the tax code. (Note: All but the earliest stage ventures should seek third-party valuations, often called 409A Opinions, to support their determinations of the fair market value of the stock.)

The longer a company waits to grant an employee options, the higher that tax will be for stock grants and the higher the strike price will be for options. Companies also have to be careful that stock/options are valued on the date the grants are completed. It is not uncommon for companies to delay formally documenting grants and backdating grants can have legal consequences.

Vesting. To achieve the goal of promoting employee retention, equity grants are usually subject to vesting. Vesting is implemented in different ways for stock grants and options, but the goal is the same—an employee leaving the company before the end of the vesting period will generally suffer an adverse consequence with respect to the unvested portion of the equity/options. Under certain circumstances, the adverse consequence is extended to vested shares.

Although there is no legally required vesting structure, the most common vesting structure is known as "4 years with a one year cliff." Under this structure, the shares remain unvested until the first anniversary, when 25% vests. The remaining 75% vests in equal monthly installments over the following three years. If the employee has already worked a significant period of time before the grant of equity/options, a portion of the grant may be fully vested immediately. When equity grants are subject to vesting, the vesting creates a potential tax issue because each vesting date is treated as a separate award. If the value of the stock has risen since the award date, the newly vested stock is taxed at its new higher price. To avoid this liability, recipients can make an 83(b) election, a tax filing that allows for an immediate tax payment on the current market value of both the vested and unvested stock. If the 83(b) election is made, there are no future taxes payable on future vesting dates, but the recipient may still be liable for capital gains taxes if the stock is sold later at a profit.

Impact of Employee Termination/Departure on Vesting. The following are the primary reason(s) why a founder/employee might leave a company:

- The founder is terminated for cause. This is usually defined to reflect genuine bad acts by the founder—things like breach of fiduciary duty, gross negligence, and illegal acts;
- The founder is terminated by the company due to poor performance or lack of skills fit as the company grows;
- The founder unilaterally decides to leave the company for his or her own reasons;
- The founder leaves the company due to a change in role to an inferior position, reduction in compensation or significant relocation of the company (this is generally known as a "good reason" departure); or
- Death or disability of the founder.

The agreements that cover equity grants usually treat vesting differently based on the circumstances of departure. In almost all circumstances unvested shares are repurchased by the company for nominal consideration and unvested options terminate. At the opposite extreme, when an employee is terminated for cause, even vested shares may be subject to a nominal repurchase option and vested options may terminate. In other situations, the company may retain a repurchase right but the purchase is at fair market value — this allows the company to avoid having a former employee who has no ongoing connection to the company remain a shareholder. Vesting may also be partially or fully accelerated under certain circumstances. The most common circumstance is the acquisition of the company, where the acquisition may by itself cause partial or full acceleration ("single trigger acceleration") or may cause acceleration if combined with another factor such as a forced relocation ("double-trigger acceleration"). Companies can tailor their grants to address each of the situations described above.

Size of Grants. A common mistake early-stage companies make is overgenerous equity grants. Equity is the credit card of the venture world, painless to grant, but painful when the bill comes due on the sale of the company. Equity should be granted to motivate key future performers, not to compensate for a new venture's inability to pay significant wages. In general, the employee equity pool will be maintained at a level of between 10 and 20% of the company's outstanding equity. This creates an equity budget and unreasonably large early grants restrict the company's flexibility to make grants to new hires later or causes additional dilution to founders. There is little comprehensive data on this topic, but a recent Osage University Partners study found that C-level executives typically receive grants of between 2 and 5%, advisors get 1% and engineers get .2% to 1.25% depending on their position and experience. It pays to do some homework on typical equity percentages for the position the company is filling in its market.

Raising Money: Angel, Seed, and Series A VC Legal Issues

Entity Formation. Among the first choices confronting company founders is the selection of corporate entity. Creating such an entity is critical because it creates a liability shield for the founders. Without a corporate entity, their personal assets may be at risk if the company incurs liability. The primary choices are a C corporation and a limited liability company (LLC). A C corporation is a tax-paying entity; if the entity wants to distribute profits to its shareholders, the shareholders pay a second tax on the dividends. An LLC is a pass-through entity which means gains and losses are passed on to its members (the LLC equivalent of shareholders) who then pay taxes. This avoids the double tax on C corporation shareholders. However, startups rarely have profits in their initial years and so the tax benefits of selecting an LLC tend not to be significant. There is a view in the startup community that LLCs are less expensive to set up. While this is true initially (although the difference is not great), over time LLCs may be more expensive because there is no industry standard LLC documentation. This results in additional document review time and drafting. Many venture capital firms either will not or strongly prefer not to invest in LLCs. Conversion from an LLC to a C corporation is possible and can be relatively simple. However, startups should discuss the LLC versus C corporation decision with their counsel because the best choice may not be obvious.

A secondary question that founders must address is the state of incorporation. This does not have to be, and often is not, the state where the company's principal place of business is located. The most common state for incorporation is Delaware. The main reasons for this are that Delaware has a very well-developed corporate law and its courts have a great deal of familiarity with corporate venture disputes. In addition, many of the industry's forms are drafted under Delaware law. Much less common, but not unheard of if the main office is based in the state, are incorporations in California, New York, and Massachusetts. If the state of incorporation is not the location where a company conducts business, it will have to qualify as a foreign business in each state where it is considered to be doing business. What constitutes doing business is a sometimes-tricky legal question and should be resolved in consultation with a lawyer.

Fundraising Path. Venture financing is done incrementally in a series of rounds of increasing size as the company grows. Rounds are usually intended to fund the company's operations for periods of between 12 and 24 months, although more often towards the lower half of that range. Early financing usually comes from the founders' own resources and a loose network of friends and family. This period is sometimes labeled pre-seed. As the financial needs increase, the investor circle expands to include angel investors, both individuals and networks, and early-stage institutional venture investors. This is known as the seed stage. Finally, as rounds become dominated by venture capital firms, the venture enters the investment alphabet as rounds are known as Series A, Series B, Series C, etc. Increasingly, especially in later stages, investors in these rounds include corporate venture arms, mutual funds, and private equity funds. Recently there has been significant grade inflation when it comes to financings. For example, seed financing rounds which historically rarely exceeded $1 million now routinely exceed several million dollars and often consist of multiple rounds of financing.

When discussing venture finance, two terms are critical and serve as a report card on a company's progress—pre-money valuation and post-money valuation. Pre-money is the value of a venture before receiving a new round of financing and post-money is the value of a venture after receiving venture financing. To illustrate the concept, assume an investor offers $1 million for 25% of a company. This offer implies a pre-money valuation of the company of $3 million. The post-money valuation of the company (the pre-money plus the new investment) is $4 million.

A company's post-money valuation then becomes the yardstick against which the next financing is measured. Let's assume that a new investor offers to invest $5 million for 25% of the company. This means that the pre-money valuation of the company is $15 million, a significant increase from the $4 million post-money valuation from the last round. This is known as an up round. On the other hand, if the company has not done well, a new investor may offer $1 million for 50% of the company. This creates a pre-money valuation of $1 million, a significant decrease from the last round post-money. This is known as a down round. In addition to forcing the company to sell more equity to raise a given sum of money, a down round forces existing investors to write down the value of their investment. The reverse is true of up rounds. The presence or absence of up rounds versus down rounds serves as a report card of a venture's progress.

Forms of Financing. Venture finance is generally done thought the sale of equity, with investors (as opposed to founders and employees) receiving shares of preferred stock with certain economic and control preferences. In early-stage investing, a significant portion of financing is done using convertible instruments—the primary forms being convertible notes and a simple agreement for future equity (SAFE). These convertible instruments usually convert into preferred equity upon the occurrence of a future equity financing that meets specified minimum criteria. The conversion is usually done at a discounted share price to other participants in the round. The use of convertible instruments instead of the sale of priced equity is less costly from a legal fee perspective and also avoids the need to agree on a pre-money valuation.

Preferred Terms for Investors. The preferred stock received by investors usually comes with several preferential rights. The most common are:

Liquidation Preference. Most venture investors are entitled to receive their money back from any sale of the company before common shareholders receive any payout. This priority return is sometimes enhanced in one of two ways or both:

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- *Participation.* This is essentially a double dip, where the investors receive their money back and then participate in the proceeds of a company sale alongside common holders.
- *Preference Multiples.* Although rare in the current market, some preferred shares guarantee a multiple of the initial investment to investors before common shareholders receive any proceeds from the sale of the company.

Dividends. In general, venture investors are not expecting annual dividend payments since the focus is on using all available funds to grow the business. However, preferred investors generally will receive a preference if the company declares dividends and in some cases a dividend will accrue, even if not paid, and will be an additional payout to the preferred shareholders on the sale of the company.

Board Representation. Investors will generally have the right to nominate at least one member of the company board. Ideally, an early-stage board will have one member who is a founder (usually the CEO), one representative of the investors, and an independent director. Since it can be difficult for early-stage companies to engage independent directors, it is not uncommon for early-stage boards to consist of two representatives of the common shareholders and one representative of the preferred shareholder, with a specified list of corporate actions requiring the approval of the director representing the investors. It is important to have a board with an odd number of directors to avoid deadlock. Also, to be effective, boards should not have a large number of directors. Initially, a three-person board is typical, expanding to five only when a substantial number of new investors have joined the company.

Voting Control. Generally voting control will be by a simple majority, including the votes of preferred shareholders on an as converted-to-common basis. However, preferred shareholders typically benefit from protective provisions — a list of significant corporate decisions that require approval of the preferred shareholders as a class.

Information Rights. Preferred shareholders or large preferred shareholders typically benefit from information rights that include periodic financial and management reporting.

Pre-Emptive Rights. Many early-stage investors make their investment to be first-in-line if the venture is successful and raises additional money. As a result, these investors are often granted a pre-emptive right to purchase a defined pro-rata portion of subsequent financings.

Right of First Refusal (RoFR)/Co-Sale Rights. Preferred shareholders usually receive RoFR and co-sale rights. This gives the shareholders the pro-rata right to purchase the shares of selling founders (or in some cases any shareholder) or alternatively the pro-rata right to sell their shares alongside a selling founder (or in some cases any shareholder).

Anti-Dilution Protection. Although not always part of early-stage financings, many preferred shareholders can receive anti-dilution protection for future stock sales by the company in a down round. When shares are sold at a lower share price, anti-dilution gives the preferred shareholder the benefit of additional shares to offset the dilution caused by the down round. This protection can be based solely on the difference in price (called the ratchet), but more frequently is done on a weighted average basis which reflects the relationship between the total shares outstanding as compared to the shares held by the original investor.

Deal Documentation.

- *Convertible Preferred Note.* There is no industry standard document set for convertible note financings although most forms tend to be similar. A sample note and commentary can be found here. In some cases, the actual note will be combined with a note purchase agreement, especially in a situation where there are multiple simultaneous purchasers.
- *Y Combinator Safe Financing Documents.* The Y Combinator accelerator has created several Safe (Simple Agreement for Future Equity) financing documents. There are several flavors of the Safe document and recently, the Safe form was updated with the primary change being a switch in the calculation of the Safe conversion from a pre-money to a post-money calculation. The various flavors of the Safe document and an explanation of the recent changes to the form are available here.
- *Series Seed Documents.* There is no industry standard form for Series Seed equity investment documents. However, a sample is available here. Generally, Series Seed financings require an amendment to the company's certificate of incorporation to create the class of Series Seed preferred stock and an investment/purchase agreement. This agreement is a scaled-down version of the industry's form Series A documents.
- *NVCA Model Series A Documents.* Almost 20 years ago, a group under the auspices of the National Venture Capital Association met to create form documents for the venture industry. The forms address a Series A funding and are drafted for a Delaware corporation. Although many law firms have tweaked these forms, some variation of these forms drives most Series A investing in the U.S. The model documents with commentary are available here.

  The Series A documents consist of:

  - A model term sheet
  - An amended certificate of incorporation
  - A stock purchase agreement
  - An investor rights agreement
  - A co-sale and right of first refusal (RoFR) agreement
  - A voting agreement

  The model term sheet is a particularly useful document because it provides a concise summary of the preferential rights typically given to preferred shareholders. Also, because the term sheet captures the majority of key points in the definitive documents, negotiation of the full documents tends to be minimized unless final diligence surfaces new issues with the company.

Investor Diligence — Questions Companies Need to Be Ready to Answer. It is only a slight exaggeration to say that most startups are in perpetual fundraising mode. In the typical investment round, one (the lead) or sometimes multiple investors will perform due diligence to verify the state of the company and identify previously undisclosed risks and liabilities. Founders should bear in mind the old saying "you only get one chance to make a first impression." When investors are performing due diligence, the company will typically be asked to assemble a data room of relevant documentation in a shared folder online. The initial impression made by the state of a company's data room can have a huge impact on the ultimate success or failure of the financing. If relevant documents are complete, organized and fully executed, the company will generally get the benefit of the doubt as a well-run company. A poorly organized or incomplete data room is a red flag that will prompt investors to dive deeper or possibly abandon the deal.

For early-stage companies, investor diligence is likely to focus on the following document categories.

- *Corporate Governance Documents.* The certificate of incorporation, bylaws, and corporate/board resolutions.
- *Cap Table.* A cap table is a spreadsheet showing everyone who owns the company's stock and their share ownership, including option and warrant holders. It is critical that the cap table is accurate and up to date. Early-stage companies frequently run into problems when equity grants have been promised to employees or contractors, those grants were never documented and as a result, the cap table is incomplete. Cap table cleanup can significantly delay a transaction and can be quite costly in terms of legal time.
- *Employment/Contractor Documentation.* Investors will want to make sure that proper documentation is in place for all employees and contracts. Most critically, they will want to make sure that documentation addressing confidentiality and the assignment of intellectual property rights is in place with each employee/contractor.
- *Major Contracts.* Although early-stage companies may have few contracts, important contracts will be reviewed. Unusual non-market terms may be red flags.
- *Disputes.* Although rare, due diligence should highlight any litigation or threatened litigation. Because of issues related to attorney-client privilege, how this information is disclosed should be discussed with counsel.
- *Intellectual Property (IP).* Intellectual property is often the most valuable asset of an early-stage company. Investors will be keenly interested in the IP birth story. Relevant questions that should be answered are: who was involved with the creation? Did any of them previously work for companies in the same space? If third parties were involved, did the company obtain an assignment of all intellectual property?

Many investors will give their investment targets a due diligence checklist. Often these are generic, over-inclusive documents that are not tailored to the business of the target company. As a result, N/A may be the appropriate answer to a significant number of queries. However, all due diligence responses should be reviewed by counsel before being made available to investors. The company should also designate one person to oversee disclosures, to make sure there are no inadvertent disclosures, and that the company has an accurate record of what is disclosed.

Commercial and Intellectual Property Issues

Launching and running a successful business takes many things: a great idea, capital, hard work, timing, and a certain degree of good fortune. Another factor very high on that list is the team of employees, advisors, contractors, vendors, and other parties the company will rely upon. Negotiating, memorializing, and administering the various contracts with these parties — and securing the intellectual property they create — are often critical, especially in the earlier stages of a company's life cycle. This section explores some of the foundational principles for defining these commercial relationships, as well as the importance of protecting and securing ownership of valuable business intellectual property created by such parties.

Employee Non-Disclosure and Invention Assignment Agreements

As part of the process for onboarding employees, it is best practice to have each employee (or, at a minimum, those who will have access to confidential information or be involved in the creation of intellectual property) execute an agreement memorializing (i) the employee's commitment to maintain the secrecy of any confidential information; (ii) assignment to the business of any intellectual property rights developed by the employee in the scope of employment; and (iii) any non-competition restrictions to be imposed on the employee. These agreements should be standardized across the business, and records of executed copies should be maintained for future reference.

Non-Disclosure. The non-disclosure aspect of these agreements is relatively straightforward. The agreement should set forth the types of information the employee will be receiving and from whom the employee can expect to receive such information. Typically, employers will define confidential information in the broadest possible manner to capture all information the employee will have access to within the scope of his or her employment. However, this method can backfire as a court may determine such an overly broad definition to be unenforceable. As a result, it is best to be clear about what information the business is most concerned about maintaining as confidential (whether it be trade secrets, customer lists, customer information, etc.). The agreement should also include carve-outs from the definition of confidential information such as for information that is not confidential or that ceases to be confidential through no fault of the employee. Additionally, the agreement should also include an exception for disclosures required by a valid subpoena or other court order.

Ownership and Third-Party Information. Although confidential information may not necessarily include intellectual property, it is important to specify who owns any confidential information and that disclosure of the business's confidential information to an employee does not grant the employee any rights in such information. It is also important to distinguish between the business's confidential information and that of its vendors/customers, although the employee's obligations to maintain the confidentiality of such information will remain the same. Finally, it is also best practice to include language specifying that the employee will not use any of the employee's prior employer's confidential information in the performance of services on behalf of the new employer.

Whistle-Blower Immunity. For employers to receive the full benefits of the trade secret protections offered under the Defend Trade Secrets Act of 2016 (DTSA), employers must provide notice to their employees of certain whistle-blower immunities. It is therefore best practice to include the following notice provision directly in the non-disclosure and invention assignment agreement with employees. "Pursuant to 18 USC § 1833(b), an individual may not be held criminally or civilly liable under any federal or state trade secret law for disclosure of a trade secret: (i) made in confidence to a government official, either directly or indirectly, or to an attorney, solely for the purpose of reporting or investigating a suspected violation of law; and/or (ii) in a complaint or other document filed in a lawsuit or other proceeding, if such filing is made under seal. Additionally, an individual suing an employer for retaliation based on the reporting of a suspected violation of law may disclose a trade secret to his or her attorney and use the trade secret information in the court proceeding, so long as any document containing the trade secret is filed under seal and the individual does not disclose the trade secret except pursuant to court order."

Invention Assignment. Many businesses rely on a faulty premise that any intellectual property developed by employees on behalf of the business is automatically owned by the business. This is not true. Although copyrights to works developed in the scope of employment are considered works made for hire and are automatically owned by the employer, this is usually not the case for patent rights under U.S. patent law. Unless the employee assigned patent rights to inventions that he or she created or was hired by the company specifically to invent a particular product, the employee would retain those patent rights. Although in such cases the employer would likely retain certain shop rights to practice the employee's patent without paying any additional compensation, the employer would not own the patents, and therefore cannot license rights in the invention to third parties or prevent third parties from practicing the invention.

With this in mind, the invention assignment component of these agreements should set forth, among other things: (i) a clear and broad definition of what is a new development to be owned by the employer ("inventions") and any narrow exceptions to this definition; (ii) rules for incorporating any employee pre-existing intellectual property or third-party materials (including open source software) into any inventions; (iii) further assurances/covenants that the employee will assist in the execution of necessary agreements to perfect the business's interest in such inventions; and (iv) a waiver of the employee's moral rights with respect to his or her contributions.

Invention Definition and California Labor Code. The definition of what is an invention developed in the scope of employment is typically broad. Frequently, the only limitations on what is included in the definition concern the legal and regulatory boundaries of the "scope of employment" concept. For example, the California Labor Code Section 2870 specifies that any "*employment agreement which provides that an employee shall assign, or offer to assign, any of his or her rights in an invention to his or her employer shall not apply to an invention that the employee developed entirely on his or her own time without using the employer's equipment, supplies, facilities, or trade secret information except for those inventions that either: (a) Relate at the time of conception or reduction to practice of the invention to the employer's business, or actual or demonstrably anticipated research or development of the employer; or (b) result from any work performed by the employee for the employer.*" Agreements that do not provide for the foregoing exclusion are void under California law as against public policy. To avoid any discrepancy, many employers directly track this language in their non-disclosure and invention assignment agreements.

Pre-Existing and Third-Party Works. Having an employee identify any pre-existing intellectual property to which that employee claims a right will help avoid a later dispute regarding ownership. A well-drafted agreement will require the employee to make such a declaration of pre-existing intellectual property in a schedule; set forth that any inventions will be the property of the employer; and preclude the employee from claiming any rights to undeclared intellectual property incorporated into any such Inventions. To the extent the employee declares any pre-existing intellectual property, the agreement should include a broad license grant to the employer for any such pre-existing intellectual property incorporated into any invention and/or used by the employee in the scope of employment. In addition, the agreement should preclude the employee from incorporating any third-party materials (e.g., software, especially open-source software) into an invention without the prior, written approval of the employer.

Further Assurances. Because many inventions may be subject to different forms of government-sanctioned protections, it is important to include a clause obligating the employee to execute any additional documents required to perfect the employer's interest in such inventions (e.g., execution of an assignment for patentable inventions for submission to the United States Patent and Trademark Office). Such a provision should also include a power of attorney grant (coupled with an interest) so the employer can execute the documents on the employee's behalf if he or she fails to cooperate.

Non-Competition. Many employers seek to include restrictions on the employee's ability to compete with the business following termination of employment. These restrictions must be narrowly tailored to be enforceable, especially in states like California that are generally employee favorable. Non-competition restrictions that are indefinite in terms of length and scope (e.g., a restriction that forbids an employee from ever working in software development following termination) have been ruled unenforceable in many jurisdictions.

Protecting Copyrights, Patents, and Trademarks

Depending on the nature of the business, a company may wish to file applications for government recognition of its rights in particular intellectual property assets, such as copyrights, trademarks, and patents. Below is a basic primer on the rights applicable to each such filing, the filing requirements, and enforcement mechanisms once a patent or copyright/trademark registration is issued.

Copyrights. Copyright protection in the U.S. applies to original works of authorship fixed in a tangible medium of expression. A tangible medium means that a company needs to have a writing or recording of the work in question for it to be eligible for copyright protection. Ideas are not copyrightable, only the original expression of those ideas. For example, the idea for a new mobile application is not copyrightable (or patentable for that matter). However, the code embodying that idea would likely be copyrightable.

In the U.S., copyright applications are filed with the United States Copyright Office, and although the applications must be accurate, the Copyright Office does not verify ownership of the work or inspect the work to determine whether it infringes the copyrights of others. Under U.S. law, registration is not required to obtain a copyright. Rather, copyright protection exists from the moment the work is fixed into the tangible medium of expression (e.g., when a program, mobile app, or website is coded). However, registration — which is inexpensive and relatively easy to do — is required to file a lawsuit for copyright infringement and affords the registra`nt additional benefits, such as the possibility of recovering attorneys' fees, costs, and statutory damages (i.e., damages not requiring proof of actual harm). Include a copyright notice on all important copyrighted materials in substantially the following form: Copyright © [Year of First Publication] [Name of Company].

If a company believes that a third party is infringing its copyright, consult with counsel to determine rights and potential remedies. If the company and its counsel determine that there is a good-faith basis to make such a claim, the first step is generally having the company attorneys send a cease and desist letter to the infringer, demanding that it stop all such infringing activities. Oftentimes, sending a cease and desist letter with resolve the situation. For infringing materials published online, it may also be possible to have the materials taken down by sending the infringer's web host a takedown notice under the Digital Millennium Copyright Act. If the infringed material is particularly important to the company and it will be irreparably harmed by any continued infringement, consider moving for injunctive relief with a court order for the infringer to stop a specified act or behavior.

Patents. In the U.S., inventions can be patented if they are (i) eligible subject matter under Section 101 of the Patent Act (i.e., a process, machine, manufacture, or composition of matter); (ii) new; (iii) useful; and (iv) nonobvious. Patent protection in the U.S. requires a lengthy application process through the United States Patent and Trademark Office (USPTO) and may take years to complete.

For patent applications filed on or after March 16, 2013, the U.S. changed from a first-to-invent system to a first-inventor-to-file system. This means that for any given invention, the USPTO will award the patent to the applicant who files the patent application first. In light of this important change in law, a company may wish to file a provisional patent application, which is a streamlined patent application to secure a filing date while avoiding the costs and complexity of filing and prosecuting a non-provisional patent application. For example, unlike the more complicated non-provisional application, a provisional application does not require a formal patent claim, a declaration, or information about prior art. Once a provisional patent application has been filed, the applicant has a year to determine whether to file a nonprovisional application, which will receive the benefit of the provisional application's filing date.

Once a patent issues, its holder is entitled to a government-sanctioned monopoly over the patented invention for up to 20 years (with appropriate filings) from the effective filing date, which is usually the application date. Patent infringement litigation, which is costly and time consuming, typically requires expert analysis to both establish the degree of infringement and assess any potential damages.

Trademarks and Service Marks. In the U.S., trademark and service mark rights arise out of the use of a word, name, symbol, or other device (e.g., a sound or color) in commerce to indicate the source of goods and/or services and to distinguish them from the goods/services of another--think of the Nike swoosh or the Intel chime. As is the case with copyrights, a company does not need a registration to enjoy trademark/service mark protection. However, as with copyrights, there are several important benefits to obtaining a registration, which a company may obtain through the USPTO.

Registration gives the owner rebuttable evidence of its rights in the mark for the goods and services covered in the registration. Owners of famous marks enjoy enhanced protection from a third party diluting the value of their brands. Applicants may file use-based applications after they have used a mark in commerce, or, if they are anxious to protect a mark they have not yet used but have a bona fide intent to use in the future, they may file an intent-to-use application.

If another party uses a confusingly similar mark in connection with similar goods and services, or goods and services in the natural area of expansion around the mark's owner's goods and services, then the owner should seek to enforce its rights against the infringer. Trademark law encourages (and indeed requires) companies to enforce their rights and protect their brands to preserve their trademark rights and avoid a finding of abandonment.

If a company owns any trademarks or service marks (e.g., designs, logos, company or product names, etc.) that indicate they are the source of the applicable products or services, it should use the following notices for the marks: (i) if the mark is not registered, use the ™ symbol for trademarks and the ℠ symbol for service marks; and (ii) if the mark is registered with the USPTO, use the ® symbol.

Contractor Agreements

When engaging third-party contractors, vendors, or other service providers, such as developers and designers (contractors for short), it is critical to document the business arrangement and terms of the engagement. For contractors that will perform various ongoing services, a master services agreement (or MSA) may be executed that contains all of the relevant terms and conditions of the overall relationship. For each engagement under the MSA, the parties will execute a statement of work or work order that describes the specific elements of the project, such as a description of the services, the period of performance, the deliverables to be created, the price, and other business terms. If the company is engaging a contractor for a one-off engagement, it can use a simpler services agreement. Ideally, a business should develop its own contractor agreement for such engagements to create consistency across its various vendor engagements.

Here are several of the material deal points that should be covered in any contractor agreement.

Liability Limitations. Contractors often seek to limit their liability and exclude certain types of damages when performing services. Though certain limitations and exclusions are reasonable and typical, the contractor must always have enough "skin in the game" to ensure proper performance and mitigate risk. Contractors often seek to exclude indirect and consequential damages, such as lost profits, and cap their liability at the amount of fees paid under the agreement (or some other lower amount). Negotiations around this important area vary widely and often revolve around the nature of the services, the value of the agreement, the industry a company operates in, and the leverage of each party. One way to mitigate risk is to require the contractor to carry certain types and levels of insurance and name the company as an additional insured.

Indemnification. A right of indemnification allows the holder (the indemnified party) to seek payment from the other party (the indemnifying party) for specified types of damages arising from claims asserted by a third party. Businesses should seek broad indemnity rights from their contractors for potential third-party claims based on circumstances solely within the contractor's control and carve out the indemnification rights from any limitations of liability. For example, a contractor engaged to create original intellectual property should indemnify the business from any third-party claims arising from allegations that the developed intellectual property infringes upon the rights of such third party. In addition to requiring the contractor to reimburse the company for out-of-pocket expenses incurred in connection with any covered third-party claim (e.g., attorney fees), the company should also seek to have the contractor defend it from any lawsuit or claim.

Intellectual Property Ownership. If a contractor creates intellectual property when performing services on a company's behalf, the default rule is that absent a signed written agreement to the contrary, the contractor owns such created intellectual property. It is therefore imperative that the agreement with the contractor specify that: (i) the company owns all right, title, and interest in and to such deliverables, including all intellectual property rights; (ii) any copyrightable works are works-made-for hire;[1] (iii) for any works that do not qualify as works-made-for-hire, the contractor irrevocably and unconditionally assigns to the company all rights; (iv) if there are any pre-existing contractor materials incorporated into the deliverables, the company has a very broad, perpetual, royalty-free right to reproduce and use them; and (v) the contractor waives all of its moral rights.

Avoiding Deemed Employment. Agreements with contractors must state that the contractor and the contractor's personnel are not a company's employees and are not entitled to any benefits offered. However, simply stating that may be insufficient to avoid having the contractor or its personnel be deemed an employee based on a variety of factors. For example, a contractor that is obligated to perform services at a specific location, during specific hours, using a company's tools and equipment, and under company supervision, direction, and/or control may be deemed an employee. Courts will look at many factors in determining whether an independent contractor is properly classified as a contractor, and companies should be extremely careful when seeking to engage contractors that will perform services ordinarily performed by employees. This is especially true when the contractor is an individual, rather than an entity, which is strictly scrutinized in many states such as New York and California.

[1] Note, however, that in California, if a contract with a third-party contractor includes a provision treating creative works as works made for hire, the contractor will be deemed an employee under California law for purposes of unemployment and disability taxes. CA Unemp Ins Code § 686.

Privacy Policies and Terms of Use

We all know these forms. They are the lengthy, perplexing legal documents often buried at the bottom of a website or mobile application that no one reads. Despite this, they are very important in that they govern the relationship between a business and its end users/customers, and, in most cases, are enforceable (by both the business and end users/customers). Many small businesses fall into the trap of plagiarizing (er, borrowing) terms of use and privacy policies that they find on the internet. Potential copyright infringement issues aside, such reliance on form documents can lead to problems if the business does not follow them. The Federal Trade Commission (FTC) has oversight of such matters, and its regulations prohibit companies from deceiving and misleading consumers. The FTC has found that a company's failure to comply with its own terms of use and/or privacy policy is a fraudulent and deceptive business practice. Such failures have led to numerous lawsuits and hefty fines.

Here are a few guidelines when drafting and implementing these policies:

- A privacy policy should clearly and accurately describe:
  - The types of information collected. It is advisable to distinguish between the different types of data a business collects, such as personal information (e.g., name, address, phone number, email, etc.), financial information (e.g., credit card number, PayPal account information, etc.), geolocational information (i.e., data regarding an end user's physical location gleaned from his or her mobile device's GPS), and other information (e.g., anonymous or aggregate data automatically collected through an end user's use of a website/platform, such as IP address, sites visited, how long the end user engaged with a certain element of the applicable website/platform, etc.), because a company may use and disclose the various types of data differently.
  - If a company employs targeted/behavioral advertising on its platform. This has become a hot-button legal issue. Facebook regulates the use of such advertising on its platform, so be sure to review Facebook's platform policies carefully.
  - If and how end users can modify the data a company collects about them.
  - How a company uses and shares the data it collects. This section of the privacy policy is one of the most important because it governs what a company can do with all the data it collects. It is incredibly important to be accurate in this section, because it can create all sorts of problems if, for example, a company says that it does not share data with third-party marketers when it does. Companies should state that they may use and/or share the data in at least the following instances:
    - To provide end users access to, and usage of, the platform, process orders, solicit feedback, inform them about the companies' products and services, administer any rewards and promotional programs, and operate, maintain, and improve the platform.
    - To provide current and prospective business partners with aggregated user statistics to describe their products, services, and platform.
    - To enable them to employ other companies and individuals to perform functions on their behalf, such as marketing assistance, information technology support, and customer service.

    - In connection with any kind of bankruptcy, liquidity event, or change in control of the company, whether through merger, acquisition, sale of assets, etc.
    - When required by law, court order, or other government or law enforcement authority or regulatory agency, or whenever the companies believe that disclosing such information is necessary or advisable, for example, to protect the rights, property, or safety of the company or others.
  - If a company anticipates (now or in the future) sharing data with other companies that may provide end users information about the products and services they offer, that should be disclosed as well. Such a disclosure is essential if the company is sharing data for such reasons. However, to comply with various state statutes, it is important to provide end users the ability to opt-out of such sharing.
  - How a company protects the information it collects. It is important to inform end users that the company will use commercially reasonable efforts to protect their data, but that no system is 100% safe. It is imperative, especially if the company collects any financial or other sensitive information, to implement, maintain, and enforce strong technological, physical, administrative, and procedural safeguards to protect the security and integrity of such information. Numerous consultants specialize in this area, and companies are well-advised to seek assistance.
  - That the company reserves the right to change its privacy policy at any time.

Privacy laws in the U.S. are complicated and constantly changing. For example, California recently passed the most comprehensive consumer data protection law in the country. The California Consumer Privacy Act (CCPA), which goes into effect on January 1, 2020, will have profound implications for the privacy practices of direct-to-consumer brands and will likely spawn copycat legislation in other states. Companies should engage privacy counsel that is well-versed in consumer data and the myriad state and federal laws affecting a business.

If a company does business overseas, many regions — including Europe (consider the EU's General Data Protection Regulation or GDPR) and Asia — have complex privacy rules, a description of which is beyond the scope of this section. If a company does business outside the U.S. or obtains personal data from foreign individuals, especially if it has a physical presence outside U.S. borders, it needs to pay particular attention to these foreign laws, as they can have significant ramifications on a company's ability to collect, use, and share data.

- A company's terms of use should typically set forth:
  - A description of its platform, including permissible uses and restrictions (e.g., end users will not post defamatory content, upload anything that infringes on anyone's intellectual property, or reverse engineer or interrupt the proper operation of the platform).
  - Any payment and refund policies.
  - If it employs and how it handles passwords and usernames.
  - Ownership of intellectual property.
  - The company's right to terminate a user's access to the platform at any time.
  - The notice and takedown information required by the Digital Millennium Copyright Act (or DMCA), which provides a safe harbor for claims of copyright infringement arising from user-generated content if certain procedures are followed.

  - A broad disclaimer of warranties regarding the platform and a limitation of liability provision.
  - Who owns user-generated content uploaded to the platform. The trend is for the end user to retain ownership, but grant companies a very broad license to, among other things, use, reproduce, modify, and distribute the content.
  - A company's right to modify the platform and the terms of use at any time in its sole and absolute discretion.
  - A choice of law and choice of forum clause that specifies the state in which any lawsuit must occur. If a company is incorporated in Delaware, it does not mean that it needs to select Delaware for the choice of law or forum. Although many considerations go into this decision, the general rule of thumb is to pick the state that is most convenient for the company, which is typically driven by geographic proximity.
- Many states have passed laws restricting the automatic renewal of terms of service (or other customer agreements) that apply to consumers unless certain guidelines are followed. So, if a company plans on having its terms of use automatically renew, which is common for many direct-to-consumer brands that offer subscriptions, it should follow these best practices:
  - Clearly and conspicuously disclose the automatic renewal or continuous service terms before the purchase and close to the purchasing agreement (i.e., prominently in the agreement), at the point of purchase (e.g., on the checkout page), and in places the consumer views different subscription options.
  - Require the consumer to sign, click through, or otherwise affirmatively consent to any agreement that contains an automatic renewal or continuous service provision.
  - Consider sending each consumer a reminder before the end of the subscription period stating that the agreement will soon automatically renew and explaining how the consumer can cancel.
  - Always provide consumers with a clear, easy, and free way to cancel their subscriptions.
  - Avoid making material changes to the automatic renewal or continuous service terms without first providing a clear and conspicuous notice of the proposed change and further providing a straightforward cancellation process.

Web Accessibility

Class action plaintiffs are always on the hunt for new causes of action to form the basis of their suits. For some time, violation of the automatic renewal laws mentioned above was the hot-button issue of the day. Recently, plaintiffs have turned their attention to alleging that websites that do not provide a certain degree of accessibility violate the Americans with Disabilities Act (ADA). Although a detailed discussion of these type of claims is beyond the scope of this section, companies that offer goods and services via a website or mobile app — presumably every direct-to-consumer brand — are well-advised to use reasonable efforts to make their platforms accessible to all and to meet the Web Content Accessibility Guidelines (WCAG 2.1 AA), which is an accepted industry standard for accessibility for people with disabilities.

U.S. Privacy

In the U.S., data privacy is largely regulated under a piecemeal or sectoral approach, covering particular subject areas, industries, and types of consumer information where consumer harm is more likely. Additionally, federal and state unfair or deceptive acts or practices laws regulate companies by prohibiting them from engaging in activity that violates their public statements or unfairly harms consumers. No single federal law governs consumer privacy in the U.S. In the states, certain jurisdictions have adopted laws requiring companies to post privacy policies and make disclosures when sharing marketing information. Finally, industry self-regulatory codes and programs, such as the Digital Advertising Alliance (DAA), are critically important to brand advertising, giving consumers transparency and the ability to control interest-based advertising.

Federal Sectoral Laws. At the federal level, Congress set forth data privacy and security requirements for certain industries and types of consumer information. For example, the Gramm-Leach-Bliley Act,[2] Health Insurance Portability and Accountability Act,[3] and Family Educational Rights and Privacy Act,[4] along with their implementing regulations, create data privacy and security rules for financial, health, and educational information respectively. Additionally, the Children's Online Privacy Protection Act (COPPA) regulates the collection of personal information from children under the age of 13 from a website or online service directed to children, or when the data collector has actual knowledge that the data is being collected from a child under the age of 13.[5]

One federal sectoral law is of particular relevance to most direct brands: the Controlling the Assault of Non-Solicited Pornography and Marketing (CAN-SPAM) Act.[6] This law establishes rules for email marketing. According to CAN-SPAM, companies may not use false or misleading header information or subject lines in commercial email, and they must provide a mechanism for consumers to opt out of receiving commercial email from the sender.

Additionally, the Restore Online Shoppers Confidence Act (ROSCA) regulates certain online data practices, including negative option marketing, post-transaction third-party sellers, and data pass.[7] Specifically, ROSCA makes unlawful the act of "data pass," which is the disclosure by a merchant of any billing information to a post-transaction third-party seller for the use in an internet-based sale by the third-party seller.[8]

[2] Gramm-Leach-Bliley Act, 15 U.S.C. §§ 6801-6810.

[3] Health Insurance Portability and Accountability Act, 29 U.S.C. §§ 1181 et seq.; 42 U.S.C. § 300gg; 42 U.S.C. §§ 1320d *et seq*

[4] Family Educational Rights and Privacy Act, 20 U.S.C. § 1232g.

[5] Children's Online Privacy Protection Act, 15 U.S.C. §§6501 *et seq.*; 16 C.F.R. §§312.1 *et seq*.

[6] Controlling the Assault of Non-Solicited Pornography and Marketing Act, 15 U.S.C. §§ 7701-7713.

[7] Restore Online Shoppers Confidence Act, 15 U.S.C. §§8401 *et seq*.

[8] 15 U.S.C. §8402.

Unfair or Deceptive Acts or Practices. Section 5 of the Federal Trade Commission (FTC) Act and its state law counterparts prohibit unfair or deceptive acts or practices in commerce.[9] In the privacy arena, these statutes are generally triggered when companies violate their consumer-facing statements, such as those made in privacy policies, marketing materials, and other public communications. Furthermore, these laws have been used to bring enforcement actions against companies that make a material change to a privacy policy, and then use previously collected data in that materially new way without the consent of affected consumers. One way to avoid these types of enforcement actions is to limit the data used in a new data practice to prospectively collected data, and not apply the change retroactively.

State Laws. California, Delaware, and Nevada require operators of commercial websites or online services to post conspicuous, public-facing privacy policies.[10] Those laws generally require, among other obligations, that privacy policies identify the types of information collected, the categories of companies it may be shared with, whether third parties collect data from the website or online service, and other information about a brand's data practices.[11]

Additionally, California law requires companies to provide consumers with certain information upon request if it discloses consumer information to third parties for their direct marketing purposes.[12] This statute, known as the Shine the Light law, requires companies to either provide consumers with a list of third parties and categories of data that was shared for direct marketing activity by the third party, provide an opt-out of that practice, obtain the consumer's opt-in permission, or state that the company does not disclose personal information for third-party direct marketing purposes.

In 2018, California passed the California Consumer Privacy Act (CCPA), a comprehensive consumer privacy statute.[13] This law will become effective January 1, 2020, and the contours of its requirements are still being determined by the state's regulators. The law creates several new consumer rights, including the rights to access and deletion or personal information, and the right to opt-out of the sale of information to third parties. Additionally, the CCPA creates a broad definition of personal information, including common online identifiers such as IP addresses and cookies, within its definition.[14] Companies should continue to monitor developments with the CCPA to learn how their practices will be affected, as well as other states that are contemplating similar laws.

[9] Federal Trade Commission Act, 15 U.S.C. § 45(a).

[10] Cal. Bus. & Prof. Code §§ 22575-22579; Del. Code Ann. tit. 6, § 1205C; Nev. Rev. Stat. §§ 603A.310-360.

[11] Cal. Bus. & Prof. Code § 22575.

[12] Cal. Civ. Code § 1798.83.

[13] Cal. Civ. Code §§ 1798.100 et seq.

[14] Cal. Civ. Code § 1798.140(o).

Most recently, Nevada passed a privacy statute that went into effect October 1, 2019.[15] Nevada's law creates an opt-out-of-sale requirement related to a limited definition of covered information. The Nevada bill defines covered information to be more traditional personally identifiable information, such as names, email addresses, telephone numbers, and social security numbers.[16] Nevada limits its definition of "sale" to the exchange of covered information for monetary consideration by the operator of an online service for the recipient of the information to license or sell the information to other entities.[17]

Self-Regulatory Codes and Programs. Several self-regulatory programs supplement the sectoral privacy laws. One such code is the DAA, whose requirements are incorporated into the IAB Code of Conduct. It applies to entities that engage in specific data practices, including interest-based advertising, whether or not the entity is a participant in the program.[18] If a company operates a website or mobile application that allows third parties to collect web viewing or application use data across non-affiliated websites and mobile apps over time to predict consumer preferences to deliver relevant advertising back to the browser or device, or associated browsers or devices, the DAA principles require that the company provide enhanced transparency to consumers and link to the DAA's choice tools. Additionally, if a company's mobile app allows the collection of precise location data (e.g., GPS location) by third parties for advertising purposes, or if a company transfers such data to a third party for interest-based advertising, the company should obtain consent for that activity. Failure to comply with the DAA principles can result in public enforcement actions by the DAA's independent accountability programs.

Advertising and Marketing Law

What Is Truth in Advertising? Advertising and marketing must be truthful, not misleading, and not unfair. This is the very simple standard that is enforced at the federal and state level in the U.S. There are some more specific laws and detailed guidance for specific types of advertising, but it all boils down to these three concepts. With everything, step back and consider the campaign from the standpoint of the target consumer. Not only is truth in advertising the law, being truthful and ethical also means business success by gaining consumer goodwill and growing brand loyalty. Advertisers should ask:

- Are we telling the truth?
- Is anything confusing or likely to be misunderstood?
- Are we leaving out any key information necessary to understand the offer?
- Is the way we are interacting with consumers likely to cause harm or is it unethical or against public policy?

If the answer to any of these questions is yes, consult with legal counsel right away. They will find a way to revise or restructure a campaign to make it compliant.

[15] Nevada, S.B.220.

[16] Nev. Rev. Stat. § 603A.320.

[17] *Id.* at Sec. 1.6.

[18] DAA, *Self-Regulatory Principles for Online Behavioral Advertising* (Jul. 2009); IAB, Code of Conduct (2019).

Who Enforces the Truth in Advertising Rules? The FTC is the federal enforcer that is responsible for truth in advertising, primarily under the FTC Act, though the Federal Communications Commission (FCC) may also enforce truth in advertising over broadcast and the radio. The state attorneys general also have oversight for truth in advertising under their Unfair and Deceptive Acts or Practices (UDAP) laws. Often, the states look to the federal government for guidance, but sometimes states have laws in addition to the federal requirements. Under state UDAP laws, private citizens can bring a claim. Consumer fraud class actions—where one customer can allege they have been deceived and bring a case on behalf of themselves and other purchasers of the product—are very common, particularly in California. Companies can also challenge competitive advertising under the federal Lanham Act statute. In short, law enforcement officers, customers, and competitors all act as watchdogs for truth in advertising.

Some other federal agencies have oversight for truth in advertising for specific products or services. The FCC is responsible for oversight of television and radio. The Food and Drug Administration (FDA) enforces truth in advertising for pharmaceuticals and shares oversight with the FTC for certain advertising for over-the-counter medicines, medical devices, dietary supplements, food, and cosmetics. The Federal Aviation Administration (FAA) has oversight for airline advertising. The Consumer Financial Protection Bureau (CFPB) has oversight along with the FTC for consumer financial services and products. The Environment Protection Agency (EPA) has oversight for the advertising of pesticides.

Many national marketers also participate in self-regulatory programs. For example, the National Advertising Division (NAD) of the Better Business Bureau (BBB) provides a forum for reviewing advertising where companies can challenge advertising of their competitors outside of the court process. Sometimes these self-regulatory programs are industry-specific, such as Distilled Spirits Council of the United States (DISCUS), and members hold themselves to a higher standard than may be legally required for their advertising.

Who Is Responsible for Deceptive or Unfair Advertising? Anyone who participates in the creation or dissemination of deceptive or unfair advertising can be liable if the advertising is deceptive or unfair. The FTC has brought many cases against advertising agencies when they knew or should have known that representations made in the ads are false or misleading. It is therefore important to make sure product claims can be backed up or substantiated. While companies are not expected to be experts in things like evaluating clinical trials, they should review the underlying support for advertising claims and question or flag easily discoverable flaws.

How Do We Make Sure Advertising Is Truthful? Substantiation. In the U.S., advertising must be substantiated before a claim is made. In other words, before making a promise to consumers about what a product or service can do, an advertiser needs evidence or support to back it up. This is called prior substantiation. Before any campaign is approved, ensure all claims are substantiated. If the substantiation is technical or scientific, build in time to review it with counsel.

- Objective advertising claims require prior substantiation. Claims can be express or implied and generally relate to tangible characteristics of a product or service. If an ad contains claims about a product or service that can be measured or otherwise proved true or false, advertisers must ensure there is a reasonable basis for those claims. A good rule of thumb for what constitutes a reasonable basis is the amount and type of evidence that substantiation experts in the field believe is reasonable to support the claim.

- Special care is required for health and other claims that consumers cannot evaluate on their own, such as "reduces engine wear by 25% or more." Advertising that includes health claims often must be substantiated by well-controlled, double-blind human clinical studies.
- If a company makes health claims to sell a product or service, it should be able to answer the following important questions:
  - Does the ad contain numerical or comparative claims (e.g., "contains 20% fewer calories than the leading brand")?
  - Does the ad contain express statements (e.g., "studies prove" or "two out of three doctors recommend") about the amount or type of support it has for the product or service? If so, does the company have the amount or type of support claimed?
  - is the company relying on studies of the product to substantiate a claim? If the company is relying on studies of other products, do those products contain the same ingredients, in the same quantity, and of the same quality?
  - Are there studies of the product about which the company is making claims that contradict the study or studies it is relying on for substantiation?

Disclaimers

It's hard not to notice disclaimers; they are everywhere. But as a consumer it's also hard to commit to the disclaimer as you struggle to read the fine print or wonder what jargon just flashed across the television screen. While it may seem that some marketers adhere to the adage that "a disclaimer a day keeps enforcement away," disclaimers are not the answer to a false or misleading advertising claim. The FTC's regular enforcement of disclosure rules for national advertising should serve as a warning to advertisers to clean up the fine print.

Regulators encourage advertisers to write clearer ad copy rather than rely on disclaimers, and if a company does use a disclaimer, it should be clear and conspicuous and appear close to what it is disclaiming. Also consider whether it should appear in the same form (verbal or written) as the advertising claim. The content of the disclosure should not contradict or significantly limit the advertising claim. In other words, the disclosure should explain the advertising claim, not change the advertising claim. The FTC's .com Disclosures guidelines and NAD decisions provide a great deal of guidance on crafting disclaimers.

Advertisers should be judicious in their use of disclaimers. The basic rule is that disclaimers must be easy to understand, unavoidable, and designed and placed so a consumer is likely to notice and read them. Specifically:

- Disclaimers should be near the claim they qualify.
- Disclaimers should be conspicuous (e.g., readable type that is not on a background with a lot of clutter or movement).
- Disclaimers should be clear and appear for a sufficient amount of time to be readable. As a rule, the more important the qualifying information is to the consumer and the more unexpected the qualification may be, the greater the requirements regarding prominence and conspicuousness.

- Disclaimers should not contradict the claim. For example, the claim “Average weight loss of 10 pounds” should not be qualified with a disclaimer that says, “among those individuals who lost weight.”

Online Disclaimers

The FTC, state attorneys general, and class action lawyers are paying very close attention to the clarity and prominence of consumer-facing online disclosures. Anyone who markets online, including in mobile and social platforms, should review the FTC’s March 2013 .com Disclosures as well as the Commission’s Guides Concerning the Use of Endorsements and Testimonials (and its subsequent FAQs and addenda). The FTC guidance discusses how to make disclosures clear and conspicuous across the various devices and platforms used by today’s consumer. If an ad or endorsement requires a disclosure to avoid being deceptive, but that disclosure cannot be made clearly and conspicuously on a particular device or platform, the FTC says companies should not run the ad or endorsement on that device or platform. The clarity and conspicuousness of online disclosures are a constant source of government enforcement and private litigation, with regulatory agencies and federal and state courts opining (sometimes differently) about what constitutes an adequate online disclosure.

Given the heightened level of scrutiny, companies should monitor the evolving standards laid down by the courts:

- Disclaimers should not appear below the fold. They should be visible without the consumer scrolling down.
- Hyperlinks are generally okay, but should be avoided if the information is especially material to the claim. Hyperlinks must be clear and provide additional information concerning the nature of the information that can be found by clicking on the link first (e.g., “For important limitations, click here.”)
- If a particular platform is not conducive to making a necessary disclaimer, the claim should not be made on that platform.
- Important disclaimers must be made before a consumer places an item into a shopping cart.
- Disclosures must be clear, conspicuous and unavoidable in terms of font size, wording, and proximity to the claim. Other parts of the web page should not distract attention from the disclosures.
- The disclosure should not materially modify the message of the advertisement. The more the disclaimer or disclosure modifies the primary message, the more prominent and conspicuous the disclosure needs to be.
- The disclosure should be readily viewable on the particular device or platform.
- Visual or other cues should direct consumers to the disclosure.

Omissions

A claim can also be deceptive because it fails to disclose an important fact or what the FTC calls a material fact. A material fact is typically thought of as one that might influence a consumer’s purchase decision. For example, if a consumer needs to purchase other items to make a product functional, this should be disclosed, such as “Batteries not included.” Similarly, if a product has a benefit, but that benefit is only temporary, this should also be disclosed. For example, if a product reduces wrinkles, but only temporarily, the appropriate claim is “temporarily reduces the appearance of fine lines and wrinkles” while it could be deceptive to omit “temporarily.”

However, there is no general duty to disclose the disadvantages of a product or service along with the advantage (e.g., “we’re number one, but more expensive.”) There can be an exception to this when the two claims are closely related. For example, if an ad claims that a food is low in saturated fat, it may be misleading to omit the fact that it is high in sodium because both nutrients relate to the risk of heart disease. Companies are expected to include all the key information needed for a consumer to understand the claims being made.

Comparative Claims

Comparative claims are permissible but have a heightened risk of competitive challenge. At one point, they were discouraged. As a result, ads often referred to “Brand X.” Today, regulators believe that truthful non-misleading comparative advertising benefits consumers. At the same time, specifically calling out a competitor is sure to get their attention, including unwanted attention, if there is reason to believe the comparison is misleading.

Key points to bear in mind are: (1) Compare apples to apples (as much as possible); and (2) be clear about what products and characteristics are being compared.

- Is the comparison apples to apples? If not, is it clear what is being compared? As a general rule, companies should be comparing a product to the most similar product sold by the competitor.
- A “better” or “best” claim by itself might just be puffery; for example, “better pizza” but if a company says why a product is “better” or “best” (e.g., “It’s better because it’s fresh”), then it needs to support the claim.
- Don’t use dangling comparatives (e.g., “now even less waste”). Is a product being compared to a competitor’s product or a prior version of the same product?

Social Media

While there are many advantages to using social media to market a brand, there are just as many potential regulatory pitfalls.

Marketing via social media can trigger issues with, among other things, deceptive advertising and substantiation of product claims, compliance with the FTC’s endorsement and testimonial rules, sweepstakes and contests compliance, CAN-SPAM, intellectual property rights, advertising to children, and compliance with the social media platforms’ own rules. The FTC, state attorneys general, and many of the social media platforms have published guidance, established rules, and pursued enforcement actions against marketers that failed to comply with the law in advertising via social media. When developing a social media strategy, companies should consider the following when developing a social media campaign:

- Is the promotion being run in compliance with any special legal requirements and/or specific rules imposed by the relevant social media platform(s)? For example, sweepstakes are subject to specific legal requirements like registration and bonding under state and federal law, as well as the various rules imposed by the social media platforms, such as Facebook’s and YouTube’s rules for advertising prize promotions.
- Are consumers being asked or encouraged to do or say something about a product or service that a company would not be permitted to do or say on its own?

- If a promotion is running across multiple social media platforms, have the campaign materials been carefully reviewed to ensure that disclosures and claims appear appropriately on every platform, in compliance with both the rules of each platform and any specific guidance provided by the FTC?
- Does the company and its agencies/vendors have appropriate social media policies in place? Do the people writing about the product or service, whether they are bloggers, influencers, or otherwise, have material connections to the company that may need to be disclosed? Are they being paid or receiving something else of value to review or post, tweet, or otherwise talk about a product?
- Is proper monitoring being conducted to determine whether the company's agencies, vendors, and other third parties are complying with its social media policy and rules for disclosure of material connections? Are the policies being enforced as necessary and appropriate?
- If celebrities or other third parties are featured in a social media campaign, have they given permission for their image or likeness to be associated with the company? Have any material connections between the celebrity and the company been properly disclosed?
- Is the company using influencers and/or native content as part of its branding strategy that may require disclosures? Is it clear that the content is sponsored advertising?
- If the company is asking for user-generated content as part of its social media campaign, has it put screening and moderation guidelines into place to address issues relating to intellectual property, rights of publicity, obscenity, etc.?

Social Media Influencers and Endorsements

The use of social media influencers such as celebrities or other people with large followings on social media has become an increasingly popular method of promoting and amplifying marketing messages. The FTC has provided business guidance outlining how to disclose material connections, such as payment or provision of free product or other compensation, between a brand and an influencer — including what words to use and where to place the disclosures depending on the social platform. This is a rapidly-evolving area that should be monitored for developments.

The FTC has made it clear that the rules regarding disclaiming material connections apply in the social media context. The use of social media to generate endorsements generally falls into three categories: (1) supplying free product or gifts to a social media influencer; (2) paying a social media influencer to write about product or services; and (3) encouraging employees to talk about products or services on social media. In each of these instances, disclosure of the connection between the company and the social media influencer is critical.

These best practices can help:

- If the company sends a free product to social media influencers for them to try and write about, or pays them to write about the company or competitors, make sure the influencer discloses the gift or compensation. There are no magic words, but simple disclosures often work best, such as “X company gave me a free product to try.”
- The same rule applies to endorsers or celebrities who are paid to post or tweet about a product or services. Hashtags such as #ad, #sponsored, #[BRANDNAME] ambassador are effective in conveying that it’s an ad; #spon may not be. When marketing to children, this should be particularly explicit.
- The disclosure of the connection to a company must be upfront, ideally at the start of a post, not after a reader has to click “read more.” The disclosure should not be at the end of the post or in the middle of a string of hashtags, where it is unlikely to be noticed and appreciated.
- Establish a program to periodically remind employees that they must disclose their connection to the company if they use social media to discuss company products or services.
- Asking consumers to “like” a product or service in some fashion may trigger a disclosure requirement. If the platform doesn’t allow or permit a company to do that, then the FTC has said that advertisers shouldn’t request endorsements on such platforms.
- Social media posts that are made as part of a contest entry must disclose that they are being made as part of a sweepstakes or contest. The FTC has warned against using abbreviations like #sweeps instead of #sweepstakes or #entry, because there is not enough evidence that consumers understand what that means.
- If a company is using video as part of its social media strategy, any disclosure must be made in the video itself, right at the start and not in the video description.
- Keep in mind that while the disclosure mechanisms built into the social media platforms are attractive, the FTC says companies can’t assume they are sufficiently clear and conspicuous.
- Advertisers are responsible for what their social media influencers say. Adopting a social media influencer policy, making reasonable efforts to monitor what they are saying, and taking prompt action if any problems are found will help prevent regulatory problems.
- Similarly, if a company uses third parties to implement social media strategies, they should be monitored for compliance.

Choosing Disclosure Words

- Use clear words for disclosures that consumers are likely to understand, such as “ad,” “advertising,” “paid,” or “sponsored.”
- Other words, including “partner” and “ambassador,” can be used along with the brand name, using capital letters or other visual cues to set the words apart. For example, if the influencer is promoting a product made by the Acme Company, the disclosure could be “#AcmeParter” or “#AcmeAmbassador.”

- Companies can disclose the material connection without a short form or hashtag disclosure if the social post is not character or space limited, such as "I am excited to partner with Acme to show you their fall shoes."
- Do not use words to describe the relationship like partner, ambassador, or employee alone. They can be used when placed with the name of the brand so that the brand name and the relationship are clearly legible (i.e., not all run together in lowercase letters such as #acmepartner or separated such as @Acme #partner).
- Influencers should not thank the company as a form of disclosure unless they also include what was given. If the influencer received both payment and free product it is not sufficient only to mention the free product.
- Use of the brand name alone is not sufficient disclosure.
- Do not abbreviate disclosures by using words such as "spon" or "sweeps" — though "ad" is still ok.

Where to Place the Disclosure

All disclosures of a material connection must be placed such that followers are likely to notice and appreciate them. Where to place a disclosure so it is clear and conspicuous will vary depending on the platform.

- Place at the beginning of a post.
- Place before any other #, @, or web links in any string.
- In videos, place the disclosure in the video itself at the beginning. The disclosure should appear in written and audio form.
- In any post that is only a picture or only a video with no accompanying written post, the disclosure should be in the picture or video.
- Use platform disclosures but also use an additional disclosure in the post itself.

Testimonials and Endorsements

The FTC's 2009 revisions to its Guides Concerning the Use of Endorsements and Testimonials in Advertising changed the rules for product promotion and placed significantly heavier burdens on advertisers and marketers to substantiate the claims made by endorsers of a product or service. Among the most important changes to the Guides were the requirement that marketers disclose material connections with endorsers and the removal of the long-standing safe harbor for endorsements.

The previous editions of the Guides included a safe harbor allowing advertisers to use testimonials reporting specific successful experiences with an advertised product or service, as long as a disclaimer such as "results not typical" was included. The revised Guides require consumer testimonials that represent an atypical experience with a product or service as typical to clearly disclose the results that consumers can generally expect.

Increasingly, companies are using social media and social media influencers to promote their products. The use of influencers is itself a type of endorsement and can raise particularly challenging issues. When using endorsements or testimonials to market products or services, be ready to answer the following questions:

- Does the endorsement fail to accurately represent the endorser's experience with the product?
- Is the endorser's experience atypical of what a user of the product or service can expect?
- Was a non-celebrity endorser aware of the possibility of payment before making the endorsement? Were they given free product?
- Celebrity endorsers do not need to disclose payment in recognized advertising, but is it clear that the endorsement is an ad? For example, a celebrity tweet may not be perceived as an ad. For further discussion of endorsements and social media, see the next section.
- Does anyone in the company have an undisclosed relationship with the endorser that could lead to possible bias (e.g., a family member)?
- If the endorser is an expert with respect to the product or service, did he/she evaluate the product or service?

Native Advertising

Advertisers looking to rise above the noise by integrating their brand and marketing messages with quality digital content are wrestling with when and how they need to disclose their sponsorship of so-called native advertising. Though native advertising is often used to describe sponsored tweets, advertorials, and search ads, other definitions of native advertising include weaving brand messages into the editorial content of websites. Regardless of a company's definition, some key questions will help untangle an advertiser's disclosure obligations.

- **Has the company paid to place an article about the features and benefits of a product or product category, or that disparages a competitor's product?** If the answer is yes, the company likely must disclose its sponsorship. The FTC requires similar disclosure of print and broadcast advertorials. There is no reason to believe the rules would be different online.

  Product placement on television or in movies does not always trigger a disclosure obligation. If the product is shown as selected over other products or providing a benefit to users, this likely goes beyond product placement and triggers a need to disclose. Similarly, if the product is being used by an expert (e.g., a home improvement professional), a disclosure may be needed.

- **Has the company paid to include a link to news about its brand on a publisher's website?** Disclosure that the link is sponsored is required, and if the news it is linking to is also native advertising, then disclosure should appear in the article as well.

- **How has the company accomplished disclosure?** This can be done in multiple ways, including a statement in the article itself that the company was involved in the creation or curation of the content. It can also be done with conspicuous headers that make it clear that the content is advertising or is sponsored, sometimes with background shading or borders to further distinguish the sponsored content. Disclosure at the end of an article or at the bottom of a web page is not sufficient. The FTC's preference is top left above the byline. For video content, the disclosure should be in the video itself and not just in the description at the bottom.
- **Does the company partner with an advertising widget content provider or service that places links to the content on other third-party publisher websites?** If so, make sure the links used to describe the content are accurate and state unmistakably that readers are traveling to advertising content.

If a company is using agencies or other third parties to help with a native advertising strategy, they should monitor compliance with disclosure and other obligations. You can find additional information in the FTC's Native Advertising: A Guide for Business.

Green Claims

The FTC has issued detailed and specific guidance for marketers about how to substantiate so-called green claims — claims that products or services are environmentally friendly. Unsubstantiated green claims have been and will continue to be an enforcement priority.

Marketers planning to use green claims to promote the environmentally conscious aspects of a product should consider the best practices listed below to avoid so-called greenwashing claims. Even if a company is making green claims only to distributors or retailers rather than directly to consumers, the FTC's Green Guides still apply, as such claims are often "passed along" to consumers.

When taking a product to market that is, or may be, regulated by the FTC, marketers should consider the following:

- Avoid vague claims such as "green" or "earth-friendly" unless they can be qualified to explain the specific environmental benefit(s) the product provides.
- Qualify the claims to specify whether they apply to the service provided, the product being sold, any product packaging, or a combination thereof.
- If the company is using seals of approval or certifications, tell consumers what they mean, disclose whether the award is from a third-party based on objective criteria, and disclose any material connection the company may have with the third-party in accordance with the FTC's Endorsement Guides.
- If the product is ordinarily disposed of in landfills, it cannot support an unqualified biodegradable claim.
- Support carbon offset claims with competent and reliable scientific evidence and disclose whether the emissions reduction is expected far into the future (2+ years).
- Do not make claims that a product is non-toxic unless the product has been proved safe for people and the environment generally, using competent and reliable scientific evidence.

- Avoid "free of" claims unless the company has intentionally not added any of the substance to its product and any naturally occurring amounts are at trace levels not associated with possible harm.
- Use "renewable materials" claims only when the material used is identified and the renewable amount of the product and method used are disclosed.
- When claiming a product or its packaging is recyclable (and specify what exactly is recyclable), ensure that the product or packaging is recyclable by at least 60 percent of consumers where the product is sold. If it is not, qualify the claim by disclosing the limited availability of recycling for the product.
- Use recycled content claims only if the materials were diverted from the waste stream and the amount diverted is disclosed.

Made in the USA Claims

Under FTC guidance, if a product is claimed to be Made in the USA, final assembly must take place in the U.S., and all or virtually all of the good must be attributable to U.S. sources. The FTC also considers a claim of Manufactured in the USA or Crafted in the USA to be the same as a Made in the USA claim.

If some part of the product development occurs in the U.S., depending upon the degree of U.S. manufacturing and sourcing, it may be possible to use qualified Made in the USA claims such as Made in the USA from domestic and imported parts, Assembled in the USA, or Designed in the USA.

Companies should be cautious when making Made in the USA claims because federal enforcement in this area has also ramped up recently. Before getting patriotic, consider the following:

- Analyze the cost of goods sold to make sure manufacturing takes place in the U.S. and the significant majority of the components or ingredients are also from the U.S.
- Ask suppliers where the inputs originated. It is not enough to buy a part from a U.S. company and assume that part is American made.
- If a product must be labeled as made in a foreign country under U.S. customs laws, it cannot make a Made in the USA claim.
- Featuring a flag or an eagle could be understood as making a Made in the USA claim.
- Companies that market in California should analyze the claim for compliance with California's Made in the USA law, which has U.S. wholesale value thresholds of 90% or 95%, depending upon certain factors.

Marketing to Children

When marketing to children under the age of 13, there are heightened requirements that go beyond standard truth in advertising and fair advertising practices. Both the FTC and the Children's Advertising Review Unit (CARU) of the Council of Better Business Bureaus (BBB) monitor and review advertising targeting children for unfair and deceptive practices. CARU sets forth specific guidelines for ads on children's television, in children's publications, and on websites with content directed to children. The basic idea behind these standards is that children have a difficult time understanding when they are being given a sales pitch and distinguishing between reality and fantasy. For these reasons, claims need to be narrowly tailored and very clear. Both the FTC and CARU monitor and enforce compliance with the Children's Online Privacy Protection Act.

Here are some specific best practices related to children's advertising:

- If the product or activity in the ad typically requires parental supervision, show adults actively monitoring the scene.
- If there is a product shot, make it clear what comes with the initial purchase and what must be purchased separately.
- If children are using the product or engaged in physical activity, show them wearing all necessary safety equipment and playing responsibly.
- Depict product use realistically and avoid suggesting the product will make a child more popular or stronger.
- If food products are shown, depict reasonable portions to encourage a healthy lifestyle.
- If disclaimers are necessary, give them both in writing and orally.
- When directing children to a phone number or website, always state they should get their parents' permission before calling or going online.
- When advertising a sweepstakes, contest, or similar promotion, make clear the free means of entry and that "many will enter, few will win."
- If offering a free product, the advertisement should focus on the product rather than the giveaway.
- Avoid calls to action, such as "act fast, buy now" or "ask your parents to call now," that could be viewed as overly aggressive for a child audience.

Sale and Free Claims

Calling out the value of a product, particularly if it is available as a special deal or on sale for a limited time, is often critical to gaining sales and loyalty from deal-savvy customers. And in the age of the Internet, price-comparison shopping has never been easier. The FTC has issued guidance for businesses on how to make sales claims. In addition, many states have unique laws. This can be a complicated regulatory minefield, even though everyone would agree that low prices are good for consumers. Many state laws limit the duration of sales and require that goods be offered at a regular price before going on sale. Sale pricing has also recently become very fashionable for class action filings.

Consider the following factors when making sale claims:

- Do not have perma-sales. Consider flexing the sale and regular price. If a deal is ongoing, it should not be called out in a way that implies it is a limited offer.
- Before making a percentage off or a compare at price claim, make sure the higher price used for comparison is a real price. It should be either a price at which it has been sold recently or a price other retailers have used to sell the same product. Never create a fictitious higher price to make sale reductions more attractive.
- When comparing the price to comparable but not identical merchandise, this needs to be made clear.
- Free offers, such as “buy one, get one free” must really be free. If customers need to pay separate postage and handling for the free item, this must be disclosed clearly and conspicuously.

Sweepstakes and Contests

Whether running sweepstakes, where winners are selected in a random drawing from among all eligible entries or a contest, where winners are selected based on a bona fide skill, promotions are an essential aspect of most companies’ marketing strategies.

Federal and state laws prohibit illegal lotteries, which are any promotions containing the following three elements: (1) a prize or award; (2) an element of chance; and (3) the giving of something of value, known as consideration (e.g., a purchase or entry fee). Legally compliant promotions eliminate one of these three elements.

Promotions must always have a set of easily understandable official rules. All advertising for a promotion should include a rules summary, with basic disclosures and instructions for obtaining the full official rules.

Specific regulations and definitions vary widely from state to state and country to country (where additional prize restrictions, and registration and translation requirements may be triggered). Failing to consider these differences when structuring promotions may create legal risk. In addition, the emergence of promotions using digital media, which often solicit user-generated content, has made ensuring promotions’ legal compliance even more complex and challenging.

Because a violation of the laws in this area may trigger criminal penalties, it is important to plan the promotion carefully before running that next giveaway or video contest.

When developing a sweepstakes and contests strategy, marketers should consider the following factors to mitigate legal, regulatory, and reputational risk:

- Official rules should disclose eligibility, how to enter, the number of winners and how they are chosen (with odds if applicable), the identity and value of prizes, and the deadline for entry. Other specific rules requirements vary from state to state.
- An alternative method of entry (AMOE) can help marketers avoid violating the lottery laws, particularly if sweepstakes entries are given to consumers purchasing a certain product. Clearly disclose the AMOE and enter purchasers and non-purchasers on equal terms in all advertising.

- When running online promotions, comply with all promotions laws and regulations, but also include disclaimers for IT-related issues in the rules, and reserve the right to terminate, suspend, or modify the promotion if it is compromised. Rules should also disclaim all implied warranties and responsibility for printing, production, and typographical errors. Consider international laws, unless the official rules expressly limit participation to U.S. residents.
- Promotions targeting children require clear and conspicuous disclosures in language that children will understand, such as "Many will enter, few will win," to describe the child's chances of winning, and "You must ask your parents for permission to enter." The free alternative method of entry must also be clear and described in a way that children will understand. Promotions targeting children under 13 must also comply with the Children's Online Privacy Protection Act (COPPA).
- Some states require that sweepstakes promoters register in advance. New York and Florida require that promoters establish a trust or escrow account or provide a surety bond to cover the total retail value of all prizes. These states also require advance registration if the total value of all prizes is more than $5,000. Prize awards over $500 trigger a similar requirement in Rhode Island for promotions run through retail outlets. Arizona requires that contest sponsors pre-register certain games of skill.
- Promotion sponsors that require entrants to tweet or post to enter must require that the entrant disclose they are entering a promotion in the post, for example by including the hashtag #contest or #sweepstakes.

Product Liability

Companies both big and small need to know about potential product liability risks if products do not meet government or consumer expectations about safety. Even a product that is completely safe can carry product liability risk if the public perceives it as unsafe — and a safety claim, unsubstantiated or not, can damage a company's brand.

One of the biggest wildcards for consumer brands today is technological advances that lead to unpredictable legal landscapes. When it comes to product liability, the Internet of Things (IoT) is the next legal frontier. By giving companies the power to connect devices and gather exponential amounts of data, the IoT is paving the way for countless opportunities. But with opportunity also comes risk.

Fortunately, companies can take several steps to help protect themselves from regulatory and consumer risks, reducing their exposure to product liability lawsuits. These steps, discussed below in the framework of setting out the product liability landscape, include regulatory compliance programs, implementing design and quality controls, and taking care to include indemnification provisions into design, manufacturing, and supply contracts.

Who Regulates Product Safety?

The U.S. Consumer Product Safety Commission (CPSC) is the federal agency that regulates consumer product safety through various statutes and regulations. Companies that become aware of a potential product safety hazard may have an immediate obligation to report the issue to CPSC. In addition to the potential for civil fines, regulatory scrutiny can harm a company's brand. Any product manufacturer, importer, distributor, or retailer should be aware of the CPSC reporting requirements and work with counsel on proactive and reactive steps toward regulatory compliance. Proactively, companies should work to develop a compliance program that catches product complaints on a company-wide basis. Reactively, counsel can help companies understand the effects of reporting, voluntary recalls, or any CPSC enforcement activity.

Consumers also play a role in product safety through product liability lawsuits. The remainder of this chapter discusses product liability litigation and provides guideposts for companies seeking to limit their product liability exposure.

What Is Product Liability Litigation?

Product liability is based on the underlying policy that manufacturers, suppliers, and sellers of goods have a duty not to place unreasonably dangerous products into the stream of commerce. Thus, product liability generally holds responsible companies for injuries caused by defective products that they have placed into distribution channels.

Strict Liability

This holds any participant in the manufacturing chain or the sale of a product liable for injuries associated with the product without regard to whose fault it was. Strict liability claims are typically associated with a design defect, a manufacturing defect, or a failure to warn.

Design defect claims arise when an element of the product's design leads to injury. The test for design defects varies by jurisdiction, but generally evaluates either the risk-benefit profile of the product or whether the product performs the way a typical consumer would expect. To mitigate exposure to design defect lawsuits, companies can take steps such as implementing strict design controls or putting in place indemnification agreements with contract designers and engineers.

Manufacturing defect claims typically arise when a product does not meet the product specifications or differs from other products in the same manufacturing lot and as a result causes injury to a consumer. To protect against this type of exposure, companies can implement manufacturing and quality controls as well as include indemnification provisions in supply and manufacturing contracts.

Failure-to-warn claims are based on a duty to warn consumers of hazards that are known or should be known. Many states impose a duty to warn even if the injury arises from misuse, if the misuse is foreseeable. Failure-to-warn claims are the most common product liability claims since they are more subjective and less difficult to prove than manufacturing or design defects. Companies can mitigate the risk of failure-to-warn claims through safety warnings, labeling, and instructions. Ensuring adequate and effective warnings requires constant vigilance since what is knowable or foreseeable often changes as companies receive feedback on their products. In addition, companies can potentially over-warn, causing warning fatigue and making warnings less effective. Adequate and effective warnings are important and can support an assumption of risk defense, which bars or reduces a plaintiff's right to recovery if he or she voluntarily and knowingly assumed a known risk.

Negligence

Product liability claims can also be brought as negligence claims. While strict liability applies regardless of fault, negligence claims require the plaintiff to prove that: (1) the manufacturer broke a duty owed to the plaintiff, (2) this breach of duty actually and proximately cause of the plaintiff's injury, and (3) the plaintiff suffered damages as a result of a negligent act.

Breach of Warranty

This occurs when the immediate seller of a product makes false representations about the quality of a product. Because negligence on the part of the seller is not necessary, sellers may be liable even if they believed that the warranties were true.

Express warranties are written or oral affirmations of facts or promises that the seller makes to the buyer. Companies should carefully consider representations made on product packaging, websites, training pamphlets, and promotional materials.

Sellers may also be liable for **implied warranties**, including the implied warranty of fitness for a particular purpose and the implied warranty of merchantability. The implied warranty of fitness for a particular purpose arises when the seller knows the buyer is purchasing the product for a particular purpose and is relying on the seller to select a product to fulfill that purpose. The implied warranty of merchantability means that a seller can be liable if the product does not do what it is supposed to do.

Legal Defenses for Product Liability

Modification and Misuse: The product is different from when it left the manufacturer. To prove modification, companies must be able to prove that the product was changed in a way that caused the plaintiff's injury. Companies can also avoid liability if they can prove that the plaintiff used the product in an unforeseeable way.

Contributory/Comparative Negligence: Although this defense varies by jurisdiction, the general idea is that a consumer's negligence in using a product offsets damages owed by the company.

Lack of Privity: For breach of warranty claims, the plaintiff must be the purchaser or the immediate family of the purchaser to recover damages regardless of whether the defendant is at fault.

Disclaimers: A statement informing the purchaser that the seller is not bound by any warranty guarantees related to the product.

Limitation of Remedies: Companies may limit the plaintiff's relief to repair or replacement of the product; however, companies cannot limit remedies for personal injuries.

Failure to Give Timely Notice: Companies may limit the time a consumer has to notify it of an injury to recover damages.

Statute of Limitations: Limitations periods (typically three years) set by common law and statutes to encourage consumers to promptly file their claims after discovering the harm or risk having their claims deemed time barred.

Statute of Repose: Another limitations period that is usually triggered by the first date that the product is sold. If a plaintiff is within the statute of limitations, but the statute of repose has expired, his or her claim is not valid.

The Internet of Things

One of the greatest opportunities that IoT products provide is the chance to enter into a contractual arrangement with consumers through terms of service. Since IoT products typically require an account, IoT product manufacturers can impose terms of service that can increase the effective delivery of warnings and instructions while also disclaiming and limiting liability. Terms of service can also contain dispute resolution provisions, such as an arbitration clause, that can provide an alternative forum to courtroom disputes.

The key risks arise from two questions, the answers to which remain unknown. First, whether software can be considered a product subject to product liability. Although no set guidelines currently detail the applicability of typical product liability claims to software, manufacturers, distributors, and retailers of IoT products should bear in mind this potential future exposure arising from software bugs or defects — or from AI decision making.

Second, to what extent will companies be expected to know what is in the data they collect from IoT products? Because failure-to-warn liability largely turns on hazards that a company knew or should have known about, this will be an important question in future product liability litigation.

Insurance

As legal landscapes change, companies should carefully evaluate insurance policies to make sure that emerging liabilities are covered. This will help provide a sound backstop against product liability claims, which cannot always be avoided.

Conclusion

Although companies can raise several defenses, it is best to take affirmative steps to avoid product liability exposure and protect the company's brand. These include implementing design and manufacturing controls, drafting indemnification provisions, and ensuring that consumers receive adequate warnings and disclaimers. In addition, IoT companies can leverage terms of service to disclaim and limit liability.

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