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NEW YORK BUSINESS LAW JOURNAL

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Committee Reports

Committee on Futures and Derivatives Law

The Committee on Futures and Derivatives Law met on September 28, 2000, at the law offices of Sullivan & Cromwell, 125 Broad Street, New York, NY 10004, and on October 24, 2000, at the law offices of Brauner Baron Rosenzweig & Klein, LLP, 61 Broadway, New York, NY 10006. James R. Ponichtera, from Stroock & Stroock & Lavan LLP, was the Committee's guest speaker at the October 24, 2000 meeting. Mr. Ponichtera presented an excellent overview of the "Electronic Signatures in Global and National Commerce Act" (the "E-Signatures Act"), which, for the most part, became effective on October 1, 2000. Mr. Ponichtera explained that the most important aspect of the E-Signatures Act is that it gives legal effect to electronic signatures, thereby eliminating the need to follow up with pen-and-paper signatures. Mr. Ponichtera concluded that, at least in the short term, industries that are traditionally paper-intensive and, to some extent, already conduct business online would be impacted the most by the E-Signatures Act. For example, brokers will be able to open customer accounts online without the added expense and delay of obtaining the customer's paper-based signature.

In keeping with an electronic theme, one of the Committee's current projects involves the creation of a Web site. Although it is still in the initial design phase, potential elements may include links to Committee reports, comment letters, meeting schedules and third-party Web sites that are relevant to futures and derivatives law, Committee member contact information and the ability to update Committee member information. The Committee also has taken steps to correspond with its members through the increased use of e-mail. Another Committee project has involved the drafting of a report on futures commission merchant liability for the torts of non-guaranteed introducing brokers, of which Samuel F. Abernethy and Norma B. Levy have been the principal drafters.

Respectfully submitted,
Rebecca J. Simmons, Chair

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Committee on Corporations and Other Business Entities

January 24, 2001 Meeting

During the New York State Bar Association's Winter gathering at the New York Marriott Marquis Hotel, the Committee on Corporations and Other Business Entities held a lively meeting. The Committee looks forward, after several years of delay, to the passage of a Business Trust statute in the coming legislative session in Albany, to provide another valuable vehicle for financing transactions under New York law.

The Committee reflected on one of its highest long-term priorities—the repeal of § 630 of the New York Business Corporation Law, which imposes liability on the ten largest shareholders of non-public companies for a wide variety of employment-related claims. The Committee believes that this provision, which is unique to New York, materially diminishes the formation of corporations in New York, to say nothing of the surprise to which it springs on unwary practitioners and their clients. Although there are entrenched political positions on this section which have hindered the Committee's efforts on this issue, the Committee's members have vowed to keep pressing this issue.

The Committee reviewed its efforts to revise the Not-For-Profit Corporation Law based on the successful modernization of the Business Corporation Law that it had championed several years ago. The Committee is reaching out to NFP practitioners for their input. Please contact Greg Blasi (Gblasi@huberlaw.com or 212-445-5532) if you would like to contribute to this project.

A number of proposed revisions to the New York LLC and LLP laws were discussed. One provision clarifies that the operating agreement of a single member LLC is valid notwithstanding that it is only signed by one member. A second provision provides that payments for past services provided to an entity do not constitute distributions, making such payments less vulnerable to attack under bankruptcy preferences rules.

Gary Trechel of the Department of State updated the Committee on the efforts of the Department of State to provide its services more efficiently. The Department of State now accepts credit card payment for most of its services and has a Web site, http://dos.state.ny.us, which can be used to obtain basic filing information on New York entities and which has forms and other valuable information.

The Committee continues to develop its agenda for new initiatives and welcomes suggestions from our colleagues.

Respectfully submitted,
Gregory J. Blasi, Chair

* * *

Committee on Franchise, Distribution and Licensing Law

September 27, 2000 Meeting

The Franchise Law Committee of the New York State Bar Association met on September 27, 2000 at the law offices of Nixon Peabody LLP, located at 437 Madison Avenue in New York City. The following members and guests were present: Peter Bauer, Barry A. Cooper, Cory J. Covert, Florence Darqus-Lane, William Estes, Cynthia G. Fischer, David J. Kaufmann, Harold L. Kestenbaum, Lorraine Morrison, David Oppenheim, Lee J. Plave, Joseph J. Punturo, Roger Raimond, Richard Rosen, Bruce Schaeffer, R.C. Seely, and Ralph Wood.

Committee Chair Joseph Punturo opened the meeting by thanking Harold Kestenbaum for graciously sponsoring the continental breakfast, and wishing him a happy birthday. Mr. Punturo also announced Judith Welsh's marriage engagement and mentioned that she is looking to relocate to Albany. She has been a franchise examiner with the New York State Attorney General's Office for four years.

I. Electronic Signatures

Presenter—Roger Raimond—Committee member Roger Raimond is an attorney at Robinson Brog Leinwald Greene Genovese & Gluck P.C.

Mr. Raimond began his presentation on electronic signatures by circulating several documents, including the federal "Electronic Signatures in Global and National Commerce Act," New York State's "Electronic Signatures and Records Act" (ESRA), a list of Internet Sites of General Interest, an article from *Leaders Franchising and Business Law Alert* entitled "FTC Promises to End Confusion Over E-Sign" by Rochelle Spandorf, and an article from the Nixon Peabody Web site entitled "The New Federal Electronic Signatures Act: Federal Law Begins to Catch Up With the E-Business Revolution" by Bruce Baker.

Mr. Raimond explained that one of the purposes of the Electronic Signatures Act is the need to reliably signify assent or acceptance of an offer via an electronic source (e.g., the Internet, computer disk, or digital transmissions), and that the Act now validates electronic signatures. At one time, authenticity was signified with the use of a seal, or perhaps a stamp; however, our digital era has made those methods less utilized, and in turn, has created a myriad of new obstacles. For example, how should digital fraud and mistakes be dealt with when your original is in a completely electronic format?

Mr. Raimond then explained that "electronic signatures" is the catch-all term used to refer to electronic signatures, secure electronic signatures, and digital signatures. An electronic signature represents *any* electronic symbol that is used in place of a tangible signature, for example, the typed symbol and name "/s/ John Doe." Secure electronic signatures possess a slightly higher level of reliability as they allow the receiver of the electronic document to be notified if the document has been altered, thus invalidating the electronic signature. Digital signatures currently possess the highest level of security as they employ encryption technology. Such technology allows the use of mathematical algorithms and other techniques to transfer data—such as the text of a contract—from its original plain text form to encrypted or ciphertext form. The ciphertext and its accompanying signature cannot be read or restored to plain text form without the use of a decryption key.

Encryption technology uses a mathematical algorithm to create a lock and key symmetrical encryption device. While these algorithms can be extremely complex and are becoming more reliable, they are still imperfect. They can be deciphered without permission by a computer that repeatedly tries various combinations with the hope of fortuitously hitting the correct one. This problem of a "brute force" assault is further compounded by the ever increasing speed of computers. As their speed increases, so does the number of combinations they can try per second. Thus, there is a greater chance that computers will achieve their goal of gaining un-permitted access.

Mr. Raimond then explained that through the use of dual key public infrastructure technology, encryption programs can be created that are unique to each document and are under the exclusive control of the party utilizing the technology. Furthermore, these encrypted documents are verifiable and attached to the electronic record so that if the record is altered in any way, the signature is invalidated. Public infrastructure technology creates a system of encryption that is highly secure, and arguably, unbreakable.

Mr. Raimond then stated that ESRA removes barriers to electronic commerce and that electronic signatures now satisfy the statute of frauds. ESRA establishes liability rules for electronic commerce in the area of encryption so that when confidence is breached, the burden is shifted to the receiver to prove that he did not receive the document. However, there are certain exceptions to ESRA, such as wills, negotiable instruments, real property interests, and articles from the office of electronic facilitator.

II. Planning and Implementing an International Franchise Program

Presenter—Leonard N. Swartz—Mr. Swartz is the Worldwide Managing Director for Franchise Services at Arthur Andersen LLP. He has been a CEO, CFO, and COO of several large franchisors, and he sits on the Franchise Advisory Committee of the North American Securities Administrators Association.

Mr. Swartz began by describing some recent international franchise activities in which he has participated, and the various formats of franchising which have become popular in International Franchising:

1. Direct Franchising: A system in which the franchisor sells directly to franchisees. These are decreasing in popularity in both domestic and international franchising.
2. Master Franchising: A system in which a franchisor sells to *master* franchisees, who in turn sell their franchises to other franchisees. The *master* franchisee can also operate one, several, or all of the franchises purchased from the initial franchisor. These are very prevalent internationally, but are declining in popularity because, although the franchisor gets a large initial fee, the subsequent fees must be split three ways.
3. Area Development: A system in which a franchisor sells to an area developer, who then opens and operates all the franchise units in that particular area. This method is growing in domestic and international use.
4. Licensing: Mr. Swartz said licensing agreements tend not to work well because operational controls cannot be enforced and legal rights may not be enforceable across international borders. If used, however, these agreements must be defined.
5. Joint Venture: A system in which a franchisor joins with a third party who then sells to subfranchisees and/or operates its own units.

Mr. Swartz further discussed other trends in worldwide franchising. He noted that due to falling travel expenses and the introduction of the Internet and digital communication, franchising internationally has become much more competitive. Foreign competition is also increasing, as many governments in areas such as Singapore, Malaysia, and the Middle East are promoting franchising and introducing franchise-friendly regulation. These governments are also trying to attract foreign franchisors to facilitate the transfer of technology, marketing, and managerial skills to the local population. In addition, the growth of franchising creates jobs for local workers.

Mr. Swartz then stated that while some foreign countries are trying to become more enticing to franchisors through franchise-friendly legislation, other countries have increased franchise regulation. Mr. Swartz stated that most recently, Ontario, Canada has introduced franchise regulations.

Mr. Swartz next covered various reasons for franchising internationally, stressing the increase in name recognition, the potential increase in sales and profits, protection in the international market from copy-cat or bootleg competitors, and dedicated management at the local level.

Mr. Swartz then discussed various success factors for international expansion. He distinguished that franchisors should have sound and profitable businesses domestically before expanding internationally. They should also have strong financial resources, a dedicated human resource department, and patience.

Franchisors should also be diligent in choosing the proper market in which to open their franchises and the appropriate format for marketing their franchises in a foreign market. However, franchising internationally also requires a heightened ability to listen and adapt to local cultures. Mr. Swartz emphasized this final point with an anecdote about a franchisor's name translating into a very unfavorable term in a foreign market. Luckily the franchisor was made aware of this prior to selling any franchises and was able to remedy the problem.

III. Book Discussion—*Martha Matilda Harper and the American Dream: How One Woman Changed the Face of Modern Business*

Presenter—Jane Plitt—Ms. Plitt is a visiting scholar at the University of Rochester. She has been a business owner, labor arbitrator, and social justice advocate. The United States Small Business Administration recognized Ms. Plitt as a business advocate, and *SAVVY* magazine named her one of the 14 outstanding women in New York State. A portion of the royalties from Ms. Plitt's book will be donated to the Women's Foundation of Genesee Valley.

Ms. Plitt talked about her biography of Martha Matilda Harper, a pioneer of franchising who started the first business format franchise in the late 1800s. Born in 1857, in the impoverished town of Oakville, Ontario, Ms. Harper was thrust into a life of poverty and forced to work as a servant girl at age seven. Ms. Harper, in her early 30s, learned hair care techniques and a hair tonic formula from her last employer, a homeopathic doctor. After the doctor's death, Ms. Harper patented the hair tonic, which later became her first commercial product.

Ms. Plitt described how Ms. Harper traveled to Rochester, New York, and modeled her hair-care franchise hierarchy on that of the Christian Science religion. She created a network of businesses all linked to a central source. Harper began her business with $360 in capital; around the same time, Kodak started with $1 million in capital. But what Harper lacked in capital or financial backing, she made up for in ingenuity. She designed the first reclining chair for shampooing hair. She developed a training system for her franchisees and employees which grew to include five training centers around the world, and she developed her own manufacturing and distributorship system for her products, with two manufacturing plants (one in Rochester and one in Canada). She held conventions to inspire her franchisees and organized regional and national associations. Her salons even had child care centers so parents would be able to get uninterrupted service and the next generation of customers would be weaned on the Harper method. But Ms. Harper's biggest asset was her own hair, which extended down to her ankles. When a photographer once asked if he could take pictures of her hair, Harper agreed, providing she could have the right to use the photograph. She then used the photograph to promote her salons.

Her first franchise opened in Buffalo in 1891, and before she died, she had expanded her business to include over 500 shops worldwide. However, she would not open a store in any area until there was a petition from that area with 25 signatures on it, thus securing an initial customer base.

Ms. Plitt's book was published in May 2000 by Syracuse University Press, and it may be purchased through any retail bookstore, or via the Internet.

Respectfully submitted,
Joseph Punturo, Chair
William Estes, Secretary
R.C. Seely

If you are interested in joining the Franchise, Distribution, and Licensing Law Committee, please call Committee Chair Joseph Punturo at (212) 416-8211.

Department of State
Division of Corporations, State Records and Uniform Commercial Code

M E M O R A N D U M

Please take notice of the recent decision by the Appellate Division, First Department, in the matter of *Sardanis v. Sumitomo Corporation*, as reported in the *New York Law Journal* on January 12, 2001:

> [W]e hold that the complaint should have been dismissed as against defendant Sumitomo. Personal jurisdiction was purportedly effected on this Japanese corporation, which has no business address or designated agent in New York, by service on the New York Secretary of State under Business Corporation Law § 307. But the service requirements of this dispute are governed by the Hague Convention. Article 15 of the Convention requires service of process either by actual delivery or by "a method prescribed by the internal law of the State addressed for the service of documents in domestic actions upon persons who are within its territory." Paragraph (a) of Article 10 permits the "[sending of] judicial documents, by postal channels, directly to persons abroad," but that paragraph pertains to the forwarding of informational material, not the "service" of documents for jurisdictional purposes. Japan has clearly indicated its preference for personal service by objecting to paragraphs (b) and (c) of Article 10, which would permit a form of foreign substituted "service of judicial documents."
>
> We recognize that American courts have divided over whether Article 10(a) should be interpreted as allowing foreign service of the type permitted under BCL § 307. Even in New York there has been a division of authority among the departments of the Appellate Division. This Court approved such service in *Philip v Monarch Knitting Mach. Corp.* (169 AD2d 603), citing our earlier dictum in *Low v Bayerische Motoren Werke* (88 AD2d 504, 505) and a Fourth Department decision in *Rissew v Yamaha Motor Co.* (129 AD2d 94); *see also, Cantara v Peeler* (267 AD2d 997). But we are now convinced that the contrary interpretation, as expressed by the Third Department in *Reynolds v Woosup Koh* (109 AD2d 97), is the better reasoned, especially in light of the U.S. Supreme Court's reading of "service" in the Hague Convention as a term of art, referring specifically to the process that initiates a lawsuit and secures jurisdiction over an adversary party (*Volkswagenwerk AG. v Schlunk*, 486 US 694, 698).
>
> Personal jurisdiction was never obtained over Sumitomo Corporation. The complaint must accordingly be dismissed as against that defendant. Our 1991 interpretation of the treaty to the contrary, in *Philip v. Monarch Knitting Mach. Corp*. (*supra*), is overruled.

While the Department of State will continue to accept service of process pursuant to BCL § 307**, the Department does not pass on the validity of such service, and acceptance of such service by the Department does not guarantee that such service is valid. It remains the duty of the person effecting service pursuant to BCL § 307 to determine that such service is valid under all applicable laws (including, but not necessarily limited to, the Hague Convention, if applicable).**

Dated: January 26, 2001

Nonprime Mortgage Lending in New York: New Limitations and Restrictions in the Empire State

By Timothy P. Meredith

Effective October 1, 2000, new rules applied to lenders and brokers operating in New York State. The New York State Banking Department (the "Banking Department") enacted a remarkable new Part 41 of the Banking Regulations (codified at 3 N.Y.C.R.R. Part 41). The rules are remarkable not because they attempt to police predatory mortgage lending practices, but because they restrict lending to a much greater extent than any other previous attempt at the state or federal level. While the new rules may make it more difficult for home improvement contractors, brokers and lenders to engage in predatory or abusive lending practices, it remains to be seen whether they will also restrict the number of legitimate, non-abusive mortgage lenders willing to make loans in the subprime market (including low- and moderate-income neighborhoods).

The new rules include a number of novel provisions, highlighted here, and discussed in greater detail below. In addition to Part 41 itself, this article refers to a set of questions and answers that the Banking Department staff has posted on the Banking Department's Web site. The questions and answers are referred to on the Web site as "Revised Expanded Questions and Answers Regarding Part 41." They are referred to in this article as the "Q&A." Note that the Banking Department has taken to amending the Q&As without giving any notice to the lending community. Also, keep in mind that the Q&As are, at best, informal advice from the Banking Department staff about how one or more members of the staff currently interpret a particular facet of Part 41. Under no circumstances may you read the Q&As as an official commentary that supersedes, amends, modifies or clarifies any particular provision. They have no force of law or precedent. The Q&As discussed in this article are those that appeared on the Banking Department's Web site as of February 2, 2001.

I. Coverage

The rules apply to any high cost consumer-purpose loan secured by an owner-occupied, one- to four-family residence (other than a reverse mortgage), in a principal amount that does not exceed the lesser of the Fannie Mae conforming loan limit (currently $275,000[1]) or $300,000.[2] The home must be the borrower's principal dwelling.[3] The lien position does not matter. The loan may be closed-end or open-end (i.e., home equity lines of credit (HELOCs) are subject to the requirements). Both purchase money loans and non-purchase money loans are subject to the requirements. Retail installment contracts are not covered. In order to be subject to the rule, the application for a high cost loan must be taken by a broker or lender on or after October 1, 2000.[4]

Part 41 does not apply to loans secured by the borrower's second home or vacation home or to business purpose loans secured by the borrower's principal residence. If the property is a mixed-use property, the loan is covered so long as 50 percent or more of the square footage of the property is used for residential purposes.[5] The Banking Department staff has taken the position that loans made under the installment loan authority in § 108.4 of the New York Banking Law (or one of the similar installment lending authorities available to depository institutions in New York) are not subject to Part 41 even if the loan would otherwise appear to be covered. While the staff has not yet taken a position on the application of the rule to lenders that rely on federal law for the authority to lend, logic says that if the staff is willing to find that a local New York depository institution can avoid Part 41 by relying on the authority to make loans found in some other New York law, then Part 41 can hardly be found to apply to a lender relying, for example, on exportation authority under § 85 of the National Bank Act or to a federal association relying on the authority to make loans under the Home Owner's Loan Act. But the scope and ramifications of such alternate lending authorities and the scope of available federal preemption arguments remain as yet undefined and untested.

Contrast these results with the HOEPA rules.[6] Under HOEPA, open-end lines of credit are exempt. In addition, residential mortgage transactions are exempt (i.e., those where the borrower applies the loan proceeds to acquire title to or finance the initial construction of his or her principal dwelling). On the other hand, retail installment transactions are subject to HOEPA, but not to the New York rules.

Any product offered as a mortgage loan by an instrumentality of the United States or of any state (such as loan products offered by the Veterans Administration (VA), Federal Housing Administration (FHA) or the State of New York Mortgage Agency (SONYMA)) is exempt from Part 41.[7] It is not clear whether this exemption applies to loans made by these entities or to loans that are guaranteed and/or insured by these entities. Obviously, these entities guarantee or insure many more loans than they make. Initially, loans that were sold "promptly and directly" to Fannie Mae or Freddie Mac after the loan closing were also exempt from Part 41. However, this exemption was withdrawn by the Banking Department, which has since issued a Proposal for Pre-Sapa Comment to engage interested parties in discussion of whether loans sold to Fannie Mae or Freddie Mac should be treated any differently than other loans. In the interim lenders should not assume that loans promptly sold to Fannie or Freddie will be exempt from Part 41 until there is additional clarification on this point.

The rules apply only to persons who originate high cost loans, i.e., lenders and brokers. The term "lender" is defined as the entity to which the obligation is initially payable, either on the face of the note or by agreement where there is no note.[8] As a result, the rules do not apply to purchasers of a high cost loan.[9] This conclusion raises some interesting questions. For example, the rules require the lender to make regular (at least annual) reports to consumer reporting agencies about the borrower's payment history.[10] Since few, if any, mortgage bankers will actually hold the loans in portfolio, what happens to this ongoing consumer reporting responsibility once the loan is sold? Another issue that will no doubt need to be settled is what liability (if any) does a purchaser/assignee have for the lender's failure to comply with the law? Can the secondary markets rely on the Banking Department's position that a purchaser is not accountable for mistakes made by the original creditor, or will the Banking Department eventually become more aggressive against purchasers who knew or could have known that the Part 41 requirements had not been met? When, if ever, will a consumer find a way to bring a private cause of action in connection with these rules?

II. Trigger Terms

As under HOEPA, loans are subject to both a rate test and a points and fees test. If the loan passes either test, then it is a Part 41 loan.

A. Rate Test

Part 41 establishes a separate rate test for first lien transactions and junior lien transactions.

1. First Lien Transactions

A first lien loan is subject to Part 41 if the APR exceeds the yield on United States Treasury securities with a comparable term to maturity (measured on the 15th of the month preceding the month in which the application is taken) by eight or more percentage points (8%).[11] The Banking Department staff has taken the informal position that the "maturity date" for a HELOC is the last day of the draw period.

2. Junior Lien Transactions

A junior lien loan is subject to Part 41 if the APR exceeds the yield on U.S. Treasury securities with a comparable term to maturity (again, measured on the 15th of the month preceding the month in which the application is taken) by nine or more percentage points (9%).[12] The Banking Department staff has taken the informal position that the "maturity date" for a HELOC is the last day of the draw period.

3. Annual Percentage Rate (APR)

The APR must be calculated under the rules established in the Truth in Lending Act. For open-end credit, the APR is the "highest corresponding APR required to be disclosed under §§ 226.6(a)(2) and 226.14(b)" of Regulation Z. In most cases, the corresponding APR will be the initial interest rate. However, if the HELOC is one where the lender offers an initial interest rate discount (i.e., the initial interest rate is less than the index plus the margin), the lender must use the fully indexed rate (based on the index value at the time of consummation plus the margin).[13] The Q&As do not explain how to calculate the APR on a HELOC where the rate is variable but the initial rate is a premium rate (i.e., greater than the index plus the margin). Until the staff weighs in, the safest course is to assume that the measuring rate is the premium initial rate. While this rate may be inconsistent with the logic of Q&A No. 3, it is consistent with the language of the rule itself.

4. Comparison to HOEPA

The HOEPA test requires you to add ten percentage points (10%) to the matching Treasury yield.[14]

B. Points and Fees Test

The points and fees test is the same for both first and junior lien transactions. It requires an understanding of a number of new concepts, not all of which are defined.

1. Five Points

A loan is a high cost loan if the total points and fees payable by the borrower at or before closing exceed five percent (5%) of the total loan amount.[15]

2. Plus Three "Bona Fide Loan Discount Points"

A lender may charge up to three "bona fide loan discount points" in addition to the five points permitted under the points and fees test. The phrase "bona fide loan discount points" is defined as follows:[16]

> "Bona fide loan discount points" means loan discount points paid for the purpose of reducing, and which in fact result in a bona fide reduction of, the interest rate or time-price differential applicable to the loan, provided the amount of the interest rate reduction purchased by the discount points is reasonably consistent with established industry norms and practices for secondary mortgage market transactions. For purposes of this Part [41], it shall be presumed that a point is a bona fide loan discount point if it reduces the interest rate by a minimum of 35 basis points or 3/8 of a point provided all other terms of the loan remain the same.

The Banking Department staff has taken the position that a lender may use the lower value of 35 basis points rather than the three-eighths of a point.[17]

3. Comparison to HOEPA

Under HOEPA, a loan is a high cost loan if the sum of points and fees exceeds eight percent (8%) of the total loan amount.[18] The concept of additional "bona fide loan discount points" does not exist under the HOEPA rules.

4. Definition of "Points and Fees"

Part 41 has imported the definition of "points and fees" from Regulation Z.[19] "Points and fees" are defined at § 226.32(b) of Regulation Z to include:

- All items required to be disclosed under § 226.4(a) and § 226.4(b), except interest or the time-price differential;
- all compensation paid to mortgage brokers; and
- All items listed in § 226.4(c)(7) (other than amounts held for future payment of taxes) unless the charge is reasonable, the creditor receives no direct or indirect compensation in connection with the charge, and the charge is not paid to an affiliate[20] of the creditor.

Fees paid by the lender are not included in the points and fees, even if the lender increases the interest rate to reimburse itself out of the higher yield on the loan. So, for example, a yield spread premium paid to a mortgage broker is not included in this calculation.[21]

5. Definition of "Total Loan Amount"

The "total loan amount" is not defined in Part 41. Left alone with a dictionary and the rule, a court could reasonably find that the "total loan amount" is the principal amount of the loan. However, the Banking Department staff has taken the position that "total loan amount" for closed-end credit should be calculated according to the rules set out in HOEPA.[22] "Total loan amount" is defined at paragraph 32(a)(1)(ii)-1 of the Official Commentary to Regulation Z[23] as follows:

> For purposes of the "points and fees" test, the total loan amount is calculated by taking the amount financed, as determined according to section 226.18(b), and deducting any cost listed in section 226.32(b)(1)(iii) that is both included as points and fees under section 226.32(b)(1) and financed by the creditor.

This means that, in order to calculate the "total loan amount," a lender must deduct all prepaid finance charges from the principal amount of the loan and deduct any additional fees that are not prepaid finance charges but are paid to the lender or its affiliates and financed by the lender. The Banking Department staff has taken the position that "total loan amount" for open-end credit equals the maximum credit limit, without subtracting any amounts for closing costs.

III. Underwriting Requirements

One of the goals of Part 41 was to stop lenders from making loans to borrowers who could not afford the payments. The perception was that some lenders would intentionally drive borrowers to default on their loans so that they could foreclose on the mortgage, sell the home, and recoup any actual amounts loaned to the borrower. To prevent such practices, Part 41 imposes two general underwriting requirements.[24] One requires you to impose a specific 50% debt to income ratio test if the borrower's income falls below a statistical threshold. The other requires you to set payment amounts so that you can reasonably expect repayment.

A. Special Rules for Borrowers Below the Mean

If the applicant's income is less than the median family income-based threshold, a lender must be able to demonstrate that it reasonably believed the borrower had the ability to repay the loan. The rules offer a limited safe harbor. A lender will be presumed to have a reasonable belief in the borrower's ability to repay if the debt to income ratio did not exceed 50% at the time the loan was made.

1. Defining the Mean

If the borrower's income (as reported on the application and verified by the lender) is less than or equal to 120% of the median family income for the Metropolitan Statistical Area (MSA) in which the real property collateral will be located, then special handling is required. If the property is not located in an MSA, then the benchmark is 120% of the non-metropolitan median family income for New York State. (Note: you may only use the borrower's income for this test. You may not use the combination of borrower and guarantor income.)

2. Reasonable Belief

A lender may not make a high cost loan to a borrower who is below the mean unless the lender reasonably believes that the obligors (the combination of borrowers and guarantors) will be able to make the "scheduled monthly payments."

a. You Must Verify Debts and Income

In order for the belief to be reasonable, a lender must verify the obligors' debts and income by some reasonable means, including a credit report, application, financial statement or other financial information. (Note: the term "obligors" includes each borrower, co-borrower, co-signer or guarantor obligated to pay the loan.[25]) If the applicant offers bank statements as proof of income, then the lender must review a minimum of 12 months' worth of statements in order to reach the standard of "reasonable verification."[26]

b. You Must Compare "Scheduled Monthly Payments" to Income

You must compare the scheduled monthly payments at consummation (or after the first rate adjustment if the initial interest rate is discounted) to the combined monthly gross income. The phrase "scheduled monthly payments" is defined as follows:[27]

> "[S]cheduled monthly payments" means minimum sums required to be paid with respect to all of the borrower's debts that are reported on a nationally recognized consumer credit bureau report and the monthly mortgage payment due under the high cost home loan (ignoring any reduction arising from a lower introductory rate) plus one twelfth of the annualized cost of real estate tax and insurance premium payments during the immediately preceding twelve months. Scheduled monthly payments shall not include any debts that are consolidated with or paid off by the high cost home loan.

The Banking Department staff has offered the following additional comments. A lender is permitted to rely on the information in a credit report from a nationally recognized credit reporting bureau even if the information is in error.[28] If a lender has two different credit reports and a debt is reported on only one of the reports, the lender must include that debt in the computation.[29] A lender must include a 401-K payroll deduction in the calculation of "scheduled monthly payments" only if it is reflected on the applicant's credit report.[30]

c. Presumption: 50% Debt to Income

The law establishes a presumption for this underwriting decision. If the ratio of the obligors' scheduled monthly payments to their monthly gross income did not exceed 50 percent at the time the loan was made, then the lender is "presumed" to have given due attention to the obligors' ability to repay.[31]

d. Use VA Residual Income Analysis

The Banking Department staff has also suggested that a lender could apply a residual income analysis to determine whether the payment terms are affordable. To that end, the staff has posted the Veteran's Administration residual income guidelines on the Department's Web site.

B. All Loans: Repayment Terms May Not Be Unconscionable

Regardless of where the applicant's income falls relative to the MSA mean, a lender may not make a high cost loan with repayment terms that so exceed the borrower's financial capacity to repay as to be unconscionable.[32] This test applies regardless of the outcome of the median family income test, discussed above.

1. Definition of Unconscionable

The word "unconscionable" is defined at § 41.1(i) of 3 N.Y.C.R.R. as follows: "'Unconscionable' means oppressive or unreasonably harsh or unfair, considering all of the circumstances of the loan transaction as such term 'unconscionable' is described in the Official Comment and New York Annotations for § 2-302 of the Uniform Commercial Code."

2. Presumption

A loan is presumed to pass this test if the combined income of the borrowers and guarantors exceeds the 50% debt to income test established under § 41.3(b) of 3 N.Y.C.R.R.. In addition, a lender may rebut evidence that the repayment terms exceed the borrower's reasonable capacity to repay by establishing the following:

- a showing that the lender reasonably believed at the time the loan was consummated that the borrower and any obligor had the capacity to repay the loan based upon consideration of their current and expected income, current obligations, excluding the owner's equity in the dwelling that secures repayment of the loan and including any other collateral securing repayment of the loan, or

- a showing that other compelling circumstances existed that justified the making of the loan notwithstanding the borrower's apparent lack of capacity to repay the loan based upon the factors stated above.

3. Obligation to Verify Income

While a lender generally has no duty to verify income where the applicant asserts income that exceeds 120% of the MSA mean threshold discussed above, lenders must be alert and police situations where it appears obvious that the applicant's stated income is or may not be truthful. The Banking Department staff describes this duty as follows:[33]

> . . . for example, an applicant is a senior citizen with a modest pension who receives modest social security payments, lives in a poor neighborhood and states that his/her off the books income is $50,000 per year, then the lender must verify the income even if it is greater than 120% of the median family income for the relevant MSA since the lender is on notice that the income appears to be questionable.

"Off the books" income of $50,000 seems an easy case. However, lenders are on notice that they must perform some level of due diligence even when the hidden income is lower, as is more likely to be the case.

As a practical matter, unless the lender is simply not subject to the rule (because it made no high cost loans during the preceding 12 months, the lender may no longer make a mortgage loan without verifying income.

IV. Financing Closing Costs

Part 41 places limits on the amount of closing costs that you can charge and finance in connection with purchase money, equity and refinance transactions.

A. May Not Require a Borrower to Finance Fees

You may not require a borrower to directly or indirectly finance any portion of the points, fees or other charges in connection with a high cost loan. This means that you must offer each customer a pricing option that does not require the borrower to finance any points or fees. What about a yield spread premium paid to a mortgage broker? The answer appears to be that a lender and borrower may agree to pay a broker (or any other settlement service provider, for that matter) out of the lender's yield on the loan so long as that payment mechanism does not result in an increase in the principal amount owed. In other words, if the effect of the payment is to increase the interest rate to the borrower, then the payment is permitted. If the effect of the payment is to increase the principal amount owed by the borrower, then the borrower must be offered an alternative.[34]

B. Purchase Money/Equity Transaction: 5% Cap

If the loan is a purchase money or other equity loan or line of credit (i.e., not a refinance of an existing loan or line of credit), you may not allow the borrower to finance points, fees or other charges in an amount greater than five percent (5%) of the principal amount of the loan.[35]

1. What Are Points, Fees and Other Charges?

As simple as that sounds, there are two difficult definitional issues. First, keep in mind that the "points, fees or other charges" that are the subject of this part of the rule are not the same thing as the "points and fees" in the "points and fees" test to determine whether the loan is a high cost loan. "Points, fees and other charges" include any points, fees or other charges paid, directly or indirectly, by the borrower to the lender or a third party (other than appraisal fees, credit report fees, mortgage recording tax, fire and miscellaneous property insurance, voluntary credit, disability, unemployment and/or life insurance, title report and title insurance charges). While the list of fees in the parenthetical appears to follow the list of fees that are excluded from the finance charge under § 226.4(c)(7) of Regulation Z, it is not the same list. For example, while a notary fee paid to a third party would not be included among the fees that make up the "points and fees" test for purposes of determining whether the transaction is a high cost mortgage, a notary fee is part of the closing cost bundle that is subject to the five percent financing limitation. Other generic closing fees that must be included under the five percent financing cap include: property survey fees, pest inspection fees, document preparation fees.

2. Measure Against the Principal Amount

Finally, keep in mind that the New York rule specifically makes use of the "principal amount" of the loan as the measure for this test, so some creditors may have to run two separate tests when they price a high cost loan in New York. First, a lender will need to calculate and use the "total loan amount" (a term that is undefined in New York law, but which appears to have the meaning given it in § 32 of Regulation Z) to determine whether the loan is a high cost loan. Then, the lender must use the principal amount (presumably, the note amount) to determine the maximum amount of fees and charges that may be added to the principal amount. The Banking Department staff has taken the informal position that the principal amount of a HELOC is its maximum credit limit.[36]

C. Refinance Transactions

There are three rules that apply to refinancing. The first applies to all refinances, whether the refinance is by the same creditor or a different creditor, and regardless of when the preexisting loan was originated or whether the preexisting loan was also a high cost loan. The second applies to same-creditor refinances of high cost loans that were subject to Part 41 when originated. The third applies to refinances of high cost loans that were subject to Part 41 when originated, provided that the new loan is arranged by a mortgage broker.

1. What Is a Refinance?

Close attention to the definitions is critical to understanding these provisions of Part 41. First, you have to decide what kind of refinance is subject to these rules. The options here include: (1) a refinance of any loan, (2) a refinance of an existing loan that was a Part 41 loan when it was originated, or (3) a refinance of one or the other, but only if the new loan is a Part 41 loan.

The most logical answer given the structure of § 41.3(c) is that the refinance rules apply only to a refinancing where the new loan will be a Part 41 high cost loan and the old loan was also a high cost loan subject to Part 41 (i.e., the application for the existing loan was taken by a lender or broker after October 1, 2000 and the loan is a high cost loan). You reach this conclusion because the rule states that you can charge points on the "additional proceeds" offered on the new loan. The definition of "additional proceeds" necessarily requires that the old loan also be a high cost loan subject to Part 41 because it must be "an existing high cost home loan." "Additional proceeds" is defined as follows:[37]

> For purposes of this [subsection 41.3(c)], "additional proceeds" for a closed end loan is the amount over and above the current principal balance of the ***existing high cost home loan***. For an open-end loan, "additional proceeds" is the amount by which the line of credit on the new loan exceeds current principal balance of the ***existing high cost home loan***.

As a result, the transaction must involve the refinance (with a new high cost loan) of an existing high cost loan. Taking this definition at face value, the limitations on refinancing would not affect any new loan unless the borrower's current loan was a high cost loan under the rules in Part 41. If the lender determined that application for the consumer's existing loan (the one that the consumer wants to refinance now) had been taken before October 1, 2000, then the consumer's existing loan does not meet the definition of a high cost loan and the refinance would not be subject to Part 41's limitations on refinances. The Banking Department staff disagrees with this analysis. They take the position that a "refinance" transaction is subject to these rules regardless of whether the consumer's preexisting mortgage loan is itself a high cost loan. In order to bolster their argument, they have added a new definition of "additional proceeds" at Q&A No. 28. Note that this definition is not consistent with the definition in Part 41:

> **28. With regard to section 41.3 (c), if there is no existing high cost home loan, how are "additional proceeds" calculated?**
>
> "Additional proceeds" for a closed end home loan is calculated the same way, i.e., is the amount over and above the current principal balance of the existing home loan, irrespective of whether the existing home loan is or is not a high cost home loan the application for which was taken on or after October 1, 2000.

As a result, it is clearly the view of the Banking Department staff that the general refinance rule applies to a refinancing of any preexisting mortgage loan, whether or not it was a high cost loan when made.

2. General Refinance Rule

Under the general refinance rule, if the new high cost loan is a refinance, then you may not finance points, fees or other charges that exceed five percent (5%) of the *additional proceeds* (if any) borrowed.

3. Definition of Additional Proceeds

"Additional proceeds" for a closed-end loan is the amount over and above the current principal balance of the existing high cost home loan. For an open-end loan, "additional proceeds" is the amount by which the line of credit on the new loan exceeds the current principal balance (or in the case of a HELOC, the current maximum credit limit) of the existing high cost home loan.

4. Same-Creditor Refinances

Same-creditor refinances are subject to two additional restrictions.

a. Definition

A same-creditor refinance includes any loan that refinances a loan that was made by the same creditor or by an "affiliate" (apparently regardless of whether the original transaction was a Part 41 loan). "Affiliate" is defined at § 41.1(b) of 3 N.Y.C.R.R. to include:

> any company that controls, is controlled by, or is under the common control of another company. Control shall mean ownership of ten percent or more of any class of outstanding capital stock of the company or the power to direct or cause the direction of the management and policies of the company[.]

Note that the definition of "same-creditor" has nothing to do with who the holder of the loan is or who the servicer of the loan may be. As a result, unless you are a portfolio lender (few, if any mortgage bankers are portfolio lenders), you will have to establish recordkeeping procedures to know whether a new applicant is someone that you loaned to earlier.

b. May Not Finance Prepayment Penalties

The same-creditor may not finance any prepayment penalties that are imposed in connection with a high cost loan that is used to prepay the balance of a preexisting loan.[38] Again, under the theory put forth by the Banking Department staff, this rule applies to any same-creditor refinance, regardless of whether the preexisting loan was subject to Part 41. Note that it does not prevent a holder of a loan that was purchased in the secondary market from charging and financing the prepayment penalty in connection with a refinancing.

c. Special Rules for Refinancing of Preexisting High Cost Loans (Two Years or Less): No Flipping

If the same-creditor wants to use a high cost loan to refinance a preexisting high cost loan that has been outstanding for two years or less, the creditor may only charge those points and fees that reflect the lender's typical point and fee structure for high cost refinance loans. In addition, the points and fees must be calculated based only on the additional proceeds provided to the customer. The meaning of this provision is not clear. For example, what fees could a lender charge that do not reflect the lender's typical point and fee structure for high cost refinance loans? This seems less a limitation on the pricing of the loan than a requirement that the lender limit the authority of its loan officer to negotiate wildly disparate loan terms from transaction to transaction. In other words, Part 41 appears to permit a lender to charge as much as it wants so long as everybody gets charged the same thing (i.e., that you not charge higher amounts to less sophisticated borrowers simply because they are less successful negotiators).

The requirement that the points and fees must be calculated based only on the additional proceeds provided to the customer also seems vague. Many fees typically imposed on a mortgage transaction are not related to the amount of the credit. Things like appraisals, credit reports, title reports and settlement agent fees usually cost what they cost regardless of the amount of the loan. On the other hand, points and mortgage taxes may change based on the amount of new or additional proceeds. Hopefully, all that the Banking Department staff means to accomplish with this provision is to remind lenders that to the extent a fee is calculated based on the debt amount, that particular fee must be set based on the amount of the new or additional proceeds on the refinance (if any) rather than the whole loan amount.[39]

5. Mortgage Broker Refinances: Again, No Flipping

If a high cost loan refinancing is arranged by a mortgage broker and involves the refinance of a preexisting high cost loan that has been outstanding for two years or less, the creditor may only charge those points and fees that reflect the lender's typical point and fee structure for high cost refinance loans. In addition, the points and fees must be calculated based only on the additional proceeds provided to the customer. These issues are discussed in the immediately preceding section.

Both the same-creditor refinance and mortgage broker refinance limitations appear to be intended to limit "flipping." "Flipping" is generally understood to be a process where the borrower is pressured to refinance over and over again, each time adding points and closing costs to the principal balance until the borrower loses the ability to make payments, defaults, and loses his or her home in foreclosure. Some people believe that mortgage brokers are particularly adept at this practice, because they are fully paid at each closing and therefore have an economic incentive to generate as many closings as possible. Some lenders believe that brokers maintain lists of applicants they have placed into loans and constantly work those lists to churn new loans and new fees.

6. How to Determine the Status of the Preexisting Loan

How is a lender supposed to determine whether a preexisting loan is a Part 41 loan? Will lenders be permitted to rely on a statement from the borrower as to whether or not the preexisting transaction was a Part 41 loan? Will the lender be able to rely on the fact that the mortgage document does not include the required Part 41 notice? Will the lender be required to search for this notice in the records maintained at the county recorder's office?

The staff at the Banking Department has suggested that the lender can review the mortgage at the County Recorder's office to determine whether the mortgage contains the new legend discussed below.[40] Obviously, if a creditor relies on this method to determine the status of the preexisting transaction, none of the "application" disclosures (discussed below) will ever be delivered at the time of application because the lender will not have had time to arrange for someone to drive to the County Recorder's office, find parking, do a deed search, find the mortgage (assuming the recorder has actually placed it in the records and is not behind on her work), determine whether it includes the legend, make a copy for the records to be audited by the Banking Department, and then drive back to the office.

After all that is done, the lender must also discover the stated interest rate on the old loan. The Banking Department has made clear that lenders may not rely on the form of the mortgage if the "stated interest rate is significantly higher than the usual rate for mortgages made at that time."[41] Ask yourself how the new lender is supposed to discover the stated interest rate on the preexisting loan. The previous lender certainly has no incentive to tell the world because, in most cases, it would much prefer that its loan not be taken out. What are the chances that the borrower can be relied upon to deliver a copy of the previous note? Will borrowers mind if a few days or weeks are added to the application process? What if the borrower faces some kind of emergency and needs the new money now to fix a hole in the roof, pay for a medical procedure, or avoid a foreclosure? HOEPA allows the consumer to waive those provisions in § 32 that could delay a loan closing in the case of a bona fide personal financial emergency. Part 41 makes no provision for a consumer to waive the benefit of these requirements in the case of personal distress or financial emergency.

7. Other Issues

Other questions remain to be answered. For example, what is the difference between a modification and a refinance? Under the special rule for modifications at 3 N.Y.C.R.R. § 41.2(g), a lender is permitted to charge fees (in addition to those that are related to "additional proceeds" and reflect the creditor's typical rate and fee structure for high cost loans) to modify, renew, extend, or amend its own existing high cost home loan or defer any payment due under a high cost home loan only if, after the modification, renewal, extension or amendment, (i) the loan is no longer a high cost home loan and (ii) the APR has decreased by at least two percentage points. On the other hand, if the holder of the loan refinances the loan, and the new transaction is not a high cost loan, the fee limitations in Part 41 do not apply. So what is the difference between a modification and a refinance and why should different rules apply?

V. Selling Insurance

A. Limitations on Financing Premiums

The new rules limit the way that credit insurance can be underwritten and sold. If the loan is a high cost loan, you may not finance voluntary unemployment insurance unless the underwriting for the loan is predicated on the borrower's W-2, 1099 income statement or original, current payroll check stub. You may not finance fire and miscellaneous property insurance and/or voluntary credit, disability, unemployment and/or life insurance in addition to the five percent limit set forth above unless the obligor's scheduled monthly payments do not exceed fifty percent of the obligor's monthly gross income.[42] Keep in mind that the term "obligor" includes the combination of the borrower, any co-borrower and any cosigner or guarantor. In addition, if you want to sell credit insurance and finance the premiums, you must make oral and written disclosures to the borrower at least three days before the loan closes.

B. "Packing" Prohibited

The rules prohibit "packing" or selling the consumer goods or services as part of the loan that are not needed or wanted by the consumer. In the most egregious cases, borrowers may not even know that they actually bought the additional item. The new rules establish a definition of the term and describe a complex series of oral and written disclosures a creditor must make in order to sell additional services and products without engaging in unlawful activity.

1. Definition of Packing

"Packing" is defined at § 41.5(b)(5) of 3 N.Y.C.R.R. as follows:

> the practice of selling credit life, accident and health, disability or unemployment insurance products or unrelated goods or services in conjunction with a high cost home loan without the informed consent of the borrower under circumstances where:

- the broker or lender solicits the sale of such insurance, goods or services;

- the broker or lender receives direct or indirect compensation for the sale of such insurance, goods or services; and
- the charges for such insurance, goods or services are prepaid with the proceeds of the loan and financed as part of the principal amount of the loan.

2. Necessary Disclosures

If you want to sell credit insurance or other goods or services that are "unrelated" to the credit transaction, you must provide both oral and written disclosures. You must make the disclosures to the borrower at least three business days before the loan is closed, both orally and in a clear and conspicuous written disclosure (in at least 12-point type). The disclosures must contain the following information:

- the cost of the credit insurance or other goods and services;
- the fact that the insurance, goods, or services will be prepaid and financed at the interest rate provided for in the loan; and
- that the purchase of such insurance, goods or services is not required to obtain the mortgage loan.

In addition, the written disclosure must contain a signed and dated acknowledgment by the obligor(s) that the oral disclosure was made and a signed and dated acknowledgment by the broker or lender that the oral disclosure was made. Note that the rule appears to be in conflict with itself on who must receive the disclosures. It seems to suggest that the disclosures must be made to the borrowers. However, it requires the lender to obtain acknowledgments from the obligors (a defined term that includes the borrowers as well as any co-signers or guarantors in the transaction) that they received the oral disclosures. Obviously, until this apparent discrepancy is corrected, the best course is to provide all of the oral and written disclosures to each of the obligors.

VI. Prohibited Loan Terms

A high cost loan may not include the following loan terms.

A. Balloon Payments

No high cost home loan may contain a scheduled final payment that is more than twice as large as the average of earlier scheduled monthly payments unless the term before the balloon payment becomes due and payable is at least seven years. Balloon payments are permitted without limitation if (1) the payment schedule is adjusted to account for the seasonal or irregular income of the borrower, (2) the purpose of the loan is a "bridge" loan connected with the acquisition or construction of a dwelling intended to become the borrower's principal dwelling, or (3) the loan is a home equity line of credit.[43]

B. Negative Amortization

Notwithstanding any statute or regulation to the contrary, no high cost home loan may contain a payment schedule with regular periodic payments that cause the principal balance to increase. Exceptions from the general rule include loans where the negative amortization results from a temporary forbearance sought by the borrower and home equity lines of credit.[44]

C. Call Provisions

No high cost home loan may contain a call provision that permits the lender, in its sole discretion, to accelerate the indebtedness. This prohibition does not apply when repayment of the loan has been accelerated by bona fide default, pursuant to a due-on-sale provision, or pursuant to some other provision of the loan agreement unrelated to the payment schedule such as bankruptcy or receivership.[45]

D. Increased Default Rates

No high cost home loan may contain a provision that increases the interest rate after default. This provision does not apply to periodic interest rate changes in a variable rate loan otherwise consistent with the provisions of the loan agreement, provided the change in the interest rate is not triggered by the event of default or the acceleration of the indebtedness.[46]

E. Advance Payments

No high cost home loan may include terms under which more than two periodic payments required under the loan are consolidated and paid in advance from the loan proceeds provided to the borrower.[47]

F. Oppressive Mandatory Arbitration Clause

No high cost home loan may be subject to a mandatory arbitration clause that is oppressive, unfair, unconscionable, or substantially in derogation of the rights of consumers. Arbitration clauses that comply with the standards set forth in the Statement of Principles of the National Consumer Dispute Advisory Committee (http://www.adr.org/education/education/consumer_protocol.html) in effect as of October 1, 2000 are presumed not to violate this standard.[48]

G. Modification or Deferral Fees

A lender may not charge a borrower any fees to modify, renew, extend, or amend its own existing high cost home loan or defer any payment due under a high cost home loan if, after the modification, renewal, extension or amendment, the loan is still a high cost loan or, if no longer a high cost home loan, the APR has not been decreased by at least two percentage points. For purposes of this paragraph, fees do not include interest that is otherwise payable and consistent with the provisions of the loan documents. This provision does not prohibit a lender from charging points and fees in connection with any additional proceeds or new money received by the borrower provided that the compensation must reflect the lender's typical point and fee structure for high cost home loans. This provision does not apply if the existing high cost home loan is in default or is 60 or more days delinquent and the modification, renewal, extension, amendment or deferral is part of a work-out process.[49]

H. Home Improvement Contracts

A lender may not pay a contractor under a home-improvement contract from the proceeds of a high cost home loan other than by an instrument payable to the borrower or jointly to the borrower and the contractor or, at the election of the borrower, through a third-party escrow agent in accordance with terms established in a written agreement signed by the borrower, the lender, and the contractor prior to the disbursement of funds to the contractor. Note that this rule applies only to direct loans (promissory notes). Part 41 has no impact on home improvement contractors who use retail installment contracts as a financing method. While this may be a surprise to those who believe that rogue home improvement contractors may be the source of a large portion of the abusive practices in many neighborhoods, the fact is that the Banking Department staff does not have the statutory authority to regulate home improvement contractors or retail installment lending.[50]

VII. New Mortgage Legend

You must add the following language to the top of the mortgage document in 12-point type:[51]

> **This mortgage is a high cost home loan subject to Part 41 of the General Regulations of the Banking Board.**

VIII. New Application Disclosures

You must provide a number of new disclosures.

A. Where the New Loan Will Decrease Payments/Increase Principal

You must provide a specific disclosure to the applicant if you expect the new loan to decrease the borrower's regular monthly payments and increase the amount of the debt on an existing loan. At or prior to taking an application for a refinance (but in any event, at least three days prior to the loan closing), a lender must deliver, place in the mail, fax or electronically transmit to the borrower a statement in substantially the following form:[52]

> **Although your aggregate monthly debt payment may decrease, the high cost home loan may increase both (i) your aggregate number of monthly debt payments and (ii) the aggregate amount paid by you over the term of the high cost home loan.**

This disclosure need not be on a separate form. A lender may agree with a broker that the broker shall make the disclosures required by this Part and Part 38 on behalf of the lender. However, the lender is responsible for the disclosure and must ensure that such disclosures are made. In the event that the lender or broker does not know whether the borrower's application is a high cost home loan application, such disclosure must be made as soon as the lender determines that it is a high cost home loan application, but in any event, at least three days prior to the closing. In the event of a telephone application, the disclosure must be made immediately after receipt of the application by telephone, but in any event, at least three days prior to the closing. In order to utilize electronic transmission to make these disclosures, the lender or broker must first obtain either written or electronically transmitted permission from the borrower. Note that the electronic delivery requirements are preempted by the new federal ESIGN requirements.

B. You Better Shop Around

You must add the following notice immediately above the borrower's signature line on the application in at least 12-point type:[53]

> **The loan which may be offered to you is not necessarily the least expensive loan available to you and you are advised to shop around to determine comparative interest rates, points and other fees and charges.**

If you do not know that the loan will be a high cost loan at the time of application, then you must deliver the notice as soon as you determine that the loan is a high cost loan, but in no event less than three days before the loan is closed. If the application is a telephone application, then the disclosure must be made to the borrowers at least three days before the closing (whether or not funds are then disbursed.) The Banking

Department staff has taken the informal position that lenders may comply with this requirement by printing the required disclosure on a separate sheet and then attaching the sheet to the application.

C. Available Credit Counselors

You must deliver the following notice at the time of application (on a separate form from other disclosures) in at least 12-point type:[54]

> **You should consider financial counseling prior to executing loan documents. The enclosed list of counselors is provided by the New York State Banking Department staff.**

If you receive the application by telephone, you must deliver the notice immediately after you take the application, but in any event, at least three days before the closing. If you want to deliver the notice electronically, you must first obtain either written or electronically transmitted permission from the customer. Note that the electronic delivery requirements are preempted by the new federal ESIGN requirements. The list of available counselors is maintained at the Banking Department's Web site.[55]

D. Disclosures to Multiple Borrowers

Where there is more than one borrower, and the rules require you to deliver a notice to obtain a signature, you may comply with the requirement by delivering the disclosure or obtaining the signature of any one borrower. As noted above, the rules draw a distinction between borrowers and obligors (a category that includes borrowers, co-signers and guarantors) that has not found its way into this "one for all and all for one" disclosure rule. This is probably an oversight in the rule. The Banking Department staff presumably intended lenders to be able to deliver the disclosures to any one borrower on behalf of all obligors.[56]

IX. Reporting Requirements

The following additional requirements and limitations apply to high cost loans.

A. Mandatory Credit Reporting

A lender must report both the favorable and unfavorable payment history of the borrower to a nationally recognized consumer credit bureau at least annually.[57] What happens when the lender sells the loan? Will the holder have a similar reporting duty? Watch this very carefully. As a general rule, Part 41 does not apply to any lender who does not originate high cost loans. So, right now, if a lender does not want to be bothered with Part 41, the lender can avoid it by not making high cost loans. Companies that acquire servicing rights do not have to comply with Part 41.

B. Reporting Requirements

Mortgage brokers and lenders that make ten or more high cost loans in a calendar year must file a report with the Banking Department staff on or before March 31st of the following year. The report must identify the names and addresses of the three home improvement contractors, the three consultants and the three attorneys who provide the most referrals of high cost loans, if any, and the three to whom the broker and lender make the most referrals of high cost home loans, if any. The report must also identify the names and addresses of any home improvement company that is an affiliate. This provision does not apply to referrals from consumers or from attorneys in their capacity as closing attorneys for lenders.[58]

X. Enforcement

A. Pattern or Practice of Noncompliance

Any lender who engages in a pattern or practice of violating any provision of Part 41 will be deemed to lack the character and fitness necessary to be licensed or registered by the Banking Department staff.

B. Unfair, Deceptive or Unconscionable Acts or Practices

Any lender who engages in unfair, deceptive or unconscionable practices will also be found lacking the character necessary to be licensed or registered by the Banking Department staff. The following acts are examples:

1. Junk Fees or Excessive Fees

You may not charge the borrower fees for services not actually performed. You may not charge fees that bear no reasonable relationship to the value of the services performed. You may not charge any fees that are otherwise unconscionable.[59]

2. Unconscionable Repayment Terms

A lender may not make a high cost loan with repayment terms that so exceed the borrower's financial capacity to repay as to be unconscionable.[60] See the discussion on underwriting requirements, above.

3. Unconscionable Points, Fees, or Other Finance Charges

You may not broker or make a high cost loan that includes points, fees or other finance charges that, considering the loan transaction as a whole (including the creditworthiness of the borrower, the terms of the loan, the value of the collateral, and the owner's equity in the collateral), so significantly exceed the usual and customary charges incurred by New York mortgage consumers as to be unconscionable.[61]

4. Flipping

You may not make a high cost loan to a borrower that refinances an existing loan when, considering all the circumstances of the refinancing, the refinancing is unconscionable.[62] A loan that complies with 3 N.Y.C.R.R. § 41.3(d) is presumed not to violate this requirement.

5. Recommending Default

You may not recommend or encourage a borrower to default on an existing loan or other debt prior to closing a high cost loan that refinances all or any portion of the existing loan or debt.[63]

6. Advertising Limitations

You may not advertise that refinancing pre-existing debt with a high cost home loan will reduce a borrower's aggregate monthly debt payment without also disclosing, if such are likely the case, that the high cost home loan will increase both (i) a borrower's aggregate number of monthly debt payments and (ii) the aggregate amount paid by a borrower over the term of the high cost mortgage loan.[64]

C. Cure Provision

The rule includes the following cure provision:[65]

> A lender or assignee has no liability under this Part for any failure to comply with any requirement imposed under this Part, if within sixty days after discovering an error, whether pursuant to a final written examination report, through the lender's or assignee's own procedures, or through a complaint from the obligor, and prior to the institution of an action under this Part, the lender or assignee notifies the individual(s) concerned of the error and makes whatever adjustments are necessary to either correct the error or assure that the person will not be required to pay an amount that will make the loan subject to this Part. Moreover, a lender or assignee has the right to correct errors and may not be held liable for a violation of this Part, only if the lender or assignee shows by a preponderance of evidence that the error was not intentional and resulted from a bona fide error notwithstanding the maintenance of procedures reasonably adopted to avoid any such error. Examples of a bona fide error include, but are not limited to, clerical, calculation, computer malfunction and programming, and printer errors, except that an error of legal judgment with respect to a person's obligations under this Part is not a bona fide error.

While it is gratifying to see a statute with a cure provision, this one is drafted in a way that may render it moot. Unlike the cure provision in § 130(b) of the Truth in Lending Act,[66] the rule does not permit a lender to cure any type of error. The errors that are subject to the right to cure are those that are "not intentional and resulted from a bona fide error notwithstanding the maintenance of procedures reasonably adopted to avoid any such error." In effect, the New York rule combines the "bona fide error defense" available under § 130(c) of the Truth in Lending Act[67] with the cure provisions. The result is that a lender must demonstrate that it has "clean hands" before it is able to rely on the cure provision. This standard has proven very difficult to reach under § 130(c) of the Truth in Lending Act and may continue to be difficult to establish under the New York rules.

D. Reliance on TILA

The rule provides that, to the extent it has imported a definition from the Truth in Lending Act, a lender or assignee may rely on the official determinations of the Federal Reserve Board as to the meaning of those terms. You may also rely on any "rule, regulation, release, bulletin, or interpretation" issued by the Banking Department staff with respect to any other actions.[68]

Endnotes

1. The Fannie Mae single-family loan limit became $275,000 on January 1, 2001. On October 1, 2000, when Part 41 became effective, the Fannie Mae single-family loan limit was $252,700.
2. N.Y. Comp. Codes R. & Regs. Tit. 3, § 41.1(e)(1) (hereinafter "N.Y.C.R.R.").
3. 3 N.Y.C.R.R. § 41.1(e)(4).
4. Q&A No. 1.
5. Q&A No. 29.
6. The Home Ownership and Equity Protection Act of 1994 (HOEPA) became effective October 1, 1995. *See* Pub. L. No. 103-325, §§ 151-58, 108 Stat. 2160 and implementing regulations at 12 C.F.R. § 226.31-.33 (2000). HOEPA imposed limitations on high cost mortgage loans and significantly increased the remedies available to consumers who suffer at the hands of high cost lenders.
7. 3 N.Y.C.R.R. § 41.8.
8. 3 N.Y.C.R.R. § 41.1(a).
9. Q&A No. 20.
10. 3 N.Y.C.R.R. § 414.1(h).
11. 3 N.Y.C.R.R. § 41.1(e)(6)(i).

12. 3 N.Y.C.R.R. § 41.1(e)(6)(ii).
13. 3 N.Y.C.R.R. § 41.1(c); Q&A No. 3.
14. 12 C.F.R. § 226.32(a)(1)(i).
15. 3 N.Y.C.R.R. § 41.1(e)(6)(iii).
16. 3 N.Y.C.R.R. § 41.1(d).
17. Q&A No. 24.
18. 12 C.F.R. § 226.32(a)(1)(ii).
19. 3 N.Y.C.R.R. § 41.1(g).
20. An "affiliate" is defined as any company that controls, is controlled by, or is under common control with another company, as set forth in the Bank Holding Company Act of 1956. *See* 12 C.F.R. § 226.32(b)(2), which incorporates the definition of "affiliate" found at 12 U.S.C. § 1841(k).
21. Q&A No. 6.
22. Q&A No. 30.
23. 12 C.F.R. pt. 226, supp. I, cmt. 32(a)(1)(ii)-1 (2000).
24. These are discussed at 3 N.Y.C.R.R. § 41.3(b).
25. 3 N.Y.C.R.R. § 41.1(f).
26. Q&A No. 17.
27. 3 N.Y.C.R.R. § 41.1(h).
28. Q&A No. 12.
29. Q&A No. 13.
30. Q&A No. 14.
31. 3 N.Y.C.R.R. § 41.3(b).
32. 3 N.Y.C.R.R. § 41.5(b)(3).
33. Q&A No. 15.
34. 3 N.Y.C.R.R. § 41.3(c).
35. *Id.*
36. Q&A No. 30.
37. 3 N.Y.C.R.R. § 41.3(c) (emphasis added).
38. *Id.*
39. 3 N.Y.C.R.R. § 41.3(d).
40. Q&A No. 27.
41. Q&A No. 18.
42. 3 N.Y.C.R.R. § 41.3(c).
43. 3 N.Y.C.R.R. § 41.2(b).
44. 3 N.Y.C.R.R. § 41.2(c).
45. 3 N.Y.C.R.R. § 41.2(a).
46. 3 N.Y.C.R.R. § 41.2(d).
47. 3 N.Y.C.R.R. § 41.2(f).
48. 3 N.Y.C.R.R. § 41.2(e).
49. 3 N.Y.C.R.R. § 41.2(g).
50. 3 N.Y.C.R.R. § 41.3(e).
51. 3 N.Y.C.R.R. § 41.7.
52. 3 N.Y.C.R.R. § 41.4(a).
53. 3 N.Y.C.R.R. § 41.4(d).
54. 3 N.Y.C.R.R. § 41.3(a).
55. 3 N.Y.C.R.R. § 41.3(f).
56. 3 N.Y.C.R.R. § 41.6.
57. 3 N.Y.C.R.R. § 41.4(b).
58. 3 N.Y.C.R.R. § 41.4(c).
59. 3 N.Y.C.R.R. § 41.5(b)(2).
60. 3 N.Y.C.R.R. § 41.5(b)(3).
61. 3 N.Y.C.R.R. § 41.5(b)(1).
62. 3 N.Y.C.R.R. § 41.5(b)(4).
63. 3 N.Y.C.R.R. § 41.5(b)(6).
64. 3 N.Y.C.R.R. § 41.5(b)(7).
65. 3 N.Y.C.R.R. § 41.9.
66. 15 U.S.C. § 1640(b).
67. 15 U.S.C. § 1640(c).
68. 3 N.Y.C.R.R. § 41.10.

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Regulation FD: What Is It—And What Does It Mean for Public Companies, Investors and Other Market Participants?

The Securities and Exchange Commission (SEC) recently adopted Regulation FD, which bars selective disclosure of material corporate information to certain participants in the U.S. securities markets.[1] The new rules became effective on October 23, 2000.

- Regulation FD requires U.S. public companies to make broad, non-selective public dissemination of any material, non-public information disclosed by their directors, executive officers or investor relations personnel to analysts, money managers or certain shareholders.
- Where a selective disclosure is intentional, the company will violate Regulation FD unless simultaneous disclosure is made to the securities markets as a whole via one or more of several SEC-approved methods—which means that it is now illegal (though not fraudulent, as explained below) to make a selective disclosure of material, previously undisclosed corporate information to analysts, money managers or certain shareholders, except under a few limited circumstances.
- In the case of an unintentional selective disclosure, such as a senior manager's quick, off-the-cuff response to an unexpected question on next year's earnings fired at him by an analyst during a trade show, the company will have 24 hours after discovery of this mistake to release the information to the public.
- With respect to a company's choice of publication methods, the SEC does not consider the use of the Internet alone to be sufficient, but does offer some guidance on how companies may use their Web sites to supplement other, more traditional corporate disclosure vehicles.

Corporate dialogue with the markets may be inhibited in the short term, as public companies re-examine their internal policies and procedures for dealing with analysts, investors and the press in light of the active enforcement regime apparently contemplated by Regulation FD. The difficulties of making snap materiality judgments could discourage the spontaneous discussions of a company's performance and prospects that often occur between senior managers and market professionals in analyst conference calls and small or one-on-one meetings and telephone conversations. SEC statements in the adopting release illuminate how its enforcement staff may analyze the materiality of a particular item of selectively disclosed information. This clearly signals the agency's conviction that earnings projections and other forward-looking data craved by market participants almost always will be considered material, and therefore must be disclosed to all investors at the same time. As such, the release merely underscores the SEC's apparent determination to combat the practice of "earnings guidance" through enforcement actions under Regulation FD, making it likely that companies will think twice before responding between formal quarterly announcements to analyst or investor inquiries on various measures of future financial performance.

Many of the corporations which commented on proposed Regulation FD argued against its adoption on the ground that most public companies already have in place strong policies and procedures designed to guard against selective disclosure while ensuring that market professionals and shareholders alike receive all the information they need to make sound, fully informed judgments about a particular company's business and financial condition. Thus, it is possible that the SEC is correct in predicting that important corporate information will continue to flow freely to the securities markets, undeterred by the constraints of Regulation FD.

Regulation FD in a Nutshell

Beginning on October 23 of last year, Regulation FD established a new corporate disclosure obligation that, even if breached, will not result in liability for securities fraud but will subject public companies and their senior officials to SEC enforcement proceedings. Distilled to its essence, the rule requires companies whose senior officials provide material, nonpublic information to specified market participants to publish this information widely, either at the same time (if the disclosure was intentional) or within a 24-hour period after discovery (if the disclosure was unintentional). In a significant narrowing of the rule as originally proposed, it does not apply to ordinary, business-related communications between corporations and their customers or suppliers, or to corporate communications with the press or broadcast media (unless analysts are present).

What Companies Are Covered?

U.S. companies that file reports with the SEC—either because their securities are traded on a stock exchange or NASDAQ, or they have made a registered offering of securities in the last 12 months—are subject to the new rule. This would include closed-end investment companies that have reporting obligations (e.g., because their shares are listed on the NYSE), but not open-end funds or other types of investment companies. Non-U.S. companies that file reports with the SEC (commonly referred to as "foreign private issuers") also have been carved out of Regulation FD, although this is because the SEC is undertaking a comprehensive re-examination of the special disclosure standards applicable to these companies.

What Types of Corporate Communications Are Covered?

The types of Regulation FD-covered communications are defined, in the first instance, by those specified persons who communicate and receive material, non-public information.

Covered Corporate Officials

Regulation FD will require each U.S. reporting company to make broad, non-exclusive disclosure to the securities markets of any "material, non-public" information that any of several specified persons acting on its behalf shares on a selective basis with any of the various market participants identified in the rule. Two regulatory definitions are significant here:

> "person acting on behalf of an issuer," which means "any senior official of the issuer . . . or any other officer, employee or agent of an issuer who regularly communicates with any . . . [of several market professionals enumerated in the next subsection of this article], or with holders of the issuer's securities." An officer, director, employee or agent of a company who discloses material, non-public information in violation of a duty of trust or confidence owed to the company is not considered to be "acting on behalf of an issuer" for Regulation FD purposes; and
>
> "senior official," which means "any director, executive officer . . ., investor relations or public relations officer, or other person with similar functions."

Covered Information Recipients

Regulation FD will come into play only when material, non-public information about the company or its securities is disclosed to certain categories of recipients reasonably likely to trade on that information, or to advise others to do so. The following recipients are specifically identified in the rule:

(1) an employee or other representative of a broker-dealer, whether he or she works on the trading desk or in the research department.

However, the rule does not affect the ability of senior corporate officials to share confidential corporate information with a broker-dealer's investment banking side in connection with the provision of professional services. Examples of such business engagements that would establish the requisite confidential relationship between an investment banker and a public company might include (but are not limited to) the provision of financial advisory services to a public company in connection with a proposed or pending M&A deal, or participation as an underwriter in that company's registered underwritten securities offering. While critical to the broker-dealer from an antifraud compliance perspective, the adequacy of internal informational barriers erected between the investment banking and trading/research departments in such situations should be irrelevant to the communicating company from a Regulation FD compliance perspective, absent actual knowledge that these barriers have been breached.

Broker-dealers should already have in place rigorous policies and procedures designed to prevent the flow of selectively-disclosed information received in an advisory capacity to their trading and research arms to diminish the risk of potential violations of Rule 10b-5 (insider trading) and Regulation M (bids for and purchases of securities during a distribution). Nevertheless, the advent of Regulation FD should compel a careful reassessment of current broker-dealer compliance systems.[2]

(2) a large money manager that must file so-called 13F reports with the SEC, and any person associated with it.

These institutions should undertake the same reassessment, described in (1) above, of existing internal policies and procedures to prevent misuse of confidential information.

(3) an investment adviser whose activities are regulated by the SEC, and any associated person.

The previous discussion in (1), regarding the need to reassess internal policies and procedures, applies here.

(4) an investment company, whether or not registered with the SEC, and any affiliate.

This category encompasses such diverse entities as a registered mutual fund and its investment adviser, as well as an SEC-exempt hedge fund. The same need to reassess informational barriers pertains here. Venture-capital funds, which are typically exempt from investment-company registration and reporting obligations, often have large equity stakes in, and representation on the boards of, public companies. As a result, they should re-examine in light of Regulation FD the sufficiency of internal informational barriers that should be in place now to minimize Rule 10b-5 and § 16(b) liability exposure.

(5) any shareholder of the company, when the particular facts and circumstances make it reasonably foreseeable to the speaker that this shareholder will trade on the basis of the information.

This is perhaps the most troubling category. No guidance is given in Regulation FD or the adopting release on how to apply the "reasonable foreseeability" standard. Generally speaking, however, companies should anticipate that the SEC will impose on them the burden of providing some evidentiary support for the reasonableness of any stated belief that a shareholder-recipient of material, non-public information would not trade on the basis of, or disclose, this information. If the company has any doubts, it always has the option of insisting that the shareholder enter into a confidentiality agreement that prohibits trading and tipping, as discussed below.

"Confidentiality Agreement" Exception

Regulation FD permits disclosure of material nonpublic information to any person or entity, even those just described, where a duty of trust or confidence is owed to the company. Thus, a company is free to share sensitive confidential information with "temporary insiders," such as investment bankers, lawyers or accountants, who render professional services to the company. Moreover, the company may reveal that information to anyone who enters into an express agreement with the company to abstain from trading and to preserve the confidentiality of this information. Interestingly enough, the SEC believes that such agreements are common in connection with private placements which, as discussed below, are subject to Regulation FD.

To satisfy Regulation FD, a confidentiality agreement need not be in writing so long as an express oral agreement is reached. In addition, the parties may enter into the agreement after an otherwise prohibited selective disclosure occurs, provided that there has been no trading or disclosure to a third party. This may be one way to "cure" an inadvertent selective disclosure, as described later in this article. Finally, any breach by the information recipient of the duty of trust or confidence that exists by virtue of the contract (e.g., through improper tipping or trading), though not actionable under Regulation FD, still could be found to violate traditional principles of insider trading law developed under Rule 10b-5.

Public companies are well-advised to create contemporaneous written records of oral agreements made with any of the "prohibited" recipients of material, nonpublic information if they intend later to rely on the "confidentiality agreement" exception to Regulation FD in the event of an SEC investigation into whether an improper selective disclosure was made. Once such an investigation is opened, a subject company should expect a request from the staff for production of corroborating written evidence of an oral agreement with the recipient. Because the SEC's attention probably would be attracted here by potentially illegal insider trading or tipping with respect to a company's securities, the information recipient suspected of such activities in all likelihood would deny the existence of a confidentiality agreement sufficient to create a duty of trust and confidence running to the company.

This ability to use express oral agreements should calm concerns, voiced by commenters, that Regulation FD might trigger a premature duty to disclose preliminary merger negotiations. Parties engaged in these negotiations sometimes exchange material, non-public information in advance of signing a written confidentiality agreement. Similarly, it is not unusual for a prospective acquirer in either a friendly or hostile deal to solicit voting support from large shareholders at an early stage of the proposed transaction. This is important because, even though communications made with a prospective merger partner and/or its large shareholders in connection with registered mergers and other business combinations subject to new Regulation MA have been carved out of Regulation FD (see the following subsection of this article), this exception to Regulation FD coverage is not available until the commencement of the transaction—defined by the SEC to mean the first public announcement of the merger, tender offer or other extraordinary transaction.

Corporate dialogues with several major constituencies remain unaffected by Regulation FD, i.e., with the print and broadcast media, including the financial press, customers, suppliers and other business partners who do not own stock in the company, and credit rating agencies. With respect to rating agencies, material confidential information may be shared only to assist in the development of a credit rating, and only where the particular agency makes its ratings publicly available.

Excluded and Non-Excluded Communications

The universe of corporate communications subject to Regulation FD is perhaps best understood by reference to those communications that the SEC has explicitly excluded from or included in coverage. Particular types of communications that fall in either category are outlined below. It seems reasonable to assume that any other communication by a senior corporate official with a "prohibited" information recipient—for example, in connection with soliciting activities of a public company relating to an all-cash merger or tender offer—would implicate Regulation FD.

Excluded Communications—Registered Underwritten Offerings

With limited exceptions, covered companies will not be forced yet to try to reconcile the apparent conflict between Regulation FD's broad disclosure mandate and the highly restrictive SEC rules that limit communications by companies and their underwriters when raising capital in the public markets. This is because the SEC has specifically excluded from Regulation FD coverage any corporate communications made in connection with a registered offering of securities for financing purposes (pending its decision whether to modify applicable Securities Act restrictions in a separate rule-making project). The SEC reasoned here that non-public information material to an investment decision in this setting must, in any event, be published solely within the four corners of the prospectus rather than revealed selectively in roadshows. Subject to the SEC's current preference for limiting all material disclosures to the prospectus, public companies and their underwriters should be able to continue with established solicitation practices, and thus to make judgments on the materiality and/or inclusion in the prospectus of non-public information shared selectively with investors during roadshows and one-on-one meetings.

Registered M&A Transactions

Mergers and acquisitions that involve registered securities offerings also have been exempted, even though the SEC substantially liberalized the rules governing M&A transactions in late 1999 to permit freer oral and written communication outside of the required disclosure document, and has not signaled since then any desire to revisit the revised rules. Current soliciting practices in M&A deals, whether those practices entail one-on-one communications with large investors or more traditional "live" or electronic roadshows attended by analysts, broker-dealers, investment advisers and a variety of institutional investors, therefore should be able to continue in accordance with existing rules until further action is taken by the SEC.[3]

Several important points are worth emphasizing with respect to capital-formation and M&A deals alike. Regulation FD defines when these registered offerings will be deemed to begin and end, presumably to prevent companies from unduly prolonging any Regulation FD "black-out" periods. More important, the SEC cautioned that even when a public company is engaging in a registered offering, not all of its communications will be protected by the applicable Regulation FD exemption. By way of illustration, the SEC observed that earnings predictions or other material information bearing on a company's future financial performance disclosed selectively in a "regularly scheduled" analyst conference call would not be protected by the exemption.

Though unstated in the release, one logical inference to be drawn from the SEC's cautionary illustration is that a company facing this situation must comply with Regulation FD, without violating securities law constraints on communications, by also publishing the "soft" information in the prospectus—either directly or through a Form 8-K filed to satisfy Regulation FD and incorporated by reference into the registration statement containing the prospectus. The choice to furnish the Form 8-K, discussed below, would not be available on these facts in a capital-raising deal because of the current prohibition against free-writing, although no such constraints exist any longer for registered M&A transactions (so long as the free-writing is filed with the SEC). Of course, in an M&A deal the company (either or both the acquirer or acquired) might argue that this information need not be carried in the proxy/prospectus or the exchange offer prospectus because it constitutes permissible free writing or oral communication. Companies should be aware, however, that the SEC and its staff increasingly are taking the position—in both capital-formation and M&A offerings registered under the Securities Act—that earnings estimates and other types of soft financial information are virtually always material to an investment decision and therefore must be set forth in the final or other statutory prospectus delivered to investors.

Non-Excluded Communications—Certain Shelf Registrations

Regulation FD still applies to companies engaged in continuous shelf registration, whether because they maintain registered DRIP or employee stock purchase programs, or because they must provide an ongoing opportunity for exercise or conversion (or resale of the underlying securities) by holders of outstanding warrants or convertible securities. Regulation FD obligations also attach to corporate communications made during the pendency of a secondary shelf registration statement for selling shareholders. The SEC is concerned that, "[b]ecause of the nature of those offerings, issuers would be exempt from the operation of Regulation FD for extended periods of time if the exclusion for registered offerings covered them." In the SEC's view, "[p]ublic companies that engage in these offerings should be accustomed to resolving any [securities law] issues relating to their public disclosure of material information during these offerings."

Unregistered Offerings

There is no Regulation FD exclusion for unregistered offerings, which leaves exposed to the rule any selective corporate disclosure of material, non-public information to investors in offerings conducted in reliance on Regulation D, Rule 144A and Regulation S. Corporate soliciting activities in connection with public offerings exempt under Securities Act §§ 3(a)(9) (issuer exchange offers) and 3(a)(10) (judicial or regulatory determination of the fairness of a stock-based transaction) likewise fall within Regulation FD.

Companies do have an alternative to forced public disclosure if they release material, nonpublic information to investors in unregistered offerings. They are free, and in fact may be compelled by antifraud considerations, to make selective disclosure of material, previously undisclosed information if all prospective investors enter into oral or written confidentiality agreements barring disclosure or trading. Based on present Rule 144A soliciting practices, however, it seems unrealistic to expect a company to obtain binding confidentiality agreements from QIBs.

The SEC's decision not to extend Regulation FD to registered offerings, at least in the near term, reflects a commendable recognition of the need for a more careful and considered approach to regulating issuer communications in a capital-formation context. Nevertheless, it is unclear from a policy perspective why a company's selective disclosure of material information in the course of a roadshow would be proscribed in a § 3(a)(9)-exempt transaction, but not if the same transaction were registered. Focusing solely on unregistered private offerings, moreover, the new Regulation FD overlay likely will compound the metaphysical confusion already generated by applicable Securities Act communications restrictions. Counsel may find it even more difficult, for example, to advise domestic corporate clients on how to comply with this new disclosure obligation while avoiding the pitfalls of "general solicitation" in Regulation D financings, solicitation of non-QIBs in Rule 144A deals, and "U.S. directed selling efforts" in Regulation S transactions. This is particularly true with respect to the so-called "underwritten" Rule 144A deals that now resemble registered offerings; it is unlikely that large numbers of QIBs that normally buy a Rule 144A debt issue directly from an investment banking firm would be amenable to an agreement with the issuer to forgo trading in its public equity.

How Does a Company Decide What Information Is Material, and When It Is Nonpublic?

Courts and the SEC have long wrestled with the concept of materiality in insider trading and other antifraud cases brought under the securities laws. For purposes of Regulation FD, which is not a fraud rule, the SEC uses the same definition of materiality that applies in the fraud context. Quoting the Supreme Court, the SEC stated in the Regulation FD adopting release that "information is material if 'there is a substantial likelihood that a reasonable shareholder would consider it important' in making an investment decision," and there is "a substantial likelihood that a fact [that is selectively disclosed] 'would have been viewed by a reasonable investor as having significantly altered the total mix of information made available.'"

While referenced only in a footnote (n. 38), the specter of Staff Accounting Bulletin No. 99's expansive reading of the Supreme Court's test looms over the Regulation FD materiality analysis. SAB 99, though nominally attributed to the SEC's accounting staff and focused on financial-statement materiality, has generated concerns about spillover into the MD&A and other parts of mandated SEC disclosure documents because it analyzes judicial precedent that has far broader significance. The emphasis placed by the staff on the probative value of stock price movements has heightened these concerns: "[T]he demonstrated volatility of the price of a registrant's securities in response to certain types of disclosures may provide guidance as to whether investors regard quantitatively small misstatements [often considered dispositive of materiality in a financial-statement context] as material." High-tech companies whose stock is particularly volatile may find it hard to prove, in hindsight, that selectively disclosed information did not contribute to a sharp rise or fall in their stock prices. It remains to be seen whether the SEC intends, as suggested by its description of SAB 99 in the footnote, to limit this materiality analysis to financial statements.

Recognizing the difficulty of making quick materiality judgments under the Supreme Court's amorphous "facts-and-circumstances" test, the SEC identified certain types of information or events in the adopting release that it believes should be evaluated carefully to determine their materiality. This list, which is not exhaustive, includes:

- earnings information, both hard and soft;
- mergers, acquisitions, tender offers, joint ventures or changes in assets;
- new products or discoveries;
- developments regarding customers or suppliers, such as the acquisition or loss of an important contract;
- changes in control or management;
- changes in auditors, or an auditor's notice that the company can no longer rely on the audit report;
- events relating to the company's securities, such as defaults on senior securities, redemption calls, repurchase plans, stock splits or changes in dividend policy, alteration of shareholder rights, public or private sales of additional securities; and
- bankruptcy or receivership.

Disclosure of some of these items already is compelled under Form 8-K—this may simply accelerate the filing due date unless a company opts for another publication alternative (see the next section of this article for a discussion of what alternatives to Form 8-K constitute adequate public dissemination of material, non-public information).

The SEC maintains that the examples on this list are not intended to signal any conclusion on per se materiality. Companies nevertheless should be prepared to support a non-materiality determination when any of the items cited is involved.

To guide the determination of whether a particular informational item is non-public, the SEC prescribes this test: "Information is nonpublic if it has not been disseminated in a manner making it available to investors generally." An accompanying footnote advises that the markets must have a reasonable period of time to digest any material information that is widely released before the information will be considered "public."

Commenters' concerns that difficult materiality judgments made in good faith that turn out later to have been mistaken would unfairly subject companies to Regulation FD liability persuaded the SEC to announce that it would bring enforcement cases only where senior officials made knowing or reckless misjudgments on whether an item of selectively disclosed information either was material or non-public in character. The SEC's concession in this regard is significant, as the agency normally preserves the flexibility to base non-fraud disclosure cases on negligent noncompliance with line-item informational standards.

Consultation with outside counsel in formulating materiality judgments should be helpful in attempting to convince the SEC's enforcement staff that the company relied in good faith on the advice of counsel.

When Must Widespread Public Disclosure Be Made, and What Constitutes Adequate Disclosure?

The "When" of Public Disclosure

The timing of the mandatory public dissemination of any material, selectively disclosed information under Regulation FD will depend on whether this information was disseminated intentionally or inadvertently. Where a particular selective disclosure is "intentional"—i.e., the disclosing person either knows, or is reckless in not knowing, that the information he or she is communicating is both material and non-public—the company must simultaneously disclose the same information to the public to avoid violating Regulation FD.

Somewhat more latitude is afforded a company upon discovery of a non-intentional selective disclosure within the scope of Regulation FD. Here, the company must publish the information "promptly," which means

> as soon as reasonably practicable (but in no event after the later of 24 hours or the commencement of the next day's trading on the New York Stock Exchange) after a senior official of the issuer . . . learns that there has been a non-intentional disclosure by the issuer or person acting on behalf of the issuer of information that the senior official knows, or is reckless in not knowing, is both material and non-public.

A non-intentional selective disclosure presumably need not be remedied by widespread market dissemination if the senior official who subsequently learns of the mistake concludes in good faith that the content of the disclosure was immaterial, or had already been disclosed to the public. In other words, a senior official's negligent error in gauging the materiality or non-public nature of information that he or she learns after the fact has been selectively communicated by one of the persons authorized to speak for the company will not lead to Regulation FD liability, so long as the senior official neither knew, nor was reckless in not knowing, that the information disclosed was in fact material.

Or, as the SEC put it, "the requirements of the regulation are only triggered when a responsible senior official (1) learns that certain information has been disclosed, (2) knows (or is reckless in not knowing) that the information disclosed is material, and (3) knows (or is reckless in not knowing) that the information disclosed is non-public." At the same time, the Commission warned that a pattern of mistaken materiality determinations could diminish the credibility of a company's claim that any given disclosure was not intentional.

Although an objective, "reasonable person" test will govern whether a given selective disclosure is found to be intentional or inadvertent, the reasonableness of the speaker's judgment as to the materiality of the information thus disclosed must be evaluated in light of all relevant facts and circumstances. The SEC acknowledges, for example, "that a materiality judgment that might be reckless in the context of a prepared written statement would not necessarily be reckless in the context of an impromptu answer to an unanticipated question."

The "How" of Public Disclosure

Regardless of whether a particular selective disclosure of material, non-public information is intentional or non-intentional, this disclosure must be accompanied or promptly followed by adequate public disclosure within the meaning of Regulation FD. This requirement will be met if a company simultaneously (for intentional disclosures) or "promptly" (for unintentional disclosures) files or furnishes a Form 8-K containing the selectively disclosed information, or disseminates the information "through another method (or combination of methods) of disclosure that is reasonably designed to provide broad, non-exclusionary distribution of information to the public." In the case of planned communications characteristic of regular analyst conference calls, the SEC appears to encourage (but, as explained below, certainly does not require) the current practice of many companies of publishing earnings and other material financial information reasonably well in advance of a particular call, although, contrary to the practice of some companies, all investors and the press now must be invited to participate.

Where a Form 8-K is the chosen method of publication, the SEC assumes that distribution of material information is broad and non-exclusionary as contemplated by Regulation FD. Different liability consequences attach to the decision whether to file or "furnish" (i.e., submit without filing) a Form 8-K. Filed Forms 8-K are incorporated by reference automatically into Form S-3 registration statements (which the SEC believes subjects the contents to strict liability under Securities Act § 11) and, simply because they are filed, their content is exposed to express (§ 18) as well as implied (Rule 10b-5) antifraud liability under the Exchange Act. Furnished 8-Ks, in contrast, are not deemed incorporated by reference into any other document absent the company's express election and are not considered "filed" for § 18 purposes. This flexible treatment is essentially the same as that long afforded the glossy annual report and the Compensation Committee Report and Performance Graph required in the proxy statement.

Other than to state that Web site posting alone will not be considered adequate to effect widespread public dissemination under Regulation FD, the SEC has not identified any preferred disclosure approach where a Form 8-K is not the method selected. Instead, the SEC recognized a variety of alternatives, or combinations of alternatives, that a company may use to achieve the necessary "broad, non-exclusionary distribution." This flexibility is not unqualified—a company's departure from its usual practices for making public disclosure could influence the SEC's evaluation of whether that method was reasonable in a particular setting. For example, the SEC said in the release that it would be skeptical of a company's claim that it met its Regulation FD obligations by means of a last-minute webcast of its quarterly earnings results in conjunction with a closed analyst conference call, where the company normally disclosed quarterly earnings in regularly-circulated press releases.

Acceptable "alternative" publication methods cited in the Regulation FD adopting release include press releases distributed through a widely disseminated news or wire service (e.g., Dow Jones, Bloomberg, Reuters, AP, Business Wire). If a company knows that its press releases routinely are not carried by the major business wires, this method would not satisfy Regulation FD. The company therefore would have to

> use other or additional methods of dissemination, such as the distribution of the information to the local media, furnishing or filing a Form 8-K with the Commission, posting the information on its Web site, or using a service that distributes the press release to a variety of media outlets and/or retains the press release.

Despite the SEC's use of the disjunctive "or" in this illustration, the quoted language should not be read to mean that a company here could rely solely on a Web posting to overcome the deficiencies of the original method chosen. Elsewhere in the release (as noted in the next paragraph), the SEC states unequivocally that reliance on the Web as a public dissemination vehicle is appropriate only where it is one of a combination of publication methods.

Another acceptable "alternative" publication method consists of announcements made through press conferences or conference calls open to all investors, along with analysts, large institutional investors and other, more traditional participants, so long as sufficient advance notice is furnished to the public of the time, place and manner of accessing the press conference or call. The SEC also encourages companies to broadcast real-time audio or audio-visual transmissions of a press conference or conference call on the Internet. Where the Web is used as part of a combination of disclosure vehicles, the SEC asks companies to consider making recorded webcasts or transcripts of press conferences and analyst calls available for a reasonable period of time after the event, to allow subsequent review of the information by those who could not participate in the original press conference or call. This menu of possible choices laid out in the release underscores the SEC's statement that, "in some circumstances an issuer may be able to demonstrate that disclosure made on its Web site could be part of a combination of methods, 'reasonably designed to provide broad, non-exclusionary distribution' of information to the public."

SEC Disclosure Model

In the adopting release, the SEC suggested a disclosure model employing a combination of methods for a company's scheduled earnings announcement, which would pass muster under the new rule.

- First, the company would issue a press release, distributed through regular channels, that announces the material, previously undisclosed earnings information. There is no indication in the SEC release whether this disclosure must contain both historical and projected earnings information to allow discussion of future quarters in the conference call. Because of the SEC's apparent willingness to allow companies some latitude for judgment in the publication area (so long as the disclosure medium is not confined to the Internet), we believe that the press release alone would suffice to effect adequate public dissemination of the earnings results if carried by one or more of the major wire services.
- Second, the company must provide adequate notice, "by press release and/or Web site posting," of the conference call in which the earnings announcement will be discussed by senior management. The time and date of the call must be disclosed, along with instructions on how to gain access to the call. Given the SEC's view of the inadequacy of Web-based disclosure without supplementation by other media, the use of the disjunctive "or" by the SEC should not be read literally to mean that a Web posting alone would be sufficient.

  Notwithstanding the SEC's explicit approval of a two-step notice process, there would appear to be no reason why a company couldn't use the initial announcement to notify the broader investment community of the time, place and manner of the scheduled conference call. What is important here is that all segments of the market receive the earnings information at the same time.
- Third, the conference call must be conducted "in an open manner, permitting [all interested investors] to listen in either by telephonic means or through Internet webcasting." Even though any interested investor must be able to gain access to this call, the SEC will permit the company to use a "listen-only" feature that limits questioning to analysts (both buy- and sell-side, presumably). If one of the company's senior managers mistakenly releases predictive or other sensitive information omitted from the initial press release when responding to an analyst question during the call, Regulation FD would likely require a subsequent press release or Form 8-K filing (or submission) that widely circulates this information. We reach this conclusion because the first press release, which in our revised version of the hypothetical contained only historical financial information, and the subsequent invitation to participate in the call, did not alert the public to the possibility that future earnings data would be released at that time. Analysts' reasonable expectations that future quarters would be covered here because that had been management's practice would not remedy the deficient public notice.

This hypothetical case highlights the SEC's determination to combat the perceived practice of "earnings guidance," whereby sensitive financial data or performance metrics are conveyed to a select few before being widely released to the market as a whole. While the SEC did not address specifically the applicability of Regulation FD to the practice by some companies of engaging in pre-publication review of analyst reports containing projections of corporate earnings and other indicia of future financial performance, this activity likely would be perceived by the SEC enforcement staff as yet another way to influence analyst earnings estimates in contravention of Regulation FD.

The same conclusion applies equally to a CFO's or other company official's ability to respond to individual inquiries seeking concurrence in or disagreement with an analyst's earnings estimate, or even with consensus "Street" estimates. Again, the only way this legally could be done in the new post-Regulation FD world, if at all, would be to effect simultaneous widespread publication, which would be difficult if not impossible given these facts.

By the same token, the SEC has not sought to foreclose companies from discussing with an analyst or other market professional what their senior officials reasonably determine to be non-material information, or even material information previously disclosed in an SEC filing. The SEC acknowledged that the objective standard for measuring materiality is what a reasonable investor would find important, not what the particular analyst believes is or might be significant as he or she assembles an informational mosaic from pieces of publicly available information and whatever immaterial information can be elicited from the CFO or other senior manager. According to the SEC, "Regulation FD will not be implicated where an issuer discloses immaterial information whose significance is discerned by the analyst. Analysts can provide a valuable service in sifting through and extracting information that would not be significant to the ordinary investor to reach material conclusions. We do not intend, by Regulation FD, to discourage this sort of activity."

Limitations on Liability/Consequences

The SEC went to great lengths to assure companies that they will not face SEC or private antifraud actions if they fail to comply with their Regulation FD disclosure obligations. The language of the rule is explicit on this point: "No failure to make a public disclosure required solely by [Regulation FD] . . . shall be deemed to be a violation of Rule 10b-5 . . . under the Securities Exchange Act." Though the Commission retains the power to bring judicial or administrative proceedings against public companies and responsible senior officials for noncompliance with Regulation FD, the agency recognizes that it must prove an improper disclosure was either intentional or reckless—a higher standard of proof than in most enforcement actions for non-fraudulent disclosure violations. This relatively unusual concession with respect to the scope of SEC enforcement powers, coupled with the agency's assertion that there is no private right of action for violation of Regulation FD, is designed to mitigate corporate fears of enhanced liability that arise from this new disclosure duty.

In an important caveat, however, the SEC cautioned that compliance with Regulation FD will not confer immunity from SEC enforcement or private litigation under Rule 10b-5 if the content of the information disclosed is materially false or misleading by omission of a material fact. In addition, Regulation FD does not displace traditional theories of insider trading liability that apply, for example, when any person who owes a duty of trust or confidence to the company, such as its officers and directors, breaches that duty by trading on the basis of material, non-public information or tipping another person who in turn trades or tips someone else.

Nor does Regulation FD appear to affect the "entanglement/adoption" line of cases under Rule 10b-5 that typically involve fact patterns in which companies become involved in pre-publication review of draft research reports, or concur in or endorse analyst estimates already published in a report. If anything, Regulation FD claims may be brought by the SEC as a supplement to Rule 10b-5 claims in this area.

Violations of Regulation FD also will not cause a company to lose its eligibility to file short-form registration statements, such as Form S-3 and Form S-8, that require a current reporting history as a condition to use. Similarly, a Regulation FD violation will not limit a shareholder's ability to resell company securities into the public markets under Rule 144, which has a similar "current public information" condition. Commenters' objections to these penalties, which were part of proposed Regulation FD, persuaded the SEC to remove them from the final version of the rule.

What Does Regulation FD Mean for Corporate Communications with Analysts, Money Managers, and Other Market Participants?

How will Regulation FD affect corporate relations with analysts and other members of the investment community? It is tempting to conclude, upon a quick review of current "best practices," that the effects will be minimal. This is certainly the view of the SEC. A significant number of companies already use a variety of the communications media described by the SEC as adequate to satisfy the Regulation FD litmus test: "disclosure reasonably designed to provide broad, non-exclusionary distribution to the public." Many companies have conducted conference calls that are open to individual investors and the press (usually "listen-only" access), as well as to the analyst community. Audio and, in some instances, audio/visual transmissions of these calls are webcast on a real-time basis on the company's

Internet Web site, followed by the continued Web posting of the audio/visual transmission, or a transcript of the call, for a reasonable period after the call. At least with respect to earnings announcements, a significant percentage of public companies now publish earnings in a press release before discussing them in analyst conference calls or meetings with large institutional investors. Many public companies also restrict the number of officials authorized to speak, on both a formal and informal basis, to analysts, investors and the press, and are careful to ensure that these officials understand the applicable law and are aware of what information is deemed material and non-public. To the extent in-house counsel is not present at these formal or informal meetings, counsel and other senior company personnel may debrief the designated spokesperson after-the-fact to assess whether any information that might be considered material and confidential was disclosed, and therefore needs to be released promptly to the markets.

Still, whatever the SEC's protestations to the contrary, it is likely that one-on-one meetings or telephone discussions between senior corporate officials and analysts, portfolio managers and other large investors will be discouraged, at least in the short term, as companies re-examine their internal policies and procedures for compliance with Regulation FD. Company officials also may begin to decline invitations to investment banking conferences and trade shows. Clearly, the practice of selectively guiding analyst earnings estimates prior to the publication of earnings results will be extremely risky.

This does not necessarily spell the demise of earnings guidance, which often serves a valid business purpose. Rather, public companies will have to determine whether they can readjust to furnishing such guidance where necessary through widely disseminated analyst conference calls or other methods reasonably designed to ensure the requisite broad, real-time publication of financial data. Corporate managers' ability to achieve some level of comfort with respect to whether these Regulation FD-compliant publications will expose them to increased antifraud litigation likely will shape post-Regulation FD disclosure practices. In this regard, forward-looking information that is widely disseminated (whether by plan or mistake), can be protected against antifraud liability in the context of a conference call or press conference by reciting at the beginning of the presentation the meaningful cautionary statements called for by available statutory and judicial safe harbors. And corporate-analyst communications even may improve to the extent that companies will no longer be able to punish analysts who downgrade earnings estimates or otherwise issue unfavorable research reports by excluding them from earnings conference calls.

Companies that continue to follow "best practices," modified if appropriate to address the SEC's strongly-expressed concerns regarding selective earnings guidance, therefore should find little difficulty adapting to Regulation FD. In the future, the SEC will be bound by the statement, made directly in the text of Regulation FD as well as in the adopting release, that a company's failure to comply with the new rule will not support either SEC enforcement or private actions under Rule 10b-5 (though companies considering the risk of Regulation FD enforcement will not find this particularly reassuring). By offering more explicit guidance to public companies on materiality and adequate public dissemination, free of the risk of antifraud liability exposure, the SEC ultimately may be correct in predicting that an unfettered flow of corporate information to the securities markets will be promoted rather than chilled by Regulation FD.

Only time and experience with the new rule will tell whether it triggers unintended negative consequences, such as a possible court ruling that Regulation FD disclosures give rise to a continuous duty to update. Perhaps some comfort can be taken from the SEC's commitment to an economic study of Regulation FD's impact on companies and market participants, as well as the markets as a whole, with a view toward revisiting its conclusion that the benefits of Regulation FD outweigh the costs.

Important Exclusions From Regulation FD

In attempting to summarize the implications of Regulation FD, it is helpful to reiterate those areas of regular corporate communication that are *not* affected. As previously discussed, Regulation FD does not apply to corporate communications with market professionals and investors that are made:

- during registered offerings of securities in connection with both capital-raising and M&A transactions;
- within the confines of a professional relationship that gives rise to a duty of trust and confidence, such as that formed between a company and an investment banking firm serving as its financial adviser;
- to the press, customers, suppliers, and rating agencies (noting, of course, that the SEC's insider trading prohibitions still apply);
- to investors in private placements (or other exempt, unregistered offerings) who enter into express oral or written agreements not to trade on the basis of, or to disclose, this sensitive information; or

- by a company's middle managers and employees (which again does not mean that material, non-public information can be communicated in this context without running afoul of Rule 10b-5's insider trading ban).[4]

Endnotes

1. *See* SEC Rel. No. 33-7881, Aug. 15, 2000, at www.sec.gov/rules/final/33-7881.html).
2. This is particularly important given the recent changes in federal banking laws that permit banks, broker-dealers and insurance companies to consolidate. For example, material non-public information given to a bank regarding a corporate borrower's financial prospects in connection with negotiation of a loan restructuring could not be shared with personnel of the bank's broker-dealer, investment adviser, and/or venture-capital fund affiliates without incurring a substantial risk of insider trading liability. Again, the borrower in this circumstance presumably could rely on the adequacy of the bank's informational barriers for Regulation FD purposes unless it has actual knowledge that a leak occurred.
3. For a statement of the staff's views on when electronic roadshows in M&A deals must be treated as a prospectus and filed with the SEC, see Division of Corporation Finance: Manual of Publicly Available Telephone Interpretations (July 2000), at www.sec.gov/offices/corpfin/phonits3.htm.
4. For example, a conversation at an industry trade show between an analyst and a junior sales manager in which the sales manager projects sales in his region, while not devoid of risk from a Rule 10b-5 perspective, should not implicate Regulation FD, even if that analyst later downgrades his recommendation from "Buy" to "Hold" based in part on this information. There is one important caveat: the SEC stressed that analyst or investor communications with middle managers and other lower-level employees could trigger Regulation FD if the facts show that these personnel were used by a senior executive, director or IR official as a conduit for leaking material, non-public information to the analyst.

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Authorizations Required in Real Property Transactions Involving Corporations and Limited Liability Companies

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The duties of the Department of State include the filing and maintenance of documents relating to a number of statutorily recognized entities, including business corporations, not-for-profit corporations and limited liability companies. Given the large number of these entities organized and existing under the laws of New York,[1] it is inevitable that business law practitioners will encounter one or more of these entities in a variety of transactions.

As creatures of statute, such entities have certain rules which apply to a variety of transactions, particularly transactions involving real property. This article examines the types of authorizations, both "internal" (e.g., board of directors, shareholder, member or manager) and "external" (e.g., supreme or county court), to be obtained by business corporations, not-for-profit corporations and limited liability companies in a variety of real property transactions, and provides an overview of the relevant statutory provisions necessary to obtain required authorizations.

Also discussed are issues relevant to the formation and continued existence of these entities, and their powers to enter into the real property transactions. Finally, some Department of State services useful to the practitioner involved in such transactions are described.

I. Business Corporations

A. Formation, Existence and Powers

Under the Business Corporation Law (the "BCL"), the corporate existence of a New York business corporation begins upon the filing of the corporation's certificate of incorporation by the Department of State, or on such later date, not to exceed 90 days after filing, as may be specified in the certificate of incorporation.[2] Once formed, a business corporation will have perpetual duration, unless the corporation's certificate of incorporation expressly provides for less than perpetual duration.[3] However, any business corporation, even a business corporation having perpetual duration, may cease to exist by reason of merger or consolidation[4] or dissolution.[5] A fairly common example of an involuntary dissolution is the dissolution, by proclamation published by the Secretary of State, of a business corporation that has failed to file franchise tax returns and/or to pay franchise taxes.[6]

Generally, a business corporation has power to ". . . purchase . . . or otherwise acquire, own, hold, improve, employ, use and otherwise deal in and with, real or personal property, or any interest therein, wherever situated," and power to "sell, convey, lease, exchange, transfer or otherwise dispose of, or mortgage or pledge, or create a security interest in, all or any of its property, or any interest therein, wherever situated."[7] However, these powers are subject to such limitations as may be provided in the corporation's certificate of incorporation.[8]

Further, the powers of a business corporation must be exercised "in furtherance of" the corporate purposes of the corporation.[9] The corporate purposes of a business corporation must be stated in the corporation's certificate of incorporation.[10] With certain exceptions, a business corporation may be formed under the BCL "for any lawful business purpose or purposes."[11]

An attorney involved in a sale or mortgage of real property transaction by a business corporation should review the corporation's certificate of incorporation,[12] and the Department of State's records pertaining to the corporation, to determine if the corporation existed when it first acquired the real property, if the corporation still exists, if the certificate of incorporation contains any provision limiting the power of the corporation to engage in the proposed transaction, and if the proposed transaction will be "in furtherance of" the corporate purposes of the corporation.[13]

B. Authorizations Required

1. Sale

Generally, the business of a corporation is managed under the direction of its board of directors.[14] Business corporations have the power to elect or appoint officers, and to define their duties.[15] Often, the president or other high-ranking officer of a corporation is given broad authority. In some cases such authority may be construed to authorize sale of corporate real property, even absent express board approval of such sale.[16] However, the buyer's attorney should not assume such authority exists, nor should the seller's attorney assume the purchaser will close without express authorization of the sale by the seller's board of directors. Typically, the purchaser, or the purchaser's title insurance company, will require a resolution of the seller's board of directors authorizing the sale.[17]

As a general rule, a sale of corporate property will not require the vote or consent of the seller's shareholders. See, however, the exceptions discussed below.

2. Mortgage

With respect to a mortgage of corporate property, the BCL is express: any mortgage or pledge of, or the creation of a security interest in, all or any part of the corporate property, or any interest therein, wherever situated, requires authorization by the board of directors.[18]

If required by the corporation's certificate of incorporation, a mortgage or pledge of corporate property will also require shareholder approval. As a general rule, in the absence of such a provision in the corporation's certificate of incorporation, no vote or consent of shareholders is required to approve a mortgage of corporate property.[19] See, however, the exceptions discussed below.

3. Exception—All or Substantially All of the Assets

A sale, lease, exchange or other disposition of "all or substantially all" of the assets of a corporation, if not made in the "usual or regular course of the business actually conducted" by the corporation, must be authorized by the procedure set forth in BCL § 909(a). Briefly, the procedure is as follows: (1) the board of directors must authorize the transaction and direct submission of the transaction to a vote of the shareholders, (2) notice of a meeting must be given to all shareholders, including those not entitled to vote, (3) the shareholders must approve the sale, lease, exchange or other disposition, and (4) the shareholder must fix the terms and conditions and the consideration to be received or authorize the board of directors to do so.[20]

No precise formula exists for determining what constitutes "all or substantially all" of the assets of a corporation. Clearly, when the real property to be sold is "the only significant asset owned" by the selling corporation, the sale will clearly involve "all or substantially all" of the assets of the corporation.[21] However, "[w]here . . . the transferor owns more than one property it contemplates transferring or is engaged in another business which will continue, if the property retained or the continued business is 'substantial,' the contemplated transfer falls outside of BCL Section 909, and shareholder approval will not be necessary."[22]

Even if a proposed sale does involve "all or substantially all" of the assets of the selling corporation, BCL § 909 will not apply, and shareholder approval will not be required, if the sale is within the "usual or regular course of the business actually conducted" by the corporation. However, for the purpose of determining whether a proposed sale is or is not within the "usual or regular course of the business actually conducted" by the corporation, the purposes clause of the corporation's certificate of incorporation will not be determinative; the "usual or regular course of the business actually conducted" by the corporation must be considered. In *Vig v. Deka Realty Corp.*,[23] the selling corporation (Deka) was formed "to do everything suitable, proper and conducive to the successful conduct of a real estate business," including the buying and selling of real property. The action involved a contract for the sale of property that was the "only significant asset" owned by the corporation. However, and notwithstanding the broad provisions in the certificate of incorporation, "Deka's regular business was managing this one piece of property. It was not actually engaged in the business of selling real property. Thus, the sale of this property, Deka's sole asset, was not made in its usual course of business. Consequently, the sale required shareholder approval."[24]

It is customary for a deed from a corporation to include a recital to the effect that (1) the property described in the deed does not constitute all or substantially all of the assets of the corporation, or (2) the disposition of the property was made in the usual or regular course of business of the corporation, or (3) the shareholders have duly authorized the disposition. The BCL provides that any such recital "shall be presumptive evidence of the fact so recited."[25]

4. Exception—"Ultra Vires" Guaranty

BCL § 908 provides that a business corporation may give a guaranty "although not in furtherance of its corporate purposes, when authorized at a meeting of shareholders by two-thirds of the votes of all outstanding shares entitled to vote thereon."[26] Further, if authorized by a "like vote," such a guaranty may be secured by "a mortgage or pledge of, or the creation of a security interest in, all or any part of the corporate property, or any interest therein, wherever situated."[27]

5. Exception—Management by Shareholders

Under certain circumstances, the certificate of incorporation of a "closely held" corporation may include a provision that restricts the board in its management of the corporation or transfers all or any part of the management of the corporation to shareholders or persons selected by shareholders.[28] In the case of a corporation with such a provision in its certificate, a sale of corporate real property must be authorized by the shareholders (or the persons selected by the shareholders), even if the property does not constitute all or substantially all of the assets of the corporation.

6. Exception—Provision in Certificate of Incorporation

As previously discussed, the powers of a business corporation are subject to such limitations as may be provided in the corporation's certificate of incorporation. Accordingly, the certificate of incorporation should be reviewed for any provision that may require the corporation to obtain consent, approval or authorization from another person, entity or agency in connection with any proposed sale, mortgage or other transaction involving the corporation's real estate.[29]

C. Procedures for Obtaining Required Authorizations

1. Action by the Board of Directors

As a general rule, an authorization by the board of directors of a sale or mortgage of corporate property must be by resolution adopted at a meeting of the board.[30] If authorized by the certificate of incorporation or by-laws of the corporation, the board of directors may designate one or more committees, each consisting of one or more directors. Each such committee has, to the extent provided in the board resolution by which it was designated or by the certificate of incorporation or by the by-laws, the "authority of the board."[31]

Regular meetings of the board may be held without notice if the time and place of such meetings are fixed by the by-laws or the board, while special meetings of the board require notice to the directors.[32] The corporation's by-laws may "prescribe what shall constitute notice of meeting of the board."[33] Notice need not be given to any director who waives notice or who attends the meeting and fails to object to lack of notice.[34]

The BCL specifies quorum requirements[35] and voting requirements[36] for board meetings; however, the quorum requirements can be changed by provision in the certificate of incorporation or by-laws.[37] Generally, members of the board or any committee of the board may participate in a meeting by means of a conference telephone or other similar communications equipment; however, the right to participate in meeting by such means may be restricted by provisions in the certificate of incorporation or the by-laws.[38]

BCL § 708 (b) provides that "any action required or permitted to be taken by the board or any committee thereof may be taken without a meeting if all members of the board or the committee consent in writing to the adoption of a resolution authorizing the action." However, the right of the board or a committee of the board to take action by written consent may be restricted by the certificate of incorporation or the by-laws.[39] Note that even in the absence of such restrictions in the certificate of incorporation or by-laws, board or committee action by written consent without a meeting must be unanimous.

2. Action by Shareholders

In those cases where shareholder approval is required, the BCL provisions regarding shareholder meetings,[40] notice of meetings of shareholders,[41] and voting requirements[42] and quorum requirements[43] at such meetings must be considered. The BCL also provides that, under certain circumstances, action by shareholders may be taken without a meeting, by written consent signed by all shareholders entitled to vote, or, if permitted by the certificate of incorporation, "signed by the holders of outstanding shares having not less than the minimum number of votes that would be necessary to authorize or take such action at a meeting at which all shares entitled to vote thereon were present and voted."[44]

II. Not-for-Profit Corporations

A. Formation, Existence and Powers

Under the Not-for-Profit Corporation Law (the "N-PCL"), the corporate existence of a not-for-profit corporation begins when its certificate of incorporation is filed by the Department of State.[45] A not-for-profit corporation will have perpetual duration, unless the corporation's certificate of incorporation expressly provides for less than perpetual duration.[46] A not-for-profit corporation may dissolve or be dissolved,[47] and a not-for-profit corporation may be merged or consolidated out of existence.[48]

The N-PCL provisions regarding the power of a not-for-profit corporation to purchase or otherwise acquire real property, to own, hold, employ and use real property, and to sell, convey, lease, exchange, transfer or otherwise dispose of real property, and to mortgage or pledge or otherwise create a security interest in real property, are substantially similar to the corresponding provisions in the BCL.[49]

The powers of a not-for-profit corporation are subject to such limitations as may be provided in the corporation's certificate of incorporation.[50] Further, the powers of a not-for-profit corporation must be exercised "in furtherance of" the corporation's purposes.[51] The purposes of a not-for-profit corporation must be stated in the corporation's certificate of incorporation.[52] However, unlike the BCL, which permits formation of a business corporation for virtually any lawful business purpose, the N-PCL permits formation of a not-for-profit corporation only for one or more of the purposes permitted under N-PCL 202.[53]

An attorney involved in the sale or mortgage of real property by a not-for-profit corporation should review the corporation's certificate of incorporation,[54] and the Department of State's records pertaining to the corporation, to determine if the corporation existed when it first acquired the real property, if the corporation still exists, if the certificate of incorporation contains any provision limiting the corporation's power to engage in the proposed transaction,[55] and if the proposed transaction is "in furtherance of" the corporation's purposes. This review is particularly important in light of the more specific nature of the "purposes" clause in the certificate of incorporation of a not-for-profit corporation, as compared to the "all purpose" clause in the certificate of incorporation of a typical business corporation.[56]

B. Authorizations Required

1. Purchase, Sale or Mortgage

In the case of a not-for-profit corporation, any purchase of real property, and any sale, mortgage or lease of real property, requires authorization by the board of directors.[57] If the board has fewer than 21 directors, the board authorization must be "by the vote of two-thirds of the entire board;" if the board consists of 21 or more directors, "the vote of a majority of the entire board shall be sufficient."[58]

2. Exception—All or Substantially All of the Assets

In the case of a not-for-profit corporation that has "members entitled to vote thereon,"[59] a sale, lease, exchange or other disposition of "all or substantially all" of the assets of a corporation[60] must be authorized by the following procedure: (1) the board of directors must adopt a resolution that (a) specifies the terms and conditions of the proposed transaction, including the consideration to be received by the corporation and the eventual disposition of such consideration, (b) includes a statement that the dissolution of the corporation is or is not contemplated after the proposed transaction, and (c) recommends the proposed transaction; (2) notice of a meeting of members must be given to "each member and each holder of subvention certificates or bonds of the corporation, whether or not entitled to vote;" (3) the board's resolution must be submitted to a vote at such meeting of members; and (4) at the meeting, the members must, by a two-thirds vote, either (a) approve the proposed transaction according to the terms of the resolution of the board, or (b) approve such sale, lease, exchange or other disposition and authorize the board to modify the terms and conditions thereof.[61]

In the case of a not-for-profit corporation that does not have "members entitled to vote thereon," a sale, lease, exchange or other disposition of all or substantially all of the assets of the corporation must be authorized by the board of directors. If the board has fewer than 21 directors, a vote of at least two-thirds of the entire board will be required; if the board has 21 or more directors, the vote of a majority of the entire board shall be sufficient.[62]

Without regard to whether the corporation has "members entitled to vote thereon," in the event of a sale, lease, exchange or other disposition of all, or substantially all, the assets of a corporation which is (or which would be, if formed under the N-PCL) a Type B or Type C corporation,[63] such sale, lease, exchange or other disposition shall require, in addition to the board (or board and member) approvals discussed above, "leave of the supreme court in the judicial district or of the county court of the county in which the corporation has its office or principal place of carrying out the purposes for which it was formed."[64]

3. Exception—Provision in Certificate of Incorporation

The certificate of incorporation of a not-for-profit corporation should be reviewed for any provision that requires the corporation to obtain consent, approval or authorization from another person, entity or agency in connection with any proposed sale, mortgage or other transaction involving the corporation's real property.[65]

C. Procedures for Obtaining Required Authorizations

1. Action by Board of Directors

Generally, action by the board of directors of a not-for-profit corporation is to be taken at a meeting of the board.[66] The N-PCL contemplates the appointment of committees of the board.[67] The N-PCL also provides rules governing notice of board meetings, waivers of notice,[68] quorum and voting requirements at board meetings,[69] changes to quorum and voting requirements that may be made by provision in the certificate of incorporation or by-laws,[70] and participation in board or committee meetings by conference telephone or other similar means.[71] The N-PCL also provides for action by the board or any committee thereof by written consent without a meeting.[72]

2. Action by Members

In situations where member authorization is required, the N-PCL provisions regarding meetings of members,[73] notice of meetings of members,[74] voting requirements[75] and quorum requirements[76] must be considered. Alternative voting and quorum requirements may be fixed by provision in the certificate of incorporation or by-laws.[77] In certain situations, members may take action by written consent without a meeting.[78]

3. Leave of Court

N-PCL § 511 describes the contents of the petition required when a corporation must seek leave of the Court to sell, lease, exchange or otherwise dispose of all or substantially all its assets.[79] Upon presentation of the petition, the Court must direct that a minimum of 15 days' notice of the application be given to the attorney general.[80] The Court may also direct that notice of the application be given to any person interested therein, as member, officer or creditor of the corporation.[81] If the corporation is insolvent, or if its assets are insufficient to pay its debts, the Court must direct that notice of the application be given to all creditors.[82] The Court may authorize the transaction if it finds that ". . . the consideration and the terms of the transaction are fair and reasonable to the corporation and that the purposes of the corporation or the interests of the members will be promoted."[83]

D. Education Corporations and Religious Corporations

Certain corporations formed under statutes other than the N-PCL are, nevertheless, subject to certain N-PCL provisions, or to modified versions of certain N-PCL provisions. For example, in the case of education corporations,[84] N-PCL § 509 does not apply,[85] while N-PCL § 511 (with a minor modification) does apply.[86] Similarly, in the case of religious corporations,[87] most provisions of the N-PCL apply;[88] however, "a religious corporation shall not sell, mortgage or lease for a term exceeding five years *any* of its real property without applying for and obtaining leave of the court therefor pursuant to section five hundred eleven of the not-for-profit corporation law. . . ."[89] Note that leave of the Court must be obtained even if the proposed sale, mortgage or lease does not involve "all or substantially all" of the assets of the religious corporation.

III. Limited Liability Companies

A. Formation, Existence and Powers

Under the Limited Liability Company Law, a limited liability company (LLC) is formed at the time of the filing of its initial articles of organization with the Department of State, or on such later date (not to exceed 60 days after the filing of the initial articles of organization) as may be specified in the articles of organization.[90] Generally, an LLC has "perpetual existence."[91] However, if the articles of organization specify the latest date on which the LLC is to dissolve, then the LLC will dissolve no later than that date. Further, an LLC will be dissolved upon the occurrence of any event or events specified in the operating agreement as triggering dissolution, or upon the vote or written consent of the requisite number of members, or upon there being no members of the LLC for the requisite period of time, or upon entry of a decree of judicial dissolution.[92]

Generally, an LLC has power to " . . . purchase . . . or otherwise acquire, own, hold, improve, use and otherwise deal in and with real or personal property or an interest in real or personal property, wherever situated" and power to "sell, convey, assign, encumber, mortgage, pledge, lease, exchange, transfer, create a security interest in or otherwise dispose of all or any of its property or assets."[93] However, these powers are subject to any provision in the articles of organization that may "provide otherwise."[94]

An attorney involved in the sale or mortgage of real property by an LLC should review the LLC's articles of organization,[95] and the Department of State's records pertaining to the LLC, to determine if the LLC existed when it first acquired the real property, if the LLC still exists, and if the articles of organization contain any provisions limiting the LLC's power to engage in the proposed transaction.[96]

B. Authorizations Required

1. General Rule

If an LLC's articles of organization so provide, the LLC will be managed by one or more managers; however, in the absence of such a provision, the LLC will be managed by its members, subject to any provisions in the articles of organization or the operating agreement.[97]

Without regard to whether the LLC is managed by members or by managers, the members of the LLC are required to adopt a written operating agreement.[98] The operating agreement may contain provisions relating to, *inter alia*, the rights, powers and responsibilities of the members and managers.[99]

An attorney involved in a real property transaction of an LLC should review the articles of organization of the LLC to determine if the LLC is managed by manager(s) or by members. In either event, the attorney should review both the articles of organization and the operating agreement to determine if the group charged with management is subject to any limitations or restrictions on its management of the contemplated transactions. Subject to any contrary provision in the articles of organization or the operating agreement, a sale or mortgage of real property by an LLC that is managed by managers should be authorized by the managers, and a sale or mortgage of real property by an LLC that is managed by the members should be authorized by the members.[100]

2. Exception—All or Substantially All of the Assets

Once again, there is an exception to the general rule discussed above in the event of a sale, exchange, lease, mortgage, pledge or other transfer of "all or substantially all" of the assets of an LLC. In such events, without regard to whether the LLC is managed by its members or by manager(s), the transaction must be approved by a vote of at least a majority in interest of the members entitled to vote thereon.[101]

3. Exception—Provision in Articles of Organization

The LLC's articles of organization should be reviewed for any requirement that the LLC obtain consent, approval or authorization from another person, entity or agency related to the proposed sale, mortgage or other transaction involving the LLC's real estate.

C. Procedures for Obtaining Required Authorizations

The Limited Liability Company Law contains provisions governing meetings of members,[102] notice of such meetings,[103] waivers of notice,[104] quorum and voting requirements,[105] participation in meetings by conference telephone or other similar equipment,[106] and action by members by written consent without a meeting,[107] as well as management by managers (including voting requirements, participation in meetings of managers by means of conference telephone or other similar equipment, and actions by managers by written consent).[108] However, each of these statutory provisions contains the qualification "except as provided in the operating agreement." Accordingly, a review of the LLC's operating agreement is an essential part of the review of any resolution adopted or other action taken by an LLC's members or managers, and an essential part of consideration of any action taken by members by written consent without a meeting.

IV. Other Considerations

Determining that an entity selling or mortgaging its real property exists and has duly authorized the transaction is an essential part of the lawyer's task, but is only part of that task. Other matters must also be considered. For example, a sale of all or substantially all of the assets of a corporation or LLC (or of any other person or entity) may be subject to article 6 of the Uniform Commercial Code, entitled "Bulk Transfers," or to § 1141(c) of the Tax Law, or both. The New York Debtor and Creditor Law and the federal Bankruptcy Code should be considered, particularly in connection with a transaction in which a party is insolvent, a transaction which may render a party insolvent, a transaction involving "insiders," or a transaction which may amount to a fraudulent conveyance or a preferential transfer.[109]

V. Services Available From the Department of State

Confirming an entity's existence and due authorization of a real property transaction before the transaction takes place will minimize the chances of a later attack on the validity of the transaction. This is of obvious importance to the lawyer representing a purchaser or mortgagee. This is also of importance to the lawyer representing the seller or mortgagee, since that lawyer may be called upon to issue an opinion letter. In any event, the title company insuring the buyer and/or the mortgagee will require confirmation of the entity's existence and due authorization. The Department of State provides services which a practitioner can use in confirming an entity's existence and in confirming the contents of certain documents relevant to an entity's formation and operation.[110]

A preliminary determination of existence of a business corporation, not-for-profit corporation or limited liability company can be made by using the "Search Our Corporation and Business Entity Database" feature at the Department of State's Web site (http://www.dos.state.ny.us); by calling an information line (1-900-TEL-CORP (1-900-835-2677)) at a cost of $4 per call; by sending a written request to the Division of Corporations by mail (Department of State, Division of Corporations, 41 State Street, Albany, NY 12231) or by fax ((518) 473-1654); or by sending a request to the Division of Corporations by e-mail (corporations@dos.state.ny.us). The following information is available: (1) the current name of the entity, (2) the date of the entity's incorporation or formation, (3) the jurisdiction in which the entity was formed, if other than New York State, (4) the county in which the entity's office is located, as indicated in the entity's certificate of incorporation or articles of organization, (5) the address to which a copy of process served upon the Secretary of State, as agent for the entity, is to be mailed, (6) the entity's registered agent, if any, and (7) the current status of the entity.

More formal documentation of the existence of an entity is available in the form of a Certificate of Existence issued by the Department of State.[111] The Certificate of Existence (often referred to as a "Certificate of Good Standing") will state (1) the current name of the entity, (2) the name under which the entity was formed (if different from the current name), (3) the date on which the entity was incorporated or formed, and (4) whether any certificate, order or record of dissolution has been filed with the Department of State. A "long form" Certificate of Existence will set forth a list of all documents which are relevant to the entity and which have been filed by or with the Department of State. In light of the statutory definitions of "certificate of incorporation"[112] and "articles of organization,"[113] this complete list of filed documents will be very useful in determining that the most complete and up-to-date version of the certificate of incorporation or articles of organization has been submitted for review and consideration. Certificates of Existence may be obtained by submitting a written request to the New York State Department of State, Division of Corporations, 41 State Street, Albany, NY 12231, or by accessing the computerized inquiry system mentioned below. The fee for a Certificate of Existence is $25.

The Division of Corporations also maintains a computerized inquiry system, which may be accessed directly by members of the public. This system contains the complete history of all active corporations (business and not-for-profit), limited partnerships, limited liability companies, and limited liability partnerships, and a complete or partial history of certain inactive corporations. A user of this system will also be able to print Certificates of Existence on the user's printer. To access this system, a user must establish a drawdown (prepay) account with the Division of Corporations. Further information about this service, including information regarding applicable fees, is available at the Department of State's Web site, and in "Business Record Keeping and Records Access at the New York State Department of State: Preparing for the 21st Century," New York Business Law Journal, Vol. 2, No. 2 (Fall 1998), at page 28.

Copies of documents filed with the Department of State can be obtained by submitting a written request, along with the appropriate fee, to the Department at the address mentioned in the preceding paragraph. A fee of $5 will be charged for ordinary copies, and a fee of $10 will be charged for certified copies.[114]

The Division of Corporations accepts MasterCard and VISA for the payment of fees. The Division of Corporations has also developed a credit card authorization form that can be used for paying a fee by credit card when not appearing in person at the Division of Corporations.

Endnotes

1. As of December 14, 2000, there were 777,260 active New York business corporations, 165,291 active New York not-for-profit corporations, and 83,671 active New York limited liability companies.
2. Business Corporation Law § 403 (hereinafter "BCL").
3. BCL § 402(a)(9). *See also* BCL § 202(a)(1), which provides that business corporations have the power to have perpetual duration.
4. *See* BCL art. 9.
5. *See* BCL art. 10 (regarding voluntary, or "non-judicial," dissolution); BCL art. 11 (regarding involuntary, or "judicial," dissolution).
6. Tax Law § 203-a. However, "a corporation dissolved by proclamation under Tax Law § 203-a may have such proclamation retroactively annulled by paying all accrued franchise taxes, penalties, and interest charges, and filing in the Department of State a certificate of the Tax Commission attesting to the fact that all these charges have been paid." Warren's Weed, New York Real Property, "Cooperative Conversions" § 4.03(9)(a) (citing Tax Law § 203-a(7)).
7. BCL § 202(a)(4), (5).
8. BCL § 202(a). The powers of a business corporation are also subject to any limitations provided in the BCL or any other New York statute.
9. BCL § 202(a).
10. BCL § 402(a)(2). Many business corporations formed in recent years have used the "all purpose" clause set forth in BCL § 402(a)(2) (". . . it being sufficient to state, either alone or with other purposes, that the purpose of the corporation is to engage in any lawful act or activity for which corporations may be organized under this chapter, provided that it also state that it is not formed to engage in any act or activity requiring the consent or approval of any state official, department, board, agency or other body without such consent or approval first being obtained.").
11. BCL § 202. In the case of "any business for which formation is permitted under any other statute of this state," a corporation formed to perform such business must be formed under such other statute "unless such statute permits formation under [the BCL]." *Id.*
12. In the BCL, unless the context otherwise requires, the term "certificate of incorporation" ". . . includes . . . the original certificate of incorporation . . ., as amended, supplemented or restated by certificates of amendment, merger or consolidation or other certificates or instruments filed or issued under any statute." BCL § 102(3).
13. "An example of the limitation in 'furtherance of corporate purposes,' imposed by this provision may be as follows. If a corporation is organized to manufacture and market furniture, it may only deal with real property in furtherance of its corporate purpose. Owning and managing an apartment building with excess funds generated in the business may not be permitted under the Business Corporation Law. In order to engage in such an activity, the corporation would probably have to include in its certificate of incorporation a clause permitting it to do so." Warren's Weed, New York Real Property, "Cooperative Conversions" § 4.02. *But see* BCL § 203 (providing, in part, that "[n]o act of a

corporation and no transfer of real or personal property to or by a corporation, otherwise lawful, shall be invalid by reason of the fact that the corporation was without capacity or power to do such act or to make or receive such transfer. . . .").

14. BCL § 701. Prior to the 1977 amendment, BCL § 701 provided that the business of a corporation was to be managed *by* its board.

15. BCL § 202(a)(10). Generally, officers are to be elected or appointed by the board; however, some or all of the officers may be elected by the shareholders if the certificate of incorporation so provides. BCL § 715(a)-(b).

16. *See*, *e.g.*, *Grace v. Grace Institute*, 22 A.D.2d 897, 255 N.Y.S.2d 400 (2d Dep't 1964).

17. *See* Warren's Weed, New York Real Property, "Management and Maintenance" § 7.02 ("The title insurer referred to above . . . raises the following exceptions, or requires the following items to be addressed before it is willing to insure title when a corporation is selling real property or is in the chain of title. . . . The company requires that the corporation submit a resolution of the board of directors authorizing the sale and the delivery of the deed. The resolution must be certified by the secretary or assistant secretary of the corporation.").

18. BCL § 911.

19. *Id*. Under the former Stock Corporation Law, corporate mortgages (other than purchase money mortgages) *did* require the consent of shareholders.

20. BCL § 909(a). Prior to a 1997 amendment to BCL § 909(a)(3), the shareholder approval was required to be by two-thirds of all outstanding shares entitled to vote thereon. The 1997 amendment provides that such shareholder approval is to be by ". . . (A) for corporations in existence on the effective date of this clause the certificate of incorporation of which expressly provides such or corporations incorporated after the effective date of this clause, a majority of the votes of all outstanding shares entitled to vote thereon or (B) for other corporations in existence on the effective date of this clause, two-thirds of the votes of all outstanding shares entitled to vote thereon."

21. *Vig v. Deka Realty Corp.*, 143 A.D.2d 185, 531 N.Y.S.2d 633 (2d Dep't 1988).

22. 4 White on New York Business Corporations, ¶ 909.02(1), at page 9-129.1 to 9-128.2, (1969) (citing *Israels*, Corporate Practice 415).

23. 143 A.D.2d 185, 531 N.Y.S.2d 633 (2d Dep't 1988).

24. *Vig*, 143 A.D.2d at 186.

25. BCL § 909(b); s*ee also* BCL § 909(c) (providing that any action challenging a conveyance by a corporation on the ground that the conveyance was not authorized in the manner set forth in BCL § 909(a) above must be commenced within one year after the deed is recorded).

26. This authority to grant a corporate guarantee "not in furtherance" of corporate purposes is an exception to the requirement, under BCL § 202, that corporate powers are to be exercised "in furtherance of" corporate purposes. Further, there is authority for the proposition that BCL § 203 (discussed at endnote 13 above) will not operate to validate an "ultra vires" guaranty where the requirements of BCL § 908 have not been satisfied. *See Commercial Trading Co. v. 120 Jane Corp.*, 27 A.D.2d 533, 275 N.Y.S.2d 621 (1st Dep't 1966).

27. BCL § 908. Note that the "corporate purposes" to be considered in determining if BCL § 908 is applicable are those of the corporate guarantor. For example, Corporation A may be a shareholder of Corporation B. A lender making a loan to Corporation A may require a guaranty from Corporation B. While it may be "in furtherance of" the purposes of Corporation A to cause the guaranty to be given, it may not necessarily be "in furtherance of" the purposes of Corporation B to give its guaranty, or to pledge its assets as security for that guaranty.

28. BCL § 620. Among the requirements that must be satisfied before a corporation can include such a provision in its certificate of incorporation is the requirement that the corporation not be listed on a national exchange or regularly quoted in an over-the-counter market. *Id.*

29. For example, the certificate of incorporation of a corporation that is a subsidiary of another corporation may provide that the subsidiary shall not purchase, mortgage or sell real property without the consent of the parent.

30. BCL § 708.

31. BCL § 712. However, no committee may be given authority as to certain matters specified in § 712.

32. BCL § 711(a).

33. BCL § 711(b). Generally, a corporation's by-laws "may contain any provision relating to the business of the corporation, the conduct of its affairs, its rights or powers or the rights or powers of its shareholders, directors or officers." BCL § 601(b). However, the by-laws must be "not inconsistent" with the BCL or any other statute. *Id.*

34. BCL § 711(c).

35. BCL § 707.

36. BCL § 708(d).

37. BCL §§ 707, 709.

38. BCL § 708(c).

39. BCL § 708(b).

40. BCL § 602.

41. BCL § 605.

42. BCL § 614. *See also* BCL § 616 (providing for changing these requirements by provision in the certificate of incorporation).

43. BCL § 608. *See also* BCL § 616 (providing for changing these requirements by provision in the certificate of incorporation).

44. BCL § 615.

45. Not-for-Profit Corporation Law § 403 (hereinafter "N-PCL"). Unlike the corresponding provision in the BCL, there is no provision in the N-PCL for the certificate of incorporation to specify a later date on which corporate existence is to begin.

46. N-PCL § 402(a)(5). N-PCL § 202(a)(1) provides that a not-for-profit corporation has the power to have perpetual duration.

47. *See* N-PCL art. 10 (regarding voluntary dissolution) and N-PCL art. 11 (regarding involuntary dissolution).

48. *See* N-PCL art. 9.

49. N-PCL § 202(a)(4), (5).

50. N-PCL § 202(a). The powers of a not-for-profit corporation are also subject to any limitations provided in the N-PCL or any other New York statute. *Id.*

51. N-PCL § 202(a).

52. N-PCL § 402(a)(2). In the case of a Type C corporation, the "lawful public or quasi-public objective which each business purpose will achieve" must also be stated.

53. "Paragraph (b) of N-PCL § 201 provides for four types of not-for-profit corporations to be formed—Type A, Type B, Type C and Type D.

"A Type A corporation may be formed for any lawful non-business purpose including civic, patriotic, political, social, fraternal, athletic, agricultural, horticultural, animal husbandry and for professional, commercial, industrial trade or service associations. This list of Type A corporations is not inclusive. . . .

"Type B is the charitable, educational, religious, scientific, literary or cultural corporation or one formed to prevent cruelty to children or animals. . . . This type of corporation is established primarily to benefit society in general as opposed to the members of a not-for-profit corporation. This type of corporation is also more carefully regulated then Type A corporations because of the public benefit purpose and because of public funding. . . .

"The Type C not-for-profit corporation may be formed for any activity which is usually carried for profit but the principal reason must be for achieving a purpose other than making a profit. . . .

"Type D permits a not-for-profit corporation to be formed for the purposes provided in another law. . . . A Type D corporation is subject to all the provisions of the N-PCL which are applicable to a Type B corporation and subject to the contrary provisions of other corporate laws authorizing the formation under N-PCL of the Type D corporation." McKinney's N-PCL § 201, Practice Commentaries.

54. In the N-PCL, unless the context otherwise requires, the term "certificate of incorporation" ". . . includes . . . the original certificate of incorporation . . ., as amended, supplemented or restated by certificates of amendment, merger or consolidation or other certificates or instruments filed or issued under any statute." N-PCL § 102(3).

55. For example, the certificate of incorporation of a not-for-profit corporation that is intended to operate only in a specified county or area may provide that the corporation shall not purchase, mortgage or sell real property outside such county or area.

56. See, however, N-PCL § 203, which provides, in part, as follows:

> No act of a (not-for-profit) corporation and no transfer of real or personal property to or by a (not-for-profit) corporation, otherwise lawful, shall, if duly approved or authorized by a judge, court or administrative department or agency as required, be invalid by reason of the fact that the corporation was without capacity or power to do such act or to make or receive such transfer. . . ."

57. N-PCL § 509. In the N-PCL, the term "director" means any member of the governing board of a corporation, whether designated as director, trustee, manager, governor, or by any other title. N-PCL § 102(a)(6).

58. N-PCL § 509.

59. "A corporation shall have one or more classes of members, or, in the case of a Type B corporation, may have no members. . . ." N-PCL § 601(a). Further,

> [t]he certificate of incorporation or the by-laws may provide, either absolutely or contingently, that the members of any class shall not be entitled to vote, or it may limit or define the matters on, and the circumstances in, which a member or a class of members shall be entitled to vote, and, except as otherwise provided in this chapter, such provisions of the certificate of incorporation or the by-laws shall prevail, according to their tenor, in all elections and in all proceedings, over the provisions of this chapter which authorize any action by the members, but no such denial, limitation or definition of voting rights shall be effective unless at the time one or more classes of members, singly or in the aggregate, are entitled to full voting rights.

N-PCL § 612.

60. Regarding the issue of what constitutes "all or substantially all" of the assets of a corporation, see *Rose Ocko Foundation, Inc. v. Lebovits,* 259 A.D.2d 685, 686 N.Y.S.2d 861 (2d Dep't 1999), *appeal dismissed*, *leave to appeal denied*, 93 N.Y.2d 997, 696 N.Y.S.2d 107, 718 N.E.2d 412 (1999). The *Rose* court reasoned that

> [a]lthough the Not-For-Profit Corporation Law does not define what constitutes "all or substantially all" of the assets of a corporation, it is clear that the purpose of the statutes is to protect the beneficiaries of a charitable organization from "loss through unwise bargains and from perversion of the use of the property." . . . Although the parties dispute the monetary value of the property in relation to the Foundation's total assets, it was uncontested that the approximately 34 acres were the Foundation's largest, most significant, and single most valuable possession. Moreover, the sale of the property for inadequate consideration severely hampered the Foundation's ability to carry out its charitable mission. Accordingly, the transaction should have been subjected to judicial scrutiny as required by Not-For-Profit Corporation Law §§ 510 and 511.

Id. 259 A.D.2d at 688, 686 N.Y.S.2d at 864 (citations omitted).

61. N-PCL § 510(a)(1).

62. N-PCL § 510(a)(2).

63. See endnote 53 for an overview of the "types" of not-for-profit corporations.

64. N-PCL § 510(a)(3).

65. For example, the certificate of incorporation of a not-for-profit corporation that is a chapter of, or otherwise affiliated with, a "parent" organization may provide that the chapter/affiliate shall not purchase, mortgage or sell real property without the consent of the parent organization; and the certificate of incorporation of a not-for-profit corporation performing activities that are regulated by a governmental agency may provide that the corporation shall not purchase, mortgage or sell real property without the consent of such agency.

66. N-PCL § 708(a).

67. N-PCL § 712(a). In contrast to BCL § 712, which allows committees of business corporations to consist of one or more directors, N-PCL § 712 requires standing committees to consist of three or more directors. However, in light of N-PCL § 509, which requires real property transactions to be authorized by two-thirds of the "entire board" (or, in the case of boards having 21 or more directors, by a majority of the "entire board"), it would appear that a committee of a not-for-profit corporation would not have the authority to authorize real property transactions.

68. N-PCL §§ 711(a), (b), (c).

69. N-PCL §§ 707, 708(d). Section 708(d) provides that "*Except as otherwise provided in this chapter*, the vote of a majority of the directors present at the time of the vote, if a quorum is present

at such time, shall be the act of the board." (Emphasis added.) As discussed above, N-PCL § 509 requires the vote of *two-thirds* of the *entire board* (or, if there are 21 or more directors, the vote of a majority of the *entire board*) in connection with real property transactions. (Emphasis added.) The more specific requirements of § 509 will control over the general requirements of § 708(d).

70. N-PCL §§ 707, 709. Note that § 709(a)(2) permits a corporation to include in its certificate of incorporation a provision to the effect that ". . . the proportion of votes of directors that shall be necessary for the transaction of business or of any specified item of business shall be greater than the proportion prescribed by this chapter in the absence of such provision." In light of N-PCL § 509, such a provision, in connection with a real property transaction, could only increase the required vote to some number greater than two-thirds of the entire board (or, in the case of a board having 21 or more directors, to some number greater than a majority of the entire board).

71. N-PCL § 708(c). In contrast to BCL § 708(c), which permits participation in a board or committee meeting of a business corporation by telephone or other similar means unless restricted by the certificate of incorporation or by-laws, N-PCL § 708(c) permits participation in a board or committee meeting of a not-for-profit corporation by telephone or other similar means only if authorized by the certificate of incorporation or by-laws.

72. N-PCL § 708(b). The right of the board or a committee of the board to take action by written consent may be restricted by the certificate of incorporation or the by-laws; further, even in the absence of such restrictions in the certificate of incorporation or by-laws, board or committee action by written consent without a meeting must be unanimous.

73. N-PCL § 603.

74. N-PCL § 605.

75. N-PCL § 613.

76. N-PCL § 608.

77. N-PCL §§ 608(b), 615.

78. N-PCL § 614.

79. As previously discussed, such leave is required in the event of a sale, lease, exchange or other disposition of all, or substantially all, the assets of a corporation which is (or which would be, if formed under the N-PCL) a Type B or Type C corporation.

80. N-PCL § 511(b).

81. *Id.* The court may, "upon a showing of good cause," provide for less than 15 days' notice to the attorney general. *Id.*

82. N-PCL § 511(c).

83. N-PCL § 511(d).

84. "The term 'education corporation,' as used in (Education Law § 216-a) means a corporation (a) chartered or incorporated by the regents or otherwise formed under this chapter, or (b) formed by a special act of this state with its principal purpose an education purpose and which is a member of the university of the state of New York, or (c) formed under laws other than the statutes of this state which, if it were to be formed currently under the laws of this state, might be chartered by the regents, and which has been authorized to conduct its activities in this state by the regents or as an authorized foreign education corporation with the consent of the commissioner. A corporation as defined in the business corporation law is not an education corporation under this section." Education Law § 216-a.

85. Education Law § 216-a(4)(c).

86. An education corporation that is required to apply for leave of the court in connection with a proposed sale, lease, exchange or other disposition of all or substantially all its assets must give notice of the application to the Commissioner of Education, as well as the Attorney General. *See* Education Law § 216-a(4)(d)(3).

87. *See generally* Religious Corporations Law. In most cases, the certificate of incorporation of a religious corporation is filed and recorded in the office of the clerk of the county in which the principal office or place of worship of the corporation is to be located. Religious Corporations Law § 3.

88. *See* Religious Corporations Law § 2-b.

89. Religious Corporations Law § 12(a) (emphasis added). Leave of court is not required in the case of a purchase money mortgage. *Id.* Religious corporations falling within certain specified denominations are not required to provide the Attorney General with notice of an application for leave to sell, mortgage or lease real property. Religious Corporations Law § 2-b(1)(d-1).

90. Limited Liability Company Law § 203(d).

91. Limited Liability Company Law § 701(a)(1).

92. Limited Liability Company Law § 701(a).

93. Limited Liability Company Law §§ 202(b), (c).

94. Limited Liability Company Law § 202. An LLC's powers are also "subject to any limitations provided in (the Limited Liability Company Law) or any other law of this state." *Id.*

95. In the Limited Liability Company Law, the term "articles of organization" means "the articles of organization filed with the department of state for the purpose of forming a limited liability company pursuant to § two hundred three of this chapter, as amended or restated pursuant to § two hundred eleven or § two hundred fourteen of this chapter." Limited Liability Company Law § 102(a).

96. The Limited Liability Company Law does not contain any provision that expressly requires that the powers of an LLC be exercised "in furtherance of" the LLC's purposes. Further, the Limited Liability Company Law does not require that an LLC's articles of organization contain a statement of the purposes for which the LLC is formed. *See* Limited Liability Company Law § 203(e). However, the articles of organization may contain a statement of purposes. *See* Limited Liability Company Law § 203(e)(7)(A).

97. Limited Liability Company Law § 401(a).

98. Limited Liability Company Law § 417(a).

99. *Id.*

100. In light of the flexibility afforded by the Limited Liability Company Law to drafters of articles of organization and operating agreements, careful attention must be paid to these documents in any given transaction in order to determine who has managerial power in such transaction. A purchaser or mortgagee dealing with an LLC that has managers may simply request that the transaction be authorized by both the managers and the members, rather than run the risk of misreading the LLC's documents. Fortunately, in the case of an LLC that has managers, it is quite common for the managers also to be the members, or a subset of the members, and not an entirely separate group.

101. Limited Liability Company Law § 402(d)(2). Note, however, that § 402(d) begins with the qualification "except as provided in the operating agreement."

102. Limited Liability Company Law § 403.

103. Limited Liability Company Law § 405.

104. Limited Liability Company Law § 406.

105. Limited Liability Company Law §§ 403, 402.

106. Limited Liability Company Law § 403.

107. Limited Liability Company Law § 407. Except as may be provided in the operating agreement, an action by members of an LLC by written consent, without a meeting, need not be unanimous; the consent must be signed by members "who hold the voting interests having not less than the minimum number of votes that would be necessary to authorize or take such action at a meeting at which all of the members entitled to vote therein were present and voted. . . ." Limited Liability Company Law § 407(a).

108. Limited Liability Company Law § 408. In contrast to action by members of an LLC by written consent, which need not be unanimous, action by the managers of an LLC by written consent must be unanimous. Limited Liability Company Law § 408(c).

109. See also article 9 of the BCL, article 9 of the N-PCL and article 10 of the Limited Liability Company Law regarding mergers and consolidations and transfers of property resulting therefrom, and articles 10 and 11 of the BCL, articles 10 and 11 of the N-PCL, and article 7 of the Limited Liability Company Law, regarding voluntary and judicial dissolutions and transfers of property incidental thereto. The list of "other considerations" set forth in the body of this article is not intended to be exhaustive.

110. As a general rule, neither the resolutions adopted by an entity in connection with a real property transaction nor any "external" approvals or authorizations of such transactions are filed with, or available through, the Department of State. Further, certain relevant documents, such as the by-laws of a corporation and the operating agreement of an LLC, are not filed with or available through the Department of State.

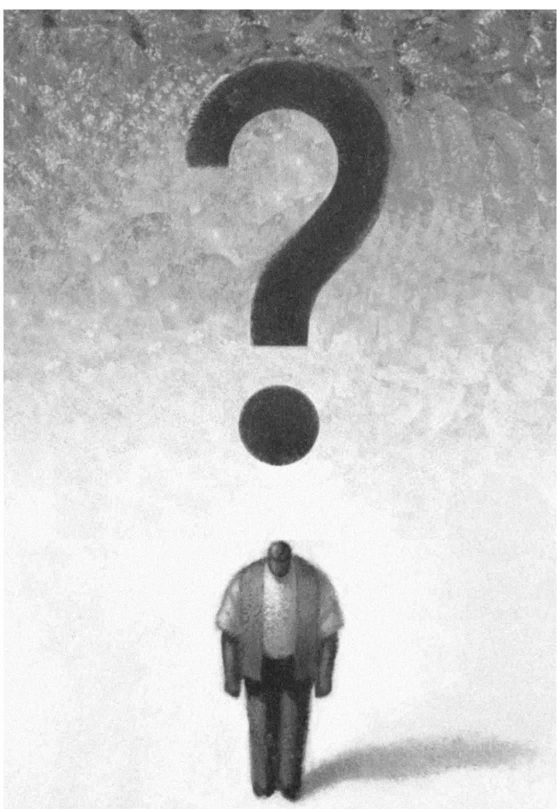
111. Depending on the nature and size of the transaction, a purchaser or mortgagee will often require the selling or mortgaging entity to furnish a recently issued Certificate of Existence.

112. *See* endnotes 12 and 54.

113. *See* endnote 95.

114. Neither the by-laws of a business corporation, nor the by-laws of a not-for-profit corporation, nor the operating agreement of an LLC, nor the resolutions adopted by directors, shareholders or members of any entity, are filed by or with the Department of State. Accordingly, copies of such documents (together with satisfactory proof that the copies are true and complete) must be obtained from the entity.

Secretary of State Treadwell would like to acknowledge the contributions of Joseph Ball, Attorney with the Division of Corporations, and James C. Aube, Director of the Division of Corporations, in the preparation of this article.



Case Notes

Biondi v. Beekman Hill House Apartment Corp.

94 N.Y.2d 659; 709 N.Y.S.2d 861; 731 N.E.2d 577) (April 11, 2000)

In New York State, §§ 721 and 722 of the Business Corporation Law provide guidance for the potential indemnification of directors and officers in the conduct of their official duties. Under both N.Y. Business Corporation Law § 722 (a) and (c), the standard of conduct is the same: A corporation may indemnify a director who acts in good faith for a purpose which he reasonably believed to be in the best interests of the corporation.[1] Note that this is permissive—not mandatory—indemnification, based upon the "good faith" standard. In addition, even though N.Y. Business Corporation Law § 721 contains nonexclusivity language which broadens the scope of indemnification, its "bad faith" standard demonstrates further limits on indemnification.[2] At issue in this appeal were 1) whether public policy would bar a cooperative apartment corporation from indemnifying one of its directors for punitive damages imposed on the director, who denied a proposed tenant's sublease application on the basis of race and retaliated against a shareholder for opposing the denial; and 2) whether, in consideration of the same facts, N.Y. Business Corporation Law § 721 would bar indemnification where the underlying judgment was that the director acted in bad faith.[3]

Plaintiff Nicholas A. Biondi was the former president of the board of directors of defendant Beekman Hill House Apartment Corporation. In 1995, one of the shareholder tenants informed Biondi that she intended to sublease her apartment to another financially eligible couple. Although a full board meeting for approval was not required, such meeting was held after Biondi informed another board member that the potential sublessee was African-American and told yet a third board member that he felt "uneasy" about him.[4] Subsequently, the board unanimously denied the application of the sublessee and issued a notice of default against the tenant shareholder for her conduct in accusing Biondi and the board of racism.

In review of consolidated actions in federal district court, involving suit against Beekman and its directors (the "Beekman defendants") for violations of various federal and state civil rights laws in the denial of the sublease application based on the sublessee's race, the jury found that the Beekman defendants, including Biondi both personally and in his official capacity as president of the board of directors, violated the Federal Fair Housing Act, 42 U.S.C. §§ 1981 and 1982, and New York Human Rights Law § 296(5) with regard to the prospective sublessee. The jury also found that Biondi and the Beekman defendants violated the shareholder's rights under the Federal Fair Housing Act and the New York Human Rights Law, breached their fiduciary duties to her, and tortiously interfered with her proposed sublease agreement. As a result, the jury found Biondi and the Beekman defendants liable to both parties for both compensatory damages and punitive damages, with proportional amounts of these damages assigned to Biondi individually.

Biondi subsequently sued Beekman for indemnification in New York State Supreme Court, citing Article VII of Beekman's by-laws, which stated

> To the extent allowed by law, the Corporation shall also indemnify any person, made, or threatened to be made, a party to an action or proceeding . . . whether civil or criminal, including an action by or in the right of any other corporation, domestic or foreign, which he served in any capacity at the request of the Corporation by reason of the fact that he . . . was a director or officer of the Corporation or served it in any capacity against judgments, fines, amounts paid in settlement, and reasonable expenses, including attorneys' fees . . . if such director or officer acted in good faith, for a purpose which he reasonably believed to be in the best interests of the Corporation and, in criminal actions or proceedings, in

addition, had no reasonable cause to believe that his conduct was unlawful.[5]

The Supreme Court denied Beekman's motion for dismissal due to failure to state a cause of action, and held that Beekman's by-laws did in fact authorize indemnification for directors who acted in "good faith," and the fact that the federal jury found Biondi liable for violating the parties' civil rights was not dispositive of that issue. In addition, the court held that the public policy prohibition against indemnification for punitive damages did not apply because the settlement agreement did not clearly identify Biondi's damages as being punitive in nature.[6]

The Appellate Division unanimously reversed and dismissed the complaint, holding that Biondi's settlement agreement limited his liability to punitive damages and that indemnification for punitive damages was prohibited by public policy. The court also held that New York Business Corporation Law § 721 barred indemnification when the jury in the underlying action found that in fact Biondi had acted in bad faith towards the prospective sublessee and the tenant shareholder.

The Court of Appeals affirmed the decision of the Appellate Division. Using the analogy to insurance indemnification, the court noted that the rule to be applied with respect to a punitive damage award made in a Civil Rights Act action was that coverage was proscribed as a matter of public policy, and that indemnification would actually defeat the purpose of punitive damages, which is to punish individuals and thus deter others from similar actions and decisions.[7] The court indicated that Beekman should not bear the cost of indemnifying its director for punitive damages imposed for his acts of bad faith, stating that the federal district court found that Biondi willfully violated the civil rights of both the tenant shareholder and prospective sublessee, imposed personal liability against Biondi greater than that imposed on any other single director, and sought to single out Biondi for punishment. If Biondi was now allowed to shift this penalty to Beekman through indemnification, this would in essence eviscerate the deterrent effect of such punitive damages and would violate the principle that "no one should be permitted to take advantage of his own wrong."[8]

Similarly, even though Business Corporation Law §§ 722(a) and (c) are permissive in allowing corporations to indemnify directors against third-party actions and derivative suits, the standard is whether the director acted "in good faith, for a purpose which he reasonably believed to be in . . . the best interests of the corporation. . . ."[9] The Business Corporation Law also addresses indemnification, and expands it to include any additional rights conferred by a corporation in its certificate of incorporation or by-laws, but limits this by stating that "no indemnification may be made to or on behalf of any director or officer if a judgment or other final adjudication adverse to the director or officer establishes that his acts were committed in bad faith or were the result of active or deliberate dishonesty and were material to the cause of action so adjudicated. . . ."[10]

The court read §§ 721 and 722 of the Business Corporation Law together and, applying them consistently, held that the key to indemnification is a director's good faith toward the corporation and that a judgment against a director, standing alone, may not be dispositive of whether the director acted in good or bad faith. However, the court held that on the entire record, there was nothing in Biondi's behavior that could be construed as being undertaken in "good faith" for a purpose "reasonably believed" to be in the best interests of Beekman. According to the court, by intentionally influencing the denial of the sublessee's application on the basis of race, Biondi knowingly exposed the corporation to liability under state and federal civil rights laws. In addition, by breaching his fiduciary duty to the shareholder tenant, Biondi acted in bad faith, according to the underlying federal judgment.[11] The court thus found that Biondi was not entitled to indemnification and denied him the opportunity to relitigate the good faith versus bad faith issue.

Michael J. Dutkowsky

Endnotes

1. N.Y. Business Corporation Law §§ 722(a), (c).
2. N.Y. Bus. Corp. Law § 721.
3. *Biondi v. Beekman Hill House Apt. Corp.*, 94 N.Y.2d 659, 661, 709 N.Y.S.2d 861, 731 N.E.2d 577 (2000).
4. *Id.* at 662.
5. *Id.* at 665.
6. *Id.* at 663.
7. *Hartford Acc. & Indem Co. v. Vil. of Hempstead*, 48 N.Y.2d 218, 228, 422 N.Y.S.2d 47, 397 N.E.2d 737 (1979).
8. *Public Serv. Ins. v. Goldfarb*, 53 N.Y.2d 392, 400, 442 N.Y.S.2d 422, 425 N.E.2d 810 (1981).
9. N.Y. Bus. Corp. Law §§ 722(a), (c).
10. N.Y. Bus. Corp. Law § 721.
11. *Broome v. Biondi*, 17 F. Supp. 2d 211, 220 (S.D.N.Y. 1997).

Michael J. Dutkowsky received his Juris Doctorate degree in December 2000 from Albany Law School and was student editor of the Fall 2000 edition of the *NY Business Law Journal*. He has a B.S. in secondary education from Cortland College and an Ed.M. and Ed.D. in educational administration from the University at Buffalo.

* * *

Novak v. Kasaks

216 F.3d 300 (2d Cir. 2000)

The Court of Appeals for the Second Circuit recently addressed the pleading standard for a securities fraud action in light of the Private Securities Litigation Reform Act of 1995 (PSLRA). In *Novak v. Kasaks*,[1] the Second Circuit reviewed claims by a class of investors alleging violations of §§ 10(b) and 20(a) of the Securities Exchange Act ("the 1934 Act"), and set forth the pleading standard for such actions.

Plaintiffs-appellants were members of a class of investors who had purchased common stock of the AnnTaylor Stores Corporation (hereinafter "AnnTaylor" or the "Company") between February 3, 1994, and May 4, 1995 (hereinafter the "Class Period"). Plaintiffs brought suit for securities fraud against two groups of defendants: (1) AnnTaylor, its wholly owned subsidiary AnnTaylor, Inc., and several high-level AnnTaylor officers; and (2) Merrill Lynch, a group of entities and individuals that had collectively held a dominant share of AnnTaylor stock and sold a significant amount of their holdings during the Class Period.

Plaintiffs alleged that during the Class Period, defendants made, or controlled those who made, materially false and misleading statements and omissions regarding the financial performance of AnnTaylor. Plaintiffs claimed that the AnnTaylor defendants knowingly and intentionally issued financial statements that overstated the Company's financial performance by accounting for a substantial quantity of out-of-date inventory that they knew to be nearly worthless at inflated values, and by intentionally failing to conform to Generally Accepted Accounting Principles (GAAP) that required price markdowns under such circumstances. It was further contended that the defendants made, or caused to be made, a series of statements to the public that positively described the company's performance and future prospects and that kept AnnTaylor's stock price at an artificially high level during the Class Period. When the Company was forced to publicly acknowledge serious inventory problems, and therefore announce lower earnings for the fiscal year than had been projected, the price of AnnTaylor stock fell dramatically, leading plaintiffs to file a class action against defendants for securities fraud.

Pursuant to Federal Rule of Civil Procedure 12(b)(6) and 15 U.S.C. § 78u-4(b)(3)(A), the district court dismissed plaintiffs' original and amended complaints for failure to plead with sufficient particularity facts giving rise to a strong inference that the defendants had acted fraudulently. Plaintiffs appealed. Subsequently, plaintiffs reached a settlement with the Merrill Lynch defendants and withdrew the appeal against them.

In order to state a claim for violation of § 10(b) of the 1934 Act, the complaint must allege that the defendants acted with scienter. In *Ernst & Ernst v. Hochfelder*,[2] the Supreme Court held that "no private cause of action for damages will lie under § 10(b) and Rule 10b-5 in the absence of any allegation of 'scienter'—intent to deceive, manipulate, or defraud."[3] In addition to pleading scienter, the complaint must also plead certain facts with particularity in order to state a claim. Prior to the passage of the PSLRA, which amended the 1934 Act, plaintiffs in the Second Circuit had to plead facts giving rise to "'a strong inference of fraudulent intent.'"[4] The PSLRA imposed more stringent pleading requirements on plaintiffs, requiring that "the complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."[5] Furthermore, where defendant is alleged to have "made an untrue statement of a material fact," or "omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading," plaintiff's complaint "shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed."[6] If plaintiff fails to meet the pleading requirements, the PSLRA requires courts to dismiss the complaint.[7]

The various circuits have differed on the interpretation of the new pleading standard imposed by the PSLRA. Upon reviewing the plain language of the statute, the Second Circuit concluded that enactment of the PSLRA did not change the circuit's basic pleading standard for scienter, holding that the act adopted its pre-existing "strong inference" standard. Therefore, in order to plead scienter in the Second Circuit, "plaintiffs must 'state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind,' as required by the language of the Act itself."[8] The court stated that the inference may arise where the complaint sufficiently alleges that the defendants: (1) benefited in a concrete and personal way from the alleged fraud; (2) engaged in deliberately illegal behavior; (3) knew facts or had access to information suggesting that their public statements were not accurate; or (4) failed to check information they had a duty to monitor.

Applying this standard to the *Kasaks* case, the court found that the complaint had alleged that the defendants engaged in conscious misstatements with the intent to deceive. According to the complaint, the AnnTaylor defendants knew at all relevant times that the Company had serious inventory problems, and by refusing to mark down inventory they knew to be outdated and "unsalable," the defendants "acted 'intentionally and deliberately' to artificially inflate [the Company's] reported financial results."[9] Plaintiffs also pleaded that the defendants knowingly approved inventory management practices that violated the Company's markdown policy, as stated in the Company's public filings, causing those filings to be materially misleading in that the disclosed policy no longer reflected actual practice. Further, the complaint alleged that despite knowledge to the contrary, the defendants made repeated statements to the investing community giving false assurances that inventory was under control, or giving false explanations for its growth. Based on the foregoing, the court found that the pleading satisfied the standard for scienter under *Hochfelder* and the requirement of the PSLRA that plaintiffs state with particularity facts that show a strong inference of fraudulent intent. "When managers deliberately make materially false statements concerning inventory with the intent to deceive the investment community, they have engaged in conduct actionable under the securities laws."[10]

The Second Circuit also addressed the issue of whether the plaintiffs had to reveal the identity of the confidential sources of their factual allegations. The district court had held that the plaintiffs had failed to meet the pleading requirements, in substantial part because they failed to reveal such confidential sources. The Second Circuit recognized that the complaint did not state with particularity every fact upon which some of plaintiffs' beliefs were based, but stated that "plaintiffs who rely on confidential sources are not always required to name those sources, even when they make allegations on information and belief concerning false or misleading statements."[11] The court reasoned that first, no case law in the circuit requires plaintiffs to reveal confidential sources at the pleading stage. Second, while paragraph (b)(1) of the PSLRA may require plaintiffs to reveal such sources under certain circumstances, the court found that such circumstances were not necessarily present in the *Kasaks* case. In the view of the Second Circuit, the PSLRA does not compel plaintiffs to plead with particularity every fact upon which their beliefs concerning false or misleading statements were made. "Rather, plaintiffs need only plead with particularity sufficient facts to support those beliefs . . . [and] where plaintiffs rely on confidential personal sources but also on other facts, they need not name their sources as long as the latter facts provide an adequate basis for believing that the defendants' statements were false."[12] Accordingly, it appears that so long as plaintiffs describe personal sources in the complaint with sufficient particularity to support the probability that a person in the position occupied by the source would possess the information alleged, there is no requirement that confidential sources have to be named. The court indicated that documentary evidence and/or a general description of the confidential sources should suffice to meet the pleading requirement. From a public policy standpoint, the Second Circuit noted that if a general requirement of disclosure of confidential sources was imposed, it could deter informants from providing important information necessary to bring suit against alleged violators of the 1934 Act.

The Second Circuit vacated and remanded the judgment of the district court, with instructions to allow the plaintiffs to replead in light of the decision, and to reconsider the particularity of plaintiffs' pleading in light of the proper standards.

Elizabeth Tse

Endnotes

1. 216 F.3d 300 (2d Cir. 2000).
2. 425 U.S. 185 (1976).
3. *Id*. at 193.
4. *Novak v. Kasaks*, 216 F.3d 300 (2d Cir. 2000) (citing *Acito v. IMCERA Group, Inc*., 47 F.3d 47, 52 (2d Cir. 1995)).
5. *Id*. at 306-07 (citing 15 U.S.C. § 78u-4(b)(2)).
6. *Id*.
7. *See* 15 U.S.C. § 78u-4(b)(3)(A) (1995).
8. *Kasaks*, 216 F.3d at 311.
9. *Id*.
10. *Id*. at 312.
11. *Id*. at 313.
12. *Id*. at 313-14.

Elizabeth Tse is a third-year student at Albany Law School and is expected to receive her Juris Doctorate degree in May 2001.

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