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# Message from the Editor

You have in your hands the Fall 2000 issue of the *NY Business Law Journal.* As always, I would like to thank our contributing authors who have devoted much time and effort from their busy schedules to share their expertise and interest with their fellow members of the Business Law Section of the New York State Bar, and to encourage all Section members to submit articles for consideration for our future issues. I look forward to seeing your work.

We begin our Fall issue with two committee reports. The first, from the Committee on Franchise, Distribution & Licensing Law, is based on events at two recent Committee meetings held on April 10, 2000 and July 27, 2000. Among other topics discussed at these meetings, Committee members reviewed the FTC's proposed revisions to its franchise rule, which will take into account matters such as: 1) potential FTC jurisdiction over certain international transactions; 2) the meeting of FTC disclosure requirements through electronic filings; and 3) certain additions to and exemptions from disclosure. The Committee also learned about new developments in the area of encroachment as a result of a recent Eleventh Circuit Court of Appeals decision and the significance of that opinion in light of other recent encroachment decisions in Pennsylvania and New Jersey, and then it engaged in a discussion of problems stemming from the underreporting of royalties by franchisees. The Committee also debated issues related to the registration and protection of trademarks and listened to an overview of the Attorney Referral Service sponsored jointly by the Association of the Bar of the City of New York and the New York County Lawyer's Association. Finally, the Committee heard from the co-author of the popular *Franchising for Dummies* treatise, written by Michael Seid in conjunction with Dave Thomas, Founder and Senior Chairman of the Wendy's hamburger franchise.

The second committee report, from the Committee on Banking Law, discusses the impact of the Gramm-Leach-Bliley Financial Modernization Act (also the subject of our first article, described below), which has substantially increased the complexity of bank regulation and the work of those in the business of representing bank institutions. Additionally, the committee report describes state legislative initiatives in the area of banking law and comments on ATM fees and ATM safety, financial privacy initiatives, proposed changes in trust law and power of attorney forms, and enactment of recent amendments to the Uniform Commercial Code. The report also mentions banking industry concerns related to IOLA and recent educational efforts of the Committee on behalf of the New York State Bar Association.

Our first article for the Fall issue is by Grace Sterrett of the law firm of Hiscock & Barclay, LLP. Ms. Sterrett has written a timely and perceptive article on the Gramm-Leach-Bliley Act of 1999, which has allowed for the sale of banking, securities and insurance products under the single corporate umbrella of a financial holding company, and which has thus worked the effective repeal of the Depression-era Glass-Steagall Act. This critical article focuses on the problems posed by the new legislation to financial institutions which are simultaneously expected to disclose certain information with respect to their "customers" or "consumers," terms of art under the Act, at the same time that they must respect the privacy interests of these same parties. This fastidiously detailed article should prove of great value to those who represent financial institutions or parties who deal with them, and it could not be more timely given the current heightened interest in consumer privacy posed by advances in Internet technology and in other areas.

Next follows a more detailed discussion of the FTC's proposed revisions to its franchise rule than was presented in the Committee on Franchise, Distribution & Licensing Law report mentioned earlier. David J. Kaufmann, a Senior Partner in Kaufmann, Feiner, Yamin, Gildin & Robbins, LLP, and an expert in franchising law, provides a much-needed analysis of changes to the current disclosure scheme contemplated by the Federal Trade Commission—changes which will, if adopted substantially as proposed, work dramatic alterations in the disclosure landscape and affect all who practice before the FTC in this area or who represent clients subject to FTC franchising oversight.

Frederick G. Attea, a member of the law firm of Phillips, Lytle, Hitchcock, Blaine & Huber, LLP, next issues a *cri de coeur* to the New York State Legislature to cease raising needless, counterproductive hurdles in the path of businesses which, but for the many anachronistic provisions in the statutory law, might otherwise incorporate in the Empire State. Mr. Attea provides a cogent argument convincingly demonstrating that the net effect of much of this outdated legislation is to compel corporations to incorporate in Delaware rather than in New York, and he advocates the immediate repeal of the worst provisions of the law which have served only to inhibit corporate formation inside the state, to the detriment of everyone but the residents of the state of Delaware. His call to arms should not go unheeded.

Our next article, by David L. Glass, Counsel with Clifford Chance Rogers & Wells LLP, in New York, discusses the heightened professional responsibility of attorneys and law firms representing banking institutions in the wake of the savings and loan crisis of the 1980s and early 1990s. Using the Kaye, Scholer dilemma which followed from the failure of Charles Keating's Lincoln Savings & Loan as a backdrop, Mr. Glass cautions lawyers on the duties which they may owe to bank regulators and the public at large, advising attorneys to keep in mind 1) that the bank is the client, not its individual directors or trustees; 2) that the entirety of a transaction or course of conduct should be taken into consideration when an attorney opines on its legality; 3) that there may exist an affirmative duty in the attorney to notify directors or other bank officials of potential violations of law, unsafe or unsound banking practices, or breaches of fiduciary duty; and 4) that the attorney may be under a duty to refrain from assisting in, and to advise and warn the bank about, breaches of fiduciary duty owed to the bank by others. Mr. Glass then continues his article by expanding on these various duties, giving hypothetical examples of how they might operate in practice, and concludes with timely advice on how certain derelictions in fulfilling these duties can get the lawyer into trouble. His article is an important one for anyone who represents or advises financial institutions.

Next follow two articles by Guy P. Lander, a partner in Goodman Phillips & Vineberg in New York City and a loyal contributor to this *Journal.* The first article discusses the resale of private placement securities under Securities and Exchange Commission rules and regulations, including via registration, Rule 144, Rule 144A, Regulation S, or the euphemistically dubbed "Section 4(1½ )" exemption. This article provides valuable guidance for those practicing in this area who are forced to confront the important decision of how properly to structure the resale of restricted securities without running afoul of the complex SEC filing and disclosure requirements.

Mr. Lander's second article deals with recent SEC initiatives in the area of electronic media and the use of the Internet to convey information to prospective investors. The SEC has recently clarified its views on the permissibility of issuers conveying information to investors and the market place electronically, as well as updating its stance on the legality of issuer communications during a registered offering and with respect to online private offerings under Regulation D. This article should prove to be most valuable indeed to those whose practice involves fulfilling the disclosure requirements of clients who offer their securities either to the investing public or though the mechanism of a private placement.

We next have two comment letters to the SEC by the Committee on Securities Regulation of the Business Law Section of the New York State Bar Association. The first letter, dated April 19, 2000, gives the Committee's opinion regarding proposed SEC additions to Regulation S-K. These additions would require companies to disclose valuation or loss accrual accounts, including FAS 5 reserves, as well as information about changes in long-lived assets and corresponding depreciation, depletion, and amortization accounts. The Committee's letter raises concerns about possible waivers of the attorney-client privilege if the SEC's proposed changes go into effect, competitive and economic harm to companies required to make the new disclosures, and the absence of a demonstrated need for the changes suggested by the SEC. This letter should prove of interest to those who practice in the area of financial accounting or who represent clients subject to Regulation S-K.

The second SEC comment letter, dated April 28, 2000, discusses the Committee's views with respect to the SEC's proposed Regulation FD. The Committee's letter centers on the application of the new regulation to the disclosure of material nonpublic information to "any other person outside the issuer," raising concerns about the virtually unlimited potential liability of company officials who discuss information with outsiders without the protection of a confidentiality agreement, the need for which may not readily be foreseeable without the benefit of legal counsel. The letter also points out that, given the amorphousness of the term "materiality" even to securities law experts, it is unrealistic and perhaps unfair for the SEC to impose a requirement on corporate officials untrained in the law to make a judgment before they speak about whether what they are about to say is "material" as a matter of law. The letter also discusses problems with respect to Regulation FD's "intent" requirement and concludes with an analysis of certain liability issues and other perceived adverse consequences which, in the Committee's view, are sure to result if the SEC adopts the regulation as planned. The Committee therefore urges the SEC not to adopt Regulation FD, or at least not as it is currently proposed.

Last but not least, Michael J. Dutkowsky, my ever-diligent research assistant on this issue of the *NY Business Law Journal,* concludes with an excellently-written case note on an important recent New York Court of Appeals opinion, *Pinnacle Consultants, Ltd v. Leucadia Natl. Corp.,* 94 N.Y.2d 426 (2000). At issue in this case were allegations of breach of fiduciary duty and waste in connection with the issuance of certain warrants, and of the violation of New York Business Corporation Law § 612 in connection with the vote of shareholders who approved a merger. This is a case which business practitioners in the state of New York need to be aware of.

As always, read, enjoy, submit!

**Sincerely,**
**James D. Redwood**
**Professor of Law**
**Albany Law School**

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# Committee Reports

## Report of the Committee on Franchise, Distribution & Licensing Law

The Franchise, Distribution & Licensing Law Committee of the New York State Bar Association met on April 10, 2000, at the Association of the Bar of the City of New York, 42 West 44th Street, New York, NY 10036-6689, and on July 27, 2000, at the law offices of Nixon Peabody LLP, 437 Madison Avenue, New York, NY 10022. Among the topics discussed were the following:

**1. FTC Notice of Proposed Rulemaking (NPR).** Susan Morton, Esq., Senior Associate at Kaufmann, Feiner, Yamin, Gilden & Robbins, discussed the Federal Trade Commission's (FTC) revision of the FTC Franchise Rule (the "Rule"). Ms. Morton said that the NPR shows a very careful, intelligent, sophisticated and foresighted updating of the franchise disclosure rules. First, the FTC intends to settle the question whether the Rule applies to international transactions by making clear that the Rule's disclosure requirements do not apply to "pure outbound" franchise sales transactions. The proposed rule will substitute a simple 14-day requirement for its current "first personal meeting" and "ten business day" disclosure timing requirements.

Another major change is that franchisors will be free to make disclosure through electronic means (over the Internet, by giving out computer disks, CD-ROMs, through e-mail, etc.), and that prospective franchisees will be able to acknowledge their receipt through "electronic signatures" (including digital signatures and passwords). The proposed rule would require franchisors to disclose any policy of obtaining contractual "gag clauses"—clauses that prohibit or restrict existing or former franchisees from discussing their business experiences with the franchisor. Franchisors would also be required to set forth in their disclosure documents the identities of all system-specific franchisee associations they know about. The proposed rule would create a new exemption for "sophisticated investor" transactions, that is, for franchise sales: (1) involving an investment by the franchisee of at least $1.5 million; (2) to large corporations which have been in the business in question for at least five years and have a net worth of at least $5 million; and, (3) to officers, directors and other executives of the franchisor.

Ms. Morton added that the FTC will not require disclosure of financial performance information or "earnings claims." The proposed rule would require franchisors to use only the Uniform Franchise Offering Circular (UFOC) disclosure format, but it creates additional disclosure requirements for the UFOC and modifies some current UFOC Guidelines requirements. For example, a number of new disclosures about the franchisor's parent will be required in Items 1, 2 and 3, and the financial statements of the franchisor's parent would have to be incorporated in the UFOC. The revised Item 3 would also require franchisors for the first time to disclose pending lawsuits they initiated against franchisees on issues involving the franchise relationship. The proposed revisions to the FTC Franchise Rule would also revise the first table in Item 20, which is currently somewhat confusing. Thus, if the Rule is ultimately revised as proposed by the NPR—and it almost certainly will be, with some minor modifications—some very big changes will result.

**2. Encroachment.** Howard Wolfson, Esq., of Morrison Cohen Singer & Weinstein, LLP, provided an update on the law of encroachment in light of the recent Eleventh Circuit Court of Appeals decision in *Burger King Corp. v. Weaver*, 169 F.3d 1310 (11th Cir. 1999). Mr. Wolfson stated the decision will not result in an end to litigation for alleged encroachment. The *Weaver* decision held that, under Florida law, a franchisee could not bring suit for breach of the implied covenant of good faith and fair dealing based upon the franchisor's licensing of another franchised site that allegedly encroaches on sales at the franchisee's established location, unless the franchisee received an exclusive territory under its franchise agreement.

Mr. Wolfson explained that although *Weaver* may be persuasive authority, it will not necessarily be followed by courts applying other states' laws. Mr. Wolfson pointed out that recently in *Foodmaker, Inc. v. Queshi*, Bus. Franchise guide (CCH) ¶ 11,780 (Dec. 1, 1999), the Superior Court of California, County of San Diego, held that a franchisor could have violated the implied covenant of good faith and fair dealing under facts analogous to *Weaver*. The court's decision in *Foodmaker* is at odds with the Eleventh Circuit's holding in *Weaver*.

Mr. Wolfson further noted that two encroachment decisions had been rendered recently in cases brought by franchisees against GNC Franchising Inc., *Oganesov v. GNC Franchising, Inc.*, Bus. Franchise Guide (CCH) ¶ 11,808 (Pa. March 3, 2000) and *Kazmierski v. GNC Franchising, Inc.*, Bus. Franchise Guide (CCH) ¶ 11,799 (D.N.J. February 9, 2000).

Mr. Wolfson explained that the law would continue to develop in this area on a case-by-case basis. A discussion then ensued regarding various business policies that franchisors have adopted or are considering in an effort to avoid further litigation with their existing franchisees regarding encroachment.

**3. Under-reporting of Royalties by Franchisees.** Corey Covert, Esq., of Rosen Einbinder & Dunn, PC, provided an overview of franchisee under-reporting based on his experiences overseeing Minuteman franchisees. In opening, Mr. Covert stated that franchise agreements and operating manuals must define terms, such as "gross sales" or "billings," and should set up penalties and the costs for audit or attorney fees for under-reporting franchisees.

Mr. Covert stated that large franchise systems can have franchisees report to the franchisor electronically, collect financial statements, or conduct an audit from a random sampling of franchisees. When deciding to do a sampling, Mr. Covert recommended selecting franchisees that are in states that are franchisor-friendly and franchisees that are the least likely to litigate. In determining which franchisees to select for an audit, a franchisor should speak to field representatives and to ex-employees of the franchisee.

Mr. Covert stated that high walk-in traffic usually means that a lot of cash is being paid, which is easier to conceal than credit cards or checks. Other red flags may include the following: 1) a franchise location which reports sales that are less than overhead, but which continues to operate the business year after year at an apparent profit; 2) existing franchises that are sold at high prices, yet report only marginal sales to the franchisor; 3) existing franchises that are sold at low prices in comparison with sales, which may indicate cash is being hidden under the table and that the new franchisee will do the same to avoid making royalty payments to the franchisor.

In conducting the audit, all financial statements, bank accounts and purchase of supply records should be reviewed. Gross sales can be hidden by cash transactions that are never rung up, and by maintaining two separate invoice books. Some franchisees install temporary registers which are removed or hidden and never reported, and some franchisees arrange for alternative suppliers so that supply usage cannot be monitored.

Mr. Covert concluded by stating that if it is learned that a franchisee was under-reporting, a full accounting should be demanded to determine the royalties owed. Once the accounting is concluded, a demand should be made for immediate payment of royalties along with penalties and audit and attorney fees.

**4. Registration and Protection of Trademarks.** Barry Cooper, Esq., of Gottlieb, Rackman & Reisman, P.C. gave a brief overview of intellectual property law as it applies to franchising. Mr. Cooper began with the basic definitions and terms of trademarking, then moved on to the common law "use" rights of trademark and trade dress law and the current requirements of registration. Mr. Cooper explained that under common law a trademark can be established through consistent usage, as well as through explicit registration, and that marks can become unprotectable through "genericide" when the trade name is used generically.

Mr. Cooper explained the necessary steps to begin registration, including trademark searches by both government (the public can access the Patent and Trademark website) and private entities, as well as the allowance or disallowance of substantially similar trademarks, and things that cannot be trademarked due to generality or lack of descriptiveness or likelihood of confusion. The application for registration process was discussed, including applications by U.S. domiciliaries in foreign countries, multiple country registration, actual use of the trademark, subsequent registration, and fees.

Mr. Cooper fielded questions on the efficiency of both federal registration and state registration, as well as on foreign entities registering within the United States. Mr. Cooper said he did not feel that state registration was a worthwhile effort. He then explained the procedures examiners follow when reviewing registration forms, as well as post-registration issues, policing, and the role of the U.S. Customs Agency in deterring shipment of non-licensed goods. Finally, Mr. Cooper discussed the increasing number of Internet issues arising from the trademarking of domain names.

**5. Attorney Referral Service ("Service").** Clara Schwabe, Esq., of the Association of the Bar of the City of New York (ABCNY), gave an overview of this cooperative effort between ABCNY and the New York County Lawyer's Association which was started in 1946. The Service consists of 600 attorneys and receives 350-400 telephone calls and e-mail messages from all over the world involving business, family, landlord/tenant and consumer issues. ABCNY is a nonprofit organization, and thus, to sustain itself, it charges the attorney a fee of $25 per client after the first consultation, or if a retainer agreement of over $600 is signed, a small percentage of the retainer.

When the public calls the Service, they are transferred to one of its many in-house attorneys who screens the call, makes sure each claim is meritorious and routes it to the proper list of attorney specialists. If a caller's problems are not appropriate for attorney referral, then they are referred to city agencies, pro-bono programs, law clinics or community outreach programs. Ms. Schwabe explained that attorneys are placed in subject groups so that potential clients will receive an attorney with a specialty in their particular problem.

**6. *Franchising for Dummies*.** Michael Seid, Managing Director of Michael H. Seid & Associates, LLC, discussed his new book, *Franchising for Dummies*, which he recently co-authored with Dave Thomas, Founder and Senior Chairman of Wendy's International, a well-known hamburger franchise. Seid discussed the various goals he and Thomas had for the publication, emphasizing their desire to provide readers with a factual, first-person, understandable account of the franchising industry. Directed mainly toward franchisees, the book points out what Seid calls "the pimples, warts, and problems" of franchising, discussing issues ranging from how to research a franchise to how to find a reliable attorney who will offer guidance throughout the franchising process. Seid noted that in the book, he and Thomas took hard positions on serious issues, addressing the utility of franchise brokerage as well as the high death-rate of new franchisors.

*Franchising for Dummies* discusses current problems for women and minorities in franchising, as well as the influence of e-commerce and the Internet on the industry. While franchisees constitute the book's target audience, Seid and Thomas also took the franchisor's interests into account. They offer advice not only on how to look for a good franchisor, but also on how to become one, and they address the challenges small franchisors face in trying to expand their businesses, increase sales, and improve relationships with franchisees. Seid summed up both the book and the presentation with a piece of Thomas's advice, noting that while it is important for a franchisor to maintain standards and customer satisfaction, consistency can be overrated if achieved at the expense of the needs of the franchisee.

**Respectfully submitted,**
**Joseph Punturo, Chair**
**William Estes, Secretary**
**Richard Seely**
**Mirella deRose**

## Report of the Committee on Banking Law

The Committee on Banking Law has had an active and productive year. Meetings of the full Committee were held in New York City in January, in conjunction with the NYSBA annual meeting, and in April. The next meeting is scheduled to take place in Puerto Rico at the Business Law Section Annual Meeting in October.

The passage of the Gramm-Leach-Bliley Financial Modernization Act (GLB Act) last fall, despite being billed as a deregulatory reform, has substantially increased the complexity of bank regulation, and much of the Committee's work has been focused in that direction. Among our guests have been Sara Kelsey, Deputy Superintendent and Counsel of the New York State Banking Department, and Roseanne Notaro of the Department legal staff; Michael Schussler, a senior attorney with the Federal Reserve; and Jonathan Rushdoony, District Counsel of the Office of the Comptroller of the Currency. All of these individuals were very generous in sharing their insights regarding financial reform from the regulatory perspective, and joined in an active dialogue with the Committee members.

Other guests included Teri Kleinmann, a legislative aide to Speaker of the Assembly Sheldon Silver, and Roberta Kotkin, General Counsel of the New York Bankers Association. Along with the ongoing outstanding work of Committee Legislative Chairman Jim Orband, their contribution has kept us close to legislative developments in Albany. The Committee contributed comments on ATM fees and ATM safety; financial privacy initiatives; proposed changes in trust law and power of attorney forms; and enactment of revised UCC articles 3, 4 and 5. Steven Brooks, General Counsel of the New York IOLA Fund, has also joined us in a constructive dialogue on issues of concern to the banking industry in relation to IOLA.

Finally, the Committee has been actively involved in educational efforts for NYSBA more broadly. We were involved in developing and presenting a program on UCC article 9 at the Fall 1999 Business Law Section Annual Meeting; a NYSBA CLE program on financial reform in May, chaired by David Glass; a program on bank lending for the Fall 2000 Business Law Section Annual Meeting, to be chaired by Bruce Baker; and a program on the effects of financial reform to date, to be presented at the NYSBA annual meeting in January 2001.

**Respectfully submitted,**
**David L. Glass, Chairman**

# Financial Privacy: New Rights for Consumers; New Burden for Financial Institutions

By Grace Sterrett

Few would have predicted that when the long awaited financial services modernization law, known as the Gramm-Leach-Bliley Act (GLB or "Act") was enacted on November 12, 1999,[1] allowing the sale of banking, securities and insurance products under the single corporate umbrella of a "financial holding company," the portion of the law which would garner the most attention and scrutiny by the public would be the section regarding the obligation of financial institutions to protect the privacy of their customers. As consumers, we enjoy the convenience of being able to purchase goods and services via the Internet, over the phone or even in person by "presenting" a plastic card by which the cost of our purchases is charged to a credit card or debited to a deposit account in an effortless and seamless manner. The price for this "convenience," however, has been a loss of privacy. Many consumers are dismayed to discover that information we assumed was personal, including where we live, how much we earn, and how we spend and invest our money, has become widely disseminated throughout the marketplace. Of particular concern is the privacy of our personal financial records and credit histories.

The GLB directly addresses this concern in Subtitle A of title V entitled "Disclosure of nonpublic personal information,"[2] by expressly limiting the circumstances under which a "financial institution" may disclose customers' nonpublic personal information. Declaring that financial institutions have an "obligation" to protect the nonpublic personal information which they possess, the Act provides as follows:[3] "It is the policy of the Congress that each financial institution has an affirmative and continuing obligation to respect the privacy of its customers and to protect the security and confidentiality of those customers' nonpublic personal information."

## Scope

The Act directs the federal agencies which supervise participants in the financial services industry to develop privacy standards for the "financial institutions" which they regulate to:

1. ensure the security and confidentiality of customer records and information;
2. protect against any anticipated threats or hazards to the security or integrity of those records; and
3. protect against unauthorized access to, or use of, the records or information which could result in substantial harm or *inconvenience* (emphasis supplied) to any customer.[4]

The agencies assigned this task are the "federal banking agencies," consisting of the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS), collectively referred to as "Bank Agencies" or "Banking Agencies." In addition, the National Credit Union Administration (NCUA); the Federal Trade Commission (FTC); the Secretary of the Treasury ("Treasury"), and the Securities and Exchange Commission (SEC) have also been directed to issue privacy regulations for the "financial institutions" under their respective jurisdictions. Each agency has been directed to issue implementing regulations "after a consultation as appropriate with representatives of state insurance authorities designated by the National Association of Insurance Commissioners."[5]

The focus of this paper will be on the privacy regulations that have been jointly issued by the Bank Agencies to implement the privacy provisions of the Act.[6] The Bank Agencies also jointly issued a "Supplementary Information" statement preceding the adoption of the final rule which provides valuable insight into their interpretation of the Act and how the regulations should be applied in various situations.[7]

The other regulators have also been active. For example, the FTC, which is the primary federal regulator of "non-bank" companies that offer consumer financial services including many finance companies, mortgage bankers, sales finance companies and similar lenders and servicers,[8] has issued a final rule which is substantially similar to that adopted by the Bank Agencies.[9] The NCUA has also issued a final rule, which is described as being comparable to that of the other Bank Agencies, but yet modified to reflect the "unique nature of credit union structure and relationship issues between the Credit Union, its members and credit union service organizations."[10] The SEC issued final rules[11] in late June, which will be applicable to brokers, dealers, investment companies and investment advisors.[12] Persons engaged in "providing insurance" are subject to regulations issued by the state insurance authority of the state in which the insurance entity is domiciled.[13] The Bank Agencies have concluded, however, that any insurance activities conducted by an insured depository institution will remain subject to the privacy rules of the applicable federal bank regulator.[14]

## Deadline

The Bank Agencies, the FTC and the NCUA have uniformly set the mandatory compliance deadline for July 1, 2000.[15] Under the Act, the provisions of title V were to take effect six months after the date on which the rules were required to be issued or November 12, 2000, but the regulators responded favorably to the request of the financial industry for an extension. Comments from industry representatives noted that if, for example, the Bank Agencies required compliance by November 12, 2000, those institutions that wanted to continue sharing nonpublic personal information with non-affiliated third parties without interruption would have been required to issue the appropriate disclosures within 30 days of the effective date of the final rule—realistically too short a time to develop the materials, distribute them and provide adequate training for staff, let alone develop the software needed to track opt-out requests from individuals who ask that their nonpublic information not be shared.[16] As a result, financial institutions have a bit of a "breather," as the mandatory date has been extended until July 1, 2001. The Bank Agencies have made it clear, however, that financial institutions are expected to be in *complete* compliance with the privacy regulations and that development and testing of the software systems, preparation of the privacy disclosures, and distribution of material to customers would have to be done fairly soon in order to represent that the institution was in compliance on July 1.[17]

## Message?

The six-month extension is no reason to delay the compliance efforts which will be substantial for any institution. The Act and the implementing regulations require not only the creation, distribution and compliance with new disclosures, but they also require the development of a "back office" screening and record-keeping system which may be difficult and costly for some institutions to comply with. If institutions cannot do this internally, they will have to seek out a "qualified" third-party vendor—all of which will take time. The requirement to develop/purchase new systems to meet these privacy rules is only the beginning. Subtitle B of title V of the Act, entitled "Fraudulent Access to Financial Information," will require financial institutions to improve their security programs to protect customer data under the new standards of the Act. The Bank Agencies and the NCUA are directed to issue regulations to create standards for financial institutions to better ensure the protection and confidentiality of customer information.[18]

## What Is a Financial Institution?

As the Act only imposes privacy obligations on "financial institutions" this raises the question, "What is a financial institution?" The Bank Agencies have answered by defining a "financial institution" as ". . . any institution the business of which is engaging in activities that are financial in nature or incidental to such financial activities as described in § 4(k) of the Bank Holding Company Act of 1956."[19] The regulations made some exceptions, noting that a financial institution does not include an entity or activity under the jurisdiction of the Commodity Futures Trading Commission, the Federal Agricultural Mortgage Corporation, and institutions chartered by Congress specifically to engage in securitization, secondary market sales or similar transactions, provided they do not sell/transfer nonpublic personal information to a non-affiliated third party.[20] Under these definitions, it is very clear that a commercial bank, a thrift, or a bank holding company or a financial holding company would, in fact, be a "financial institution" subject to the privacy regulations. The important point is that entities other than traditional banks, which provide financial products or services to persons for personal, family or household use, will also be deemed to be "financial institutions" subject to the provisions of the Act and the applicable regulations. For example, mortgage brokers, mortgage bankers, and loan servicers are deemed to be financial institutions for purposes of the new privacy rules. [21]

## What Is a Financial Product or Service?

Basically, it's any product or service that a "financial holding company" could offer (to a natural person for personal, family or household purposes) by engaging in an activity that is financial in nature and incidental as provided under § 4(k) of the Bank Holding Company Act.[22] A financial product or service is virtually anything that is financial in nature or "incidental" to a financial activity—anything that any subsidiary of a financial holding company, including a bank, insurance agency, or securities brokerage agency would offer to individuals for personal, family or household use. (As noted above, the actual privacy obligations of securities brokers are governed by the SEC, and the privacy obligations of an insurance company are governed by the appropriate state insurance regulator.)

## Who Is Protected?

By definition, the Act protects the privacy rights of "consumers"—individuals who obtain a *financial product* *or service from a financial institution primarily* for personal, family, or household purposes.[23] Given these definitions, the Act and the implementing regulations are *not* applicable to business purpose transactions. The Act distinguishes between consumers in general and those persons who have a customer relationship with a financial institution, who are called "customers," and directs the regulators to further define this relationship.[24] The regulations define the term **"consumer"** as follows: "An individual who obtains or has obtained a financial product or service from the bank that is to be used primarily for personal, family or household purposes, or that individual's legal representative."[25] Examples of who is a "consumer" given by the Bank Agencies include a person who applies to a bank for credit for personal, family or household purposes, regardless of whether or not that credit is extended; any person who provides "nonpublic personal information" in order to determine whether or not he or she may qualify for a loan, regardless of whether or not the loan is extended; and an individual who provides personal information in connection with obtaining or seeking to obtain financial investment or economic advice, regardless of whether the person and the bank establish a continuing relationship. Other consumers include mortgagors or borrowers whose loan is serviced by a bank or other financial institution.[26]

In contrast, the regulations define a **"customer"** as a person who has a continuing relationship with a bank which provides one or more financial products or services to that person which are used primarily for personal, family or household purposes.[27] Examples of those having such a relationship include: a person who has a deposit or investment account, obtains a loan, has a loan for which the bank owns the servicing rights, purchases an insurance product from the bank, or holds an investment product for the bank, such as when the bank acts as a custodian for securities or assets in an individual retirement arrangement (IRA). "Customers" also include a person who has an agreement/understanding with the bank under which the bank undertakes to arrange or broker a home mortgage loan for the consumer, or a person who enters into a lease of personal property with the bank or who obtains financial, investment or economic advisory services from the bank for a fee.[28]

The regulators do not deem an individual to be a "customer" if that person does not have a continuing relationship with the bank, such as in the following situations: the individual obtains a financial product or service only in isolated transactions such as using the bank's ATM machine to withdraw cash from another account at another financial institution or to purchase a cashier's check or a money order; the bank sells the consumer's loan and does not retain the rights to service that loan; or the bank sells the consumer airline tickets, travel insurance or traveler's checks in isolated transactions.[29]

## Who Gets What?

The distinction between a "consumer"—one without a continuing relationship with a financial institution—and a "customer"—one with a continuing relationship with the financial institution, is extremely important, because it determines whether and to what extent that financial institution must issue pre-transaction and annual disclosures as summarized below.

- **"Consumers"** (individuals without a continuing relationship) only get an *initial privacy notice*, with a description of their right to "opt out" of the institution's policy of sharing information with unaffiliated third parties if the financial institution intends, or reserves the right, to disclose any nonpublic personal information about the individual to any non-affiliated third party.[30] Therefore, if the financial institution does not intend to and, in fact, does not disclose any "nonpublic" personal information about the consumer (not a customer) to any non-affiliated third party (other than as specifically authorized on an "exception" basis as set forth in the regulations discussed below), then the financial institution need not provide this category of individuals with an initial privacy notice or with a notice of the right to opt out of the potential sharing of personal information about them with non-affiliated third parties, because there is nothing to disclose![31]
- **"Customers"** (individuals with a continuing relationship) get an initial *and* annual privacy notice complete with a description of their right to "opt out."[32]

## Initial Disclosure

Customers must receive an initial disclosure not later than when the financial institution establishes a "customer relationship." This must provide a "clear and conspicuous notice": (1) that accurately reflects the institution's privacy policies and practices and (2) describes the customer's right to "opt out" of having nonpublic personal information shared with non-affiliated third parties.

When a consumer opens a credit card account, a deposit account, obtains a loan, purchases insurance from the bank, agrees to obtain investment advisory services from the bank, becomes the bank's client for the purpose of the bank's providing credit counseling or tax preparation or other services, the consumer has initiated entering into a "customer relationship."[33] A customer relationship, however, can also be created without any action by the consumer, e.g., when the financial institution purchases the servicing rights to an existing loan for a natural person for personal, family or household reasons (e.g., the typical residential mortgage loan).[34]

## Customer Annual Notice

In addition to the "initial" notice, the financial institution must also send each customer an annual privacy notice (that describes the privacy policies and affords the customer the opportunity to "opt out") during the continuation of the customer relationship.[35] Annually means once in any 12-month period of the customer relationship. Institutions comply if they define the 12-month period as a calendar year and send the annual notice once in each calendar year following the calendar year in which the initial notice was provided.[36] This obligation ceases when the person is no longer a customer.[37]

## What Is Nonpublic Personal Information?

This is defined as: "(i) personally identifiable financial information; and (ii) any list, description or grouping of consumers (and *publicly* available information pertaining to them) that is derived using any personally identifiable financial information that is not publicly available."[38]

The final regulations are less broad than originally proposed by the Banking Agencies. Initially, the protected type of information included information that a consumer provided to a financial institution in order to obtain a financial product or service, information resulting from any transaction between the two parties involving a financial product or service, and information about a consumer that a financial institution otherwise obtains in connection with providing the financial product or service to the consumer. The proposed rule also treated the fact that a person was a "customer" of a financial institution as information which should be protected as nonpublic personally identifiable financial information. Commentators from the industry thought that the proposed definition was inappropriately "broad" because including identifying information such as name, address and telephone number went beyond the scope of "financial information." Commentators also noted that many customer relationships are a matter of public record—such as in the circumstance where a security interest involving the individual and the financial institution has been filed or recorded in a public records office. In response, the Banking Agencies noted that any information requested by a financial institution for the purpose of providing a financial product or service should be deemed "financial information." The Banking Agencies also noted that since the Act has broadly defined the term "financial institution" to include a number of entities that are not engaging in the traditional forms of financial activities (including travel agencies, insurance companies and data processors), the range of information that may impact on the terms and availability of a financial product or service, or that is used by a financial institution in connection with providing a product or service, is very broad and may include medical information and other types of information that might not be thought of as being strictly "financial."[39]

The final regulations have adopted what the Banking Agencies consider to be a "compromise" in that information such as names, addresses and telephone numbers which is "publicly available" will not be subject to the opt-out provisions of the statute unless that information has been derived from another source, such as part of a list or other grouping of consumers that in itself has been derived from personally identifiable financial information that is not publicly available. Under the final rules, "nonpublic personal information" includes "personally identifiable financial information," which the Banking Agencies have defined as including any information that a consumer provides to a financial institution to obtain the financial product or service, information about a consumer as a result of a transaction involving a financial product or service between a financial institution and a consumer, or any information that a financial institution otherwise obtains about a consumer in connection with providing a financial product or service.[40]

Examples of "personally identifiable financial information" include:[41]

- Information a consumer provides on an application to obtain a loan, a credit card, or other financial product or service;
- Account balance information; payment history; overdraft history;
- Credit or debit card purchase information;
- The fact that a person has been a customer or has obtained a financial product or service;
- Information about the bank's consumer if it is disclosed in a manner that indicates the individual is or has been a consumer;
- Information that a consumer provides to a financial institution or that that institution or its agent otherwise obtains in connection with collecting on or servicing a loan;
- Information that a financial institution obtains through an internet "cookie" (an information collecting device from a web server); and

- Information from a consumer report.

Examples of non-personally identifiable information include:[42]

- A list of names and addresses of customers of an entity which is not a financial institution; and
- Information which does not identify a consumer, such as aggregate information or blind data that do not contain personal identifiers, including account numbers, names or addresses.

## What Is Considered to Be Publicly Available Information?

The Banking Agencies have indicated that any information that a financial institution has a reasonable basis to believe is lawfully made available to the general public from governmental records, widely distributed media or mandated legal disclosures is in fact publicly available (and therefore "not protected").[43] As for determining whether the financial institution has a "reasonable" basis to believe that the information is "public," it will be necessary for that institution to have determined that it is a type of information that is available to the general public (such as non-private listed phone numbers) and to also have determined whether an individual can direct that the information not be made available to the general public and if so, that the financial institution's consumer has not done so. For example, a financial institution is deemed to have a reasonable basis to conclude that mortgage information is lawfully made available to the general public if the financial institution has determined that the information is of the type included on the public record in the jurisdiction where the mortgage would be recorded. (Typically, this includes the names of the mortgagees and the address of their "then" residence.) Similarly, a financial institution has a "reasonable basis" to believe that an individual's telephone is lawfully made available to the general public if the institution has located the telephone number in the telephone book or if the consumer has informed the financial institution that her telephone number is *not* unlisted.[44]

## Contents of Privacy Notices

The initial, annual and any revised privacy notices must contain, as applicable, nine basic items as described below.[45] The Banking Agencies have indicated that financial institutions are not required to provide lengthy and detailed privacy notices but need simply to provide individuals with a general description of the third parties to whom a financial institution discloses nonpublic personal information; the types of information that are disclosed; and any other information about the institution's privacy policies that the regulations require be made public. In the Agencies' view, these disclosures can be satisfied in most cases by a "tri-fold brochure," and smaller institutions that do not share information with third parties beyond the statutory exceptions should be able to provide a short streamlined notice.[46] The Banking Agencies have also indicated that annual notices may be provided over the institution's Web site if the customer conducts transactions electronically and agrees to accept such disclosures electronically. Under the final rule, the following information, as applicable, must be contained in any privacy notice.[47]

1. The categories of nonpublic personal information that a financial institution may collect;
2. The categories of nonpublic personal information that a financial institution may disclose;
3. The categories of affiliates and non-affiliated third parties to whom a financial institution discloses nonpublic personal information (except for disclosures to third parties necessary to "effect, administer or enforce the transaction requested or authorized by the consumer" under § 502(e) of the Act);
4. The financial institution's policies with respect to sharing information about former customers;
5. The categories of information that are disclosed pursuant to agreements with third party service providers and joint marketers and the categories of third parties providing those services;
6. A consumer's right to opt out of the disclosure of nonpublic personal information to non-affiliated third parties;
7. Any disclosure a financial institution is providing under the federal Fair Credit Reporting Act regarding the right of the consumer to opt out of the sharing of information among affiliates;
8. A financial institution's policies and practices with respect to protecting the confidentiality, security and integrity of nonpublic personal information; and
9. If the financial institution discloses nonpublic personal information to unaffiliated third parties for permitted purposes such as by consent, or if it discloses such information to service providers or for joint marketing efforts or for anti-fraud or safety and soundness purposes (as permitted under regulations at §§ 14 and 15), then the institution must disclose this fact as part of its privacy policy but need not go into detail. It would be sufficient to say something like "the financial

institution makes disclosures to other non-affiliated third parties as permitted by law."

## Shortcut for Consumer Notice[48]

In order to the reduce the burden on financial institutions for individuals with whom they have no lasting relationship, financial institutions are authorized to give a short form initial notice to consumers (individuals without a continuing relationship). This notice must be clear and conspicuous, state that the financial institution's privacy policy is available upon request, and provide a reasonable means by which that policy may be obtained, such as by calling a toll-free number, or going to an office of the financial institution for a copy.

## What About Future Disclosures?[49]

A financial institution that wishes to reserve the right to disclose information to unaffiliated third parties in the future even though it does not currently engage in such an activity must include that wish as part of its privacy policy.

## What About the Opt-Out Notice?[50]

Financial institutions must provide all their customers with an "opt-out notice," and if they reserve the right to, or do in fact share nonpublic personal information on consumers with unaffiliated third parties, they must also provide consumers with an opt-out notice. Basically, the notice must disclose that:

- The financial institution discloses or reserves the right to disclose nonpublic personal information about a consumer/customer to a non-affiliated third party;
- The individual has a right to "opt out" of the sharing of this information; and
- The way in which the consumer can "opt out" (which method must be "reasonable").

The Banking Agencies have determined that a *reasonable* method by which individuals can exercise their right to "opt out" includes the following:[51]

- have the consumer indicate in check-off boxes on the relevant form the wish to "opt out";
- include a reply form with the opt-out notice which the consumer can send back;
- provide an electronic means to opt out if the consumer has already consented to the electronic delivery of information;
- provide a toll-free telephone number.

In contrast, the Banking Agencies have declared it to be an *unreasonable* "opt-out procedure" if the consumer must write his or her own letter to exercise the right of opt out or if the only means of opting out is to use a check off box which is provided in the initial notice but which is not included with subsequent notices.[52]

## What About Joint Accounts?[53]

A financial institution has the option of providing a single opt-out notice to both account holders provided the notice explains "how" the institution will treat the "opt-out" direction by only one of the joint account holders. The financial institution may either treat an opt-out direction by "one" joint consumer/customer as applying to all of the associated persons on that account or permit each individual to opt out separately. The financial institution, however, may *not* require all joint consumers/customers to opt out before it implements any opt-out direction.

## Are There Any "Exceptions" to the Right of Opt Out?

There are three principal exceptions.

### 1. Servicing and Marketing Exception

A financial institution may share nonpublic personal information with a non-affiliated third party to perform services for, or functions on behalf of, the financial institution, including marketing of that institution's own products or services and/or marketing financial products or services offered pursuant to joint agreements between two or more financial institutions. In order to take advantage of this "opt-out" exception, the financial institution must fully disclose in the consumer/customer privacy notices that it will share "private" information for this purpose, and it also must enter into a contractual arrangement with that third party requiring it to maintain the confidentiality of such information. If the financial institution meets the "notice" and "contract" requirements, the consumer/customer does not have the right to "opt out" of letting the institution disclose nonpublic personal information to this category of non-affiliated third parties. This exception is authorized under § 502(b)(2) of the Act.[54]

#### Timing

In response to the comments of many financial institutions that already had servicing/marketing agreements in place, the Banking Agencies provided under § 18(c) that any such servicing or marketing contracts entered into on or before July 1, 2000 must be brought into compliance by July 1, 2002.

### 2. Processing, Administration Exception

Section 502(e) of the Act permits the disclosure of nonpublic personal information to non-affiliated third parties in connection with the administration, processing, servicing and sale of a consumer's account. Similar to the third party exception in § 502(b)(2), the consumer does *not* have the "right" to "opt out" of this sharing of their personal information. Unlike the other exception, however, the financial institution need not advise the public of this practice in its privacy notices and there is no contract requirement by which the third party agrees to adopt the financial privacy practices of that institution with regard to the information it receives from that institution. The Bank Agencies note that this "exception" is designed to cover services provided by firms such as attorneys, appraisers, debt collectors and others in their role to "effect, administer or enforce a transaction" on behalf of the financial institution. This exception covers situations where private customer information is shared to "enforce" the rights of those engaged in the financial transaction; to carry out the transaction on record or maintain the customer's account; to administer or service benefits related to the transaction or the product or services; to provide a confirmation statement or information on the status of the financial service to the consumer; to underwrite insurance at the customer's request and to assist any settlement or billing process.[55]

### 3. Other Exceptions Ranging from Consent to Fraud

Without notice and without giving the individual the right to opt out, financial institutions are authorized to share information with unaffiliated third parties for a variety of other "business"-related reasons including: with the consent of the consumer; to protect the security of the financial institution's records regarding a consumer or transaction; to protect against potential or actual fraud; for resolving consumer disputes; to a consumer reporting agency as required by the federal Fair Credit Reporting Act; in connection with a sale or proposed merger, as may be required by other laws, as directed by a proper subpoena and for similar reasons.[56] One can argue that the reason for this "exception" is the recognition of the fact that a financial institution is compelled by other laws and regulations in its day-to-day operations to convey information in order to obtain a rating, to protect its assets, or to protect against fraud or crime, and that it was not the intent of the Act (which was designed to protect consumers against the exploitation of their personal financial information) to inhibit the financial institution from doing whatever is necessary to make sure that it continues to be operated on a safe and sound basis and cooperates with law enforcement officials in the prevention and detection of financial services crimes.

## How Does the GLB Relate to Consumers' Rights Under the Fair Credit Reporting Act?

The Act makes several technical amendments to the Fair Credit Reporting Act (FCRA) which concern rulemaking authority and the right of the Bank Agencies to examine their banks for compliance with the FCRA requirements.[57] Section 506(c) provides very clearly that except for the rulemaking amendments, nothing in title V of the Act is to be construed to modify, limit or supersede the FCRA. The Agencies have required, however, that the initial and annual privacy notice which is given to consumers and customers include the FCRA required disclosures that certain consumer information may be shared by that institution among affiliates (if that is the case) and which also give the consumer the right to "opt out" of the disclosure of that personal information. Although some commenters objected to being obliged to make the FCRA disclosures in a privacy policy mandated by another law, the Bank Agencies took the view that in order for a financial institution to comply with its obligation under title V to disclose its policies and practices with respect to sharing information with affiliated and non-affiliated third parties, it has to describe the circumstances under which it would be sharing information with affiliates.

## What About Contrary State Laws?

Section 507 of the Act provides that title V does not preempt any state law that provides greater protections than are provided under the Act. The FTC is given the authority to make the determination as to whether a state law or title V provides greater protection to individuals, but may make that decision only after consultation with the agency that regulates the party filing a complaint or the financial institution about whom the complaint was filed.[58] The failure of the Act to preempt state privacy laws means that financial institutions will have to continue to do a "state by state" survey and to amend their privacy policies to address any state laws which are more protective to consumers/customers.

## Sample Disclosure Forms

The Agencies have published as Appendix A to their respective regulations sample clauses which financial institutions can use where appropriate. Financial institutions should review these samples because they provide guidance as to the level of detail or complexity in the disclosures that the Bank Agencies are seeking. As noted above, the Bank Agencies have indicated that the privacy statements should be very "readable" and not overly complicated. For example, the Agencies have proposed the following sample clause for the explanation of the consumer's/customer's right to "opt out":[59]

If you prefer that we not disclose non-public personal information about you to non-affiliated third parties, you may opt out of those disclosures, that is, you may direct us not to make those disclosures (other than disclosures permitted by law). If you wish to opt out of disclosures to non-affiliated third parties, you may [*describe a reasonable means of opting out, such as "call the following toll-free number: (insert number)"*]

## What to Do

July 1, 2001 is not that far away when you consider the amount of work that a bank or any other financial institution will have to do to ensure that it has *completely* implemented its privacy compliance program (including having sent all necessary notices to consumers and customers in time for them to "opt out" before July 1, 2001). This is a *partial* list of ten things that every financial institution and its affiliates need to consider in starting their action plan:

1. *Define the categories of "consumers" with whom you interact.* For example, are there categories of individuals who engage in "consumer purpose" transactions which do not result in the establishment of a customer relationship, such as: ATM transactions at your bank where the individual has an account at another institution, purchases of money orders, cashing of checks?

2. *Count the "Hopefuls" as Consumers.* Don't forget those individuals such as loan applicants who "hope" to become ***customers***, but do not because their applications for credit, to open a deposit account or receive some other service are withdrawn or rejected. These individuals are also "consumers," because in the course of applying they give the financial institution personal, private information.

3. *"When" and "How" Does a Consumer Become a Customer?* The Bank Agencies seem to suggest that once there is an execution of a written contract by a consumer and a financial institution, a customer relationship has been established. A person can still become a "customer" without a contract if that individual has obtained financial, economic or investment advisory services from a financial institution, so the "written contract" is a *good* "test" *but not the sole test*. To the extent that the institution engages in the sale of insurance, note that the customer is the policy holder and not the beneficiary. Beneficiaries would be the recipients of any insurance proceeds, thereby giving them the protections that are afforded to "consumers."

   *What about loans and the sale of loans?* If a financial institution makes a consumer purpose loan, retains it in a portfolio and also services it, then the borrower would have a customer relationship with that institution. If after the loan is funded, the servicing is sold and/or if investors purchase a partial interest in the loan, the question is whether those other entities also have a privacy duty to the same customer. The Bank Agencies have indicated that as a general rule a customer relationship will be established with the institution that makes the loan to an individual. Then this "customer" relationship will attach to the entity providing servicing. So, if the originating institution retains the servicing, it will continue to have a customer relationship with the borrower and will be obliged to provide not only the initial privacy disclosure but also the annual notices for the duration of the customer relationship with that borrower. If the servicing is sold, then the "purchaser" of the servicing rights will establish a customer relationship with the borrower, but the originating lender will have a consumer relationship. Therefore the borrower will be entitled to receive an initial notice from the originating institution prior to having the loan application approved, another initial notice from the servicer and then annual notices from the loan servicer.

   *What about Custodial Accounts and IRAs?* A customer relationship will exist when an institution acts as a custodian for securities or assets in an IRA account.

   *Who are your former customers? Do you share their private information?* Note that the privacy statements must indicate "what" information the institution shares with non-affiliated third parties on former customers. Former customers, as noted above, can be considered "consumers."

4. *Determine how you handle consumer and customer information now.* Will you share or *not* share non-public personal information about consumers? (Will you give or not give them an initial privacy notice with the right to opt out?)

5. *How will you determine what is "Nonpublic Personal Information"? Let's Review an Example of Nonpublic Personal Information.* Information will be deemed to be "publicly available" if a financial institution has a *reasonable basis* to believe that the information is lawfully made available to the general public from one of the three categories provided in the Bank Agencies' regulations: governmental records, widely distributed media, disclosures to the general public that are required under law.

The example that the Bank Agencies give to help understand the relationship between the terms "nonpublic personal information," "personally identifiable financial information," and "publicly available information," is as follows:[60]

> Assume that Mary provides her bank with various information in order to obtain a mortgage loan and to open a deposit account. Under the final rule, all of this information would be personally identifiable personal information. Once Mary establishes the customer relationship she seeks, the fact that Mary is a mortgage loan customer and a deposit account holder at the bank also would be personally identifiable personal information. It may be that certain information provided by Mary, such as her name and address, is publicly available. If the bank has a reasonable basis to believe that this information is publicly available and that the information was included on a list of all of the bank's mortgage loan customers, then her name and address would fall outside of the definition of "nonpublic personal information" in those jurisdictions where mortgages are a matter of public record. However, Mary's name and address would be protected as nonpublic personal information if the bank wanted to include those items on a list of its deposit account holders. The difference in treatment stems from the distinction drawn in the statute between lists prepared using publicly available information (as would be the case in the mortgage loan hypothetical) and lists prepared using information that is not publicly available (as would be the case in the deposit account hypothetical).

6. *Develop a Timetable for Mailing Annual Notices. How do you count "Annual"?* The Bank Agencies have issued a rule allowing a financial institution to select a calendar year as the 12-month period within which notices will be provided and to provide the first annual notice at any point in the calendar year following the year in which the customer relationship was established. This 12-month cycle has to be applied to all customers on a consistent basis.

7. *Handling the Third Party Exceptions.* The Act and the implementing regulations give financial institutions the right to give certain personal information on consumers and customers to unaffiliated third parties such as those agents which the institution hires to market its own products or to assist in the origination of its own financial products and services. Every institution needs to look at these "exceptions" and determine what they must do, such as amending their contracts with those third parties, to have that third party agree not to re-use any information that it obtains from the institution in a way that the institution could not do itself under law or its own privacy statements. (This requires you to make a list of all third party "agents" and to review their current contracts; develop a plan to amend those contracts where appropriate; draft new privacy clauses for all new contracts, etc.)

8. *Draft your Initial and Annual Policies. Should you use the Sample Clauses? If so, how?* The final regulations contain some sample clauses and forms in Appendix A to the regulation. The Agencies stress that these are samples only and that the use of them will not be a "safe harbor" if the language does not accurately reflect the financial institution's practices and policies.

9. *Sort Personal Information.* Develop a system to pre-sort information on "consumers," "customers," and "former customers" and track it so you can implement any "opt out" policies or requests. For example, a financial institution may choose *not* to share nonpublic personal information on "consumers." If that's the institution's policy, you have to be able to identify that group of persons and make sure that their personal information is not shared with third parties. Will you merge the "opt-out" requests per the Fair Credit Reporting Act (sharing with affiliates) with opt-out requests of Privacy Regulations or keep them distinct?

10. *Implementation.* Who will implement the institution's new privacy policy, oversee compliance, and be responsible for monitoring adherence to the new rules? Develop a system which will require all departments to report their handling of personal consumer information including: marketing; loan servicing; and the origination of loans, deposits, and investment services.

## Conclusion

The task of implementing and maintaining a privacy policy that complies with title V of the GLB and the implementing regulations is a daunting one. Financial institutions should not delay developing an action plan and testing their internal data processing systems which will be the backbone supporting the institution's obligation to separate "consumers" from "customers"; to subdivide customers into categories such as "existing" and "former"; and to be able to accurately implement the "direction" of consumers and customers who choose to exercise their right of "opt out." An institution should avoid adopting any "model" privacy statement offered by a regulator or an industry group until that institution knows with certainty that the privacy statement accurately reflects how the institution requests, sorts, maintains and disseminates all nonpublic personal information about its consumers and its customers.

## Endnotes

1. Pub. L. No. 106-102, 113 Stat. 1338, enacted November 12, 1999.
2. Pub. L. No. 106-2, tit. V(B), §§ 501–510; 15 U.S.C. §§ 6801–6809.
3. Pub. L. No. 106-2, tit. V(A), § 501(a), 15 U.S.C. § 6801(a).
4. Pub. L. No. 106-2, tit. V(A), § 501(b), 15 U.S.C. § 6801(b).
5. Pub. L. No. 106-2, tit. V(A), § 504(a), 15 U.S.C. § 6804(a).
6. The final rule for the Bank Agencies was issued jointly in 65 Fed. Reg. 35162 (2000) and can be found separately as follows: OCC.–12 C.F.R. pt. 40; FRB–12 C.F.R. pt. 216; FDIC–12 C.F.R. pt. 332; OTS–12 C.F.R. pt. 573. Each of the Bank Agencies has followed a similar section numbering system so references to any part of the Agencies' rule will be by section number only, *e.g.,* .3—"Definition."
7. 65 Fed. Reg. 35162– 35196 (2000).
8. Pub. L. No. 106-2, tit. V(A), § 505(a)(7), 15 U.S.C. § 6805(a)(7); *see also* 65 Fed. Reg. 33647, 33648 (2000), for a review of "scope."
9. 1 Privacy Law Advisor 87 (2000). The FTC final rule appears in 65 Fed. Reg. 33646 (2000) and is promulgated in 16 C.F.R. pt. 313.
10. 12 C.F.R. pts. 716 and 741; *see also*, 65 Fed. Reg. 31722 (2000) (Col. 2).
11. Release Nos. 34-42974; IC–24543; IA– 1883, 6/22/00.
12. Pub. L. No. 106-2, tit. V(A), § 505(a)(3-5), 15 U.S.C. § 6805(a)(3-5).
13. Pub. L. No. 106-2, tit. V(A), § 505(a)(6), 15 U.S.C. § 6805(a)(6).
14. 65 Fed. Reg. 35163 (2000).
15. Section .18; FTC & NCUA follow the same numbering system in their regulations as do the Bank Agencies described in endnote 6.
16. 65 Fed. Reg. 35184 (2000).
17. 65 Fed. Reg. 35185 (2000).
18. Tit. V(B) §§ 521–527, 15 U.S.C. §§ 6821–6827.
19. 16 C.F.R. § 313.3(k)(1).
20. 16 C.F.R. § 313.3(k)(2).
21. *See* FTC "examples," 16 C.F.R. § 313.3(k)(2).
22. 16 C.F.R. § 313.3(l).
23. Pub. L. No. 106-2, tit. V(A), § 509(9), 15 U.S.C. § 6809(9).
24. Pub. L. No. 106-2, tit. V(A), § 509(11), 15 U.S.C. § 6809(11).
25. 16 C.F.R. § 313.3(e)(1). Note the corresponding FTC definition is identical except that the term "you" is substituted for "bank" in 16 C.F.R. § 313.3(e)(1).
26. 16 C.F.R. § 313.3(e)(2).
27. 16 C.F.R. § 313.3(h).
28. 16 C.F.R. § 313.3(i)(2)(i).
29. 16 C.F.R. § 313.3(i)(2)(ii).
30. 16 C.F.R. § 313.4(a)(2).
31. 16 C.F.R. § 313.4(b).
32. 16 C.F.R. §§ 313.4(a)(1), .5(a), .6(a).
33. 16 C.F.R. § 313.4(c)(3)(i).
34. 16 C.F.R. § 313.4(c)2)(3)(ii).
35. 16 C.F.R. § 313.5.
36. 16 C.F.R. § 313.5(a).
37. 16 C.F.R. § 313.5(b).
38. 16 C.F.R. § 313.3(n)(1) (emphasis supplied).
39. 65 Fed. Reg. 35171 (2000) (Col. 1 under "o").
40. 16 C.F.R. § 313.3(n) & (o)(1).
41. 16 C.F.R. § 313.3 (o)(2)(i).
42. 16 C.F.R. § 313.3 (o)(2)(ii).
43. 16 C.F.R. § 313.3(p).
44. 16 C.F.R. § 313.3(p)(2)(iii).
45. 16 C.F.R. § 313.6.
46. 65 Fed. Reg. 35175 (2000) (3rd Col.).
47. 16 C.F.R. § 313.6. *See also* 65 Fed. Reg. 35176 (2000).
48. 16 C.F.R. § 313.6(d).
49. 16 C.F.R. § 313.6(e).
50. 16 C.F.R. § 313.7.
51. 16 C.F.R. § 313.7(a)(2)(ii).
52. 16 C.F.R. § 313.7(a)(2)(iii).
53. 16 C.F.R. § 313.7(d).
54. 16 C.F.R. § 313.13.
55. 16 C.F.R. § 313.14.
56. 16 C.F.R. § 313.15.
57. 16 C.F.R. § 313.16 (referencing FCRA at 15 U.S.C. §§ 1681 *et seq.*).
58. 16 C.F.R. § 313.17. Note: Although several "privacy" bills were introduced, none was adopted by the N.Y. Legislature when it concluded the regular 2000 session in June 2000. 75 BNA Banking Report 8 (2000) *See also* S.8091, A.11031.
59. Appendix A–A-6.
60. 65 Fed. Reg. 35172 (2000).

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# FTC Set to Revamp Federal Disclosure Rules

By David J. Kaufmann

The franchise regulatory landscape is about to undergo a seismic change. The Federal Trade Commission has now released its "Notice of Proposed Rulemaking" (NPR) detailing just how that agency intends to overhaul its FTC Franchise Rule[1] for the first time since that regulation took effect in 1979. As most readers are aware, the FTC Franchise Rule governs franchise sales activity throughout the United States, in a largely non-preemptive fashion, by mandating pre-sale comprehensive disclosure to prospective franchisees.

The FTC's NPR reflects remarkable wisdom, foresight, intellect and sophistication—along with an obvious deep understanding of the franchise arena. The product of almost five years of proposals, hearings and input from franchisors, franchisees, their counsel and advocates, the FTC truly devoted itself to doing what it considers best for the franchise arena by identifying the plethora of issues that had to be dealt with; examining just how they should be dealt with; weighing various alternatives; digging deep into the business world to truly comprehend what makes sense; and, peering into the future to construct a revised FTC Franchise Rule that would anticipate it.

*"The FTC's NPR reflects remarkable wisdom, foresight, intellect and sophistication—along with an obvious deep understanding of the franchise arena."*

Which is not to say that either franchisors or franchisees will find the proposed revisions to the FTC Franchise Rule entirely to their liking. Overall, however, it should be emphasized again that the FTC's NPR is a remarkably coherent and intelligent epistle.

If the FTC Franchise Rule is ultimately revised as suggested by the Commission's NPR (and it almost certainly will be, with some minor modifications), vast changes will result. Gone will be the Rule's coverage of both franchising and business opportunities. Only franchising will now be addressed (with the Commission to promulgate a separate regulation governing business opportunity offerings). Gone, too, will be the FTC Franchise Rule's own format of disclosure (to satisfy the Rule's disclosure requirements today, franchisors can opt to utilize either the FTC Franchise Rule disclosure format or the state ordained Uniform Franchise Offering Circular (UFOC) format). Instead, the Rule would require franchisors to utilize exclusively the UFOC disclosure format, but with a twist—the NPR layers on additional disclosure requirements (and some modified disclosure requirements) from those currently required under the UFOC Guidelines (which, as promulgated by the North American Securities Administrators Association, governs just how the UFOC disclosure document must be prepared).

Gone as well will be the debate as to whether the FTC Franchise Rule governs franchise sales activity directed by American franchisors to foreign individuals and entities. Since the Rule first went into effect in 1979, questions have always arisen as to whether it applies to such international transactions. Over the past decade, the FTC itself was signaling that it did not. But then, just two years ago, a U.S. District Court in Florida held that the Rule might be applicable to a franchise sale effected by an American-based franchisor to a South American franchisee. But the NPR reveals that the FTC intends to revise its Franchise Rule to make clear that it does not apply to such "pure outbound" franchise sales transactions. But beware—the FTC is not relinquishing its jurisdiction over such sales. That is, the NPR reveals that the Commission intends to reserve and exercise its power to combat fraudulent international franchise sales transactions through civil prosecutions.

Also gone under the Commission's proposal to revise the FTC Franchise Rule will be the days when disclosure documents had to be handed out in "hard copy." Instead, if the Rule is modified as suggested by the Commission's NPR, franchisors will be free to effect disclosure through electronic means—over the Internet; utilizing computer disks; through e-mail; or, otherwise. Gone, too, will be the days when franchisees would be required to manually sign the mandated disclosure document receipt form. Instead, such prospective franchisees could acknowledge receipt through "electronic signatures" (including digital signatures and passwords) to evidence their receipt of the disclosure document.

Scheduled to vanish also are the FTC Franchise Rule's current "first personal meeting" disclosure trigger; "ten business day" disclosure trigger; and the five business day franchise agreement dissemination obligation. As most readers are aware, the FTC Franchise Rule currently requires franchisors to tender their disclosure documents to prospective franchisees at the earlier of the "first personal (face-to-face) meeting" between them or ten business days in advance of the franchisee's executing any contract or paying any money to the franchisor (with the further requirement that the subject franchise agreement be tendered to the prospective franchisee, in a form ready for execution, at least five business days beforehand).

But this paradigm simply does not work in this age of electronic communications and disclosure. "The personal meeting disclosure trigger has become obsolete in a communications age where prospective sellers now communicate with buyers through a wide array of communications media . . .," notes the FTC's NPR. Accordingly, under the revamped FTC Franchise Rule, there would be no specific disclosure "trigger" at all. Instead, the only requirement would be that the prospective franchisee have the disclosure document in hand fourteen days (instead of ten business days) before signing any franchise agreement or paying any money to the franchisor. (That prospective franchisee would also have to have his/her/its franchise agreement in hand, in a form ready for execution, five calendar days beforehand—rather than the current "five business days" requirement.) "As long as the prospective franchisee has a minimum number of days in which to review the franchisor's disclosures, that should suffice to combat deceptive franchise sales," states the Commission's NPR.

But while the FTC proposes to eliminate from its Franchise Rule the above-referenced disclosure obligations and protocols, it is also adding new ones in their stead. In response to franchisee input, the NPR suggests that the FTC Franchise Rule will be revised to require franchisors to disclose any policy of obtaining contractual "gag clauses" prohibiting or restricting existing or former franchisees from discussing their business experiences, whether incident to litigation or otherwise. And franchisors would also be required under the revised FTC Franchise Rule to set forth in their disclosure documents the identities of all franchisee associations known to them—not just "captive franchisee associations" (those established by the franchisor itself), but all such organizations whose existence is known to the franchisor. (Not required, however, will be disclosure regarding non-system-specific franchisee associations, such as the American Franchisee Association or the American Association of Franchisees and Dealers.)

But the revised FTC Franchise Rule would confer a benefit to franchisors as well. Responding to their input, the Commission will afford a disclosure exemption altogether for "sophisticated investor" transactions—that is, franchise sales involving an investment by the franchisee of at least $1.5 million (with the Commission specifically seeking comment on whether this threshold is too high or low); sales to large corporations which have been in the subject business for at least five years and have a net worth of at least $5 million; and sales to officers, directors and other executives of the franchisor in question.

Of key concern to almost everyone in the franchise community is whether the FTC Franchise Rule will be revised so as to require franchisors to disclose "financial performance information"—information regarding past or projected franchisee gross revenues, profits, EBIDTA, "break even" points and so forth—as the states, through NASAA, are currently considering. The answer? No. What will happen if the FTC Franchise Rule, as revised, does not require such mandatory financial performance disclosure—but the states determine to mandate same—is the subject of much conjecture.

If the FTC Franchise Rule is revised as suggested by the NPR, franchisors will be prohibited from utilizing "merger and integration clauses" to shield themselves from liability for misrepresentations or omissions in their disclosure documents. To the contrary, the NPR makes clear that the revised FTC Franchise Rule will prohibit franchisors from disclaiming—through such contractual clauses or otherwise—liability for statements made in their disclosure documents. And a franchisor's referring prospective franchisees to "shills" for phony references would also be outlawed under the revised Rule.

*"Of key concern to almost everyone in the franchise community is whether the FTC Franchise Rule will be revised so as to require franchisors to disclose 'financial performance information' . . . as the states, through NASAA, are currently considering. The answer? No."*

As noted earlier, if the FTC Franchise Rule is revised as suggested in the NPR—and it almost certainly will be—then the UFOC disclosure format will be the only one available to franchisors to satisfy their disclosure obligations. But the revised rule would require additional and modified disclosures beyond those mandated today by the UFOC Guidelines, leading certain pundits to refer to the FTC's proposed disclosure requirements as "UFOC plus."

To begin with, the disclosure document's "cover page" would be completely different from that currently required by the Rule, bringing it more in line with the franchise-regulating states' cover page requirements. UFOC Item 1 would be expanded to require disclosure concerning the franchisor's parent. Item 2 would similarly require disclosure as to the business experience of the franchisor's parent's personnel who will have management responsibility relating to the offered franchises.

UFOC Item 3 would "enhance" the current UFOC requirements by requiring disclosure of litigation involving the franchisor's parent and, most critically, by requiring franchisors to disclose pending franchisor-initiated lawsuits against franchisees on issues involving the franchise relationship (currently both the FTC Franchise Rule and the UFOC Guidelines require franchisors only to disclose suits that franchisees have filed against the franchisor). " . . . (T)he Commission is persuaded that franchisor-initiated suits may reveal material information to a prospective franchisee," states the NPR. "A pattern of such suits is highly material to a prospective franchisee because it is another source of information from which prospective franchisees can assess the quality of the relationship with the franchisor and likelihood of their own success." Note, however, that only pending franchisor-initiated lawsuits will have to disclosed; there will be no requirement that franchisor-initiated suits be disclosed for a full ten years.

*"If the FTC Franchise Rule, as revised, modifies the UFOC disclosure requirements as outlined herein, what will happen to the franchise-regulating states' UFOC requirements (as contained in the NASAA-promulgated 'UFOC Guidelines')?"*

UFOC Item 12 would be revised so that franchisors not granting territorial exclusivity to their franchisees would have to state in their disclosure documents: "You will not receive an exclusive territory. (Franchisor) may establish other franchised or company owned outlets that may compete with your location."

While not mandating that franchisors disclose to prospective franchisees any financial performance information, the proposed revisions to the FTC Franchise Rule would require franchisors to disclose that the law permits them to make such financial performance disclosures (according to the NPR, there is a common misrepresentation that the FTC Franchise Rule actually prohibits franchisors from disclosing financial performance information).

Finally, the proposed revisions to the FTC Franchise Rule would revise UFOC Item 20 (in which all terminated, reacquired, transferred and non-renewed franchises must be identified) to eliminate the "double counting" problem inherent in the current disclosure format.

Which brings us to the key question. If the FTC Franchise Rule, as revised, modifies the UFOC disclosure requirements as outlined herein, what will happen to the franchise-regulating states' UFOC requirements (as contained in the NASAA-promulgated "UFOC Guidelines")? Will franchisors have to comply with two sets of UFOC disclosure obligations—those imposed by the Federal Trade Commission (in states where no franchise registration/disclosure law is extant) and those imposed by the franchise-regulating states? The answer is, probably not. For as § 436.11 of the revised FTC Franchise Rule will make clear:

> The FTC does not intend to preempt the franchise practices laws of any State or local government, except to the extent of any inconsistency with this Rule. A law is not inconsistent with this Rule if it affords prospective franchisees equal or greater protection, such as . . . more extensive disclosures.

Accordingly, since it will likely be argued that the revised FTC Franchise Rule will, in fact, afford to prospective franchisees "more extensive disclosures," the FTC Franchise Rule (as revised) will likely be deemed to pre-empt current state UFOC requirements.

Stay tuned. The FTC has signaled that sometime early in 2001 it will release its final version of the revised Rule, which will then be voted on by the FTC's Commissioners (after a brief comment period). After that, it is likely that a brief ramp-up period will be afforded for franchisors to come into compliance with the new Rule's edicts before it formally takes effect. And when will that be? This author's guess—sometime in early 2002.

## Endnote

1. 16 C.F.R. pt. 436

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# Corporate Governance and Business Formation Difficulties in New York State: A Call for Legislative Action

By Frederick G. Attea

A state's corporate laws are symbolic and reflect a legislature's attitude towards business. Legislative responsiveness to business needs is as much a part of the commercial legal landscape as state taxes. The last decade confirmed the national perception that New York State was ineffective in attracting new businesses or creating jobs. In a recent survey of 3,600 small- to medium-sized businesses, 77 percent indicated that it is more difficult to do business in New York than in other states. New York's lackluster legislative record in dealing with corporate governance and business formation has greatly contributed to its dismal reputation in corporate America, to the point that New York now even lags behind many non-commercial states in cutting-edge business laws.

Perhaps the constituency being served the best by our legislature's failure is the residents of the state of Delaware. Indeed, New York's lawyers routinely organize New York business under Delaware law. Over one-half of Fortune 500 companies and companies listed on the New York Stock Exchange are incorporated under Delaware laws. They pay as much as $150,000 per year for the privilege of being governed by Delaware's rational legislation and its efficient and expert judicial system. Delaware collects nearly *one-half billion dollars annually* in corporate franchise taxes alone—and that does not include recurrent filing fees. One need only recall that in 1995 New York was forced to pay the state of Delaware about $350 million in unclaimed dividends, interest, and other payments because these amounts, under federal law, belong to the state in which the corporation is organized—not the state where the corporation does business or where the shareholder resides. There was some expectation that this windfall to Delaware would have provided the New York legislature with sufficient incentive to reassess its attitude toward making New York's laws more hospitable to business. Regrettably, that did not happen.

The 1990s illustrated how the New York legislative process can frustrate business expectations.

1) Attempts by various business and bar associations in New York State to modernize the New York Business Corporation Law, a creature of the early 1960s, were stalled by an interminable legislative process. After several futile piecemeal efforts, a comprehensive bill was introduced in 1994. That bill did not become effective until 1998, and even as adopted, the law fell short of the mark in several major respects. In contrast, Delaware, on a continuous basis, refines its laws to meet the ever-changing needs of business.

2) A bill to permit the formation of limited liability companies was introduced in the New York legislature in early 1992. At that time only a handful of states had similar legislation. There was hope that if New York were to respond quickly, the state might gain some recognition for responsiveness to business needs. That hope vanished as the New York legislature diverted its efforts to protracted budget battles. When New York's limited liability company law was finally adopted, 46 states and the District of Columbia had already enacted similar legislation.

3) The "publication game" placed New York State at a new low during the 1990s. The legislature tied its reform of outdated limited liability partnership laws and adoption of limited liability company act legislation to a new, inexplicable publication requirement. Incredibly, every entrepreneur, as a condition to organizing such a company, would have to publish information about the new enterprise in certain newspapers for six weeks. Initially, the cost for this publication ranged from $400 upstate to over $2,000 downstate per business formation; it now ranges from $200 to $1,500. No one, including legislators, has been able to provide a rationale for the publication requirement. Based upon the range of publication costs, demographics, and the number of LLPs and LLCs that have been formed, compliance with the publication requirement has probably cost New York entrepreneurs somewhere between $50 million and $90 million, and they will continue to spend at the rate of $15 million to $20 million per year to furnish these unnecessary newspaper notices. A requirement such as this reveals the lack of understanding that even New Yorkers must compete in a global economy. Perhaps one way to put the publication costs in perspective is that the funds to be spent on useless newspaper notices could fund full scholarships to SUNY on an ongoing basis for 2,500 students or establish a fund to attract new business and jobs to New York.

4) The ultimate embarrassment to the New York business legislative scheme remains § 630 of the Business Corporation Law. Despite 40 years of attacks, this section has been preserved for political purposes. That statute makes each of the ten

largest shareholders of its non-public New York corporations personally liable for all unpaid wages and salaries. *No other state has such a law* or anything remotely similar. This liability may fall on shareholders who have had no part in management, never served on the corporation's Board of Directors, never received one penny from the corporation, and may not even be aware that they are among the ten largest shareholders. This relic of the Depression remains on the books despite the subsequent adoption of other New York laws that provide effective remedies to unpaid wage-earners and despite countless commentaries regarding its unfairness. It is the single most important reason why New York shareholders decide to incorporate in Delaware.

5) The New York legislature has been unresponsive to the needs of volunteer directors who serve on boards of directors of not-for-profit corporations, an area of overwhelming commercial significance. Liability concerns often make recruitment of the best qualified candidate difficult if not impossible. In New York, a volunteer director has a greater risk of liability exposure than a director of a profit-making corporation. Since the early 1980s, proposed legislation to give a not-for-profit director the same protection as is provided by other modern state statutes has been ignored. The only response is § 720(a) of the Not-For-Profit Corporation Law, which in essence is of little value. The legislature has never advised why it fails to protect those volunteers who act in good faith and without personal gain, at least to the extent that they protect the same individuals in the business corporation context.

6) Legislation recognizing the validity of digital signatures in e-commerce settings was introduced in the legislature in 1996. It was captive to the legislative process until finally adopted in 1999, long after most progressive states adopted comparable legislation. Will the millennium bring about any different legislative attitude? Initially, the answer seems to be a resounding "no." Revised article 5 of the Uniform Commercial Code concerning letters of credit has been adopted by most modern commercial states. New York is one of seven states that has yet to act. Although this may not have significance for the average person, it is critically important in business and banking transactions, especially international commerce. The proposed legislation has been languishing in the legislative process for nearly three years. The same is true of revised articles 3 and 4 of the Uniform Commercial Code, which deal with commercial paper, checks, and the check clearing process. New York is one of only three states that have not adopted these revised articles.

7) The New York State Bar Association has been working on legislation to permit the formation of Business Trusts, a form of organization useful to certain specialized businesses. This is the third year that such proposed legislation is still in the legislative hopper.

New York must reassess its approach to legislation governing business. The New York experience is not as much a commentary on the talent and dedication of legislators as it is a comment on the legislative process. The New York legislative process is often justified by claims of fostering consumerism and protection of investors. These excuses miss the point. Delaware laws protect investors and consumers; New York's outdated laws do not protect anyone. The loss of jobs is hardly a consumer's dream. The changes can be brought about immediately and will help local entrepreneurs who are an increasingly important part of the state's economic fabric.

A simple start would be to follow Assemblyman Robin Schimminger's lead, and, immediately and with great fanfare, abolish § 630 of the Business Corporation Law that makes shareholders personally liable for unpaid wages. The publication requirements for new businesses should be immediately abolished. These funds could then be channeled to foster economic growth. New York should adopt the updated versions of the Uniform Commercial Code instead of always being at the tail end of any updating effort.

These changes should not just be temporary fixes, but signs of a new attitude. The relevant legislative committees should be proactive, not reactive. If this requires a change in the committee mandates of its composition, let it happen.

Perhaps the legislature should rate its corporate law committees by results. If New York has a poor reputation for business, is not attracting investment, and doesn't show job growth, a serious self-assessment is in order. It's time for legislative leadership.

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# How (Not) to Represent a Bank

By David L. Glass

> *Where were these professionals, a number of whom are now asserting their rights under the Fifth Amendment, when these clearly improper transactions were being consummated?*
>
> —Judge Stanley Sporkin[1]

> *About half the practice of a decent lawyer [consists of] telling . . . clients that they are damned fools and should stop.*
>
> —Elihu Root[2]

## I. Introduction

Representing a bank[3] as outside general counsel can be among the most desirable and attractive of engagements for a law firm. Banks have deep pockets; a plethora of customer-paid transactional work; a federal safety net to protect them from failure; and a mind-numbingly complex thicket of regulations, designed to keep their counsel intellectually challenged (and well-fed). Furthermore, they can be among the most loyal (or, less charitably, captive) of clients, precisely because of the complexity of bank regulation. To represent a bank effectively requires that the attorney have the "big picture" of the bank's business needs and regulatory environment.[4] Thus, in the absence of a compelling reason to change, the bank's established outside counsel usually will have the inside track in procuring more work in the future.

For many of the same reasons, however, the representation of a bank can be fraught with pitfalls for the unwary or the complacent. In particular, the rash of thrift institution (i.e., savings & loan and savings bank) failures in the 1980s and early 1990s, and the resultant cost to the American taxpayer,[5] significantly raised the stakes for attorneys who undertake to represent banking institutions. Prior to the thrift crisis, it was generally accepted that a bank attorney was responsible only to her client.[6] And the concept of privity protected attorneys generally from malpractice suits by third parties. In the rare case where a court held an attorney liable to a third party, the usual rationale was that the third party was intended to be benefited in some way by the attorney's performance.[7]

Thus, before the thrift crisis bank attorneys

> . . . felt safe under a shield of professional ethics they believed limited their liability and made them accountable only to the officers and directors of the [banks] that hired them. They had no idea that government agencies would hold them liable for actions not contemplated by those professional codes and seek to make them responsible to the public at large and to federal regulators acting on the concerns of the public.[8]

However, the thrift crisis resulted in a public outcry to punish the wrongdoers—not to mention an unseemly scramble by some members of Congress to point the finger at someone, anyone, other than themselves and the wrong-headed laws and policies that caused the crisis in the first place.[9] Thus, in the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA),[10] the Congress for the first time created a statutory basis for liability of attorneys and other "institution affiliated parties" (IAPs). The test is whether the attorney "knowingly or recklessly" participated in any violation of law or regulation, breach of fiduciary duty, or unsafe or unsound practice, which caused or is likely to cause more than a minimal loss to, or adverse effect upon, the bank.[11]

The IAP concept was rooted in the recognition that adverse economic conditions, and even outright fraud, are seldom the sole cause of a bank's decline and failure. In a 1988 study, the Office of the Comptroller of the Currency (OCC) concluded that "all but 7% of the failed problem [national] banks also had significant internal problems related to management . . . poor management and other internal problems are the common denominator of the failed and problem banks."[12] Judge Sporkin's now-famous dictum, quoted above, closed the liability loop. Recognizing that the infamous Charles Keating had attempted to sanitize his looting of the Lincoln Savings & Loan by surrounding himself with high-priced lawyers and accountants, Judge Sporkin was asking why these professionals did not intervene to correct the mistakes of management. His question was, as we have seen, not merely rhetorical.

The Kaye, Scholer case, in particular, sent a seismic wave through the banking bar. In that case, one of many cases stemming from the failure of Keating's Lincoln Savings & Loan, the Office of Thrift Supervision (OTS), as the primary regulator, zeroed in on three partners of the firm, whom it regarded as IAPs because of their close involvement with Lincoln's operations. But the OTS went beyond that: it issued an administrative order freezing the assets of the entire firm, pending resolution of its complaint, which alleged damages of $125 million. Predictably, Kaye, Scholer caved in just a few days later, settling the case for $41 million.[13] And the

Kaye, Scholer case was not an isolated example: the federal regulators have brought damage actions totaling in excess of $1.5 billion against law firms that represented failed banks and thrift institutions, apart from the recoveries sought against directors, officers and other insiders.[14]

So the message is clear: the ground rules have permanently changed. In particular, the representation of a bank involves, explicitly or implicitly, undertaking a duty to a much larger constituency: not just the bank and its stockholders, but its depositors and regulators—and, by extension, the public at large. And this is true of the local firm representing a community bank to the same extent as, if not more than, the high-powered law firm with a money center bank client. Community banks, by definition, operate in small, well-defined markets, and understand their mandate to be serving those markets. But since the bank and the law firm both may be "the only game in town," counsel must be ever alert to the danger of falling into excessively cozy relationships, as well as outright conflicts.

Part II of this article presents a framework for the bank attorney to evaluate the scope of her duties in the brave new world of post-thrift crisis bank representation. Part III provides a few practical examples, some drawn from actual cases and some hypothetical, to illustrate how the attorney can apply this framework in day-to-day practice. The article concludes with a few observations on how (not) to represent a bank.

## II. The Scope of Bank Counsel's Duties: A Framework

For the reasons discussed above, bank counsel assumes, explicitly or implicitly, duties that go beyond those undertaken by counsel to an ordinary business corporation. First and foremost, a law firm that undertakes to act as counsel to a bank must possess the requisite expertise. To the extent that it does not, it must so advise the client and refrain from the representation. Second, an attorney acting as general counsel to a bank has an affirmative, and paramount, duty to protect his client from unsound or questionable practices, beyond merely assuring compliance with the letter of the law.

Thanks to FIRREA, both of these roles encompass duties to the public as well as to the institution. The issue is not so much that FIRREA imposes a higher standard of care on the bank attorney than on the corporate attorney generally. Rather, the nature of bank representation is such as to broaden the *scope* of the attorney's duties, to encompass, explicitly or implicitly, certain specific undertakings. These have been identified as:

1) the duty to represent the bank itself as the client, rather than the individual directors (or trustees, in the case of a mutual institution), management or shareholders;

2) the duty to advise on the entirety of a transaction or of a course of conduct (i.e., it is not sufficient that each element of the transaction or course of conduct be within the bounds of law and regulation, if the transaction or course of conduct as a whole may pose a threat to the safety and soundness of the bank);

3) An affirmative duty to notify directors, officers and other agents of the bank of existing or potential violations of law and regulation, unsafe and unsound practices, or breaches of fiduciary duty; and,

4) A duty to refrain from assisting in, and to advise and warn the bank regarding, breaches of fiduciary duties owed to the bank by others.[15]

The following discussion expands briefly upon each of these points.

### A. The Client Is the Bank

To say that the bank is the client seemingly is to state the obvious. Obvious or not, this principle is expressly articulated in the Model Code of Professional Responsibility (CPR).[16] In practice, however, counsel may, all too easily, fall into the trap of regarding the individual officers and directors with whom he may deal on a daily basis as the client. After all, the bank is incapable of acting as an entity, except through the words and deeds of these people. But the interests of these persons may not be identical with, and indeed may be adverse to, those of the bank itself. To illustrate, a bank policy compensating loan officers for new originations may create an incentive to write new business, with insufficient regard to whether that business is safe and sound within the context of the bank's overall lending policy and portfolio.

Not the least of counsel's problems is that these same individuals authorized her engagement, and have the power to dismiss her. At the same time, unless the bank is closely held, its shareholders, for whom she is presumably acting when she represents the bank as an entity, are most likely unaware of her existence, and in any event indifferent regarding who the bank retains as counsel.[17] This inherent ambiguity apparently induced Louis Brandeis to remark, when asked whom he represented in the face of numerous conflicting interests, "I represent the situation."[18]

A related issue is the potential for conflicts in the firm's representation of clients that may have dealings with the bank. Fundamental to the law firm's duty to its client is that it must not undertake representations that conflict with or compromise its paramount duty to safeguard the safety and soundness of the bank. Where the involvement of the law firm and its members in the bank and its management is pervasive—as may often be the case with community banks—representations that might otherwise be relatively innocuous become freighted with the appearance of impropriety, which the CPR admonishes attorneys to avoid. Thus, it is imperative that the firm adopt a coherent conflicts policy, and that its members be required to adhere to this policy.

### B. The Entirety of the Transaction or Course of Conduct

The bank attorney has an affirmative duty to base her advice on the entirety of a transaction or course of conduct. Stated conversely, it is not sufficient that a particular transaction be legal and enforceable. She has a duty to inquire beyond the four corners of the document to the context in which the transaction takes place. Even though the transaction complies with law, in operation could it jeopardize the safety and soundness of the bank? Could it result in a breach of fiduciary duty? If these questions are answered in the affirmative, the attorney has a duty to advise against the transaction or course of conduct, resisting as necessary the imprecations of management that the transaction allegedly will be profitable and is not technically illegal. She cannot simply be a scrivener, creating documents to order while ignoring the implications of the resulting transaction for the bank's safety and soundness.

Stating the duty in this way appears to imply that the attorney is responsible to insure the bank against risk. That is not the point. Banks are in the business of taking prudent risks, and the judgment of what risk is acceptable (not to mention the accountability for taking unacceptable risks) ultimately resides with management. Rather, the attorney's role is to confirm that assessments of risk take place within a coherently articulated framework, as defined by law and in the written policies of the bank. Thus, in the first instance she must work with management to insure that proper written policies are in place, designed to promote safety and soundness. Thereafter, she must evaluate each transaction or undertaking not only for compliance with the applicable law or regulation, but also for compliance with the bank's policies.

It follows from this that a bank's general counsel has a duty to make certain that policies and procedures are in place that govern lending and other risky activities. To be sure, the content of such policies is a management prerogative, within broad parameters. But it is incumbent on the attorney to make sure that 1) such policies are duly adopted, and 2) their content meets at least the minimum criteria of law and sound banking practice. Once a bank has policies in place, counsel has an ongoing duty to review them and assure compliance with law and sound practice.

Most important, it falls to counsel to make certain that the bank has policies and procedures in place to guard against lending limit violations. Of all the laws affecting bank safety and soundness, lending limits are perhaps the most basic. Their purpose is to insure that a bank does not incur a degree of risk to a single borrower that is large enough to threaten its soundness. For this reason, lending limit statutes impose limitations as a percentage of a bank's total assets or capital.[19] And those limitations are aggregated as to a borrower or group of related borrowers, to prevent inadvertent overexposure to what is essentially the same credit risk.

### C. Affirmative Duty to Warn and Advise

The nature of banking and bank regulation imposes an affirmative duty on counsel to warn and advise management when he perceives an actual or potential violation of law or regulation, breach of fiduciary duty, or unsafe or unsound banking practice. Further, there is an affirmative duty to disclose to the client any information which counsel has in his possession and which might affect a decision of bank management. Unless his advice encompasses all relevant information known to the attorney, that advice would be misplaced at best.

At the very least, the client must be warned when 1) there is a current or prospective violation of lending limits; 2) the bank's security on a loan is inadequate or compromised in some way; 3) there is a potential breach of fiduciary duty; 4) there is reason to be concerned regarding the honesty or solvency of a proposed counterparty; 5) there is a change in law or regulation that affects the client.

### D. Advise Against and Refrain from Assisting in a Breach of Fiduciary Duty

Lastly, bank counsel has a duty to avoid and advise against situations in which her actions may contribute to the breach of a fiduciary duty owed by another to the bank. The attorney must not cooperate in an act that constitutes a breach of duty, and must advise or warn management of the potential for such an act.

But the duty goes deeper than that. For example, suppose that an attorney has identified a proposed transaction as being potentially unsafe and unsound, even if technically legal. He notifies management of his concern. Management elects to proceed with the transaction notwithstanding. At this point, the duty to refrain from assisting in a breach of fiduciary duty requires a further action by the attorney. Depending upon the circumstances, it may call for him to go "up the ladder" to senior management or the Board, as necessary.[20] If the decision is made to proceed, the attorney should document for the file that the transaction was undertaken contrary to his advice. In an egregious case, it may be incumbent upon the attorney to resign the representation.[21]

## III. Some Practical Problems

In this section a few hypothetical problems are presented, to illustrate how they might be resolved by applying the above principles. Obviously, these examples are not, and are not intended to be, exhaustive.

### Problem 1

You have learned that the bank intends to undertake a substantial lending relationship with a new borrower. Another attorney at your firm is preparing the documents. Upon reviewing them, you become concerned that there is the potential for exceeding the bank's legal lending limit, especially since the credit line allows for additional drawdowns under certain conditions. You raise your concern with the bank's senior vice president. "Oh, don't worry," she replies. "Charlie is our most experienced loan officer, and he knows how to calculate lending limits. It's really a matter of arithmetic, not a legal question."

### Answer

The computation of lending limits may be a mechanical, arithmetic function; but the responsibility to assure compliance with lending limits, as with other regulatory requirements, falls to counsel, and this duty is not delegable. At the least, you need to satisfy yourself that policies and procedures to insure lending limit compliance are in place. You might also put a memo in the loan file, to flag the need to revisit the lending limit when and if there are further drawdowns.

### Problem 2

Jones, a member of the bank's board of directors, is a professional real estate appraiser. The bank recently has funded a substantial loan to the developer of a proposed shopping center. You have just learned that (you guessed it) Jones' firm provided the very appraisal upon which the bank based its determination of how much to lend. Furthermore, Jones actively participated in the discussion of the loan, and voted to approve it. Under state law, self-dealing by a bank director may constitute a misdemeanor. The bank's president comes to you, expresses his concern that the bank examiners might question Jones' participation in the lending decision, and instructs you to write a memo for the file arguing that this is not a violation of law. Upon reviewing the statute, you conclude that it is at least possible to make an argument that Jones's action was not illegal ("no controlling legal authority," in modern parlance). Do you write the memo?

### Answer

At the outset, there is no doubt that Jones's action breached his fiduciary duty to the bank, whether or not it was a misdemeanor under the statute. From your perspective, the point is that it compromised his ability to act in a disinterested manner in voting on a sizeable loan. If you had been aware of this situation before the fact, you should have advised the bank that Jones must recuse himself from any meeting at which that loan was discussed or voted upon. Thus, two actions that are clearly called for are 1) to change the bank's loan review procedures to require that someone (credit analyst, compliance officer, or in-house attorney) flag any potential conflicts early in the review process; and 2) to remind the board, in writing, that they must refrain from discussing or voting on any transaction in which they have an interest.

However, the horse is now out of the barn, and you have to give your client an answer. In the author's view, you should refuse to write the memorandum. Under the hypothetical facts, it appears that the purpose of this memorandum is not to protect the bank, but rather to mitigate any potential penalties against Jones. By writing this memorandum, therefore, you are effectively supporting or excusing the director's breach of his fiduciary duty to your client. You may expect that you, as well as he, will find yourself in the regulators' sights if things go bad.

### Problem 3

Notwithstanding your refusal to write the memo (Problem 2), the bank asks you to represent it in a bank examination. You are to serve as the primary contact point for the examiners as they raise questions regarding compliance and legal issues. However, you are specifically instructed not to disclose that the firm that did the appraisal is owned by a bank director. Are you obligated to do so nonetheless?

### Answer

Because this information has been given to you in confidence in the course of your representation, it is covered by the attorney-client privilege. Certainly you have a duty not to intentionally mislead the bank examiners, but there is no duty to make *affirmative* disclosure of privileged information.[22]

### Problem 4

After a board meeting, a director of the bank hands you a piece of paper with the comment, "I circulated this among the board, and it is causing quite a to-do.

What do you think of it?" You examine the paper and see that it is a letter, on the letterhead of your firm, from a senior partner who is also a director of the bank. It reads as follows:

> Joe, I'm concerned with the way the Board second-guesses every little thing Harry does. Harry's like a son to me, and I think he's doing a great job as president, but we're really getting in his way. As long as the Bank is doing well, let's cut him some slack. It's not our job as directors to get in management's way when they're trying to do their job. I want the Monday morning quarter-backing to stop.

**Answer**

It's true that the directors do not run the bank on a day-to-day basis, but your partner is treading on dangerous ground suggesting that "Monday morning quarterbacking" is not appropriate as long as the bank is doing well. The directors have an absolute fiduciary duty to oversee and "second guess" the actions of management, without regard to how well the bank is doing. In its study of the causes of bank failures, the OCC highlighted inadequate oversight and control by the board of directors as a significant factor in the great majority of failures. The OCC noted that, among other problems, weak board oversight results in placing too much power in the hands of a single individual, such as the CEO.[23] Conversely, in contrasting failed banks with banks that remained healthy despite economic downturns, the OCC noted that "without exception, [healthy banks] emphasized the importance of an active and involved board of directors."[24]

Thus, unless you act promptly to counteract your partner's letter, you leave your firm and yourself in a position in which the regulators would have no trouble finding that you "knowingly" contributed to "a breach of a fiduciary duty" that caused "more than a minimal loss, or an adverse effect" upon the bank, if things should later not go so well.[25] The firm should immediately write to every director, repudiating the letter and specifically reaffirming his duty to exercise oversight of management, in good times as well as bad. (Putting the senior partner out to pasture might not be a bad idea, as well.)

**Problem 5**

You have been asked to sit in on a meeting of the bank's Loan Review Committee, which has primary authority for approving all lending proposals over a certain size. You are told that your mandate is solely to listen to the terms of the transactions that are approved, so you can prepare the loan documents. In the course of the meeting, the Committee discusses and approves a joint venture with a real estate developer (your bank has direct investment authority under applicable law, and you are comfortable that the investment is permitted under law). The developer owns the land, and the agreement guarantees him a profit on the sale of the land into the joint venture, without regard to its appraised value. Furthermore, the bank's lien is expressly subordinated to that of another lender.

You are troubled by these terms, but hesitant to appear to question the judgment of the board. You console yourself that this is really a business, not a legal judgment; that your role is solely to prepare the documents; that the directors are seasoned professionals who know what they're doing; and that no one has asked for, or expects you to offer, your advice.

**Answer**

The ultimate judgment of whether to enter into the transaction on these terms is properly a business judgment, but that does not absolve counsel from all responsibility. Nor is it relevant that your advice was not specifically sought. Once counsel is present at such a meeting he has an affirmative duty to advise the Committee when he perceives a potentially unsafe and unsound practice, not to mention a potential violation of law, whether his advice was specifically requested or not. His proper function was, at the least, to listen to the discussion with a critical ear and advise the Committee when it might be straying into dangerous territory, either legally or on general safety and soundness grounds.

The "scrivener" defense—i.e., that the attorney was retained solely to reduce the terms of the deal to writing—has worked in some cases, but only when counsel was able to persuade the court that the scope of her engagement was, indeed, limited to particular transactions. Be assured, however, that it will not work where you, or your firm, have undertaken to be general counsel.

## IV. Conclusion: How Not to Represent a Bank

In conclusion, "these few precepts in thy memory":[26]

- If you're being paid only to prepare the documents, it is not your job to question the terms of the deal.
- Lending limits are not your department. Lawyers are not trained to crunch numbers.
- The bank's policies, procedures and by-laws are not your business, as long as the bank complies with the law.

- You don't need to stay up to date in bank regulatory law. You can learn what you need to know "on the fly."
- Don't bother with internal conflict checks when the bank asks you to work on a new transaction. What you don't know can't hurt you.
- The board and the management presumptively know more than you do about their business.
- Always do what management tells you. After all, they're paying the freight.
- And this above all, to thine own conscience be not true.

Follow these precepts carefully, and some day you too may experience the fun, excitement and intellectual challenge of trying to persuade the bank regulatory authorities, or a court, that you should not be held accountable when things fall apart.

## Endnotes

1. *Lincoln Savings & Loan Association v. Wall*, 743 F. Supp. 901, 919 (D.D.C. 1990).
2. As quoted in Geoffrey Z. Hazard, *Doing the Right Thing*, 70 Wash. U. L.Q. 691, 699 (1992).
3. For convenience, the term "bank" is used, but should be understood to include all FDIC—insured institutions, including mutual as well as stock savings & loans and savings banks. Furthermore, the author believes that the principles discussed herein are also useful for the attorney representing non-insured banking institutions, such as United States branches and agencies of foreign banks.
4. As discussed below, one of the principal ways counsel may get herself in trouble is by construing her role to be confined to advising on the narrow legality of a particular transaction, without considering the "big picture."
5. The ultimate cost to the taxpayer initially was estimated as being as high as $1 trillion. *See, e.g.*, Carl Felsenfeld, *The Savings & Loan Crisis*, 59 Fordham L. Rev. 57 (1991). Since the losses have occurred over time, however, estimating the discounted present value of the projected losses may be a more realistic approach. On this basis, the consensus view places the final tab at somewhere around $150 billion. *See* Martin Lowy, High Rollers: Inside the Savings & Loan Debacle 237 (Praeger, 1991) ("Lowy"). In any event, by any measure the losses clearly were huge.
6. *See, e.g.*, *Savings Bank v. Ward,* 100 U.S. 195 (1879).
7. *See* Christopher G. Sablich, Note: Duties of Attorneys Advising Financial Institutions in the Wake of the S&L Crisis, 68 Chi.-Kent L. Rev. 517, 518 (1992) ("Sablich"), and cases cited therein.
8. Michael M. Neltner, "Government Scapegoating, Duty to Disclose and the S&L Crisis," 62 U. Cinn. L. Rev. 655, 655 (1993) ("Neltner").
9. *See* Lowy, *supra* n. 5, for a cogent discussion of how the root cause of the thrift crisis was not a handful of scoundrels, but a series of laws and regulations over many years that attempted to deny the realities of the market.
10. Pub. L. 101-73 (Aug. 9, 1989).
11. 12 U.S.C. § 1813(u)(4).
12. Office of the Comptroller of the Currency (OCC), *An Evaluation of the Factors Contributing to the Failure of National Banks: Phase II*, 7-3 O.C.C.Q.J. 9 (September 1988) (hereafter "Failed Bank Study").
13. *See* Neltner, *supra* n. 8 at 694, for a discussion of the specific allegations in the Kaye, Scholer case.
14. *See* Matthew G. Dore, *Presumed Innocent? Financial Institutions, Professional Malpractice Claims, and Defenses Based on Management Misconduct*, 1995 Colum. Bus. L. Rev. 127, 131 n. 6.
15. *See generally*, Sablich, *supra* n. 7.
16. *See The Lawyer's Code of Professional Responsibility,* EC 5-18 (hereinafter "Code").
17. H. Lowell Brown, *The Dilemma of Corporate Counsel Faced with Client Misconduct: Disclosures of Client Confidences or Constructive Discharge*, 44 Buffalo L. Rev. 777, 781 (1996) ("Brown").
18. As quoted in Brown, *supra* n. 17 at 778 n. 3.
19. *See, e.g.*, 12 U.S.C. § 84 (national banks limited to lending no more than 15 percent of capital and surplus to any one borrower or related group of borrowers); Banking Law § 103 (same rule for New York banks).
20. *See* ABA Model Rules of Professional Conduct 1.13 (attorney may proceed as "reasonably necessary" where a corporate officer engages in a violation of law or an act detrimental to the organization, including, "if warranted by the seriousness of the matter, referral to the [board of directors].")
21. *See* Brown, *supra* n. 17 at 791. Resignation should not be undertaken lightly, however, because of the potentially adverse signal it sends to those who deal with the bank. *See id*. at 781. Thus, the conduct triggering the resignation must be truly egregious. *Id.* at 841 n. 238.
22. *See* Brown, *supra* n. 17 at 854-5.
23. *See* Failed Bank Study, *supra* n. 12 at 9-10.
24. *Id*. at 25.
25. 12 U.S.C. § 1813(u)(4).
26. William Shakespeare, Hamlet, act III., sc. 1, ln. 58.

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# SEC Comment: Resales of Private Placement Securities

By Guy P. Lander

## I. Introduction

Regulation D was intended to provide certainty for the availability of the issuer's exemption, but it did not address the availability of an exemption for resales of securities acquired by investors in a private placement.

Securities issued in a private placement are characterized as "restricted securities" and can be resold in the United States under Rule 144, § 4(1½), Rule 144A, Regulation S or a registration statement.

## II. Statutory Framework

Section 5 of the Securities Act of 1933, as amended (the "Securities Act"), makes it unlawful for any person, directly or indirectly, to sell or offer to sell securities in interstate commerce unless a registration statement is in effect for those securities.

Under § 4, the registration provisions of § 5 do not apply to:

A. Section 4(1): transactions by any person other than an issuer, underwriter or dealer.

B. Section "4(1½)" [see below].

C. Section 4(2): transactions by an issuer not involving any public offering.

D. Section 4(3): transactions by a dealer, except (1) transactions effected less than 40 days after thefirst offering to the public, (2) transactions effected less than 40 days after effectiveness of a registration statement, and (3) transactions as a participant in a distribution selling securities from an unsold allotment.

E. Section 4(4): brokers' transactions executed upon customers' orders, but not the solicitation of the other (i.e., buy) side.

## III. Section 4

The operation of § 4 is intricate:

A. Section 4(1) exempts all transactions by every person other than an issuer, underwriter or dealer.

B. Section 4(3) exempts all dealer transactions except (1) transactions within 40 days of a public offering of the security, (2) those within 40 days after the effectiveness of, or within 40 days after commencement of the first bona fide offering after the effectiveness of, a registration statement (or within such shorter period as is prescribed by SEC rule), and (3) offers and sales of unsold allotments as a participant in a distribution.

C. Together, §§ 4(1) and 4(3) exempt all transactions by anyone other than the issuer (the term "issuer," in this usage, NOT including its control persons), an underwriter, or a dealer trading (as broker or as dealer) in unsold allotments or within 40 days of the public offering of the security.

## IV. Underwriter

The problem is the scope of the term "underwriter." "Underwriter" is defined in § 2(a)(11) as "any person who has purchased from an issuer with a view to, or offers and sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking. . . . As used in this [definition], the term 'issuer' shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer."

If the prospective re-seller has bought the security from its issuer (or from one of the issuer's affiliates, i.e., controlling persons), did that prospective seller itself buy with a view to "distribution"—i.e., with a view to offering indiscriminately to members of the public? *Or* did that prospective seller offer or sell for the issuer in connection with an offering indiscriminately to members of the public? *Or* did that prospective seller have a participation in any such scheme?

Under these definitions, three types of transactions may be found to involve an "underwriter" and, therefore, require registration:

A. Resales of securities acquired in a private placement;

B. Sales of securities by controlling persons (sales of restricted securities and securities purchased in the open market which were held for a significant period of time);

C. Sales by a broker or anyone else on behalf of a controlling person.

For example:

A. A founder (one of several employees of the issuer) buys stock and then re-sells the stock to all the members of his weekend basketball league. His conduct evidences his "purchase with a view to distribution," so he's an "underwriter" and cannot avail himself of § 4(1).

B. A broker acts for a company's largest shareholder (and chief executive officer) in the sale of 5,000 shares of the company's stock in the open market.

The broker is offering and selling for a controlling person of the issuer in connection with a "distribution," so the broker is an underwriter (whether or not it's a non-exempt dealer) and cannot avail itself of § 4(1) *or* 4(3).

C. An institution has bought convertible debt under an "investment representation" in a bona fide private placement and then, when the stock starts to rise three or four months later, converts the debt into stock and sells the stock on the open market. The institution's conduct suggests the opposite of its "investment representation," so it's an underwriter and cannot avail itself of § 4(1).

## V. Rule 144

### A. Introduction

In response to the then lack of practical guidance, in 1972 the SEC adopted Rule 144, which set forth objective criteria for permissible sales of unregistered securities without registration. Rule 144 provides an exemption from registration for (a) the resale of restricted securities, (b) the resale of all securities of an issuer held by affiliates of the issuer, and (c) those who sell securities for the account of an affiliate. Two definitions under Rule 144 are particularly important:

1. An "affiliate" of an issuer is a person who directly or indirectly controls, is controlled by, or is under common control with the issuer.
2. "Restricted securities" are: (a) securities acquired directly or indirectly from an issuer or its affiliate in a transaction or chain of transactions not involving any public offering, (b) securities acquired from the issuer that are subject to the resale limitations of Regulation D or Rule 701(c) (relating to certain compensation plans), (c) securities subject to the resale limitations of Regulation D and acquired in a transaction or chain of transactions not involving any public offering, (d) securities acquired in a transaction or chain of transactions meeting the requirements of Rule 144A, or (e) equity securities of a domestic issuer acquired in a transaction or chain of transactions subject to Rule 901 or 903 under Regulation S.

When adopting the Rule, the SEC stated that three factors were important to determine whether a person is deemed not to be engaged in a distribution requiring registration:

1. The purpose and policy of the Securities Act is to protect investors and requires that there be adequate current information concerning the issuer;
2. A holding period prior to resale is essential to assure that those who buy under a private placement exemption have assumed the economic risks of the investment and are not acting as conduits for sale to the public of unregistered securities on behalf of the issuer; and
3. The impact of the particular transactions on the trading market.

### B. Conditions of the Rule

Under Rule 144, any affiliate (i.e., person controlling or controlled by or under common control with the issuer) or other person who sells restricted securities of an issuer for his own account, or any person who sells restricted or any other securities for the account of an affiliate of the issuer of such securities, shall be deemed not to be engaged in a distribution of such securities (and therefore not to be an underwriter thereof within the meaning of § 2(a)(11) of the Act) and shall be exempt from registration under § 5 of the Securities Act if either (1) all of the 6 conditions of the Rule set forth in paragraphs 1(a)-(f) below are met, or (2) the conditions of Rule 144(k) set forth in paragraph 2 below are met.

#### 1. (a) Current Public Information

The issuer must have been a reporting company under the Securities Exchange Act of 1934 (the "Exchange Act") for at least 90 days and must have filed all required reports for twelve months or for whatever shorter period it was required to file reports. The person proposing to sell securities or the broker through whom they are to be sold is entitled to rely upon a written statement from the issuer that all such reports have been filed, unless he knows or has reason to believe that the issuer has not complied with such requirements.

If the issuer is not a reporting company, specified portions of the information required by Rule 15c2-ll must be publicly available. This includes information on the nature of the issuer's business, products, services, facilities, names of the members of the board of directors, the issuer's most recent profit and loss and retained earnings statements, and comparable financial information for the last two fiscal years. This information may be made "publicly available" by providing it to brokers or market makers, to shareholders, or by publishing the financial information in a recognized financial service.

#### (b) Holding Period for Restricted Securities

A minimum of one year must elapse between the later of the date the securities were acquired from the issuer or from an affiliate of the issuer, and any resale of such securities under the Rule for the account of either the initial holder of the securities or any subsequent holder. This Rule permits a holder of restricted securities to tack his holding period to the holding periods of prior unaffiliated holders for purposes of meeting the one-year holding period. However, the one-year period does not begin until the purchase price is paid in full by the initial holder.

In certain instances, the Rule permits the seller to add his holding period to that of a predecessor holder or to his own holding period relating to other securities. The holding periods of pledger-pledgee-purchaser on default, donor-donee, settlor-trustee-beneficiary and descendant-estate-legatee may be tacked. Stock dividends, stock splits, stock acquired in recapitalizations, conversions or contingent issuances of securities may be tacked.

#### (c) Limitation on Amount of Securities Sold

The amount of restricted securities and other securities that may be sold by an affiliate of the issuer together with all sales of restricted and other securities of the same class by such person within the preceding three months cannot exceed the greater of: (1) one percent of the outstanding class or (2) the average weekly reported volume during the past four calendar weeks. The amount of restricted securities sold by any nonaffiliate of the issuer together with all other sales of restricted securities of the same class by such person within the preceding three months cannot exceed the same amounts set forth above for affiliates. The Rule requires that certain sales be aggregated for purposes of these quantity limitations, particularly if tacking is permitted.

#### (d) Manner of Sale

Sales under Rule 144 must be made in "brokers' transactions" within the meaning of § 4(4) of the Securities Act or directly with a market maker as defined in § 3(a)(38) of the Exchange Act. "Brokers' transactions" include transactions in which the broker (1) merely executes the sell order as agent and receives the usual and customary broker's commission, (2) generally does not solicit buy orders and (3) makes reasonable inquiry into the seller and the circumstances of the proposed sale.

#### (e) Notice of Proposed Sale

The seller must file a prescribed notice, Form 144, with the SEC and the principal exchange on which the securities are traded. However, no notice is required for sales during any three-month-period which do not exceed 500 shares or $10,000.

#### (f) Bona Fide Intention to Sell

The seller filing the notice described above must have a bona fide intention to sell the securities within a reasonable time.

### 2. Rule 144(k) Termination of Certain Restrictions on Sales of Restricted Securities by Persons Other than Affiliates

If at least two years have elapsed since the later of the date the securities were acquired from the issuer or from its affiliate, sellers who are neither affiliated with the issuer at the time of sale nor have been affiliated during the preceding three months may sell such restricted securities without complying with the Rule's requirement of current public information, limitation on amount of securities sold, manner of sale restriction and notice of proposed sale. In computing this two-year period, the rules for computing the holding period as described in paragraph (b) above apply.

### C. Documentation to Establish the Exemption

Although not required by the Rule, practitioners generally obtain a standard set of papers to document compliance with the Rule. These papers include (i) a seller's representation letter discussing whether such person is an affiliate, the filing of notice with the SEC, and the manner in which the securities are to be sold, (ii) a broker's representation letter, and (iii) a completed Form 144, if required.

### D. Non-exclusivity of Rule 144—Reselling Restricted Securities Outside Rule 144

As stated in Rule 144(j), the Rule is not exclusive, and sales of restricted securities may be made in accordance with other exemptions or by registration.

## VI. Section 4(1½)—Private Resales

Private sales of restricted securities outside Rule 144 (i.e., outside the public markets without waiting one or two years) are fairly common. Generally, the SEC has not objected when one private placement investor holding restricted securities privately negotiated and sold those securities to another, if the buyer agrees to hold them subject to the same restrictions as those that bind the seller. These private resales are structured similar to a § 4(2) private placement, but § 4(2) is inapplicable since by its terms it applies only to transactions by an issuer. The statutory exemption for these private resales is § 4(1), which exempts transactions by any person other than an issuer, underwriter, or dealer. The basis for this approach is that § 4(2) restrictions prevent a distribution for sales under § 4(2); therefore, they should also prevent a distribution for sales under § 4(1). Consequently, these private resales, based on § 4(1) with a § 4(2) structure, have been named § 4(1½) transactions.

To use the § 4(1) exemption, the purchaser in the private placement must avoid being characterized as an underwriter, i.e., the purchaser must not: (a) purchase the shares from the issuer in the private placement "with a view to their distribution," or (b) offer or sell the shares "for an issuer in connection with, the distribution of any security." If the purchaser is characterized as an "underwriter," he would destroy the initial private placement's § 4(2) exemption as well as violate the Act on his resale, because he would not be able to rely on § 4(1) when selling without registration.

In Rule 144, the SEC defined "restricted security" based on its view that a private placement purchaser that resells would be "taking from an issuer with a view to distribution" and, thus, be an underwriter selling without an exemption. However, the private bar reasoned that if there is no distribution, then there would be a valid § 4(1) exemption. Consequently, for limited resales from one private placement investor to another, to avoid a distribution, the private bar developed fairly standardized procedures similar to those used to ensure the availability of the § 4(2) exemption, i.e., resale restrictions, such as investment or nondistribution letters (containing basically the same representations and agreements as those provided by the original purchasers) and requirements for legal opinions. Restrictive legends placed on the certificates and stop transfer procedures remain in place from the initial private placement.

In effect, the use of the § 4(1½) restrictions keeps the privately placed securities outside the public markets for one to two years (unless registered), when they can be sold under Rule 144.

## VII. Rule 144A—Resales to Institutional Buyers

Rule 144A provides a nonexclusive safe harbor exemption from registration under the Securities Act for resales by persons other than the issuer of certain restricted securities to qualified institutional buyers (QIBs) without resale restrictions. Rule 144A, in effect, permits "underwritten private placements."

The Rule 144A scheme is as follows: issuer to dealer: the transaction is exempt under § 4(2); dealer to institutions: the transaction is exempt under Rule 144A by § 4(3); institutions back to dealer: the transaction is exempt under Rule 144A by § 4(1), for continuing re-sale within the group of QIBs.

Preliminary Note 7 to Rule 144A: a purchase by a dealer from the issuer with a view to re-sale under Rule 144A will not affect the availability of § 4(2), i.e., the dealer will *not* be classified as an "underwriter" by virtue of its intention to make immediate re-sales to QIBs.

The conditions of the Rule are:

A. **Qualified Institutional Buyers.** A qualified institutional buyer is any entity which owns or invests, on a discretionary basis, at least $100 million in securities of issuers unaffiliated with the buyer. An Exchange Act registered broker-dealer may be a qualified institutional buyer if (a) it owns or invests, on a discretionary basis, an aggregate of at least $10 million in securities of issuers that are unaffiliated with it; (b) it acts as a riskless principal for an identified qualified institutional buyer; or (c) it acts as an agent, on a nondiscretionary basis, in a sale to a qualified institutional buyer. Banks and savings and loan associations must have $25 million in net worth in addition to meeting the $100 million asset test.

B. **Notice of Possible Reliance.** The securities sold cannot, when initially issued, be fungible with exchange-listed or NASDAQ-traded securities.

C. The issuer, if neither subject to the statutory reporting requirements nor exempt from those requirements under Rule 12g3-2(b), must undertake to make prescribed information about itself available to each holder and to any prospective purchaser from a holder.

## VIII. Regulation S

Under Rule 905, equity securities of domestic issuers acquired from the issuer, a distributor or their affiliates in an offshore transaction under Rule 901 or Rule 903 of Regulation S, will be "restricted securities" within the meaning of Rule 144 (i.e., as a practical matter they must be re-sold under Rule 144 when re-sold in the U.S.), and offshore re-sales of such securities under Rule 904 will not terminate their "restricted" status.

## IX. Registration Under the Securities Act

If an exemption under the Securities Act is not available for the resale of securities by an affiliate of an issuer or by a person holding restricted securities, such securities must be registered under the Securities Act.

### A. Form S-3

Form S-3 is a streamlined form of registration statement. If the applicable requirements are met, it can be used by an issuer in an initial offering, by an affiliate to resell securities of an issuer, or by any person to resell restricted securities.

### B. Form S-1

Form S-1 is the form prescribed for use in all offerings where no other form is authorized. If Form S-3 is not available, resales of securities held by affiliates or resales of restricted securities held by any person have to be registered on Form S-1 (or Forms SB-1 or SB-2 for certain "small business issuers"). As a result of the lengthy disclosure required by Form S-1 and the review required by the SEC, registration on Form S-1 involves more time and expense than does registration on Form S-3.

**Guy P. Lander is a partner in the firm of Goodman Phillips & Vineberg. Mr. Lander is Secretary of the Business Law Section of the New York State Bar Association and former Chair of its Committee on Securities Regulation. He has written numerous articles regarding corporate law and securities law, and in 1999 authored the book *U.S. Securities Law for International Financial Transactions and Capital Markets.***

# SEC Interpretation: Use of Electronic Media

By Guy P. Lander

## I. Introduction

The SEC has released its long-awaited interpretation of the Use of Electronic Media (Rel. No. 33-7856, the "Release"). After nearly a year of senior SEC Staff members publicly discussing this project, the SEC has provided an interpretative release that is both less than originally promised and, in some areas, surprising. Overall, the Release covers three areas: (a) the use of electronic media to deliver documents under the federal securities laws, (b) issuer liability for Web site content, and (c) basic legal principles for conducting online offerings. The Release also provides examples elucidating the various interpretative guidelines and seeks comment on a number of Internet issues for which the SEC may take regulatory action in the future.

## II. Electronic Delivery

The SEC previously published its views on the use of electronic media in two releases in 1995 and 1996 (Releases No. 7233 and 7288). The framework for electronic delivery established in those releases was based on notice, access and evidence of delivery. The new Release reaffirms the guidance provided in those Releases and provides further clarification of some of the regulatory issues bedevilling practitioners as a result of the principles enumerated in those Releases.

First, investors may consent to electronic delivery telephonically. Under the 1995 Release, one method of meeting the evidence of delivery element is to obtain an informed consent from an investor to receive information through a particular electronic medium. While it was clear that informed consent may be made by written or electronic means, it is now clear that telephonic consent is also permissible, provided a record of the consent is retained and the consent is delivered in a manner that assures its authenticity.

Second, an investor may give a global consent to electronic delivery of all the documents of any issuer in which the investor buys or owns securities through the intermediary, provided the consent is informed. However, the consent (a) should be specifically authorized and not buried within new account forms (i.e., the authorization should either be in a separate section with a separate electronic delivery authorization or in a completely separate document), (b) the investor should be advised of his or her right to revoke the consent at any time (which may be on an "all-or-none" basis), and (c) the consent should specify the type(s) of electronic media that may be used and it need not specify the covered issuers. The SEC also stated its belief that if the opening of an account were conditioned upon providing a global consent, evidence of delivery would not be established, except in the case of e-brokers. Consequently, only e-brokers may require a global consent as a condition of opening an account.

Third, the Release permits the use of PDF format when delivering documents if investors are informed of the requirements needed to download PDF and investors are provided with the needed software and assistance for free.

Fourth, the Release discusses and clarifies the "envelope theory." The 1995 Release provided examples of when information on the same Web site or hyperlinked to each other would be considered to be delivered together as required by the federal securities laws as if in the same envelope. To clarify this "envelope theory," the SEC stated that information on a Web site would be part of a § 10 prospectus only if an issuer or its agent acts to make it a part of the prospectus. Consequently, an issuer that imbeds a hyperlink within a § 10 prospectus (or any other document required to be filed or delivered under the federal securities laws) causes the hyperlinked information to become a part of that prospectus, including any inactive textual references. Because many standard software programs can automatically convert an inactive URL into an active hyperlink, the SEC stated that a § 10 prospectus (or filed document required to be filed or delivered under the federal securities laws) that contains a URL (albeit merely a textual reference) results in the issuer assuming full responsibility for the information accessible through the resulting hyperlink. This means that the hyperlinked information must be filed as part of the prospectus and subjects the hyperlinked information to liability under § 11 of the Securities Act. In contrast, a hyperlink from an external document to a § 10 prospectus would result in both documents being delivered together, but would not result in the external (non-prospectus) document being deemed part of the prospectus.

Fifth, the close proximity of information on a Web site to a § 10 prospectus does not by itself make that information an "offer," "offer to sell" or "offer for sale," within the meaning of § 2(a)(3) of the Securities Act. The Web site content must be reviewed in its entirety to see whether it contains impermissible "free writing," i.e., communications that would constitute an "offer," "offer to sell" or "offer for sale," by means other than a § 10 prospectus.

## III. Web Site Content

The SEC also provided guidance on issuer responsibility for Web site content under the anti-fraud provisions of the federal securities laws and during registered offerings.

### 1. Issuer Responsibility for Hyperlinked Information

The federal securities laws apply in the same manner to the content of an issuer's Web site as to any other statements made by (or attributable to) the issuer. Issuers are responsible for the accuracy of their statements that reasonably can be expected to reach investors or the securities markets. Under some circumstances, issuers may be held liable under § 10(b) of the Exchange Act and Rule 10b-5 for third-party information to which they have hyperlinked from their Web site. Whether the third-party information is attributable to the issuer depends on whether the issuer has involved itself in the preparation of the information (the "entanglement theory"") or explicitly or implicitly endorsed or approved the information (the "adoption theory").

There is no "bright line" test for determining whether an issuer has adopted information on a third party Web site. The following are factors the SEC considers relevant although, by SEC admission, not exclusive or exhaustive, in deciding whether an issuer has adopted information on a third-party Web site to which it has established a hyperlink:

a. the context of the hyperlink, i.e., what the issuer says about the hyperlink or what is implied by the context in which the issuer places the hyperlink. If an issuer explicitly endorses the hyperlinked information or embeds a hyperlink to a Web site within a document required to be filed or delivered under the federal securities laws, the issuer will be deemed to be adopting the hyperlinked information. Additionally, when an issuer is in registration, if the issuer establishes a hyperlink (that is not embedded within a disclosure document) from its Web site to information that is an "offer, "offer to sell" or "offer for sale," under § 2(a)(3) of the Securities Act, a strong inference arises that the issuer has adopted the information for purposes of § 10(b) of the Exchange Act and Rule 10b-5.

b. the risk of confusion, i.e., whether precautions have been taken to protect against investor confusion about the source of the information. Effective procedures to avoid attribution to an issuer include a separate "jump page" indicating that the visitor is leaving the issuer's web page and that the information later viewed is not the issuer's. Also included are clear and prominent good faith disclaimers of responsibility and non-endorsement of the hyperlinked information. However, the SEC then stated that the risk of investor confusion is higher when information on a third-party Web site is "framed" or "inlined," which could be a serious trap for the unwary.

c. the presentation of the hyperlinked information, e.g., selectively establishing and terminating hyperlinks or otherwise highlighting or controlling the flow of selected information to investors may result in an issuer having adopted the information.

d. the layout of the screen may also result in an issuer differentiating or otherwise favoring hyperlinks which may result in the issuer adopting the hyperlinked information.

### 2. Issuer Communications During a Registered Offering

The Release elucidated the type of information that may be placed on an issuer's Web site (or on a third-party Web site to which the issuer has established a hyperlink) when the issuer is in registration. An issuer that is in registration must review all its public communications in light of § 5 of the Securities Act and its publicity rules. This includes the issuer's Web site as well as any third-party information to which the issuer has established a hyperlink. Consequently, third-party hyperlinked information that constitutes an "offer," "offer to sell," or "offer for sale," under § 2(a)(3) of the Securities Act raises a strong inference that the issuer has adopted the hyperlinked information. This means that, unless the information conforms to a § 10 prospectus filed with the SEC or is permissible under a safe harbor, the issuer will have made an illegal offer to sell securities.

Nevertheless, an issuer that is in registration should maintain communications with the public as long as the communications are limited to ordinary course business and financial information, which may include the following:

a. advertisements concerning the issuer's products and services;

b. Exchange Act reports required to be filed with the SEC;

c. proxy statements, annual reports to security holders and dividend notices;

d. press announcements concerning business and financial developments;

e. answers to unsolicited telephone inquiries concerning business matters from securities analysts, financial analysts, security holders and participants in the communications field who have a legitimate interest in the issuer's affairs; and

f. statements made at security holders' meetings and responses to security holder inquiries relating to these matters.

The information listed above and information permissible under a Securities Act safe harbor may be posted on an issuer's Web site when the issuer is in registration (whether posted directly or indirectly through a third-party Web site, including the Web site of a broker-dealer participating in the registered offering).

This guidance is certainly appropriate for reporting companies based on long-established principles. For the first time, the SEC extended these guidelines to non-reporting issuers preparing for initial public offerings to the extent they have established a history of making these business and financial communications in the ordinary course of their businesses. However, a non-reporting issuer preparing for its first registered offering that contemporaneously establishes a Web site may need to be more careful when evaluating its Web site content. It may not have established a history of ordinary course business communications with the marketplace, resulting in the Web site content illegally conditioning the market for the offering. Investors lacking such history may be less able to distinguish offers to sell an issuer's security in a registered offering from product service promotional activities or other business or financial information.

## IV. Online Public Offerings

The SEC declined to prescribe any specific procedures for online public offerings. The Release stated that the SEC will continue to analyze this area with a view toward possible regulatory action in the future. Nevertheless, the SEC stated two legal principles to guide issuers and offering participants in on-line public offerings. First, offering participants can neither sell, nor make contracts to sell, a security before effectiveness of the registration statement. Concomitantly, no offer to buy can be accepted and no part of the purchase price can be received until the registration statement has become effective. Second, until delivery of the final prospectus has been completed, written offers and offers transferred by radio and television cannot be made outside a § 10 prospectus (except in business combinations). After filing the registration statement, there are two limited exceptions for publishing notices of the offering (Securities Act Rules 134 and 135). After effectiveness, offering participants may disseminate sales literature and other writings if these materials are accompanied or preceded by a final prospectus.

These rules were the subject of a no-action letter (Wit Capital Corporation, avail. July 14, 1999), which remains in effect although the SEC stated that it will continue to review procedures submitted for on-line public offerings, presumably to facilitate on-line public offerings.

## V. Online Private Offerings under Regulation D

Here the SEC restated the procedures permitted in an earlier no-action letter concerning the Internet and the prohibition of general advertising and solicitation in private placements (IPO NET, avail. July 16, 1996). The permissible procedures, as restated, are as follows: screening previously unknown prospective investors to qualify as "accredited" and "sophisticated" investors; having a password-restricted web page permitting access to private offerings only after qualifying the prospective investor as "accredited" or "sophisticated" for purposes of Regulation D; and then permitting the qualified investor to purchase private placements only in offerings posted on the restricted Web site after qualification by an affiliated broker-dealer and having opened an account with the broker-dealer. The SEC went on to state, in effect, that these procedures are limited to broker-dealers, which is a significantly different interpretation than that understood by some members of the securities bar.

The SEC stated that the broker-dealer relationship requires the broker-dealer to deal fairly with, and make suitable recommendations to, its customers. This implies a substantive relationship sufficient to support the existence of "pre-existing, substantive relationship" needed to avoid the prohibition on general advertising or solicitation in a private placement. Further, the SEC stated that Web site operators and others must consider whether their activities in this area require that they register as broker-dealers.

## VI. Comments and Examples

The SEC then sought comment on a number of technology concepts and provided some examples intended to clarify the principles described above. The SEC requested comments by June 19, 2000 concerning the following: "access-equals-delivery," electronic notes, implied consent to electronic delivery, electronic-only offerings, access to historical information, communications while in registration and internal discussions forms.

## VII. Conclusion

This is an important interpretative release. However, as this area is both still new and rapidly changing, the thinking concerning the appropriate regulatory response is still evolving. Consequently, although important, this Release is not the last word on the subject nor does it presume to be.

**Guy P. Lander is a partner in the firm of Goodman Phillips & Vineberg. Mr. Lander is Secretary of the Business Law Section of the New York State Bar Association and former Chair of its Committee on Securities Regulation. He has written numerous articles regarding corporate law and securities law, and in 1999 authored the book *U.S. Securities Law for International Financial Transactions and Capital Markets*.**

# New York State Bar Association

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NYSBA



April 19, 2000

Securities and Exchange Commission
450 Fifth Street N.W.
Mail Stop 6-9
Washington, DC 20549-0609
E-mail address: rule-comments@sec.gov
Attention: Jonathan G. Katz, Secretary

Re: File No. S7-03-00

**Comments on Proposed Rule, Releases No. 33-7793; 34-42354**

Ladies and Gentlemen:

The Committee on Securities Regulation of the Business Law Section of the New York State Bar Association appreciates the opportunity to comment on the proposed rule, that would add new Items 302(c) and 302(d) to Regulation S-K.

The Committee on Securities Regulation is composed of members of the New York State Bar Association, a principal part of whose practice is in securities regulation. The Committee includes lawyers in private practice and in corporation law departments. A draft of this letter was circulated for comment among members of the Committee and the views expressed in this letter are generally consistent with those of the majority of the members who reviewed the letter in draft form. The views set forth in this letter, however, are those of the Committee and do not necessarily reflect the views of the organizations with which its members are associated, the New York State Bar Association, or its Business Law Section.

## I. General

We appreciate the opportunity to provide comments to the Securities and Exchange Commission on the proposed rule. The proposal would require companies to disclose: (1) valuation or loss accrual accounts, including all Statements of Financial Accounting Standards No. 5 (accounting for contingencies) (FAS 5) reserves, such as reserves for pending litigation, environmental remediation costs, contingent tax liabilities and product warranty liabilities (proposed Item 302(c)); and (2) information about changes in long-lived assets and corresponding depreciation, depletion and amortization accounts (proposed Item 302(d)).

We agree with the overall goal of the Commission to eliminate abusive "earnings management." However, the proposed disclosures would jeopardize the attorney-client privilege and could constitute admissions against interest, in addition to disclosing highly sensitive, proprietary, competitive information that would result in substantial harm to issuers and their shareholders. In addition, we believe that the proposal would impose cost burdens on reporting companies in excess of the estimates in the Release. There should be a compelling need for the proposed disclosures to balance against the economic and competitive harm and the loss of attorney-client privilege, to justify the proposed new disclosures. However, there has been no showing of a compelling need, or of any real need, for the proposed disclosures. Accordingly, we respectfully urge the Commission to withdraw the proposal. If the Commission decides not to withdraw the proposal, we request the opportunity to meet with the Staff prior to adoption because of our concerns regarding attorney-client privilege and communications with clients.

## II. The Attorney-Client Privilege and the Expectation of Confidentiality Would Be Lost if the Proposed Disclosures Are Required

The proposed disclosures about loss accruals from pending litigation, environmental, tax and certain other contingencies pose a serious risk of waiving the attorney-client privilege. The policy behind that privilege—to facilitate the full development of facts essential to proper legal representation and to encourage clients to seek early legal assistance—also serves to ensure accurate financial reporting. For example, FAS 5 specifically refers to the opinions or views of legal counsel among the factors to be considered in determining whether loss accruals are necessary.

The proposed disclosures would in effect require corporate clients to disclose otherwise privileged information, thus arguably waiving their right to assert the attorney-client privilege, and require their lawyers to waive the right to assert work product privilege, with respect to the proposed disclosures of information underlying the basis for reserves for litigation, as well as environmental remediation, tax disputes, and certain other loss accruals. It is well-established that a corporation is entitled to the protection of the attorney-client privilege, and thus, to withhold information from scrutiny by the judicial process provided that the corporation can show that (i) the information was disclosed by a corporate employee acting within the scope of that employee's corporate duties, (ii) in seeking legal advice from counsel, (iii) the information was considered confidential when made available, and (iv) its confidentiality has been maintained.

We understand that the Federal securities laws are based on the fundamental principle that full, fair and complete disclosure is the best method for assuring the integrity of the financial markets, and that there is an inherent tension between full disclosure and respecting the attorney-client and the related work product privileges. Society, however, has determined that encouraging clients to make full disclosure of information to their attorneys makes it more likely that an attorney will obtain the information needed to provide good legal advice, and that obtaining good legal advice is so important in a society governed by law as to warrant protecting the attorney-client privilege, even when giving others access to this information would further the pursuit of justice.

For the Commission to adopt regulations which would require disclosure of information provided in connection with legal advice will have the effect of compelling corporate clients to waive the attorney-client privilege. Moreover, there may be circumstances under which the effect of the proposed regulations would also compel corporate attorneys to waive the work product privilege. In addition, clients have the expectation of confidentiality of communications with corporate counsel. *See*, Canon 4 of the Code of Professional Responsibility—*A Lawyer Should Preserve the Confidences and Secrets of a Client.*

Finally, in the long run, adoption of the proposed disclosures may defeat the very purpose for which they are adopted, and even have the reverse effect from that which is intended. An attorney who knows in advance that he or she will be compelled to disclose sensitive information regarding whether there is "probable" liability, including increases or decreases in the probable dollar amount of liability, or other sensitive information which can be gleaned from the disclosure of the basis for accruals and the changes in accruals, will (in fact, must) advise the client that: (1) there is a requirement to disclose; and (2) as a result the attorney-client privilege may be waived and the confidentiality of client confidences may not be preserved. A necessary result will be to encourage reporting companies to make less than complete disclosures to their attorneys. The consequence, however unintended, might well be financial statements which contain less accurate evaluations of litigation and other loss contingency reserves.

## III. The Proposed Disclosures Would Cause Significant Competitive and Economic Harm to Reporting Companies with Resulting Economic Harm to Their Shareholders

It is hard to think of more damaging disclosures to the competitive and financial position of reporting companies and the economic interest of their shareholders, than the new reserve and loss accruals specified in the proposing Release. Only plaintiffs, the plaintiffs' bar, taxing authorities, and competitors will benefit.

The proposed rule would require that all reserve and loss contingencies be reported, separately by major class of loss accrual accounts, including the following reserves:

- probable losses from pending litigation
- liabilities for environmental remediation costs
- contingent income and franchise tax liabilities
- product warranty liabilities
- excess of estimated costs over revenues on contracts (loss contracts)
- allowance for sales returns, discounts and contractual allowances
- all other contingent liabilities reserved under FAS 5

For each of the above reserves, reporting companies would have to disclose:

- balance of the reserve at beginning of the period
- each significant element of the reserve if the reserve consists of various elements
- additions to the reserve during the period
- any changes in the assumptions used for estimating the reserve that had a material effect on the change in the reserve.

First of all, the disclosures could themselves constitute an admission of liability introducible in court. In any event, disclosure would provide a roadmap for plaintiffs' attorneys to use in discovery. Depending on the level of detail or aggregation which would have to be used in the disclosures, which is not clear from the proposing Release, information on specific cases might be discerned. This would be more likely on an on-going basis when additions and deductions to previously reported balances would have to be separately disclosed. Moreover, the Release would require that changes in assumptions used in estimating the reserve that had a material effect on the change would have to be disclosed, which could very easily be tied to specific litigation.

In addition, these disclosures could affect the ability of reporting companies to pursue strategies in the company's best interests. For example, in establishing reserves for a pending litigation or class of litigation, a factor to be considered in determining the probability of liability and estimation of loss is the willingness and level at which a company might settle litigation. This always is an important strategic issue for a company to balance against the cost of litigation, adverse publicity and distraction from other business imperatives. We believe that the proposed disclosures would have the unintended effect over time of driving reporting companies to a more adversarial strategy in dealing with litigation in order to avoid laying out their willingness to settle and at what price. Obviously, these disclosures would severely affect a company's ability to negotiate favorable settlements. The starting point for discussions will necessarily be the amount a company has already reserved.

Reporting companies will suffer similar economic harm in dealing with tax matters. A company's obligations to its shareholders include operating in a manner to obtain favorable tax treatment in accordance with existing law. Because of the uncertain nature of applicable statutes, rules, regulations, interpretations and positions of taxing authorities, this necessarily will involve issues in which a legitimate tax position of a company may be challenged by taxing authorities. The required proposed disclosures would interfere with a company's ability to negotiate favorable settlements in the same manner that the ability to settle pending litigation would be affected. Similarly, over time we believe that a company's tax strategy will be adversely affected.

These disclosures would reflect, and as a result invite comparison of, litigation, tax, pricing and contracting strategies of competitors. It is easy to imagine this occurring in the initial filings by competitors, if the proposal were adopted. The competitive harm would be more severe with respect to overseas competitors not subject to similar disclosure requirements. We would also expect the plaintiffs' bar to review these filings to see which companies are "easy pickings."

These disclosures not only would interfere with a company's ability to effectively manage its litigation, tax matters and competitive strategies, but they would also interfere with negotiations and contractual relations with suppliers and customers. In particular, the proposal would require disclosure of information on reserves with respect to loss contracts. It is expected that these contracts would probably be long-term, major contracts with on-going implementation and administration issues requiring negotiations and settlement. Again, reporting companies would be severely disadvantaged in dealing with a customer or supplier if these reserves accruals were disclosed. This would also provide competitors with helpful information on margins and costs they otherwise would not have. Finally, it is possible that both sides of the same long-term contract may be taking and disclosing reserves. The proposed disclosures would turn the financial statements into a strategic negotiation exercise.

## IV. There Has Been No Showing of a Legitimate Need for the Additional Disclosures

In light of the loss of the attorney-client privilege and the substantial harm to reporting companies and their shareholders if the proposal were adopted, there should have to be a compelling case for requiring the additional disclosures. However, there has been no showing of any real need for the additional disclosure.

### A. Investors and Analysts Covering Specific Companies Have Not Been Seeking this Information from Companies

We are not aware that this information is a priority item for securities analysts following registered companies or institutional or individual investors. Some of our Committee members who represent large and small companies report that their client companies have not been seeing requests for this information from analysts or institutional or individual investors. There has been no showing of a pressing need for this information or that disclosure of this information is essential for analysts covering registered companies or the companies' investors.

The proposing Release does refer to a letter request from the Association for Investment Management and Research for detailed schedules of property, plant and equipment and related accumulated depreciation, depletion and amortization, similar to the disclosure the Commission rescinded in 1994 in accordance with the views of a majority of the commentators. Again, analysts covering registered companies and institutional and retail investors have not been asking for this information, and the cost and burden on the companies to gather the information would be significantly in excess of the amounts estimated in the proposed Release. While some parties may favor the proposed disclosures, there is no need shown that would justify the harm to reporting companies and their shareholders and the additional cost and burden.

### B. Current Requirements of FAS 5 and Other Commission and Accounting Pronouncements Adequately Protect Investor Interests

To begin, we are discussing reserves or accruals that have been charged against income and are fully reflected in reported results. This means that reported earnings should reflect all costs that are attributable to operations under applicable accounting standards. The proposal does not attempt to change the underlying rules governing when to reserve or accrue or how much to reserve or accrue. Therefore, the proposal will not change reported earnings, and no claim is made in support of the proposal that the present requirements are deficient. However, we believe if adopted the proposal would have the unintended consequence of pushing reporting companies to delay making certain reserves and reserving smaller amounts, with a resulting impact on reported earnings.

In addition to total earnings, there is also the classification of the reserves and accruals on the income statement. Generally, the reserves and accruals are distributed to the appropriate cost-causing line item on the face of the income statement. Thus, the reader of the financial statements will have an accurate picture of the level of various types of costs and expenses, including Costs of Goods; Selling, General and Administrative; Research and Development; and various ratios such as gross margin and operating margin. That the reader may not know how much of any specific line item may be attributed to a reserve or loss accrual in no way changes the fact that the reader is given an accurate picture of the magnitude of various specific items, categories and ratios of costs and expenses.

Even without adoption of the proposal, the amounts, changes and other details of the following reserves are already disclosed under current accounting rules:

- reserves for liabilities for exit and employee termination costs, related to a restructuring or acquisition (*See, e.g.,* Emerging Issues Task Force (EITF) 94-3)
- liabilities for costs of discontinued operations (*See, e.g.*, Accounting Principles Board Opinion No. 30)

Additionally, based upon a spot survey we did of 20 representative reporting companies, we believe that all or almost all reporting companies are disclosing allowances for doubtful accounts, receivables and uncollectibles, and that most companies disclose valuation allowances on deferred tax assets, where material, in the schedules to Form 10-K.

That leaves undisclosed essentially the reserves or accruals whose disclosure would be most damaging to reporting companies, such as pending litigation, environmental remediation costs, contingent tax liabilities, warranty claims and contractual reserves.

Finally, there are stringent standards for establishing the reserves and significant review and oversight of the process. In the first instance, the decision on whether to establish, and if so the amount of, a reserve or accrual is the responsibility of management. This would involve the company's accountants responsible for financial and SEC reporting and the company's chief accounting officer and chief financial officer. Because many of these decisions on reserves and accruals are based on legal issues, the process often also involves the opinion and advice of company counsel. The decision is then subject to review by the company's independent auditors. We note that independent auditor review now is mandated for interim financial statements as well as the annual audit, under recently adopted Commission rules.

Further, the independent auditor is required to discuss certain matters with the company's audit committee or chairman of the audit committee, for both annual, audited and quarterly financial statements under new requirements which implement the Blue Ribbon Panel on Audit Committees recommendations, including:

- Discussion of items that have a significant impact on the representational faithfulness, verifiability, and neutrality of the accounting information included in the financial statements, including estimates, judgments, and uncertainties.
- The auditor should determine that the audit committee is informed about the process used by management in formulating particularly sensitive accounting estimates and about the basis for the auditor's conclusions regarding the reasonableness of those estimates.

Finally, the audit committee itself will be composed entirely of directors who are independent of the company and its management and who are financially literate.

## V. The Generation and Collection of Information for the Proposed Disclosures Would Impose Significant Cost Burdens

We believe that the Commission's annual cost estimate in the proposing Release of $6,500 per registered company on an on-going basis after the initial start-up cost, or a total of $18,850,000 in the aggregate for 2900 registered companies, substantially understates the cost that would be imposed by the proposed disclosures. In addition, the Commission's estimated initial start-up cost also is substantially understated. While we are not providing cost information, we understand that some registered companies or associations or organizations will provide the Commission with cost estimates based on the experience of a number of corporations. We also understand these cost estimates will be far in excess of the Commission's figures which were based on information provided by a single, diversified multi-division registrant. The reason for this disconnect between the cost figures used by the Commission and the corporate experience of reporting companies apparently is attributable to an assumption used by the Commission that the information needed for preparation of the disclosures is presently readily available. As we understand it, corporations with many units doing business in multiple locations would be required to develop and capture information far in excess of what they currently generate to manage their businesses and meet present compliance requirements.

## VI. Set Out Below Are Comments on the Specific Questions Raised in the Proposing Release

**1. Are there other specific loss accrual or valuation accounts that should be added to the list of accounts identified within proposed Item (302c)?**

No. We believe that the Commission should withdraw the proposal because several of the loss accruals would harm companies and their shareholders.

**2. Should specific percentage tests be used to trigger specific account disclosures within the proposed rules? For example, should disclosure of loss accrual account activity be required only when the balance sheet item and change during the period exceeds a certain pre-established numerical threshold (for example, 5% of total assets or 3% of pretax income)? If so, what is an appropriate threshold?**

If the proposal is adopted, a materiality threshold should be provided without providing specific quantitative tests. Materiality should be determined by existing general principles.

**3. Should the placement of the proposed data be moved within MD&A or to some other section of the filing to enhance the prominence of the disclosure?**

If the proposal is adopted, we believe that the information should be in the Schedule to Form 10-K. Also, we believe that any disclosures should be supplementary financial information not part of the audited financial statements and MD&A.

**4. Should presentation of the proposed data be limited to the Form 10-K?**

Yes. Presentation of the additional disclosures, if required, should be limited to the Form 10-K.

**5. Should the disclosure requirements be restricted to those registrants that exceed a certain size or meet some other threshold? If so, what would be the appropriate threshold?**

We believe that a size threshold would not be appropriate.

**6. Are there circumstances where registrants may appropriately exclude disclosure about loss accruals related to litigation because of concerns about confidentiality while still conforming with GAAP? If so, please describe such circumstances in detail.**

See Sections B and C above regarding litigation reserves, as well as other loss contingencies such as contingent tax liabilities and environmental reserves.

**7. Should the disclosures concerning valuation and loss accrual account activity be required when interim financial statements are presented?**

No. If the proposal is adopted, the harm to reporting companies and their shareholders would be increased if the disclosures were required for interim financial statements.

**8. Should the disclosures concerning changes in property, plant, equipment, and intangible assets and related accumulated depreciation, depletion, and amortization be required when interim financial statements are presented?**

Same as response to Question 7.

**********************************************

We hope that you will find these comments helpful. For the reasons discussed above, we respectfully urge the Commission to withdraw the proposal. Because of the importance of this matter, we would welcome the opportunity to meet with you to discuss these comments further.

**Respectfully submitted,**

**COMMITTEE ON SECURITIES REGULATION**

**Guy P. Lander**
**Chairman of the Committee**

**Drafting Committee**:
Michael J. Holliday
Micalyn S. Harris

Copy to:
The Honorable Arthur Levitt, Chairman
The Honorable Paul R. Carey, Commissioner
The Honorable Isaac C. Hunt, Jr., Commissioner
The Honorable Norman S. Johnson, Commissioner
The Honorable Laura Simone Unger, Commissioner
David M. Becker, General Counsel
David B. H. Martin, Director, Division of Corporation Finance
Lynn E. Turner, Chief Accountant
Harvey Goldschmid, Consultant to the Chairman

# New York State Bar Association

One Elk Street, Albany, New York 12207 • 518/463-3200 • http://www.nysba.org

NYSBA




April 28, 2000

Securities and Exchange Commission
450 Fifth Street N.W.
Mail Stop 6-9
Washington, D.C. 20549
E-mail address: rule-comments@sec.gov
Attention: Jonathan G. Katz, Secretary

Re: Securities Act Release No. 33-7787
Exchange Act Release No. 34-42259
(File #S7-31-99)

Ladies and Gentlemen:

The Committee on Securities Regulation of the Business Law Section of the New York State Bar Association appreciates the opportunity to comment on Releases Nos. 33-7787 and 34-42259, dated December 20, 1999 (the "Release"), as the Release relates to proposed Regulation FD.

The Committee on Securities Regulation (the "Committee") is composed of members of the New York Bar, a principal part of whose practice is in securities regulation. The Committee includes lawyers in private practice, in corporation law departments and in government agencies. A draft of this letter was circulated for comment among members of the Committee and the views expressed in this letter are generally consistent with those of the majority of the members who reviewed the letter in draft form. The views set forth in this letter, however, are those of the Committee and do not necessarily reflect the views of the organizations with which its members are associated, the New York State Bar Association, or its Business Law Section.

## 1. General

We agree with the Staff's initial statement that "information is the lifeblood of our securities markets." We also agree that the anti-fraud provisions of the federal securities laws play an important role in furthering full and fair disclosure. However, Regulation FD is not being proposed for adoption under the anti-fraud provisions of the federal securities laws, and it represents a major change in the way the Commission regulates public disclosure. We have concerns as to the Commission's authority to adopt regulations of this type, and we question the wisdom of the dramatic change in policy and law suggested by this proposal. The scope of the proposed regulation is very broad, the application of many of its terms will be unclear to issuers and their executives, and the potential liability is significant. We are most concerned that issuers and their counsel will have practical difficulties in monitoring compliance with the proposed regulation. As a result, we are fearful that Regulation FD will chill rather than expand the amount and quality of information made available to investors by reporting companies.

Moreover, even if the Commission adopts Regulation FD we believe that a number of changes are required in order for issuers to be in a better position to comply with the new requirements.

In light of the limited empirical evidence of selective disclosure, we urge the Commission to delay the adoption of Regulation FD until the impact of the proposal upon public companies can be evaluated. We believe the trend in the area of public disclosure of information has been consistent with the goals of the Release. Over time, actual practice may convince the Commission that a regulation of this type is unnecessary and impractical. The technological advances being made in the dissemination of information to the investing public, in addition to analysts and institutional investors, may also make the Regulation unnecessary. Any concern about the objectivity of sell-side analysts is being met by the media's ranking of analysts' performance. The number of Web-based advisory services also is growing. A study of two such Web sites last summer showed that, on average, they have provided more accurate earnings estimates of 101 high-tech companies than Wall Street analysts have. (Mark Hulbert, "Compromised Analysts? The SEC Is Shocked," W.S.J. December 29, 1999 at A14).

## 2. Commission Authority

We have serious reservations about the Commission's authority to adopt Regulation FD under the federal securities laws. Neither the Securities Act of 1933 nor the Securities Exchange Act of 1934 contemplates equal access to all material information that is made available to persons outside the issuer. Moreover, nothing in the current law requires all investors to have access to the same information at the same time. In both *Chiarella v. United States* and *Dirks v. SEC*, the Supreme Court denied the Commission authority to impose an absolute equal information rule in light of the absence of explicit congressional intent. Congressional action may be necessary for a proposal like Regulation FD. Even if the Commission has the legal authority to adopt Regulation FD, the discussion below should lead the Commission to conclude that the adoption of the Regulation, as proposed, would be unwise. In its effort to provide equal access to information, the Commission may be reducing the amount of material information available to investors, thereby impairing the functioning of the securities markets.

## 3. Scope

The scope of Regulation FD is too broad. The Regulation would apply to the disclosure of "material" nonpublic information to "any other person outside the issuer." If the primary objective of the Regulation is to regulate the flow of information to investors, we do not believe it is desirable for the Commission to attempt to regulate routine business communications between issuers and third parties. The proposal does not distinguish between communications to investors or analysts and those to vendors, suppliers or consultants on subjects that would cover every aspect of a corporation's business. The proposed Regulation would require executives who share corporate strategies and plans with customers, suppliers and other outsiders to get those individuals to sign confidentiality agreements if the company wants to avoid publicly disclosing the information (Lisa Fried, "Lawyers Worried About SEC's Proposed Regulation on Disclosure," N.Y.L.J. March 16, 2000). The potential liability of public companies for communications that would generally not be considered as being directed to the investing public appears unnecessary to achieve the Commission's objective of enhancing the quantity and quality of information available to investors.

The scope of the proposed Regulation also is impacted by its reference to "an issuer or any person acting on its behalf." This language could literally cover any person in the issuer's organization, notwithstanding the requirement that the disclosing person act "within the scope of his or her authority." Further, the reference to a "senior official" in relation to a non-intentional disclosure would include an outside director who generally would not be considered responsible for discussing financial matters with investors. The inclusion of an outside director impacts not only the person disclosing the information but also the person whose knowledge of a disclosure requires prompt public disclosure by the company. We believe it is unreasonable to impose obligations upon an issuer based on the need for a determination by an outside director as to whether the information is material, has not been publicly disclosed or was intentionally or unintentionally disclosed by another "person on behalf of an issuer."

## 4. Materiality

One of the cornerstones of the anti-fraud rules under the federal securities laws is the concept of materiality. For documents prepared for filing with the Commission under the supervision of counsel, the concept of materiality is an accepted standard. The materiality standard may not be easily applied to everyday communications by employees to outsiders, or securities analysts, when the definition refers to what a reasonable shareholder would consider important in making an investment decision or if the information could significantly alter the total mix of information made available. This standard places the company official in the undesirable position of determining whether the statements in question are material, without the ability to consult with counsel.

Even if counsel were present, it would be difficult for the company official to comply with the requirements of Regulation FD. On a "real time" basis, there would not be sufficient time for the company official and counsel to discuss the issue and consider all relevant factors. A company official, in a meeting with analysts or institutional investors, realistically could not consult with counsel before making a statement that might be considered material non-public information. Further, any attempt to consult with counsel could be misunderstood by the audience as suggesting that the issue is one of materiality when the reason for the consultation could be unrelated to legal issues. The materiality issue could also lead to the end of analyst "one-on-ones" with company management. Counsel would have to review all materials for such meetings for materiality. (Shaun Butler, Managing Director and Head of Investor Relations, Lehman Brothers Holdings, Inc., *1934 Act Disclosure: A Practitioner's Viewpoint*, Practicing Law Institute's Preparation of Annual Disclosure Documents 2000, January 28, 2000). It will be difficult to determine whether the Commission would consider a comment that an executive makes to an analyst explaining information already disclosed in a press release as simply an expansion of the original statement or new, material information subject to public disclosure (Lisa Fried, "Lawyers Worried About SEC's Proposed Regulation on Disclosure," N.Y.L.J. March 16, 2000).

If materiality judgments are difficult for lawyers, it seems unreasonable for the Commission to impose that standard on everyday communications by company officers and employees. This would be a heavy burden, especially when the Commission has not provided guidance (if it could) to assist issuers anxious to comply with the Regulation. This difficulty is highlighted by the subjective nature of any analysis of materiality. The Staff, in Staff Accounting Bulletin No. 99, has emphasized the fact that qualitative, in addition to quantitative, considerations must be included in the analysis. The materiality analysis may also have to take into account the volatility of an issuer's stock in response to certain types of disclosures. This uncertainty could, in our view, make issuers reluctant to share information with analysts. This would impair the analysts' ability to perform a function that the Commission acknowledges, in its Release, to be valuable.

If the Commission decides to adopt Regulation FD at this time, we believe it should attempt to identify the types of material information covered by the Regulation. The Commission could, for example, identify specific types of forward-looking information, such as projections of revenues or earnings, and other significant factors that could impact the value of an issuer's business, such as changes in customers or suppliers, applications for patents or FDA approvals.

## 5. Intent

The same deficiencies that apply to materiality also apply to the ill defined concept of "intent." When an issuer makes an intentional disclosure of material nonpublic information, proposed Rule 100(a)(1) would require that the issuer simultaneously make that disclosure to the public. Issuers will be required to determine whether a disclosure was "intentional" and subject to simultaneous public disclosure or was "non-intentional" and requires "prompt" public disclosure under proposed Rule 100(a)(2). The company will have as difficult a time determining whether a disclosure was "intentional" as it will in determining whether it was material. The requirement of "scienter" has been the standard of liability under Rule 10b-5. By eliminating the scienter requirements the Commission is creating uncertainty and a questionable basis for issuer liability. We believe that if the Commission adopts Regulation FD, the regulation should only cover intentional disclosures, recognizing that this standard would be less than the standard under Rule 10b-5.

## 6. Liability and Related Adverse Consequences

The Release states that Regulation FD is not intended to create a private right of action under the Exchange Act. The Release, however, also makes it clear that Regulation FD could result in enforcement action and liability under Section 5 of the Securities Act, when disclosures are made at the time of a public offering. A company could also be liable under the Securities Act if it incorporates into a registration statement a Form 8-K that was filed to comply with Regulation FD. Proposed Rule 181 only addresses a small piece of the problem by focusing on disclosures made after a Securities Act filing. It does not address pre-filing disclosures or the impact of the regulation on the concepts of "offer," "prospectus," "gun jumping," "general solicitation," or "directed selling effort," all of which can result in liability risk under the Securities Act.

An issuer's failure to comply with Regulation FD could also cause the loss of eligibility to use Forms S-2, S-3 and S-8 for up to twelve months. This could have a dramatic effect on the ability of issuers to raise capital, make acquisitions or maintain employee benefit plans. In addition, owners of "restricted" or "control" securities may not be able to use Rule 144 if the issuer is not timely in its Regulation FD reporting requirements. We believe that these results are unwarranted. If new rules are adopted, provision should be made so that the eligibility to use Forms S-2, S-3 and S-8, and the ability to satisfy Rule 144, are not affected by non-compliance with Regulation FD.

## 7. Non-Public Information

The Release fails to define "non-public" as it relates to the disclosure of information. As a technical matter, we believe that the Regulation should make clear that the disclosure of information in documents filed with the SEC, in press releases or in any other manner that would have been adequate under the Regulation after the fact, should eliminate the need to make subsequent disclosure under Regulation FD, at least where the time interval is reasonable.

## 8. Conclusion

We have not attempted to comment on all aspects of Regulation FD. We have attempted to highlight what we believe are the most serious deficiencies, in an effort to convince the Commission that the proposed Regulation would be counterproductive. The Commission's authority to adopt a regulation of this type is unclear. We also question the wisdom of such action, particularly at this time. It would be unfortunate, if in an effort to increase the flow of information into the marketplace, the Commission's actions had the opposite effect, causing a decrease in liquidity and an increase in the volatility of stock prices.

**Respectfully submitted,**

**COMMITTEE ON SECURITIES REGULATION**

**Guy P. Lander**
**Chairman of the Committee**

cc: Hon. Arthur Levitt
Chairman, Securities and
Exchange Commission

Hon. Paul R. Carey
Commissioner

Hon. Isaac C. Hunt, Jr.
Commissioner

Hon. Norman S. Johnson
Commissioner

Hon. Laura Simone Unger
Commissioner

David Martin
Director, Division of Corporation Finance

David Becker
General Counsel

# CASE NOTE

By Michael J. Dutkowsky

### *Pinnacle Consultants, Ltd. v. Leucadia Natl. Corp.*

(94 N.Y.2d 426, 706 N.Y.S.2d 46 (2000))

Plaintiff Pinnacle Consultants, Ltd., a Delaware corporation that bought and sold stock for the benefit of its sole shareholder, had owned stock since 1987 in defendant Leucadia National Corporation, a publicly owned financial services corporation organized in New York. Allegations of wrongdoing by Pinnacle centered on four transactions, three involving the issuance of warrants to Leucadia's chairman and president, and the fourth concerning a merger. At issue in this factually complex commercial case was: 1) whether a claim had been stated by Pinnacle for breach of fiduciary duty and waste, and 2) whether Business Corporation Law (BCL) § 612 was violated in connection with the merger effected by defendant Leucadia.[1]

In 1985, 1991, and 1992, the Leucadia board of directors approved the issuance of warrants that gave Leucadia's chairman and president, separately, options to purchase several hundred thousand shares of Leucadia stock. Proxy statements to the shareholders described the terms of these warrants, and shareholders voted to approve each of these transactions. In 1989, Leucadia repurchased the majority of the 1985 warrants. In 1990, the board of directors of Leucadia proposed a merger with the Marks Investing Corporation (MIC). The purpose of the merger was to simplify the circular ownership structure among Leucadia, MIC, and TLC associates, a partnership of which MIC owned a majority interest. The proxy statement stated this reason to shareholders, and also revealed that the merger would give the Leucadia chairman, president, and another director a controlling interest in Leucadia stock. Furthermore, the proxy statement also indicated that TLC—which would be dissolved after the merger—intended to vote its Leucadia shares (58.7% of the outstanding shares) in favor of the merger. The merger was approved by Leucadia's shareholders; however, Pinnacle chose not to vote its shares for or against the merger, nor did it return its proxy.

In 1994, Pinnacle brought a derivative action in the United States District Court for the Southern District of New York against Leucadia and its officers and directors, alleging claims under the Racketeer Influenced and Corrupt Organizations Act (RICO)[2] that the three warrants were wrongfully issued, and that the proxy statement failed to state that Business Corporation Law § 612 prohibited TLC from voting its shares in favor of the merger. The District Court dismissed the suit in part, holding that Pinnacle's claims concerning the 1985 warrants were time-barred, the proxy statements for the other two warrants were neither false nor misleading, the warrants were properly issued under BCL § 505, and BCL § 612 did not prohibit TLC, a partnership, from voting its shares in favor of the merger of Leucadia and MIC.

The United States Court of Appeals for the Second Circuit affirmed, indicating that the authorization of the warrants was proper, did not constitute a fraudulent act under RICO, and complied with BCL § 505 in that the warrants were issued to the chairman and president because of the "dramatic turnaround that Leucadia experienced" and that the corporation "could reasonably determine that the issuance of the warrants was deserved on the basis of past service."[3] In addition, the court held that there was "no fraud shown in the issuance of the warrants" and that "the Director's business judgment is conclusive that valid consideration was received for the warrants."[4] The court held that it was unnecessary to reach the question of whether BCL § 612 had been violated since two predicate acts were necessary to support a RICO claim and Pinnacle was alleging a single violation.[5]

Pinnacle subsequently brought this derivative action in state court, alleging that defendants violated BCL § 505 by its issuance of warrants and thus committed fraud, corporate waste, conversion, and breach of fiduciary duty. In addition, Pinnacle alleged that defendants had violated BCL § 612 by permitting TLC to vote its shares in favor of the merger with MIC. The Supreme Court dismissed the warrants claim on the basis of collateral estoppel, and held that BCL § 612 had not been violated since the statute only applied to corporations, and not partnerships. The court, however, held that Pinnacle had stated a claim for breach of fiduciary duty and corporate waste. The Appellate Division, upon review, modified the Supreme Court's judgment and dismissed the entire complaint, holding that Pinnacle lacked standing and was estopped from challenging any of the transactions because, as a shareholder, it had not voted against them.[6]

The Court of Appeals came to three main conclusions regarding Pinnacle's claims. First of all, the doctrine of collateral estoppel barred Pinnacle's claims for waste and breach of fiduciary duty which were based on the issuance of warrants to Leucadia's chairman and president. The court held that the issues had been fully litigated in Pinnacle's prior unsuccessful federal RICO suit against Leucadia. There, the Second Circuit had rejected Pinnacle's argument, concluding that the warrants had been validly issued to reward Leucadia's chairman and president for Leucadia's dramatic turnaround, and that there was no fraud in the issuance of the warrants. Pinnacle's claims that defendants breached their fiduciary duty and committed corporate waste by issuing such warrants were raised and necessarily decided in the federal court action. Furthermore, even though the Second Circuit, after dismissing Pinnacle's RICO claim, then dismissed its state law waste and fiduciary duty claims for lack of federal jurisdiction rather than on the merits, its dismissal necessarily determined the same issues raised by these claims, and such claims were thus barred by collateral estoppel.[7]

Secondly, the Court of Appeals held that Pinnacle's failure to vote its shares against the merger of Leucadia and MIC did not bar the claim that the TLC partnership, allegedly controlled by Leucadia, had improperly been allowed to vote its Leucadia shares in favor of the merger, in violation of BCL § 612(b). The defendant contended, and the Appellate Division held, that Pinnacle lacked standing because it failed to vote its shares against the merger, and the court relied on the general principle that any shareholder who participated in an activity may not then challenge its legality in a derivative suit.[8] However, the court distinguished the action of a shareholder who abstains from voting on a merger, where the merger requires the affirmative vote of a supermajority of shareholders in order to be approved. Since abstention is the equivalent of a negative vote, a shareholder that abstains from voting on the merger cannot be said to acquiesce in that merger.[9]

Finally, even though Pinnacle had standing to bring a claim against Leucadia for alleged violation of BCL § 612 regarding the merger vote of shareholders, the court held that this statute barring a subsidiary from voting its shares in the parent corporation applied only to subsidiary corporations, and not to partnerships. The court noted that the language in BCL § 612(b) was precise in stating that

> Treasury shares and shares held by another domestic or foreign *corporation* of any type or kind, if a majority of the shares entitled to vote in the election of directors of such other *corporation* is held by the corporation, shall not be shares entitled to vote or to be counted in determining the total number of outstanding shares.[10] (italics added)

Had Delaware General Corporation Law § 160(c) or the Model Business Corporation Act § 7.21(b) been governing, statutes which merely prohibit cross-voting where a subsidiary directly or indirectly owns shares in the parent corporation, TLC might have been precluded from voting its shares in favor of the merger. However, the court recognized BCL § 612(b) as clearly applying only to corporations, and not to partnerships, and it deferred to the legislative judgment on the limitation of prohibition of cross-voting only to subsidiary corporations.

## Endnotes

1. *Pinnacle Consultants Ltd. v. Leucadia Natl. Corp.,* 94 N.Y.2d 426, 431, 706 N.Y.S.2d 46, 48 (2000).
2. 18 U.S.C. § 1962(b)-(d).
3. *Pinnacle Consultants v. Leucadia Natl. Corp*., 101 F.3d 900, 905 (2d Cir. 1994).
4. *Id.* at 905.
5. *Id.* at 906.
6. *Pinnacle Consultants Ltd. v. Leucadia Natl. Corp*., 261 A.D.2d 164, 165, 689 N.Y.S.2d 497, 499 (1st Dep't 1999).
7. *See Browning Ave. Realty Corp. v. Rubin*, 207 A.D.2d 263, 615 N.Y.S.2d 360 (1st Dep't 1994). In this case, the federal court dismissed the RICO claim, indicating that the subsequent state law claims raised the same issue barred by collateral estoppel, even though the federal court never assumed jurisdiction over the state law claims.
8. *See e.g.*, *Diamond v. Diamond*, 307 N.Y. 263, 266, 120 N.E.2d 819 (1954).
9. *Pinnacle Consultants Ltd. v. Leucadia Natl. Corp*., 94 N.Y.2d 426, 434, 706 N.Y.S.2d 46, 51 (2000).
10. N.Y. Business Corporation Law § 612(b).

**Michael J. Dutkowsky is a third-year student at Albany Law School and student editor 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.**

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