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New Air Cargo Security Requirements: The Cost of Compliance

On May 26, 2006, the Transportation Security Administration ("TSA") issued its Final Rule on new Air Cargo Security Requirements. TSA is a federal agency within the Department of Homeland Security and is charged with the responsibility for security for all modes of transportation. The new air cargo security requirements demonstrate that the agency is taking its job quite seriously and it expects those involved in the transportation industry to do the same.

On November 10, 2004, TSA published a notice of proposed rulemaking ("NPRM") in the Federal Register to solicit public comment on proposed air cargo regulations. The NPRM proposed to, among other things:

- Address two critical risks in the air cargo environment: (1) the hostile takeover of an all-cargo aircraft leading to its use as a weapon; and (2) the use of cargo to introduce an explosive device aboard a passenger aircraft.
- Create a new mandatory security regime for aircraft operators and foreign air carriers in all-cargo operations using aircraft with a maximum certificated take-off weight more than 45,500 kg.
- Create requirements for foreign air carriers in all-cargo operation with an aircraft having a maximum certificated take-off weight more than 12,500 lbs.

but no more than 45,500 kg, and a separate program for aircraft with a maximum certificated take-off weight more than 45,500 kg.

- Require a Security Threat Assessment for individuals with unescorted access to cargo.
- Enhance existing requirements for indirect air carriers ("IAC").
- Expand Security Identification Display Area requirements where cargo is loaded and unloaded.

The Final Rule adopts the regulations proposed by the NPRM with minor revisions. Specifically, it clarifies the population subject to Security Threat Assessments ("STAs") and the areas where airports must extend Security Identification Display Area ("SIDA") measures for cargo.

The Final Rule states that about 75% of the \$2 billion ten-year estimated cost of implementation is associated with requirements that did not originate with the Final Rule, such as TSA Security Directives issued in November 2003 and security program amendments in March 2005. Therefore, the Final Rule contends that the cost of implementing its original requirements is about \$167 million over a ten year period. The Final Rule applies to airport operators, aircraft operators, foreign air carriers, and IACs. The vast majority of the additional costs (and the source of most of the frustration) associated with the Final

Rule relate to the STA requirement. This begs the questions: (1) who is subject to the STA requirement; (2) what are the costs of complying with the STA requirement; and (3) when does the STA requirement go into effect.

I. Who?

TSA currently requires a variety of individuals working in aviation to submit to a criminal history records check and an additional name-based background check. Generally, these individuals work on airport grounds and have access to secure areas. According to TSA, however, many other people who have not been subjected to such background checks have access to air cargo. The Final Rule therefore proposes that STAs be conducted on additional categories of people who have unescorted access to air cargo to verify that these individuals do not pose a security threat. Individuals who undergo

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security checks required for unescorted access to a SIDA, or who have successfully completed another STA that TSA approves as comparable would not be required to submit to an STA.

The STA requirements apply:

- Only in the United States.
- To aircraft operators with a full program, or a full all-cargo program; foreign air carriers under 49 CFR § 1546.101(a), (b), or (e); and IACs.
- To officers, directors, and people who hold 25% or more total outstanding voting stock of an IAC.
- To individuals with unescorted access to cargo who are employees or agents of:
 - Aircraft operators with a full all-cargo program and foreign air carriers under 49 CFR § 1546.101 (a) or (b) where they accept cargo;
 - Aircraft operators with a full all-cargo program and foreign air carriers under 49 CFR § 1546.101 (e) where they consolidate or inspect cargo;
 - IACs which accept cargo for transportation on aircraft operated by an aircraft operator with a full program or a foreign air carrier under 49 CFR § 1546.101(a) or (b); or

– IACs which consolidate or hold cargo for transportation aboard an aircraft operated by an aircraft operator with a full or full all-cargo program, or a foreign air-carrier under 49 CFR § 1546.101(a), (b) or (e);

– Unless the employee or agent has a Criminal History Records Check (“CHRC”) for unescorted authority to a SIDA or another STA approved by TSA as comparable to an STA. TSA considers the threat

assessments it conducts for a person holding a commercial driver’s license with a hazardous materials endorsement comparable to an

STA. See 49 CFR § 1572. TSA does not anticipate accepting the background check of a private company or a state agency as comparable to a CHRC or an STA.

It is important to note where employees and agents are not required to have an STA. Appropriate background checks for access to airport-restricted areas are obligatory under International Civil Aviation Organization (“ICAO”) Annex 17 Standards. TSA does not require STAs for unescorted access to cargo at foreign locations. Individuals do not need an STA if a person with the appropriate background check escorts them. Individuals who work near cargo, but do not require unescorted access to cargo, do not need an STA where the regulated entity has adopted access control measures to prevent unescorted access to the cargo.

According to TSA, many people who have not been subject to background checks have access to air cargo.

2. What?

Regulated parties are not responsible for conducting the required background checks; rather, they must ensure that the necessary information about their employees and agents is transferred to TSA so it may conduct the STA. Though the NPRM originally referenced a \$39 per STA fee, the Final Rule contains a revised STA fee of \$28. Once a regulated party has applied and paid for an STA for a particular employee, TSA estimates an anticipated response time of ten working days in providing authorization or initial denial. Once TSA approves an STA by issuing a “Determination of No Security Threat,” the STA will remain valid for an employee or agent from one job to another as long as that employee or agent is continuously employed. TSA will not exempt any employee from STA requirements based on length of service.

3. When?

The Final Rule is effective October 23, 2006. By November 22, 2006, IACs must comply with the requirements for IAC training under 49 CFR § 1548.11. By December 1, 2006, aircraft operators, foreign air carriers, and indirect air carriers must comply with the requirements for STAs under 49 CFR §§ 1544.228, 1546.213, 1548.15 and 1548.16.

For more information, contact Nicole Dorsky at 216.363.4593 or ndorsky@bfca.com or Clare Taft at 216.363.4435 or ctaft@bfca.com.

Achieving Liquidity—A New Alternative

Change & Challenge

The transportation and logistics industries are experiencing change and challenges at every level of the business. Growth in world trade and global sourcing is generating record freight volumes and increasing the complexity of the global supply chain. Increased demand for outsourced transportation and logistics providers and just-in-time inventory management is creating congestion in the ports, on the rail, and over the roads. Changing regulatory issues and driver shortages are also affecting the supply of transportation services available to shippers. These challenges, among others, are redefining trucking and logistics.

Increasingly, these challenges are narrowing the divide between freight hauler and logistics provider as shippers look for vendors that are able to provide a full service offering. This gradual industry transformation has become a catalyst for industry consolidation, as companies seek to offer end-to-end transportation solutions. For this reason, M&A activity is healthy as buyers look to grow their business and sellers look to cash out.

Enter Private Equity

One factor assisting this consolidation is the growth of private equity available for investment. Private equity groups ("PEGs") are partnerships that pool private capital to make minority or majority control investments, typically in private companies. Hundreds of PEGs have been formed over the past several years with an estimated \$120 billion under management.

Once thought to bid at a discount to strategic buyers (often 10%-15%), private equity firms are gaining a reputation for buying businesses at, or above, market. Pressure from limited partners to put money to work, competition to win deals, and low

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interest rates (allowing for cheaper debt financing) have all contributed to the rise of private equity interest and aggressive pricing.

What's more, the transportation and logistics industries

have caught the eye of the private equity community. Their investment thesis is simple: continued growth in international trade, growing demand for outsourced transportation and logistics, and continued consolidation of a highly fragmented industry will yield attractive returns for investors. Historically, the limited industry interest from PEGs focused on non-asset-based transportation and logistics companies. Investors had an aversion to asset-based operations due to their capital expenditure requirements. Today, many PEGs partner with experienced management teams to better evaluate acquisitions and understand asset-based opportunities.

Recap Alternative

Once considered the exception for a liquidity event, PEGs now offer business owners an attractive liquidity alternative while allowing them to stay involved with their company. One of the most attractive options for monetizing ownership value is through a recapitalization, a transaction that allows the owner of a business ("Seller")

to sell a stake (typically controlling) in his or her company. A typical recapitalization is very similar to a standard transaction, with one major variation: Seller maintains a material ownership stake in the business alongside the private equity buyer.

A recap provides many advantages to Seller. First, a recap allows Seller to effectively take some chips off the table by selling a significant portion of the business at the current market valuation. Second, Seller retains equity upside through his retained ownership, which is realized when the PEG exits the investment years later. Third, interested family members and key management have the opportunity to stay involved in the governance and management of the business and are frequently extended incentive stock options by the PEG that can become quite lucrative. Finally, the PEG provides capital and valuable M&A and strategic advisory services to help grow the business.

As challenges and change reshape the world of transportation and logistics, private equity firms are an increasingly attractive partner for growth and liquidity. Historically low tax rates, low interest rates, industry consolidation, and premium pricing paid by PEGs offer new options for family-owned and privately-held businesses.

By: Rob Erda and Henry Berling,
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Two Associates Join Transportation & Logistics Group



CLARE R. TAFT

Benesch's Transportation & Logistics Group is pleased to announce the addition of two new attorneys to the group.

Clare R. Taft joined the firm full time in 2003, after first working for Benesch as a summer associate while attending law school at Cleveland State University. She joined the Trial Practice Group in 2004, and has since represented clients in a variety of transportation matters, including freight loss and damage claims and tariff disputes.



NICOLE DORSKY

Nicole Dorsky joined Benesch in August. She has broad experience in customs, security, and international law issues. Prior to joining Benesch, she worked as an associate for another Cleveland firm handling various litigation matters. Ms. Dorsky also worked as a legal intern for the Department of Homeland Security both in Cleveland and in Washington, D.C. She earned her J.D. from Case Western Reserve University.

In spring 2007, Ms. Dorsky will be teaching a course for 2nd and 3rd year law students at Case Western Reserve University. Called the Coast Guard Lab, the course will cover immigration and transportation related border security issues, and Ms. Dorsky will assist students in writing research memos for legal issues presented to the class by the U.S. Coast Guard. Case Western is the only law school with this arrangement with the Coast Guard. Ms. Dorsky will be teaching the course with Amos Guiora, Professor of Law and Director of the Institute for Global Security Law and Policy at Case Western, and Daniel Ujcz, Border Network Affairs and Advocacy Officer with the Consulate General of Canada.

On the Horizon

39th Annual Transportation Law Institute

October 27, 2006 | Denver, CO

Marc Blubaugh is Program Chair and will also be moderating the panel "After Dubai: Ports 101 for Transportation Lawyers" and Eric Zalud will be speaking on "Electronic Discovery."

Fall Meeting of the Transportation Intermediaries Association

November 14, 2006 | Fort Lauderdale, FL

Eric Zalud will be speaking on "The Anatomy of a Freight Claim."

Benesch's Transportation and Logistics Conference

December 7, 2006 | Cleveland, OH

The theme of this year's conference is "Maximizing Opportunities and Minimizing Risks in Transportation and Logistics: How the Law can Help."

Transportation Lawyers Association's Regional Conference

January 19, 2007 | Chicago, Illinois

Marc Blubaugh will be moderating a panel entitled "Model Broker-Carrier Contracts: The Best Thing Since Sliced Bread or The End of Western Civilization As We Know It?". Bob Spira and Eric Zalud will also be in attendance.

For further information and registration, please contact Megan Crossman at 216.363.4174 or mcrossman@bfca.com.

Pass this copy of *InterConnect* on to a colleague, or email kmasuga@bfca.com to add someone to the mailing list.

For more information about the Transportation and Logistics Group, please contact one of the following:

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