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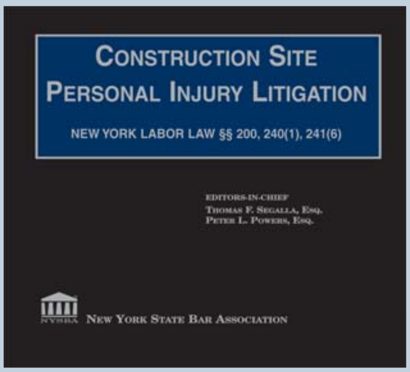

EDITORS-IN-CHIEF

Thomas F. Segalla, Esq.
Goldberg Segalla LLP
Buffalo, NY

Brian T. Stapleton, Esq.
Goldberg Segalla LLP
Buffalo, NY

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Business Law Section—Officers

Chair	Rebecca J. Simmons Sullivan & Cromwell LLP 125 Broad Street New York, NY 10004 simmonsr@sullcrom.com
First Vice-Chair	Bruce J. Baker Nixon Peabody, LLP 1100 Clinton Square Rochester, NY 14604 bbaker@nixonpeabody.com
Second Vice-Chair and Fiscal Officer	Paul H. Silverman McLaughlin & Stern LLP 260 Madison Avenue, 21st Floor New York, NY 10016 psilverman@mclaughlinstern.com
Secretary	Deborah Anne Doxey, Esq. Phillips Lytle LLP 3400 HSBC Center 34th Floor Buffalo, NY 14203-2887 ddoxey@phillipslytle.com

Business Law Section Committees

	Chair
Banking Law	Clifford S. Weber Hinman Howard & Kattell, LLP 106 Corporate Park Drive, Suite 317 White Plains, NY 10604 cweber@hhk.com
Bankruptcy Law	Mark S. Tulis Oxman Tulis Kirkpatrick Whyatt & Geiger 120 Bloomingdale Road White Plains, NY 10605 mtulis@oxmanlaw.com
Consumer Financial Services	William R. Henrick DealerTrack, Inc. 1111 Marcus Avenue, Suite M04 Lake Success, NY 11042 randy.henrick@dealertrack.com

Corporations Law .... Janet Thiele Geldzahler
Sullivan & Cromwell LLP
1701 Pennsylvania Avenue, NW
Washington, DC 20006
geldzahlerj@sullcrom.com

Derivatives and Structured Products Law .... Ilene K. Froom
JPMorgan Chase Bank, NA
245 Park Avenue, 11th Floor
New York, NY 10167
ilene.k.froom@jpmchase.com

Franchise, Distribution and Licensing Law .... Thomas M. Pitegoff
Pitegoff Law Office
445 Hamilton Avenue
Suite 1102
White Plains, NY 10601
pitegoff@pitlaw.com

Insurance Law .... Robert M. Yellen
AIG Executive Liability
175 Water Street, 10th Floor
New York, NY 10038
ry@nysbar.com

Legislative Affairs .... Peter W. LaVigne
Sullivan & Cromwell LLP
125 Broad Street
New York, NY 10004-2498
lavignep@sullcrom.com

Public Utility Law .... Deborah Michele Franco
Cullen & Dykman
100 Quentin Roosevelt Boulevard
Garden City, NY 11530-4874
dfranco@cullenanddykman.com

Securities Regulation .... Jeffrey W. Rubin
Hogan & Hartson LLP
875 Third Avenue
New York, NY 10022
jwrubin@hhlaw.com

Technology and Venture Law .... Steven R. Masur
MasurLaw
101 East 15th Street, 2nd Floor
New York, NY 10003
smasur@masurlaw.com

NY BUSINESS LAW JOURNAL

HeadNotes

On behalf of the Business Law Section, I am very pleased to welcome **New York Law School** as our new partner in producing the *NY Business Law Journal*. With its great faculty—including an adjunct faculty that draws upon outstanding New York business law practitioners—strategic location close to the New York City financial district, and brand-new, state-of-the-art teaching facility, New York Law is an ideal partner for the *Journal* going forward. Dean Richard Matasar has assured us of the enthusiastic support of the School for the Business Law Section and the *Journal*. And the timing could not be better; the School's new Center for Financial Services Law is up and running, and within the year expects to be offering the LL.M. degree, with a wide range of course offerings, from basic to advanced, in securities, banking, commodities and related legal disciplines. Professor Ronald Filler, who serves as Director of the Center, has joined us as Chair of the *Journal's* new Advisory Board, and has contributed a description of the Center and its anticipated course offerings to this issue.

The ongoing crisis in the financial markets continues to be front and center for this issue's contributors. One of the principal causes of the crisis has been the abuse of derivatives—generally, financial instruments that derive their value from an underlying security, commodity, index or other measure, and that are used to reallocate risk among market participants. Many commentators have identified the lack of an appropriate clearing mechanism for these transactions as a fundamental reason for the abrupt seizure of the markets. In "Clearing Over-the-Counter Derivatives: The Solution to the Current Financial Crisis?," Regan O'Neill, a candidate for the J.D. degree at New York Law School, cogently explains the basics of credit default swaps (CDS) and other derivatives and examines the effect of the current proposals, including pending legislation that the author believes could effectively regulate the market out of existence. Mr. O'Neill's fine and timely article will also be considered for a prize under the Business Law Section's annual Law Student Writing Competition. (The criteria for submitting an article for consideration appear elsewhere in this issue.)

Another dimension of the over-the-counter (OTC) derivatives issue is explored by attorney GuyLaine Charles, in the context of the September 2008 bankruptcy of Lehman Brothers, the event that triggered a near-total freeze in the credit markets last fall. In "OTC Derivative Contracts in Bankruptcy: The Lehman Experience," Ms. Charles provides a summary of the key provisions of the Bankruptcy Code as they apply to OTC derivatives. She notes that these provisions are intended to mitigate systemic risk to the financial system by providing a safe harbor allowing for the orderly unwinding of these derivatives contracts. However, certain counterparties did not avail themselves of the unwind provisions, allegedly because their positions were "in the money," thereby frustrating the purpose of these provisions. Ms. Charles analyzes the effect of a decision handed down earlier this year in which Lehman sought the right to assign these contracts to third parties.

Another recent court decision potentially bodes ill for ongoing efforts to deal with the credit crisis. In "Second Circuit Ruling Could Hurt Ability to Manage Credit Crisis Litigation and Could Undermine Distressed Debt Markets," Owen Pell, a partner of White & Case in New York, illustrates the unintended consequences of the ancient prohibition on "champerty"—the sale of lawsuits for the purpose of financial gain. Ten years ago the New York Court of Appeals apparently put to rest the question whether acquiring distressed debt at a discount, with the intent to pursue collection, constituted champerty. However, a case now pending before the Court has reopened this issue in the context of distressed asset-backed securities. An adverse ruling could seriously impact efforts by financial institutions to sell troubled assets.

Yet another dimension of the credit crisis is the subject of a thoughtful analytical piece submitted by attorney Warren Traiger of Traiger & Hinckley. Some commentators have pointed to the Community Reinvestment Act (CRA), a law that requires banks and other deposit-taking institutions to reinvest in their local communities, as the culprit in the mortgage-backed securities crisis, by compelling lenders to make unsound "subprime" loans in order to meet their CRA obligations. In "The Community Reinvestment Act of 1977: Not Guilty," the authors note that CRA covers only a fraction of mortgage lenders—it does not reach mortgage bankers and brokers that do not take deposits. Furthermore, the data show that lenders covered by CRA are actually less likely to engage in risky or questionable lending practices. Mr. Traiger presented before the Section's Banking Law Committee earlier this year, based upon the data in this article.

Finally, the credit crisis has brought to the fore the importance of accounting issues for financial firms and their advisers. CPAs Dr. Barry Epstein and Susan Cheng highlight a significant pending development in this area in "The Coming Transition from U.S. GAAP to IFRS: Implications for Attorneys." Earlier this year the comment period closed for the Securities and Exchange Commission's (SEC) proposal to allow all U.S. issuers of securities to file financial statements that do not reconcile to generally accepted accounting principles (GAAP), provided they were prepared in accordance with International Financial Accounting Standards (IFRS) as issued by the International Accounting Standards Board (IASB). Dr. Epstein and Ms. Cheng note that the transition will create both challenges and opportunities for attorneys—for example, by facilitating cross-border capital raising.

Continuing his enlightening series on ethical issues for business attorneys, C. Evan Stewart lays out the pitfalls for attorneys to consider before joining a corporate board in "Lawyer-Directors: Just a Bad Idea." While clarifying that it is not unethical *per se* for an attorney to serve on a board, he notes that an American Bar Association (ABA) Task Force recommends against the practice because of such issues as potential waiver of attorney-client privilege and inadequate liability coverage under standard policies.

Attorney Mark Fridman ventures a bit off the beaten track to offer an interesting and provocative article. In "Prime Time Lotteries," he discusses the numerous class action lawsuits currently pending in federal court in California, all alleging that "sweepstakes" games that are conducted in conjunction with popular television programs like *Deal or No Deal* and *The Apprentice* are actually illegal lotteries under the laws of several states. These suits allege that the petitioners were induced into participating in those lotteries, thereby entitling them to damages and restitution of their wagers; if successful, they could result in millions of dollars in losses to the major TV networks. The article explores the fine line between an illegal lottery and a legal sweepstakes promotion, and explains why the author thinks the networks are likely to lose.

Two issues directly relevant to New York business practitioners are covered by members of the Business Law Section. In "New York's Limitations on Due-on-Sale Provisions: Dead on Arrival," Section member Geoffrey Rogers and his partner Tim Meredith of the firm Hudson Cook LLP discuss the 2008 amendment to section 6-g of the Banking Law, which purports to limit the circumstances in which a New York bank may invoke a "due on sale" provision in a mortgage—i.e., a clause that requires repayment in full if the home is sold. The amendment is intended to parallel federal law. But as the authors note, because New York did not opt out of the federal law, in effect the new law is preempted and serves no apparent purpose. The article provides a useful summary of the federal law as well as the new amendment to state law.

In "What's the Point of New York's LLC Publication Requirement?," Steven Masur, the current Chair of the Section's Technology and Venture Law Committee, discusses an issue that has been an ongoing sore point for New York businesses and their lawyers—the requirement that newly formed LLCs publish notice for six weeks in two newspapers, a costly proposition that benefits no one but the newspaper industry and that the Section, along with the Real Property Section of the NYSBA, has vigorously opposed in the state legislature. The author clearly and cogently summarizes the requirement and the concern that it is driving new business formations away from the state.

Continuing his column on employment law issues for New York lawyers, James Grasso of Phillips Lytle reports on significant federal and state developments that affect New York businesses and their advisors, including the Lilly Ledbetter Fair Pay Act, which overturned a recent Supreme Court decision that had strictly interpreted the time period for filing a wage discrimination claim (but applies more broadly to other employment cases as well); amendments to the Americans with Disabilities Act; and new New York State requirements pertaining to criminal conviction notices, layoff notices, leave to give blood, breast milk breaks, and workplace privacy.

As American lawyers begin to work closely with their Chinese counterparts on a variety of business relationships, legal and cultural differences between the two countries have assumed greater prominence. In "Adapt or Die: A Comparative Analysis of the American and Chinese Legal Approaches to the M&A Deal," Megan Burke, a candidate for the J.D. degree at Albany Law School, focuses on how these issues play out in the merger and acquisition (M&A) area. The article contains much practical advice for practitioners, in part derived from discussions with practitioners in both countries, and warns against attempting to "Americanize" a deal to suit the preferences of a U.S. client. Ms. Burke's fine and insightful article has been entered in the Section's annual Law Student Writing Competition.

With the explosion of personal information available over the Internet and otherwise, privacy has become an issue of increasing concern. NYSBA has been addressing this concern through the President's Privacy Task Force, and our Section has contributed to that effort through the outstanding work of past Section Chair Grace Sterrett, current Chair of the Committee on Consumer Financial Services Randy Henrick, and April Chang of the Bankruptcy Committee. The Section's Comments to the Task Force report, prepared by Ms. Sterrett and Mr. Henrick, are included in this issue, and are also discussed by Section Chair Rebecca Simmons in the Section Report in this issue.

Last, but not least, Professor Ronald Filler of New York Law School, the incoming Chair of the *Journal's* Advisory Board, contributes an overview of the School's new Center on Financial Services Law and the career-enhancing educational opportunities it offers to New York business lawyers.

David L. Glass
Editor-in-Chief

Report of the Business Law Section

I am pleased to report on several recent initiatives of the Business Law Section.

First, at the January meeting of the Executive Committee Randy Henrick, Chair of the Consumer Financial Services Committee, and Grace Sterrett, a member of that Committee, reported on the status of the NYSBA President's Privacy Task Force. Thereafter, the Committee followed up with the Section members regarding the following questions:

- Issues relating to and arising out of an electronic health information system, as indicated as a priority in the Obama administration (this will address issues such as development of, standards for, technological safeguards and restrictions (i.e. encryption), use of and access to, etc.);
- Whether there should be a nationalized standard or federal legislation regarding any area of privacy law—for example, with respect to data security breaches, collection and use of information, etc.;
- Whether lawyers should use specific technology or be guided for specific technological standards in protecting client files and information maintained electronically (i.e., the requirement to encrypt emails) and if so, should it apply to all client information or should different standards be adopted for different kinds of information (i.e., medical records for med mal actions or employee information for employment litigation);
- Collection and use of information, whether there should be examination of the length of time certain information should be kept, and sanctions for breaches of those obligations or harms to consumers.

In addition to these specific discussion points, the Task Force will consider and hear comment on whether it should recommend the appointment of an ongoing Special Committee on Privacy, the implementation of privacy-related CLEs to educate the Bar, and outreach programs to help educate the public on privacy concerns.

Based on the input received and their own experience in dealing with "privacy" issues from the perspective of financial service providers and businesses, Randy and Grace, along with April Chang of the Bankruptcy Committee, prepared a written statement which has been submitted to the Privacy Task Force on behalf of the Section. That statement is reproduced on p. 66. We note that other NYSBA Sections, such as Health Care, Intellectual Property, Criminal Justice and Labor Law, have also been asked to provide feedback.

Second, in 2007 the Section donated $20,000 of its accumulated surplus to the New York State Bar Foundation, with the stipulation that the funds be given to programs that work with consumers in distressed debt situations. The Foundation also agreed to report to the Section on how the funds were used. Following is the Foundation's report as submitted to the Chair of the Section:

Legal Services of the Hudson Valley, White Plains, was awarded $7,500 to fund programs aimed at helping individuals struggling with mortgage foreclosure. Free legal services will be offered in the organization's seven-county area. The funding will cover specific client expenses associated with mortgage and bankruptcy proceedings, including fees for appraisals, title searches, discovery, and credit counseling. The area of coverage includes Westchester, Rockland, Putnam, Dutchess, Orange, Sullivan and Ulster counties; no other agency provides free comprehensive, civil legal services in these areas. The project will serve poor and low-income homeowners throughout the service area.

New York Legal Assistance Group (NYLAG), New York, was awarded $12,500 to fund the Foreclosure Prevention Project. This project was developed to provide legal services to low-income owners to avoid foreclosure now, through legal representation, consultation and court-based services, and in the future, through community education and financial counseling. It will help overcome the shortage of lawyers who provide free legal services and specialize in this complex, resource-intensive field of law by working with other legal service and technical assistance providers to train new ones. Finally, it will work toward macro-level solutions, such as impact litigation and policy change in collaboration with other legal service agencies including Legal Services for New York City, Legal Aid Society, City Bar Justice Center and others. The agency will partner with three community-based agencies that provide housing counseling and work with them to conduct outreach, community education and financial counseling. Moreover, NYLAG will identify clients through its 30 intake sites located citywide and other referral partners in order to reach more clients in need.

The project will work with primary partners to conduct outreach in affected neighborhoods in Southeast Queens, South Central Brooklyn, and Western Bronx. Through its 30 intake sites located throughout the five boroughs, as well as through referrals from 300 long-standing health, social service and community-based organization partners, NYLAG will bring in an additional one-quarter of the Project's clients. A total of 1,425 clients will be served over two years, not including those who may benefit from impact litigation.

—Rebecca Simmons, Chair

Committee Reports

Bankruptcy Committee

The Bankruptcy Law Committee has continued to work on the numerous issues arising from the financial crisis. A special subcommittee is monitoring proposed changes in law that would allow bankruptcy judges to modify mortgage terms on primary residences. The Committee sponsored a very successful full-day statewide sold-out CLE program this past October entitled "Practical Skills-Basics of Bankruptcy Practice," which was held in New York City, Buffalo, Long Island, Syracuse and Albany. In May of 2009 another statewide half-day CLE program, entitled "Consumers and Small Businesses in Distress: Using the Bankruptcy Code to Help Weather These Troubled Times," was held in New York City, Long Island, Albany, Rochester and Syracuse. The new CLE program will confront the major changes which are being implemented in foreclosure and bankruptcy law now being enacted by the Congress.

—Mark S. Tulis, Chair

Franchise, Distribution and Licensing Committee

The Franchise, Distribution and Licensing Committee held a meeting in January 2009. The topic was franchise legislation. David J. Kaufmann presented to the committee a proposal he had sent to Joseph Punturo, Franchise Section Chief in the Investor Protection Bureau of the New York State Attorney General's Office. The proposal was a detailed description of the ways in which the new Federal Trade Commission's trade regulation rule on franchising requires or suggests changes in the New York Franchise Act (NYFA) and regulations. This amounted to the first step toward a possible comprehensive revision of the NYFA.

The committee also discussed Assembly Bill A03589 (January 27, 2009), introduced by Assemblyman Adam T. Bradley. This bill, which is the same as Assembly Bill A10963, introduced by Assemblyman Bradley in 2008, addresses two specific issues. It would bring the definition of a franchise in line with the definitions in other states, and it would limit the extraterritorial application of the NYFA.

Thomas Pitegoff, the chair of this committee, proposed that the committee endorse A03589. Mr. Kaufmann stated his opinion that the bill would not succeed if it does not have the endorsement of the Attorney General's Office. Although Assemblyman Bradley's staff had consulted with the Attorney General's Office in preparing the bill, the Attorney General's Office had not taken a formal position on the bill. At the suggestion of Craig Tractenberg, the committee decided that the best approach would be to make a formal request in writing to the Attorney General's Office to comment on the bill before the committee takes any action. After the meeting, Mr. Pitegoff sent this request to the Attorney General's Office. As of the time that this committee report was written, the Attorney General's Office had not responded.

The committee welcomes all comments on proposed legislation or any other topic within the scope of the committee's mandate, including suggestions for future presentations and programs. Contact the Committee Chair at pitegoff@pitlaw.com.

—Thomas M. Pitegoff, Chair

Clearing Over-the-Counter Derivatives: The Solution to the Current Financial Crisis?

By Regan O'Neill

Introduction

Derivative instruments, or more simply *derivatives*, play a huge and increasingly important role in today's financial markets.[1] Derivatives are financial instruments, traded on or off an exchange, whose price is determined by, or "derived from," the value of one or more underlying securities or any other agreed-upon pricing arrangement (which can include, for example, equity indices, debt instruments, commodities, other derivative instruments, or even the movement over time of freight rates).[2] Options and futures contracts are examples of widely used exchange traded derivatives. Over-the-counter, or OTC, derivatives such as swaps are non-exchange traded derivatives.[3] Since the value of a derivative depends on the value of other financial instruments, derivatives can be a powerful tool not only to hedge risks, but also to enter highly speculative positions. As their use by investors and institutions has exploded over the last decade, derivatives have become an integral part of the investment environment.[4] Although derivatives have fostered extraordinary financial innovation, when complex derivatives are misunderstood, firms that believe they are hedging might in fact be increasing their exposure to various sources of risk.[5]

OTC derivatives were once hailed by a President's Working Group on Financial Markets as transformational in "the world of finance, increasing the range of financial products available to corporations and investors and fostering more precise ways of understanding, quantifying, and managing risk."[6] Many observers today, however, argue that the root of today's financial crisis is that firms grossly misunderstood the risk of their OTC derivative portfolios, especially their positions in mortgage-backed securities and credit default swaps (CDS).[7] When major CDS dealer Lehman Brothers filed for bankruptcy on September 15, 2008, followed immediately by the hasty federal bailout of American International Group (AIG), also a large player in the CDS market, policymakers began to rethink the existing approach to OTC derivative market regulation and oversight.[8] The worry that the largely opaque CDS market is a systemic risk to the global financial system prompted the Commodity Futures Trading Commission (CFTC), Federal Reserve Board, and SEC to execute a memorandum of understanding on November 14 of last year to establish a central clearinghouse for this market and cooperate in their oversight of the clearing platforms.[9]

This article examines the current movement to clear OTC derivatives, specifically CDS transactions, from the perspective of a U.S. policymaker. Some of the questions it attempts to resolve include: What will the regulatory environment be once CDS transactions are brought to a clearinghouse? Can clearing work for OTC derivatives? How will centralized clearing affect the CDS market? How will clearinghouses handle the risk management of these transactions? This paper argues that clearing CDS can eliminate counterparty risk since clearinghouses can guarantee that each buyer has a seller and each seller has a buyer. This clearing guarantee confronts the source of problems that financial markets are currently grappling with—the freezing of credit due to fear of default. By encouraging more centralized clearing of OTC derivatives such as CDS, policymakers are taking a positive step toward restoring confidence in the damaged financial system.

What Are Credit Default Swaps (CDS)?

Before examining the mechanics of clearing CDS, a brief discussion of what is a swap and credit default swap is necessary. In general, a swap is a type of OTC derivative where two parties contract to exchange a series of cash flows related to price or value changes of underlying referenced securities or assets.[10] Because swaps are completely negotiated instruments, there are potentially an infinite number of financial derivatives that can be created to cater to a customer's specific needs. Despite this potential diversity of swaps, there are many types of swap products that now have established markets, including interest rate swaps, basis swaps, asset swaps, currency swaps,[11] total return swaps,[12] and of course credit default swaps.

Credit default swaps are a type of credit derivative[13] that insure holders against default on a range of debt instruments.[14] A CDS allows a buyer of credit protection (the "protection buyer," with the counterparty being the "protection seller") to short the credit risk of a third party debt issuer (called the "reference entity"). In a plain vanilla CDS transaction, the protection buyer pays a periodic fixed amount to the protection seller, which is usually quoted as an annualized percentage of the notional principal amount of the swap, or "spreads." Spreads are a factor of the probability of a default and assumed recovery of principal following default. Upon the occurrence of a "credit event" during the term of the trade, the protection seller pays the face amount of the debt instrument the protection buyer is seeking to hedge. If the trade is physically settled, the protection buyer will also deliver to the protection seller the debt obligation of the reference entity. If the trade is cash settled, there is no delivery, but a net payment is made from the protection seller to protection buyer. This payment is calculated as a percentage of the principal notional amount of the CDS, where the percentage is the difference between par (100%) and solicited bids for the reference entity's debt obligation covered by the swap. Credit events are negotiated between the parties, but typically include bankruptcy, default, debt restructuring, and reorganization by the reference entity.[15]

Originally, investors in bonds used credit default swaps to transfer and thus reduce the risk of their bond holdings. If a firm owned a bond issued by company X and was concerned that the company might default, the firm would buy the swap to protect itself against this potential outcome. Banks that loaned money to company X also used the swaps to hedge their exposure. Over time, however, as with most financial instruments, credit default swaps were used to speculate. Investors, without owning debt obligations, bought and sold CDS to place directional bets on a company's creditworthiness. Similar to bearish investors that short a company's stock because they believe the share price will go down, a speculative CDS position becomes more valuable as the reference entity becomes less creditworthy.[16]

In the decade since credit default swaps were invented, the market has exploded in size from just $1 trillion in 2000 to an estimated $62 trillion today, dwarfing the size of the underlying bond issues.[17] It is undeniable that these are staggering numbers, but it is not necessarily the size of the market that has policymakers focused on reform. In fact, considering that the International Swap Dealers Association (ISDA) estimates there is a total notional amount of $530 trillion in OTC derivatives outstanding today, the entire CDS market represents a fraction of that amount.[18] What does have policymakers focused on CDS (as well as OTC derivative) reform is the destabilizing effect on the entire financial system when various market forces combine to require parties to settle *all* their OTC derivative obligations at the same time. This scenario is largely what forced the federal government to bail out AIG earlier this year. Without the bailout, AIG could not fully satisfy some $50 billion in collateral calls[19] to counterparties on $447 billion in CDS coverage it had sold.[20]

Clearing of CDS and Its Impact on the Market

The bailout of AIG was the catalyst that gave great momentum to the development of a central clearinghouse[21] for credit default swaps. Prior to AIG's collapse, exchange operations such as Eurex, an arm of Deutsche Boerse, the CME Group (CME), which runs the Chicago Mercantile Exchange, Chicago Board of Trade and the New York Mercantile Exchange, and IntercontinentalExchange (ICE) were all developing clearing proposals and platforms for credit default swaps.[22] ICE even went so far as to acquire Clearing Corp., an independent clearinghouse owned by major CDS dealer firms.[23] After AIG's collapse, the development of a central clearinghouse for CDS has become a priority for federal regulators, with the CME and ICE proposals strongly being considered. Regardless of which clearinghouse is established first, there is no doubt it will have a significant impact on the CDS market. The remainder of this section will examine various aspects of the CDS market (and OTC derivatives in general) that need to be considered before moving forward with a new CDS clearinghouse.

Regulatory Framework

With CDS and other OTC derivatives a main cause of today's financial crisis, one may question why these instruments are not regulated in the first place. While part of the reason is that these instruments do not trade on any regulated exchanges, the main reason is that in 2000, the U.S. decided not to regulate credit default swaps.[24] The Commodity Futures Modernization Act of 2000 (CFMA) specifically exempted certain derivative transactions on commodities and swap agreements, including CDS, from CFTC regulation. Part 35 of the Commodities Exchange Act (CEA) defines what types of instruments are included in the definition of a "swap agreement" and then explicitly excludes them from most of the provisions of the CEA.[25] The CFMA also amended the Securities Act of 1933 ('33 Act)[26] and Securities Exchange Act of 1934 ('34 Act)[27] to specifically exclude swap agreements from the definition of "security" and prohibited the SEC from regulating these instruments, except for its anti-fraud enforcement authority.[28] Although the CFTC and SEC have no statutory authority to regulate OTC derivatives such as CDS, they still are competing to be the primary regulator for the CDS clearinghouse being developed.[29] With respect to the actual clearing entity, both agencies stand on better ground—they have some statutory authority supporting their arguments.

Part 39 of the CEA defines derivatives clearing organizations and exempts such entities from CFTC regulations except for many provisions in Part 1 of the CEA, which provide for certain financial reporting obligations, protections for customer assets, and recordkeeping requirements.[30] Since it has oversight of operations run by futures exchanges (like those run by CME Group), the CFTC argues that it should also be the regulator for the CDS clearinghouse.[31] Both the CME and ICE clearinghouse proposals also contemplate obtaining certain exemptive relief from the SEC.[32] Depending on how the proposed clearinghouse operates, there are several potential registration exemptions to obtain. First, there is an exemption from registration as an exchange (governed by Section 6 of the '34 Act).[33] There is an exemption from registration as a broker dealer (governed by Section 15 of the '34 Act).[34] Finally, the SEC will have to consider exemptive relief from registration as a clearing agency (governed by Section 17A of the '34 Act).[35] The SEC argues that these potential registration requirements make it the more appropriate regulator for the CDS clearinghouse.[36] In addition, separate jurisdictional claims of the Federal Reserve Board and New York State Insurance Department further complicate the regulatory morass surrounding a new CDS clearinghouse. The Fed argues that since ICE will be organized as a bank holding company, the clearinghouse ICE is developing would come under its purview.[37] In September, New York State Insurance Superintendent Eric Dinallo announced his department's intention to regulate some CDS contracts because of their insurance component, proposing that the protection seller may have to be licensed as an insurer in New York.[38] With federal regulators now stepping in and pushing for a central CDS clearinghouse, however, Dinallo recently stated that the state will indefinitely delay its plans to regulate credit default swaps.[39] This position could easily change again if progress on the clearinghouse doesn't materialize soon.

With no clear answer as to who will have jurisdiction over the new CDS clearinghouse, the regulatory framework in which it operates will likely have to wait for the new administration and Congress. The regulators themselves, however, should not quarrel over which agency deserves the job, especially so soon after they signed a memorandum of understanding that they would share information and cooperate with each other.[40] Their jurisdictional battle could slow the momentum of creating a CDS clearinghouse to a halt, a situation that is undesirable and dangerous to financial market stability.

Financial Guarantee and Risk Management

While wholesale regulatory reform will require careful consideration, a CDS clearinghouse is an immediate solution that can help reduce the counterparty risks inherent in the CDS market, and thereby help mitigate potential systemic impacts.[41] Unlike OTC derivative markets, where each party assumes the risk of default by its counterparty, the post-trade system for exchange-traded financial instruments works through a clearinghouse. As soon as a trade is confirmed, the contract between buyer and seller disappears, replaced by two new ones—between the clearinghouse and seller and between the clearinghouse and buyer.[42] As a result, clearinghouses ensure that every buyer has a guaranteed seller and every seller has a guaranteed buyer, thus minimizing the risk that one counterparty's default will cause a contagion through the markets. Clearinghouses can accomplish this financial guarantee because it is backed by the collective funds of its clearing members.[43] Additionally, clearinghouses mark-to-market positions daily, collecting margin from investors with losing positions and crediting those investors with profitable positions. This daily settlement mechanism prevents the buildup of significant losses and effectively wipes clean the credit risk inherent in the system.[44] If a clearing member does default, however, the clearinghouse has several tools at its disposal to avoid assessing each clearing member to front its share of the defaulting clearing member's obligations. First, if the clearing member has proprietary trades, the clearinghouse can liquidate these positions in order to satisfy the obligations. Second, all clearinghouses have a default fund that each clearing member finances with an amount based on the clearing member's proprietary and client trading volume. Finally, clearinghouses also have insurance to protect them in case of default.[45] Most importantly, however, no U.S. futures clearinghouse has ever defaulted on its financial guarantee.[46]

While the clearing and settlement mechanism works well for the regulated exchanges, the question remains whether it can work for OTC derivatives like CDS. The answer is that it already is working. After Enron's collapse in 2001, the OTC energy derivatives markets froze, as many energy companies lacked the financial wherewithal to back their over-the-counter trades. U.S. futures exchanges sought and received approval from the CFTC to clear OTC energy products in 2002. Now many OTC energy trades are cleared through regulated clearinghouses, reducing systemic risk and opening up this marketplace to greater regulatory oversight.[47] Although appropriate initial margin requirements for clearing CDS transactions still need to be developed and scrutinized by policymakers, as OTC energy derivatives clear through regulated clearinghouses, so too can CDS.

Market Transparency

In addition to minimizing counterparty risk, the clearing process promotes market transparency, something the CDS market lacks. When transactions are cleared, government and exchange regulators receive trader and pricing information, which helps them police for manipulation and fraud. The availability of pricing information can improve competitiveness, fairness, and efficiency in dealing, all of which maintain market integrity.[48] Each of these attributes would be a great improvement to the obscure CDS market. As highlighted earlier, however, the current regulatory framework allows for exemptive relief from certain registration requirements (along with the reporting and recordkeeping obligations that come with such registrations), so the degree of transparency achieved by clearing CDS remains uncertain as it greatly depends on whether the clearinghouse entity obtains these exemptions.[49]

Operational Efficiency

Another added benefit of clearing OTC derivatives is greater operational efficiency. A main cost for firms trading these instruments is the huge allocation of operations staff and other resources to calculate, reconcile, communicate, confirm and pay swap cash flows.[50] Additionally, the documentation requirements of maintaining OTC trades are immense. ISDA estimates that most ISDA

Master Agreement and Credit Support Annex (CSA)[51] negotiations last from one to four months, while the rest take more than six months. Assuming an estimated negotiation time of 20 hours and a lawyer being paid $500 per hour, one ISDA negotiation can cost approximately $10,000.[52] Many trades can be done under one ISDA once the agreement is in place, but since it is a bilateral contract, any new counterparty requires its own ISDA Master and CSA. Clearing these OTC transactions not only eliminates these operational burdens, but also frees up resources to be allocated elsewhere, since the clearinghouse steps in to guarantee delivery to the buyer of what was bought and ensures that the seller receives his or her money.[53]

Conclusion

While clearing of credit default swaps is a welcome development to this sector of the OTC derivative market, it is useful to remember the important purposes this financial instrument was developed for in the first place. CDS can be employed to closely calibrate risk exposure to a credit or a sector. They can be used by financial institutions making heavily directional bets, as well as by dealer banks that take both long and short positions through their market-making and proprietary trading activities. Through CDS, market participants can shift credit risk from one party to another, and thus the CDS market can be an important element in a particular firm's willingness to participate in an issuer's securities offering.[54] These varied applications of CDS illustrate why the OTC derivative market will continue to thrive— customers' unique needs require specific terms, and specific terms mean derivatives will always resist standardization. The flexibility of the OTC derivative market also encourages financial innovation. For these reasons, U.S. policymakers should be careful not to regulate the OTC market out of existence, a position espoused by Tom Harkin, Chairman of the Senate Agriculture Committee.[55] In his proposed Derivatives Trading Integrity Act, Harkin calls for swaps and other OTC derivatives to be traded only on federally regulated exchanges. The proposed bill would also ban over-the-counter dealing in these instruments.[56] Enacting legislation such as Harkin's proposal would go too far and waste the current political capital focused on modernizing the regulatory framework of our markets. The more prudent approach is similar to the method being used to tackle the CDS market. Careful examination of the OTC market may lead to other types of derivatives that can be standardized enough to either be centrally cleared or moved to exchanges. As ISDA officials recently noted, however, "there will [always] be a need for customized, privately negotiated risk management solutions . . . . Eliminating the ability of businesses and investors to use these [OTC] products would hurt their ability to manage risks and weather tough market conditions."[57] Hopefully, Congress will heed that warning.

Endnotes

1. Zvi Bodie, Alex Kane & Alan J. Marcus, Investments 697 (6th ed. 2005).
2. *See* definition of "Derivative" in the Commodity Futures Trading Commission (CFTC) Glossary, http://www.cftc.gov/educationcenter/glossary/.
3. "Over the counter" is defined by the CFTC Glossary as "the trading of commodities, contracts, or other instruments not listed on any exchange." http://www.cftc.gov/educationcenter/glossary/.
4. Bodie *et al.*, *supra* note 1, at 17.
5. *Id.*
6. President's Working Group on Fin. Markets, Over-the-Counter Derivatives Markets and the Commodity Exchange Act (1999). The Working Group was composed of the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System (Federal Reserve Board), the Chairman of the Securities and Exchange Commission (SEC), and the Chairman of the CFTC. At the time of the report, these individuals were Lawrence H. Summers, Alan Greenspan, Arthur Levitt, and William J. Rainer, respectively.
7. *See* Walter Lukken, *How to Solve the Derivatives Problem*, Wall St. J., Oct. 10, 2008, at A15; Jack Willoughby, *Tearing Into the Fed and Treasury Plans*, Barron's, Oct. 27, 2008, at 52 (describing the difficulty of pricing mortgage-backed securities and credit default swaps and pointing out that there is no way of evaluating what effect a downturn would have on the derivatives markets and their counterparties).
8. *See* Jonathan R. Laing, *Defusing the CDS Bomb*, Barron's, Nov. 17, 2008, at 44.
9. *See id*.
10. *See* definition of "Swap" in the Commodity Futures Trading Commission (CFTC) Glossary, http://www.cftc.gov/educationcenter/glossary/; Bodie *et al.*, *supra* note 1, at 551.
11. An interest rate swap ("IRS") is an agreement between two parties to exchange interest payments on their debt over a period of years. Interest payments are usually in the same currency and are normally made every six months and are linked to a notional principal amount. They are made net, i.e., being the difference between what is owned by the fixed rate payer and the floating rate payer. The purpose of an interest rate swap is for both parties to reduce their borrowing costs or to match their interest payments to their expected income. With a plain vanilla IRS, there is a fixed leg linked to a fixed interest rate and a floating leg. With a basis swap, both legs are linked to different floating interest rates. For example, a basis swap might have one leg pay LIBOR (London Interbank Offered Rate) against a U.S. Treasury bill rate. With asset swaps, one of the parties is swapping the interest payments on an asset it holds, e.g., a bond it has invested in. Finally, a currency swap involves the exchange of interest liabilities in two different currencies and normally includes: a spot exchange of principal, continuing exchange of interest payments during the swap's life, and a re-exchange of principal at the maturity of the contract. Currency swaps are particularly useful in hedging project finance currency risk. Paul C. Harding, Mastering the ISDA Master Agreement: A Practical Guide for Negotiators 5–6 (2002).
12. A total return swap is an agreement in which one party makes payments based on a set rate, either fixed or variable, while the other party makes payments based on the return of an underlying asset, which includes both the income it generates and any capital gains. In total return swaps, the underlying asset, referred to as the reference asset, is usually an equity index, loans, or bonds. This is owned by the party receiving the set rate payment. Total return swaps allow the party receiving the total return to gain exposure and benefit from a reference asset without actually having to own it. http://www.investopedia.com/terms/t/totalreturnswap.asp.

13. While there is no dictionary standard definition for credit derivatives, they are customized agreements between two parties under which one party agrees to make a payment to the other party if an observable credit event occurs or there is a change in a credit spread. *See* Harding, *supra* note 11, at 8.
14. *See* David Bogoslaw, *Regulating Credit Default Swaps: Will It Work?*, BusinessWeek Online, Nov. 21, 2008, http://www.businessweek.com/investor/content/nov2008/pi20081119_756744.htm; Jonathan R. Laing, *Weapons of Mass Speculation*, Barron's, May 12, 2008, at W24.
15. *See* OTC Derivatives: Legal Framework & Risk Management Considerations, Class Presentation (on file with author); *Role of Derivatives in the Economy: Hearing Before the H. Comm. on Agriculture*, 110th Cong. (2008) [hereinafter *Hearing*] (testimony of Eric R. Dinallo, Superintendent, State of New York Insurance Department).
16. *See Hearing*, *supra* note 15 (testimony of Eric R. Dinallo).
17. *See* Laing, *supra* note 14, at W24. By comparison, there is only about $6 trillion in corporate debt outstanding, $7.5 trillion in mortgage-backed debt and $2.5 trillion in asset-backed debt. *Hearing*, *supra* note 15 (testimony of Eric R. Dinallo).
18. Derivatives Market Regulation Seminar, Nov. 18, 2008 Class Notes (on file with author).
19. Credit default swaps are marked to market, meaning the value of the swap reflects the current market value. Market value can be extremely volatile. Value changes require the parties to post collateral (depending on the direction of the change). Sudden changes in the credit rating of the reference entity or its debt obligations can produce large swings in the value of the swaps, therefore increasing the amount of posted collateral. As the parties continue to post collateral, the capital strain can create liquidity problems. The party may have enough assets to provide collateral, but the assets may not be liquid and thus not immediately accessible. When many parties are forced to sell the same assets, the price of those assets falls and these same parties are forced to take large losses just to meet collateral requirements. As the prices of the assets are driven down by forced sales, mark-to-market losses increase and the collateral posting cycle continues. *See Hearing*, *supra* note 15 (testimony of Eric R. Dinallo). Once in this vicious cycle, one can see how it can spiral out of control.
20. Laing, *supra* note 8, at 44.
21. A clearinghouse is an entity through which futures and other derivative transactions are cleared and settled. It is also charged with assuring the proper conduct of each contract's delivery procedures and the adequate financing of trading. Definition of "Clearing Organization" in the CFTC Glossary, http://www.cftc.gov/educationcenter/glossary/. *See also* the definition of "Derivatives Clearing Organization" in the CFTC Glossary, http://www.cftc.gov/educationcenter/glossary/ (describing other responsibilities that derivatives clearinghouses have, such as enabling each party to the contract to substitute, through novation or otherwise, the credit of the derivatives clearing organization for the credit of the parties; arranging or providing, on a multilateral basis, for the settlement or netting of obligations resulting from such contracts; or otherwise providing clearing services or arrangements that mutualize or transfer among participants in the derivatives clearing organization the credit risk arising from such contracts).
22. Laing, *supra* note 8.
23. *Id*.
24. *Hearing*, *supra* note 15 (testimony of Eric R. Dinallo).
25. Part 35 of the CEA available at http://ecfr.gpoaccess.gov/.
26. *See* Section 2A of the '33 Act excluding "swap agreements" from the definition of "security," *available at* http://www.law.uc.edu/CCL/33Act/sec2A.html.
27. *See* Section 3A of the '34 Act excluding "swap agreements" from the definition of "security," *available at* http://www.law.uc.edu/CCL/34Act/sec3A.html.
28. *See Hearing*, *supra* note 15 (testimony of Eric R. Dinallo).
29. Donna Block, *Turf War Erupts Over CDSs*, The Deal, Nov. 22, 2008 [hereinafter *Turf War*].
30. Part 39 of the CEA available at http://ecfr.gpoaccess.gov/.
31. *See* Donna Block, *Swap Meet*, The Deal, Nov. 30, 2008 [hereinafter *Swap Meet*].
32. *Hearing*, *supra* note 15.
33. http://www.law.uc.edu/CCL/34Act/sec6.html.
34. http://www.law.uc.edu/CCL/34Act/sec15.html.
35. http://www.law.uc.edu/CCL/34Act/sec17A.html.
36. *See Turf War*, *supra* note 29; *Hearing*, *supra* note 15.
37. *Turf War*, *supra* note 29.
38. *Swap Meet*, *supra* note 31.
39. Sarah N. Lynch, *Crisis on Wall Street: New York Will Suspend Its CDS Plan*, Wall St. J., Nov. 21, 2008, at C2.
40. *Turf War*, *supra* note 29.
41. *See Hearing*, *supra* note 15 (testimony of Erik Sirri, Director, Division of Trading and Markets, U.S. Securities and Exchange Commission).
42. Martin Mayer, *A Credit-Default Solution*, Barron's, Nov. 24, 2008, at 41.
43. *See* Lukken, *supra* note 7, at A15.
44. *Id*.
45. Derivatives Market Regulation Seminar, Sept. 23, 2008 Class Notes (on file with author).
46. Lukken, *supra* note 7, at A15.
47. *Id*.
48. *See id.*; *Hearing*, *supra* note 15 (testimony of Erik Sirri).
49. *See Hearing*, *supra* note 15 (testimony of Erik Sirri).
50. Investance UK, CME Swaps on Swapstream: Mitigating the Implied Costs and Risk of Vanilla Swaps 1 (2007), *available at* http://www.cmegroup.com/trading/interest-rates/files/Investance_CME_Swaps.pdf.
51. The ISDA Master Agreement and Credit Support Annex are standardized documents that parties use to implement OTC trades. While most of the terms are standard, the documents are still heavily negotiated to tailor the agreement to meet the needs of the counterparties.
52. Investance UK, *supra* note 50, at 2.
53. Mayer, *supra* note 42.
54. *See Hearing*, *supra* note 15 (testimony of Erik Sirri).
55. *See* Karen Brettell, *CDS Exchange Trading Not the Only Solution*, HedgeWorld Daily News, Nov. 25, 2008; Patrick Temple-West, *Derivatives: SIFMA, ISDA Oppose Bill to Extend Control Over OTC Swaps*, Bond Buyer, Nov. 24, 2008, at 5.
56. Brettell, *supra* note 55.
57. Temple-West, *supra* note 55, at 5.

Regan O'Neill is a J.D. candidate at New York Law School, expected to graduate in February, 2010. He is a Senior Editor on the *New York Law School Law Review*, and is the John Marshall Harlan scholar affiliated with the Center on Business Law and Policy. Prior to law school, he worked in the legal departments of Soros Fund Management LLC and Ospraie Management, LLC.

OTC Derivative Contracts in Bankruptcy: The Lehman Experience

By: GuyLaine Charles

I. Introduction

U.S. bankruptcy law, and more specifically Chapter 11 of the U.S. Bankruptcy Code[1] ("Bankruptcy Code"), is generally designed to protect the interests of two broad constituencies: creditors, who have an interest in maximizing the portion of their claims they recover from the estate, and shareholders and other stakeholders, who may receive an interest in a reorganized entity. The insolvency of certain Lehman Brothers entities has dramatically illustrated the fact that in cases involving debtors who have a significant presence in the financial markets, bankruptcy law should also take into account the interests of another large constituency, namely, all the other participants in the relevant markets. When a debtor is a party to a significant number of financial contracts there is a risk that its failure will have a domino effect and precipitate the failure of its counterparties.[2]

This article will discuss some of the special provisions of the Bankruptcy Code that are believed to address systemic risk.[3] It will provide a brief overview of the legislative framework dealing with the bankruptcy of parties to over-the-counter (OTC) derivative contracts.[4] It will also provide a snapshot of the proceedings under the Bankruptcy Code with respect to the insolvency of certain Lehman Brothers entities.[5]

II. Bankruptcy Code

The Bankruptcy Code contains several provisions that alter non-bankruptcy entitlements in order to protect the interests of the debtor and its creditors. First, the automatic stay provisions of the Bankruptcy Code are meant to protect the estate by preventing creditors from fragmenting the debtor's assets into parts that are worth less than the whole and from receiving more than they would be entitled to in the bankruptcy estate and to give the debtor time to reorganize.[6] Second, the provisions rendering *ipso facto*[7] clauses unenforceable ensure that a debtor's creditors continue to honor their agreements even after the debtor has filed for bankruptcy protection in order to allow the debtor to continue to operate as a going concern. Third, the avoidance powers serve to maximize the value of the estate by returning to the debtor's estate any property transferred prior to insolvency when such transfer constitutes a fraudulent conveyance or preference.[8] Fourth, the Bankruptcy Code provides that the trustee or debtor-in-possession has the discretion, within prescribed limits, to reject or assume its prepetition contracts.[9] This last right allows a debtor to choose which contracts it wishes to preserve, assuming those that are in the estate's interest, while rejecting those that are not. These provisions increase the debtor's estate but at the expense of a solvent creditor that must continue to perform under contracts that are assumed but must wait until acceptance of a plan[10] before it can recoup amounts (perhaps cents on the dollar) on the contracts the debtor rejects.

OTC derivative contracts benefit from substantial protections under the Bankruptcy Code because they are largely exempt from virtually all of the rules mentioned above. These exemptions and protections are often referred to collectively as the "safe harbor provisions." The current regime has its origins in the 1978 Bankruptcy Code,[11] which has evolved over time in certain material respects. Recent updates have notably included the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005[12] (the "2005 Act"), which expanded the definition of certain "financial contracts" (which include OTC derivative contracts) and clarified the status of these financial contracts as protected contracts under the Bankruptcy Code. The Financial Netting Improvements Act of 2006[13] builds on the 2005 Act and strengthens the netting provisions with respect to these contracts. As a result, the Bankruptcy Code now establishes a separate regime for treatment of OTC derivative contracts entered into by the debtor. One of the purposes behind this separate regime is to prevent the bankruptcy of a debtor from disrupting international financial markets.[14]

The safe harbor provisions apply to OTC derivative contracts as follows:

A. Automatic Stay

The Bankruptcy Code provides that

> [t]he filing of a petition . . . does not operate as a stay under subsection (a) of this section . . . of the exercise by a swap participant or financial participant[15] of any contractual right . . . under any security agreement or arrangement or other credit enhancement forming part of or related to any swap agreement, or of any contractual right . . . to offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with 1 or more such agreements, including any master agreement for such agreements.[16]

A similar exemption also applies to master netting participants[17] under master netting agreements.[18] Swap agreements which provide rights of "netting, setoff, liquidation, termination, acceleration, or close-out . . . " are master netting agreements.[19]

B. Termination/Liquidation

Sections 560 and 561 of the Bankruptcy Code provide that

> . . . the exercise of any contractual right . . . to cause the liquidation, termination, or acceleration of . . . swap agreements [or master netting agreements], shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by any order of a court or administrative agency in any proceeding under this title . . . [20]

The combined effect of exempting OTC derivative contracts from the automatic stay and the *ipso facto* rule is to allow the debtor's counterparty to terminate or liquidate an OTC derivative contract even after the debtor has filed a petition under Chapter 11, and to protect any netting or setoff rights that the debtor has under these contracts.

C. Avoidance Powers

Section 546 provides that the trustee or debtor-in-possession may not avoid a transfer in connection with a swap agreement that is made before the commencement of the case, except under section 548(a)(1)(A) (that is, if the transfer is made fraudulently).[21]

As a result of these provisions, no prepetition transfer made by the debtor or obligation incurred by the debtor in connection with financial contracts is subject to avoidance by the bankruptcy trustee unless such transfer was made fraudulently.

III. OTC Derivative Contracts

It is important to recognize that the safe harbor provisions of the Bankruptcy Code only intend to preserve the actual contractual rights of the debtor's counterparties. Therefore, parties to OTC derivative contracts covered by these provisions must ensure their contracts provide them the protection they need in the event of a counterparty insolvency.

Most OTC derivative contracts are documented under standard forms created by the International Swaps and Derivatives Association, Inc. (ISDA). ISDA was established in 1985 and has been developing and standardizing documentation with respect to OTC derivative contracts ever since. ISDA has developed various forms of master agreements (each an "ISDA Master") that provide the legal framework that governs the large majority of trading relationships between parties entering into various OTC derivatives trades. A standard form ISDA Master is completed and amended through the negotiation of its "Schedule." In the event the parties choose to collateralize their trades, they will enter into a "Credit Support Annex" to the Schedule. The ISDA Master, together with the Schedule, its Credit Support Annex and confirming evidence of trades, represent a single agreement between the parties. While the 2002 ISDA Master is more recent, the 1992 ISDA Master continues to be frequently used. The distinctions between the 1992 and the 2002 ISDA Masters are not particularly relevant for purposes of this article, except with respect to the calculation of the termination payment.

Section 5 of the ISDA Master establishes that upon the occurrence of certain "events of default" with respect to a party, the other party has the right to terminate all transactions under the ISDA Master. The filing of a petition for insolvency (and similar events) by a party (the "defaulting party") or its guarantor is an event of default under the ISDA Master (a "Bankruptcy Event").[22] Upon the occurrence of a Bankruptcy Event (which may, in the case of certain insolvency events, involve the expiration of a grace period) the other party (the "non-defaulting party") may, but is not obligated to, deliver a notice of early termination of the ISDA Master (the "Notice of Early Termination") to the defaulting party. The Notice of Early Termination will, upon effective delivery, have the effect of terminating all outstanding trades under the ISDA Master as of the early termination date specified in the Notice of Early Termination (which date must be within 20 days of effective delivery of the Notice of Early Termination).

Once an early termination date has been established, the non-defaulting party will calculate the value of all outstanding trades based on the applicable valuation methodology. The non-defaulting party will provide a calculation statement to the defaulting party that details how it determined the termination payment (owed by one party to the other). The non-defaulting party may also net out any collateral held by either party under the Credit Support Annex from the termination payment. Finally, the non-defaulting party may be entitled to setoff amounts owed between the parties under the ISDA Master and any other agreement if a setoff provision were to have been included in the ISDA Master.

A non-defaulting party that is out-of-the-money may elect not to terminate the ISDA Master. This is a slightly risky proposition because a party that waits too long to declare an event of default based on a Bankruptcy Event could be deemed to have waived its rights to do so.[23] However, some parties may still choose not to terminate as Section 2(a)(iii) of the ISDA Master provides that a party's obligation to perform under the ISDA Master is predicated on no event of default having occurred with respect to its counterparty. Therefore, in the event a non-defaulting party to an ISDA Master does not terminate, it is no longer required to perform under the ISDA Master.[24] As a result the non-defaulting party: (a) does not have to terminate the ISDA Master, (b) therefore does not have to pay the termination amount to the defaulting party and (c) does not have to perform under the ISDA Master.

The safe harbor provisions of the Bankruptcy Code have protected the Lehman ISDA Master counterparties with respect to the bankruptcy proceedings of certain Lehman Brothers entities by preserving the counterparties' contractual rights to terminate, liquidate, net and setoff obligations.

IV. Lehman Brothers Holdings Inc.'s (LBHI) Proceeding Under the Bankruptcy Code

LBHI filed a Chapter 11 bankruptcy petition on September 15, 2008 and was soon followed by several affiliated debtors (collectively, the "Lehman Debtors").[25] Since initiating bankruptcy proceedings, the Lehman Debtors have been operating their businesses as debtors-in-possession under the Bankruptcy Code.

Prior to LBHI's filing, as of September 12, 2008, the Lehman Debtors had 6,120 outstanding ISDA Masters, in which they calculated that they were owed $23.8 billion, and that they owed $13 billion.[26] As of January 2, 2009, 3,453 of the ISDA Masters had been terminated by the Lehman Debtors' counterparties, representing $14.3 billion payable to the Lehman Debtors and $11 billion payable by the Lehman Debtors.[27]

On November 13, 2008, the Lehman Debtors filed a motion[28] (the "Motion") for an order from the Bankruptcy Court of the Southern District of New York (the "Court") to establish procedures for assigning and settling various "derivative contracts" (which they defined as securities contracts, forward contracts, repurchase agreements and swap contracts (the "Derivative Contracts")). At the time of the Motion, the Lehman Debtors estimated that they were party to approximately 930,000 Derivative Contracts and that over 190,000 of these contracts had not been terminated by their counterparties and remained outstanding. The Lehman Debtors believed that in some instances the counterparties had not exercised their right to terminate the Derivative Contracts because the Lehman Debtors were in-the-money and the counterparties did not wish to make a termination payment to Lehman. In addition, the Lehman Debtors contended that their counterparties refused to make ongoing payments, in accordance with the terms of the Derivative Contracts, based upon the Lehman Debtors' "alleged defaults."[29] As a result, the Lehman Debtors could not realize the value of such Derivative Contracts unless their counterparties defaulted or other termination events occurred, giving the Lehman Debtors the right to terminate. Therefore the Lehman Debtors petitioned the Court for the ability to realize the value of some of their Derivative Contracts by assigning them to third parties.

The Court, in an order dated December 16, 2008[30] (the "Order"), granted the Motion, with certain modifications that reflect various objections from creditors. The Order granted the Lehman Debtors the right to: (1) enter into final settlement agreements with counterparties that have terminated Derivative Contracts; and (2) assign Derivative Contracts that have yet to be terminated to third parties in order to realize their value. In proposing an assignment, the Lehman Debtors may submit as many as 12 potential assignees to their counterparties and the counterparties are entitled to object to the assignment on various bases enumerated in the Order. The Lehman Debtors, however, may not consummate an assignment transaction or a final settlement agreement pursuant to the procedures set forth in the Order unless: (i) the Official Committee of Unsecured Creditors (the "Committee") consents to the transaction, through written notice or pursuant to the terms of an agreed protocol, or (ii) the Bankruptcy Court authorizes consummation of such transaction.[31]

Not completely satisfied with this outcome, on January 16, 2009, the Lehman Debtors filed a subsequent motion[32] (the "Second Motion") for an order from the Court requesting that the Court approve the consensual assumption and assignment of prepetition contracts. The Lehman Debtors sought an order that would limit the costs of assignment, and increase the marketability of Derivatives Contracts which are to be consensually assigned, by eliminating the requirement of Court approval for such assignments.

The Court, in an order dated January 28, 2009[33] (the "Second Order"), granted the Second Motion authorizing the Lehman Debtors to proceed with the assumption and assignment of Derivative Contracts that have not been terminated (other than with respect to special purpose entities, for which there are different procedures), with the approval of the Committee or in accordance with the terms of a protocol agreed to with the Committee, and with the written consent of the relevant counterparty.

At the hearing for the Motion, counsel for the Lehman Debtors stated that the number of Derivative Contracts that had not been terminated had gone from 190,000 at the time of the filing of the Motion to 30,000 at the date of the hearing. It is clear that counterparties to the Lehman Debtors are not particularly interested in continuing the transactions under their Derivative Contract with a third party.

V. Conclusion

The Lehman Debtors' bankruptcy has provided a dramatic test of the safe harbor provisions in the context of the failure of a major financial institution. OTC derivative counterparties have relied on those provisions to terminate and close out their ISDA Masters and thereby limit their exposure. It will be determined over the coming months and years to what extent this has served to reduce systemic risk and limit the disruption of financial markets.

Endnotes

1. 11 U.S.C. §§ 101–1532 (2006) (incorporating the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (2005), and the Financial Netting Improvements Act of 2006, Pub. L. No. 109–390, 120 Stat. 2692 (2006)).
2. Ellen H. Clark, *Developments in Derivatives and Synthetic Securitization Following the US Bankruptcy Reforms of 2005*, in Innovation in Securitization Yearbook 2006, 85–110 (De Vries Robbe and Ali ed. 2006).
3. *Id.*
4. OTC derivatives contracts are privately negotiated bilateral trades. For further explanation of the OTC market, *see* Lauren Teigland-Hunt and GuyLaine Charles, *The Evolution of Standardization of the OTC Derivatives Market*, MFA Reporter, January/ February 2009.
5. This article will not address the liquidation of Lehman Brothers Inc. (LBI) under the Securities Investors Protection Act of 1970 (SIPA) nor will it explore issues raised by the fact that a number of Lehman Brothers entities were subject to foreign laws and the jurisdiction of foreign courts, although these factors have had a significant impact on creditors and the bankruptcy.
6. The automatic stay is akin to a temporary injunction levied against creditors immediately upon a debtor filing under the Bankruptcy Code pursuant to which any activity which may result in the erosion of a debtor's assets is prohibited (e.g., lawsuits, foreclosures etc . . .). *See* 11 U.S.C. § 362(a) (2006).
7. An "*ipso facto* clause" in a contract provides that the insolvency of one party is a breach of contract, therefore allowing the non-insolvent party to the contract to terminate the agreement. Section 365(e)(1) of the Bankruptcy Code renders such *ipso facto* clauses unenforceable. *See* 11 U.S.C. § 365(e)(1) (2006).
8. Avoidance powers are powers afforded to the bankruptcy trustee pursuant to which the trustee may set aside transfers deemed to be preferences or fraudulent transfers or fraudulent obligations. *See* 11 U.S.C. §§ 544, 547–48 and 550 (2006).
9. *See* 11 U.S.C. § 365(a) (2006).
10. *See* 11 U.S.C. § 1126 (2006).
11. *See* An Act to Establish a Uniform Law on the Subject of Bankruptcies, Pub. L. No. 95-598, 92 Stat. 2549 (1978). As originally drafted, Section 362 exempted from the automatic stay "the setoff of any mutual debt and claim that are commodity futures contracts, forward commodity contracts, leverage transactions, options, warrants, rights to purchase or sell commodity futures contracts or securities, or options to purchase or sell commodities or securities." 11 U.S.C § 362(b)(6) (2006).
12. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109–8, 119 Stat. 23.
13. The Financial Netting Improvements Act of 2006, Pub. L. No. 109-390, 120 Stat.2693.
14. "Since 1978, we have been faced with a number of situations where Congress has concluded that certain rapid, high volume financial transactions warrant special bankruptcy treatment so as not to disrupt international capital markets." 136 Cong. Rec. H2281-06, H2282 (1990) (statement of Congressman Brooks).
15. "Financial participant" is defined in 11 U.S.C. § 101(22A) (2007) and "swap participant" is defined in 11 U.S.C. § 101(53C) (2007).
16. 11 U.S.C. § 362; swap agreements (§ 101(53B)) (2006) are exempt under § 362(b)(17) (2006).
17. "Master netting agreement participant" is defined in 11 U.S.C. § 101(38B) (2007).
18. "11 U.S.C. § 362(b)(27) (2007).
19. "Master netting agreement" is defined in § 101(38A) (2007).
20. A counterparty may exercise the right to terminate, liquidate or accelerate, despite the prohibition on *ipso facto* clauses in Section 365(e)(1), among other financial contracts, a swap agreement (§ 560), and a master netting agreement (§ 561).
21. 11 U.S.C. § 546(f)(g) (2006).
22. *See* ISDA Master § 5(a)(vii).
23. *See In re Amcor Funding Corp. fka Lincoln Am. Fin. Inv. Co.*, No. CIV 89-1231 PHX-RMB (D. Ariz. 1990).
24. In the Australian case of *Enron Australia v. TXU Electricity* (2003) 204 A.L.R. 658, Enron had entered into electricity swap transactions governed by the 1992 ISDA before going into administration and then liquidation. The court held that TXU, as the non-defaulting party, had no obligation to make any payments to Enron related to open trades due to the condition precedent in Section 2(a)(iii) of the ISDA Master. The court held that the payment obligation of the non-defaulting party would only arise under a pre-existing trade once the condition precedent was satisfied.
25. The term "Lehman Debtors" does not include Lehman Brothers, Inc., which is subject to proceedings under the SIPA.
26. Lehman Brothers Holdings Inc., First Creditors § 341 Meeting, January 29, 2009, p.19 and 20, *available at* http://www.lehmanbrothersestate.com/341_Meeting_01_29_09_FINAL_SS.pdf.
27. *Id.*
28. Debtors' Motion for an Order pursuant to Sections 105 and 365 of the Bankruptcy Code to Establish Procedures for the Settlement or Assumption and Assignment of Prepetition Derivatives Contracts, Lehman Brothers Holdings Inc., *et al*, No. 08-13555 (U.S. Bankr. Ct., S.D.N.Y. Nov. 13, 2008). [Docket No.1612].
29. Section 2(a)(iii) of the ISDA Master, pursuant to which the non-defaulting party is not required to perform during the existence of an event of default with respect to its counterparty, is not necessarily present in all financial contracts.
30. Order Pursuant to Sections 105 and 365 of the Bankruptcy Code to Establish Procedures for the Settlement or Assumption and Assignment of Prepetition Derivative Contracts, Lehman Brothers Holdings Inc., *et al.*, No. 08-13555 (U.S. Bankr. Ct., S.D.N.Y. Dec. 16, 2008). [Docket No. 2257].
31. There remain some outstanding objections to the Order. The terms of the Order are not applicable to any party whose objection remains outstanding.
32. Debtors' Motion for an Order Approving Consensual Assumption and Assignment of Prepetition Derivatives Contracts, Lehman Brothers Holdings Inc., *et al.*, No. 08-13555 (U.S. Bankr. Ct., S.D.N.Y. Jan. 16, 2009). [Docket No.2561].
33. Order Approving Consensual Assumption and Assignment of Prepetition Derivatives Contracts, Lehman Brothers Holdings Inc., *et al.*, No.08-13555 (U.S. Bankr. Ct., S.D.N.Y. Jan. 28, 2009). [Docket No. 2667].

GuyLaine Charles is a partner at Teigland-Hunt LLP, a New York law firm that focuses on derivative and commodity transactions and related trading and regulatory matters. Ms. Charles represents financial institutions, hedge funds and commodity trading firms in various trading agreement negotiations as well as a wide range of fixed income, equity and commodity transactions.

Second Circuit Ruling Could Hurt Ability to Manage Credit Crisis Litigation and Could Undermine Distressed Debt Markets

By Owen Pell

A recent Second Circuit decision could have significant ramifications for banks and other financial institutions attempting to manage litigation flowing from the credit crisis and manage exposure via the distressed debt market. The case, *Trust for the Certificate Holders of the Merrill Lynch Mortgage Investors, Inc. Mortgage Pass-Through Certificates v. Love Funding Corp.* ("*Love Funding*")[1] bears close attention as proceedings now move to New York State's highest court, the New York State Court of Appeals.

The central issue in *Love Funding* is whether an assignee of certain contractual rights may be barred from pursuing remedies on those rights under a New York law which codified the old English law relating to "champerty." Champerty was aimed at preventing persons from buying and selling litigation claims simply as a way of obtaining costs and attorneys' fees (which under English law may be shifted on to the losing party). As codified in New York Judiciary Law § 489(1), a company may not "solicit, buy or take an assignment of . . . any claim or demand, with the intent and for the purpose of bringing an action or proceeding thereon." Ten years ago, the Second Circuit, applying New York law, held that champerty did not apply to the purchase of sovereign debt at steep discounts with the intent of demanding full payment coupled with the threat of litigation.[2] Now the reach of that ruling—which had been thought to lay to rest champterty as a defense to debt-purchase claims—has been called into question.

Assignment of a Claim as Part of a Settlement

Love Funding involved a dispute over mortgage-backed securities. Love Funding, an originator, entered into a conduit lending arrangement with Paine Webber Real Estate Securities Inc. (which later became part of UBS). In the mortgage-loan-purchase agreement (the "UBS MLPA"), Love Funding represented that none of the underlying mortgage loans was in default. In the event that representation was untrue as to any loan, Love Funding was to buy back the loan and otherwise indemnify the bank against any claims arising from the breach of that representation (and against fees and costs associated with such claims).

Among the loans covered by the UBS MLPA was a mortgage secured by a Louisiana apartment complex (the "Louisiana mortgage"). The Louisiana mortgage, together with over 30 other Love Funding mortgages, was then assigned and sold by PaineWebber to Merrill Lynch under another mortgage-loan-purchase agreement (the "Merrill Lynch MLPA"). In the Merrill Lynch MLPA, PaineWebber provided representations parallel to those provided by Love Funding in the UBS MLPA. Merrill Lynch placed the mortgages into a trust which then sold certificates to investors.

When the Louisiana mortgage went into foreclosure proceedings, a Louisiana state court noted in passing that the mortgage had been procured by fraud, which meant that the loan had been in default from the outset. The Trust sued UBS under the Merrill Lynch MLPA with respect to 33 loans (including the Louisiana mortgage), claiming breach of the representation that no loans were in default.

After what the court termed "scorched earth litigation," UBS and the Trust agreed to settle the case. With respect to 32 loans, UBS paid $19.375 million, and with respect to the Louisiana mortgage, the Trust received an assignment of UBS's rights as against Love Funding under the UBS MLPA, including the right to attorneys' fees and costs (the "Assignment").

The Trust then sued Love Funding on its representation regarding the Louisiana mortgage. Love Funding asserted a defense of champerty. The lower court ruled for Love Funding, pointing to the lack of other consideration for the Assignment and communications between the parties about the value of the potential claim against Love Funding on the Louisiana mortgage. Thus, the lower court found that the primary purpose of the Assignment was for the Trust to purchase a lawsuit against Love Funding, which it held was sufficient intent to violate New York's anti-champerty law.[3]

New York Law Is Found to Be Less Than Clear

On the Trust's appeal, the Second Circuit reserved decision. The court found that its prior decisions, including *Elliot Associates*, had not addressed facts like this.[4] Moreover, the court had observed in *Elliot* that § 489 appeared to "forbid essentially all 'secondary' transactions in debt instruments where the purchaser had an intent to enforce the debt obligation through litigation."[5] But the court there held that New York cases, while not consistent, did not support such a broad reading. Since Elliot intended to pursue payment before suing, it lacked the intent crucial to a finding of champerty. Thus, under *Elliot* a mere intent to sue was not itself champertous.[6]

Here, the Trust had an interest in the loans which Love Funding had transferred under the UBS MLPA, but lacked the contractual privity to sue Love Funding directly. That is, although the Trust had an interest in collecting on a debt (i.e., Love Funding's obligations under the UBS MLPA), it had to "buy" that potential lawsuit by settling with UBS to acquire the contractual right to sue Love Funding. The court found New York law unclear on whether "an intent to acquire a lawsuit in such circumstances" constitutes champerty.[7] The court then invoked a procedure under which it certified to the New York State Court of Appeals three questions of New York law[8] which, to the extent answered, could then be applied to the Trust's appeal:

(1) Is it sufficient as a matter of law to find that a party accepted a challenged assignment with the "primary" intent proscribed by [the New York champerty law], or must there be a finding of "sole" intent?

(2) As a matter of law, does a party commit champerty when it "buys a lawsuit" that it could not otherwise have pursued if its purpose is thereby to collect damages for losses on a debt instrument in which it holds a pre-existing proprietary interest?

(3) (a) As a matter of law, does a party commit champerty when, as the holder of a defaulted debt obligation, it acquires the right to pursue a lawsuit against a third party in order to collect more damages through that litigation than it had demanded in settlement from the assignor?

(b) Is the answer to question 3(a) affected by the fact that the challenged assignment enabled the assignee to exercise the assignor's indemnification rights for reasonable costs and attorneys' fees?

Implications

Love Funding could greatly complicate the ability of banks and other financial institutions to manage litigation flowing from the credit crisis and exposure via the purchase and sale of debt. The Assignment at issue in *Love Funding* was part of an integrated settlement, and there is no finding on what the Assignment would have been worth if divorced from the money paid to settle the claims on the other loans. Moreover, as noted by the Second Circuit, the Trust always had an interest in the contractual representation regarding whether loans were in default; it just lacked the contractual right to sue Love Funding on that representation. There was, however, no doubt that Love Funding faced potential claims from someone (i.e., UBS). If the assignment of claims as part of settlements creates issues under New York law, it could become much harder to manage and resolve such claims.

Similarly, given that litigation, including in bankruptcy proceedings, is often the only method for resolving the value of defaulted debt, *Love Funding* adds additional risks for distressed debt purchasers to consider in buying such obligations, and also creates potential fact issues relating to the intent of the parties that could affect the pricing of distressed debt. This case bears close attention by banks and other financial institutions as the certification to the New York Court of Appeals proceeds.

Endnotes

1. No. 07-1050 (2d Cir. Feb. 13, 2009).
2. *Elliott Assocs., L.P. v. Banco de la Nacion*, 194 F.3d 363, 381 (2d Cir. 1999).
3. 499 F. Supp. 2d 314, 322 (S.D.N.Y. 2007).
4. Slip Op. at 22.
5. Slip Op. at 21 (citations and internal quotations omitted).
6. *Id.*, citing *Elliot Assocs.*, 194 F.3d at 372–73.
7. Slip Op. at 22.
8. It is difficult to say how long this procedure will take, particularly given that the New York Court of Appeals may and has declined such certifications in the past. *See* N.Y. App. Ct. R. § 500.27.

Owen Pell is a partner in the Commercial Litigation Practice of White & Case. His areas of practice include complex commercial litigation, securities litigation, litigation involving foreign sovereigns and their state-owned entities, litigation involving issues of public international law, and bankruptcy litigation. Mr. Pell also has extensive experience representing financial institutions and corporations in connection with investigations by the SEC, the DOJ, and state banking regulators, and the litigation that may arise from such investigations. Mr. Pell has conducted internal investigations with regard to the FCPA, fraud, lender liability, and historical reparation issues.

The Community Reinvestment Act of 1977: Not Guilty

Mortgage Data Refute Charge That the CRA Is at the Root of the Financial Crisis

By Warren W. Traiger

Purpose of Study

This study, Traiger & Hinckley LLP's fourth annual analysis of home mortgage lending data, builds on our 2008 report which found that banks subject to the Community Reinvestment Act of 1977 (CRA) were substantially less likely than other mortgage lenders to engage in the types of risky lending practices that helped fuel the foreclosure crisis.[1]

Publication of our 2008 report coincided with, but ran counter to, pronouncements from a small but vocal group of critics who seek to portray the CRA as a principal cause of the U.S. financial crisis. These individuals allege that CRA-subject banks downgraded their standards for originating mortgage loans in order to comply with their obligation to lend to low- and moderate-income (LMI) individuals. This "lowering of the bar" has, according to the skeptics of the CRA, facilitated or precipitated the current wave of delinquencies, defaults, and foreclosures. Because this argument is incongruous with our statistical research and our experience counseling banks on CRA compliance since 1990, we decided that this year's report should investigate the critics' accusations.

We posited the following hypothesis. If critics were correct about banks having lowered underwriting standards for LMI borrowers, lending data from 2007, a time of constricting credit and significantly tightened underwriting standards, should show greatly diminished service to LMI borrowers by CRA-subject banks. To test this hypothesis, we looked at 2007 and 2006 Home Mortgage Disclosure Act (HMDA) data from the 15 most populous U.S. metropolitan statistical areas (MSAs). As we explain below, the data tend to refute the accusation that the CRA helped cause the current mortgage crisis.

Summary Conclusion

Our study concludes that in 2007 the level of service to LMI borrowers by CRA-subject banks was essentially undiminished, notwithstanding the otherwise dismal state of the lending market. Specifically:

1. CRA-subject banks originated mortgages to LMI applicants at essentially the same rate in 2007 as in 2006;
2. The proportion of all CRA-subject bank home mortgage loans that were made to LMI borrowers held steady from 2006 to 2007; and
3. CRA-subject banks' market share of home mortgage loans to LMI borrowers grew by 30 percent from 2006 to 2007.

Discussion

The Case Against the CRA

The argument that the CRA facilitated the U.S. financial crisis is premised upon the assumption that the law forced banks to adopt lax underwriting standards in order to provide mortgage loans to LMI borrowers:

> The root of today's financial crisis can be found in the government's effort to use the banking and financial system to expand home ownership. There are many good reasons to increase home ownership in our society, but the way to do it was not by distorting the lending decisions of banks and other mortgage market participants. That, however, is the direction the government chose when it imposed the CRA on insured banks in 1977 and an "affordable housing" mission on Fannie Mae and Freddie Mac in 1992. Instead of assisting low income families to become homeowners with direct subsidies, the government—through CRA—required banks to lower their lending standards. Down payments, steady jobs, good credit histories, and income levels commensurate with mortgage obligations were abandoned in favor of "flexible" lending requirements. Bank regulators, required to enforce CRA, approved mortgage loans that would not previously have been acceptable, and demanded that banks do more.[2]

Mortgage Lending in 2007

If, in fact, LMI borrowers typically secured mortgage loans by virtue of permissive or negligent bank underwriting standards, data from 2007 should show significantly diminished service to LMI individuals. As noted by the Federal Reserve Board's Division of Research and Statistics, there "was a sharp contraction in 2007 in the willingness of lenders and investors to offer loans to higher-risk borrowers or, in some cases, to offer certain loan products that entailed features associated with elevated credit risk."[3] Unlike 2006, when banks generally reported unchanged credit standards on residential mortgage loans, the Fed's quarterly survey of bank lending practices for 2007 found that most banks tightened credit standards, particularly for nontraditional and subprime loans.[4]

Banks Reporting Tightening Credit Standards During the Prior Three Months

First-Lien Home Purchase Loan Applications

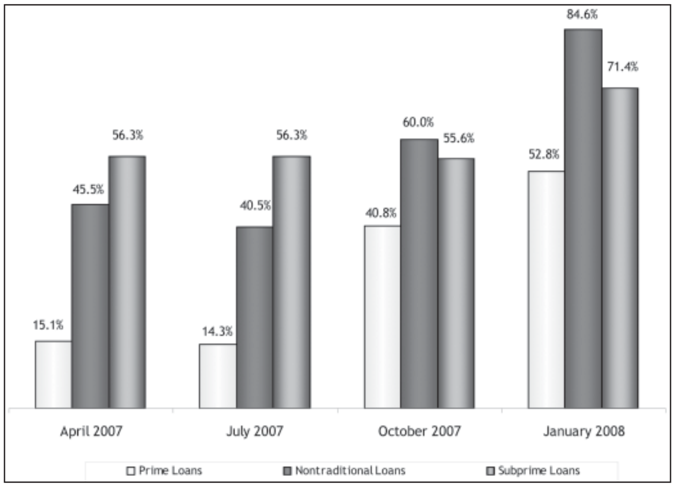

Figure 1

The Office of the Comptroller of the Currency also found that banks tightened their credit standards for mortgage loans in 2007.[5] Our own analysis, set forth in Appendix A, shows that in 2007 CRA-subject banks were nearly 32 percent more likely to deny an application reported without income information than in 2006. This suggests a greater scrutiny of applications for mortgage products sometimes referred to as "no-documentation," "low-documentation," or "stated income," which have been harshly criticized for resulting in loans which were unaffordable for their borrowers.[6] In addition, the overall increase in denial rate for those applications was 2.3 times greater than the increase in denial rate for applications with reported income information.

Far from demanding that banks comply with the CRA through flexible lending practices, in 2007 the federal banking regulators emphasized safe, sound, and transparent mortgage lending, focusing on restricting subprime and nontraditional products and on strengthening consumer protections.[7] As a result, any previous preferential or lenient treatment of LMI borrowers by CRA-subject banks should have disappeared in 2007. To put the matter bluntly, in our judgment lending to LMI individuals could have almost ground to a halt in 2007, and there would have been few protests from regulators.

Impact of Tightening Credit Standards on LMI Lending

To assess the effect of tightening credit standards on LMI mortgage lending by CRA-subject banks, we reviewed three relevant categories of HMDA data: (1) the origination rate for mortgage applications submitted by LMI individuals; (2) the proportion of CRA-subject bank mortgage loans made to LMI borrowers; and (3) the market share of LMI loans for CRA-subject banks.

Origination Rate

If, as critics allege, LMI mortgage applicants in prior years were judged by lax or negligent standards, the rate at which LMI applications were originated in 2007 should have significantly decreased. However, even with widespread tightening of credit standards in 2007, there was essentially no change in the origination rate by CRA-subject banks for LMI mortgage applications.

In the 15 MSAs reviewed, the rate at which CRA-subject banks originated home mortgage loan applications from LMI individuals was nearly the same in 2007 as in 2006. In the Boston, Houston, Los Angeles, New York, Philadelphia, and Seattle MSAs, the 2007 origination rate for LMI applicants was somewhat higher than in 2006.

Origination Rates for Home Mortgage Applications to CRA-Subject Banks from LMI Individuals

in 15 Most Populous MSAs

MSA	2006	2007	Percent Change
All MSAs	50.2%	49.9%	-0.6
Atlanta	50.0%	49.0%	-2.1
Boston	56.6%	57.3%	+1.3
Chicago	54.2%	52.0%	-4.1
Dallas	48.5%	48.1%	-0.9
Detroit	47.6%	45.9%	-3.6
Houston	45.2%	45.3%	+0.2
Los Angeles	44.7%	44.9%	+0.5
Miami	45.6%	41.8%	-8.2
New York	44.9%	46.7%	+3.9
Philadelphia	47.4%	48.7%	+2.7
Phoenix	52.4%	51.5%	-1.7
Riverside, CA	44.1%	44.1%	-0.1
San Francisco	57.7%	53.7%	-6.8
Seattle	58.3%	59.6%	+2.2
Washington, D.C.	55.7%	55.1%	-0.9

Figure 2

Significantly, while the origination rate for LMI mortgage applicants remained stable in 2007, the origination rate for middle- and upper-income (MUI) mortgage applicants fell 6.6 percent. In each of the 15 most populous MSAs, the origination rate for MUI applicants decreased by more than the rate for LMI applicants. This suggests that it was the underwriting standards for upper-income applicants that required tightening, not the standards for LMI applicants.

Change in Home Mortgage Origination Rates for CRA-Subject Banks

2006 to 2007 in 15 Most Populous MSAs

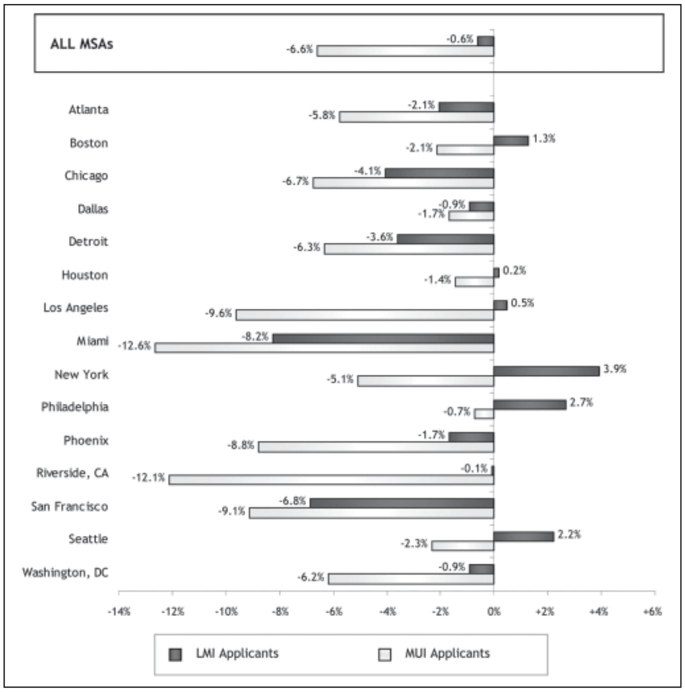

Figure 3

The contrast between the change in volume for LMI and MUI applications received and loans originated in 2006 and 2007 further undercuts the argument that lower underwriting standards for LMI borrowers caused the home mortgage crisis. Although the actual number of LMI mortgage originations by CRA-subject banks fell 8.2 percent in 2007, this was only half a percentage point more than the 7.7 percent decrease in LMI applications received. For MUI applicants, the difference between applications received and loans originated was nearly seven percentage points.

Change in Volume of Home Mortgage Applications Received and Originated by CRA-Subject Banks 2006 to 2007

Total of 15 Most Populous MSAs

Applicant/ Borrower Income	Applications	Originations	Percentage Point Difference
LMI	-7.7%	-8.2%	0.5
MUI	+2.2%	-4.5%	6.7

Figure 4

- **Proportion of all CRA-subject bank mortgage loans originated to LMI borrowers**

In spite of a lending environment characterized by more stringent credit standards, CRA-subject banks maintained their level of service to LMI individuals in 2007. The proportion of home mortgage loans made to LMI borrowers as a share of all CRA-subject bank lending was nearly the same in 2006 and 2007.

Home Mortgage Loans to LMI Borrowers as a Share of All CRA-Subject Bank Home Mortgage Lending

Total of 15 Most Populous MSAs

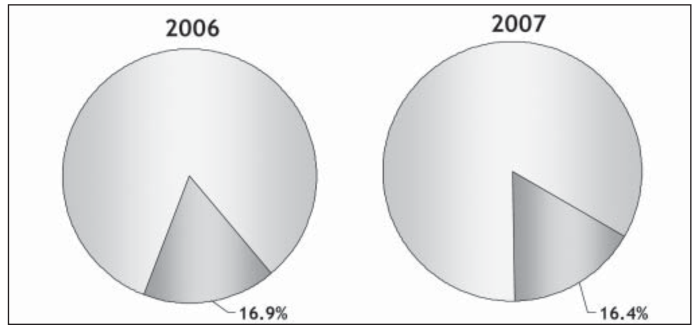

Figure 5

CRA-subject banks in the Los Angeles, Riverside, San Francisco, Seattle, and Washington, D.C. MSAs increased their shares of lending to LMI borrowers in 2007.

Home Mortgage Loans to LMI Borrowers as a Share of All CRA-Subject Bank Home Mortgage Lending

in 15 Most Populous MSAs

MSA	2006	2007	Percent Change
All MSAs	16.9%	16.4%	-3.0
Atlanta	27.5%	26.4%	-4.0
Boston	23.2%	22.2%	-4.3
Chicago	23.2%	21.5%	-7.3
Dallas	23.0%	20.8%	-10.0
Detroit	33.4%	31.4%	-6.0
Houston	20.4%	16.8%	-17.6
Los Angeles	3.7%	4.0%	+5.4
Miami	9.3%	7.9%	-15.1
New York	11.9%	11.3%	-5.0
Philadelphia	28.1%	27.1%	-3.6
Phoenix	16.3%	16.0%	-2.5
Riverside, CA	5.3%	6.9%	+30.2
San Francisco	8.2%	8.4%	+2.4
Seattle	15.5%	15.6%	+6.5
Washington, D.C.	23.2%	27.4%	+17.7

Figure 6

- **Market share of mortgage loans to LMI borrowers**

CRA-subject banks increased their market share of home mortgage originations to LMI borrowers by 30 percent in 2007. We suspect that the void created by non-bank lenders who ceased or curtailed their mortgage operations in 2007—and obviously not underwriting standards—was the primary reason for CRA-subject banks' increased market share of LMI loans. More importantly, the increase in CRA-subject bank market share indicates that even in a year when the federal banking regulators emphasized safety and soundness, CRA-subject banks were still able to fulfill their CRA obligation to lend to LMI individuals.

Market Share of Home Mortgage Loans to LMI Borrowers by CRA-Subject Bank Home Mortgage Lending

Total of 15 Most Populous MSAs

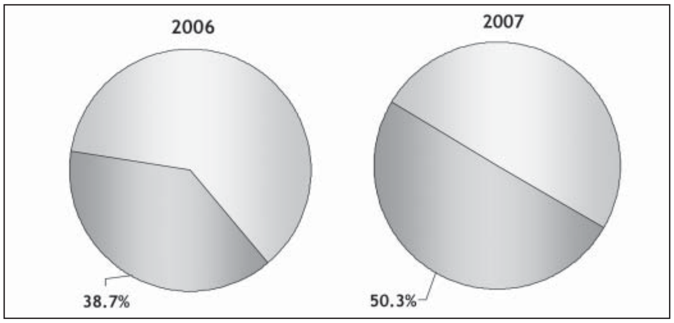

Figure 7

CRA-subject bank market share of LMI home mortgage loans increased in each of the 15 most populous MSAs.

Market Share of Home Mortgage Loans to LMI Borrowers by CRA-Subject Banks

in 15 Most Populous MSAs

MSA	2006	2007	Percent Increase
All MSAs	38.7%	50.3%	30.0
Atlanta	31.9%	44.4%	39.0
Boston	44.5%	56.6%	27.3
Chicago	45.1%	56.4%	25.0
Dallas	34.0%	48.7%	43.1
Detroit	32.6%	47.6%	45.9
Houston	33.4%	52.1%	56.3
Los Angeles	36.4%	46.6%	27.9
Miami	39.7%	51.0%	28.4
New York	44.1%	52.5%	19.1
Philadelphia	48.4%	50.7%	4.7
Phoenix	28.6%	42.2%	47.5
Riverside, CA	30.1%	43.6%	44.7
San Francisco	51.6%	62.7%	21.6
Seattle	38.9%	50.3%	29.4
Washington, D.C.	37.1%	48.7%	31.1

Figure 8

Conclusion

Critics of the CRA claim that the law compels banks to downgrade their credit standards in order to make mortgage loans to unqualified LMI borrowers. We hypothesized that if this was true, lending data from 2007, a time of tightened underwriting standards and regulatory emphasis on safety and soundness, would show significantly diminished lending to LMI borrowers by CRA-subject banks.

Instead, our analysis of 2007 data indicates that the percentage of LMI applications that were originated by CRA-subject banks remained stable even in the climate of heightened scrutiny and wariness that prevailed. This finding contradicts the notion that compliance with the CRA is dependent on imprudent lending. Thus, we conclude that the CRA cannot be rationally blamed for current problems in the mortgage market, much less for the U.S. financial crisis.

That CRA-subject banks continue to make mortgage loans to LMI borrowers while simultaneously strengthening their underwriting standards not only contradicts the claims of critics who blame the CRA for our present crisis, but also suggests that without the 32-year-old law, the home mortgage market might be in even worse condition. This suggestion is reinforced by our 2008 study, which showed CRA-subject banks were substantially less likely than other lenders to engage in the risky lending practices that helped fuel the foreclosure crisis. Moreover, a recent Federal Reserve Bank of San Francisco review of LMI lending found "the CRA, and particularly its emphasis on loans made within a lender's assessment area, helped to ensure responsible lending, even during a period of overall declines in underwriting standards."[8]

Finally, critics have chosen a particularly inauspicious time to attack the CRA. We are currently in the midst of a crisis that has Congress and the Executive Branch, including the Treasury Department and banking regulators, working to stimulate the economy and free-up credit. Right now, the CRA, a law that has spurred responsible lending to underserved borrowers, looks like a particularly wise and inspired piece of legislation. Indeed, policy makers should consider looking to the CRA for guidance on how the government can spur responsible lending to other qualified borrowers.

Endnotes

1. Traiger & Hinckley LLP, *The Community Reinvestment Act: A Welcome Anomaly in the Foreclosure Crisis*, Jan. 7, 2008, http://traigerlaw.com/publications/traiger_hinckley_llp_cra_foreclosure_study_1-7-08.pdf.
2. Peter J. Wallison, *What Got Us Here?*, Hudson New York, Dec. 9, 2008, (emphasis supplied), http://www.hudsonny.org/2008/12/what-got-us-here.php. Mr. Wallison is the Arthur F. Burns Fellow in Financial Policy Studies at the American Enterprise Institute and former General Counsel of the U.S. Treasury Department and Counsel to President Ronald Reagan.
3. Robert B. Avery *et al*., *The 2007 HMDA Data*, FED. RESERVE BULLETIN, Dec. 2008, http://www.federalreserve.gov/pubs/bulletin/2008/pdf/hmda07final.pdf at A108.
4. Federal Reserve Board, *Senior Loan Officer Opinion Survey on Bank Lending Practices* (2007), http://www.federalreserve.gov/boarddocs/snloansurvey/.
5. Office of the Comptroller of the Currency, *Survey of Credit Underwriting Practices 2008*, June 2008, http://www.occ.treas.gov/cusurvey/2008UnderwritingSurvey.pdf. Among the 62 largest national banks with approximately 83 percent of the total loans in the banking system, 56 percent tightened their underwriting standards for residential real estate loans during the year ended March 31, 2008, and none eased their standards.
6. *See, e.g.*, *Comments of the National Consumer Law Center and the National Association of Consumer Advocates to the Board of Governors of the Federal Reserve System Regarding the Board's Authority under HOEPA to Prohibit Unfair Acts or Practices in Connection with Mortgage Lending* (No. OP-1288) (Aug. 9, 2007), http://www.federalreserve.gov/SECRS/2007/August/20070816/OP-1288/OP-1288_52_1.pdf.
7. *See, e.g.,* Statement by Chairman Ben S. Bernanke on proposed changes to Regulation Z, (Dec. 18, 2007): "[M]arket discipline has in some cases broken down and the incentives to follow prudent lending procedures have, at times, eroded. The consequences, as we are currently seeing, can include the proliferation of unfair and deceptive practices that can be devastating to consumers and to communities." *Available at* http://www.federalreserve.gov/newsevents/press/bcreg/bernankehoepa20071218.htm; and Joint Press Release, Fed. Fin. Regulatory Agencies Issue Final Statement on Subprime Mortgage Lending, (June 29, 2007): "The statement describes the prudent safety and soundness and consumer protection standards that institutions should follow to ensure borrowers obtain loans they can afford to repay." *Available at* http://www.federalreserve.gov/newsevents/press/bcreg/20070629a.htm.
8. Elizabeth Laderman & Carolina Reid, *Lending in Low- and Moderate-Income Neighborhoods in California: The Performance of CRA Lending During the Subprime Meltdown*, (Fed. Reserve Bank of San Francisco, Working Paper No. 2008-05, Nov. 2008), *available at* http://www.frbsf.org/publications/community/wpapers/2008/wp08-05.pdf.

Warren W. Traiger is a partner at Traiger & Hinckley LLP in New York City. Since 1990, attorneys at Traiger & Hinckley LLP have counseled a wide range of banks on the Community Reinvestment Act. Warren Traiger has testified before Congress and the federal banking agencies on fair lending and CRA reform and served as Special Counsel for CRA for the New York Banking Department. He and his colleague Joseph Calluori argued before the U.S. Court of Appeals for the Second Circuit in *Lee v. Board of Governors*, a benchmark case that helped define the rights of community organizations to challenge Federal Reserve Board determinations on merger applications.

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Denial Rates for Applications Without Income Information

Under HMDA, a mortgage lender reports the gross annual income relied upon in evaluating an applicant's creditworthiness. However, no income is reported if the lender does not take income into account when underwriting a mortgage application.[1]

In 2007, CRA-subject banks were nearly 32 percent more likely to deny an application reported without income than in 2006.

CRA-Subject Bank Denial Rates for Home Mortgage Applications Without Income Information
in 15 Most Populous MSAs

MSA	2006	2007	Percent Increase
All MSAs	18.0%	23.8%	31.9
Atlanta	18.0%	20.3%	12.8
Boston	17.7%	23.2%	31.2
Chicago	15.2%	20.2%	33.1
Dallas	15.4%	18.5%	19.8
Detroit	22.2%	26.1%	17.8
Houston	20.2%	24.4%	20.6
Los Angeles	18.6%	24.2%	29.8
Miami	18.0%	26.2%	45.3
New York	22.4%	28.8%	28.5
Philadelphia	18.8%	19.5%	4.1
Phoenix	17.9%	24.4%	36.8
Riverside, CA	19.1%	27.6%	44.4
San Francisco	16.7%	23.5%	40.8
Seattle	15.0%	16.6%	10.8
Washington, D.C.	13.7%	21.9%	60.4

Figure 9

In addition, the overall increase in denial rates for applications without income information was 2.3 times as great as the increase for applications with income information.

Percent Change in Denial Rate of 1-4 Family Applications With and Without Income Information for CRA-Subject Banks
2006 to 2007 in 15 Most Populous MSAs

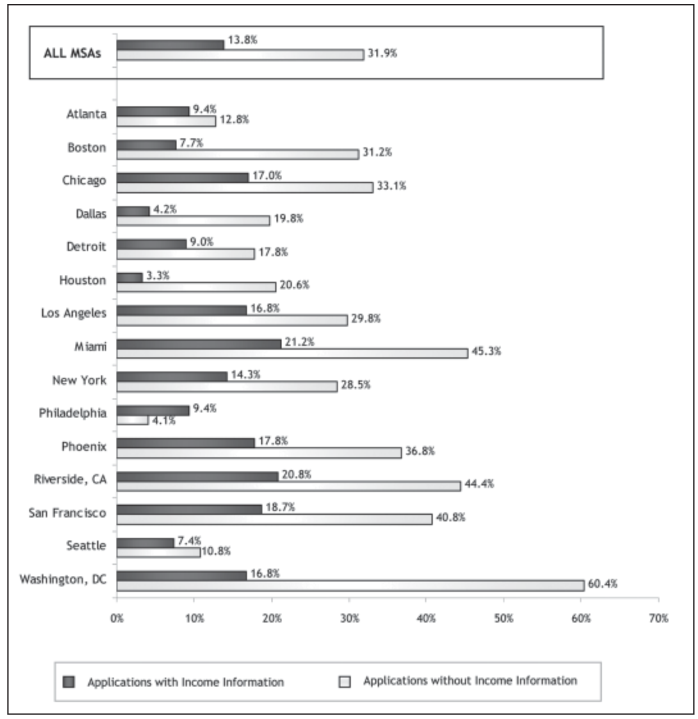


Figure 10

Endnote

1. Income also need not be reported for loan purchases, loans to employees of the lender, applicants that are not natural persons, and multifamily properties. Our analyses do not include loan purchases, and this part of our analysis excludes multifamily properties. We believe the other categories are a very small part of the total.

Appendix B

Methodology

This study examined HMDA-reported loan applications submitted to FDIC-insured banks (CRA-subject banks) in 2006 and 2007 in the 15 most populous MSAs according to the U.S. Census Bureau as of July 1, 2007. For each MSA, Federal Financial Institutions Examination Council data were obtained on each HMDA-reported application and HMDA-reporting institution.

Definitions

- **Applications Without Income Information—** Applications for which the applicant's income was not reported by the lender because it was not asked for or relied upon by the lender, the property is a multifamily dwelling, the applicant was not a natural person, or the loan was to an employee and the lender wished to protect the employee's privacy. In this study, figures for applications without income information remove applications submitted on multifamily dwellings in order to more closely approximate those applications where income information was not asked for or relied on by the lender.
- **Denial Rate—**The percentage of applications denied.
- **Loan—**A HMDA-reported loan origination.
- **Low- and Moderate-Income (LMI) Applicants or Borrowers—**Applicants or borrowers whose income is less than 80 percent of the Area Median Income. For applicants or borrowers located in an MSA, the Area Median Income is the median family income for the MSA.
- **Middle- and Upper-Income (MUI) Applicants or Borrowers—**Applicants or borrowers whose income is at least 80 percent of the Area Median Income. For applicants or borrowers located in an MSA, the Area Median Income is the median family income for the MSA.
- **Origination Rate—**The percentage of applications originated.
- **Subprime Loans—**Loan originations designated by HMDA as having rate spreads because their Annual Percentage Rates (APRs) were higher than the yields on comparable maturity Treasury securities by at least three percentage points for first-lien loans and at least five percentage points for junior-lien loans.

Notes

1. Calculations for "All MSAs" combine figures for the 15 most populous MSAs, effectively causing MSAs with more loans to have greater weight.
2. The term "application" as used in this report refers to submitted applications and consists of applications originated, approved by the lender but not accepted by the applicant, denied by the lender, withdrawn by the applicant, or submitted incomplete by the applicant. It excludes purchased loans and preapprovals.
3. A lender was deemed to be a "bank" if its Agency Code was 1, 2, 3, or 4, indicating it is regulated by the Federal Deposit Institution Corporation, Office of the Comptroller of the Currency, Federal Reserve System, or Office of Thrift Supervision and its Other Lender Code was "0."

Descriptions of the 15 Most Populous MSAs

The following counties and/or cities comprise each of the 15 most populous MSAs reviewed:

1. **Atlanta: MSA 12060 Atlanta-Sandy Springs-Marietta, GA—**Barrow, Bartow, Butts, Carroll, Cherokee, Clayton, Cobb, Coweta, Dawson, DeKalb, Douglas, Fayette, Forsyth, Fulton, Gwinnett, Haralson, Heard, Henry, Jasper, Lamar, Meriwether, Newton, Paulding, Pickens, Pike, Rockdale, Spalding, and Walton counties in Georgia.
2. **Boston: MSA 14460 Boston-Cambridge-Quincy, MA-NH—**Essex, Middlesex, Norfolk, Plymouth, and Suffolk counties in Massachusetts; Rockingham and Strafford counties in New Hampshire.
3. **Chicago: MSA 16980 Chicago-Naperville-Joliet, IL-IN-WI—**Cook, DeKalb, DuPage, Grundy, Kane, Kendall, Lake, McHenry, and Will counties in Illinois; Jasper, Lake, Newton, and Porter counties in Indiana; Kenosha County in Wisconsin.
4. **Dallas: MSA 19100 Dallas-Fort Worth-Arlington, TX—**Collin, Dallas, Delta, Denton, Ellis, Hunt, Johnson, Kaufman, Parker, Rockwall, Tarrant, and Wise counties in Texas.
5. **Detroit: MSA 19820 Detroit-Warren-Livonia, MI—**Lapeer, Livingston, Macomb, Oakland, St. Clair, and Wayne counties in Michigan.

6. **Houston: MSA 26420 Houston-Baytown-Sugar Land, TX—**Austin, Brazoria, Chambers, Fort Bend, Galveston, Harris, Liberty, Montgomery, San Jacinto, and Waller counties in Texas.

7. **Los Angeles: MSA 31100 Los Angeles-Long Beach-Santa Ana, CA—**Los Angeles and Orange counties in California.

8. **Miami: MSA 33100 Miami-Fort Lauderdale-Miami Beach, FL—**Broward, Miami-Dade, and Palm Beach counties in Florida.

9. **New York: MSA 35620 New York-Northern New Jersey-Long Island, NY-NJ-PA—**Bronx, Kings, Nassau, New York, Putnam, Queens, Richmond, Rockland, Suffolk, and Westchester counties in New York; Bergen, Essex, Hudson, Hunterdon, Middlesex, Monmouth, Ocean, Somerset, Union, and Passaic counties in New Jersey; Pike County in Pennsylvania.

10. **Philadelphia: MSA 37980 Philadelphia-Camden-Wilmington, PA-NJ-DE-MD—**Bucks, Chester, Delaware, Montgomery, and Philadelphia counties in Pennsylvania; Burlington, Camden, Gloucester, and Salem counties in New Jersey; New Castle County in Delaware; Cecil County in Maryland.

11. **Phoenix: MSA 38060 Phoenix-Mesa-Scottsdale, AZ—**Maricopa and Pinal counties in Arizona.

12. **Riverside, CA: MSA 40140 Riverside-San Bernardino-Ontario, CA—**Riverside and San Bernardino counties in California.

13. **San Francisco: MSA 41860 San Francisco-Oakland-Fremont, CA—**Alameda, Contra Costa, Marin, San Francisco, and San Mateo counties in California.

14. **Seattle: MSA 42660 Seattle-Tacoma-Bellevue, WA—**King, Pierce, and Snohomish counties in Washington.

15. **Washington, DC: MSA 47900 Washington-Arlington-Alexandria, DC-VA-MD-WV—**District of Columbia; Clarke, Fairfax, Fauquier, Loudoun, Prince William, Spotsylvania, Stafford, and Warren counties and Alexandria, Fairfax, Falls Church, Fredericksburg, Manassas, and Manassas Park cities in Virginia; Calvert, Charles, Frederick, Montgomery, and Prince George's counties in Maryland; Jefferson County in West Virginia.

The Coming Transition from U.S. GAAP to IFRS: Implications for Attorneys

By Barry Jay Epstein, Ph.D., CPA and Susan Cheng, CPA, CA, CFA, CFE

Background

Following a unanimous vote in August 2008, the Securities and Exchange Commission (SEC) recently published for public comment a proposed Roadmap on the potential future mandatory use, by all U.S. issuers, of International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB). This Roadmap sets forth seven milestones which, if achieved, could lead to having U.S. issuers filing with the SEC financial statements prepared in accordance with IFRS, beginning as soon as 2014. Currently, we are at the end of the 90-day comment period, with all public comments having been due back to the SEC no later than February 19, 2009. This latest development followed an earlier final rule release, a little more than a year ago, in December, 2007, whereby the SEC allowed foreign private issuers (FPIs) in the U.S. to file financial statements without reconciliation to U.S. Generally Accepted Accounting Principles (GAAP) if those financial statements were prepared using IFRS as issued by the IASB.

While it is still not yet a total certainty that U.S. domestic issuers will be required to use IFRS, the mere fact that this is under active consideration is a positive step in the ongoing movement toward alignment of U.S. and international accounting standards. The fact that former SEC Chairman Christopher Cox publicly hailed that "an international language of disclosure and transparency is a goal worth pursuing on behalf of investors who seek comparable financial information to make well-informed investment decisions" clearly signals the SEC's desire to bring about an end to the era of multiple sets of financial reporting regimes, making enactment of this change highly probable.

The anointing of IFRS as the global standard for accounting and financial reporting, for publicly held and private companies alike, seems to be only a matter of time—and a brief time, at that. This all-but-inevitable outcome was ordained when FPIs were given the unfettered right to report under IFRS, making it politically problematic (if not actually impossible) to deny this same right to U.S.-based registrants.

Separately, since 2002 the primary U.S. accounting standard-setter, FASB, has been engaged in a "convergence" effort with IASB. As a result, a number of older standards were revised, and several new standards were promulgated, mostly to conform to IFRS (although a few older IFRS have been modified to embrace U.S. GAAP). In other words, whether IFRS are formally acknowledged or not, U.S. GAAP are in the process of becoming indistinguishable from IFRS.

It is often claimed (including by the IASB) that adoption of IFRS-based reporting would reduce preparers' cost of capital. Widely cited theoretical arguments based on well-accepted economic and financial postulates credit the anticipated effects of reduced estimation risk of future returns on investments, decreased transaction costs, and mitigated information asymmetries between management and external investors, while logical arguments focus on greater transparency in financial reporting. Despite academicians' actual research yielding mixed findings regarding these claimed benefits, neither theoretical arguments nor research results have cited any downside risk to adopting IFRS, other than the short-term cost of implementing the new requirements.

In any event, the trend is irreversible, with over 100 countries, including the 27 members of the European Union, now requiring or permitting the use of IFRS (some for all companies, others only for publicly traded ones), and with major nations such as Canada, Japan, China, and Russia all committed to implementing IFRS within a few years. On a more local level, bilateral trade between New York State and Canada amounts to some $35 billion annually—and almost 470,000 New York jobs depend on that trade—underscoring the need for New York-based businesses to continue to communicate freely and effectively with their Canadian partners.

Major reasons cited for the U.S. to adopt IFRS are to open up U.S. capital markets, to remove barriers to raising capital anywhere in the world, to lower transaction costs, and to facilitate business on a global scale. The fear of losing listings to London or other exchanges (which would exacerbate the already experienced loss of some listings, allegedly due to the cost of Sarbanes-Oxley compliance) has encouraged the financial services sector to line up solidly behind IFRS adoption. As with any major change, unexpected impediments are sure to be encountered beyond the already well-anticipated costs of modifying accounting systems, training staff, and increasing audit time and cost.

While the expected permission to make this transition to IFRS-based financial reporting is great news for U.S.-listed companies seeking reporting parity with foreign peers and competitors, this shift may create potential ramifications, including increased litigation and greater challenges in structuring the terms of business transactions. For those U.S.-based attorneys who are conversant with IFRS—currently only a relative handful—those challenges could indeed present them with opportunities.

In the following paragraphs, certain of these matters are addressed.

Attorney IFRS Readiness

Given what has unfolded to date, and what seems likely to follow, attorneys clearly have a need to be trained in this new accounting "language," in order to effectively assist their clients in the transition. As accounting standards impact all aspects of a client's business, attorneys need to be aware of the changes IFRS bring, and how those changes may affect their clients. For instance, while U.S. GAAP has traditionally been the accounting standard to invoke in many contractual arrangements, with the wide respect that IFRS has gained over the past ten years, it is no longer a foregone conclusion that U.S. GAAP will be the only—or even the primary—standard to follow. With IFRS now mandated or permitted by over 100 nations (and even the U.S. GAAP-look-alike Canadian GAAP is being scheduled for replacement by IFRS in 2011 for publicly accountable profit-oriented enterprises (PAEs)), it is clear that, in the immediate future, international business arrangements will need to be largely or exclusively measured and reported under IFRS. It is therefore highly likely that future contractual and other legal instruments will stipulate IFRS as the accounting standard to which the parties will adhere.

Implications for Transactional Attorneys

Transactional lawyers, who play a key advisory role in structuring contractual relationships with foreign-based entities on behalf of their clients, will benefit from increased knowledge about international legal and financial reporting issues. Oftentimes, the risks and rewards of the contracts—such as those governing joint ventures or earn-outs associated with business acquisitions—are closely linked to the counterparties' reported financial performance. Lack of familiarity with accounting principles may affect one party's judgments regarding the other's financial position and/or recent results of operations, and consequently hinder initial and continuing decisions to engage in such routine relationships as those between vendor and customer, and between lessee and lessor. The impact will be even more pronounced if U.S. entities are investees or joint venturers with foreign-based enterprises and reporting "upstream" on an IFRS basis is suddenly mandated. Converting to a new financial reporting basis could impose a range of burdens and could have deleterious effects on these relationships, with possibly major economic consequences for attorneys' commercial clients.

U.S. lawyers should, accordingly, seek to quickly develop a more in-depth understanding of the differences between current U.S. GAAP and IFRS in order to better service corporate clients. If their U.S. business clients are, or become, subsidiaries or investees of foreign companies, there will be an immediate demand for them to produce IFRS-basis financial statements to upstream to their parent or investor entities—a marked change from the recent past, when many of these foreign parent entities were quite willing to accept U.S. GAAP-based financial reporting packages, performing conversion duties, if at all, at the parent company level. For large international law and accounting firms, accommodating these new demands will not prove a major problem, because resources for such undertakings doubtless already exist. For other advisors, there may be a need to establish relationships with technical experts from the law firms' regular accounting firms, other consultancies, or university faculties, which are rapidly becoming attuned to the demand for IFRS expertise.

Based on gaining an understanding of the still substantial differences between U.S. GAAP and IFRS, various business and legal strategies may present themselves, in an effort to mitigate or isolate the risks of having changing GAAP affect contractual compliance. One example of such a strategy is to include what is sometimes referred to as a "frozen GAAP" contractual provision, where the accounting principles employed at the inception of the relationship are preserved, for measurement purposes, throughout the term of the arrangement. In the authors' experience, this has been most successfully invoked within a GAAP regime (e.g., within U.S. GAAP, for instance, by keeping goodwill amortization in place even in the face of new standards that eliminated amortization in favor of impairment testing).

Superimposing a "frozen GAAP" provision on the rapidly changing landscape of international financial reporting may be more challenging to achieve, however. Given the wholesale changes that would have to be made if IFRS supersedes U.S. GAAP, the need to maintain two sets of books and records may prove impractical, and even if possible, could pose potential litigation risks. Attorneys who possess an enhanced understanding of IFRS are therefore better equipped to proactively educate—and to add value for—their existing clients, as well as to more effectively market their capabilities to prospective clients. Counsel, together with accounting advisors, might offer prospective clients various aids (such as "accounting convergence checklists") to further assist them in making this transition process. In the authors' opinion, this would be more effective, and better provide for long-term client satisfaction, than would fighting a "rear-guard" action to preserve the remnants of U.S. GAAP compliance in the face of growing internationalization of financial reporting standards.

Opportunities for U.S. Securities Lawyers

Having the SEC's former reconciliation requirement waived (to the extent foreign private issuers file financial statements that fully comply with IFRS) provides potential opportunities for domestic law firms as well. From the perspective of foreign registrants, this move will reduce compliance costs, improve efficiencies, and most importantly, facilitate cross-border capital formation. Improving access to the U.S. capital markets by eliminating reconciliation may result in some lost business for accounting firms, but (if basic economic theory holds true) this should also result in expanded business opportunities for both law and accounting firms. U.S.-based securities lawyers may be called upon to advise an expanded number of foreign would-be registrants in completing their securities offerings in U.S. capital markets. Additionally, some FPIs that now have the option of filing under IFRS may wish to consult with U.S. securities counsel to determine if it is in their best interest to do so under current U.S. securities laws.

Potential Litigation Risks

Clearly, any changes to reporting standards (even routine changes to U.S. GAAP) can engender disputes that may evolve into contractual or securities litigation. Notwithstanding the significant convergence that has already occurred, substantial differences between U.S. GAAP and IFRS do still remain. A change from U.S. GAAP to IFRS reporting standards would create—in the near term, at least—greater risk of misunderstandings, and of improper application of unfamiliar rules by preparers and even by auditors. Thus, the change could exacerbate already serious litigation risks, where investors or other users of financial statements claim to have suffered harm flowing from reliance on improperly prepared or inadequately explained financial reports. In the authors' opinion, based on extensive experience with securities litigation, the expanded use of IFRS-based reporting will, for some period of time, create expanded litigation risk, which has long been disproportionately a U.S. phenomenon. Therefore, having an awareness that these risks exist should stimulate the exercise of greater care and caution, which hopefully would, to a degree, ameliorate the dangers.

Are There Governance Implications for the Board and/or Audit Committee?

Corporate directors—and in particular, audit committee members—need to be mindful in the selection and application of financial reporting standards. Specifically, the risks of "opportunistic behavior" by management, or "accounting principles shopping" in choosing between U.S. GAAP or IFRS adoption, in order to affect key financial ratios and other performance measures, potentially affecting bonus awards and option grants, may demand greater board scrutiny. Directors, together with any legal or accounting counsel, must gain comfort with management's choices, both as to the propriety and appropriateness of the actual accounting standards selected, and also as to the internal control implications of making those choices. Furthermore, they should anticipate, and in fact insist upon, greater scrutiny of these management decisions by the reporting entity's outside auditors. This is another area where audit committee consultation with special counsel or independent accountants—the engagement of which is explicitly authorized under the Sarbanes-Oxley Act (§ 301)—may be particularly warranted, for both substantive and defensive reasons.

Concluding Thoughts

The next few years will be a time of challenges and opportunities—with major changes in financial reporting regimes, particularly in the U.S., being extremely likely to occur. Securities lawyers, transactional attorneys, and outside corporate counsel, supported by accounting experts, can provide valuable services to their clients. Litigation counsel will be faced with complex but significant opportunities to assist securities litigation plaintiffs and companies sort through the changing financial reporting landscape. Constructing a good foundation of IFRS competence, including an understanding about how the new reporting regime may affect preparers, auditors and users of financial statements and the various contractual and other arrangements based thereon, should be seen as a priority activity for each of these groups of practicing attorneys.

Barry Jay Epstein, Ph.D., CPA (BEpstein@RNCO.com) is Partner in the Chicago, Illinois firm of Russell Novak & Company, LLP, where his practice is concentrated on technical consultations on GAAP and IFRS, and as a consulting and testifying expert on civil and white collar criminal litigation matters. Dr. Epstein is the co-author of *Wiley GAAP 09*, *Wiley IFRS 08*, *Wiley IFRS Policies and Procedures*, and other books. Susan Cheng is a senior manager with Russell Novak & Company, LLP, focusing on international accounting matters, litigation consulting, and forensic accounting.

Ethical Issues for Business Lawyers

Lawyer-Directors: Just a Bad Idea

By C. Evan Stewart

One of the biggest country hits of 1978 was "Mamas, Don't Let Your Babies Grow Up to Be Cowboys."[1] Substitute "Lawyers" for "Babies" and "Directors" for "Cowboys," and you will get the theme of this article.

Is It Ethical?

First off, and as Richard Nixon used to say, let me make one thing perfectly clear: It is not unethical for lawyers to serve as directors of public companies. Indeed, it is not necessarily unethical for a lawyer to serve as a director of a corporation which is also a client. ABA Model Rule 1.7(a)(2) sets forth the guiding principle: a lawyer runs afoul of her ethical obligations if "there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client." Comment 35 to that Rule more specifically addresses the lawyer/director/two-hats issue:

> A lawyer for a corporation or other organization who is also a member of its board of directors should determine whether the responsibilities of the two roles may conflict. The lawyer may be called on to advise the corporation in matters involving actions of the directors. Consideration should be given to the frequency with which such situations may arise, the potential intensity of the conflict, the effect of the lawyer's resignation from the board and the possibility of the corporation's obtaining legal advice from another lawyer in such situations. If there is material risk that the dual role will compromise the lawyer's independence of professional judgment, the lawyer should not serve as a director or should cease to act as the corporation's lawyer when conflicts of interest arise. The lawyer should advise the other members of the board that in some circumstances matters discussed at a board meeting while the lawyer is present in the capacity of director might not be protected by the attorney-client privilege and that conflict of interest considerations might require the lawyer's recusal as a director or might require the lawyer and the lawyer's firm to decline representation of the corporation in a matter.

In 1998, the ABA went further in providing guidance with ABA Formal Ethics Opinions 98-410.[2] The opinion answered "yes" to the "may lawyers serve as directors of corporate clients" question, subject to a number of caveats. The key ones are that a lawyer seeking to wear two hats should: (i) sufficiently inform management and the board about his or her dual roles; (ii) make clear that he or she will be required to recuse him or herself when faced with a conflict of interest (e.g., choosing outside counsel on a matter); and (iii) recognize there may be circumstances in which he or she should decline to act in his or her role as counsel (e.g., where there may be potential liability arising out of a board decision).

Later that same year an ABA task force went further.[3] While recognizing there "is no *per se* rule of professional ethics that prohibits any lawyer—inside or outside—for a corporation or other organization from also serving on its board of directors," the task force sought to discourage the practice because "the risks may prove to be significant in certain circumstances" (e.g., potential waiver of the attorney-client privilege, the creation of conflicts of interest, possible coverage gaps at the intersection of malpractice insurance and corporate D&O policies, undermining the lawyer's professional independence, exposing lawyers to increased liability risks).[4]

But Is It Smart?

The first danger identified by the ABA—waiver of the privilege—is a real one. Numerous courts have held that, because a lawyer/director has fiduciary duties to the shareholders, there would be no privilege as to certain communications between the lawyer's firm and the corporation.[5] Attempting to navigate through these dangerous shoals by erecting information barriers has not proved uniformly successful.[6] And beyond this issue is the related concern that a lawyer's legal duties may be in conflict with his or her director duties and thus create some unfortunate (and unforeseeable) consequences.[7] The insurance coverage issue is also no academic matter, as the WorldCom directors (which included outside legal talent) discovered, much to their individual financial detriment.[8]

As if the foregoing were not enough to dissuade lawyers, one would think that greater exposure to increased liability would close the deal. As it is, directors' legal and regulatory exposure has been ratcheted up tremendously over the past decade (and more).[9] And even before that it was clear that lawyers who serve as directors do so with a bulls-eye on their chests—i.e., lawyers are held to a higher standard of care.[10]

The first real jurisprudence on heightened lawyer liability came in *Escott v. BarChris Construction Corp.*[11] Analyzing whether a lawyer-director (who also was an outside lawyer to the company) could successfully assert the due diligence defense under Section 11(b) of the Securities Act of 1933, the court accepted the individual's representations that he was not aware of any material problems in the company's prospectus. The court nonetheless found that there were certain matters of which someone of the lawyers' expertise and experience should have been aware, which constituted clear red flags or were at least discoverable upon a non-audit like investigation (e.g., overstatement of the value of contracts, loans to the corporation by its officers). As such, the lawyer-director was held liable for his failure(s) to act.[12]

Several years later this liability trap was further "clarified" in *Feit v. Leasco Data Processing Equipment Corp.*[13] Once again the legal issue was what met the due diligence defense safe harbor for purpose of Section 11(b). As a broad principle, the court opined:

> What constitutes "reasonable investigation" and a "reasonable ground to believe" will vary with the degree of involvement of the individual, his experience, and his access to the pertinent information and data. What is reasonable for one director may not be reasonable for another by virtue of their differing positions. . . . Inside directors with intimate knowledge of corporate affairs and of the particular transactions will be expected to make a more complete investigation and have more extensive knowledge of facts supporting or contradicting inclusions in the Registration statements than outside directors. . . . Each must undertake that investigation which a reasonably prudent man in that position would conduct.[14]

Applying that standard to the lawyer-director in the hot seat, the court held that his responsibility came near to being a "guarantor of accuracy" for the securities filing.[15] Subsequent courts have followed the *BarChris* and *Feit* courts as to lawyer-directors' higher standards to uncover fraud or wrongdoing.[16] Other related liability hooks include lawyer-directors being held to be "controlling persons" under Section 20 of the Securities Exchange Act of 1934,[17] as well as a law firm being held to have fiduciary obligations to corporate shareholders by dint of one of its partners serving on the corporation's board of directors.[18]

Conclusion

Notwithstanding the many obvious downsides mentioned above, a number of lawyers still clamor for the honor and glory of being a corporate director.[19] This seems to stem from some notion that we lawyers may in fact be smarter than our business clients, that we really are "the best and the brightest," etc.[20] Unfortunately, that sort of hubris shows how really smart people can be really dumb sometimes.[21] On this subject, perhaps lawyers should just remember (and act upon) Mom's advice!

Endnotes

1. This song, by Waylon Jennings and Willie Nelson, spent four weeks at No. 1 on Billboard's Hot Country Singles chart (replacing *Don't Break the Heart That Loves You*, by Margo Smith, and being replaced by *Ready for the Times to Get Better* by Crystal Gayle). Jennings and Nelson won a Grammy award for the song (Best Country Vocal Performance by a Duo or Group).
2. *See* 14 Law. Man. Prof. Conduct 105 (1998). For other Bar authorities offering guidance for lawyers serving on clients' board of directors, *see also* Oregon Ethics Op. 1991-91 (1991), New York State Ethics Op. 589 (1988), Maryland Ethics Op. 87-29 (1987), Illinois Ethics Op. 86-14 (1987) and New Hampshire Ethics Op. (7A) (1982). For a view that the "two hats" should never be worn, *see* Albert, *The Lawyer-Director: An Oxymoron?*, 9 Geo. J. Legal Ethics 413 (1996); Mundheim, *Code of Professional Responsibility Forbids Lawyers to Serve on Boards of Corporations for Which They Act as Counsel*, 33 Bus. Law. 1507 (1978). For the contrary view, *see* Straub, *ABA Task Force Misses the Mark: Attorneys Should Not Be Discouraged from Serving on Their Corporate Clients' Board of Directors*, 25 Del. J. Corp. L. 261 (2000).
3. *See* 14 Law. Man. Prof. Conduct 183 (1998).
4. The American Law Institute has issued an advisory opinion similar to that of the ABA's task force. *See* Restatement of the Law Governing Lawyers § 135 cmt. d (2000).
5. *See, e.g.*, *AOC Ltd. Partnership v. Horsham Corp.*, 1992 Del. Ch. LEXIS (Del. Ch. 1992); *Deutsch v. Logan*, 580 A.2d 100 (Del. Ch. 1990); *Securities and Exchange Commission v. Gulf & Western Ind., Inc.*, 518 F. Supp. 675 (D.D.C. 1981); *Valente v. PepsiCo, Inc.*, 68 F.R.D. 361 (D. Del. 1975); *U.S. v. Vehicular Parking Ltd.*, 52 F. Supp. 749 (D. Del. 1949). Some of the issues inherent in this area are highlighted by the ongoing criminal and civil litigations involving AIG. In one manifestation, two former senior AIG officers and directors under indictment (who also have civil disputes with their former company) were allowed by the Appellate Division, First Department, to inspect privileged legal memoranda that were prepared for AIG during their tenure on the board of directors. *See Indicted Directors Entitled to See Legal Memos, New York Court Rules*, BNA Securities Regulation & Law Report 327 (March 3, 2008).
6. *See, e.g.*, *American Steamship Owners Mutual Protection & Indemnity Association, Inc. v. Alcoa Steamship Co.*, 232 F.R.D. 191 (S.D.N.Y. 2005). Corporate boards relying instead on the so-called "self-evaluation" privilege to protect communications should be skeptical (at best). *See Beam v. Martha Stewart*, 845 A.2d 1040 (Del. Sup. Ct. 2004). *See also* C. E. Stewart, *Self-Critical Analysis: An Emerging Privilege?* N.Y.L.J. (December 17, 1992).
7. *See, e.g.,* Ohio Supreme Court Bd. of Commissioners on Grievances and Discipline, Op. 2008-2 (June 6, 2008) (lawyer's service as a director bars lawyer's firm from suing corporation); *FDIC v. Mmahat*, 907 F.2d 546 (5th Cor. 1990) (lawyer/director held to have improperly urged board members to approve "risky" loans in order to generate fees for his law firm); *Harrison v. Keystones Coca-Cola Bottling Co.*, 428 F. Supp. 149 (M.D. Pa. 1977) (lawyer/director

disqualified because he was a co-defendant with the corporation); *Cottonwood Estates Inc. v. Paradise Builders Inc.*, 624 P.2d 296 (Ariz. 1981) (lawyer disqualified from representing corporation where he had to testify as to board actions). One company recently solved the conflict issue by firing the law firm and keeping the lawyer on as a director. *See* A. Efrati, *Showdowns Highlight Lawyers-as-Directors Risks*, (June 7, 2007) (reported on WSJ.com on law and business and the business of law).

8. *See* Morgenson, *10 Ex-Directors From WorldCom to Pay Millions Using Their Own Money: Rare Sort of Concession Is Made in Settlement of Investor Lawsuit*, N.Y. Times, Jan. 6, 2005 at A1. *See also FSLIC v. Mmahat*, 1988 U.S. Dist. LEXIS 7136 (E.D. La. Jun. 29 1988), *aff'd sub nom. FDIC v. Mmahat*, 907 F.2d 546 (5th Cir. 1990) (jury found that neither a lawyer-director of failed savings and loan, nor his law firm, was covered by malpractice insurance or the D&O policy); *Continental Casualty Co. v. Smith*, 2003 U.S. Dist. LEXIS 50 (E.D. La. Jan. 2, 2003) (malpractice insurance did not cover lawyer-director). *See generally* Metzger & Chunias, *Two Years After Sarbanes-Oxley: Assessing the Impact on D&O Liability Insurance*, 37 Sec. & Com. Reg. 99 (May 25, 2004); Rosenberg, Sigelko, Chaskin, Posner & McGhee, *Negotiating D&O Policies: Key Terms and Conditions*, 37 Sec. & Com. Reg. 31 (Feb. 25, 2004).

9. *See* C. E. Stewart, *The Yin & Yang of Corporate Governance*, N.Y.L.J. (Oct. 11, 2005); R. C. Saver, *The Changing Dimensions of Director Liability Under the Federal Securities Laws,* BNA Securities Regulation & Law Report 413 (Mar. 7, 2005); L. N. Silverman & S. L. Fisher, *Director Due Diligence After WorldCom,* 39 Sec. & Com. Reg. 1 (Jan. 18, 2006); *see also* White, *Blame for Scandals Entering the Board Room*, Washington Post, at E1 (Jan. 7, 2005) ("What was once a gilded position offering hefty compensation for minimal work is becoming a more challenging job fraught with the risk of significant financial liability.").

10. This recalls the *Far Side* cartoon by Gary Larson in which two deer are conversing in the woods. One deer with a normal coat of fur says to the other deer, which has a large bulls-eye emblazoned on its chest, "Bummer of a birthmark, Hal."

11. 283 F. Supp. 643 (S.D.N.Y. 1968).

12. *Id.* at 690.

13. 332 F. Supp. 544 (E.D.N.Y. 1971).

14. *Id.* at 578.

15. In most instances, lawyer-directors wearing two hats will be deemed to be "inside" directors. *See Feit*, *supra*, 332 F. Supp. at 575–76, 578. In some limited circumstances, however, lawyers have evaded that bulls-eye. *See Counsel to Fund's Independent Directors May Also Serve as Disinterested Director,* BNA Corporate Counsel Weekly 147 (May 8, 2002).

16. *See, e.g., Blakely v. Lisae* 357 F. Supp. 255 (D. Ore. 1972). A similar analysis has been used to hold directors with "specialized financial expertise" to a higher standard. *See In re Lernout & Hauspie Sec. Litig.*, 286 B.R. 33 (D. Mass. 2002); *In re Emerging Communications Inc. Shareholders Litig.*, 2004 Del. Ch. LEXIS (May 3, 2004); *In re WorldCom, Inc. Sec. Litig.*, Fed. Sec. L. Rep. (CCH) ¶ 93,137 (S.D.N.Y. Mar. 21, 2005).

17. *See Cammer v. Bloom*, 711 F. Supp. 1264 (D. N.J. 1989) (lawyer, who was a director, assistant corporate secretary, and outside counsel held a "controlling person" under Section 20). *See also In re WorldCom, Inc. Sec. Litig.*, 2005 WL 638268 (S.D.N.Y. March 21, 2005) (review of "controlling person" liability).

18. *See Deutsch v. Cogan*, 580 A.2d 100 (Del. Ch. 1990).

19. *See* E. Rosen, *Female Lawyers Set Sights on Yet One More Goal: A Seat on a Board,* N.Y. Times, Sept. 6, 2007, at C5; A. Peters, *Lawyers Get Back on Board,* Fulton County Daily Report (July 19, 2007) (reported on Law.com's In-House Counsel); A. Efrati, *Showdowns Highlight Lawyers-as-Directors Risks* (June 7, 2007) (reported on WSJ.com on law and business and the business of law); J. Scheck, *Prominent Corporate Lawyers Didn't Stop Shady Options Deals*, The Recorder (August 28, 2006) (reported on Law.com's In-House Counsel).

20. *See* Mundheim, *supra* note 2 at 1515-16 (Remarks of Kenneth J. Bialkin: "Some of the best of us are not only damn good lawyers, but damn good businessmen; and to deprive the business community of the opportunity to use those people's services in both roles . . . would be a terrible mistake.").

21. The foregoing traps are, of course, exclusive of the extra responsibilities and liabilities imposed upon lawyers by Sarbanes-Oxley and the subsequent legacy of that legislation. *See* C. E. Stewart, *Regulating the Legal Profession: Sense or Nonsense?*, N.Y.L.J. (May 15, 2008); C. E. Stewart, *The Pit, the Pendulum, and the Legal Profession: Where Do We Stand After Five Years of Sarbanes-Oxley?*, BNA SECURITIES REGULATION & LAW REPORT (Feb. 18, 2008).

C. Evan Stewart is a partner in the New York City office of Zuckerman Spaeder LLP, focusing on business and commercial litigation. He has published over 150 articles on various legal topics and is a frequent contributor to the *New York Law Journal* and this publication.

Prime Time Lotteries

By Mark Fridman

Currently, in a federal district court in California, numerous class action lawsuits are pending, all alleging that various entities have been running massive, multi-million dollar, illegal lotteries in violation of various states' laws, and claiming that the petitioners were induced into participating in those lotteries, thereby entitling them to damages and restitution of their wagers.[1] These alleged lotteries are not being secretly conducted in an attempt to hide them from the eyes of the law. In fact, these alleged lotteries are being conducted by all the major television networks, on prime time television, during and in conjunction with some of the most popular programs on television, including *Deal or No Deal*, *1 vs. 100*, *The Apprentice*, and *American Idol*.[2] To the casual observer, the alleged lotteries may appear to be legal, promotional games of chance known as sweepstakes.[3] But a careful examination of the applicable law can only lead to the conclusion that the networks are in fact running illegal lotteries on a scale never seen before.[4]

The alleged lotteries operate more or less the same way.[5] For example, on *Deal or No Deal*, at various points throughout the program, an announcer invites viewers to participate in a game of chance called "The Lucky Case Game."[6] Six suitcases are displayed on the television screen, one of which contains $10,000.[7] Viewers participate by guessing which suitcase contains the $10,000.[8] Those who guess correctly are entered into a random drawing, performed at the end of the telecast, the winner of which receives the $10,000.[9] Viewers submit their guess either via the show's Web site or by sending a text message.[10] Entering through the Web site is free, whereas entering using a text message costs the viewer a premium text messaging charge of $.99, in addition to any text messaging fees the viewer's mobile phone service provider charges.[11]

Commonly recognized lotteries, like the state-sponsored lotteries, are played similarly.[12] Participants pay $1 for a guess at which numbers will be randomly drawn.[13] Whoever guesses correctly receives a cash prize.[14] When run by a private individual or entity, such as a television network, such a lottery is illegal.[15] Private individuals or entities that run unauthorized lotteries are subject to criminal penalties[16] and may additionally find themselves subject to private actions initiated by people who are induced to participate in the lotteries.[17] Lotteries are typically defined as containing three elements: (1) consideration, (2) chance,[18] and (3) prize.[19]

Consideration + Chance + Prize = Lottery

If consideration is exchanged for a chance to win a prize, you have a lottery, and if run by a private entity, such an enterprise is illegal.

The complaints at issue allege that the networks are running illegal lotteries because participants who enter the games using the text messaging method pay consideration of $.99 for a chance to win a prize, fulfilling all three elements of an illegal lottery.[20] The networks argue that they are not running illegal lotteries, but rather, are operating legal sweepstakes.[21] A sweepstakes is simply a lottery with the element of consideration missing.[22]

(–Consideration) + Chance + Prize = Legal Sweepstakes

Chance and prize are present, but no consideration is necessary to receive the chance to win a prize. Since the element of consideration is missing, a sweepstakes is legal.[23]

A game of chance lacks the element of consideration when participants receive the chance to win a prize for free. Where some participants receive the chance to win a prize after giving consideration to the game promoter, as in the networks' sweepstakes, the only way the element of consideration can be absent is if a legitimate product or service is promoted by the sweepstakes promoter.[24] In fact, sweepstakes are permitted by law precisely for the purpose of giving businesses an additional way to promote their products or services.[25] A sweepstakes gives consumers an extra little nudge to purchase a product or service by appealing to their "gambling instinct."[26] Not only do they appeal to the gambling instinct inherent in people, but since no consideration must be exchanged for the chance to win a prize, they involve no risk. This is precisely what makes sweepstakes promotions such a popular, successful marketing tool.[27]

A classic example of a legitimate sweepstakes promotion is the soda bottle sweepstakes. When a consumer purchases a bottle of soda, the inside of the bottle cap may, by chance, reveal a prize.[28] The prize could be anything from a free bottle to $10,000.[29] To participate in the game of chance, consumers can either pay $1 for the bottle of soda, or they can obtain a free game piece by mailing a request for one to the soda manufacturer.[30] The sweepstakes promotion just described appears to have all the elements of a lottery: those who do not use the free method of entry appear to exchange $1 consideration for the soda *and* a chance to win a prize. But in fact, such an exchange is legal because it technically does not contain the element of consideration, and therefore does not constitute a lottery.

To understand why such a sweepstakes promotion does not contain the element of consideration, it is necessary to separate the participants into two groups. One group of participants enters for free by mailing a request for a free chance to win a prize to the soda manufacturer. I will refer to this group as Alpha Group. Participants who enter a sweepstakes through a free method of entry do not give consideration for their chance to win a prize;[31] therefore, no lottery exists in regard to Alpha Group. Participants in the second group are entered into the sweepstakes when they purchase a soda bottle for $1. I will refer to this group as Beta Group. Participants in this group do not give consideration for the chance to win a prize because their $1 consideration only goes toward the product purchase;[32] the chance to win a prize is incidental to the product. This is evidenced by the fact that whether the soda manufacturer is running a sweepstakes promotion or not, the price of a soda bottle remains constant.[33] If the price of a bottle was $.75 when there was no sweepstakes, and became $1 when there was a sweepstakes, the increase in price would indicate that $.25 went toward a chance to win a prize. But where the price of the product remains constant, $1 before and during the sweepstakes promotion, this is evidence that no part of Beta Group's consideration went toward the chance to win a prize. The existence of a free method of entry further supports the proposition that Beta Group gives consideration only for the product, not for the chance to win a prize.[34] Since any participant could receive a free chance to win a prize, it follows that anyone who chooses to make a product purchase (Beta Group) gives consideration only for the product; anyone who only wants a chance to win a prize presumably would use the free method of entry.[35] Since neither Alpha Group nor Beta Group actually gives any consideration for the chance to win a prize, such a sweepstakes promotion lacks the element of consideration and is not an illegal lottery.

- Alpha Group—receives chance to win a prize for free.
- Beta Group—receives chance to win a prize in conjunction with purchase of a product or service.

If any sweepstakes participant gives consideration for the chance to win a prize, an illegal lottery occurs.[36] An illegal lottery occurs in regard to Alpha Group when a sweepstakes promotion has no free method of entry.[37] With no free method of entry, anyone who does not want to make a product purchase, but does want a chance to win a prize (Alpha Group), is forced to purchase a product in order to participate.[38] Since Alpha Group desires a chance to win a prize for free, Alpha Group's consideration does not go toward the product purchase, but rather, goes toward the chance to win a prize; the product is incidental to the game of chance.

Even where a free method of entry exists, courts may deem that free method of entry illusory. If the free method of entry is illusory, there is no true free method of entry, and a lottery exists in regard to Alpha Group. For instance, a newspaper publisher in Illinois ran a sweepstakes promotion where a chance to win a prize could be obtained with the purchase of a newspaper (Beta Group) or by coming to the newspaper's office to obtain a free chance (Alpha Group).[39] The obstacles to obtaining a free game piece included:

> The publisher's name and address do not appear on the three-part entry form itself; there is no listing for the *Minority News Review* in the Chicago telephone directory or in the directory of the building where Carney resides; the hotel staff does not and will not distribute free entry forms for the publisher and will not assist anyone in entering the contest or in locating the "office" of the *Minority News Review;* Carney, who has no employees, is not always at his office during normal business hours and will not send free entry forms through the mail; and although he claimed to have given away two or three free entry forms (an infinitesimally small number in relation to the number of issues sold), Carney could not produce any records to substantiate even this claim.[40]

The court believed "that the offer of free entry forms was illusory . . . [because] the obstacles to obtaining a free entry [form were] so formidable, the publisher's offer of a free entry blank must be regarded as chimerical."[41] Where it is prohibitively difficult to obtain a free chance to win a prize, it is as though no free method of entry exists, and Alpha Group is forced to purchase the advertised product in order to participate, thereby giving consideration for a chance to win a prize.

Likewise, an insufficiently advertised free method of entry is no free method of entry at all. A free method of entry is insufficiently advertised when it is not properly disclosed to consumers; usually, when it is mentioned in publicity for the sweepstakes, but buried in fine print, or when salespeople are not instructed to inform consumers of the free method of entry. For instance:

> Recently, the CVS drugstore chain was fined heavily for offering a sweepstakes without clearly disclosing that no purchase was necessary. Consumers were mistakenly told that they first had to make a purchase in the photo department, even though the rules provided for a free method. Similarly, Nestle was cited for its candy promotion where children were told to buy candy to see if it turned their tongues "Prankster Purple." While the "no purchase necessary" language was included in the ad, it was so small in comparison to the rest of the copy that it was ineffective. The maker of Tylenol was fined for telling entrants in large letters "Buy Tylenol" for a chance to win, and

> making the [no purchase necessary] language too small to make a difference.[42]

Where the free method of entry is insufficiently advertised, Alpha Group is unaware of the free method of entry, and members of Alpha Group are forced to make a product purchase in order to participate, thereby giving consideration for the chance to win a prize.

Courts may also find that there is no free method of entry because the free method of entry is technically not "free" at all. If the "free" method of entry is not actually free, then Alpha Group gives consideration for a chance to win a prize when it uses the "free" method of entry, and an illegal lottery occurs in regard to Alpha Group. This determination is dependent on the definition of consideration a court employs in the context of lotteries and sweepstakes. Some courts use the contract law definition of consideration:

> [I]f the consideration is sufficient to sustain a simple contract (if otherwise legal), it is sufficient to satisfy this third alleged element of lottery. Although the payment of money or a promise to pay money was the form that consideration generally took in the early days of lotteries, the consideration in a lottery, as in any form of simple contract, need not be money or the promise of money. Nor need it be of intrinsic value; "a rose, a hawk or a peppercorn" will suffice, provided it is what is asked for by the promisor and is not illegal.[43]

The court in *State v. Eckerd's Suburban, Inc.* explained that "consideration in the sense in which it is an element of a lottery need not consist of money or something of actual pecuniary value, but could consist of an act done at the request of the holder of the lottery if that act is one bargained for by the holder of the lottery."[44] For instance, applying the contract law definition of consideration, if the free method of entry requires a participant to physically go to the promoter's store to obtain the free chance to win a prize, this "free" method of entry may constitute consideration.[45] Likewise, mailing a request for a free game piece, or even the act of calling an 800-number to request a free game piece, may be sufficient to constitute consideration. If the jurisdiction follows the broad, contract law definition of consideration, then a method of entry that otherwise appears free might not be considered free, and Alpha Group gives consideration for the chance to win a prize when it uses that method of entry.

Most courts today, though, reject the broader, contract law definition of consideration, and use a narrower definition of consideration in the context of lotteries and sweepstakes.[46] For instance, in *People v. Eagle Food Centers, Inc.*, the Illinois Supreme Court held:

> [S]ome authorities hold that the presence or absence of consideration is "measured by the usual test applicable in the law of contracts," and hence need not be a direct monetary consideration, but "may consist of a benefit to the person conducting the scheme, or an inconvenience or disadvantage to the promisee." The People urge that this contract definition and concept of consideration must be read into our statute and, on this basis, contend that even though there is no direct monetary consideration paid, either the increased profits and sales enjoyed by defendant, or, . . . the time and effort expended by customers to obtain the split dollars, is sufficient to supply the element of consideration. For our part, we do not believe the statute is susceptible of the technical construction urged.[47]

As explained by the Court of Appeals of Maryland, the narrower definition of consideration normally requires the exchange of money to constitute consideration:

> [T]he decisions of this Court have made plain that the essential elements of lottery are *consideration, chance* and *prize* and that the element of *consideration* requires *the payment of money or other thing of value by the purchaser to the lottery sponsor for the opportunity to win a prize awarded by chance*.[48]

This narrower definition of consideration used in the context of lotteries may come from the fact that traditional lotteries always involve the giving of money or something of value, and anti-lottery statutes were enacted to prevent citizens from parting with that money or thing of value. As the court in *Cudd v. Aschenbrenner*, another case involving attendance at a grocery store, explained:

> We have shown that the anti-lottery statutes were enacted to prevent the impoverishment of the individual and its attendant evils. Unless a scheme requires that (1) a participant part with a consideration, and (2) the consideration be something of economic value to him, participation therein can rob him neither of his purse nor his accumulated worldly goods. We must conclude, therefore, that the anti-lottery provisions of our statute are directed at schemes in which participants are obligated to contribute something which is of economic value to them as a condition of participation. We do no violence to the law of contracts when we hold that a lottery contemplates a greater

consideration than is generally required to support a contract.[49]

Therefore, in such jurisdictions, acts such as going to a store to obtain a free chance to win a prize, mailing a request for a free game piece, or calling an 800-number to request a game piece do not constitute consideration in the context of a lottery. Kansas, in its statutory definition of consideration in the context of lotteries, goes so far as to state that "[m]ere registration without purchase of goods or services; personal attendance at places or events, without payment of an admission price or fee; listening to or watching radio and television programs; answering the telephone or making a telephone call and acts of like nature are not consideration."[50] Where the free method of entry in a sweepstakes is such an act, that method of entry truly is free in jurisdictions that use the narrower definition of consideration, and Alpha Group is able to participate without technically giving consideration for a chance to win a prize.

Since the issue has not yet been litigated, it is not clear whether entering a sweepstakes for free through the Internet is an acceptable free method of entry. Surely, in any jurisdiction that uses a narrow definition of consideration in the context of lotteries, entering through the Internet does not constitute consideration. All that anyone has to do is go to the local library to use the Internet. This is no more an inconvenience than a free method of entry that requires mailing in a request for a free game piece. But where the Internet is the *only* free method of entry, an illegal lottery may occur in regard to certain members of Alpha Group.[51] What makes such a sweepstakes problematic is that a significant part of the population, namely the elderly, is still Internet illiterate.[52] If the only free method of entry is the Internet, those members of Alpha Group who are Internet illiterate are unable to enter for free. This sub-group of Alpha Group is forced to make a product purchase in order to receive a chance to win a prize, and since no sweepstakes participant can be required to make a product purchase in order to obtain a chance to win a prize, an illegal lottery occurs in regard to that sub-group of Alpha Group.

In the traditional sweepstakes example, neither Alpha Group nor Beta Group pays consideration for a chance to win a prize. Alpha Group enters for free through a legitimate free method of entry, whereas Beta Group enters for free because, technically, the payment given by Beta Group goes toward the purchase of a product, not toward the chance to win a prize. In the examples *supra*, the promotions failed as legal sweepstakes because Alpha Group was forced to give consideration for a chance to win a prize since the apparent free methods of entry were either technically insufficient or nonexistent.

But problems may also arise in regard to Beta Group. An illegal lottery occurs in regard to Beta Group when a court finds that the money given by Beta Group does not go toward the purchase of the product that is being promoted, but rather goes toward the chance to win a prize.[53] Although a constant price and a free method of entry are evidence that Beta Group gives consideration only for the product, not for the chance to win a prize, the presence of either does not mean a court will automatically accept this proposition.[54] Courts look at a variety of evidence to determine if Beta Group is in fact paying for the chance to win a prize, rather than for the product purchased.

Where there is no "legitimate, valuable product" being paid for by Beta Group, the consideration given by Beta Group does not go toward the purchase of a product, but rather goes toward the chance to win a prize.[55] This occurs when Beta Group receives something in exchange for the consideration provided, but that something is *de minimis* in value.[56] In *Minn. Souvenir Milkcaps, LLC v. State*, a company sold paper milkcaps with an attached sweepstakes promotion.[57] The court found that these milkcaps were virtually of no value, so those who received their chance to win a prize by purchasing milkcaps (Beta Group) essentially received nothing in exchange for their consideration other than the chance to win a prize, and therefore an illegal lottery existed in regard to Beta Group.[58]

Courts will also determine that Beta Group is giving consideration for the chance to win a prize based on consumer behavior that demonstrates an interest in making the purchase just to get the chance to win a prize. For instance, in *Midwestern Enterprises, Inc. v. Stenehjem*, $1 telephone calling cards with two minutes of talk time were sold with an attached sweepstakes.[59] Evidence was presented that consumers would purchase the phone cards, check to see if they won a prize, and then throw away the cards at the point of purchase without using the phone time.[60] Business owners would then take the discarded phone cards, place them in a basket, and make them available to people for free.[61] The court reasoned: "Despite this ready availability of [free] two-minute phone cards, people continued to [purchase phone cards]. Since phone cards were available free for the taking, it is logical to conclude people paid their dollars for a chance to win cash."[62] Participants clearly purchased the product for no other reason than the immediate gratification of playing the game of chance, leading the court to conclude that an illegal lottery existed in regard to those who purchased the product (Beta Group).[63]

Courts also look to the nature of the promotion itself and the business model of the sweepstakes promoter to determine if Beta Group is in fact giving consideration for the chance to win a prize. Courts ask whether what is being promoted and sold to consumers is the product, which results in a legal sweepstakes, or whether what is being promoted and sold to consumers is the chance to win a prize.[64] Courts might pose the same question as whether the game of chance is incidental to the product being promoted or whether the product is incidental to the game.[65] If the sweepstakes operator appears to be in the business of promoting the game of chance, rather than the product, or if the product appears incidental to the game of chance, then a court may hold that Beta Group's consideration does not go toward the product purchase, but rather toward the chance to win a prize.

Underlying all of the above examples of promotions that fail as sweepstakes is the theory that "if it looks like a duck, walks like a duck, and sounds like a duck, it is a duck."[66] Although the law refers to a three-element definition of what constitutes a lottery, when necessary, courts will abandon that definition and "look to the substance and actual operation of the scheme or device charged to be a lottery to determine whether it possesses that character."[67] Courts recognize that

> [s]o varied have been the techniques used by promoters to conceal the joint factors of prize, chance, and consideration, and so clever have they been in applying these techniques to feigned as well as legitimate business activities, that it has often been difficult to apply the decision of one case to the facts of another.[68]

For this reason, courts are reluctant to impose "rigorous and formalistic requirements on what constitutes a lottery,"[69] because as soon as they do "[i]t is no sooner undertaken than some ingenious person evolves some scheme not quite within the letter of the definition given for the purpose of evading the lottery statutes."[70] If a court believes that a sweepstakes promotion is designed to evade the anti-lottery laws, rather than legitimately promote a product or business, courts will deem the technically compliant sweepstakes a lottery.

Courts go beyond the formal definition of what constitutes a lottery because "[t]he evil which arises out of such practices is that it fosters in men and women a desire to gain profit, not by their own efforts, not as a reward for skill or accomplishment, but solely by the lucky turn of chance, that it encourages in them the gambling instinct and that it makes it appeal to the baser elements in their nature."[71] As the court so eloquently explained in *Yellow-Stone Kit v. State*:

> The history of lotteries for the past three centuries in England, and for nearly a hundred years in America, shows that they have been schemes for the distribution of money or property by lot in which chances were sold for money, either directly, or through some cunning device. The evil flowing from them has been the cultivation of the gambling spirit,—the hazarding of money with the hope by chance of obtaining a larger sum,—often stimulating an inordinate love of gain, arousing the most violent passions of one's baser nature, sometimes tempting the gambler to risk all he possesses on the turn of a single card or cast of a single die, and "tending, as centuries of human experience now fully attest, to mendicancy and idleness on the one hand, and moral profligacy and debauchery on the other." It is in the light of these facts, and the mischief thus intended to be remedied, that we must construe our statutory and constitutional prohibitions against lotteries and devices in the nature of lotteries.[72]

Thus, in the eternal quest for "remedying the mischief intended to be prevented"[73] by the anti-lottery laws, "'[c]ourts will not tolerate subterfuge, however ingenious may be the scheme devised to evade the law.'"[74] If it looks like a lottery, walks like a lottery, and sounds like a lottery, it is a lottery.

In light of the applicable law, the only conclusion that can be reached in regard to the networks' sweepstakes is that they are illegal lotteries. To the casual observer, the networks' sweepstakes appear identical to the classic soda bottle sweepstakes, but in fact they are fundamentally different. The soda bottle sweepstakes have a true free method of entry; Alpha Group does not give consideration for the chance to win a prize. The networks' free method of entry is illusory in regard to certain members of Alpha Group; these participants are required to give consideration for the chance to win a prize. In the soda bottle sweepstakes, Beta Group gives consideration for a legitimate product rather than the chance to win a prize; in the networks' sweepstakes, participants who give consideration receive nothing other than the chance to win a prize. Most importantly, the soda manufacturer uses the sweepstakes to promote its business of selling bottles of soda; the networks' sweepstakes promote nothing but the games of chance themselves. The networks' promotions are in essence ducks, i.e., lotteries.

The networks' sweepstakes are illegal lotteries in regard to certain members of Alpha Group because the sweepstakes lack a sufficient free method of entry. The only free method of entry offered by the networks' sweepstakes is through the Internet.[75] Since this is the only free method of entry, those members of Alpha Group who are Internet illiterate are unable to enter for free, and instead, are forced to enter through the $.99 text message method, thereby giving consideration for the chance to win a prize. An illegal lottery also occurs in regard to any participants who do not have the Internet at home. Typical sweepstakes run for weeks, even months,[76] allowing anyone who does not have the Internet at home plenty of time to go to the library and access the Internet to enter for free. Since participants in the networks' sweepstakes are only able to enter during the broadcast of the television programs,[77] it is impossible for any participants who do not have the Internet at home to enter for free while watching the program.[78] The sub-group of Alpha Group that does not have the Internet at home is forced to enter by sending a $.99 premium text message, thereby giving consideration for the chance to win a prize.[79] Since those members of Alpha Group who are Internet illiterate, or who do not have the Internet at home, desire a free chance to win a prize, an illegal lottery occurs in regard to both sub-groups when they are forced to enter through the $.99 premium text message method of entry.

The networks' sweepstakes are also illegal lotteries in regard to Beta Group because those who enter using the $.99 premium text message method do not give that $.99 consideration for anything but a chance to win a prize. Some commentators argue that interaction with a television program provides entertainment value, which is the thing of value exchanged for Beta Group's consideration.[80] The problem is that the interaction with the television programs in this case is no greater than receiving a chance to win a prize; therefore, giving consideration for such an interaction results in an illegal lottery. One cannot run a lottery, and then claim that the consideration given does not go toward the chance to win a prize, but rather goes toward the entertainment value of participating in the lottery. To argue that the consideration given goes toward the entertainment value of interacting with a television program, the interaction must be something greater than just receiving a chance to win a prize.[81] For instance, if viewers voted for which suitcase must be opened next by the on-air contestant on *Deal or No Deal*, or viewers voted for which contestant must be removed that night from *The Apprentice*, it could be argued that such an interaction has a market value of $.99 because it is likely that many viewers would pay $.99 to have such an impact on the shows, even without an attached sweepstakes. If viewers were given a chance to win a prize when they paid $.99 to impact the show with their vote (and a free method of entry was available), then it could be argued that the $.99 given went toward the entertainment value of truly interacting with the show, not toward the chance to win a prize.

Other commentators have proposed that providing participants who use the $.99 text message method of entry with a ringtone or wallpaper will solve the problem that those who enter using the $.99 text message method receive nothing of value in return other than the chance to win a prize.[82] Likewise, one company argues that providing points that can be redeemed for a variety of products to those who enter using the $.99 text messaging method will solve the problem.[83] In fact, *Deal or No Deal*, which continues to run its sweepstakes game during the current litigation, has begun to provide participants who enter using a $.99 text message with something of value: a mobile phone game.[84]

But what *Deal or No Deal* now offers, and what commentators have proposed, would not necessarily solve the problem that Beta Group gives $.99 consideration for a chance to win a prize. Things like wallpapers, ring tones, and mobile phone games do have a market value of at least $.99,[85] as evidenced by the fact that millions of people have paid $.99 or more for such products.[86] Nonetheless, gratuitously providing something of equivalent value does not mean participants are giving their $.99 for these things. Currently, on *Deal or No Deal*, when the on-air announcer explains to viewers how to enter the game of chance, he mentions that those who enter using the $.99 text message method will receive a free mobile phone game.[87] The mobile phone game is not presented as the product for which participants pay $.99; rather, it is presented as a gratuitous present that those who enter the game of chance using the $.99 text message method will receive. If people pay for a chance to win a prize, and happen to get something complimentary that has value, it does not change the fact that people gave consideration for a chance to win a prize. In order for a mobile phone game, wallpaper, or ringtone to solve the problem of consideration, the networks must enter the business of selling such products and use their sweepstakes as promotional tools to sell these products.[88] Unless the networks are using the sweepstakes to market a product, or providing legitimate entertainment value beyond just receiving a chance to win a prize, Beta Group gives its consideration for the chance to win a prize, and an illegal lottery occurs.

The purpose of a legitimate sweepstakes promotion is to promote a business and its products or services.[89] The networks could argue that the sweepstakes promote their television programs to viewers,[90] increasing viewership, and allowing them to command a higher premium for advertising space. In this way, the sweepstakes do promote the business of the networks, but charging a $.99 premium text messaging fee does not comport with this business model since viewers are not purchasing anything with their $.99 consideration. The appropriate sweepstakes for such a business model is to offer an entirely *free* sweepstakes to viewers, increase viewership, and then command a higher premium for advertising space.[91] By charging the $.99 premium text messaging fee, the networks are creating an entirely different revenue stream from their normal business of selling advertising space; they are engaging in a new business, the business of operating a lottery.

California law, the state's law that is at issue in the current litigation,[92] is no different than the law anywhere else in the country. *People v. Shira*, California's leading case on the distinction between an illegal lottery and a legal sweepstakes, indicates that for a sweepstakes to be legal, a free method of entry must be available to everyone who wants to use it (Alpha Group); and the sweepstakes promoter must use the sweepstakes to promote a legitimate product or service so that anyone who does give consideration (Beta Group) has given that consideration for the purchase of that legitimate product, rather than the chance to win a prize.[93] The *Shira* court found an illegal lottery existed where the defendants operated a game of chance, known as RINGO, which required participants to give monetary consideration for a chance to win a prize, did not promote any legitimate product (those who gave consideration received nothing but the chance to win a prize), and did not have a free method of entry available to anyone who wanted it (only certain participants were able to enter for free).[94] The court held that:

> [I]n order for a promotional giveaway scheme to be *legal any* and *all* persons must be given a [chance] free of charge and without any of them paying for the opportunity of a chance to win the prize. Conversely, a promotional scheme is *illegal* where *any* and *all* persons *cannot* participate in a chance for the prize and *some* of the participants who want a chance to win must pay for it.[95]

The first sentence of the holding, "in order for a promotional giveaway scheme to be *legal any* and *all* persons must be given a [chance] free of charge and without any of them paying for the opportunity of a chance to win the prize,"[96] indicates that *everyone* must be given a free chance to win a prize. Implicitly, this rule requires that a legitimate product or service be promoted by the sweepstakes.[97] This is the only way that "*all* persons [can] be given a [chance] free of charge."[98] If no legitimate product or service is promoted, then those who give consideration (Beta Group) do so only for the chance to win a prize; they do not receive their chance to win a prize "free of charge"[99] and the first rule of the holding is violated. The second sentence of the holding, "a promotional scheme is *illegal* where *any* and *all* persons *cannot* participate in a chance for the prize and *some* of the participants who want a chance to win must pay for it," [100] indicates that if anyone *must* pay for his or her chance to win a prize, there is an illegal lottery. In other words, there must be a free method of entry available to anyone who wants to use it (Alpha Group); otherwise, "*some* of the participants who want a chance to win must pay for it."[101] To comply with California law, both rules must be satisfied.

The networks' sweepstakes violate both rules. The first rule is violated because "*any* and *all* persons" are not given a free chance to win a prize.[102] Only those who enter through the Internet are given a free chance to win a prize. Those who enter using the $.99 text message method are not given a free chance to win a prize since no legitimate product is marketed to them and given in exchange for their consideration. The second rule is also violated because it stipulates that "a promotional scheme is *illegal* where . . . *some* of the participants who want a chance to win *must* pay for it," [103] and in the networks' sweepstakes, the Internet-illiterate and those without Internet access at home *must* pay for their chance to win a prize by entering through the $.99 text message method of entry.

The networks argue that only the second rule need be complied with in order to have a legal sweepstakes in California.[104] The networks argue that as long as there is a free method of entry, it is irrelevant if some participants give consideration for a chance to win a prize.[105] They argue that no legitimate product needs to be provided to those who give consideration as long as they had the opportunity to enter for free.[106] The networks rely on confused, misspoken *dicta*[107] found in *Shira,* where the court said:

> In the game of RINGO defendants would have to do what the operators did in the *Regal*, *Cardas*, and *Carpenter* schemes to render the game legal and that is to make a general and indiscriminate distribution of [chances] free to *any* and *all* who asked for one and then permit those persons to participate and claim the prize if they won.[108]

The court appears to say that the operators of RINGO needed only offer a free method of entry in order to render their game of chance legal. The networks argue that since the *Shira* court did not go on to say that the operators of RINGO also needed to comply with the first part of the holding and promote a legitimate product, then the only thing necessary to make an otherwise illegal lottery a legal sweepstakes is to have a free method of entry.[109] If the *Shira* court did intend to say that a free method of entry is all that is necessary to transform an otherwise illegal lottery into a legal sweepstakes, then the court would be contradicting its own holding. The *Shira* court rule requires that "*any* and *all* persons *must*" be given a chance to enter for free,[110] not that any and all persons *could* enter for free. The position the defendants take is further weakened by the *Shira* court's approval of the decisions in several other cases which held that the existence of a free method of entry does not automatically negate the element of consideration in regard to those participants who give consideration for a chance to win a prize.[111]

Unless the court defies generally accepted conventions in regard to lottery laws, the networks will inevitably lose their case. If the argument made by the networks is given validity by the court, then in that jurisdiction lottery schemes will no longer need to be disguised as sweepstakes. A lottery will simply need a free method of entry to make it legal, and no legitimate product will need to be promoted. If the court rules in favor of the networks, a second California gold rush will occur as lottery promoters will flock to the state to cut in on the networks' business. In the first quarter of 2007 alone, sweepstakes premium text messaging generated more than $35 million.[112] On the other hand, if the networks lose their case, the effect will be just as dramatic. Millions of dollars in revenue will be lost, both from the damages in the suit and from future sweepstakes revenue that the networks will lose out on. The networks chose to enter the risky business of disguised gambling, and were successful for a period of time, but it appears that their house of cards may soon fall.

Endnotes

1. *Herbert v. Endemol USA, Inc.*, No. 2:07-cv-03537 (C.D. Cal. filed May 31, 2007); *Cunningham v. Endemol USA, Inc.*, No. 2:07-cv-03643 (C.D. Cal. filed June 5, 2007); *Bentley v. NBC Universal, Inc.*, No. 2:07-cv-03647 (C.D. Cal. filed June 5, 2007); *Couch v. Telescope, Inc.*, No. 2:07-cv-03916 (C.D. Cal. filed June 15, 2007); *Glass v. NBC Universal, Inc.*, No. 2:07-cv-08044 (C.D. Cal. filed Dec. 11, 2007); *Snelson v. Endemol USA, Inc.*, No. 2:07-cv-08122 (C.D. Cal. filed Dec. 13, 2007); *Miller v. Upper Ground Enters.*, Inc., No. 2:07-cv-08196 (C.D. Cal. filed Dec. 17, 2007); Greenwood v. Verizon Wireless Telecom, Inc., No. 2:08-cv-01893 (C.D. Cal. filed Mar. 20, 2008); *Greenwood v. Sprint Spectrum LP*, No. 2:08-cv-03537 (C.D. Cal. filed May 29, 2008). Since all the lawsuits involve the same issues with essentially the same facts, the cases have been consolidated by the court and put before one judge. Order Denying Defendants' Motions and Joint Motions to Dismiss at 2, *Herbert*, No. 2:07-cv-03537 (C.D. Cal. Nov. 30, 2007); Order Re Transfer Pursuant to General Order 07-02, *Glass*, No. 2:07-cv-08044 (C.D. Cal. Jan. 8, 2008); Order Re Transfer Pursuant to General Order 07-02, *Snelson*, No. 2:07-cv-08122 (C.D. Cal. Jan. 8, 2008); Order Re Transfer Pursuant to General Order 07-02, *Miller*, No. 2:07-cv-08196 (C.D. Cal. Jan. 8, 2008); Order Re Transfer Pursuant to General Order 07-02, *Greenwood*, No. 2:08-cv-01893 (C.D. Cal. Feb. 4, 2008); Order Re Transfer Pursuant to General Order 07-02, *Greenwood*, No. 2:08-cv-03537 (C.D. Cal. Feb. 4, 2008).
2. As of this writing, some of the alleged lotteries are still in operation, some are in hiatus. Some that are still in operation have been renamed. For instance, the alleged lottery run on *Deal or No Deal* was called "The Lucky Case Game," but is now called the "Beat the Banker Game." Deal or No Deal Play & Win Rules, http://www.nbc.com/Deal_or_No_Deal/playwin/rules.shtml (last visited Apr. 13, 2009).
3. The games of chance are presented as promotional sweepstakes to the public. *See, e.g.*, *id.* ("Promotion Description: The Promotion is a promotional sweepstakes designed to generate interest in and viewership of the Show by allowing viewers at home to experience the same thrill and excitement of playing the Deal-or-No-Deal game as the on-air contestants.")
4. An identical class action lawsuit, *Hardin v. NBC Universal, Inc.*, No. 2:07-cv-00064 (N.D. Ga. 2007), was brought in federal district court in Georgia but was dismissed because the Georgia Supreme Court, in response to a certified question from the federal court, held that the statute under which the suit was brought did not allow recovery to participants in a lottery. *Hardin v. NBC Universal, Inc.*, 283 Ga. 477, 479 (2008). The court did not reach the issue of whether an illegal lottery had actually occurred or not. *Id.* at 480 n.2 ("[W]e do not reach the question of whether the activity involved in this case constitutes a 'lottery.' . . .").
5. For a description of each game, see Order Denying Defendants' Motions and Joint Motions to Dismiss at 2–5, *Herbert*, No. 2:07-cv-03537 (C.D. Cal. Nov. 30, 2007).
6. *Id.* at 3.
7. *Id.*
8. *Id.*
9. *Id.*
10. *Id.*
11. *Id.*
12. For a comprehensive discussion of state-sponsored lotteries and their history, see Ronald J. Rychlack, *Lotteries, Revenues and Social Costs: A Historical Examination of State-Sponsored Gambling*, 34 B.C. L. Rev. 11 (1992).
13. Mega Millions Official Home, How to Play, http://www.megamillions.com/howto (last visited Apr. 13, 2009).
14. *Id.*
15. *See, e.g.*, *State ex rel. Tyson v. Ted's Game Enters.*, 893 So. 2d 355, 369–70 (Ala. Civ. App. 2002) ("[T]he problems lotteries created were of such a magnitude and were so pervasive that by the late 1800s the States were nearly unanimous in imposing constitutional prohibitions on lotteries." (citing Rychlack, *supra* note 12, at 37)); W. Va. Const. art. VI, § 36 (amended 1984) ("The legislature shall have no power to authorize lotteries . . . for any purpose, and shall pass laws to prohibit the sale of lottery . . . tickets in this State; except that the legislature may authorize lotteries which are regulated, controlled, owned and operated by the State of West Virginia. . . .").
16. *See, e.g.*, Mich. Comp. Laws Ann. § 750.372 (West 2004) ("(1) . . . a person shall not do any of the following: (a) Set up or promote within this state any lottery . . . for money. . . . (3) A person violating subsection (1) is guilty of a misdemeanor punishable by imprisonment for not more than 2 years or by a fine of not more than $1,000.00.").
17. *See, e.g.*, Cal. Bus. & Prof. Code § 17200 *et seq.* (West 2008) (one of the statutes under which the current class action lawsuits are brought (Order Granting Defendants' Motions for Certification of Order for Interlocutory Appeal and for Stay of Proceedings at 3, *Herbert v. Endemol USA, Inc.*, No. 2:07-cv-03537 (C.D. Cal. Mar. 25, 2008)). Cal. Bus. & Prof. Code § 17204 (West 2008), provides that "[a]ctions for any relief pursuant to this chapter shall be prosecuted . . . by any person who has suffered injury in fact and has lost money or property as a result of the unfair competition." "[U]nfair competition . . . mean[s] and include[s] any unlawful . . . business act or practice." Cal. Bus. & Prof. Code § 17200 (West 2008). Since a lottery is an unlawful act pursuant to Cal. Penal Code § 319 (West 1999), it is unfair competition within the meaning of Cal. Bus. & Prof. Code § 17200 (West 2008), and actionable pursuant to Cal. Bus. & Prof. Code § 17204 (West 2008).
18. *See* Opinion of the Justices No. 373, 795 So. 2d 630, 635 (Ala. 2001) ("'Chance' . . . [is] a lack of control over events or the absence of 'controllable causation'—'the opposite of intention.'" (quoting Black's Law Dictionary 231 (6th ed.1990))).
19. *See Retail Section of Chamber of Commerce v. Kieck*, 128 Neb. 13, 16 (1934) ("[P]rize may be anything of value." (quoting *State v. Neb. Home Co.*, 66 Neb. 349 (1902))). *See, e.g.*, 720 Ill. Comp. Stat. Ann. 5/28-2(b) (West 2008) ("A 'lottery' is any scheme or procedure whereby one or more prizes are distributed by chance among persons who have paid or promised consideration for a chance to win such prizes. . . ."); *Miss. Gaming Comm'n v. Treasured Arts, Inc.*, 699 So. 2d 936, 938 (Miss. 1997) ("The common law definition of a lottery is: '(1) The offering of a prize; (2) the awarding of a prize by chance; (3) the giving of a consideration for the opportunity to win the prize; and all three of these elements must concur in order to constitute a lottery.'" (quoting *Williams Furniture Co. v. McComb Chamber of Commerce*, 147 Miss. 649 (1927))); *F.A.C.E. Trading, Inc. v. Dep't of Consumer & Indus. Servs.*, 270 Mich. App. 653, 666 (Ct. App. 2006) ("'Lottery' is commonly defined as 'a gambling game or method of raising money in which a large number of tickets are sold and a drawing is held for prizes,' 'a drawing of lots,' and 'any happening or process that is or appears to be determined by chance. . . .'" (quoting Random House Webster's College Dictionary (2d ed. 1997))).
20. Class Action Complaint at 4–6, *Herbert v. Endemol USA, Inc.*, No. 2:07-cv-03537 (C.D. Cal. May 31, 2007).
21. Order Denying Defendants' Motions and Joint Motions to Dismiss at 8, *Id.*, No. 2:07-cv-03537 (C.D. Cal. Nov. 30, 2007) ("Defendants concede that the elements of chance and prize are met. They argue instead that there is an absence of consideration: because they offer viewers a free alternative method of entry, (that is, because viewers can enter online for free, rather than pay 99 cents per text message), there is no consideration and thus no lottery.")).
22. *See, e.g.*, Ronald R. Urbach, *Sweepstakes, Promotion and Marketing in the Books and Magazine Industry: A Brief Overview, Recent Developments and What's Hot*, 516 PLI/Pat 729, 731 (1998) ("The terminology in promotion law is relatively simple, but often misused. The general category is promotions. A lottery is a form of promotion, though it is also gambling. A sweepstakes is a promotion in which there is prize and chance, but no consideration."); Tsan Abrahamson, *The Promotion That Went South*,

BUS. L. TODAY, July–Aug. 2006, at 25, 26 ("A legal promotion will contain two of three essential components: (1) a prize, (2) the element of chance, or (3) consideration. . . . 'Sweepstakes,' also called *games of chance*, eliminate the element of consideration."); Anthony N. Cabot & Louis V. Csoka, *The Games People Play: Is It Time for a New Legal Approach to Prize Games?*, 4 NEV. L.J. 197, 202 (2003) ("[B]ecause sweepstakes lack 'consideration' (i.e., an entry fee), they are generally deemed to fall outside lottery prohibitions."); 39 U.S.C. § 3001(k)(1)(D) (2006) ("[T]he term 'sweepstakes' means a game of chance for which no consideration is required to enter."); CAL. BUS. & PROF. CODE § 17539.5(12) (West 2008) ("'Sweepstakes' means any procedure for the distribution of anything of value by lot or by chance that is not unlawful under other provisions of law including, but not limited to, the [prohibition against lotteries].").

23. *See, e.g.*, *People v. Eagle Food Ctrs., Inc.*, 31 Ill. 2d 535, 538 (1964) ("[O]ur courts aligned themselves with the universally accepted views: (1) that there are three elements essential to the existence of a lottery, viz., chance, consideration and a prize; and (2) that there is no lottery if any one of these elements or ingredients is missing.").

24. This author knows of only one court that has ever held otherwise: *Glick v. MTV Networks*, 796 F. Supp. 743 (S.D.N.Y. 1992) (holding that the element of consideration was absent from a game of chance that promoted no legitimate product or service even though some participants were entered into the sweepstakes after giving monetary consideration to the sweepstakes promoter).

25. *See, e.g.*, Richard A. Kurnit, *Advertising and Promotion Liability*, SN019 A.L.I.–A.B.A. 391, 415 (2008) ("All states permit sweepstakes in connection with promotions of other products or services provided that no consideration is required."); Miriam S. Wilkinson & Eric H. Miller, *Florida Game Promotions Statute: A Novel Application of an Exception to Florida's Prohibition on Gambling*, 11 GAMING L. REV. 98, 99 (2007) ("In 1971, the Florida Legislature adopted § 849.094, Florida Statutes, authorizing games of chance within the context of sale of consumer goods or services."); IOWA CODE ANN. § 725.12(1) (West 2003) ("If any person makes or aids in making or establishing, or advertises or makes public a scheme for a lottery[,] . . . the person commits a serious misdemeanor. This section . . . does not prohibit the advertising of a lottery, game of chance, contest, or activity conducted . . . by a commercial organization as a promotional activity which is clearly occasional and ancillary to the primary business of that organization. . . ."); MICH. COMP. LAWS § 750.372 (West 2004) ("(1) . . . a person shall not do any of the following: (a) Set up or promote within this state any lottery . . . for money. . . . (2) Subsection (1) does not apply to a lottery . . . conducted by a person as a promotional activity that is clearly occasional and ancillary to the primary business of that person. As used in this subsection, 'promotional activity' means an activity that is calculated to promote a business enterprise or the sale of its products or services. . . ."); 18 U.S.C. § 1307 (2006) ("(a) The [prohibition on lotteries] shall not apply to . . . (2) an advertisement, list of prizes, or other information concerning a lottery . . . or similar scheme . . . that is authorized or not otherwise prohibited by the State in which it is conducted and which is . . . (B) conducted as a promotional activity by a commercial organization and is clearly occasional and ancillary to the primary business of that organization.").

26. *State v. Dorau*, 124 Conn. 160, 164 (1938) ("The evil which arises out of such practices is that it fosters in men and women a desire to gain profit, not by their own efforts, not as a reward for skill or accomplishment, but solely by the lucky turn of chance, that it encourages in them the gambling instinct and that it makes it appeal to the baser elements in their nature.").

27. *See* Mark B. Wessman, *Is "Contract" The Name of the Game? Promotional Games as Test Cases for Contract Theory*, 34 ARIZ. L. REV. 635, 636 (1992) ("[Sweepstakes] are significant to the economy because of the sheer frequency of their use and their purported effect on sales volume. In 1967, when the Federal Trade Commission (FTC) surveyed all known game promoters in connection with its study on the use of games of chance in food and gasoline retailing, annual billings for promotional games already amounted to $37.2 million. The FTC study also found that, although games were not invariably successful, they often were followed by significant increases in sales and changes in market share. By 1987, reported expenditures for sweepstakes and games in retail promotions amounted to $185,946,000." (footnotes omitted)).

28. *See Pepsi Cola Bottling Co. of Luverne, Inc. v. Coca-Cola Bottling Co.*, 534 So. 2d 295, 296 (Ala. 1988) (describing a similar sweepstakes promotion).

29. *Id.*

30. *Id.*

31. *See, e.g.*, *People v. Cardas*, 137 Cal. App. Supp. 788, 791 (App. Dep't Super. Ct. 1933) ("The question is: Did the holders of prize [chances] pay a valuable consideration for the chance? Certainly those who received prize [chances] without buying [a product] did not pay anything for the chance of getting the prize.").

32. *See, e.g.*, *Minn. Souvenir Milkcaps, LLC v. State*, 687 N.W.2d 400, 403–04 (Minn. Ct. App. 2004) ("Because a lottery is defined, in part, as paying consideration for the chance to [win a prize], it is not a lottery if the payment is for the purchase of a product instead of the chance to win.").

33. *See, e.g.*, *Mid-Atlantic Coca-Cola Bottling Co., Inc. v. Chen, Walsh & Tecler*, 296 Md. 99, 108 (1983) ("[W]here, as here, the price for the purchase of the appellant's product is constant before, during and at the termination of the promotion, the fact that some of its purchasers (or non-purchasers) may receive a prize awarded on the basis of chance does not violate the provisions of the Constitution. . . ."); *People v. Eagle Food Ctrs., Inc.*, 31 Ill.2d 535, 541 (1964) ("No purchase was required, and even those purchasing were required to pay nothing over and above the amount necessary to pay for merchandise actually received. The chance to win was therefore entirely free, and the necessary consideration contemplated by the statute was lacking."); *People v. Shira*, 62 Cal. App. 3d 442, 459 (Ct. App. 1976) ("[T]he schemes lacked the element of consideration and were *legal* because . . . the money paid by the patrons for the admission ticket to the theater or for gasoline was no more consideration for viewing the movie or for the gasoline itself.").

34. *See, e.g.*, *Am. Treasures, Inc. v. State*, 173 N.C. App. 170, 178 (Ct. App. 2005) ("A second reason supporting the validity of plaintiff's promotional scheme is that consumers may receive free [chances] without purchasing the [product] . . . which is some evidence that those who purchase the [product] are doing so to receive the [product] and not the accompanying [chance to win a prize].").

35. *See, e.g.*, *Cardas*, 137 Cal. App. Supp. at 791 ("The question is: Did the holders of prize [chances] pay a valuable consideration for the chance? . . . [T]hose who purchased [products] and received prize [chances] . . . could not be said to have paid a consideration for the prize [chances] since they could have received them free.").

36. *See, e.g.*, *Midwestern Enters., Inc. v. Stenehjem*, 625 N.W.2d 234, 240 (N.D. 2001) ("It is adequate to be defined as a lottery if *some* of the participants have given a consideration for the chance to be selected as a winner." (emphasis added)); *Tierce v. State*, 122 Ga. App. 845, 847 (Ct. App. 1970) ("We do not believe the legislature intended to drastically change the test to require *all* participants to have paid a consideration in order to have a lottery or similar scheme." (emphasis added)).

37. *See, e.g.*, *Shira*, 62 Cal. App. 3d at 459–61 (promotion was an illegal lottery because free method of entry was not available to every participant who wanted to enter for free); *Pepsi Cola Bottling Co. of Luverne, Inc. v. Coca-Cola Bottling Co.*, 534 So. 2d 295, 297 (Ala. 1988) (sweepstakes promotion was legal because sweepstakes participants were not required to make a product purchase in order to receive a chance to win a prize).

38. *See, e.g.*, *Shira*, 62 Cal. App. 3d at 455–56 ("The court concluded that since '[t]here was no general or indiscriminate distribution of [chances] to persons irrespective of whether they paid

admission, . . . [i]t was therefore a condition that a person pay a consideration, namely, the charge for at least one admission, in order to participate in the drawing . . . and therefore '[a] valuable consideration was paid for the chance of obtaining such property upon an understanding that it was to be distributed by chance.'" (quoting *People v. Gonzales*, 62 Cal. App. 2d 274, 278–80 (Dist. Ct. App. 1944))).

39. *G.A. Carney, Ltd. v. Brzeczek*, 117 Ill. App. 3d 478, 480–81 (App. Ct. 1983).

40. *Id.* at 484–85.

41. *Id.*

42. Tsan Abrahamson, *The Promotion That Went South*, BUS. L. TODAY, July–Aug. 2006, at 25, 29. In these examples, the companies running the sweepstakes agreed to pay fines rather than contest the validity of their advertising practices in court. For further information, see Press Release, Office of the New York State Attorney General, CVS to Amend Sweepstakes Promotion (July 8, 2004), http://www.oag.state.ny.us/media_center/2004/jul/jul08a_04.html; Press Release, Office of the New York State Attorney General, Tylenol Manufacturer to Amend Sweepstakes Ads (Sept. 10, 2004), http://www.oag.state.ny.us/media_center/2004/sep/sep10a_04.html. *See also* Press Release, Office of the New York State Attorney General, Attorney General Cuomo Stops H&R Block's Deceptive Advertising Tactics In Sweepstakes Programs, (June 27, 2008), http://www.oag.state.ny.us/media_center/2008/jun/june27a_08.html (H&R Block sweepstakes promotion insufficiently disclosed the availability of a free method of entry).

43. *Lucky Calendar Co. v. Cohen*, 19 N.J. 399, 415 (1955).

44. 53 Del. 103, 107 (1960).

45. *See, e.g.*, *Blackburn v. Ippolito*, 156 So. 2d 550 (Fla. Dist. Ct. App. 1963) (going to a supermarket to obtain a free chance to win a prize was an act sufficient to constitute the consideration necessary to satisfy an illegal lottery); *G2, Inc. v. Midwest Gaming, Inc.*, 485 F. Supp. 2d 757, 770 (W.D. Tex. 2007) ("Some jurisdictions outside of the State of Texas have held that requiring a person to actually go to the location of the sweepstakes sponsor in order to participate constitutes consideration."); s*ee Lucky Calendar Co.,* 19 N.J. 399 (holding that consideration exists where a customer is burdened by having to visit the store where the coupons are being offered); *Knox Indus. Corp. v. State ex rel. Scanland,* 258 P.2d 910, 914 (Okla.1953) (element of consideration is present when the customer is "subjected to the sales appeal of the merchandise offered for sale" at the store offering the merchandise); *State v. Dorau,* 124 Conn. 160 (1938) ("arriving at a movie theater, the fact that a customer is more likely to buy a ticket is enough to satisfy the consideration element of a lottery"). (citation omitted)).

46. *See* Anthony N. Cabot & Louis V. Csoka, *The Games People Play: Is It Time for a New Legal Approach to Prize Games?*, 4 NEV. L.J. 197, 204 (2003) ("Under the *majority rule*, incidental expenses or inconveniences undertaken to enter a [sweepstakes] promotion are not consideration.") (emphasis added)); Laura Handman & Denise Gough, *Online Promotions: Sweepstakes and Contests*, 610 PLI/PAT 441, 468 (2000) ("*Most states* require that participants must give 'valuable consideration' that has economic value for the participants before consideration exists.") (emphasis added)).

47. 31 Ill. 2d 535, 538–39 (1964) (citations omitted).

48. *Mid-Atlantic Coca-Cola Bottling Co., Inc. v. Chen, Walsh & Tecler*, 296 Md. 99, 105 (1983).

49. 233 Or. 272, 281–82 (1962).

50. KAN. STAT. ANN. § 21-4302(c) (West 2008).

51. The New York Attorney General's office recently attacked a CVS Pharmacy promotion where participants could enter either by making an in-store purchase (Beta Group) or enter for free through the Internet (Alpha Group). Press Release, Office of the New York State Attorney General, CVS to Amend Sweepstakes Promotion (July 8, 2004), http://www.oag.state.ny.us/media_center/2004/jul/jul08a_04.html. CVS Pharmacy reached a settlement with the New York Attorney General's office which required that the Internet not be the only free method of entry. *Id.*

52. For statistics on Internet usage, see The Harris Poll, Four Out of Five Adults Now Use the Internet (Nov. 17, 2008), http://www.harrisinteractive.com/harris_poll/index.asp?PID=973; eMarketer's Predictions for 2009 (Dec. 16, 2008), http://www.emarketer.com/Article.aspx?id=1006813; Internet World Stats, North America Internet Usage Statistics, http://www.internetworldstats.com/stats14.htm (last visited Apr. 13, 2009).

53. Some courts hold that where Beta Group is in fact giving consideration for a chance to win a prize, there is not just a lottery in regard to Beta Group, but Alpha Group too. The reasoning is that where Beta Group gives consideration, it pays for all participants as a whole, "in bulk." *Tierce v. State*, 122 Ga. App. 845, 847 (Ct. App. 1970); s*ee also State v. Mabrey*, 245 Iowa 428, 435 (1954) ("[I]n actual operation [product] purchasers—perhaps unwittingly—paid for their own chance at prizes and also for the chance of those who were admitted to the game without paying.").

54. *See, e.g.*, *id.* at 435 ("[T]he game here was a lottery at least as to those who purchased [products]. It did not cease to be a lottery because some were admitted to play without paying for the privilege, so long as others paid for their chances. Presence of the nonpaying participants did not change the status of those who paid."); *Barber v. Jefferson County Racing Ass'n, Inc.*, 960 So. 2d 599, 613 (Ala. 2006) ("[T]he opportunity for free [chances] does not negate the element of consideration, or obviate an inquiry into the purpose and effect of the operation as 'the final proof of . . . consideration.'" (quoting *Grimes v. State*, 235 Ala. 192, 194 (1937))); *F.A.C.E. Trading, Inc. v. Dep't of Consumer & Indus. Servs.*, 270 Mich. App. 653, 670 (Ct. App. 2006) ("Thus, we conclude that the [free] method of entry does not render the transaction free of consideration."); *Commonwealth v. Wall*, 295 Mass. 70, 73 (1936) ("[A] game does not cease to be a lottery because some, or even many, of the players are admitted to play free, so long as others continued to pay for their chances."). This author knows of only one court that has ever held otherwise: *Glick v. MTV Networks*, 796 F. Supp. 743 (S.D.N.Y. 1992) (holding that a free method of entry automatically negated the element of consideration necessary for the existence of a lottery even where some participants gave consideration for nothing other than the chance to win a prize).

55. *Minn. Souvenir Milkcaps, LLC v. State*, 687 N.W.2d 400, 403 (Minn. Ct. App. 2004).

56. Of course, this also occurs where Beta Group receives no product or service at all in exchange for its consideration.

57. *Id.* at 402.

58. *Id.* at 403–04. *Contra Bohrer v. City of Milwaukee*, 248 Wis. 2d 319, 330 n.9 (Ct. App. 2001) (where the court held that an identical promotion was a legal sweepstakes because such milkcaps were "collectable and valuable"). Also compare *Am. Treasures, Inc. v. State*, 173 N.C. App. 170, 178 (Ct. App. 2005) ("[P]laintiff's pre-paid phone card is sufficiently compatible with the price being charged and has sufficient value and utility to support the conclusion that it, and not the associated game of chance, is the object being purchased."), where the court found a promotional sweepstakes legal after determining that telephone calling cards that offered a long-distance rate of $.50 per minute were of sufficient value to support the proposition that consumers were in fact paying for the cards, not for the game of chance.

59. 625 N.W.2d 234, 235 (N.D. 2001).

60. *Id.* at 236.

61. *Id.* at 238.

62. *Id.*

63. *Id.* at 240.

64. *See, e.g.*, *Sniezek v. Colo. Dep't of Revenue*, 113 P.3d 1280, 1282 (Colo. Ct. App. 2005) ("For these reasons, we conclude that plaintiffs' machine is designed to promote the sale of the [chance to win

a prize], not the [product], and that the [product] is merely incidental to the [chance to win a prize]."). In that case, a vending machine that dispensed coupon booklets with an attached sweepstakes game was held to be an illegal gambling device because the game of chance was promoted to consumers, rather than the product. Although cases involving illegal gambling devices are distinguishable from sweepstakes-lottery cases, often, in order to determine whether a device is an illegal gambling device, a court will first determine whether what is dispensed by the machine is an illegal lottery. *See also Animal Prot. Soc'y of Durham, Inc. v. State*, 95 N.C. App. 258, 268 (Ct. App. 1989) ("Despite plaintiffs' assertions to the contrary, the situation before us is far different from an advertising promotion directed at increasing sales of a legitimate product or service offered in the free marketplace by a business regularly engaged in the sale of such goods or services. The evidence before us unequivocally shows that [the game of chance], not combs and candies, was the product promoted.").

65. *See, e.g.*, *F.A.C.E. Trading, Inc. v. Todd*, 393 Md. 364, 375 (2006) ([T]he . . . "game of chance is not incidental to the purchase of products. Instead, . . . the product . . . is merely incidental to the game of chance."). In that case, because Maryland's anti-lottery law was narrowly construed, the court held that the sweepstakes was not an illegal lottery, but it did violate Maryland's anti-gambling law, which requires the same three elements of consideration, chance, and prize that are necessary for a lottery. *Id. See also Am. Treasures, Inc. v. State*, 173 N.C. App. 170, 178 (Ct. App. 2005) ("[T]here are situations where it is clear that the product being 'sold' is merely ancillary and incidental to the accompanying game of chance. . . ."). Evidence in that case indicated that the game of chance was incidental to the product; therefore, the sweepstakes promotion was legitimate.

66. *People ex rel. Lockyer v. Pac. Gaming Techs*., 82 Cal. App. 4th 699, 701 (Ct. App. 2000) (referring to whether a vending machine that dispenses telephone calling cards with an attached sweepstakes is an illegal gambling device or not).

67. *Ex parte Gray*, 23 Ariz. 461, 465 (1922); s*ee also F.A.C.E. Trading, Inc. v. Dep't of Consumer & Indus. Servs.*, 270 Mich. App. 653, 668 (Ct. App. 2006) ("Thus, while . . . the essentials of a lottery generally are consideration, prize, and chance, these essentials cannot be used to frustrate the plain and ordinary meaning of the word 'lottery.'").

68. *FCC v. Am. Broad. Co.*, 347 U.S. 284, 293 (1954).

69. *F.A.C.E.*, 270 Mich. App. at 667–68 ("Significantly, our Supreme Court warned against imposing rigorous and formalistic requirements on what constitutes a lottery.").

70. *Bills v. People*, 113 Colo. 326, 335 (1945).

71. *State v. Dorau*, 124 Conn. 160, 164 (Conn. 1938).

72. 7 So. 338, 339 (Ala. 1890) (quoting *Johnson v. State*, 3 So. 790, 791 (Ala. 1888)) (citation omitted).

73. *Ex parte Gray*, 23 Ariz. 461, 465 (1922) ("And statutes prohibiting lotteries should be construed with a view to remedying the mischief intended to be prevented, and to suppress all evasions for the continuance of the mischief.").

74. *People v. Shira*, 62 Cal. App. 3d 442, 461 (Ct. App. 1976) (quoting *Finster v. Keller*, 18 Cal. App. 3d 836, 842 n.1 (Ct. App. 1971)).

75. Order Denying Defendants' Motions and Joint Motions to Dismiss at 2–5, *Herbert v. Endemol USA, Inc*., No. 2:07-cv-03537 (C.D. Cal. Nov. 30, 2007).

76. *See, e.g.*, Dr. Pepper Major League Gaming Promotion Official Rules, http://softcoin.com/p/handler?target=general&action=displayPage&sid=3550&pageId=241 (last visited Apr. 13, 2009) (sweepstakes runs from Jan. 2, 2009 to Apr. 30, 2009).

77. Order Denying Defendants' Motions and Joint Motions to Dismiss at 2–5, *Herbert*, No. 2:07-cv-03537 (C.D. Cal. Nov. 30, 2007). The promotional game offered during *American Idol* is the exception: it had a twenty-four hour entry period. *Id.* at 2.

78. For statistics on how many people in the U.S. have Internet access at home, see John B. Horrigan, *Home Broadband Adoption 2008* (Pew Internet & American Life Project, D.C.), July 2008, at 1, *available at* http://www.pewinternet.org/~/media/Files/Reports/2008/PIP_Broadband_2008.pdf ("Fully 55% of Americans reported having a high-speed internet connection at home . . . 10% of American adults say they use dialup internet connections at home to go online.").

79. As of this writing, the *Deal or No Deal* sweepstakes game has changed its rules to allow viewers to participate in the game up to twenty-four hours before the show airs, and then closes the game at the end of the show. Deal or No Deal Play & Win Rules, http://www.nbc.com/Deal_or_No_Deal/playwin/rules.shtml (last visited Apr. 13, 2009). Viewers who do not have the Internet at home could possibly go somewhere to access the Internet before the show airs, but the show's producers do not publicize the twenty-four hour entry period at all; it is buried in the fine print of the sweepstakes rules on the Web site. Viewers tune in to the show and are simply told to vote before the end of that night's program. If the twenty-four hour entry period is not advertised, it is an unadvertised free method of entry, which is no free method of entry at all. Therefore, the only time there is technically a free method available is during the one-hour period the program is on the air.

80. *See, e.g.*, Joseph J. Lewczak, *Message To Mr. Trump: Tune In Here To Win Sweepstakes Lawsuit Against "Apprentice,"* The Metro. Corp. Couns., Apr. 2007, at 46 ("[T]here is value to the participant and, thus, no lottery or gambling law violation has occurred. . . . The 'value' stems from the entertainment and interaction they receive as part of the television viewing experience."); ADLAW by Request—In the Courts, Attention! A Premium Charge and Class Action Lawsuit May Apply . . . (July 23, 2007), http://www.adlawbyrequestlegacy.com/in_the_courts.cfm?citid=2788&FaArea2=customWidgets.contentview_1&usecache=false&ocl_id=article ("What [the defendants] will need to show in order to defend against [the] class action suit is that the contestants do not pay to enter a game of chance; rather, they pay for the entertainment value involved in voting for their favorite players on a reality game show.").

81. None of the sweepstakes games actually impacted or affected the on-air programs in any way. *See* Order Denying Defendants' Motions and Joint Motions to Dismiss at 2–4, *Herbert*, No. 2:07-cv-03537 (C.D. Cal. Nov. 30, 2007). The games presented during *American Idol* and *1 v. 100* had participants answer a trivia question; *Deal or No Deal* had participants guess which of six suitcases contained the prize money, and *The Apprentice* had participants take part in a poll, answering the question of which *Apprentice* contestant should be fired by Donald Trump on that night's episode. *Id.*

82. *See, e.g.*, Network For Online Commerce E-Newsletter, US Law Suits Allege Texting Votes, Games on 'Apprentice,' Other TV Shows Violate Lottery Rule (June 29, 2007), http://newsweaver.co.uk/noc/e_article000848320.cfm?x=b11,0,w ("Producers may have been better off if they'd offered mobile users ringtones or wallpaper in exchange for sending the text."); Alan L. Friel, *No Purchase Necessary*, Marketing Mgmt., Mar.–Apr 2008, at 48, 48–49 ("This might not be the case if the person also received a ringtone or wallpaper that is sold separately for more than the text charge."); Text Message Promotions Article by Cohen Silverman Rowan Marketing and Promotional Law Firm, http://www.promolaw.com/resources/text_message_promotion.htm (last visited Apr. 13, 2009) ("[A] natural reading of the Court's order suggests that had the text message participant received something of value beyond the ability to participate in the promotion (say, for example, a ring tone), the Court may well have reached a different conclusion.").

83. Press Release, Limbo, Premium SMS Sweepstakes—Are They a Deal, or No Deal? (July 9, 2007), http://www.limbo.com/presscenter?pr=pr20070709.html ("The [points] provide[] value

commensurate with the cost of the premium SMS and hence helps satisfy the legal requirements of a sweepstakes.").

84. Deal or No Deal Play & Win Rules, http://www.nbc.com/Deal_or_No_Deal/playwin/rules.shtml (last visited Apr. 13, 2009). It does not appear that anything of value was provided to participants in the networks' sweepstakes at the time the plaintiffs in the current litigation participated in the sweepstakes. Order Denying Defendants' Motions and Joint Motions to Dismiss at 2–5, *Herbert*, No. 2:07-cv-03537 (C.D. Cal. Nov. 30, 2007). Nothing more than a chance to win a prize was given to those who entered using the $.99 text message method of entry. *Id.*

85. The market value of the redeemable points would depend on the value of what they can be redeemed for.

86. *See* Press Release, M:Metrics, Mobile Phone Metrics (Nov. 26, 2007), http://www.mmetrics.com/press/PressRelease.aspx?article=20071126-salesmetrics; Press Release, BMI, Ringback Tones Lead Mobile Music Market Growth in '08 (Mar. 27, 2008), http://www.bmi.com/news/entry/536285 ("The company estimates the ringtone domain experienced sales of $600 million in calendar year 2006. . . . "); Press Release, Nielsen Mobile, Mobile Game Revenue in the U.S. (Mar. 5, 2007), http://www.nielsenmobile.com/html/GDC07_press_release_template.html ("On-portal mobile game revenue jumped 61 percent year-over-year to $151 million in Q4 2006. . . .").

87. *Deal or No Deal* (NBC Television broadcast Dec. 29, 2008) (on file with author).

88. *See, e.g.*, *Sniezek v. Colorado Dep't of Revenue*, 113 P.3d 1280, 1283 (Colo. Ct. App. 2005) ("The important distinction is, again, the connection between the game and the sale of a business's product. The sanctioned promotions involve the sale of the company's primary product, a meal or drink, coupled with a chance to win a prize. The customer knows what is being purchased. And the business is promoting its primary commercial activity through the game."). *See also supra* notes 65, 66, and accompanying text.

89. *See supra* note 26 and accompanying text.

90. The networks never argue that their games have a promotional purpose. *See* Opposition to Motion for Certification of Order for Interlocutory Appeal and for Stay of Proceedings at 3, *Herbert v. Endemol USA, Inc.*, No. 2:07-cv-03537 (C.D. Cal. Feb. 4, 2008) ("Defendants have not contended . . . that the Game is used as a legitimate promotion of products or services that people acquire when entering the Game.").

91. See, for example, the sweepstakes promotion at issue in *ACF Wrigley Stores, Inc. v. Olsen*, 359 Mich. 215 (1960), which "did not promote the purchase of any item, but only promoted further television viewing," *F.A.C.E. Trading, Inc. v. Dep't of Consumer & Indus. Servs*., 270 Mich. App. 653, 671 (Ct. App. 2006). There was no entry method that required consideration (there was no Beta Group); all viewers participated for free (only Alpha Group existed), and the promotion was held to be legal.

92. The plaintiffs allege violations of other states' laws also, but as of this writing, it is only California law that is at issue. Order Granting Defendants' Motions for Certification of Order for Interlocutory Appeal and for Stay of Proceedings at 3, *Herbert v. Endemol USA, Inc.*, No. 2:07-cv-03537 (C.D. Cal. Mar. 25, 2008).

93. 62 Cal. App. 3d 442 (Ct. App. 1976).

94. *Id.* at 446–48.

95. *Id.* at 459.

96. *Id.*

97. The requirement that a legal sweepstakes must promote a legitimate product is supported by the court's analysis of prior California case law:

> An obvious important factual distinction between the above referred to cases which found a lottery did not exist and the case at bench is that they involved promotional schemes by using [the chance to win a prize] to increase the purchases of legitimate goods and services in the free market place. . . . While here, the RINGO game is conducted as a business and the game itself is the product being merchandized.

Id. at 458.

98. *Id.* at 459.

99. *Id.*

100. *Id.*

101. *Id.*

102. *Id.*

103. *Id.* (second emphasis added).

104. Defendants' Reply In Support of Motion for Certification of Order for Interlocutory Appeal and for Stay of Proceedings at 1, *Herbert v. Endemol USA, Inc.*, No. 2:07-cv-03537 (C.D. Cal. Feb. 4, 2008).

105. *Id.*

106. *Id.* at 4.

107. *Id.* at 3.

108. *Shira*, 62 Cal. App. 3d at 459–60.

109. Defendants' Reply In Support of Motion for Certification of Order for Interlocutory Appeal and for Stay of Proceedings at 4, *Herbert*, No. 2:07-cv-03537 (C.D. Cal. Feb. 4, 2008).

110. *Shira*, 62 Cal. App. 3d at 459 (second emphasis added).

111. The *Shira* court noted: "The logic and reasonableness of the language in *State v. Mabrey* (1953) 245 Iowa 428, is persuasive where the court said:

> [T]he game here was a lottery at least as to those who purchased [products]. It did not cease to be a lottery because some were admitted to play without paying for the privilege, so long as others paid for their chances. Presence of the nonpaying participants did not change the status of those who paid. *If it was a lottery as to some who played the game it was nonetheless a lottery*. [¶] Unless we close our eyes to reality the conclusion is justified that in actual operation [product] purchasers—perhaps unwittingly—paid for their own chance at prizes and also for the chance of those who were admitted to the game without paying. Thus presence of the nonpaying participants did not change the essential character of the enterprise. . . . (Italics added.)*

*See also: Commonwealth v. Wall (1936) 295 Mass. 70, which stated:"[A] game does not cease to be a lottery because some, or even many, of the players are admitted to play free, so long as others continued to pay for their chances.'" and McFadden v. Bain (1939) 162 Ore. 250, where the court said: "To constitute a lottery, it is not necessary for all participants to pay for their chances, but it is sufficient if some do though many do not pay a valuable consideration. The legal effect of the transaction is not changed by the fact that some do not pay." (See also State v. Eames (1936) 87 N.H. 477, 480–481.)"

Id. at 460 (citations omitted).

112. Press Release, Nielsen Mobile, Off Portal Premium SMS Transactions (June 1, 2007), http://www.nielsenmobile.com/html/PremiumSMSJune2007revised.html.

Mark Fridman is a graduate of the Touro College Jacob D. Fuchsberg Law Center. He is currently awaiting admission to the New York and New Jersey Bars. He would like to thank Professor Thomas A. Schweitzer for his guidance and encouragement.

New York's New Limitations on Due-on-Sale Provisions: Dead on Arrival

By Geoffrey C. Rogers and Timothy P. Meredith

New York State amended New York Banking Law § 6-g ("Banking Law § 6-g") in July, 2008, to limit the circumstances under which a state-chartered bank can exercise a "due-on-sale" clause in a home mortgage loan.[1] A due-on-sale clause allows a lender to accelerate a mortgage loan if the mortgagor transfers title to the real property that secures the loan. According to the legislative memorandum that accompanied the bill, the amendment is intended to accomplish two objectives. First, the amendment is intended to create certain limited exceptions to the right of a state bank to exercise a due-on-sale clause.[2] Second, the amendment is intended to subject state banks to the same limits on the exercise of a due-on-sale clause that apply to federally chartered banks.

However, federal law already governs the exercise of due-on-sale clauses by state banks in New York.[3] Existing federal law allows both state and federal lenders to exercise due-on-sale rights except in certain limited circumstances ("Federal Due-on-Sale Law").[4] The Federal Due-on-Sale Law also preempts any state limitations on the exercise of a due-on-sale provision contained in a mortgage.[5] As a result, the new state law has no force or effect and is unenforceable.

Historical Background

As described in the legislative memorandum, a due-on-sale clause in a mortgage allows the lender to call a mortgage loan due if the owner of the real property securing the loan sells or otherwise transfers an interest in the real property. If the lender did not have that option, the borrower might be able to sell the property, subject to the lender's lien, and continue to make payments on the loan (or agree with the buyer that the buyer would make the payments on the seller's behalf). This kind of transaction could be attractive to the buyer and seller if current market interest rates are higher than the rate on the existing loan. The transaction would be unattractive to the lender, who would want to be paid off on the existing, lower rate loan and make a new, higher rate loan. The transaction would also be unattractive to the secondary mortgage markets for the same reason. Congress decided that the interests of lenders and the secondary markets outweighed those of individual borrowers when it enacted the Federal Due-on-Sale Law in 1982.

Some may recall the rapid inflationary period that existed in the late 1970s and early 1980s. Mortgage lenders (mostly banks in those days) had extended many long-term mortgage loans at relatively low fixed rates of interest in reliance upon historically low rates of inflation. However, when inflation increased at virtually unprecedented rates, the cost of funds for banks (through deposit accounts or other sources) also increased at an alarming rate.[6] Because many states had laws placing interest rate caps and other limitations on mortgage loans, banks couldn't make mortgage loans at a high enough interest rate to cover their cost of funds, so they stopped making the loans. Recent history demonstrates what happens to the economy when banks stop making credit available. So, in the early 1980s, the federal government stepped in.

Federal Preemption

In an attempt to stimulate the economy, Congress took several major steps to encourage banks to reopen the mortgage loan market. The first step was to preempt state usury limits that applied to most first-lien residential mortgage loans ("Federally Related Mortgage Loans"). Thus, Congress passed the Depository Institutions Deregulation and Monetary Control Act of 1980[7] (DIDMCA) preempting (subject to certain state "opt-out" rights) state usury ceilings otherwise applicable to Federally Related Mortgage Loans. DIDMCA allowed banks (and other lenders) to charge higher rates of interest to reduce the risk associated with making long-term, fixed-rate mortgage loans in an unstable rate environment. The theory was that a loan at a higher rate was better for the borrower and the economy than no loan at all.

A second major step Congress took was to authorize mortgage loans with interest rates that track (more or less) the rate of inflation. Thus, Congress passed the Garn-St. Germain Depository Institutions Act of 1982[8] (the "Garn Act"). While the Garn Act had a number of historically significant purposes, Title VIII of the Garn Act, also known as the "Alternative Mortgage Transaction Parity Act"[9] (the "Parity Act"), preempted state laws that restrict "alternative mortgage transactions" (mortgage loans other than fixed-rate, self-amortizing loans). While federally chartered financial institutions previously had the authority to engage in "alternative mortgage transactions," the Parity Act provided "parity" for state-chartered and state-licensed financial institutions. Thus, the Parity Act extended to state mortgage lenders the authority to make mortgage loans that include, among other features, interest rates tied to indices that track inflation, irrespective of any state law prohibiting or limiting such features.

Congress was sensitive to certain "states' rights" sentiments, recognizing that a state might have an overriding interest in governing the financial affairs of its citizens. Thus, Congress included a three-year "opt-out period" or "window period" in the Parity Act during which a state could, by express statute or constitutional amendment, elect not to accept the federal preemption.[10] However, once that three-year period expired, so did a state's right to opt out of the preemptive effects of the law.[11] Since the Garn Act (including the Parity Act) was effective October 15, 1982, a state had to act by October 15, 1985, if it wanted to opt out. New York enacted Banking Law § 6-g in 1983. The law states that New York opted out of the federal preemption in the Parity Act.[12] Thus, state-licensed or chartered lenders must look to New York law for authority to make "alternative mortgage transactions" to residents of New York.[13]

The Federal Due-on-Sale Law, enacted as Section 341 of Title III of the Garn Act,[14] targeted yet another area of state law that Congress felt had a negative impact on the margin squeeze experienced by banks, state "due-on-sale" limitations. Some states prohibited or substantially restricted due-on-sale clauses in mortgage loans. In some places, due-on-sale restrictions were considered an unlawful restraint on alienation. Those states required lenders to allow a home purchaser to assume an existing mortgage loan on the property being purchased, or to take ownership of the property subject to the existing mortgage. These states allowed property purchasers to take advantage of existing mortgage loans with low fixed rates of interest, resulting in a further squeeze on bank margins.[15]

By enacting the Federal Due-on-Sale Law, Congress preempted state restrictions on due-on-sale clauses, stating that "the exercise by the lender of its option pursuant to such a clause shall be exclusively governed by the terms of the loan contract, and all rights and remedies of the lender and the borrower shall be fixed and governed by the contract."[16] But the Federal Due-on-Sale Law also imposed limits on the exercise of due-on-sale clauses. Congress recognized that giving a lender an unfettered right to call a mortgage loan upon the transfer of property rights would be inappropriate in certain circumstances. So, the Federal Due on Sale Law provides a list of circumstances under which a lender cannot exercise its rights under a due-on-sale clause.[17] Similar to the approach it took in the Parity Act, Congress provided to the states a three-year "window period" to opt out of the federal preemption in the Federal Due-on-Sale Law.[18] New York did not opt out. As a result, in each instance where the exception under the Federal Due-on-Sale Law differs from New York law, the New York law is preempted. New York has no room to add or subtract from a lender's due-on-sale rights.

Contrary to the stated intent of the New York legislature, the limits in Banking Law § 6-g on the exercise of a due-on-sale clause are not the same as the federal limits.[19] First, the Federal Due-on-Sale Law prohibits the exercise of a due-on-sale clause in the event of a further encumbrance or lien on the property.[20] For example, under this rule, a first-lien mortgage lender cannot call the loan due when a borrower obtains a second-lien mortgage loan on the same real property. Banking Law § 6-g contains no comparable provision. Second, both the federal and state laws include limitations with respect to certain intra-family transfers, but the two laws treat the limitations differently. Both laws generally prohibit the exercise of a due-on-sale clause in the following circumstances:

- A transfer to a relative resulting from the death of the borrower;
- A transfer where the spouse or child(ren) becomes an owner of the property; or
- A transfer resulting from a decree of dissolution of marriage, legal separation agreement, or from an incidental property settlement agreement by which the spouse (N.Y. adds, "of the borrower") becomes an owner of the property.

However, the Federal Due-on-Sale Law provides that the limitations apply only where "the transferee is a person who occupies or will occupy the property."[21] The New York law contains no such language. So, under Banking Law § 6-g, exercise of a due-on-sale clause would be prohibited for the described intra-family transfers whether or not the transferee occupies or will occupy the property. In short, the limitations in the Federal Due-on-Sale Law and the limitations in Banking Law § 6-g are different.

The Bottom Line

The bottom line is this: New York chose not to opt out of the Federal Due-on-Sale Law preemption within the statutory three-year opt-out period. Therefore, absent an amendment to the federal law, New York is foreclosed from opting out or overriding the federal law. So, it is puzzling that the New York legislature found it necessary to add due-on-sale limitations parallel (but not identical) to those in the Federal Due-on-Sale Law when the amendments would be preempted by the federal law. The recent amendments to Banking Law § 6-g limiting the exercise of due-on-sale clauses by state mortgage lenders are preempted, and mortgage lenders in New York State are subject to the same limitations on due-on-sale clauses as federally chartered financial institutions, as they were before the amendment.

Endnotes

1. 2008 N.Y. Laws ch. 152, § 1 (*eff.* July 7, 2008).
2. A "due-on-sale" clause in a mortgage requires that the borrower pay the full balance of a mortgage when a property is sold. Federal law prohibits federally-chartered banks from treating property transfers between family members as a sale with respect to this contract clause, and they are therefore unable to require that the balance of a mortgage be paid upon transfer in these cases. State-chartered banks are not subject to the same rule, and although they rarely exercise the option pursuant to the "due on sale" clause in these cases, New York State law should provide this protection for family members. State-chartered banks currently have the option of requiring the full balance of a mortgage be paid upon the death of the property owner, transfer of property to children, transfers during a divorce, and in other cases. This bill would codify what is already done in practice, providing consumers with definitive legal protection when receiving property through a transfer from a family member, trust,

or leasehold interest. A251, 2008 N.Y. Leg. Sess., Memorandum in Support of Legislation.

3. *See* 12 U.S.C. § 1701j-3(a). The federal due-on-sale rules apply to state-chartered banks and other state licensed lenders.
4. *See* 12 U.S.C. § 1701j-3(d); 12 C.F.R. § 591.5(b).
5. 12 U.S.C.A. § 1701j-3(b)(2); 12 C.F.R. § 591.5(a).
6. Recall that, in the late 1970s and early 1980s, prior to the proliferation of securitization trusts and mortgage backed securities, more lenders held their mortgage loans in portfolio.
7. 93 Stat. 1113 (*codified as* 12 U.S.C. § 1735f-7).
8. 96 U.S. Stat. 1469.
9. 96 U.S. Stat. 1469, 1545-1548 (*codified as* 12 U.S.C. §§ 3801–3805).
10. 12 U.S.C. § 1701j-3(c).
11. *Id*.
12. "The provisions of Title VIII of an act of congress entitled 'Garn-St. Germain Depository Institutions Act of 1982,' United States Public Law 97-320, and the preemption of state law provided in section 804 thereof, shall not apply with respect to residential real property and cooperative apartment unit alternative mortgage transactions subject to the laws of this state, except as provided in this section." 1983 Laws of New York, c. 1, § 2 (*enacted as* New York Banking Law § 6-g).
13. New York had already enacted a statute, Banking Law § 6-f, and the New York State Banking Board had promulgated implementing regulations, 3 N.Y.C.R.R. Part 82, which governed and continue to govern "alternative mortgage transactions."
14. 96 U.S. Stat. 1469, 1505–1507 (*codified as* 12 U.S.C. § 1701j-3).
15. You can find a good history of due-on-sale issues in *Fidelity Federal Sav. and Loan Ass'n v. de la Cuesta*, 458 U.S. 141 (1982).
16. 12 U.S.C.A. § 1701j-3(b)(2).
17. *Specific limitations*. With respect to any loan on the security of a home occupied or to be occupied by the borrower,

    (1) A lender shall not (except with regard to a reverse mortgage) exercise its option pursuant to a due-on-sale clause upon:

    (i) The creation of a lien or other encumbrance subordinate to the lender's security instrument which does not relate to a transfer of rights of occupancy in the property: Provided, That such lien or encumbrance is not created pursuant to a contract for deed;

    (ii) The creation of a purchase-money security interest for household appliances;

    (iii) A transfer by devise, descent, or operation of law on the death of a joint tenant or tenant by the entirety;

    (iv) The granting of a leasehold interest which has a term of three years or less and which does not contain an option to purchase (that is, either a lease of more than three years or a lease with an option to purchase will allow the exercise of a due-on-sale clause);

    (v) A transfer, in which the transferee is a person who occupies or will occupy the property, which is:

    (A) A transfer to a relative resulting from the death of the borrower;

    (B) A transfer where the spouse or child(ren) becomes an owner of the property; or

    (C) A transfer resulting from a decree of dissolution of marriage, legal separation agreement, or from an incidental property settlement agreement by which the spouse becomes an owner of the property; or

    (vi) A transfer into an inter vivos trust in which the borrower is and remains the beneficiary and occupant of the property, unless, as a condition precedent to such transfer, the borrower refuses to provide the lender with reasonable means acceptable to the lender by which the lender will be assured of timely notice of any subsequent transfer of the beneficial interest or change in occupancy.

    (2) A lender shall not impose a prepayment penalty or equivalent fee when the lender or party acting on behalf of the lender

    (i) Declares by written notice that the loan is due pursuant to a due-on-sale clause or

    (ii) Commences a judicial or nonjudicial foreclosure proceeding to enforce a due-on-sale clause or to seek payment in full as a result of invoking such clause.

    (3) A lender shall not impose a prepayment penalty or equivalent fee when the lender or party acting on behalf of the lender fails to approve within 30 days the completed credit application of a qualified transferee of the security property to assume the loan in accordance with the terms of the loan, and thereafter the borrower transfers the security property to such transferee and prepays the loan in full within 120 days after receipt by the lender of the completed credit application. For purposes of this paragraph (b)(3), a qualified transferee is a person who qualifies for the loan under the lender's applicable underwriting standards and who occupies or will occupy the security property.

    (4) A lender waives its option to exercise a due-on-sale clause as to a specific transfer if, before the transfer, the lender and the existing borrower's prospective successor in interest agree in writing that the successor in interest will be obligated under the terms of the loan and that interest on sums secured by the lender's security interest will be payable at a rate the lender shall request. Upon such agreement and resultant waiver, a lender shall release the existing borrower from all obligations under the loan instruments, and the lender is deemed to have made a new loan to the existing borrower's successor in interest. The waiver and release apply to all loans secured by homes occupied by borrowers made by a Federal savings association after July 31, 1976, and to all loans secured by homes occupied by borrowers made by other lenders after the effective date of this regulation.

    (5) Nothing in paragraph (b)(1) of this section shall be construed to restrict a lender's right to enforce a due-on-sale clause upon the subsequent occurrence of any event which disqualifies a transfer for a previously-applicable exception under that paragraph (b)(1). 12 C.F.R. § 591.5(b).
18. 12 U.S.C. § 1701j-3(c)(1)(A).
19. *See* 12 C.F.R. § 591.5(b), New York Banking Law § 6-g(2).
20. 12 C.F.R. § 591.5(b)(1)(i).
21. 12 C.F.R. § 591.5(b)(1)(v).

Geoffrey C. Rogers is a partner in the Clifton Park, New York office of Hudson Cook, LLP. Timothy P. Meredith is a partner in the Hanover, Maryland office of Hudson Cook, LLP. Hudson Cook, LLP advises national and state banks, federally and state-chartered savings associations, bank and thrift holding companies, licensed finance companies and mortgage bankers, insurance and securities companies, investment banks, and many "e-commerce" firms in virtually all aspects of state and federal consumer financial services law.

What's the Point of New York's LLC Publication Requirement?

By Steven Masur

Introduction

In New York, every new Limited Liability Company must announce its formation by placing notices in two publications for six weeks, at a cost of up to $2,000. Despite the information being readily available on the Web site of the New York Department of State, the legislature has long affirmed the mandatory publication of an LLC's name, basic contact information, and notice of formation. Lawyers, investors, and others who understand how difficult it is to attract new start-ups to New York have long been outraged by the publication requirement, but the legislature has consistently reaffirmed the requirement, most recently in 2006. Various arguments have been advanced regarding the purpose of this tax on new businesses in New York. But ultimately, the real effect is to foster confusion and drive new businesses away from New York.[1] Now there is a new movement to abolish the requirement, which is picking up steam.

The Publication Requirement and Its Most Recent Changes

Prior to June 1, 2006, the publication requirement (Limited Liability Company Law § 206) required businesses formed as LLCs to announce their existence in two newspapers, one daily and one weekly, for a period of six consecutive weeks. Depending on the county in which the LLC is located, and the periodicals specified by the County Clerk, the total cost hovers around $2,000.[2] The publication cannot take the form of an advertisement. It must adhere to strict formatting guidelines spelled out by the statute. (See example of actual LLC publication notice which follows).

> Posted: 09-JUL-08
>
> **NOTICE OF FORMATION of Capitol Capital, LLC.**
>
> Articles of Organization filed with Secy. of State of NY (SSNY) on June 9, 2008. Office location: New York County. SSNY designated as agent of LLC upon whom process against it may be served. SSNY shall mail process to: Capitol Capital, LLC, c/o Ms. Nancy Preston, 7 Cactus Avenue, Dix Hills, NY 11746. Purpose: any lawful act or activity. 4046941 jy8-Tu au12

A Typical LLC Publication Notice: Price is approximately $1,000 for six weeks.

Seeing no immediate utility in publishing an expensive announcement that no one reads, many LLCs have simply ignored the requirement and have allocated this money to more pressing areas of their business. Prior to the 2006 amendment, the only penalty enforced by the state was that the LLC would lose standing to bring a lawsuit in New York.[3] Consequently, a noncompliant LLC wishing to sue would simply publish, wait six weeks, file and sue, or publish simultaneously with their lawsuit and come into compliance prior to opposing counsel's motion to dismiss for lack of standing. With no penalties for delaying the publication of the notice, it was a better business decision to publish when actually necessary, instead of within 120 days as the law requires

Many attorneys presumed that the legislature would eventually amend the statute to do away with the publication requirement, especially given that only two other states[4] have similar publication requirements for LLCs.[5]

However, instead of removing the publishing barrier, in 2006 the Legislature amended the penalty to suspend a noncompliant LLC's right "to carry on, conduct or transact any business" in New York.[6] Initially it was difficult to discern what this actually meant, because the new law explicitly does not impair the LLC's right to contract, or the right of other parties to sue the LLC. Furthermore, the statute states that suspension will not "result in any member, manager, or agent of such limited liability company becoming liable for the contractual obligations or other liabilities of the limited liability company."[7] The practical effect of the new penalty was essentially nothing more than an intimidating rewording of the preexisting penalty. In addition, the Secretary of State has indicated it will not keep a record of LLCs that are not in compliance, further reducing any real liability for failing to publish.[8] Still, faced with the possibility of sudden enforcement, risk-averse attorneys are likely to advise new ventures to form elsewhere.

What If New York Is the Only Place You Can Do Business?

According to the New York County Lawyers' Association's Executive Committee's 2006 letter to then-Governor Pataki, the original legislative intent of this "antiquated requirement . . . [was] one of consumer protection, as the publication of the notice of formation ostensibly serves to put the public on notice that an entity has been formed to do business . . . within a corporate structure that shields its owners from personal liability for the debts, obligations and liabilities of the business entity."[9] But if this is the true purpose of the requirement, then it is surely a holdover from a prior age, given the easy ability to obtain the same information from the Secretary of State's own

Web site for free. However, the analysis above begs a more important question. What is a well-meaning early stage entrepreneur supposed to do, given the complicated state of affairs discussed above?

The statute appears unlikely to achieve its alleged goal of causing more LLCs to publish their existence. Instead, it seems clear that well-advised new businesses will use a different business form in New York, or will form their LLC in a different state, as long as they can avoid filing an Application for Authority to Do Business in New York. In short, well-informed LLCs will avoid forming in New York if possible.

So Why Have the Publication Requirement at All?

Given the clear discrepancy between the stated purpose and actual consequences of the publication requirement, there must be some valid reason why the New York legislature continually preserves this requirement. We believe the most probable answer is the financial benefit afforded to the short list of newspapers in which LLCs must publish.

The statute dictates explicit requirements for the publishing and formatting of the notice ads.[10] Also, the County Clerk maintains a short list of newspapers that fit the statute's strict circulation and publication frequency requirements. This short list of approved newspapers can charge a premium for publishing the notices of formation. Consequently, the publication requirement forces an LLC choosing to do business in New York to pay what amounts to a state-mandated formation tax to a *private* print publication, the amount of which is arbitrarily set by that publication. Like a Mario Puzo novel, the LLC wishing to do business in New York is given "an offer it can't refuse." The only other option is to willfully ignore the law. Some have even argued that the statute's formatting requirements are "quasi-judicial" and will create a controlled market that is likely to further increase this premium.[11]

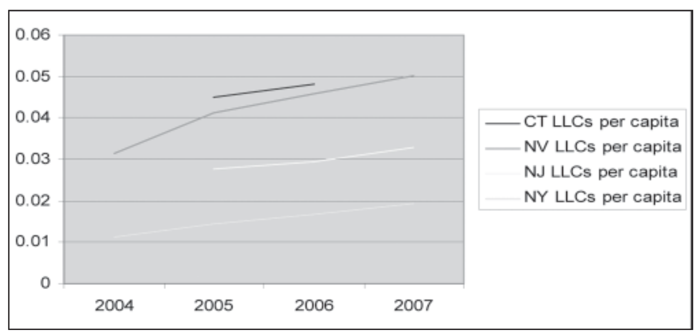
An examination of the 2006 legislative history adds credence to this theory. The original Chapter 767 amendment scaled the duration of publication back to four weeks, but at the eleventh hour the duration was pushed back up to six weeks.[12] Two more weeks does not meaningfully increase the public's chance of becoming aware of an LLC. The public already enjoys unfettered, 24-hour access to a database containing information about every New York business. The only beneficiaries are the periodicals that New York LLCs must pay to publish a 14-line ad.[13] The publications get two more weeks of revenue.

What Is the Legislature Doing Now?

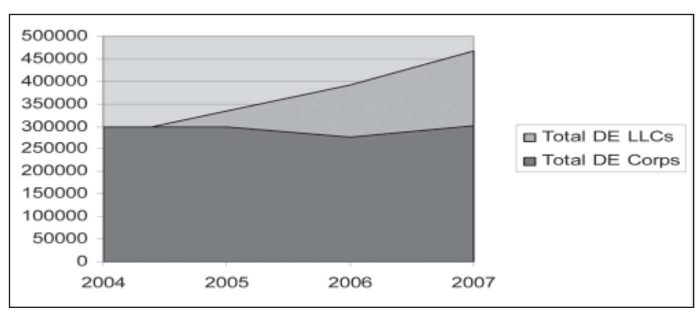
On May 27, 2008, Assemblyman Micah Z. Kellner brought Bill A11287 before the New York State Assembly. If successful, the bill would have eliminated the publication requirement and the corresponding filing fees for affidavits of publication. The bill proposed an online filing requirement with a fee of $50, essentially updating N.Y. LLC law to actually accomplish its alleged purpose of providing notice to the public, and providing the state with some revenue to cover its costs. However, the bill was introduced very close to the end of session and did not go to a vote.[14] With a potential $35 million of income at stake, the publishing industry unsurprisingly opposes the bill.[15] Arrayed against New York's highly organized and well represented publishing elite are a few frustrated attorneys and thousands of LLCs who either don't know, or have no incentive to disclose, that they are in violation of the statute for failing to publish.

Our Conclusions

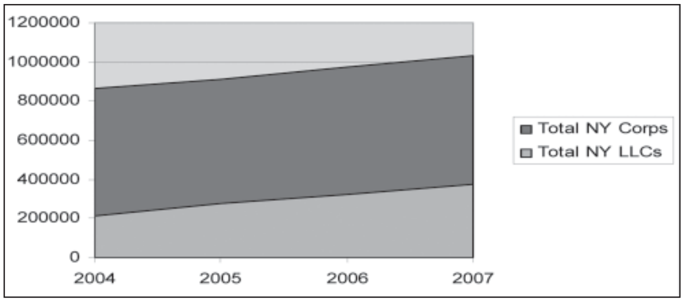
New York's publication requirement will cause new LLCs to avoid forming in New York in order to avoid the unnecessary fees, or if they must form in New York, to ignore the requirement or choose a different form. Since this statute also applies to any foreign LLC with sufficient contacts in New York to warrant filing for authority to do business within the state, it will also cause these LLCs to avoid doing business in New York, if possible. The numbers bear out the truth of these statements. As the charts below show, the ratio of new LLC formations to new corporation formations in New York is half that of both Delaware and New Jersey.[16]



LLCs Per Capita: NY is well below CT, NV & NJ (DE is off the charts at ~.300-.500+).



Total DE LLCs vs. Total DE Corporations: LLCs are on a sharp increase, while corporations remain somewhat constant.



Total NY LLCs vs. Total NY Corps: The slower growth of NY LLCs compared with DE LLCs suggests that businesses are choosing to form corporations instead of LLCs, or simply choosing to form in a different state.

The legislature should not continue to overlook the negative effect the publication requirement has on LLCs that want to do business in New York. Almost any business starting in New York would wish to spend its money more strategically and avoid the risk that the LLC will be declared invalid, exposing the owners to personal liability. Businesses with a choice will form LLCs elsewhere, while those with no choice will choose a different form. We urge the legislature to abolish the publication requirement.

How Attorneys Should Counsel Their Clients

As long as the publication requirement for LLCs exists in New York, responsible attorneys should counsel their clients to either form a corporation, or when forming an LLC, to comply with the publication requirement in order to remain in good standing within New York. However, since the penalty does not revoke the right to contract, clients may be made aware that the only direct penalty for not complying with the law is the loss of the right to bring lawsuits within the state. As a result, if a noncompliant LLC should ever need to file a suit in New York, it must take into account the time required to bring itself into compliance with the publication requirement before filing its claim.

Endnotes

1. The New York State Bar Association (NYSBA) Real Property Law Section, and an overwhelming majority of the NYSBA Executive Committee, opposed the publication requirement generally, along with the recently enacted amendments to the LLC publication requirements set forth in Chapter 767 of the Laws of New York 2005. *See* Memorandum in Opposition from the Real Prop. Law Section of the NYSBA (Mar. 31, 2006).
2. For average costs, *see* Beth D. Tractenberg, New York Limited Liability Companies and Partnerships: A Guide to Law and Practice, 1 N.Y. Prac. § 5:12, n. 2 (2008).
3. N.Y. LLC Law § 206 (a)(7) (1999), *amended by* N.Y. LLC Law § 206 (2006).
4. At the time of writing, these states were Arizona (Ariz. Rev. Stat. § 29-635(C)) and Nebraska (Neb. Rev. Stat. § 21-2653), which also maintain a publication requirement for corporations. However, New York is the only state with a publication requirement that applies only to LLCs and NOT to corporations. *See* J. William Callison & Maureen A. Sullivan, Limited Liability Companies: A State-by-State Guide to Law and Practice § 14:11-60 (West 2008).
5. *See* Joshua Stein, *New York's Limited Liability Company Law Takes a Big Step in the Wrong Direction*, 34 N.Y. REAL PROP. J. 2, 2–4 (2006).
6. N.Y. LLC Law § 206(a)(7).
7. *Id.*
8. Bruce A. Rich, West's McKinney's Forms Limited Liability Company Law Summary, 3E (MCF SELLLC SUM).
9. Letter from Norman L. Reimer, President of the New York County Lawyers' Association, to George Pataki, Governor of the State of New York, *et al.*, (Apr. 26, 2006) (on file at http://www.nycla.org/siteFiles/News/News32_0.pdf).
10. N.Y. LLC Law § 206(a).
11. *See* Joshua Stein, *New York's Limited Liability Company Law Takes a Big Step in the Wrong Direction*, 34 N.Y. REAL PROP. J. 2, 2–4 (2006). *See also* Nat'l Corporate Research Ltd., New York's Publication Requirements: Department of State's Position on "Suspended" Status (Feb. 2007), www.nationalcorp.com/pdfs/NY_DOS_suspension_Feb_12_07.pdf.
12. *See* S.6831-B, (2006), *amending* Chapter 767 of the Laws of 2005.
13. A public notice in the *New York Law Journal* costs $723.20 for up to 14 lines. There is an additional $8.55 per line/insertion for every line thereafter; *see* http://publicnotices.law.com/NYLawyer/.
14. http://assembly.state.ny.us/leg/?bn=A11287.
15. According to the International Association of Commercial Administrators' (www.iaca.org) Annual Jurisdictional Reports (2008), there were 49,797 new LLCs in NY in 2007. That number, assuming all new LLCs publish, multiplied by a conservative average cost of $700 (*see supra* note 3), comes to $34,857,900 in potential income for the industry.
16. Int'l Ass'n of Commercial Adm'rs, Annual Jurisdictional Reports (2008), *available at* http://www.iaca.org/node/80.

Mr. Masur is the managing director of MasurLaw, a technology, entertainment and venture law firm internationally recognized for its work with new businesses. **Mr. Masur would like to thank Andrew Bain, Peter Elkins-Williams & Stephen Barrett, without whose help this article would not have been written.**

New York Employment Law Update

By James R. Grasso

Ledbetter Fair Pay Act Enacted

On January 29, 2009, President Obama signed into law the Lilly Ledbetter Fair Pay Act ("Act"). The Act reverses the Supreme Court's decision in *Ledbetter v. Goodyear Tire & Rubber Co.*, 550 U.S. 618 (2007), in which the Supreme Court held that the time for an employee to challenge discrimination in compensation begins to run from the time the discriminatory compensation action occurs. In *Ledbette*r, the Supreme Court held that Ledbetter's claim that her current pay was unlawful sex discrimination in violation of Title VII was untimely because the compensation action that she complained about, the setting of her pay rate, was made outside the time period for filing a charge with the Equal Employment Opportunity Commission. The Act is not limited to sex discrimination claims and amends not only Title VII, but also the Americans with Disabilities Act (ADA), the Rehabilitation Act, and the Age Discrimination in Employment Act (ADEA), by extending the statute of limitations for bringing a compensation discrimination claim under those statutes. Contrary to popular reports, the Act is not an "equal pay bill" or a "gender pay equity law."

Under the Act, the time for filing a claim of compensation discrimination commences: (1) when a discriminatory compensation decision or other practice is adopted; (2) when an individual becomes subject to a discriminatory compensation decision or other practice; or (3) when an individual is affected by application of a discriminatory compensation decision or other practice, including each time wages, benefits, or other compensation is paid, resulting in whole or in part from such a decision or other practice. Thus, the Act makes a compensation discrimination claim timely under any of the amended statutes if it is brought within the statutory charge filing period beginning on the date of the last paycheck that the employee contends was affected by a discriminatory compensation action, no matter when the discriminatory action occurred. Each successive affected paycheck restarts the period for filing a charge. Although the Act extends the statute of limitations for filing a claim, it does not impose unlimited back pay liability on employers. Employees may obtain relief, including recovery of back pay, for two years preceding the filing of a charge of discrimination, where the unlawful practices that occurred during the charge filing period are similar or related to unlawful compensation discrimination that occurred outside the time period for filing a charge.

The Act is retroactive to May 28, 2007, and applies to all claims of compensation discrimination under Title VII, the ADEA, the ADA, and the Rehabilitation Act pending on or after that date.

ADA Amendments Effective January 1, 2009

On January 1, 2009, the ADA Amendments Act of 2008 (Act) became effective. The Act expands the protections provided by the Americans with Disabilities Act (ADA) and overturns several U.S. Supreme Court decisions that restricted the scope of the ADA's protection. As a result of the Act, more individuals will now qualify as disabled under the ADA, and it will be more difficult for employers to have ADA disability discrimination cases dismissed before trial.

The Act expands the ADA in several ways. It provides that an impairment that substantially limits one major life activity need not limit other major life activities to be considered a disability. An impairment that is episodic or in remission will now be considered a disability if it would limit a major life activity when active. The new law also eliminates consideration of mitigating measures in determining if a person is disabled within the meaning of the ADA. Several kinds of mitigating measures are explicitly identified as being prohibited from consideration, including the following: (1) medication, medical supplies, equipment and appliances and low-vision devices (not including ordinary eyeglasses or contact lenses); (2) prosthetics, hearing aids and mobility devices; (3) oxygen therapy equipment; and (4) learned behavioral or adaptive neurological modifications. Individuals who wear ordinary eyeglasses and contact lenses remain outside the ADA's coverage.

The Act also clarifies the ADA by defining "major life activity" to include the following: caring for oneself, performing manual tasks, seeing, hearing, eating, sleeping, walking, standing, lifting, bending, speaking, breathing, learning, reading, concentrating, thinking, communicating and working. The term "major life activity" also includes "the operation of a major bodily function, including but not limited to, functions of the immune system, normal cell growth, digestive, bowel, bladder, neurological, brain, respiratory, circulatory, endocrine and reproductive functions."

Another major change affects the "regarded as" category of the ADA's definition of disability. Under current law an individual alleging discrimination under the "regarded as" prong must show that his or her employer regards him or her as having an impairment that substantially limits a major life activity. The Act loosens the "regarded as" standard by providing that an individual qualifies as disabled under the ADA's "regarded as" prong "if the individual establishes that he or she has been subjected to an action prohibited under this Act because of an actual or perceived physical or mental impairment, whether or not the impairment limits or is perceived to limit a major life activity." Thus, to qualify as disabled under the "regarded as" prong, an individual will now only have to prove that his or her employer perceived the individual as having an impairment and discriminated against him or her as a result. The "regarded as" category excludes impairments that are transitory (less than six months in actual or expected duration) and minor. The Act provides that reasonable accommodations are required only for persons who have an impairment that substantially limits a major life activity or a record of such an impairment. Reasonable accommodations need not be provided to persons who are "regarded as" having an impairment.

New Criminal Conviction Notice Requirements for Employers and Consumer Reporting Agencies

As of February 1, 2009, New York employers are now required to post a copy of Article 23-A of the New York Correction Law and any related regulations issued in the future. Article 23-A contains the conditions under which an employer may deny an applicant employment or act adversely toward an employee because of a prior criminal conviction. This new posting requirement stems from the recent enactment of Section 201-f of the New York Labor Law. The posting must be done in a place accessible to employees and in a visually conspicuous manner. As a result of an amendment to General Business Law § 380-c, in addition to having to post a copy of Article 23-A, New York employers must also now provide a copy of Article 23-A to individuals subject to background checks conducted by third parties at the same time that the individual is notified that a background check may be requested. The General Business Law has also been amended by adding Section 380-g(d), which requires that whenever a consumer reporting agency provides a consumer report to a client that contains criminal conviction information, the agency must also provide a written or electronic copy of Article 23-A to the person who is the subject of the report.

New York Employers Must Comply With New Guidelines Regarding Blood Donation Leave and Break Time to Express Breast Milk

New York employers with at least one site of employment with 20 or more employees must now comply with guidelines recently issued by the New York State Department of Labor (NYDOL) implementing the provisions of New York's blood donation leave law, Labor Law § 202-j. Under the guidelines, employers must provide either up to three (3) hours of unpaid leave per year for employees to donate blood off-site or provide paid leave at least twice per year for employees to donate blood at on-site blood drives. Regardless of which option is provided, the employer must provide written notice to employees of their rights. In the case of unpaid leave for off-site donation, notice may be provided either by posting a notice in a conspicuous location, providing a notice directly to employees, or including a notice in an employee handbook. In the case of on-site blood drives, notice of the blood drive must be posted in the workplace at least two weeks beforehand. The blood donation guidelines can be obtained from the NYDOL.

All New York employers, regardless of size, must now also comply with NYDOL guidelines implementing New York Labor Law § 206-c regarding the expression of breast milk in the workplace. Under the guidelines, employers must provide written notice to employees of their right to take unpaid breaks to express breast milk in the workplace. This notice requirement can be met by either posting a notice in a conspicuous location, providing a notice directly to employees, or including a notice in an employee handbook. The guidelines provide that in most circumstances each break must be at least 20 minutes and that employees may take a break every three hours. Employees may elect to use paid break or meal periods in lieu of unpaid breaks. If the employee requests, the employer must also allow the employee to work before or after the employee's normal shift to make up the amount of time used during unpaid breaks, so long as the additional time requested falls within the employer's normal work hours. The breast milk guidelines also contain, among other things, specific rules about the condition of the room or location that employers must provide to employees who express breast milk in the workplace. The breast milk guidelines can be obtained from the NYDOL.

New York Enacts New Workplace Privacy Laws

As of January 4, 2009, New York employers are now subject to two new laws intended to strengthen existing identity theft laws. These new laws impose new obligations on employers regarding the handling of employee personal information.

A. Use of Social Security Numbers Restricted

Labor Law § 203-d has been amended to restrict employers' use of employees' Social Security numbers. These new restrictions are in addition to the amendments to General Business Law § 399-d dealing with the use of Social Security numbers that went into effect on January 1, 2008. The amendments to Labor Law § 203-d prohibit employers from doing the following:

i. posting or displaying an employee's Social Security number;

ii. visibly printing a Social Security number on any identification badge or card (including a time card); and

iii. placing Social Security numbers in files with open access.

B. Disclosure of "Personal Identifying Information" Prohibited

The amendment to Labor Law § 203-d also prohibits employers from communicating an employee's "personal identifying information" to the public. For purposes of this prohibition, "personal identifying information" means an employee's Social Security number, home address, telephone number, personal e-mail address, Internet identification or password, last name prior to marriage, and driver's license number.

Employers who knowingly violate the law are subject to a civil penalty of up to $500. A knowing violation will be presumed if the employer does not have in place policies or procedures to safeguard against violations, including procedures to notify or train employees about the law's restrictions.

C. Encoding or Embedding Social Security Number Prohibited

Section 399-dd(2) of the General Business Law has also been amended to prohibit encoding or embedding a Social Security number in or on a card or document, such as by means of a bar code, chip, magnetic strip or other technology, in lieu of removing the Social Security number.

New York Enacts "WARN" Law for Layoffs, Closings and Relocations

The New York State Worker Adjustment and Retraining Notification Act (NYWARN) became effective on February 1, 2009. Although patterned after the federal Worker Adjustment and Retraining Notification Act (WARN), NYWARN applies to employers not otherwise covered by WARN, thereby expanding the number of New York employers who must now give notice of a mass layoff, plant closing or covered relocation.

NYWARN, like federal WARN, requires notice of mass layoffs and plant closings. However, NYWARN applies to smaller employers and requires fewer affected employees for its notice requirements to apply. NYWARN covers employers who employ 50 or more full-time employees or who employ 50 or more employees who work in the aggregate at least 2,000 hours per week.

NYWARN requires that 90 days notice, instead of the 60 days required by WARN, be given if any one of the following applies:

i. 25 full-time employees who constitute at least 33% of the workforce are laid off during any 30-day period;

ii. at least 250 full-time employees are laid off during any 30-day period; or

iii. at least 25 full-time employees are terminated as the result of a plant closing over a 30-day period.

NYWARN also requires 90 days advance notice if an employer relocates all or substantially all of its operations 50 miles or more from the current location regardless of whether this causes an employment loss. This requirement is not present in WARN. Like WARN, NYWARN also contains exemptions in the cases of an employer actively seeking capital and for closings caused by natural disasters.

The New York Department of Labor has issued emergency regulations implementing NYWARN, and it should be consulted before undertaking any covered mass layoff, closing or relocation.

James R. Grasso is a partner with Phillips Lytle LLP, Buffalo. He focuses his practice in the area of labor and employment on behalf of management in the private and public sectors and counsels clients on the full range of human resources issues. His labor law practice encompasses labor arbitrations, negotiating collective bargaining agreements, contract administration and defending management before NLRB, PERB and other federal and state agencies.

Adapt or Die[1]

A Comparative Analysis of the American and Chinese Legal Approaches to the M&A Deal

By Megan Burke

The U.S. and Chinese legal systems differ fundamentally in a number of areas. With respect to a merger or acquisition transaction (individually, an "M&A deal" and collectively, "M&A deals" or "M&A"), there are basic differences in compliance standards, transaction regulation, governing case law, cultural influences, negotiation style and deal mechanics. Consequently, these differences can present numerous challenges for an American practitioner working on an M&A deal involving Chinese entities or taking place in China.

This article provides an overview of the differences in M&A practice in the two countries. Section I offers a brief overview of the Chinese deal-making landscape. Section II will explain key legal considerations that Chinese and American attorneys should keep in mind, with an emphasis on actual laws that have recently been enacted in China and how such laws impact the viability of an M&A deal. Section III outlines how Chinese and American culture impact M&A in China. Section IV will offer a conclusion of the article's analysis.

The research explored in this article is especially relevant for New York transactional attorneys because so many U.S. law firms that practice in China are headquartered in New York State. Given the robust M&A market in China and the fact that many U.S. multinational companies are being directly impacted by the 2006 M&A Rules and the 2008 Anti-Monopoly Rules (Coca Cola just had a deal blocked because of these rules), the issue is important for both New York attorneys and their clients who are involved in foreign deals.

Themes introduced throughout this article are based upon secondary research conducted from August 2008 until December 2008. Research results were bolstered by a December 2008 visit to Shanghai, China and numerous telephone and in-person interviews with attorneys, trained in both China and the United States, who practice M&A law in China and the United States.[2]

I. Introduction: Deal Landscape Overview

Over the last fifteen years,[3] the manner in which an M&A deal closes in China has changed significantly, due to a variety of factors. Significant changes have taken place within the Chinese legal and economic landscapes, forcing M&A attorneys in China, the U.S. and elsewhere to keep up with new and quickly evolving M&A rules, while remaining cognizant of the gamut of Chinese and American cultural tendencies which influence the way business is conducted in a broad sense and, more specifically, the way an M&A deal is transacted. This article will discuss the New 2006 M&A Rules (the "2006 Rules"),[4] the M&A Provisions of the August 2008 Anti-Monopoly Law (the "AML M&A Provisions," or the "2008 Provisions")[5] as well as Chinese M&A rules, generally, in order to explain how these rules impact Chinese and American attorneys' efforts to close deals.

A. Government Approval Required: China

Regardless of the nature or scope of a merger conducted in China, or the industries and sectors represented by the companies involved in the transaction, "all investments in China by foreign entities require extensive government approvals. Depending on the nature of the buyer, the seller, and the target, such approvals may be required from several different regulators in addition to the principal regulator of foreign investment in China, the Ministry of Commerce, known as MOFCOM."[6]

These layers of regulation, which were formalized by the 2006 Rules and re-enforced by the AML M&A Provisions, have yielded the following significant results: (1) deals take much longer to complete in China than they do in the United States and Europe, and (2) more factors which have a direct impact on the deal are left "up in the air" (pending regulatory approval), leaving questions unanswered and deal terms without finality.

The combination of a longer deal time line, which is counter-intuitive to the American approach of pushing the deal through no matter what, and considerable deal term uncertainty can lead to two very practical concerns for American attorneys and Chinese attorneys representing American clients: (i) an increase in the legal fees associated with the deal (caused by the fact that deals require more attorney billable hours to close), and (ii) a higher level of client frustration (attributable to the higher bills and the longer time before a deal is done).

The regulatory structure in place since the 2006 Rules were passed highlights the fact that

> [Chinese] government agencies play an important role in Chinese M&A transactions. There is a higher level of government participation in M&A transactions in China than is typical in other jurisdictions. Despite the recent relaxation of foreign investment restrictions, pervasive

> approval requirements remain a distinctive feature of M&A transactions in China . . . in many M&A transactions, government agencies act as both regulator and vendor, and will have social concerns that extend well beyond the commercial aspects of the transaction.[7]

B. High Levels of Government Involvement: Intrusive or Necessary?

Before 2007, American M&A attorneys might scoff at the level of regulation the Chinese government has in place in order to complete an M&A deal. However, given the current economic climate, the increasing number of M&A deals taking place in China, the recent U.S. measures that have resulted in the American government holding a considerable stake in private companies, in addition to the public outcry of American citizens for increased regulation, one can argue that the U.S. can learn significant lessons from the way the Chinese government regulates M&A deals.

In assessing such lessons, it is important to keep in mind the contrast between U.S. and Chinese market structures and economic philosophies, as each impacts the feasibility of M&A deals.[8]

II. Legal Considerations

There are many legal concepts and doctrines that come into play when an attorney represents a multinational client, a client with a significant percentage of Chinese holdings, or a Chinese client within the context of an M&A deal. These include several layers of regulation, choice of law, distinctions between a common law (American) and a civil law (Chinese) judicial system, the court's reliance (or non-reliance) on precedent, the age and history of a country's modern legal profession, differences in economic structure and contrasting judicial approaches to decision-making.[9]

A. Choice of Law

Of all of these legal concepts, the one that comes into play earliest on in the course of a deal is the choice of law (i.e., whose law will govern and what jurisdiction will preside over conflicts and legal questions that arise). It is important to keep in mind that given the number of layers of approval the Chinese regulatory scheme requires and the Chinese tendency toward state-owned entities, one of the most critical legal questions that must be answered before a deal can begin is "whose law will apply?"

According to an article in the *American Journal of Comparative Law*,

> foreign investments in China are always conducted against a multi-jurisdictional background. The question of which law is governing the different aspects of foreign investment projects in China is therefore of tremendous theoretical and practical significance.[10] The determination of the law governing a respective transaction is therefore crucial. Courts and arbitral institutions in China and elsewhere normally apply the private international law (PIL) rules of the country of their seat (lex fori) in order to solve conflict of laws questions. [11]

According to attorneys David Patrick Eich and Adam Li, the issue of choice of law is not open to interpretation. As expressed in his response to the question of how U.S.-trained attorneys can be successful in transacting Chinese M&A deals, Mr. Eich replied that the American attorney must "adapt or die."[12] In other words, the choice of law for an M&A deal involving a Chinese entity or an entity that has significant holdings in China is Chinese law.[13]

In addition to understanding relevant choice-of-law considerations, it is critical that both U.S.-trained and China-trained attorneys understand how courts operate in the U.S. as compared to how courts operate in China.[14] American and Chinese judges rely on different authority when making decisions because the U.S. is a common law jurisdiction and China is a civil law jurisdiction. Also, the existence of precedent (heavily relied upon in the U.S. and, up to now, practically non-existent in China) affects what attorneys rely upon when drafting transactional documents.[15] Lastly, what U.S. and Chinese judges consider (i.e., contractual terms, business standards, length and specificity level of a deal document) when making decisions generally and judicial decisions about M&A transactions more specifically, varies significantly.

B. Three Significant Regulatory Challenges

According to Adam Li, a partner of Jun He Law Offices, based in Shanghai, there are three main regulatory challenges that multinational corporations face when they begin to engage in an M&A deal in China:[16]

1. **Lack of Certainty:** Multinational corporations are often uncomfortable with the lack of certainty related to the deal (i.e., will the attorneys be able to obtain the necessary approvals and will the deal go through?). As an American attorney working on (i) a deal in China, or (ii) a deal that involves a Chinese entity, one must manage the client's expectations and be candid with the client about lack-of-certainty issues that arise during the course of the transaction, especially if the particular client is a company that has done little to no business in China. Similarly, Chinese attorneys who represent multinational corporations which engage in Chinese M&A must take similar steps to make their clients aware of the nuances associated with doing such transactions.

2. **Approval Requirements:** Deal approval requirements are extensive and take a long time to acquire. Thus, American and Chinese attorneys need to continue to manage client expectations, especially as they relate to attorneys' fees.

3. **Elements Beyond One's Control:** The inherent nature of doing business in China implicates many elements beyond one's control which have the potential to impact or delay a deal, including the Chinese government's lack of the human resource capacity required to approve many deals in a timely fashion, and the fact that certain industries are held to a higher standard of regulatory scrutiny while deals involving other industries are strictly prohibited.[17]

C. Challenges Posed By a Lack of Certainty

Facing elements beyond one's control (a unique regulatory framework, national security concerns and the government's capacity constraints) can be frustrating for business people and attorneys who are not used to the way deals are done in China. Mr. Li explained that American attorneys often seek certainty of deal terms, a deadline-driven deal timeline and many other formalized logistical aspects of a deal. According to Mr. Li, this is why working on an M&A deal can be challenging for American attorneys who are not well-versed in the Chinese way of doing things. Thus, it is important for an M&A team to consist of American attorneys who are well-versed in doing business in China (though these attorneys will serve largely as legal consultants because, according to Chinese law, they cannot formally appear before a judge in China),[18] as well as Chinese attorneys.

If the multi-national corporation involved in a deal is not headquartered in the United States, then it is not necessary for U.S. attorneys to be on the deal team. Rather, attorneys from the jurisdiction in which the multinational corporation is based, who are well-versed in how to do business in China, should be on the team. Mr. Li explained that the three challenges outlined above can be overcome by attorney and client patience and acceptance of the uncertainty.

Additional challenges associated with transacting an M&A deal in China include state ownership, sector/industry regulation and restriction and the American perception of an impermeable Chinese regulatory scheme.

David Patrick Eich further explained the impact of the lack of certainty on M&A deals involving Chinese entities. In his article entitled "Private Equity M&A in China," he wrote:

> given that certainty of property and other economic rights tends to be a key factor in determining the quantum of investment capital committed to a particular market, the impact of the flaws in China's legal system in general on M&A in China is probably considerable. Although China has shown substantial improvement in recent years, it remains somewhere in the middle of the pack of countries in respect to the amount of certainty its legal system provides investors.[19]

On the one hand, because the differences in regulatory structure and requirements in the U.S. and China are abundantly clear, one can easily understand how a lack of certainty (or even a perceived lack of certainty) could be both frustrating for non-Chinese entities trying to engage in M&A deals in China and counter-productive to China's overall economic interests and goals (especially given the country's significant rate of growth, despite the current global economic downturn).[20] On the other hand, although some might contest China's current regulatory scheme, the country is experiencing a high rate of economic growth as compared to other countries, which could be a sign that there is nothing wrong with the Chinese M&A regulatory framework.

Despite these challenges, as more deals are done in China (and which involve Chinese entities or entities that have significant holdings in China), and as the relevant laws in China evolve, some attorneys and business people believe that things are getting better and are moving toward more certainty, perhaps as a direct result of the recently enacted AML M&A Provisions.[21]

So what does all of this mean for transactional attorneys, multinational corporations and the market? China's accession to the WTO and regulatory changes have made the country a more viable M&A environment, because although there are many layers of regulatory review to overcome a legal structure is in place, and meeting all of the regulatory requirements is possible. However, government ownership stake and regulation pose significant challenges to American attorneys who are used to working on deals outside of China.

It is important that executives at non-Chinese entities who seek to pursue M&A deals in China, or with entities that have significant holdings in China, hire a legal team well-versed in both the formal legal regulations and the more nuanced yet equally pervasive non-legal challenges discussed throughout this article.

D. The 2006 Rules and Beyond

The 2006 Rules were "promulgated on August 8, 2006, effective on September 8, 2006"[22] and they "superseded the existing M&A Rules in China that were in place since April 12, 2003 [the "2003 Rules"]."[23] Not only did the new rules involve "six Chinese Government Agencies"[24] generally, but specifically, they set out significant differences for the Ministry of Commerce (MOFCOM). The 2006 rules required that MOFCOM "coordinate with other ministries during the approval process."[25] In addition, the rules gave "authority to the CSRC to approve offshore listings that concern Chinese assets, permit(ted) the use of foreign corporation securities to acquire Chinese corporations, [and] establish(ed) national security reporting requirements for acquisition of control by foreigners of companies in key industries, and reinfor[ced] the ability of government to monitor and prohibit foreign control transactions in key industries."[26] The new rules were promulgated by the six "principal agencies responsible for the oversight and regulation of foreign investment in China."[27]

E. Differences Between the 2006 Rules and Their Predecessors (the 2003 M&A Rules)

David Eich outlined three of the ways in which the 2006 Rules differ from the 2003 Rules. According to Eich, the three most notable changes (as compared to the 2003 Rules) for a foreign investor are (i) the fact that share exchange is now expressly permitted; (ii) foreign investors are now required to notify a Chinese government agency if a proposed deal results in foreign investor control of a Chinese company, as relates to a few key areas, and (iii) approval by a Chinese government agency is required "where a 'domestic person' in China establishes or controls a foreign company and the foreign company acquires a Chinese affiliated company."[28]

What is notable about these three changes is that while they still require significant approval from Chinese governmental agencies at every step of the way, they are less prohibitive than previous restrictions outlined in the 2003 Rules. Moreover, it appears as though the AML M&A Provisions enacted in 2008 will enhance, if not supersede, the 2006 Rules. However, because the AML was enacted so recently, the full extent of the impact of the AML M&A Provisions on deal activity and the ease with which a deal can be consummated remain to be seen; however, a recent proposed merger between Coca Cola and Chinese tea company Huiyuan was blocked because of the AML M&A Provisions. As a result, shares of the tea company plummeted by over 50%.[29]

F. A Vague Statute: A *Harvard Business Review* Case Sheds Light on the Ambiguous Language of the New Rules

A significant challenge that accompanies the 2006 Rules is the vagueness of the statutes' language. "There is no definition or standard on how to determine 'important industries,' 'actual control,' 'famous Chinese brand names'."[30] This ambiguity may or may not have been intentional on the part of the Chinese governmental agencies that issued these rules, given the pervasive role of regulation and the significant stake the Chinese government has in M&A transactions that take place in China. Notably, it is this same ambiguity in language that consistently presents challenges to American transactional attorneys, who often seek to eliminate vague terms in merger agreements in order to avoid ambiguities in language that could potentially result in client liability.

The statutory vagueness of language described in the Sonnenschein article is analogous to another type of ambiguity found in the Chinese M&A deal: vagueness in deal terms that is required by Chinese members of the deal team. A *Harvard Business Review* article entitled "Wyoff and China-Lu-Quan: Negotiating a Joint Venture,"[31] illustrates this point. In the case which the article discusses, the Chinese members of a joint venture negotiating team proposed a certain set of ground rules for the negotiation. The suggested ground rules included what the Chinese called "general principles." The rules were vague, and although the American members of the team were not quite comfortable with the general principles (mainly because the terms were so general that the American members did not fully understand what the Chinese negotiators were requiring), the Americans agreed to the terms because they wanted to forge ahead in an effort to "get the deal done." In the end, the Chinese negotiators, who considered relationship and trust-building (which included adherence to these ground rules) to be essential to closing the deal, tried to enforce the ground rules. Because the terms lacked specificity, conflict ensued between the American and Chinese deal teams, and the deal ultimately died.

This *Harvard Business Review* case illustrates how using less specific language in an agreement or within the course of a negotiation can be a strategy that the Chinese members of an M&A negotiating team use. This approach differs significantly from the American approach to negotiating and drafting, which places a strong emphasis on specificity, so as to prevent potential client liability.

Given the differences between the approach that American and Chinese attorneys and business people take when working on a deal, the fact that U.S.-trained attorneys are not allowed to fully practice law in China, the existing multi-layered regulatory scheme in China and the cultural differences that impact the dynamic of a transaction, American attorneys working on M&A transactions in China must adapt and understand that every term may not ultimately be memorialized in the deal documents.

Attorney willingness to adapt is also important for purposes of client-centered representation. For example, Chinese judges who find transactional documents to be too long (with many defined terms and every potential liability sealed up by pages of legalese) may become frustrated by the American approach and may view the additional language and attempts to avoid liability as completely irrelevant, or rather, planning for the divorce before the marriage.[32] Ultimately, if a Chinese judge is not comfortable with any aspect of a deal, he or she may prohibit that deal, which could cause a client to experience significant financial losses.

According to some, the 2006 Rules, as the AML M&A Provisions, "set up the most comprehensive and workable legal framework for takeovers of Chinese listed companies to date,"[33] while others believe that such regulations impose more roadblocks that impede an M&A transaction. Compared with the 2003 Rules, the 2006 Rules are likely to be found more facilitative. However, compared with the current regulatory scheme in the United States, the 2006 Rules may be viewed as prohibitive. Over the next year, as U.S. regulators struggle to define what needs to be done in the wake of the current global financial crisis, it will be interesting to follow whether U.S. regulators add new layers of regulation, while China begins to peel layers away with such measures as it begins to fully implement the 2008 AML M&A Provisions.

In deciphering the recent changes to Chinese M&A regulation (namely the implementation of the 2006 Rules and the 2008 AML M&A Provisions) and the recent influx of deal flow in China, one might wonder why the deal activity is so robust in China, given the length of time that China took to join the WTO and the country's historic prohibition of M&A deals. According to a March 2008 article in *AsiaLaw*, there are three main reasons why so much M&A deal-making is currently taking place and why many experts suggest that the number of deals [in China and involving Chinese entities] will only increase.[34]

First, China currently has the capital available to pursue M&A deals.[35] Despite a worldwide economic slowdown, China's economy continues to grow. Although many economists and business people have expressed strong sentiments of disappointment regarding the performance of world markets, China has still experienced a rate of growth that is markedly higher than other previously leading economies. Second, foreign exchange rates are favorable to the Chinese Yuan, and third, the Chinese government has been encouraging certain types of deals (i.e., deals in sectors not prohibited by regulation) to go through, even going so far as "offering state-owned enterprises low-interest bank loans to pursue acquisitions."[36]

However, although the Chinese economy continues to grow (albeit at a lower rate than the Chinese government would like, but still at a significantly swifter pace than many other world economic leaders) and deals continue to get done, there are still considerable legal barriers in place that attorneys, regardless of their familiarity or experience doing business in China, must keep in mind when working on an M&A deal. For example, the regulations themselves (namely the 2006 Rules and the more recently enacted AML M&A Provisions) impose a tiered regulatory structure that requires approval from numerous governmental agencies.

Additionally, because practicing law in China is a relatively new development (it has only been legal for China-trained attorneys to practice law, in the modern sense, for approximately the last 30 years)[37] and because Chinese law must govern when conducting an M&A deal in China,[38] attorneys and business people, regardless of their level of familiarity with doing a deal in China, are confronted with numerous and considerable legal and regulatory challenges each time they set out to transact a deal. For American attorneys, one of the most significant legal hurdles is the fact that they cannot officially practice law in China. Rather, they must serve as legal consultants. Additionally, the requirements of China's regulatory structure have resulted in a significant increase in the length of time each deal takes to close and marks one of the most marked differences between transacting an M&A deal in China versus in the U.S.

As mentioned above, certain sectors get special treatment under China's 2006 Rules. "In a few industrial sectors, the State is encouraging state-owned enterprises to consolidate into large integrated conglomerates, which are intended to be global leaders in their fields, while in other sectors, the State is actively seeking to reduce the level of its equity holding."[39] "One of the government's overarching policy goals is the so-called Guotui Minjin (state capital retreating to let private capital in")."[40]

G. After the M&A Rules: The Merger Provisions of the Anti-Monopoly Law and the ABA Committee's Suggestions for Making the Provisions More Practicable

The 2006 Rules symbolized an attempt to regulate M&A transactions in China. However, what the 2006 Rules set out to do has been supplemented by the 2008 AML M&A Provisions. The 2008 Provisions add clarification and, some might argue, more practical guidelines for getting a deal done in China.

A March briefing prepared by attorneys at Freshfields Bruckhaus Deringer entitled "China Consults on Merger Control Implementing Regulations" compares the 2008 Provisions to the 2006 Rules:

> The clarification of the definition of a "concentration of undertakings," and in particular the notion of acquisition of control, represents a significant improvement from the existing merger control regime under the PRC Rules on the Merger with and Acquisition of Domestic Enterprises by Foreign Investors (the M&A Rules). The M&A Rules do not require the acquisition of control for a notification obligation to arise, and in practice this has led to notifications being required for transactions where a controlling shareholder increases its stake or the acquisitions of a small, minority stake.[41]

However, the 2008 Provisions have still left many attorneys scratching their heads when it comes to figuring out some of the most significant particulars of a deal (e.g., deal time line, regulation requirements and deadlines, legal certainty regarding the status of a pending transaction, etc.).

Several sections of the American Bar Association (the Section of Antitrust Law, Section of Business Law and Section of International Law) have drafted Joint Comments of the American Bar Association's Section of Antitrust Law, Section of Business Law and Section of International Law on Draft for Comments of the State Council Regulations on Notifications of Concentrations of Undertakings.[42] The comments were originally prepared in draft form and were ultimately finalized on January 30, 2009. The purpose of the comments was to make suggestions to the Chinese Government regarding changes to the AML M&A Provisions that could be implemented in order to make it easier for attorneys and clients to complete M&A transactions. The draft comments "recognize[d] . . . China's continuing commitment to develop a competition law regime that is within the mainstream of global competition policy and tailored to China's needs" (Draft comments, p. 1), while at the same time asking the Chinese government to consider making several updates to the merger provisions of the AML, which would make its implementation more practical and would ultimately encourage more deals to take place. Some of the recommendations/requests that the committee made included:

- clarification of notification thresholds;
- provisions relating to confidential treatment of sensitive business information;
- clarification pertaining to the "undertaking to the concentration" provision and whether such language refers to the "specific business, assets being acquired in the concentration, and not the seller group."[43]

The committee also raised concerns regarding the burden that market share calculation places on companies, the challenges associated with inconsistent calculation costs, and the impact of the 2008 Provisions' market share calculation requirement on transactions (i.e., requiring companies to compute their share of the market requires high level macro-economic analysis, which places an undue burden on transacting entities and ultimately slows or even kills deals).

The underlying themes/areas of concern that existed throughout the draft comments included timely regulatory review, legal certainty, issues of control and the clarification of vague or open-ended terms. In other words, the ABA sections that contributed to the comments were trying to reconcile the rules set forth in the 2008 Provisions with the goals of legal certainty and a clear deal time frame.

In the final comments, the ABA sections that contributed recommended the following, in an effort to both clarify the provisions and ensure that they do not pose a direct conflict with U.S. merger regulations:

- Clarification of the "role that market definition plays as the initial step of the competitive analysis";
- Clarification "that the determination of geographic market definition is based on the principle that prices and other competitive variables are determined by competition among enterprises **within** that geographic area, rather than by competition from enterprises in **other geographic areas**";
- Emphasis on the idea that "market definition is a matter of degree, and reasonable judgment must be exercised when drawing the boundaries of the relevant market" so as not to allow the regulations to be so restrictive that they block too many otherwise viable transactions;
- "Excessive focus on structural characteristics of the market—i.e., the effect of the transaction on concentration measures—can lead to overemphasis on market definition and can detract from the broader and ultimately more important judgment regarding competitive effects."[44]

H. How Vagueness of Terms Implicates U.S. Contract Law Concepts

The difference in American and Chinese perception of the importance of the specificity of deal terms, illustrated in the Wyoff *Harvard Business Review* article, illuminates some differences between Chinese and American contract law, including the doctrine of "substantial performance."

According to an article by John H. Matheson, the purpose of the American notion of "substantial performance" is to prevent forfeiture and consider the benefit received by the injured party.[45] Matheson goes on to explain that "a major factor determining if substantial performance can be applied is the extent to which the injured party can adequately be compensated for damages. [I]f the breach is substantial and damages are uncertain or insufficient to pay for correction, a court is unlikely to find substantial performance."[46] As Matheson describes it, the American concept of substantial performance relies on the specific wrongs that can be used for determining the basis on which to calculate damages.

Contrastingly,

> under Chinese law, the extent to which a party's partial performance can allow it to recover under the contract is governed by rules covering "fundamental breach." Chinese Law looks to the following factors in considering whether a breach was

fundamental: (1) the intended purpose of the contract; (2) the importance of the unperformed obligation; (3) the extent of nonperformance; (4) the consequence of nonperformance; (5) the likelihood of cure; (6) the personal nature of the contract; (7) the willfulness of breach; and (8) the possibility and desirability of future performance.[47]

The Chinese test for substantial performance has many more prongs than the American test. In addition, some of the prongs (such as intent and desirability) are more subjective standards and thus are more difficult to measure or prove, as compared with the American approach, when assessing a breach of contract claim. "In Chinese contract law, there are concepts like reasonableness, fair dealing, and good faith that might seem familiar to foreigners, but the terms are not defined in Chinese jurisprudence . . . the inherent problem with vagueness is that it leads to inconsistency. . . . [and] corruption,"[48] and could potentially open the door to significant client liability.

The 2006 Rules provided some level of antitrust regulation, although the 2008 Rules seem to take a more comprehensive approach to the ways in which anti-trust concerns impact an M&A deal. Under the 2006 Rules, if a transaction is large or if a transaction involves large companies, approval from the MOC and SAIC is required if:

i. a party has more than RM 1.5B in Chinese sales during the current year;

ii. the foreign investor acquires more than 10 companies in a "related industry" in China within one year;

iii. a party controls 20% of the Chinese market; [or]

iv. as a result of such transaction, a party controls 25% of the market in China.[49]

It is important to mention that the Chinese definition of "a party to such transaction" includes affiliates of a foreign investor. This definition differs from the American definition of a "party to such transaction" in that an "affiliate" is not automatically considered a party to an M&A deal.

The 2008 Provisions presented an additional significant regulatory hurdle for M&A deals that involve Chinese entities or foreign entities that have a considerable stake in a Chinese entity, but which do not take place on Chinese soil. "Certain M&A transactions among foreign companies occurring outside of China could . . . be subject to antitrust review in China"[50] because of the 2008 Provisions which pertain to a company's percentage of Chinese holdings.

I. Compliance Considerations: U.S. and China

As with any type of transaction, compliance standards play a key role in getting an M&A deal done in both jurisdictions. In China, M&A compliance regulations can generally be broken down into two main categories: foreign direct investment laws and WTO compliance considerations. This section will offer a brief overview of both categories.

1. Foreign Direct Investment Laws

"Sino-foreign Joint Ventures Laws and Wholly Foreign Owned Enterprises Law and others secure the basic corporate governance of foreign invested companies, but also warrant the government approval before any FIE (Foreign Invested Entity) can be set up."[51] The following is a list of the different regulations that fall within the bounds of Foreign Direct Investment laws and therefore impact M&A transactions:

- Industry Level Regulation
- Foreign Investment Regulation
- Initial Capital Requirements
- Restriction on Debt/Equity Ratio
- Guidelines for Market Access by Foreign Investment[52]

In addition to the above-mentioned requirements, there are tax considerations and foreign invested entity rules that come into play within the context of the Foreign Direct Investment category of compliance.

2. WTO Compliance

China's membership in the WTO opened up M&A opportunities for foreign entities in China and involving Chinese entities. "Until China joined the World Trade Organization in 2001, national regulations often encouraged (or required) foreign entrants to form joint ventures to set up [wholly foreign-owned enterprises] WFOEs, while explicitly discouraging M&A."[53]

That changed when China joined the WTO. "On December 11, 2001, the 15-year campaign for China to join the World Trade Organization ("WTO") came to an end when China became a full member of the WTO. The immediate effect of China's entry was that, as a WTO member, China was obliged to open its domestic market further."[54]

The impact of expanding the Chinese domestic market was hugely significant because it prompted Chinese lawmakers and business people to let down their guards, so to speak, in an effort to engage in M&A transactions under a new, less restrictive regulatory scheme. "In keeping with its WTO commitments, China has been revising large numbers of laws and regulations, including those affecting foreign investment in China."[55] With the revision of laws and regulations comes the revision of the way that Chinese business people and attorneys conduct M&A deals, as well as revision of the comfort level of all parties who engage in deal negotiation.

On the one hand, China's membership in the WTO has facilitated transactions, with "China's WTO accession encourag[ing] an increase in merger and acquisition activities in the country, as various restrictions or prohibitions against foreign acquisitions of certain types of companies or assets of companies in certain industries continue to be lifted."[56] On the other hand, the 2006 Rules do impose significant levels of regulation and restriction.

Not only do many feel as though China's accession to the WTO opened the door for M&A activity overall, but more specifically, it "has opened previously closed industry sectors to foreign investment, and is gradually lifting operating restrictions previously imposed on enterprises with foreign investment, permitting greater access to China's domestic market."[57]

III. How Chinese and American Culture Impact the M&A Deal in China

In addition to the myriad legal challenges that American and Chinese attorneys face when working on a Chinese M&A transaction, cultural differences play a significant role in every aspect of the way business people and attorneys conduct an M&A deal, including pre-negotiation processes, negotiation style and strategy, approaches to drafting and finalizing a contract, attorney patience, timing of the deal and choice of law.

A. Cultural Differences in the Approach to Contract Law

For example, American attorneys often seek to eliminate as many potential sources of future litigation as possible for their clients, via the negotiation and drafting process. However, according to Adam Li, contracts drafted by American attorneys are often considered by Chinese attorneys and judges to be much too lengthy, with many of the terms that U.S. attorneys consider "boilerplate" ultimately becoming lost in translation (and leading to decisions made by Chinese judges that the terms are either unnecessary or irrelevant).[58] According to Mr. Li, Chinese transactional documents tend to be much leaner than their American counterparts, with the documents focusing on the basic terms of the deal: price, payment, collateral, escrow, representations and warranties.

Mr. Li emphasized the importance of the following for American attorneys and U.S-based law firms whose clients conduct business in China: Chinese law must rule, attorneys must exercise sensitivity to jurisdiction, the approach needs to be localized (although a company may be multi-national, the approach that attorneys and business people take to an M&A deal in China must abide by local laws and take into account local cultural considerations).[59]

Culture's impact on the deal is quite complicated, given the influence of Communism and Confucianism on Chinese culture. One very practical and pertinent way in which this comes into play (while touching on certain legal concepts such as anti-corruption, compliance and FCPA-related issues) is within the context of Chinese due diligence procedures.

B. Cultural Impact on Due Diligence Procedures

According to a *Harvard Business Review* article written by Mike Peng,

> It is well known that many Chinese SOE's maintain three sets of books: One set that exaggerates performance to administrative superiors; one that underreports performance, for tax purposes; and one that is fairly accurate for managers themselves. Acquisition targets are likely to show foreign negotiators the bragging books initially. As a result, foreign firms need to be aggressive in conducting due diligence to uncover an accurate picture of targets' assets and resources.[60]

In negotiating a deal with a Chinese entity, American companies and the attorneys representing them should make clear that they want to review the Chinese entity's most accurate books, while simultaneously keeping in mind financial reporting procedures and American disclosure and anti-fraud provisions. That said, American attorneys must be sensitive to the way that business is done in China, to the fact that Chinese law will undoubtedly govern, and to the fact that the diligence process (of asking the executives from another company to produce confidential financial information) is a delicate one which in China is largely based on trust and relationship-building.

In a recent article in *Mergers and Acquisitions*, author Jonathan Marino emphasized how the differences between Chinese and American culture impact the M&A deal: "'You're on a completely different cultural planet. . . . Laws are different, financial reporting can be more difficult to decipher and just the cultural differences mean that parties need to approach the market with an open mind."[61]

American attorneys working on deals in China need to be mindful of Chinese business practices and negotiating styles as the differences between the American and Chinese ways of doing business are stark. Similarly, Chinese attorneys and business people should acknowledge that when engaging in a transaction with businesses and attorneys from other countries, those countries have culturally different business practices. It should therefore not be mandatory that countries outside of China completely abandon their own practices, especially given the fact that those from outside China involved in M&A deals in China almost always have to defer to Chinese jurisdiction.

There is a mutual cultural acceptance and open-mindedness that, if achieved, can help to strengthen the relationship between both sides (an element that is of highest priority to Chinese attorneys and business people), while facilitating the successful completion of the transaction.

C. Suggestions and Recommendations

Perhaps the simplest way to think about this is to suggest that Chinese and American attorneys and business people (i) acknowledge the existing cultural differences that impact M&A deals, (ii) concede on differences that are of no material consequence to the attorneys' respective clients, and (iii) stand firm on the issues that really matter most. In essence, it is important that American attorneys and Chinese attorneys be aware of the cultural differences, but it is also critical that American attorneys not engage in business with Chinese attorneys in an effort to Americanize the deal and that Chinese attorneys do give in when they are able to do so. In that regard, and because multi-layered regulatory structures and complicated cultural considerations play an integral role when it comes to getting a deal done in China, it makes sense for U.S.-based law firms to have attorneys who specialize in transactions that involve Chinese entities. Those attorneys can become experienced in the significant legal and cultural challenges associated with transacting deals in China. Although all of this understanding is important for non-legal reasons, from a legal perspective both sides must acknowledge the existence of and abide by the law of the applicable jurisdiction, which in most cases will be Chinese law.

IV. Conclusion

Given the ever-growing M&A environment in China and the challenges that face legal teams comprised of attorneys from China and the United States, it is important that attorneys working on Chinese M&A deals be familiar with China's regulatory scheme and legal requirements, while keeping in mind U.S. limitations and restrictions. In addition to the legal considerations, attorneys must realize that the cultural norms for negotiating a deal differ in the United States and China and that ignoring such cultural differences and approaches can bring negotiations to a screeching halt. As David Patrick Eich pointed out in his article about private equity M&A in China, although there are many challenges to transacting a deal in China, there are many accompanying rewards: "China is a difficult market in which to do a deal—but it can also be very rewarding to those who are persistent and adaptable."[62]

Endnotes

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Megan Burke is an Albany Law School JD/MBA candidate in the class of 2010. She participated in Albany Law School's Securities Arbitration Clinic this year and is spending the summer in Washington, DC as a participant in the U.S. Securities and Exchange Commission's Summer Honors Law Program.

Business Law Section Comments to the Privacy Task Force

By Randy Henrick and Grace Sterrett

Preliminary Statement

As business lawyers, we represent clients and work on transactions that bring privacy issues to the forefront. Some of us represent clients that collect, analyze and use private information, such as financial institutions, creditors, credit bureaus and information brokers. Others encounter privacy issues in bankruptcy proceedings when personal information of the debtor's customers becomes an estate asset to which others seek access or use. Collectively, we represent financial institutions and others that are subject to the principal federal privacy laws and oversight currently in effect, such as the Gramm-Leach-Bliley Act (GLB), the Fair Credit Reporting Act (FCRA) and the overview of the Federal Trade Commission (FTC), which has brought unfair trade practice enforcement actions against businesses which failed to safeguard the personal consumer data which they collected.

We understand that as technology has developed new ways to collect, compile, use and disseminate personal information of consumers—oftentimes without their knowledge or consent— the privacy of even the most confidential personal information is at risk.

It is in the context of understanding the business value of obtaining and using personal information of consumers that we address the five bullet points proposed by the Task Force for future study and have set forth specific issues that we believe relate to them. We encourage the NYSBA and the Task Force to consider these issues and the policy recommendations stated below.

I. Issues relating to and arising out of an *electronic health information system*, as indicated as a priority in the Obama administration (this will address issues such as development of, standards for, technological safeguards and restrictions (i.e., encryption), use of and access to, etc.), including an examination of the problems that exist in the current financial information and credit bureau national databases.

We support the Task Force's continued study of this area. We believe that nationalizing health information presents a potential efficiency to provide effective health care treatment but also presents a threat to the privacy of the most sensitive personal information that, if not adequately verified and secured, could well compromise effective treatment. The national electronic health database policymakers must carefully study and implement physical, technological, and legal safeguards to avoid many of the abuses and shortfalls that have been documented with respect to information brokers and credit bureaus and their largely unregulated compilation, use, and dissemination of personal information for collateral business purposes.

Notwithstanding the requirements of Gramm-Leach-Bliley (GLB) and the restrictions of the Fair Credit Reporting Act (FCRA), penalties for violations of these laws intended to safeguard consumer personal information have not deterred the aggressive use of private information by some entities in profiling customers, creating credit scoring and behavioral models, and communicating that information to third parties without the approval of the consumer.

Health information, like personal identity and financial information of consumers, will have great value for information-based industries looking to provide data and services to health care industry businesses or for more nefarious purposes such as medical identity theft.

The following issues of personal information collection, compilation and usage, with respect to companies that create large databases of consumer information, present important areas for study and assessment in undertaking to collect and disseminate a consumer's health records in large databases:

1. Verification of individual identity and the inclusion of a medical record into or use of an individual's health database by a provider should require due diligence by the record provider, the system manager, and the user as to the legitimacy of the information in relation to the patient. Personal information of consumers such as Social Security numbers should not be used to establish multiple files for different people. (Credit bureaus currently maintain such multiples files, a practice which arguably contributes to identity theft.) Providers and users should be required to use a multi-factor authentication process and procedures similar to those required by the FTC and federal banking regulators' "Red Flags Rule" to verify patient identities and the legitimacy of information relating to that individual patient. The system provider should implement technological tools and behavioral algorithms to identify patterns that may suggest inaccuracies. Medical decisions based on inaccurate information can be life-threatening, so the accuracy of system information is the highest priority.
2. Transparency of a patient's medical data file to the patient is important to refine accuracy. Not until 2004 did U.S. consumers have the right to obtain a free copy of their credit report under federal law

and their ability to challenge inaccurate information remains cumbersome and difficult at best. Much information collected, analyzed and maintained by information brokers and credit bureaus remains unavailable to consumers. For example, a credit bureau will not inform a consumer of how many files it has established for other consumers using the same Social Security number, critical information to help consumers prevent identity theft. Investigative information in a credit file is available to consumers only under very limited circumstances. Medical information files must be more transparent to consumers.

3. Access to and control over medical information need to be monitored as an essential safeguard. User permissions should be limited, a log of user access and the permissible purpose for each use should be maintained by the system provider, and the ability to download or export information from the database should be severely restricted.

4. Permissible uses of medical information should be limited to treatment and prevention of disease and/or health conditions for the patient by primary providers. In the medical arena, insurance companies and health marketers should have neither the right nor the ability to access a person's medical file, directly or indirectly, for collateral purposes. Substantial penalties, possibly including the right to bring private causes of action and class actions, need to be enacted to make the abuse of health information a high-risk proposition for the user and persons to whom it discloses the information.

5. Entities permitted to examine aggregated health information must be carefully monitored and should be the exception rather than the rule.

6. We also suggest further study of the existing obligations that federal bankruptcy law imposes upon health care businesses. If a debtor is a "health care business" as defined under Section 101(27A) of the Code, then there are certain obligations imposed on the debtor regarding the disposal of patient records (11 U.S.C. § 351). Under Section 351 of the Code, the trustee is responsible for storing patient records "in the manner required under applicable Federal or State law." If there are insufficient funds for the payment of storage, however, then the trustee must give notice for the records to be claimed and, after a certain amount of time, seek to deposit the records with a federal agency or, if necessary, destroy any unclaimed or unaccepted records (11 U.S.C. § 351). While these obligations are a good first step, they seem insufficient for entities providing health information or operators of health care information databases. For example, the current standard seems to leave open the possibility of records being left with a federal agency indefinitely, without further explanation of the federal agency's responsibility for the records. HIPPA may be the appropriate law to address these issues and, if so, those rules should preempt the Bankruptcy Code or state law.

II. Careful study of the flaws in protecting privacy of identification information in the business and financial sectors is critical to establishing a national health care database that will provide the societal benefits while preventing the potential abuses that are lurking behind the scenes. Should there be a *nationalized standard* or federal legislation regarding any area of privacy law, for example, with respect to *data security breaches, collection and use of information*, etc.?

A uniform federal standard with respect to data security breach notifications and other identity theft prevention measures, backed by appropriate enforcement penalties, could provide important efficiencies and benefits to consumers and to businesses. The following is a "short" list of areas which we believe merit further consideration:

1. Development of a single national standard for data security breach notices, including a standard for what level of potential harm should trigger the need to notify potentially affected individuals.

2. Development of a national standard, or at least a federal "safe harbor," for systematic protection (safeguarding) of non-public personal information of consumers in all phases of its life cycle, including collection, transmittal (internally and externally), storage in all media formats, and disposal. Massachusetts' recent initiative to require specific systematic and physical protections for information about Massachusetts residents may be a model for such a uniform standard and should be carefully studied.

3. Imposing a national restriction on the use of Social Security numbers as primary identifiers and requirements for multi-factor identification and the possible use of biometric data for identity verification and permission-based access to sensitive customer information. We encourage the Task Force to reach out to the Intellectual Property Section as well as the private sector to seek alternative secure solutions for validating a person's identity.

4. Providing transparency in information collected on individuals by third parties, including information brokers, credit bureaus, technology providers, marketing companies and others so that consumers will have the right to know what information

has been compiled about them and the opportunity to correct it or prohibit the use of it.

5. Addressing the disposal and use of consumer information when an entity files for bankruptcy protection. Bankruptcy laws present important issues for the protection of personal information. Currently, the federal bankruptcy laws only address the obligations of (1) a bankrupt business looking to sell consumer information, and (2) health care businesses. This overlooks a large class of businesses, both small and large, that have in their possession a significant amount of confidential consumer information. We recommend a review of the feasibility of having business records containing information that is readily identifiable to an individual consumer (i.e., not information in the aggregate), whether in electronic or hard-copy form, be separated from and treated differently than the rest of the company's records. When the consumer information will not be sold, it should be promptly and securely destroyed both in Chapter 7 and Chapter 11 proceedings where the information will not be used upon the company's successful reorganization. A separate provision in the Bankruptcy Code may be appropriate to address these obligations, placing the burden on the trustee to ensure that consumer information is properly handled and destroyed.

III. Should the law impose *specific technological standards on lawyers for protecting client files and electronic information* (i.e., the requirement to encrypt e-mails) and, if so, should they apply to all client information or should different standards be adopted for different kinds of information (i.e., medical records for med mal actions or employee information for employment litigation)?

With electronic technology has come an explosion in records as e-mails and other electronic records are forwarded, copied and modified. These technologies present challenges for client confidentiality and the attorney-client and work product privileges. E-mail, especially Web-based e-mail like AOL, Hotmail, Yahoo and others, is not secure and is accessible to not only the e-mail system provider but others in the chain of delivery. E-mail is easily manipulated at multiple points in its life cycle (including after archiving) and, although forensic analyses of metadata may identify some of the manipulations (such as a change in dates or text), there is no legal presumption that a sent e-mail is delivered or read by the intended party. This contrasts to first class postal mail for which a presumption of delivery attends the deposit of postage-paid mail. Even encrypted e-mail is subject to being manipulated and can be accessed in plain text at points in its lifecycle. While the costs to encrypt are coming down, encryption can be a cumbersome and expensive proposition.

We encourage the Task Force to study new technologies such as the concept of registered e-mail or other systematic validators of e-mail and other electronic communications. We encourage reaching out to the Litigation and Intellectual Property Sections for consideration of how different technologies impact legal rights and admissibility of electronic records in courts.

IV. *Collection and use of information:* Should there be examination of the length of time certain information should be kept, and sanctions for breaches of those obligations or harms to consumers?

Today there exist myriad federal and state laws and regulations relating to record-keeping and the minimum time period for which categories of records must be retained. Examples include the Equal Credit Opportunity Act and the Federal Reserve Board's Regulation B, which requires creditors to retain information concerning credit applications, credit reports and the decisioning of the credit application for 25 months from informing the customer of the decision. Regulatory agencies on both the state and federal level mandate minimum record retention periods for classes of documents relating to business of entities within their supervisory authority.

However, few of these laws and regulations mandate maximum time periods for retention or require the destruction of records. Gramm-Leach-Bliley regulations require that records containing personal information of consumers be destroyed in a secure manner for both paper and electronic records but do not give an outside time line for doing so. The Federal Trade Commission has indicated that a business should not retain consumer information for longer than is necessary but has offered little guidance on what factors dictate the period of necessity.

As information proliferates, especially electronic information, data storage requires increased costs, and the risks of an unauthorized intrusion or access (or an authorized access that uses the information in an unauthorized manner) present a greater challenge to businesses. Inconsistency in applying record retention policies, as well as the difficulty in identifying records on remote-access devices, make this an area of risk for the business community.

While we believe it is difficult to adapt a single time period for the mandatory destruction of all records containing personal consumer information, the establishment of a "catch-all" standard of say 10 years from the record's creation (which period could be extended for a class of records for good cause shown) is something that merits further review. Consideration also should be given to recommendation of the appointment of an ongoing Special

Committee on Privacy, the implementation of privacy-related CLE's to educate the bar, and/or outreach programs to help educate the public on privacy concerns.

V. Should There Be a Privacy Committee? CLE?

We strongly support the evolution of the Task Force into a Committee or Section on "privacy" because of the breadth of the topic and its implications for all aspects of our business and personal worlds, as well as homeland security. As electronic information expands exponentially and evaluative behavioral algorithms become more refined, our leaders will be forced to consider how willing they are to trade off privacy rights for the ability to identify and profile individuals. The medical information database brings these issues into critical focus because of the potential value in health care provision that a robust and accurate national or regional database can provide. However, the medical database issue also provides an important crossroads for protecting and validating individual medical information and not repeating the mistakes that were made when legislation was enacted to address the collection and safeguarding of personal consumer information in connection with financial service transactions.

A Privacy Committee could be the central point for addressing privacy issues that arise in different substantive legal areas and could work with the other Sections on privacy-related issues in their areas of expertise. Privacy touches so many substantive areas of law and policy that it merits an independent entity within the NYSBA so that the Association can provide leadership and input into the decisions that will literally affect each and every one of us.

We also support privacy CLE programs. The Business Law Section has done programs on identity theft and bankruptcy issues and we are willing to have our experts work with those in other Sections on additional CLE programs as the laws, regulations, and cases in this area continue to evolve. We encourage our members to work with community outreach groups, such as those created by the New York City Department of Consumer Affairs, to provide consumers with information on financial services and credit laws as well as to inform them of rights and remedies they may possess to safeguard their personal information. Finally, we encourage the Task Force to reach out to the academic community for consideration of how the collection of information and the way people communicate have changed over the last generation and the implications of these changes for securing privacy in a technological world. A new generation that discards traditional communication in favor of IMs, text messages and other electronic solutions, and who willingly post personal information on social networking sites like Facebook, will have implications for the privacy of data and the abuse of consumer information. As the noted communications scholar Marshall McLuhan once said, "The medium is the message." As new media have overtaken large segments of society, we should consider their implications for privacy and data protection. These subtle understandings may provide important context for much of our work.

Randy Henrick is Associate General Counsel for Regulatory and Compliance for DealerTrack Inc., and has previously served on the legal staffs of GE Capital, Citigroup, MasterCard International, and FleetBoston Financial. He lectures extensively on the subjects of privacy, data security, the Red Flags Rule, and identity theft prevention. Mr. Henrick is an Adjunct Professor of Law at New York Law School where he teaches a course on U.S. Consumer Credit and Privacy.

Grace Sterrett is a partner in the New York Office of Hudson Cook, LLP. She is a Past Chair of the Business Law Section and of the Consumer Financial Services Committee, and currently represents the Section as a Member of the House of Delegates of the NYSBA. Ms. Sterrett is also a member of the Consumer Financial Services Committee of the American Bar Association; Founding Member of the American College of Consumer Financial Services Lawyers; member of the New York Bankers Association's Lawyers Advisory Committee and member of the Board of Directors of the NY Retail Council Services Corp. She is a frequent speaker before Bar and banking industry groups on a range of banking and consumer financial topics

Financial Services Law at New York Law School

By Ronald Filler

New York Law School has a presence in the financial services law field that few, if any, other U.S. law schools can match. New York Law School provides academic courses and programs in the area of financial services law at the highest level with a prominent faculty. This LL.M. program, which will commence with the 2009/2010 academic year, offers more than 50 different law-related courses, many of which involve advanced discussion and skills-related practices, ensuring that LL.M. students graduate with a thorough knowledge of the area of concentration selected.

Whether to pursue an LL.M. in Financial Services Law is obviously a personal decision that each attorney will have to make for him or herself. However, LL.M. programs are increasingly important for many reasons. As the legal profession has become more competitive over the last two decades, firms have pulled back from offering the mentoring and training that junior lawyers need to develop their talents to the fullest. Lawyers now grow their knowledge and skills in a piecemeal fashion, as the work that crosses their desk dictates. This can mean lopsided development, where many attorneys know a great deal about small areas of the law but may lack the confidence and abilities that come with a mastery of the law and skills needed to take their practice to the next level.

These problems are especially important in a field like financial services, which is undergoing major legal, regulatory, and business changes globally. Today, government lawyers and in-house counsel at financial institutions must be thoroughly knowledgeable about current laws, regulations, products, and business practices as well as all of these new legislative and regulatory policy developments. As the laws and regulations change, so will the products and business practices to ensure compliance.

The Law School's commitment to financial services law is supported by a number of other important resources unique to the Law School, including the Center on Business Law & Policy, the Center for International Law, the Center for New York City Law and the Center for Real Estate Studies.

The Graduate Program in Financial Services Law

LL.M. students must elect one of four areas of concentration: Asset Management, Banking, Capital Markets, and International Regulation. Each LL.M. degree student must take a minimum of five courses in one of these areas of concentration and complete the academic hour requirement (24 credit hours) through electives. Each LL.M. degree student must also take the Regulatory Policy course and the Advanced Research Seminar course, which count toward the 24 academic credits minimum requirement.

The Joint J.D./LL.M. Program

Students applying to New York Law School, or those currently enrolled at New York Law School, may apply for a joint J.D./LL.M. degree program, which a full-time student may complete in as little as seven semesters. Alternatively, a joint J.D./LL.M. degree student can take the full 24-credit LL.M. in Financial Services Law and receive a tuition credit for the final eight credits of the degree program. The required course work must be approved by the LL.M. Program Director.

By applying to the joint J.D./LL.M. program, a student can not only reduce the time and cost of the two degrees, but can also ensure admission to the LL.M. program while planning an integrated program of study from the beginning of his or her law school career.

Center on Business Law & Policy

The Center on Business Law & Policy provides an enriched educational experience in the business, securities, and commercial law areas, preparing students to excel as planners and counselors in general advising, litigation, and especially deal-making situations with business clients. The Center offers a range of programs providing a firm grounding in the fundamentals needed to enter business-oriented law firms, law departments in corporations, investment banks, financial services and brokerage firms, institutional investors, as well as regulators and other commercially oriented governmental offices.

Center for International Law

The Center for International Law provides students and faculty with in-depth support for instruction in many areas of international law. Founded in 1996 with major funding from The Starr Foundation, the Center maintains close ties with New York City's business, financial, and legal communities. The Center's activities include sponsoring the prestigious C.V. Starr Lectures and the Otto L. Walter Lecture Series, which regularly bring world-renowned speakers to the Law School; embarking on the Iran Project, which appraises the impact of nongovernmental organizations on democracy and development in Iran; and producing *The International Review*, the Center's award-winning newsletter.

Center for New York City Law

Established in 1993, the Center for New York City Law is the only program of its kind in the country. Its objectives are to gather and disseminate information about New York City's laws, rules, and procedures; to sponsor publications, symposia, and conferences on topics related to governing the city; and to suggest reforms to make city government more effective and efficient. The Center produces several publications, including *CityLaw*, which tracks New York City's rules and regulations, how they are enforced, and court challenges to them; and *CityLand*, which reports decisions from the New York City land use agencies.

Center for Real Estate Studies

The Center for Real Estate Studies (CRES) at New York Law School provides students with a unique educational opportunity to study both the private practice and public regulation of real estate. Leveraging the School's location in the prime real estate market of New York City, the Center enables students to gain practical experience in the real estate community and make contacts for future employment.

Conclusion

An LL.M. can be valuable to attorneys at various points in their careers. Governmental agencies, financial institutions, and law firms are increasingly reluctant to hire young attorneys who can't hit the ground running, which gives the LL.M. candidate an important leg up in seeking a rewarding and challenging new career opportunity, whether one is in his or her first position or changing career paths. The advanced training offered by this LL.M. program is also valuable to experienced lawyers looking to focus on a broader practice in the area of financial services law or just hone their skills. And it will provide a valuable route for lawyers who may have been out of practice for a period of time and are now seeking to re-enter the profession with greater knowledge. This LL.M. program is also a place for recent J.D. graduates with no financial services background and lawyers seeking a new specialty in their practice. We welcome the opportunity to discuss the Center and its programs with all interested practitioners and law students.

For further information about the LL.M. in Financial Services Law at New York Law School, please contact the Office of Admissions or Professor Ronald Filler at 212-431-2888.

Professor Ronald Filler joined the faculty of New York Law School in 2008, and serves as Director of the Center on Financial Services Law and as the Program Director for the LL.M. in Financial Services Law.

New York State Bar Association
Business Law Section

ANNUAL STUDENT WRITING COMPETITION

The Business Law Section sponsors an annual Student Writing Competition, open to all students who are candidates for the J.D. or LL.M. degree at an accredited law school during the year in which the article is submitted. The student articles submitted in a given year that are judged first and second best, provided they are of publishable quality and otherwise meet the criteria of the Competition, will receive cash prizes of $1,500 and $1,000, respectively. At the discretion of the editors, they also will be published in the NYSBA *NY Business Law Journal*, which is sponsored by the Section and by New York Law School and is published in the Spring and Fall. Additional cash prizes may be awarded in the discretion of the Section. Entries that do not qualify for cash prizes may also be considered for publication in the *Journal*.

Articles submitted will be judged on the following criteria:

- Relevance to the *Journal*'s audience (New York business lawyers)
- Timeliness of the topic
- Originality
- Quality of research and writing
- Clarity and conciseness

The manuscript should follow Bluebook cite format (using endnotes rather than footnotes) and be a minimum of 3,000 words (there is no maximum). Submissions should be made by February 15 for the Spring issue and August 15 for the Fall issue of the Journal. All submissions become the property of the NYSBA and the *NY Business Law Journal*. By submitting an article, the student is deemed to consent to its publication, whether or not a cash prize is awarded.

To enter, the student should submit an original, unpublished manuscript in Word format to David L. Glass, editor in chief, NYSBA *NY Business Law Journal* (david.glass@macquarie.com). The student should include a brief biography, including law school attended, degree for which the student is a candidate, and expected year of graduation.

Publication Policy and Manuscript Guidelines for Authors

All proposed articles should be submitted to the *Journal*'s Editor-in-Chief. Submissions should be e-mailed or sent on a disk or CD in electronic format, preferably Microsoft Word (pdfs are not acceptable). A short author's biography should also be included.

The editors reserve the right to edit the manuscript to have it conform to the *Journal*'s standard in style, usage and analysis. All citations will be confirmed. Authors should consult standard authorities in preparing both text and footnotes, and should consult and follow the style presented in *Bluebook: A Uniform System of Citation*. An *Author's Guide* can be obtained by contacting the Editor-in-Chief. The revised manuscript will be submitted to the author for approval prior to publication.

The views expressed by the authors are not necessarily those of the *Journal*, its editors, or the Business Law Section of the New York State Bar Association. All material published in the *Journal* becomes the property of the *Journal*. The *Journal* reserves the right to grant permission to reprint any articles appearing in it. The *Journal* expects that a manuscript submitted to the *Journal*, if accepted, will appear only in the *Journal* and that a manuscript submitted to the *Journal* has not been previously published.

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The Section's Committees are also encouraged to submit for publication in the *Journal* notices of committee events, Annual Meeting notices, information regarding programs and seminars and other news items of topical interest to the members of the Business Law Section.

Deadlines

Manuscripts intended for publication in the fall and spring issues must be received by the preceding July 31 and February 15, respectively. Manuscripts are to be submitted to:

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e-mail: david.glass@macquarie.com

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