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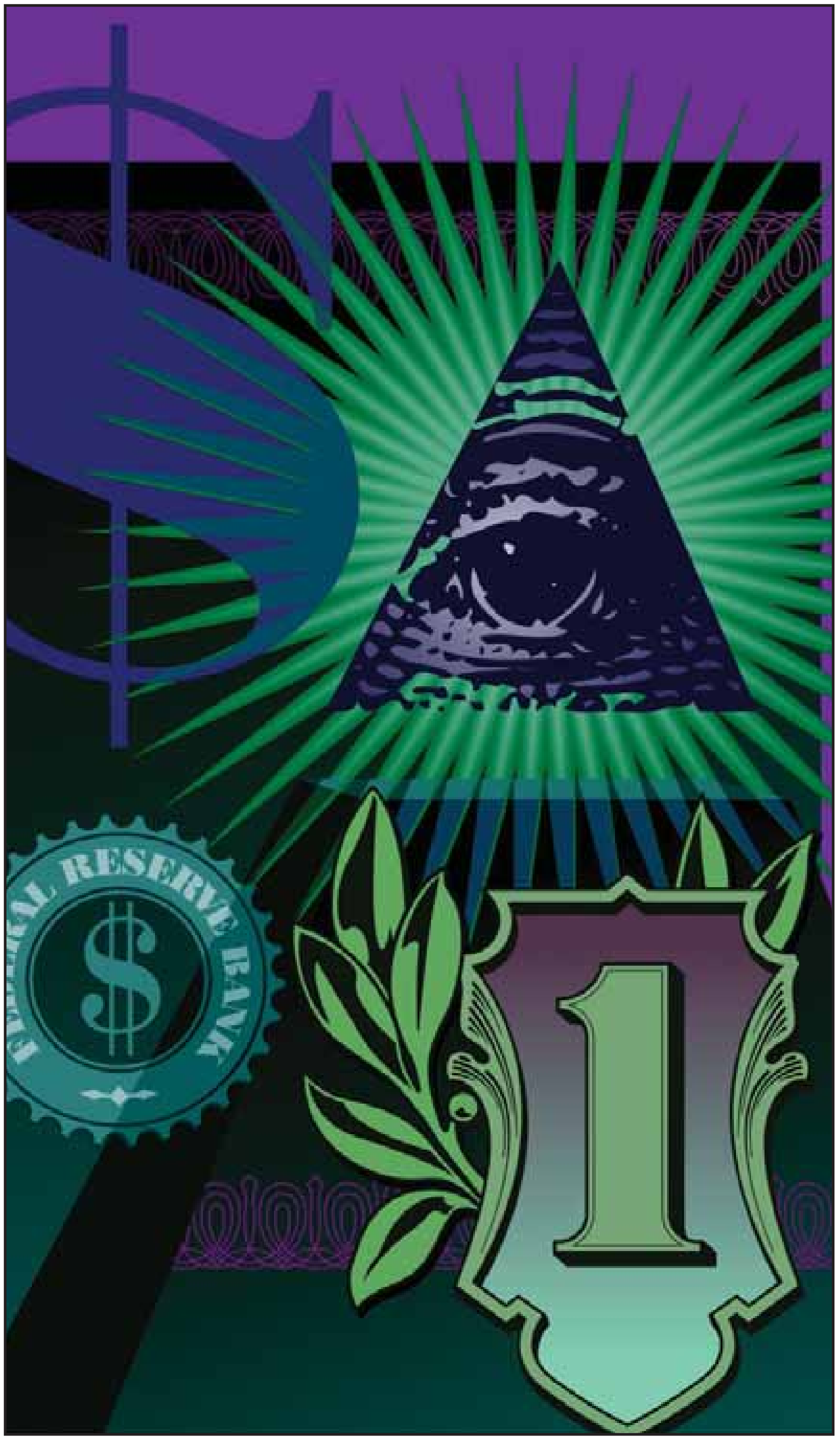

Inside

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HeadNotes

In Yogi's felicitous formulation, it's déjà vu all over again for New York business lawyers. Specifically: the Federal Trade Commission (FTC) has decided that lawyers are subject to the "Red Flag Rule" under the Fair and Accurate Credit Transactions Act (FACT Act), which mandates that "creditors" implement a program to protect their clients from identity theft (i.e., in connection with personal information given to the attorney in confidence by the client). The American Bar Association (ABA) has filed suit, alleging that the FTC's action is arbitrary, capricious and contrary to law, in that the FTC has failed to "articulate, among other things: a rational connection between the practice of law and identity theft; an explanation of how the manner in which lawyers bill their clients can be considered an extension of credit under the [FACT Act]; or any legally supportable basis for application of the Red Flag Rule to lawyers engaged in the practice of law." (Note: as this issue went to press, the lower court ruled in favor of the ABA. It is not known whether the FTC plans to appeal.)

But why should anything as trivial as the law stop a federal agency on a mission? Following enactment of the Gramm-Leach-Bliley (GLB) Act of 1999, which among other things required all "financial institutions" to implement a policy to protect the privacy of their customers and annually send privacy notices to them, the FTC likewise decided that lawyers were "financial institutions," at least to the extent that they engaged in tax preparation, real estate settlement and similar activities, and, as such, were required to comply with the GLB Act privacy provisions—notwithstanding that all attorneys are subject to state ethics rules that impose substantially greater duties on them and are more protective of their clients, and that there was no indication whatever that the Congress ever intended these provisions to apply to lawyers. In that case the NYSBA, joined by the ABA, took the lead in suing the FTC; the NYSBA's then-president analogized the plight of business lawyers to that of dolphins inadvertently caught in a tuna net.

In a pair of articles published in the NYSBA *Business Law Journal*, I analyzed first the NYSBA's complaint and the legal issues it raised ("Are You a Dolphin? Or a Financial Institution?" 6-2 NYSBA Bus. Law J. 16 (2002)) and the court's decision overturning the FTC's wrongheaded conclusion as arbitrary, capricious and contrary to law ("NYSBA v. FTC: The Dolphins Escape! (Or Do They?)" 8-2 NYSBA Bus. Law J. 25 (2004)). Both articles are accessible by Section members through the NYSBA Web site (www.nysba.org/BusinessLawJournal). In the latter article I admonished business lawyers to "keep your eyes peeled for those lurking tuna nets." Given the FTC's latest, it appears that warning was not just academic. The only saving grace at the moment is that implementation of the Red Flag Rule—which already had been delayed a full year from the original target date of November 1, 2008—has now been pushed back again, this time to June 2010, apparently at the request of Congress. Look for an article on the subject in the Spring issue.

Leaving aside the FTC and its caprices, financial markets reform remains front-and-center as 2009 winds to a close. As this issue went to press, Rep. Barney Frank (D-MA), Chair of the House Financial Services Committee, had just introduced legislation to implement the Obama Administration's reform proposals. We anticipate that our Spring 2010 issue will have more to say on the subject. In the meantime:

"[T]he public outcry over unseemly bonuses and other compensation arrangements for executives of financial firms that received Government assistance has led to various proposals to limit or regulate compensation—both for firms actually receiving federal aid and for large, systemically important financial companies more generally."

One of the most controversial, and certainly inflammatory, aspects of the financial crisis was the role played by executive compensation in creating perverse incentives for financial firms and their managers. In particular, the public outcry over unseemly bonuses and other compensation arrangements for executives of financial firms that received Government assistance has led to various proposals to limit or regulate compensation—both for firms actually receiving federal aid and for large, systemically important financial companies more generally. Pending the outcome of current legislative efforts, attorneys Allen Major and Stephanie Soondar present a comprehensive and thoroughly researched overview of the existing bases in federal and state law upon which compensation deemed to be excessive has been challenged. In "Litigation and Recoupment of Executive Compensation," they review the compensation provisions under the Troubled Assets Relief Program (TARP) enacted by Congress last year, as well as the earlier Sarbanes-Oxley Act (SOX), the Bankruptcy Code and other federal statutes. They also analyze the unsuccessful litigation brought by then-New York Attorney General Eliot Spitzer regarding the allegedly excessive compensation paid by the New York Stock Exchange to its chairman, Richard Grasso, and the *Disney* case, involving a claim of corporate waste under Delaware law based on allegedly excessive severance payments to a senior executive.

Another consequence of the economic downturn has been a sharp ramp-up in bankruptcy filings. Given the federal policy favoring arbitration and alternative dispute resolution, perhaps predictably this has in turn led to a clash between the conflicting objectives of the Federal Arbitration Act (FAA) and the Bankruptcy Code, which seeks to centralize all disputes involving a bankrupt debtor in bankruptcy court. In "Arbitration Agreements and Bankruptcy—Which Law Trumps When?" Edna Sussman, who is chair-elect of NYSBA's Dispute Resolution Section, cogently explains the nature of the conflict and analyzes some of the recent case law regarding the effect of a bankruptcy filing on an existing arbitration agreement. Her conclusion? Unfortunately, "there is no bright line" (but when is there ever in the modern practice of business law?). Still, her article offers practical guidance for attorneys in analyzing the conflict between these two bodies of law.

As business litigation accelerates and becomes more complex, it is predictable that discovery demands will follow suit. In the modern environment the need to produce electronic records has placed new demands on businesses and their lawyers to preserve these records in suitable form. The need goes beyond litigation; in the wake of the failure of Lehman last year, for example, the SEC subpoenaed e-mails and other electronic records from numerous broker-dealer firms, seeking evidence of rumor-spreading or insider trading. In "E-discovery 'Worst Practices': Ten Sure-Fire Ways to Mismanage a Litigation Hold," attorneys Jack Pace and John Rue of White & Case in New York City wryly heed the admonition of Catherine the Great—"If you can't be a good example, then you'll just have to be a horrible warning"—as they lucidly illustrate the pitfalls awaiting businesses that fail to properly implement a sound retention policy.

Beginning with this issue, we are pleased to introduce a new recurring feature: "Inside the Courts," prepared by the law firm Skadden Arps, which provides an update on key securities-related litigation. This issue's column provides timely updates on more than 30 recent cases dealing with issues ranging from class certification to SEC disbarment, pleading standards, whistleblowers and other securities litigation-related issues. On behalf of the *Journal*, I express our appreciation to the Skadden attorneys involved for sharing this very useful feature with us.

The financial crisis also has renewed the controversy regarding the Gramm-Leach-Bliley (GLB) Act of 1999, which enabled banks, broker / dealers and insurance companies to affiliate and broadened the range of financial activities permitted to financial holding companies that met certain criteria in terms of capital, management and meeting community credit needs. One feature of the Act was the concept of "functional regulation"—i.e., rather than being regulated by entity, financial companies should be regulated based upon the particular function or service offered. One aspect of this was to give the Securities and Exchange Commission (SEC) jurisdiction over bank securities activities that previously were exempt from its purview, with certain exceptions for traditional bank securities activities. Attorney Vlad Frants tackles one of these exceptions—the so-called "networking exception," which permits a bank to enter into an arrangement with a registered broker-dealer to offer certain securities products to its customers, and allows the bank to be compensated for referring customers for this purpose, notwithstanding the general prohibition on commission-sharing by broker-dealers. In "A Functionalist Perspective on the Effectiveness of the Gramm-Leach-Bliley Networking Exception and Its Related Regulation R Provisions," Mr. Frants analyzes and explains how the networking exception was implemented by joint Federal Reserve-SEC rulemaking. He argues that, as implemented, the networking exception does not accomplish the intended objectives of functional regulation, including investor protection and competitive equality.

Another ramification of the financial dislocations of recent years has been the increasing pressure on business lawyers to act as whistleblowers on their clients. Under the Sarbanes-Oxley Act (SOX) of 2002, the Securities and Exchange Commission (SEC) was empowered to regulate the conduct of lawyers, at least those who practice before the SEC. Running with this mandate, the SEC introduced "permissive" disclosure standards, whereby attorneys would be permitted (read: required; the FTC apparently is not the only federal agency hostile to the attorney-client privilege) to disclose client confidences in certain circumstances. In "New York's New Ethics Rules: What You Don't Know Can Hurt You!" C. Evan Stewart, who regularly writes on ethics issues for the *Journal*, reviews the background of the "permissive disclosure" concept and discusses the more measured approach taken by New York. But the author notes that the SEC has made clear its belief that state rules are preempted by its rules pursuant to SOX. The article is must reading for any attorney with a capital markets practice.

One area in which business lawyers used to have some certainty is the question of whether a foreign corporation is doing business in New York (or another state), for purposes of qualifying to do business or for litigation. The courts would point to such objective factors as whether the corporation maintained an office, owned real property, or had bank accounts in the state. But (perhaps predictably), the dawn of the Internet has thrown that relative certainty into the ether as well. In “When Is a Foreign Corporation Doing Business in New York?” Stuart B. Newman, founder and Advisor Emeritus of the *Journal*, and his colleague, Ari Spett at Salon Marrow Dyckman Newman & Broudy LLP in New York City, discuss the implications of a recent case in which a company was found to be doing business in New York without any of the traditional indicia, based on an Internet auction used by the company to provide services to, *inter alia*, customers in New York. As the author notes, this standard is overbroad to a worrisome extent, in an era when doing business over the internet is *de rigueur* for most businesses.

Another new headache for New York business lawyers is the new durable power of attorney form, use of which is mandatory. The intent of the new form was to protect senior citizens from abuse by persons to whom they entrust their affairs. But—as is so often the case when dramatic changes in the law are made with good intentions—the law of unanticipated consequences has reared its head. In “What Every Attorney Should Know About the New Durable Power of Attorney Form,” attorney Anthony Enea highlights the many pitfalls, practical as well as substantive, for New York practitioners, and offers a practical guide to using the new form.

This issue’s Employment Law Update features two significant, and narrowly divided, Supreme Court decisions: the *Ricci* case, which was an issue in the confirmation hearings for new Justice Sotomayor, in which white firefighters alleged reverse discrimination; and *Gross v. FBL Financial Services, Inc.*, in which the Court effectively raised the bar for certain plaintiffs alleging age discrimination under the Age Discrimination in Employment Act. James Grasso of Phillips Lytle also provides updates on amendments to New York law, including a significant change in the Insurance Law to mandate that employers cover dependents of their employees up to age 29, if the dependent is living at home, is unemployed and is not otherwise covered.

Our last issue concluded with a fine piece by Megan Burke, a candidate for the JD / MBA degree at Albany Law School, comparing mergers and acquisitions (M&A) law in China as compared to the U.S. Ms. Burke has followed up with a companion article: “Ethics Flu: Legal Ethics Concerns for New York-Licensed Cross-Border Transactional Attorneys.” Using China as an example again, Ms. Burke elucidates some of the ethical pitfalls for New York attorneys engaged in cross-border transactions, where the ethical standards of the other jurisdiction differ from those of New York.

David L. Glass
Editor-in-Chief

Litigation and Recoupment of Executive Compensation

By Stephanie L. Soondar and Allen Major
Edited by Candace Hines

1. Introduction

Merrill Lynch ("Merrill") suffered fourth quarter losses of $9.8 billion in 2008. Contemporaneously, but preceding its $50 billion federally aided acquisition by Bank of America ("BofA"), Merrill was given the green light to pay as much as $5.6 billion in incentive compensation. The legal fallout has been dramatic by any standard, and the dispute of whether this compensation was properly disclosed to shareholders is yet pending in the courts. Troubled Asset Relief Program ("TARP") Special Master Kenneth Feinberg has recently received and ruled on compensation structures for the twenty-five highest paid executives from several companies receiving the most significant federal financing. Before 2009 closes, Feinberg will not only assess and structure the compensation for the next seventy-five highest paid employees at the same companies, but he will also assess whether or not to claw back any compensation already paid. And of course there is New York Attorney General Andrew Cuomo, who in July 2009 publicly released an investigative report detailing executive compensation numbers of various banks and firms.[1] In light of these circumstances and the ongoing economic crisis and populist political rhetoric, shareholders and creditors may grow activist and seek recoupment of executive compensation awarded to high-level management. This article functions as a broad overview of the possible state and federal legal authorities parties in New York may face in litigation.[2]

The federal Troubled Asset Relief Program ("TARP") contains extensive provisions regarding executive compensation for companies which received federal money under the program. TARP provisions do include a clawback mechanism. The Sarbanes Oxley Act of 2002 ("SOX") also has a clawback mechanism, though subject to significant limitations. The Securities Exchange Act of 1934 is also used frequently under Section 10(b) and Rule 10b-5 claims to recapture executive compensation under circumstances of fraud, though recent allegations have failed to survive motions to dismiss for a variety of reasons. Too, the federal Bankruptcy Code may provide recovery for executive compensation paid by debtor corporations.

State authority similarly offers a basis on which litigating parties can find support for their claims and defenses. Delaware offers broad discretion for board of director determination of executive compensation. This discretion, however, is not unlimited, as evidenced in *Valeant Pharmaceuticals*. In New York State, a variety of possible bases exists for plaintiffs. Defense counsel, however, will be comforted by the lack of modern precedent, and the recent and substantial Richard Grasso victory. Other jurisdictions, such as Alabama in the matter of *Scrushy*, have taken novel claims and reapplied them to contemporaneous fact patterns, effectuating recoupment.

In regards to any of these authorities, or others not discussed in this article, "the perfect storm" involving recoupment of executive compensation appears to have built and is on the cusp of breaking. Although precedent is a guide, it is unknown how a court influenced by the current social and political environment may interpret the fact intensive inquiries required by the laws discussed in this document. For instance, although New York common law contains precedent for the recoupment of executive compensation, there is no modern equivalent for the rulings. It is a matter of interpretation how a New York court today will apply that law to modern facts. This article seeks to provide a solid foundation on which to further explore or develop these inquiries.

2. Federal Authority

2.1 Troubled Asset Relief Program ("TARP")

In the fall of 2008, the U.S. economy was facing significant challenges, including a weak housing market, elevated inflation, rising mortgage delinquencies and a weakening labor market.[3] Several large banks realized major losses, particularly on mortgage-related assets, and had difficulty raising new capital to offset the losses.[4] Financial markets became increasingly stressed, and the broader economy continued to deteriorate.[5] In light of the financial crisis, Congress sought to strengthen the economy and stabilize the financial system by offering public money to private companies.[6] In turn, to help thaw frozen credit markets, the government wanted the private banks which received government money to lend the money to businesses, consumers and other banks.[7] As part of these bank bailout packages, Congress and the Treasury Department ("Treasury") have imposed restrictions on executive compensation at firms receiving government money through the Troubled Asset Relief Program ("TARP").[8] The restrictions are intended to ensure that government funds are used to further the public interest and not for inappropriate private gain.[9] In particular, President Barack Obama indicated that he does not want the government to subsidize large payouts to poorly performing bank executives who played a part in endangering the financial system.[10] Treasury has indicated that with the ultimate goal of systemic regulatory reform, the government is engaging in a long-term effort to investigate the extent to which past executive compensation structures at banks contributed to the financial crisis, and how corporate governance regulation can be improved to better promote long-term economic growth and to prevent future financial crises.[11]

Congress Passes EESA, ARRA; Treasury Issues Interim Final Rule

The TARP bailout was authorized by Congress in the Emergency Economic Stabilization Act of 2008 ("EESA"), and section 111 of EESA contains provisions limiting executive pay at TARP recipients.[12] Treasury issued interim final rules in October 2008 and January 2009 pursuant to EESA to provide guidance on EESA's executive compensation and corporate governance provisions.[13] Treasury issued a third interim final rule in June 2009 (the "IFR") pursuant to the American Recovery and Reinvestment Act of 2009 ("ARRA," also known as the "stimulus bill"), which amended and restated the EESA executive pay and corporate governance provisions.[14]

Between the release of the second and third interim final rules, on February 4, 2009, Treasury issued a separate set of guidelines limiting executive pay ("Treasury Guidelines").[15] The Treasury Guidelines distinguished between firms participating in any new "generally available capital access program" and firms receiving "exceptional financial assistance."[16] An example of a "generally available capital access program" is the Capital Purchase Program ("CPP") created under TARP,[17] while institutions that negotiate bank-specific agreements with Treasury are deemed to require "exceptional assistance."[18] The companies currently receiving "exceptional assistance" include AIG, Citigroup, Bank of America, Chrysler, GM, GMAC and Chrysler Financial.[19] At firms receiving "exceptional assistance," the Treasury Guidelines imposed a strict cap of $500,000 in total annual compensation paid to each senior executive except for restricted stock awards.[20] A similar cap was placed on senior executive pay at firms participating in "generally available capital access programs," except that such companies could waive the cap so long as they fully disclose senior executive compensation and, if requested, allow a "say on pay" shareholder resolution.[21] The Treasury Guidelines' framework of strictly capping executive pay was abandoned in the IFR, which, pursuant to ARRA, focuses on limiting bonuses paid to most highly compensated employees.[22] Under the IFR framework, unlike the Treasury Guidelines, the primary distinction between firms receiving "exceptional assistance" and those that do not is that the former must submit their compensation payments and structures to the Special Master for TARP Executive Compensation (the "Special Master") for his approval, while the latter may apply to the Special Master for an advisory opinion but are not required to do so.[23]

Less than two weeks after the release of the Treasury Guidelines, on February 17, 2009, President Barack Obama signed ARRA into law.[24] ARRA amended and restated section 111 of the EESA, and, for the first time, imposed limitations on bonuses paid to employees of TARP recipients.[25] The executive pay restrictions in ARRA apply to all recipients of TARP funds, including retroactively to those who received money in the past.[26] The ARRA pay restrictions apply during the period in which any obligation arising from the receipt of TARP funds remains outstanding, not including any period during which the government holds only warrants to purchase the TARP recipient's common stock (the "TARP Period").[27] The IFR consolidates and supersedes prior rules and guidance regarding executive compensation, and became effective as of June 15, 2009.[28] For the period between October 20, 2008 and June 15, 2009, the October 2008 interim final rule remained in effect.[29] Additionally, to the extent they are not inconsistent with ARRA or the IFR, previous contractual provisions entered into by TARP recipients remain in effect.[30] Since the January 2009 interim final rule was never published in the Federal Register, the Treasury considers it void.[31]

The Office of the Special Master

The IFR establishes the Office of the Special Master, and Treasury immediately named Kenneth R. Feinberg as the Special Master.[32] The Special Master's responsibilities include the interpretation and application of section 111 of EESA and its rules and regulations.[33] The Special Master's decisions will not be subject to appeal.[34] For TARP recipients receiving "exceptional assistance," the Special Master must determine whether the compensation payments and compensation structures for the senior executive officers ("SEOs")[35] and the twenty next most highly compensated employees[36] may result in payments that are inconsistent with the purposes of TARP or contrary to the public interest.[37] Additionally, any remaining executive officers and the one hundred most highly compensated employees of a TARP recipient receiving "exceptional assistance" must submit their compensation structures for review by the Special Master, and the Special Master must determine whether the compensation structures may result in payments that are inconsistent with the purposes of TARP or contrary to the public interest.[38] The IFR provides a safe harbor regarding compensation paid to employees of TARP recipients requiring "exceptional assistance" so long as the employee is not an SEO or one of the twenty next most highly paid employees, and the employee's total annual compensation does not exceed $500,000 other than long-term restricted stock. In such cases, the compensation will automatically be deemed appropriate even without the prior approval of the Special Master.[39]

Even at TARP recipients not receiving "exceptional assistance," the IFR allows such firms or employees of such firms to request an advisory opinion from the Special Master as to whether a compensation structure may result in payments that are inconsistent with the purposes of TARP or contrary to the public interest.[40] Additionally, the Special Master is given the power to render advisory opinions on his own initiative as to whether compensation payments or structures at any TARP recipient meet the appropriate standards. If the Special Master renders an adverse opinion, he may negotiate with the TARP recipient and employee for reimbursement to the TARP recipient or the Federal government.[41] Whenever the Special Master reviews compensation payments or structures for consistency with the purposes of TARP and conformity with the public interest, the Special Master must apply the following principles: avoidance of incentives to take unnecessary risk, taxpayer return, appropriate allocation among the components of compensation, appropriate portion of performance-based compensation, comparable structures and payments, and employee contribution to TARP recipient value.[42]

Clawback of Improperly Determined Pay

ARRA requires a TARP recipient to recover or claw back bonuses, retention awards, or incentive compensation paid to an SEO and the next twenty most highly compensated employees based on materially inaccurate statements of earnings, revenues, gains or any other performance metric criteria.[43] A determination of material inaccuracy depends on the facts and circumstances, but if an employee knowingly provides inaccurate information relating to financial statements or performance metrics, such financial statements or performance metrics are deemed materially inaccurate with respect to that employee.[44] The IFR requires a TARP recipient to exercise its clawback rights unless the TARP recipient demonstrates that it would be unreasonable to do so.[45] Additionally, once an employee obtains a legally binding right to a bonus payment, the bonus is deemed to be made.[46]

Limitations on Bonus Payments

ARRA prohibits the payment or accrual of any "bonus,[47] retention award,[48] or incentive compensation"[49] to a certain number of employees under a sliding scale depending on the amount of TARP funding the company received.[50] This bonus limitation does not apply to bonuses paid or accrued prior to June 15, 2009.[51] For a company that receives less than $25 million in TARP funding, only the most highly compensated employee may not be paid a bonus.[52] Companies that receive between $25 million and $249.999 million may not pay bonuses to at least the five most highly paid employees. The SEOs and at least the next ten most highly paid employees may not earn bonuses at institutions which receive between $250 million and $499.999 million. Finally, the bonus restriction at companies receiving more than $500 million in TARP funding applies to the SEOs and at least the next twenty highest paid employees.[53] The IFR includes an anti-abuse rule that recharacterizes certain bonus payments that are intended to bypass the bonus restriction. For example, suppose a bonus is not permitted to accrue in a given year for a certain employee because he or she is subject to the bonus restriction, but the bonus is paid in the subsequent year when the employee is no longer subject to the bonus restriction. Such a bonus payment would be prohibited pursuant to the bonus limitation.[54]

Payments made in long-term restricted stock are allowed notwithstanding the above prohibition on incentive pay so long as the restricted stock does not fully vest during the TARP period, has a value less than or equal to one-third of the restricted stock recipient's total annual compensation,[55] and is subject to any other terms and conditions that Treasury deems to be in the public interest.[56] Permissible long-term restricted stock awards include both restricted stock and restricted stock units, which can be settled in stock or cash.[57] The IFR requires that before long-term restricted stock vests, an employee must provide services to the TARP recipient for at least two years after the date of the grant of the stock. Additionally, the IFR provides a schedule under which the stock may become transferable.[58] A second exception which allows for the payment of bonuses notwithstanding the restriction applies if a bonus payment is required by a written employment contract executed on or before February 11, 2009.[59] The Treasury Secretary, however, has the discretion to determine that the employment agreement is invalid.[60] This employment agreement exception applies only if the employee has a legally binding right to the payment under the employment contract.[61] The IFR adds that if a pre-February 11 employment agreement is amended after February 11 and materially enhances the benefit to the employee, such as a pay increase or an acceleration of vesting conditions, then the benefit will not fall within the employment agreement exception.[62] Finally, the Special Master may provide an advisory opinion regarding pre-June 15 bonus payments and / or payments made pursuant to a pre-February 11 employment contract to determine whether such payments are consistent with TARP or contrary to the public interest.[63]

Limitations on Severance Pay

ARRA prohibits a TARP recipient from making a golden parachute payment to an SEO or any of the next five highest paid employees.[64] A golden parachute payment is defined as any payment to an SEO for departure from a TARP recipient for any reason, except for payment for services performed or benefits already accrued.[65] The IFR deems payments due to a change in control of the TARP recipient as golden parachute payments, including the acceleration of vesting due to a departure or change in control.[66] The present value of all golden parachute payments is treated as paid at the time of the employee's departure or change in control of the TARP recipient.[67] Thus, if an SEO terminates employment during the TARP period but does not gain the right to a golden parachute payment until after the TARP period, the payment would be barred because the payment is deemed paid while the TARP recipient was subject to the prohibition on golden parachutes.[68] The IFR states that payments from qualified pension or retirement plans, payments due to an employee's death or disability, and certain benefit and deferred compensation plan payments are not golden parachute payments.[69]

Other Notable ARRA Provisions

ARRA assigns broad discretion to the Treasury Secretary to review past compensation decisions made at TARP recipients, but the legislation also makes it easier for banks to withdraw from the program. ARRA directs the Treasury Secretary to review past bonus payments, retention awards, and other compensation paid to the twenty-five most highly paid employees of a TARP recipient, including payments made before February 17, 2009, to determine whether any payments were inconsistent with the purpose of TARP or otherwise contrary to the public interest.[70] If such a determination is made, the Secretary must negotiate with financial institutions and affected employees for the reimbursement of those payments to the federal government.[71] In the IFR, the Treasury Secretary delegates these duties to the Special Master.[72] Additionally, ARRA removes past provisions which required TARP recipients to wait for a certain time period and to replace the funds through other sources before repaying the government.[73] Now, so long as the federal banking regulator approves, a TARP recipient may repay the government funds at any time. After the assistance is repaid, the Treasury Secretary will sell outstanding stock warrants at the current market price.[74] In fact, in June 2009, Treasury allowed ten banks to repay $68 billion in TARP money. These banks included J.P. Morgan Chase, Goldman Sachs and Morgan Stanley.[75]

ARRA requires that shareholders of institutions that have or will receive TARP money be given a "say on pay" to approve the compensation of executives.[76] In its annual meeting proxy statement, a TARP recipient must disclose its executive compensation pursuant to the SEC's compensation disclosure rules, including the compensation discussion and analysis, compensation tables and the associated narrative.[77] In the area of corporate governance, ARRA requires each TARP recipient to establish a compensation committee made up entirely of independent directors to review employee compensation plans.[78] The compensation committee must meet at least semiannually and assess any risk posed to the company from the compensation plans.[79]

Consequences of Government Regulation of Executive Pay

While the pay restrictions outlined above were intended to prevent companies from paying out rewards, subsidized by U.S. taxpayers, to poorly performing executives,[80] the restrictions might result in unintended consequences and may even be bypassed by crafty lawyers and accountants. For one, to comply with ARRA's limitation on the use of incentive compensation, banks might be forced to raise salaries, a development which corporate governance reformers oppose. Big banks typically pay their executives a small salary, but offer large bonuses if certain performance-based criteria are met.[81] This practice, known as pay for performance, serves to align an executive's desire for high pay with shareholders' interest in increased company value. However, with the restriction on bonuses, banks might need to raise salaries to retain and recruit executives, and such salaries will have to be paid no matter how poorly the company performs.[82] In short, with incentive compensation restricted, an executive's incentive for guiding his or her company to reach its performance benchmarks is diminished. Supporting the prediction that TARP recipients would raise salaries, a report stated that Citigroup was planning on boosting salaries for certain rank-and-file employees by as much as 50% to offset smaller bonuses.[83]

Other unintended negative consequences resulting from the pay restrictions on TARP recipients include the possibility that firms might rush to repay the government even before they are sufficiently capitalized, and some, particularly those receiving "exceptional assistance," might have difficulty hiring and retaining senior executives. The government's rationale for extending financing to private banks was to shore up the balance sheets of weak banks, to increase lending activity and to build up confidence, in particular, in the financial system and in the economy in general.[84] However, if TARP recipients view the restrictions as too onerous and therefore pressure the banking regulator to allow them to return the funding, these banks might still be at risk of failure even after returning TARP money. In fact, TARP recipients now have further incentive to push for permission to repay the government because now that numerous banks have been allowed to return their money, the market might perceive those that continue to hold government money as relatively weak and unstable. Another problematic consequence of limiting bonuses only at certain banks is that executives at TARP recipients might be tempted to leave for financial institutions not constrained by the pay restrictions, such as private equity funds, subsidiaries of foreign banks or strong U.S. banks which do not hold government funds.[85] Similarly, a tottering TARP recipient that is integral to the financial system might have difficulty recruiting top executives due to the pay limitations even though such a bank greatly needs able executives to see it through the crisis.[86]

Clarifying an ambiguity in ARRA, the IFR states that most highly compensated status is determined based on employees' compensation earned in the prior year.[87] This, however, leaves room for TARP recipients to "intentionally cycle" employees in and out of most highly compensated employee status in alternate years.[88] To illustrate, pursuant to the IFR, a firm receiving more than $500 million in TARP funds must impose the bonus restriction in 2009 on the twenty-five highest paid employees of 2008.[89] Due to the pay restriction, that group likely would not be the highest paid in 2009, so a different group of twenty-five would be the highest paid in 2009. Pursuant to ARRA, this second group would not be allowed to earn bonuses in 2010. The bonus restriction would thus be lifted from the original group who earned the most money in 2008 so that they could earn bonuses in 2010. This might result, intentionally or unintentionally, in groups of twenty-five employees trading places as highest paid every year. The IFR contemplates this possibility and suggests a couple of methods to mitigate abuse. One suggestion is to determine most highly compensated status based on an average of the preceding two or three years' annual compensation.[90] Another suggestion is to require most highly compensated employees identified for one year to remain subject to the restrictions for a certain number of additional years.[91] The Treasury invites comment on the issue, including the extent to which intentional cycling is likely to occur and how to address the issue.[92]

2.2 Sarbanes-Oxley and Section 304

The Sarbanes Oxley Act of 2002 ("SOX") was the legislative response to the Enron and WorldCom financial scandals of 2000.[93] By enacting SOX, Congress gave the Securities and Exchange Commission ("SEC") a greater tool for enforcement, and afforded aggrieved shareholders a means of recapturing some of their value lost to fraud and mismanagement.[94] Among these tools is the "clawback" mechanism of Section 304.[95] Broadly speaking, it provides for disgorgement of executive compensation in instances of "misconduct."[96] Executive compensation here means any incentive or equity-based pay received from the issuer during the twelve months following the misconduct.[97] This does not include salary.[98] Profits earned from the sale of issuer securities during the same twelve-month period are also subject to disgorgement.[99] Though the potential for recoupment under SOX may appear quite broad, § 304 is subject to significant limitations.

Vague Statutory Language

Section 304 allows for recoupment of executive compensation awarded only to a properly named chief executive officer ("CEO") and chief financial officer ("CFO").[100] No other corporate employee's compensation is included in the statutory language.[101] The statute's language does not explicitly exclude holding the CEO or CFO responsible for the misconduct of other executives and corporate employees, but until recently the SEC was focused on cases that involved only CEO and CFO misconduct.[102] This was ironic in light of the broad consensus that corporate culture and tone – as regards business ethics and aggressiveness – were set by the CEO and CFO, to be followed by other senior management and by employees generally throughout the corporation.[103] In July of 2009, however, the SEC filed a complaint against Maynard Jenkins, CEO of CSK Auto Corporation.[104] The complaint seeks disgorgement under § 304 of more than $4 million in bonus and equity compensation.[105] The complaint does not, however, contain any allegations of securities fraud by Jenkins himself.[106] Rather, the complaint alleges that the original financial statements were fraudulent, that Jenkins signed them, and that Jenkins was paid $4 million in various compensation upon publication of the misstated financial statements.[107] The resolution of this complaint is eagerly anticipated, as it potentially broadens CEO and CFO liability to include securities fraud committed by other corporate employees during the CEO's or CFO's tenure.[108]

Because the SEC has not adopted enforcement provisions for § 304,[109] courts are left to determine what various terms mean and how to apply them. For example, although the statute punishes "misconduct," it does not define what that term encompasses.[110] The courts have found, however, that it is not enough for "misconduct" to occur, or to even have been known of.[111] Rather, a public financial restatement must formally be filed by the corporation.[112]

The factual allegations of cases successfully filed under § 304 offer us some guidance as to what "misconduct" means. Section 304 has been alleged successfully in instances of stock option backdating[113] and manipulated profit margins.[114] *SEC v. McGuire*[115] involved backdating and was the first settlement with an individual under § 304, totaling a record $468 million.[116] McGuire was the former CEO and Chairman of the Board at UnitedHealth Group, Inc., and was accused of stock-option backdating.[117] The allegations described a twelve-year period where McGuire selectively chose low common stock closing prices, and signed back-dated documents falsely indicating that options had been granted on the dates with the lowest price.[118] The false documents led to UnitedHealth understating its compensation expenses on public financial statements, contrary to existing accounting rules and misleading shareholders.[119] When UnitedHealth restated twelve annual financial statements for the years 1994 through 2005, the errors totaled $1.526 billion.[120] In *SEC v. Brooks*,[121] a former CEO and Chairman of the Board at DHB Industries was alleged to have overstated inventory values, falsified journal entries, and failed to charge obsolete inventory, thereby manipulating the company's gross profit margin.[122] Brooks also allegedly misused corporate money, engaged in insider trading, and ultimately facilitated the delivery of false financial documents to the public.[123] As of the time of this writing, the case is still pending in the Southern District of Florida.[124]

Other statutory terms not identified by the Legislature, or yet substantially materialized by the courts, include: "required [to prepare]" when discussing when an issuer must restate its financials, and the meaning of "material noncompliance" when discussing misconduct.[125] Also, § 304 does not identify the state of mind the CEO or CFO must have while perpetrating the misconduct.[126] Rather than alleging acts were committed recklessly or with intent, the SEC has alleged fraud in every case.[127] Minor other limitations include: no retroactive money has been awarded to the issuer for executive compensation paid before SOX enactment in 2002,[128] and reimbursement has been limited solely to the issuer and not to any individual or collection of shareholders.[129]

No Private Right of Action

Section 304's most significant limitation is the lack of a private right of action.[130] The statutory language does not explicitly include or exclude a private right of action, but the courts have interpreted the statute to carry none.[131] At the time of authorship, however, only one circuit court has definitively ruled on the matter.[132] There is, however, some debate that the legislative intent was to include a private right of action.[133] Some scholars also argued that an implied private right of action exists, relying on the *Cort*[134] four-factor test.[135] This test enables a court to find a private right of action in a statute that does not explicitly contain one, if, *inter alia*, the plaintiff is among the class protected by the statute.[136] The Court of Appeals for the Ninth Circuit entertained this *Cort* argument in *Diaz*,[137] but still held there was no § 304 private right of action.[138] *Diaz* noted that harm under a federal statute does not automatically give rise to a private right of action.[139] Seeing no explicit statutory language creating such a right, the Court then analyzed the implied right via the *Cort* four-factor test, treating as dispositive "whether Congress intended to provide the plaintiff with a private right of action."[140] The Court concluded that Congress had not, for several reasons. First, the language of § 304 focuses on the person regulated (the executive) and not the person ultimately protected (the issuer or shareholder).[141] Secondly, the Court looked to other sections of SOX for guidance, finding, for example, that Congress had explicitly made a private right of action available under § 306 for equitable remedies but not under § 303.[142] The Court concluded that Congress, therefore, was equally capable of drafting, or excluding, language for a private right of action under § 304.[143] The *Diaz* holding has since been followed in the Ninth Circuit.[144]

It is interesting to note that not until nearly five years after the enactment of SOX was a case number filed under § 304.[145] The limited number of circuit court opinions on the matter of a private right of action under § 304 may be an opportunity for aggrieved shareholders to continue to file § 304 actions in the district courts. In light of the public outrage over executive compensation and the current economic crisis, an activist district court unrestrained by a contrary opinion from its circuit court may choose to read the statutory language more broadly. This seems unlikely, however, and where district and circuit courts follow *Diaz*, shareholders will be barred from pursuing a private claim under § 304.[146] Shareholders intent on pursuing disgorgement of executive bonuses and profits in a private action, then, must look to alternative law.[147]

2.3 Stock Option Backdating[148] and Securities Law[149]

Frequently, corporate compensation includes equity-based stock option grants[150] which are also subject to possible recoupment. Private rights of action exist under the federal securities laws, empowering the shareholder, as an individual or derivatively on behalf of the corporation, to seek such recoupment.

How Stock Option Grants Are Backdated

A stock option grant creates within the recipient executive the right to purchase a specific amount of stock at a specific exercise price on a specific date.[151] As a matter of corporate governance, options are generally granted "at the money."[152] This means the exercise price is equal to the current fair market price of the stock on the day of the grant.[153] "In-the-money," or discounted options, means that the exercise price is lower than the fair market stock price on the day of the grant.[154] Backdating describes the act of, either at the time the grant is written or retroactively after the grant is written, changing the grant date to an earlier date so that the exercise price is lower than the fair market stock price on the day of the grant.[155] This practice creates a gain for the recipient executive, between the low backdated price and the high grant date price.[156] This practice of backdating is not categorically illegal.[157] Where the practice is duly authorized by the board,[158] fully disclosed, and in compliance with relevant accounting and tax provisions, then backdating is not illegal.[159] However, as of January 2007, over 200 companies had come under investigation for backdating by either the SEC, the Justice Department, or their own boards.[160] Backdating came to light in 2006, and to date, the ultimate ramifications are not yet fully known.[161]

Tax[162] and Financial Reporting Consequences

The tax and financial reporting consequences of backdating are complex.[163] For instance, an at-the-money stock option is considered performance-based and therefore does not count toward the corporation's $1 million executive compensation deduction cap under Internal Revenue Code § 162(m).[164] However, in-the-money stock options are not considered performance-based as specifically regards the difference between the low exercise price and the higher fair market price of the stock on the day of the grant[165] (referred to as intrinsic value).[166] That difference in price, then, counts toward the $1 million deduction under § 162(m).[167] Depending on the circumstances of backdating, a corporation may have taken full deductions on amounts that should have been limited.[168]

As regards financial statements which are represented as "GAAP compliant," the corporation must record a compensation expense when in-the-money stock options are granted.[169] The expensed amount is the intrinsic value of the in-the-money options. If this expense was not properly recorded during the financial period it was incurred, a corporation may need to restate financial statements to accurately reflect the compensation expense.[170] Since the accounting of options is recorded over the course of the designated vesting period, a single act of backdating may result in the restatement of several years of financial statements.[171] Also, corporations must disclose their executive compensation in proxy statements to shareholders.[172] If a corporation disclosed that at-the-money options were granted, but as a result of backdating, in-the-money options were in fact granted, those proxy statements would be inaccurate and might be considered fraudulent.[173]

SOX requires corporations to file a Form 4, reporting changes in beneficial ownership of securities to insiders within two days of a transaction.[174] Since 2002, then, the possible universe for backdating is two days.[175] Although Form 4s are not always timely filed,[176] a late Form 4 suggests possible backdating.[177] SOX's Form 4 was followed by the "new" Executive Compensation rules released by the SEC in August and December of 2006.[178] Among several things accomplished by these new rules was adoption of a Compensation Discussion and Analysis ("CD&A") requirement.[179] The CD&A requires the corporation to articulate in detail the objectives of executive compensation, citing specific elements used to arrive at a final compensation package.[180] Also required by the new executive compensation rules is a tabular disclosure requirement.[181] This tabular format includes a number of columns that will aid the shareholder in better understanding the value of the option grant at the time it was awarded.[182] This includes the date on which the option was awarded and the fair market value of the security on that date.[183] Both the CD&A and tabular data must be filed with the SEC, and therefore any statements or representations made therein are subject to the liability provisions of the 1933 and 1934 Acts.[184]

Backdating and Derivatives Litigation

Zoran[185] is an example of how disgruntled shareholders in derivative litigation have recaptured some of the value high-level executives gained when compensated with stock option grants. *Zoran* involved claims of backdating and false proxy statements.[186] After surviving a motion to dismiss, plaintiff settled and the corporation was reimbursed $3.4 million, and several options were repriced at an estimated recaptured value of nearly $2 million.[187] The suit alleged that the corporation's CEO and CFO had violated § 10(b), Rule 10b-5, and § 20(a) of the 1934 Act.[188] Section 10(b) and Rule 10b-5 claims involve the existence and use of manipulative and deceptive devices.[189] Plaintiff alleged that defendant's Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO") had misrepresented to the corporation the value of the stock options granted.[190] The corporation then relied on these misrepresentations in awarding option grants, suffering harm by "parting with its shares at a lower price than was right."[191] The Court found the allegations were successfully pled and refused to dismiss the claim.[192] The claim for control person liability under § 20(a) was also leveled against the CEO and CFO.[193] Plaintiff failed, however, to successfully plead that other people who committed fraud were in fact under the control of the CEO and CFO, and the Court dismissed that additional claim.[194]

"Essential Link"[195] and Proxy Statements

The plaintiff also made a claim, under § 14(a) of the 1934 Act, against the members of the audit and compensation committees for issuing false proxy statements to the corporation's shareholders.[196] The Court found this claim was properly pled and denied a motion to dismiss.[197] Of important note regarding the § 14(a) proxy claim is that the plaintiff properly pled the "essential link" element.[198] This has been a problematic element for other plaintiffs to satisfy.[199] Plaintiff had to show that the proxy solicitation itself, and not the fraud contained within it, was the cause of the injury to the corporation.[200] *Zoran*'s plaintiff survived this standard by pleading that the board members used the proxy statements to maintain their positions and continue the backdating practice.[201] The shareholders voted on the information contained inside those proxy statements without knowledge of the nature of the backdating which had occurred.[202] Board members, once re-elected, could then continue the process of backdating.[203] The corporation was harmed by distributing corporate assets inefficiently, causing an SEC inquiry, and causing reputational damage within the investing community.[204] Plaintiff alleged that had the shareholders known of the backdating, those shareholders would not have voted affirmatively on the proxy statements.[205]

Special Committees and Demand Futility

Derivative actions filed in either a federal district or a New York supreme court must meet a demand futility test.[206] New York Business Corporation Law § 626(c) requires plaintiffs in a shareholder derivative action to plead with particularity that a demand was made to the Board of Directors to initiate the action on behalf of the corporation, or that such demand would have been futile.[207] In New York a demand is futile, and therefore excused, where a majority of the directors are interested in the transaction(s) in dispute, or the directors were not reasonably informed about the transaction(s), or the directors failed to use business judgment regarding the transaction(s).[208] Although the plaintiffs in *Comverse*[209] had successfully pled two of the three tests for demand futility, the trial court dismissed the claim because the director defendants had created a special committee to internally investigate the backdating matter.[210] The trial court found the special committee represented the Board's willingness to remedy the problem on behalf of the corporation, rendering the demand futility question moot.[211] The Appellate Division disagreed, however, and found the creation of the special committee, alone,[212] insufficient to establish the "board's willingness to take all the necessary and appropriate steps to obtain the relief available."[213] The Court reversed the trial opinion and reinstated the claim.[214]

Backdating and Class Action

The requirements for demand futility can be avoided if the moving party pursues class action. Class action, of course, has separate requirements which must be satisfied,[215] but shareholders have experienced some success in option backdating cases. The Southern District Court of New York recently analyzed the sufficiency of backdating claims in *Take-Two*.[216] Plaintiffs alleged two counts of securities fraud as regards options backdating.[217] Count One alleged fraud under § 10(b) and Rule 10b-5, where fraudulent statements regarding the backdating practices were made, causing the investing public to purchase Take-Two shares at inflated prices.[218] Count Two alleged control person liability under § 20(a) against two former CEOs and a former CFO, as these individuals controlled the corporation during the fraud perpetrated in Count One.[219]

The defendants made several motions to dismiss for inadequacy in the pleadings for the § 10(b) and Rule 10b-5 claims, including insufficient loss causation,[220] material misstatements,[221] and scienter.[222] The Court dismissed the bulk of these motions, granting in part those regarding scienter.[223] As regards loss causation, the Court concluded the plaintiffs had successfully pled a diminution in share price as a result of a summer 2006 Take-Two public disclosure revealing an SEC investigation.[224] This particular disclosure was credited with a 7.5 % drop in the company's share price.[225] The loss in value and simultaneous announcement of SEC activity were sufficient to satisfy the causation element.[226] The Court also concluded that the plaintiffs had successfully pled materiality, as the defendants' fraud caused the company to overstate earnings by 20% in 2002, 11% in 2003, and nearly 6% in 2004–2005.[227] Plaintiffs successfully alleged that a reasonably objective investor would have taken this information into consideration before purchasing Take-Two shares, and therefore materiality was present.[228] Although the Second Circuit has refused to create hard-and-fast quantitative markers of materiality, "the significant overstatement of a company's earnings may constitute a 'material' misrepresentation."[229]

The plaintiffs also successfully alleged the § 10(b) and Rule 10b-5 element of scienter against some of the defendants: one CEO,[230] several compensation committee members,[231] and Take-Two itself as a corporation.[232] In the instance of the CEO, the Court considered the backdating admissions made to the Manhattan District Attorney's office sufficient to infer an intent to make false statements, and held that such an inference was more believable than innocent explanations for the CEO's conduct.[233] Regarding the compensation committee members, the Court considered the allegations well-pled as regards both motive and opportunity.[234] The committee members allegedly received backdated options.[235] This constituted motive,[236] evidenced by each committee member reaching an agreement with the corporation to repay the value of the inappropriately backdated options.[237] It was also adequately alleged that the compensation committee defendants sat on the committee when the options were backdated, and were in fact responsible for determining the exercise price for the options.[238] The Court went further, and considered it dispositive that the compensation committee defendants had the ability to "influence the drafting and preparation" of the company's public disclosures.[239] The Court did not give weight to the explanations by defendants of their innocence,[240] but rather concluded that the facts alleged constituted opportunity. [241] As regards the corporation, the Court reasoned, "Courts readily attribute [ ] the scienter of management-level employees to corporate defendants."[242] In this case, the plaintiffs had adequately alleged scienter against the former CEO and compensation committee members, which could therefore be imputed to the corporation.[243]

The *Take-Two* Court also addressed a claim of control person liability under § 20(a) against former executives, two CEOs and a CFO.[244] *Take-Two* defined control as " the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.' "[245] Here, although the plaintiffs successfully alleged that two former CEOs and a former CFO influenced the content and dissemination of various false statements and day-to-day supervision of the corporation,[246] plaintiffs failed to plead culpable participation for any defendant other than one of the former CEOs.[247] Culpable participation requires that a defendant have a reckless mental state,[248] or alternatively, that scienter be "adequate[ly]" pled.[249] In this case, plaintiffs failed to establish a reckless state of mind.[250] The pleadings did not allege that the former president and second CEO knew or should have known of the corporation's fraudulent misrepresentation of the company's options-granting policy.[251]

The corporation settled with the SEC and the Manhattan District Attorney's office for $3.3 million. [252] Several of the executive defendants have individually pled guilty to falsifying Take-Two documents to accomplish the backdating.[253] The class action in the Southern District Court of New York settled for more than $20 million.[254]

It is important to emphasize the similarly pled claims that have not survived motions to dismiss.[255] Many claims are also settled out of court before they reach trial.[256] Further, please note that though this section has focused on claims arising under the '33 and '34 Acts, such claims represent only a portion of the possible civil and criminal actions that could be brought in the context of stock options backdating.[257]

2.4 Bankruptcy Code[258]

For companies that file for bankruptcy, creditors may be able to recover compensation paid by the debtor corporation to its executives.[259]

Key Employee Retention Programs (“KERPS”)

The Enron and WorldCom crises of 2000 can also be credited with the legislative effort to stop corporate insiders from benefiting while the corporation fights for survival in bankruptcy.[260] In particular, there appears to be clear Congressional intent addressing the oftentimes substantial executive pay packages awarded, despite the dramatic job losses labor and non-management employees sustained.[261] Specifically, these legislative efforts targeted retention bonuses,[262] or Key Employee Retention Programs (“KERPs”).[263] KERPs were once used by debtor corporations to persuade existing managers to remain with the corporation through and until the conclusion of the bankruptcy proceedings.[264] The rationale was that those individuals who knew the business and company best were in the best position to quickly and efficiently move the company through the bankruptcy process.[265] KERPs were also intended to retain management talent that otherwise would flee the sinking ship.[266] The argument against this is predictable: KERPs reward the very same people who managed the company into bankruptcy.[267] Recent “mega-bankruptcies” used such retention bonuses.[268] WorldCom, for example, had a court-approved plan to pay $25 million in bonuses to key employees.[269] Gary Winnick of Global Crossing received $512 million; Ken Lay of Enron received $247 million;[270] and Jeff Skilling, also of Enron, received $89 million.[271] The philosophical arguments for and against KERPs aside, Congress and then-President Bush acted in 2005 to eliminate them.[272]

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”) amends the U.S. Bankruptcy Code[273] to limit the transfers a debtor can make during and prior to filing for bankruptcy.[274] The trustee is given more power to set aside these transfers.[275] Three types of transfers were affected.[276] First, administrative expenses, such as KERPs, were subject to significant change.[277] Section 331 of BAPCPA amended § 503 of the Bankruptcy Code to add subsection (c).[278] Subsection (c) is a test that debtors must meet in order to obtain court approval of their compensation plan.[279] In its broadest terms, the proposed KERP must be essential to keep a person who has an outside job offer paying equal or higher compensation and who is essential to the survival of the business; furthermore, the KERP amount cannot be greater than certain transfers to nonmanagement employees or other insiders for the year preceding the payment.[280] The test provides for more involvement by the court in reviewing debtor transfers.[281]

Second, severance payments were limited by § 331 of BAPCPA.[282] In broad terms, severance payments will not be court approved unless the amount is less than ten times the mean severance pay nonmanagement employees receive in the calendar year preceding the payment.[283]

Lastly, BAPCPA affected fraudulent transfers.[284] Section 548 of the Bankruptcy Code allows a trustee to set aside fraudulent transfers.[285] The Bankruptcy Code defines a fraudulent transfer by a debtor’s “intent to hinder, delay, or defraud [creditors],”[286] and by a nonequivalent exchange made during insolvency, or which when made created the insolvency.[287] Pre-BAPCPA, a fraudulent transfer could be avoided if made or incurred one year prior to the bankruptcy petition.[288] Section 1402 of BAPCPA extended this reach-back to two years.[289] BAPCPA § 1402 also expanded the definition of “fraudulent transfer” to include transfers made “to or for the benefit of an insider[290] under an employment contract.”[291]

In *Teligent*,[292] a plaintiff recovered $12 million from a former Chief Executive Officer (“CEO”) under claims of a fraudulent conveyance.[293] At the time of hire, the terms of the CEO’s compensation agreement included a $15 million loan.[294] The agreement provided for stages of forgiveness.[295] For example, the loan would be “‘automatically [ ] forgiven’” if the company terminated the CEO without cause, or the CEO left for “good reason,” before the fifth year of the CEO’s employment.[296] Additionally, there was an amendment to the compensation agreement which accelerated the loan forgiveness.[297] Where the CEO continued in his position through the first year of employment, one-fifth of the principal, or $3 million, would be forgiven.[298] The CEO was employed between 1996 and 2001, thus satisfying the amendment and reducing the balance of the loan to $12 million.[299] When the company went through an acquisition, the CEO departed.[300] There was a question of whether the CEO ended the employment, or whether he was terminated.[301] The facts developed at trial persuaded the court that the CEO should have been forced into repaying the loan.[302] A Separation Agreement had been signed at the time of the CEO’s departure, however, which stated termination was for “other than cause,” and restructured the loan to forgive in twenty annual installments rather than one.[303] The plaintiff argued this separation agreement inappropriately released the CEO from repaying the $12 million loan and was a fraudulent transfer.[304] The facts pled showed the company transferred property to the CEO while insolvent, and for less than equivalent value.[305] The Court found this to be a fraudulent transfer and avoided it under § 548.[306]

Debtor Defenses

The debtor does have recourse to defenses in bankruptcy.[307] Under § 547(c), the ordinary course of business defense, a debtor can argue a transfer is “made in the ordinary course of business or financial affairs of the debtor and the transferee.”[308] Alternatively, the transfer can be “made according to ordinary business terms.”[309] In *National Gas Distributors*,[310] the Court stated the defense depends on both the dealings of the parties and the industry of the creditor, as well as “consideration of the debtor’s industry standards and the standards applicable to business in general.”[311] Alternatively, parties can use the contemporaneous exchange for new value defense in adversary trustee claims of preferential transfers.[312] A debtor must prove the transfer was intended to be contemporaneous, for new value, and that the value exchanged between the parties was equal.[313] The provision essentially offers incentive for third parties to continue business with the insolvent party during bankruptcy, and ensures that debtor payment for goods or services will not be recoverable by the trustee.[314]

Debtor Company Adaptation to 503(c)

In light of these BAPCPA limitations, some debtor companies have modified their approach to having a compensation proposal approved.[315] Section 503(c) has been considered a "KERP Killer," and debtors have taken the KERP characteristics—retention plans known as "pay to stay"—and recharacterized them as performance incentive plans ("PIPs")[316]—"produce value for pay."[317] Debtor counsel have tried to avoid BAPCPA § 503(c) scrutiny, and instead have sought to have incentive plans evaluated by the historic § 363 business judgment criteria.[318] This approach was used in *In re Dana Corporation*,[319] where the Court refused to accept the payment plan offered for approval as incentive-based.[320] The debtor company filed a compensation plan that requested relief under a number of Bankruptcy Code provisions, but 503(c) was not among them.[321] The Court made clear that any payment made to induce an insider to remain with the debtor, or made as severance, must satisfy 503(c) evidentiary standards.[322] The Court found that a payment that fell into either of those categories could not be scrutinized under the § 363 business judgment rule.[323]

The Court ultimately concluded that the debtor's compensation proposal did not satisfy § 503(c) BAPCPA standards.[324] The Court found the completion bonus had a retention effect in that executives could capture nearly two-thirds of their bonus if the company lost a quarter of its value.[325] The Court did not consider this incentive-based under § 503(c).[326] Further, the severance / non-compete payment failed to satisfy § 503(c)(2)'s definition of severance.[327] To avoid 503(c) scrutiny, the debtor company re-characterized the severance payments as "exchange for non-compete agreements" upon involuntary dismissal or resignation for good reason.[328] The Court interpreted this characterization in light of the Second Circuit's definition of severance, "amounts due whenever termination of employment occurs."[329] The Court concluded the payments were in fact severance, and therefore subject to 503(c).[330]

Other courts have also acted to restrain executive compensation. The Court in *Ownit Mortgage Solutions*[331] found a $150,000 bonus outside the ordinary course of business, where the performance exchanged was relocating the company's headquarters, resolving the remaining mortgage loans, and filing a tax return.[332] The Court in *Delphi*[333] reduced an executive compensation plan from $87 million to $16.5 million for unreasonableness.[334]

Lehman Bankruptcy

The executive compensation topic becomes especially interesting in light of, *inter alia*, the Lehman bankruptcy and the compensation that was paid prior to entry into bankruptcy.[335] According to a March 5, 2008 proxy statement, the top five executives at Lehman were awarded $81 million in bonuses; a small fraction of the $5.7 billion in bonuses the company paid in 2007.[336] Then-CEO Richard Fuld was awarded $34.4 million in 2007 alone.[337] Lehman had $613 billion in debt when the company collapsed in 2008.[338] Creditors may yet seek possible recovery of these monies via fraudulent transfer theory, reasoning that the company did not receive full value for its money.[339]

3. State Authority

3.1 New York State

Common Corporate Responsibilities in New York

Customary corporate responsibilities in New York include fiduciary duty,[340] good faith,[341] and business judgment.[342] This section will discuss claims stemming from these theories that parties may use to recapture executive compensation.[343] The discussion begins with the Grasso litigation and the defense's victory in a case[344] involving the former Chairman and Chief Executive Officer ("CEO") of the New York Stock Exchange ("NYSE").

Richard Grasso Litigation

Grasso was a party to several compensation agreements, covering the period 1995 to 2003.[345] From 1995 to 2002, Grasso earned a salary of $1.4 million.[346] In contrast, in 2003 Grasso was paid a lump sum of nearly $140 million in salary, with an additional $48 million to be paid out to him over the course of the next four years.[347] The bonus awards to Grasso also jumped dramatically: from $900,000 in 1995 to $10.6 million in 2002.[348] During Grasso's employment, the NYSE was organized under New York's Not-For-Profit Corporation Law ("N-PCL").[349] The Attorney General's office filed a complaint asserting six causes of action against Grasso.[350]

Defendant Grasso moved to dismiss four of the non-statutory claims.[351] When reviewed by the Court of Appeals, legislative intent was dispositive of the underlying legal claims.[352] The N-PCL codifies the business judgment rule for New York's non-profits.[353] This means that liability in the case of a not-for-profit officer or director requires knowledge or bad faith.[354] The Court of Appeals found the Attorney General had "crafted"[355] the four non-statutory claims in such a way that, while premised on themes in the N-PCL, the claims did not satisfy this element of knowledge or bad faith.[356] The Court found that although doing this made the Attorney General's claims easier to prove,[357] failing to satisfy the knowledge or bad faith element essentially subverted the legislature's role as policy-maker.[358] The Court found that disregarding the N-PCL as written by the Legislature was beyond the authority of the Executive branch, in this case the Attorney General.[359] The Court emphasized that although the compensation may have appeared unreasonable on its face, the Attorney General could not prove liability for that reason alone.[360]

The remaining two claims against Grasso, both statute-based, were decided in Grasso's favor by a separate court.[361] The Appellate Division reversed a Supreme Court ruling stating the Attorney General's enforcement power had not lapsed when the NYSE became a for-profit corporation.[362] The Appellate Division reasoned that although the N-PCL explicitly authorizes the Attorney General to bring suit on behalf of a not-for-profit corporation for non-compliance by the not-for-profit's executives, there is no such enforcement provision on behalf of a for-profit corporation.[363] Additionally, although there is statutory authorization for such litigation to continue under these circumstances,[364] there is no statutory provision for standing by the Attorney General in these circumstances.[365] The Appellate Division refused to infer such a right.[366]

The Court analyzed *parens patriae* as a possible means of allowing the Attorney General's litigation to continue.[367] *Parens patriae* is a common law doctrine where the sovereign can initiate a legal action to protect those who are unable to litigate on their own behalf.[368] *Parens patriae* requires that the Attorney General have some quasi-governmental interest in representing the private parties, apart from the interest the private parties themselves have in the litigation.[369] The Court reasoned, however, that there was no public policy concern in the *Grasso* matter.[370] Further, the Court considered that a corporation which was engaged in active business was in no need of the "nursing quality" of the *parens patriae* power of the State,[371] and that the wronged parties had "ample remedies" to pursue resolution of the matter on their own initiative.[372] Problematic for the Attorney General in this regard was that money damages were sought against the NYSE as the sole remedy.[373] Not only would it had been ironic to return these money damages to a now for-profit corporation,[374] but the Second Circuit has ruled that money damages are an inappropriate remedy to protect the integrity of the state's marketplace.[375]

Corporate Waste

Other remedies under New York common law include a claim for corporate waste.[376] An officer or director is responsible for mismanagement of corporate assets, and can be held to account for his or her mismanagement or misconduct.[377] For a claim of corporate waste involving executive compensation, a plaintiff must plead and allege that executive "compensation rates [were] excessive on their face or other facts which call into question whether the compensation was fair to the corporation when approved, the good faith of the directors setting those rates, or that the decision to set the compensation could not have been a product of valid business judgment."[378] This test was announced by the Court of Appeals of New York in *Marx*,[379] but was limited by the Court's reluctance to review matters of executive compensation.[380] Too, cases subsequent to *Marx* follow *Marx* for the demand futility test it announced, but not the element test for the recoupment of executive compensation under the claim of corporate waste.[381] Older cases discussing executive compensation and corporate waste echo similar themes.

In *Baker*,[382] for instance, a 1942 New York trial court found that directors and officers of a corporation had abused their fiduciary duties by awarding themselves excessive compensation.[383] The Court ordered them to repay monies to the corporation.[384] The Court reasoned that officers' and directors' salaries must bear some proportional relationship to the services rendered and the income of the business.[385] Where the compensation was so disproportionate—in that case, between 44-80% of the company's gross income—a rebuttable presumption existed that the defendants had acted in their own interest at the cost of the company's.[386] The defendants in *Baker* failed to defeat that presumption.[387] *Stearns*,[388] a 1948 case, used the same rebuttable presumption[389] and similar reasoning.[390] In that case, a group of directors and officers was ordered to repay compensation and bonuses.[391] There, the bonus system should have been suspended after a fire destroyed the company, but the system was continued during lengthy liquidation.[392] Contrary precedent does exist, however. In *Epstein*,[393] a 1939 case, compensation was considered in relation to the services rendered in a claim involving corporate waste.[394] The Court refused to substitute its judgment for that of the board's[395] regarding the "conced[edly]" large payments.[396]

New York Blue Sky Provision, the Martin Act

The *Fischbein*[397] case was a claim of corporate waste involving a merger and acquisition.[398] There, the acquiring entity paid high compensation to its executives prior to the merger closing.[399] These facts are similar to the Bank of America ("BofA") Merrill acquisition.[400] BofA relied on $20 billion in federal government financing to take over Merrill for $50 billion in September 2008.[401] Merrill had sustained losses of $27.5 billion in 2008.[402] Despite this record loss, Merrill paid $3.6 billion in bonuses days before the companies merged.[403] In the Spring of 2009, it was alleged by BofA's shareholders that they were not informed of the bonuses prior to voting on the merger.[404] In response, BofA maintained it had no legal obligation to so inform its shareholders.[405] The matter has evolved, however, generating several separate lawsuits and investigations involving various issues.[406] SEC Chairwoman Mary Schapiro indicated in the Spring that she was evaluating the matter.[407] By summer, moments before the SEC was to file a complaint alleging, *inter alia*, misrepresentation, a settlement with BofA was reached in the amount of $33 million.[408] The settlement, however, was not approved by Judge Rakoff of the Southern District Court of New York.[409] Through his multiple opinions on the matter, Judge Rakoff has clearly communicated his disapproval of the settlement as unfair to shareholders.[410] The matter is still pending, and BofA's defense has changed only marginally. BofA maintains it did nothing wrong, and that in fact the matter of the Merrill compensation was disclosed through multiple references in the proxy statement.[411] A trial date of February 1, 2010 has been set.[412]

Attorney General Cuomo[413] is also among those pursuing BofA regarding the Merrill bonuses.[414] Early in his investigation of the matter, Attorney General Cuomo relied on one of New York's blue sky provisions, the Martin Act.[415] The Martin Act gives the New York Attorney General broad powers to investigate and litigate financial fraud.[416] The purpose of the act is to prevent any form of deception related to securities.[417] The Act gives the Attorney General discretion as to what matters to investigate and provides him with the power to subpoena witnesses and produce evidence.[418]

The Attorney General may have relied on cases such as *Loengard*[419] as his office moved forward with the BofA matter. In *Loengard*, plaintiff minority shareholders claimed that defendants—a parent and wholly-owned subsidiary involved in a short form merger[420]—acted fraudulently by not providing the plaintiffs with notice of the merger,[421] and by deflating the value of the plaintiffs' shares.[422] After lengthy litigation,[423] the District Court found that plaintiffs failed to state a cause of action under the Martin Act by not showing fraudulent conduct.[424] The Court reasoned that fraudulent conduct under the Act was understood as a "'tendency' to deceive or mislead."[425] The Court did not find the appraisal of plaintiffs' shares fraudulent,[426] nor did it find that the defendants had any duty under the law to provide the plaintiffs with notice of the merger.[427] Prospectively, it should be noted that although the Martin Act was intended to be interpreted broadly,[428] it contains no private right of action.[429] Any litigation pursuant to the Act must be initiated by the Attorney General.[430]

At the time of authorship, it is widely speculated the Attorney General's office will ultimately pursue civil litigation against BofA executives and directors.[431]

Common Law Action for Fraud

It has been suggested that a common law action for fraud may be useful to recoup executive compensation in New York.[432] The rule, summarized in *Sterling,*[433] is that a plaintiff must allege that "defendants made misrepresentations of material existing fact; which were false and known to be false by the defendants when made, for the purpose of inducing plaintiffs' reliance; justifiable reliance on the alleged misrepresentation or omission by the plaintiffs; and injury [sic]."[434] "In addition, 3016(b) requires that the complaint set forth the misconduct complained of in sufficient detail to clearly inform each defendant of what their respective roles were in the incidents complained of."[435]

Unjust Enrichment

Unjust enrichment has also been proposed as a theory for aggrieved plaintiffs.[436] Plaintiffs must "assert [ ] that a benefit was bestowed…by plaintiffs and that defendants will obtain such benefit without adequately compensating plaintiffs," particularly where the defendants have clearly benefited, and "equity and good conscience require that they make restitution."[437] "The receipt of a benefit alone," however, "is insufficient to establish a cause of action."[438]

Duty to Corporate Creditors

Aggrieved shareholders aside, wronged creditors may have claims regarding executive compensation. Directors owe a duty of faithful conduct to corporate creditors.[439] Creditors are in fact empowered by statute to pursue both directors and officers for misconduct.[440] In New York, directors and officers of an insolvent corporation can be considered trustees of its assets on behalf of the creditors.[441] An action to enforce this fiduciary duty precludes the directors and officers from placing their interests ahead of those of the creditors.[442]

Fraudulent Conveyance

Creditor rights might also be pursued under fraudulent conveyance principles in New York's Uniform Fraudulent Conveyance Act, codified by statute in Article 10 of New York's Debtor and Creditor Law.[443] Actions can be brought only by creditors,[444] against the transferee or beneficiaries,[445] and amounts sought to be recovered are limited to the amount alleged to be improperly transferred.[446] Attorney General Cuomo in 2008 effectively leveraged the threat of a fraudulent conveyance action against American International Group ("AIG"), securing AIG's agreement to freeze salaries and eliminate bonuses for high-level officers.[447] Cuomo continued to use the threat of fraudulent conveyance against AIG, and recently subpoenaed the names of those who received bonuses in March of 2009,[448] as well as information on who negotiated their compensation.[449] In March 2009, public outcry resulted in fifteen of the top twenty bonus recipients voluntarily forfeiting their bonuses to AIG.[450] These repayments have not stymied the "moral outrage,"[451] and a derivative suit was filed in April of 2009 in California State Court against current CEO Edward Liddy and various other Directors and Officers.[452] The complaint alleges "no rational business purpose or justification" for the high executive compensation, particularly in light of the company's performance and financial condition.[453] The pleadings allege corporate waste, breach of fiduciary duty, abuse of control, and unjust enrichment.[454]

3.2 Delaware State

The directors of a Delaware corporation have the authority and discretion to make executive compensation decisions.[455] It is the essence of business judgment[456] for an independent and informed board, acting in good faith, to determine if "a particular individual warrant[s] large amounts of money, whether in the form of current salary or severance provisions."[457] Courts thus generally decline to pass judgment on what constitutes reasonable compensation.[458] Under Delaware law, however, director discretion in setting executive compensation is not unlimited. Indeed, the Delaware Supreme Court stated that "there is an outer limit" to the board's discretion, "at which point a decision of the directors on executive compensation is so disproportionately large as to be unconscionable and constitute waste."[459]

Seeking Recoupment of Executive Pay: Breach of Fiduciary Duty, Waste

The typical way for plaintiff shareholders, in common law actions, to seek to recoup excessive pay from executives of Delaware corporations is to claim that the corporate directors breached their fiduciary duties and that the approved payments constituted corporate waste.[460] Plaintiffs may claim that the directors breached their fiduciary duty of due care[461] and / or their fiduciary duty of loyalty[462] (the latter encompassing the duty of good faith).[463] The due care claim is more difficult for plaintiffs to establish because of the substantial protections afforded by the Delaware courts to directors under the business judgment rule, and because the vast majority of Delaware corporations eliminate or limit their directors' personal liability to the corporation or stockholders for money damages for breaches of the duty of care.[464] Plaintiffs have been successful in recouping executive compensation by demonstrating a breach of the duty of loyalty where self-interested transactions occur.[465] In such cases, the business judgment rule does not apply, and the burden shifts to the defendants to prove that the challenged transaction was entirely fair to the corporation.[466] A third basis for recouping executive pay, that the payout amounted to waste, involves an onerous standard for plaintiffs.[467] As the following cases illustrate, the Delaware courts are vigilant about self-dealing; but disinterested directors, even where conduct falls significantly short of corporate governance best practices,[468] who approve lucrative payouts to officers will not be held liable if they exercise their duties of due care and good faith.

The *Disney* Case: Claims for Breach of Fiduciary Duty, Waste

In the much discussed *Walt Disney Company Derivative Litigation*, the plaintiffs of the Walt Disney Company ("Disney") brought a derivative action against the Disney directors for breach of their fiduciary duties for blindly approving an employment agreement with Michael Ovitz, the President of Disney, and for ultimately approving Ovitz's no-fault termination and the resulting severance payment of approximately $130–140 million[469] made pursuant to the employment agreement.[470] The plaintiffs contended that the Disney directors' actions constituted a breach of their fiduciary duties to act with due care and in good faith, and that even if the directors' actions were protected by the business judgment rule, the payout to Ovitz amounted to corporate waste.[471] The plaintiffs sought rescission and / or money damages from the Disney directors and Ovitz and disgorgement of Ovitz's unjust enrichment.[472] However, the Court of Chancery determined, and the Supreme Court affirmed, that the challenged actions of the Disney defendants were protected business judgments, did not involve breach of fiduciary duty,[473] nor did they constitute corporate waste.[474]

The Chancellor held that in agreeing to the key terms of Ovitz's employment agreement, the directors acted in good faith and believed that they were acting in the best interests of the company. He further held that the plaintiffs failed to meet their burden to demonstrate that the directors acted in a grossly negligent manner or that they failed to inform themselves of all material information reasonably available when making their decision.[475] Similarly, with respect to Ovitz's no-fault termination and the payout of the severance package, the Court ruled that the Disney defendants did not breach their fiduciary duties, nor did they act in bad faith.[476] The Board did not need to formally terminate Ovitz because the Company's governing instruments granted the Chairman / CEO, Michael Eisner, the right to unilaterally terminate inferior officers, and the Board was informed of and supported Eisner's decision.[477] Similarly, the board did not need to approve the payout of Ovitz's severance package because the board had delegated to the compensation committee the responsibility to approve compensation for Ovitz, and the committee's approval of Ovitz's compensation package included approval of the severance package.[478]

It is very rare for Delaware courts to make a finding of corporate waste, even in cases which challenge lavish payouts of executive compensation.[479] To prevail on a claim for waste, the plaintiff must prove that the defendant authorized "an exchange that is so one-sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration."[480] In other words, waste is a rare, "unconscionable case where directors irrationally squander or give away corporate assets."[481]

The Supreme Court in *Disney* concluded that the plaintiffs' claim for waste did "not come close" to meeting the "high hurdle" required to prove corporate waste.[482] The plaintiffs argued that the no-fault termination provisions in Ovitz's employment agreement were wasteful because they provided Ovitz with an incentive to perform poorly as Disney's President and thus be eligible to receive the lavish severance package provided for in his employment agreement.[483] The Supreme Court noted that the challenge of a severance payment made pursuant to an employment agreement under a waste claim, without more, is meritless when a company is contractually obligated to make the payments.[484] The only way that the payment of a contractually obligated amount can constitute waste is if the contractual obligation itself is wasteful.[485] The Supreme Court held that Disney's contractual obligations were not wasteful because the no-fault provisions in Ovitz's employment agreement had the rational business purpose of inducing Ovitz to leave his previous job, at which he earned tens of millions of dollars annually.[486] The Chancellor in the trial court further found it unreasonable to assume that Ovitz intended to perform just poorly enough to be fired quickly and thus be eligible for the severance package, but not so poorly that he could be terminated for cause and thus not be eligible for his lavish payout.[487] The Chancellor further concluded that there was no indication that Ovitz brought anything less than his best efforts to the company, that there was credible evidence that the company would be better off without Ovitz, and that given his performance, he could not be fired for cause.[488] Thus, plaintiffs did not meet the stringent requirements of the waste test, and the payment of Ovitz's severance package did not constitute waste.[489]

Seeking Recoupment of Executive Pay: Self-Interested Transactions

Plaintiffs in Delaware courts have had far more success in recouping executive pay where directors or officers pay themselves a salary or bonus without the approval of an independent compensation committee. Directors who stand on both sides of a transaction have "the burden of establishing its entire fairness, sufficient to pass the test of careful scrutiny by the courts."[490] Self-interested compensation decisions made without independent protections are subject to this same entire fairness standard.[491] The two components of entire fairness are fair dealing and fair price.[492] Fair dealing "embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained."[493] Fair price "assures the transaction was substantively fair by examining 'the economic and financial considerations.'"[494]

In a Delaware case concerning a plaintiff who challenged the payout to a director who fixed his own compensation, the Court imposed upon the recipient the burden of showing the reasonableness of his compensation.[495] In determining whether the defendant's compensation was reasonable, the Court in that case listed numerous relevant factors, including what other similarly situated executives received; the ability of the executive; to what extent the Internal Revenue Service ("IRS") allowed the corporation to deduct the salary; whether the salary bore a reasonable relation to the success of the corporation; the amount previously received as salary; whether increases in salary were geared to increases in the value of services rendered; and the amount of the challenged salary compared to other salaries paid by the employer.[496] The Court concluded that the defendant failed to meet his burden of demonstrating reasonableness since he failed to produce substantial evidence as to what other executives in the industry earned, and there was doubt as to whether defendant's work was as essential and productive as he contended. The defendant also raised his own pay three-fold in the span of five years even though the earnings of the company rose only by approximately 79% in that time span.[497] The Court did concede that the defendant's services to the corporation appeared to have been important to its success, and taking into account that the business had twenty employees and that the company's profits rose during the contested pay period, the Court allowed for compensation in excess of an amount suggested by an expert witness but less than the amount considered appropriate by the IRS.[498] The Court ordered the defendant to return the excess compensation to the corporate treasury with interest.[499]

In a more recent Delaware case, the Court ordered a former director / president of a corporation to disgorge his entire bonus after the directors and executives decided to pay themselves large amounts in connection with a proposed initial public offering and spin-off of the company's most valuable asset.[500] In that case, the payouts were approved by a compensation committee which was "clearly and substantially interested in the transaction they were asked to consider."[501] Thus, even the defendant conceded that he bore the burden of proving that the transaction was entirely fair.[502] In analyzing the fair dealing prong of the "entire fairness test," the Court determined that the process for determining bonuses was dominated by the company's chairman / CEO, who predetermined the size of the bonus pool that was later justified by the compensation committee.[503] In concluding that the process was unfair, the Court noted that the challenged transaction was initiated by management, and was structured, without negotiation, so that everyone would receive a bonus.[504] Also key was that the relevant parties, including the board, the compensation committee and the outside experts, relied on inflated and misleading information provided by management.[505] The Court further held that while management did occasionally receive bonuses in connection with extraordinary activities, the sort of event in the given case did not justify such substantial additional bonuses, which amounted to 2% of the total value of the spin-off.[506] As further support that the bonus payments were unfair, the Court noted that the transaction involved merely a restructuring of the biggest and most valuable asset of an already public company into a different public company.[507] Moreover, management of the parent company was to have no further involvement in the spun company.[508] In sum, the Court held that the price terms of the bonuses could not be justified by reference to any reliable market, and there was no proof of substantial comparable transactions to provide support for the size of the bonuses.[509]

Where a court determines that a self-dealing transaction is unfair, the transaction is voidable as between the parties.[510] Additionally, the underlying breach of the fiduciary duty of loyalty can give rise to other damages, including incidental damages.[511] The Court in *Valeant* held that the defendant had to disgorge his entire $3 million bonus as a voidable transaction.[512] The defendant was also ordered to return his pro-rata share of the bonuses paid to non-directors[513] and his pro-rata share of fees and expenses of the special litigation committee.[514]

3.3 Other Notable State Positions; *Scrushy v. Tucker*

In a 2006 decision, the Alabama Supreme Court held in *Scrushy v. Tucker* that the former CEO of a publicly traded corporation involved in an accounting scandal was unjustly enriched[515] by the payment of $47 million in bonuses, and ordered him to repay the gross amount of the bonuses.[516] In separate proceedings, fifteen senior executives of the corporation, HealthSouth, pled guilty to various criminal acts, including falsifying and fabricating the corporation's financial statements.[517] The former CEO and defendant in *Scrushy*, Richard Scrushy, was acquitted in an earlier proceeding of any criminal wrongdoing.[518] The parties in *Scrushy* stipulated that Scrushy was not responsible for the falsification of the company's financial statements, and Scrushy did not dispute that the original financial statements were inaccurate and unreliable.[519] Scrushy, however, argued that he was entitled to keep his bonus payments because his employment agreement with HealthSouth obligated the company to pay him annual target bonuses.[520] The Court decided that the defendant's employment agreement merely gave him "the *opportunity to earn* an annual target bonus," but that the company's disclosure in its annual proxy on Form 14A precluded the payment of bonuses because the company sustained annual net losses.[521] The company's annual proxy provided that no bonuses would be paid unless annual net income exceeded budgeted net income.[522] Since the company did not have net income during the years in question, Scrushy did not have the opportunity to earn target bonuses pursuant to his employment agreement, and the company was not contractually obligated to pay bonuses.[523]

The Court concluded that, under the law of either Delaware or Alabama, equity and good conscience required restitution in the form of the repayment of the bonuses because the payments were made as a result of the vast accounting fraud perpetrated upon HealthSouth and its shareholders.[524] The Court noted that as a manager of HealthSouth, Scrushy was responsible for the filing of accurate financial statements, and he did not fulfill those responsibilities adequately.[525] The Court stated that it would have been unconscionable to allow Scrushy to keep millions of dollars at the expense of the corporation to which he owed a fiduciary duty.[526]

4. Concluding Thoughts

This article has presented possible theories and legal authorities that parties may use while involved in litigation over recoupment of executive compensation. Some avenues for success seem possible for plaintiffs, such as the '34 Act or the federal Bankruptcy Code. Reciprocally, defense counsel may find a more favorable environment for their clients under Delaware State law. Both sides will have to consider and address the new TARP provisions, however. The ongoing economic crisis has created an antagonistic political and social energy, and the litigation that will develop over this time period will be difficult and hard-fought. This article has sought to present various legal authorities that will shape that litigation and inform Counsel's attempts to recoup or defend executive compensation.

Endnotes

1. Andrew Cuomo, *No Rhyme or Reason: The 'Heads I Win, Tails You Lose' Bank Bonus Culture*, http://www.oag.state.ny.us/media_center/2009/july/pdfs/Bonus%20Report%20Final%207.30.09.pdf (July 30, 2009).
2. It may or may not surprise the reader that shareholders and creditors are not the only parties pursuing litigation in this context, as the variety of suits include executives' claims that the they were illegally not rewarded bonuses, or were fired for protesting others' bonus rewards. Tresa Baldas, Law.com, *Executive Bonuses Triggering Lawsuits Nationwide* ¶ 2, http://www.law.com/jsp/article.jsp?id=1202429689471 (Apr. 6, 2009). This includes a suit against Citizens Republic Bancorp in Michigan, where the executive claims he was fired for questioning a CEO bonus. *Id.* at ¶ 5 (citing *Schwab v. Citizens Republic Bancorp*, No. 09-090916-CZ (Genessee Co., Mich., Cir. Ct.)). Another executive sued his employer in California for his bonus, was then fired, and then claims his enforcing his rights led to his dismissal. *Id.* at ¶ 6 (citing *Pautsch v. Centex Corp.*, No. 2:2008cv02360 (E.D. Calif.)). A case was also settled in March 2009 in Connecticut, where a high level employee filed suit for a bonus not paid. *Id.* at ¶ 7 (citing *Edwards v. Edwards Wines*, No. CV-08-5008054-S (New London, Conn., Super. Ct.)).
3. Federal Reserve Chairman Ben S. Bernanke, Testimony before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Federal Reserve System, Sept. 23, 2008.
4. *Id.*
5. *Id.*
6. *See, e.g.*, Emergency Economic Stabilization Act of 2008 ("EESA"). EESA, passed in late 2008, established the $700 billion financial sector bailout whose initial purpose was to buy up toxic mortgage assets from financial institutions. The Treasury Department abandoned the initial plan and decided that the funds would be used to make direct investments in banks and to shore up consumer credit markets. David Lawder, *U.S. Backs Away From Plan to Buy Bad Assets*, Reuters, Nov. 12, 2008.
7. Erin Nothwehr, *Emergency Economic Stabilization Act of 2008*, The University of Iowa Center for International Finance and Development, December 2008, *available at* http://www.uiowa.edu/ifdebook/issues/bailouts/eesa.shtml.
8. *See* Emergency Economic Stabilization Act of 2008 § 111, 12 U.S.C. § 5221, as amended by American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 7001.
9. Press Release of U.S. Department of Treasury No. TG-15, *Treasury Announces New Restrictions On Executive Compensation* (February 4, 2009) (*available at* http://www.treasury.gov/press/releases/tg15.htm) (hereinafter, "Treasury Release").
10. Jonathan Weisman & Joann S. Lublin, *Obama Lays Out Limits on Executive Pay*, Wall St. J., Feb. 17, 2009, at A1. More generally, President Obama said that executive pay helped lead to a "reckless culture and a quarter-by-quarter mentality that in turn helped to wreak havoc in our financial system." Deborah Solomon & Damian Paletta, *U.S. Eyes Bank Pay Overhaul*, Wall St. J., May 13, 2009, at A1.

11. *See* Treasury Release. Chairman Ben Bernanke said during a Congressional hearing that the Fed was working on rules that will "ask or tell banks to structure their compensation, not just at the very top level but down much further, in a way that is consistent with safety and soundness—which means that payments, bonuses and so on should be tied to performance and should not induce excessive risk." Deborah Solomon & Damian Paletta, *supra* note 10.

12. *See* Emergency Economic Stabilization Act of 2008 § 111, 12 U.S.C. § 5221.

13. *Federal Register*, Vol. 74, No. 113, June 15, 2009, 28395. The IFR complies with the requirement in ARRA that Treasury promulgate standards that implement the ARRA provisions. *Id.* at 28396.

14. 31 CFR 30, TARP Standards for Compensation and Corporate Governance; Federal Register, Vol. 74, No. 113, June 15, 2009, 28394.

15. *See* Treasury Release.

16. *Id.*

17. Generally available capital access programs provide for the same terms for all recipients, including limits on the amount each company may receive and specified returns for taxpayers. The goal of these programs is to make sure that the financial system, including smaller community banks, can provide the credit necessary for economic recovery. *Id.*

18. *Id.*

19. These companies receive assistance under one of the following programs: the Targeted Investment Program, the Automotive Industry Financing Program or the Programs for Systemically Significant Failing Institutions. Press Release of U.S. Department of Treasury No. TG-165, *Interim Final Rule on TARP Standards for Compensation and Corporate Governance* (June 10, 2009) (*available at* http://www.treasury.gov/press/releases/tg165.htm).

20. *See* Treasury Release.

21. *Id.*

22. Treasury Secretary Timothy Geithner said that the Obama administration is not interested in "capping pay" or "setting forth precise prescriptions for how companies should set compensation." Rather, he said, the government wants to restrain pay practices that motivated executives to take excessive risks in pursuit of profit. David Cho, Zachary A. Goldfarb, et al., *U.S. Targets Excessive Pay for Top Executives*, WASH. POST, June 11, 2009.

23. Federal Register, Vol. 74, No. 113, June 15, 2009, 28394. For a more complete discussion of the role and responsibilities of the Special Master, see *infra* text accompanying notes 32-43.

24. Jeffrey Martin, Eddie Adkins, et al., *The Road Ahead: Executive Compensation Provisions for TARP Recipients Under the American Recovery and Reinvestment Act of 2009*. In discussing an amendment to the bill that would have taxed bonuses at TARP recipients but was later stripped from the bill, discussed *infra* at note 62, Senate Finance Committee Chairman Max Baucus made a stunning admission. "Frankly it was such a rush—we're talking about the stimulus bill now—to get it passed, I didn't have time and other conferees didn't have time to address many of the provisions that were modified significantly. We shouldn't be here. [The bill taxing bonuses] should have passed, but it didn't." Dana Bush and Ted Barrett, *Bonuses Allowed By Stimulus Bill*, cnn.com, *available at* http://www.cnn.com/2009/POLITICS/03/17/aig.bonuses.congress/index.html.

    ARRA also contains provisions that seek to limit unnecessary risk-taking, require executives to certify that the company has complied with the law and adopts a policy limiting luxury expenditures. *See* American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 7001.

25. "TARP Recipient" is defined as "any entity that has received or will receive financial assistance under the financial assistance provided under the TARP." American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 7001. The IFR contains an anti-abuse rule which includes in the definition of TARP recipient any entity related to a TARP recipient whose primary purpose is to evade the IFR. Federal Register, Vol. 74, No. 113, June 15, 2009, 28412, §30.1. Even before President Obama signed ARRA into law, the administration indicated that it thought that the bill's approach to limiting executive pay was stricter than the one it favored, and that it would seek revisions. Barney Frank, the Chairman of the House Financial Services Committee, said that administration officials may not like the executive pay provision, but "it is going to be enforced." *White House Wants to Revise Compensation Part of Stimulus*, ASSOCIATED PRESS, Feb. 15, 2009.

26. Jeffrey Martin, Eddie Adkins, et al., *The Road Ahead: Executive Compensation Provisions for TARP Recipients Under the American Recovery and Reinvestment Act of 2009*.

27. *Id.*

28. Federal Register, Vol. 74, No. 113, June 15, 2009, 28396. One exception is that the requirement that TARP recipients provide shareholders with a "say on pay" became effective upon enactment of ARRA. *Id.* at 28404.

29. *Id.* at 28404.

30. *Id.* at 28423.

31. *Id.* at 28395.

32. Press Release of U.S. Department of Treasury No. TG-165, *Interim Final Rule on TARP Standards for Compensation and Corporate Governance* (June 10, 2009) (*available at* http://www.treasury.gov/press/releases/tg165.htm).

33. Federal Register, Vol. 74, No. 113, June 15, 2009, 28420, § 30.16.

34. Deborah Solomon, *Pay Czar Gets Broad Authority Over Executive Compensation*, WALL ST J., June 11, 2009, at A4.

35. Senior executive officers are defined in ARRA as the five highest paid employees, whose compensation must be disclosed under the Securities Exchange Act of 1934. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 7001. The IFR includes in the definition of senior executive officer a "named executive officer" under Instruction 1 to Item 402(a)(3) of Regulation S-K who is an employee of the TARP recipient. Federal Register, Vol. 74, No. 113, June 15, 2009, 28411.

36. A "most highly-compensated employee" is an employee of a TARP recipient, other than an SEO, whose annual compensation for the last completed fiscal year is determined, pursuant to Item 402(a) of Regulation S-K, to be the highest among all employees. A most highly compensated employee need not be an executive officer of the TARP recipient. A former employee who is not employed by the TARP recipient on the first day of the fiscal year for which the determination is being made is not a most highly compensated employee, unless it is reasonably anticipated that the employee will return to employment with the TARP recipient during the fiscal year. *Id.* at 28398.

37. Federal Register, Vol. 74, No. 113, June 15, 2009, 28420-21, § 30.16.

38. *Id.* at 28421, § 30.16.

39. *Id.* at 28421, § 30.16.

40. *Id.* at 28422, § 30.16.

41. *Id.*

42. *Id.* at 28422-23, § 30.16.

43. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 7001(b)(3)(B).

44. Federal Register, Vol. 74, No. 113, June 15, 2009, 28414.

45. *Id.* An example where it would be unreasonable for a TARP recipient to exercise its clawback rights is if the expense of enforcing its rights exceeds the amount to be recovered. *Id.*

46. *Id.*

47. The IFR defines a bonus as any payment in addition to an amount payable to an employee for services performed at a regular hourly, daily, weekly, monthly or similar periodic rate. Commission compensation is generally not a bonus so long as the commission rate is pre-established and reasonable, and is applied consistently to the sale of substantially similar goods or services. Benefits under a qualified retirement or a broad-based benefit plan, bona fide overtime pay and bona fide expense reimbursements are not considered bonuses. *Id.* at 28405-06, § 30.1.

48. A retention award is generally defined as a payment that is contingent on the completion of a period of future service with the TARP recipient or the completion of a specific project, and is not based on the performance of the employee or value of the TARP recipient. Excluded from the definition is any payment to an employee that is payable periodically for services performed at regular hourly, daily, weekly, monthly, or a similar periodic rate. Also not considered retention awards are payments from a qualified retirement or benefit plan, overtime pay, reasonable expense reimbursement, or amounts accrued under a nonqualified deferred compensation plan. *Id.* at 28411, § 30.1.

49. An incentive compensation plan means an "incentive plan" as defined in Item 402(a)(6)(iii) of Regulation S-K, any plan providing stock or options as defined in Item 402(a)(6)(i) of Regulation S-K, and other equity-based compensation. The term includes a stock option or stock plan, regardless of whether the plans are subject to performance-based vesting. A TARP recipient may, however, pay salary or other permissible payments in the form of stock or stock units. *Id.* at 28409, § 30.1.

50. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 7001.

51. Federal Register, Vol. 74, No. 113, June 15, 2009, 28404.

52. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 7001.

53. *Id.* ARRA grants the Treasury Secretary the discretion, concerning TARP recipients of $25 million or more, to extend the prohibition on bonus payments to a greater number of employees than required by the text of ARRA. *Id.*

54. Federal Register, Vol. 74, No. 113, June 15, 2009, 28400.

55. For purposes of the long-term restricted stock exception, total annual compensation includes all equity-based compensation only in the year in which it was granted at its total fair market value on the grant date. Therefore, all equity-based compensation granted in fiscal years ending before June 15, 2009 will not be included in annual compensation. *Id.*

56. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 7001(b)(3)(D)(i).

57. Federal Register, Vol. 74, No. 113, June 15, 2009, 28400.

58. The IFR generally deems the long-term restricted stock transferable in increments of 25% for each 25% of financial assistance repaid by the TARP recipient. Once the final repayment is made, the remaining stock becomes transferable. *Id.* at 28401.

59. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 7001(b)(3)(D)(iii).

    This provision exempted from ARRA pay restrictions the $165 million in retention bonuses paid to AIG executives. The ensuing outrage over the bonus payments exhibited by lawmakers included some initial confusion as to who inserted this exemption in the bill. At first, the Senate Banking Committee Chairman, Christopher Dodd, who originally introduced the executive pay limits, denied that he included the last-minute exemption. There was a bipartisan amendment proposed that would have taxed bonuses at TARP recipients, but it was stripped from the bill during hurried, closed-door negotiations between the White House and the House of Representatives. Dana Bush and Ted Barrett, *Bonuses Allowed By Stimulus Bill*, cnn.com (*available at* http://www.cnn.com/2009/POLITICS/03/17/aig.bonuses.congress/index.html). After his initial denial, Senator Dodd admitted that he added the exemption, but only did so after the Obama administration pushed for it. Ed Hornick, Ted Barrett, & Kristi Keck, *Dodd: Administration Pushed For Language Protecting Bonuses* (*available at* http://www.cnn.com/2009/POLITICS/03/18/aig.bonuses.congress/). Representative Barney Frank said that the government, as owner of AIG, should assert its ownership rights, including bringing lawsuits against people who did damage to the company. Alison Vekshin, *AIG's Liddy Acknowledges 'Distasteful' Retention Pay*, Bloomberg.com, March 18, 2009. Citing ARRA's provision allowing the Treasury Secretary to claw back payments "inconsistent with the purpose" of TARP or "otherwise contrary to public interest," discussed *infra* in text accompanying notes 73-74, Secretary Timothy Geithner said that Treasury planned to deduct the cost of the bonuses from the government's upcoming round of cash infusion for AIG and to extract additional penalties from AIG operating funds. Jonathan Weisman, Naftali Bendavid & Deborah Solomon, *Treasury Will Make Grab to Recoup Bonus Funds*, Wall St. J., March 18, 2009, at A1. In response to the populist outcry over the AIG bonuses, the House of Representatives voted overwhelmingly, 328-93, to approve a bill imposing a 90% surtax on bonuses paid to employees with household income of $250,000 or more at companies that have received at least $5 billion from the government. It appears, however, that the bill will not be taken up in the Senate in light of the fact that a number of AIG executives returned their bonus payments. Greg Hitt, *Drive to Tax AIG Bonuses Slows*, Wall St. J., March 25, 2009, at A1. In the aftermath of the AIG bonus controversy, it was reported that President Obama would seek "resolution authority" that would allow his administration to abrogate contracts that it can show do not serve the good of newly regulated entities such as AIG. Jonathan Weisman, *Obama Seeks Legal Authority to Stop Future Bonuses*, Wall St. J., March 19, 2009.

60. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 7001(b)(3)(D)(iii).

61. To determine whether an employee had a legally binding right to payment, the IFR points to 26 C.F.R. § 1.409A-1(b)(i). Federal Register, Vol. 74, No. 113, June 15, 2009, 28416, § 30.10.

62. *Id.*

63. *Id.* at 28404.

64. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 7001(b)(3)(C).

65. *Id.* at (a)(2). Whether a payment is for services performed or benefits accrued is determined based on the facts and circumstances. Generally, a payment is considered a payment for services performed or benefits accrued only if the payment would be made regardless of whether the employee departs or the change in control occurs, or if the payment is due upon the departure of the employee, regardless of whether the departure is voluntary or involuntary. Federal Register, Vol. 74, No. 113, June 15, 2009, 28408, § 30.1.

66. *Id.*

67. *Id.* at 28414, § 30.9.

68. *Id.*

69. *Id.* at 28408-09, § 30.1.

70. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 7001(f).

71. *Id.*

72. Federal Register, Vol. 74, No. 113, June 15, 2009, 28420, § 30.16.

73. Sheryl Vander Baan & Kevin F. Powers, *Developments in TARP Executive Compensation Restrictions*, Feb. 23, 2009 (*available at* http://www.crowehorwath.com/crowe/Publications/generatePubPDF.cfm?id=2041).

74. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 7001(g).

75. The other banks given permission to return government money were U.S. Bancorp, BB&T, American Express, Capital One Financial, Bank of New York Mellon, State Street and Northern Trust. Robin Sidel & Deborah Solomon, *Treasury Lets 10 Banks Repay $68 Billion in Bailout Cash*, Wall St. J., June 10, 2009, at A4.

76. The SEC leadership has indicated that it supports the adoption of "say on pay" for all companies, even those not subject to ARRA. Mary Schapiro, Chair of the SEC, said "giving shareholders a greater say on…how company executives are paid" is on the SEC's agenda. Beverly Fanger Chase, Ning Chiu, et al., *'Say on Pay' Now a Reality for TARP Participants*, February 25, 2009 (*available at* http://www.dpw.com/1485409/clientmemos/2009/02.25.09.say.on.pay.pdf). Compensation experts expect Congress to pass a law this year requiring all listed companies to adopt "say on pay." Opponents of "say on pay" argue that the practice is vague and ineffective. It is unclear what a "no" vote means and companies are free to ignore the voting results. Phred Dvorak, *Hundreds of Firms Must Grant 'Say on Pay,'* Wall St. J., Feb. 27, 2009.

77. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 7001(e).

78. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 7001(c).

79. *Id.*

80. President Obama said, "This is America. We don't disparage wealth. We don't begrudge anybody for achieving success. And we believe success should be rewarded. But what gets people upset—and rightfully so—are executives being rewarded for failure, especially when those rewards are subsidized by U.S. taxpayers." Jonathan Weisman and Joann S. Lublin, *Obama Lays Out Limits on Executive Pay*, Wall St. J., Feb. 17, 2009, at A1.

81. Mark Maremont and Joann S. Lublin, *Limits on Pay Left Unclear in New Law*, Wall St. J., Feb. 18, 2009, at A4.

82. *Id.* A senior executive responsible for human resources at an investment bank, regarding the limit on bonuses said, "[t]o be put in a situation where you're limiting performance-based compensation is the dumbest thing you can do. Everything that shareholder advocates have been seeking for years is thrown out the window." *Id.*

83. Eric Dash, *Citigroup Is Said to Be Raising Pay*, N.Y. Times, June 24, 2009, at B1. Another bank, Wells Fargo & Co., which received $25 billion in government money, increased the base salaries of its CEO and two other executives. Kate Kelly & David Enrich, *Wall Street Pursues Pay Loopholes*, Wall St. J., March 17, 2009.

84. Erin Nothwehr, *Emergency Economic Stabilization Act of 2008*, The University of Iowa Center for International Finance and Development, December 2008, (*available at* http://www.uiowa.edu/ifdebook/issues/bailouts/eesa.shtml).

85. Thorold Barker, *Capping the Banks' Wages of Sin*, Wall St. J., Feb. 6, 2009, at C10. In fact, the New York Times reported that a brain drain is occurring at some of the biggest Wall Street banks. Top bankers have been leaving Goldman Sachs, Morgan Stanley, Citigroup and others to join foreign banks, smaller start-up companies and hedge funds which do not face pay caps. The CEOs of Citigroup and JPMorgan Chase said that it will be harder to pay back government loans if the workers most capable of leading their banks toward recovery jump ship. On the other hand, a professor of finance at New York University indicated that there is a positive element to the exodus from large banks. By spreading risk to smaller institutions, there is no longer a systemic threat, and innovation is spread as well. Graham Bowley & Louise Story, *Crisis Altering Wall St. as Starts Begin to Scatter*, N.Y. Times, April 12, 2009, at A1. More recently, Citigroup asked Treasury for permission to pay special bonuses to key members of its energy-trading unit, Phibro. Phibro has made hundreds of million of dollars for the bank, and members of the unit are threatening to leave due to government pay restrictions. Citigroup is looking to free Phibro from the pay limits by either spinning off the unit into an independent hedge fund or opening it to outside investors. David Enrich & Ann Davis, *Citi Seeks Approval to Pay Out Bonuses*, Wall St. J., April 29, 2009.

86. An additional concern of some bank executives is the politicization of lending resulting from government involvement in the banking system. Said Kelly King, chief executive of BB&T Corporation, "Rational, objective lending is one of the most important purposes of the banking system, and when you inject Congress and the administration into it, it effectively politicizes the process, which is not healthy." *3 Banks Plan to Raise Cash to Repay Government*, Reuters, May 11, 2009.

87. Federal Register, Vol. 74, No. 113, June 15, 2009, 28398.

88. *Id.*

89. *Id.* at 28399.

90. *Id.* at 28398.

91. *Id.*

92. *Id.*

93. *See generally* Scott Harshbarger & Goutam U. Jois, *Looking Back and Looking Forward: Sarbanes-Oxley and the Future of Corporate Governance*, 40 Akron L. Rev. 1, 3 (2007).

94. *See generally* David B. Pitofsky & Matthew Tulchin, *New York Law Journal, Limiting, Clawing Back Executive Pay In the Wake of Financial Bailout* ¶ 4, (Jan. 28, 2009) (*available at* http://www.goodwinprocter.com/~/media/32869322B5754960AD1B186DECBD6C58.ashx).

95. 15 U.S.C.A. § 7243(a)(2009). SOX 304 provides:

> If an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws, the chief executive officer and chief financial officer of the issuer shall reimburse the issuer for (1) any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the Commission (whichever first occurs) of the financial document embodying such financial reporting requirement; and (2) any profits realized from the sale of securities of the issuer during that 12-month period.

96. Pitofsky & Tulchin, *supra* note 94, at "Existing Legal Options."

97. James F. Reda, Stewart Reifler & Laura G. Thatcher, *Compensation Committee Handbook*, 156 (3d ed., John Wiley & Sons, Inc., 2008).

98. *Id.*

99. *Id.*

100. Pitofsky & Tulchin, *supra* note 94, at "Existing Legal Options."

101. *Id.*

102. *See generally* Nader H. Salehi & Elizabeth A. Marino, N.Y.L.J., *Section 304 of SOX: New Tool for Disgorgement? (available at* http://www.law.com/jsp/ihc/PubArticleIHC.jsp?id=1202421589570) (May 22, 2008).

103. *See generally* Harshbarger & Jois, *supra* note 93, at 29.

104. SEC, *Litigation Release No. 21149A*, http://www.sec.gov/litigation/litreleases/2009/lr21149a.htm (July 23, 2009).

105. *SEC v. Jenkins*, Civil Action No. 2:09-cv-01510-JWS (D. Ariz. 2009) (pending).

106. *Id.*

107. *Id.* The SEC's formal actions against CSK include a March 2009 civil injunction charging former executives with various securities charges, including fraud. *See supra* note 104, at ¶ 4. In May 2009, the SEC also instituted settled cease-and-desist proceedings

against the company for releasing two years of fraudulent financial statements. *Id.* CSK, of course, neither admitted nor denied the charges in accepting the settlement. *Id.*

108. Jordan Eth & Brian L. Levin, Morrison & Foerster, LLP, *Legal Updates & News, SEC Raises Stakes on Restatements*, (*available at* http://www.mofo.com/news/updates/files/15847.html) (Aug. 2009).

109. Milbank, Tweed, Hadley & McCloy LLP, *Corporate Governance Group Client Alert, Ninth Circuit Finds No Private Right of Action Under Section 304 of Sarbanes-Oxley*, (*available at* http://www.milbank.com/NR/rdonlyres/09C1C769-7795-4A07-960C-83C23C1A89DB/0/010509_In_re_Digimarc_Corporation_Derivative_Litigation.pdf) (Jan. 5, 2009).

110. *C.f. In re AFC Enterprises, Inc. Derivative Litig.*, 224 F.R.D. 515, 521 (N.D. Ga. 2004).

111. *Teachers' Retirement System of Louisiana v. Hunter*, 477 F.3d 162, 188-189 (4th Cir. 2007).

112. *Teachers' Retirement System*, 477 F.3d at 189.

113. *SEC v. McGuire*, 2007 SEC LEXIS 2837 (D. Minn. 2007) (Litigation Release No. 20387). *See also SEC v. Nicholas III*, Civil Action No. SACV 08-00539-CJC (RNbX) (C.D. Cal 2008), *civil proceeding stayed pending completion of criminal proceedings*, 569 F. Supp. 2d 1065 (C.D. Cal. 2008); *SEC v. Jasper*, Case No. C-07-6122 HRL (N.D. Cal. 2007) (pending).

114. SEC, *Litigation Release No. 20345, SEC v. David H. Brooks*, Civil Action No. 07-61526-CIV-Altonaga/Turnoff, http://www.sec.gov/litigation/litreleases/2007/lr20345.htm (S.D. Fla. 2007).

115. *McGuire*, 2007 SEC LEXIS 2837.

116. *McGuire*, 2007 SEC LEXIS 2837 at *4 (D. Minn. Dec. 6, 2007). "The McGuire settlement was the first settlement reached under SOX 304, and remains the largest SEC settlement reached under allegations of stock option backdating." *Id.* at *1. The amount represents $11 million in ill-gotten gains, $2 million in prejudgment interest, $7 million as a penalty, and $448 million in disgorged cash bonuses and profits made from the exercise and sale of UnitedHealth stock and unexercised UnitedHealth options. *Id.* at *4.

Note: In December of 2008, the SEC again moved against UnitedHealth, and separately, its General Counsel (who settled his case privately). SEC, *Litigation Release No. 20836*, http://www.sec.gov/litigation/litreleases/2008/lr20836.htm (Dec. 22 2008). Neither case alleged § 304 violations, however. *Id.*

117. *McGuire*, 2007 SEC LEXIS 2837 at *1. The derivative settlement was $900 million, historically the largest settlement to date among the backdating settlements, rivaled only by the recent Broadcom partial settlement of $118 million. Kevin LaCroix, D & O Diary, *Broadcom Options Backdating Derivative Suit*, http://www.dandodiary.com/2009/09/articles/options-backdating/do-insurers-fund-118-million-partial-settlement-of-broadcom-options-backdating-derivative-suit/ (Sept. 1 2009).

118. *Id.* at 2.

119. *Id.* at 2-3 (the fabricated documents were those relied on by outside auditors).

120. *Id.* at 3.

121. *Brooks*, Civil Action No. 07-61526-CIV-Altonaga/Turnoff (S.D. Fla. filed Oct. 25, 2007).

122. SEC, *Litigation Release No. 20345*, *supra* note 114, at 2.

123. *Id.* at 3.

124. DHB Industries did settle the class action and derivative suit against it in the Eastern District Court of New York for $35,200,000. Tech Agreements, *Stipulation and Agreement of Settlement* 9 at 1.30 (*available at* http://www.techagreements.com/agreement-preview.aspx?search=lawfirm&lawFirmID=197&num=418744&title=DHB%20Industries%20-%20Stipulation%20And%20Agreement%20of%20Settlement) (Nov. 30, 2006) (resolving class action CV 05-4296(JS)(ETB) and derivative action CV 05-4345(JS)(ETB)).

125. Reda, Reifler & Thatcher, *supra* note 97, at 155 (questioning whether a restatement is "required" under § 304: when a new accounting firm offers advice to the corporation, or, only under the counsel of SEC comments and suggestions). Also not defined by the language of § 304 is when compensation is in fact "received" by the executive, and what time period is to be used when assessing "profits" from the sale of shares (comparing the sale price to the purchase price of the acquisition). *Id.*

126. Salehi and Marino, *supra* note 102, at "SOX 304's Ambiguities."

127. *Id.*

128. *AFC Enterprises*, 224 F.R.D. at 521.

129. *In re Qwest Communs. Int'l, Inc. Sec. Litig*, 387 F. Supp. 2d 1130, 1150 (D. Colo. Sept. 12, 2005).

130. *Diaz v. Davis, (In re Digimarc Corp. Derivative Litig.)*, 549 F.3d 1223, 1233 (9th Cir. 2008). *See also, e.g., In re Brocade Communs. Sys. Derivative Litig.*, 2009 U.S. Dist. LEXIS 295 at **51-52 (N.D. Cal. Jan. 6, 2009); *In re InfoSonics Corp. Derivative Litig.*, 2007 U.S. Dist. LEXIS 66043 at *24 (S.D. Cal. Sept. 4, 2007); *Mehlenbacker v. Jitaru*, 2005 U.S. Dist. LEXIS 42007 at *33 (M.D. Fla. 2005); *In re Whitehall Jewelers, Inc. S'holder Derivative Litig.*, 2006 U.S. Dist. LEXIS 16635 at *27-28 (N.D. Ill. Feb. 27, 2006); *In re iBasis, Inc., Derivative Litig.*, 532 F. Supp. 2d 214, 223-25 (D. Mass. 2007); *In re BISYS Group Inc. Derivative Action*, 396 F. Supp. 2d 463, 464 (S.D.N.Y. 2005); *In re Diebold Derivative Litig.*, 2008 U.S. Dist. LEXIS 15747 at **5-6 (N.D. Ohio Feb. 29, 2008); *Neer v. Pelino*, 389 F. Supp. 2d 648, 657 (E.D. Pa. 2005); *Pedroli ex rel. Microtune, Inc. v. Bartek*, 564 F. Supp. 2d 683, 686 (E.D. Tex. 2008).

131. *Id.*

132. *Diaz*, 549 F.3d at 1233. *See also Teachers' Retirement System of Louisiana*, 477 F.3d at 189 (Fourth Circuit Court explicitly states it is not discussing the matter of a private right of action under § 304, but that in any event, none exists); *Pirelli Armstrong Tire Corp. Retiree Med. Benefits Trust v. Raines*, 534 F.3d 779, 793 (D.C. Cir. 2008) (indicating in dicta that "§ 304 does not create a private right of action").

133. Salehi and Marino, *supra* note 102, at "SOX 304's Ambiguities" (discussing the significance of language being dropped from the final bill indicating an exclusive SEC enforcement role under § 304).

134. *Cort v. Ash*, 422 U.S. 66 (1975).

135. Harshbarger & Jois, *supra* note 93, at 30.

The *Cort* four-factor test is used to determine if an implied private remedy is contained in a federal statute. *Cort v. Ash*, 422 U.S. 66 at 78. The factors include: whether plaintiff is among the class for whom the statute was passed to protect or help; if there is legislative intent creating or prohibiting a private right of action; whether recognizing a private right of action is consistent with the "underlying purposes" of the statute; and whether the private cause of action sought is actually a matter of state legislation, and inappropriate to recognize in a federal context. *Id.*

It is somewhat perplexing that academia would suggest modern courts look to *Cort* for guidance, as this factor test has since been changed. In *Sandoval*, the Supreme Court concluded that "statutory intent [ ] is determinative" as regards the existence of a private right of action. *Alexander v. Sandoval*, 532 U.S. 275, 286 (2001). The Court specifically instructed that any subsequent court's task is to determine whether the statute, as passed by Congress, "displays an intent to create not just a private right but also a private remedy." *Id.* at 286-287. Apart from these considerations, courts "may not create [a private right of action]." *Id.* This has been adopted in the Second Circuit by the Court in both *Olmstead* and *Bellikoff*, as regards provisions of the Investment Company Act of 1940. *Halebian v. Berv*, 2007 U.S. Dist. LEXIS 55326 (S.D.N.Y. 2007) (discussing *Olmstead v. Pruco Life Ins. Co. of New Jersey*, 283 F.3d 429

(2d Cir. 2002); *Bellikoff v. Eaton Vance Corp.*, 481 F.3d 110 (2d Cir. 2007)). The *Olmstead* factor test includes considerations of whether the statute contains an explicit private right of action; whether the statute contains "rights-creating language" for the protected class; whether the statute provides for alternative methods of enforcement; and whether there was a private right of action provided for anywhere else in the statute. *Halebian*, 2007 U.S. Dist. LEXIS 55326 at *40 (citing *Olmstead*, 283 F.3d at 432-434).

136. *Cort*, 422 U.S. 78.

137. *Diaz*, 549 F.3d 1223.

138. *Id.* at 1232-1233.

139. *Id.* at 1229-1230 (citing *Touche Rosse & Co. v. Redington*, 422 U.S. 560, 568 (1979)).

140. *Id.* at 1230-1231 (citing *Opera Plaza Residential Parcel Homeowners Ass'n v. Hoang*, 376 F.3d 831, 835 (9th Cir. 2004)).

141. *Id.* at 1232 (citing *Alexander v. Sandoval*, 532 U.S. 275, 289 (2001)).

142. *Id.* at 1232-1233.

143. *Id.*

144. *In re Brocade Communs. Sys. Derivative Litig.*, 2009 U.S. Dist. LEXIS 295 at *52 (N.D. Cal. Jan. 2009).

145. Salehi and Marino, *supra* note 102, at "Lack of Use of SOX 304" (citing *McGuire*, 2007 SEC LEXIS 2837).

146. Milbank, Tweed, Hadley & McCloy LLP, *supra* note 109, at "Conclusion."

147. *Id.*

148. Stock option backdating is widespread and complex, and warrants its own investigation. It involves securities law, tax law and accounting principles. For purposes of this article, stock option backdating is treated as relevant, but ancillary to the main topic of litigation and executive compensation.

149. The Securities Act of 1933 has been cited in some litigation to combat fraud allegations ("33 Act"). 15 U.S.C. § 77a (2009); *see generally, e.g., SEC v. Reyes*, No. 06-CV-3844 (E.D.N.Y. Aug. 9, 2006). The 1933 Act focuses almost exclusively on the public distribution of securities. *See generally* Thomas L. Hazen, *The Law of Securities Regulation 3*, 326-357 (5th ed., Rev. 2005). In contrast, the Securities Exchange Act of 1934 deals more generally in the trading of securities, as well as the regulation of the markets and the securities industry ("34 Act"). 15 U.S.C. § 78a (2009); Hazen, *supra* note 149. In order to adhere to this article's litigation focus, discussion herein focuses on the '34 Act allegations.

150. United States Congress, Joint Committee on Taxation, *Present Law and Background Relating to Executive Compensation* 4 (*available at* http://www.house.gov/jct/x-39-06.pdf) (Sept. 6, 2006). The practice of equity-based compensation, in theory, is to link the executive's compensation to his or her performance at the company. M.P. Narayanan, Cindy A. Schipani, and H. Nejat Seyhun, *The Economic Impact of Backdating of Executive Stock Options*, Vol. 105 Mich. L. Rev. Issue 8, 1606 (2007). The harder and smarter he or she works, the more the corporation benefits, the fair market price of the corporation's stock rises, and the executive earns more money when his or her stock options vest in the future. Too, linking the executive's compensation this way to his or her performance sometimes ameliorates criticism of excessive executive salaries. John D. Shipman, *The Future of Backdating Equity Options in the Wake of SEC Executive Compensation Disclosure Rules*, 85 N.C.L. Rev. 1194, 1200 (2007). The practice of backdating, however, dilutes the interests of existing shareholders by increasing the number of outstanding shares. *Id.* at 1200. Equity-based compensation also creates a moral hazard when the vesting period is short, causing the executive to focus on short-term growth, and perhaps tempting executives to circumvent existing laws to reap greater profit. *Id.*

151. Frank Ahrens, The Washington Post, *Scandal Grows Over Backdating of Options*, "How Does Backdating Work?" (*available at* http://www.washingtonpost.com/wp-dyn/content/article/2006/10/11/AR2006101100425_pf.html) (Oct. 12, 2006).

152. Dr. Sunil Panikkath, Matthew Evans, Dr. Patrick Conroy, Erik Stettler and Nathan Saperia, NERA Economic Consulting, *Options Backdating: A Primer* 7 (*available at* http://www.nera.com/image/PUB_Backdating_Part_1_Primer_SEC1381_final.pdf) (Oct. 5, 2006).

There are a number of reasons at-the-money options are typical. First, before the summer of 2005, companies were required to grant options with a strike price "at least equal" to the fair market value of the option. Jeffrey M. Taylor, *Understanding the Options Backdating Controversy—New Developments* 4 n. 1, http://www.blankrome.com/siteFiles/News/0583BEE9934239C296F74285849E0AAD.pdf (Aug. 17, 2007) (citing Accounting Principles Board Opinion No. 25). Second, in most cases, an option characterized as an "incentive stock option" must be issued as at-the-money or out-of-the-money on the date of the grant. *Id.* (citing I.R.C. § 422 (1986)). Third, public corporations must disclose to the investing public any grant of in-the-money options. *Id.* (citing Item 402(d)(2)(vii) of Regulation S-K, 17 C.F.R. § 229.402(d)(2)(vii)).

153. Panikkath, Evans, Conroy, Stettler, & Sapiera, *supra* note 152, at 7.

154. Shipman, *supra* note 150, at 1201-1202.

155. Cooley Godward Kronish LLP, Cooley Alerts, *Stock Option Backdating: The Latest "Hot Issue"* (*available at* http://www.cooley.com/news/alerts.aspx?id=39704820) (June 5, 2006).

It should also be noted that business academics also track and analyze "forward dating." Narayanan, Schipani, & Seyhun, *supra* note 150, at 1602-1603. This is the practice of deferring a grant date in light of a current low stock price that will foreseeably continue to fall in the short-term. *Id.* The option grant is then set on a date when the fair-market price of the stock is at a foreseeable low of lows. *Id.* There is also "spring loading" or "bullet dodging," which respectively mean, timing a grant before a public announcement of good news or directly after a public announcement of bad news. Eric Lie, *Backdating of Executive Stock Option Grants (ESO)*, "What About Spring Loading and Bullet Dodging?" (*available at* http://www.biz.uiowa.edu/faculty/elie/backdating.htm). (accessed Mar. 15, 2009).

156. Ahrens, *supra* note 151, at "How Does Backdating Work?".

157. Panikkath, Evans, Conroy, Stettler & Saperia, *supra* note 152, at 9.

158. *Compare Ryan v. Gifford*, 918 A.2d 341, 355-356 (Del. Ch. 2007) (quoting *Aronson v. Lewis*, 473 A.2d 805, 815 (Del. 1984)) ("Backdating options qualifies as one of those rare cases [in which] a transaction may be so egregious on its face that board approval cannot meet the test of business judgment."); *In re Tyson Foods Inc. Consol. Shareholder Litig.*, 919 A.2d 563, 592 n. 74 (Del. Ch. 2007); *In re Comverse Technology, Inc., Derivative Litigation Leonard Sollins, et al, v. Comverse Technology, Inc.*, 56 A.D.3d 49, 56 (N.Y. App. Div. 1st Dep't 2008).

159. Narayanan, Schipani & Seyhun, *supra* note 150, at 1601-1602.

160. Daniel W. Collins, Guojin Gong and Haidan Li, *Corporate Governance and Backdating of Executive Stock Options* 2 n. 1 (*available at* http://ssrn.com/abstract=934881) (August 2008) (citing *The Wall Street Journal Online, Options Scorecard*, http://online.wsj.com/public/resources/documents/info-optionsscore06-full.html (last updated Sept. 2007)).

161. *See generally* U.S. Securities and Exchange Commission, *Spotlight On: Stock Options Backdatings* (*available at* http://www.sec.gov/spotlight/optionsbackdating.htm) (last updated May 15, 2009).

162. *N.B.* This disclosure is made per Treasury Department Circular 230. Any discussion of federal tax issues contained within this article does not constitute advice. This document was written as a means of marketing and research. Any discussion of federal tax issues was not written as advice, and therefore cannot reasonably be used by any person to avoid obligations imposed upon them via the Internal Revenue Code.

163. Although it would be beyond the scope of this article to discuss in greater detail the tax environment surrounding options

backdating, some basic information is appropriate. For example, where options are granted as incentive stock options, the exercise of that option by the optionee does not typically result in taxable income. Taylor, *supra* note 152, at 40. This presumes, however, that certain incentive stock option rules are followed, one of which is that the option's exercise price is equal to or greater than the fair market value of the stock on the day of the grant. *Id.* Non-compliance would disqualify the option for favorable treatment. *Id.* at 41.

A false or inaccurate tax return can be treated in a variety of different ways. Taylor, *supra* note 152, at 42. If the taxpayer—corporation or individual—willfully made a false return, there is a possible criminal penalty of up to three years of incarceration and a $100,000 fine for each violation. *Id.* (citing I.R.C. § 7206(1) (West 2002)). Alternatively, if the taxpayer innocently made a false return, the Internal Revenue Service ("IRS") may collect any unpaid taxes, penalties, or interest. *Id.*

164. Karen Field, *KPMG, Misdated and Other Discounted Stock Options* 4, http://www.kpmginfo.com/PayrollInsights/downloads/Section409A_Explanation.pdf (Feb. 16, 2007) (discussing I.R.C. § 162(m) (2007)). There is a small debate to the effect that this deduction cap of $1 million can legally be exceeded. *See e.g.* Shipman, *supra* note 150, at 1201 (citing Eric Lie, *On the Timing of CEO Stock Option Awards,* 51 Mgmt. Sci. 802, 803 (2005)).

165. Field, *supra* note 164, at 4.

166. Raquel Meyer Alexander, Mark Hirschey and Suan Scholz, The CPA Journal, *Backdating Employee Stock Options: Accounting and Legal Implications*, "Employee Stock Option Accounting," http://www.nysscpa.org/cpajournal/2007/1007/infocus/p18.htm (Oct. 2007).

167. Field, *supra* note 164, at 4. The tax effects are more complex. In brief, know that 162(m) also requires that the options be granted by a compensation committee, and by shareholder approval. Narayanan, Schipani and Seyhun, *supra* note 150, at 1620-1621. Also note there is differing tax treatment under §§ 409(a) and 422 of the Code, for deferred compensation, statutory incentive stock option ("ISO") plans, and non-statutory stock option plans ("NSO"). *Id.*

168. Field, *supra* note 167, at 4.

169. Narayanan, Schipani and Seyhun, *supra* note 150, at 1606. The 34 Act requires a public corporation to maintain its books to accurately reflect that corporation's assets. Taylor, *supra* note 152, at 23-24 (citing 34 Act § 13(b)(2)(A), 15 U.S.C.A. § 78m(b)(2)(A) (West Supp. 2007)). Public corporations are also required to maintain an internal system of accounting controls to ensure continued accurate reporting of transactions. *Id.* (citing 34 Act § 13(b)(2)(B), 15 U.S.C.A. § 78m(b)(2)(B) (West Supp. 2007)). A public corporation must assess this internal system annually, and disclose any material impact caused, or foreseeably caused, by any changes. *Id.* (citing Exchange Act Rule 13a015(c), (d), 17 C.F.R. § 240.13a-15(c), (d)).

170. Cooley Godward, *supra* note 155, at "What are the potential ramifications?".

171. *Id.*

172. Law.com, In-House Counsel, Corporate Counsel's 2008 GC Compensation Survey ¶ 2, http://www.law.com/jsp/ihc/PubArticleIHC.jsp?id=1202423065928 (Aug. 2008).

173. Cooley Godward, *supra* note 155, at "What are the potential ramifications?" Federal securities law provides a number of different means for combating fraud in investor and shareholder disclosures. Fraud, in this case, includes materially misleading misstatements in registration statements (33 Act § 11, 15 U.S.C.A. § 77j (West 2002)), prospectuses (33 Act § 12(a)(2), 15 U.S.C.A. § 77k(a)(2) (West 2002)), securities transactions (*e.g.*, 33 Act § 17(a)(3), 15 U.S.C.A. § 77p(a) (West 2007)), proxy statements (Exchange Act Rule 14a-9(a), 17 C.F.R. § 240.14a-9(a)), SEC reports (34 Act § 18(a), 15 U.S.C.A. § 78r(a) (West 2002)), and public announcements, such as press releases (Exchange Act Rule 10b-5(b), 17 C.F.R. § 240.10b-5(b)). Taylor, *supra* note 152, at 18.

174. *In re Zoran Corp. Derivative Litigation*, 511 F. Supp. 2d 986, 1006 (N.D. Cal. 2007), *settlement approved,* 2008 U.S. Dist. LEXIS 76623 (N. D. Cal. Sept. 2, 2008) (citing 15 U.S.C. 78p(a)(2)(C)). The '34 Act prohibits insider trading. Taylor, *supra* note 152, at 20. Where a person owes a duty of trust or confidence to the corporation or the corporation's shareholders, and is in possession of material non-public information, that person must either disclose the information to the person he or she is trading with or abstain from trading altogether. *Id.* (citing *Chiarella v. U.S.*, 445 U.S. 222, 233 (1980)). A person is also guilty of insider trading if he or she has confidential information of another to whom she owes a duty of loyalty and confidence to, and trades on that information ("misappropriation theory"). *Id.* (citing *U.S. v. O'Hagan*, 521 U.S. 642, 652 (1997)); Exchange Act Rule 10b5-2, 17 C.F.R. § 240.10b5-2.

175. *Id.* at 1006.

176. *Id.*

177. Vinson & Elkins, *Options Backdating Update, V&E Securities Litigation E-communication*, "Effects of Sarbanes-Oxley," http://www.vinson-elkins.com/resources/pub_detail.aspx?id=8672 (July 26, 2006) (discussing academic studies which report 10-21% of option grants are untimely filed, suggesting backdating). Other red flags include a spike in the corporation's stock price immediately after publicly reporting a grant, or the practice of grants by unanimous written consents. Cooley Godward, *supra* note 155, at "What is Backdating?".

178. United States Securities and Exchange Commission, *Item 402 of Regulation S-K-Executive Compensation* ¶ 1, http://www.sec.gov/divisions/corpfin/guidance/execcomp402interp.htm (last updated Aug. 8, 2007) (discussing Securities Act Release No. 8732A and Securities Act Release No. 8765, respectively). The SEC is considering changing, once again, how corporations report executive income, so as to effectuate greater disclosure. Center on Executive Compensation, *Schapiro Says SEC Considering Broader Pay Disclosure Requirements* ¶ 1, http://www.execcomp.org/news/news-story.aspx?ID=723 (May 1, 2009).

179. Emery B. Sheer and Danielle K. Sheer, *Business Network, Shedding Light on Executive Pay: In Their Audits of Compensation, Auditors Should Review the Controls that Ensure Appropriate Disclosure as Mandated by New SEC Rules* ¶ 5, http://findarticles.com/p/articles/mi_m4153/is_2_64/ai_n19020895 (Apr. 2007) (discussing Item 402(b) or Regulation S-K).

180. *Id.* Language from Item 402(b) of Regulation S-K includes a suggestion of twenty-one different topics for discussion in the CD&A. The University of Cincinnati College of Law, *Securities Lawyer's Deskbook*, "b. Compensation Discussion and Analysis," http://www.law.uc.edu/CCL/regS-K/SK402.html (accessed Mar. 20, 2009). This includes, but is not limited to: the policy behind awarding equity compensation as opposed to cash compensation (*Id.* at 402(b)(2)(ii)); how compensation is designed to award executive performance (*Id.* at 402(b)(2)(vii)); the effect of executive compensation on corporate tax and financial reporting matters (*Id.* at 402(b)(2)(xii)).

181. Shipman, *supra* note 150, at 1207-1208.

182. *Id.*

183. *Id.*

184. Sheer and Sheer, *supra* note 179, at ¶ 5. *See also* Taylor, *supra* note 152, at 25-26. The principal executive officer and principal financial officer must sign certifications for each annual and quarterly report. *Id.* citing 34 Act 13a-14, 17 C.F.R. § 240.13a-14. These certifications attest to, among other things: the accuracy of the financial statements, the proper disclosure of information to auditors, as well as the disclosure of any fraud. *Id.* (citing 18 U.S.C.A. § 1350 (West 2002); Item 601(b)(31) of Regulation S-K, 17 C.F.R. § 229.601(b)(31)).

185. *Zoran*, 511 F. Supp. 2d 986.

186. *Id.*

187. *In re Zoran Corporation Derivative Litigation*, 2008 U.S. Dist. LEXIS 76623 at *4 (N.D. Cal. 2008) (court approved settlement).

188. *Zoran*, 511 F. Supp. 2d at 1010-1011.

189. *Id.* (discussing 15 U.S.C.S. § 78j (2008) and 17 C.F.R. § 240.10b-5 (2008), respectively). A successful § 10(b) and Rule 10b-5 claim in the Ninth Circuit requires the plaintiff to plead with regard to each defendant:

> (1) that defendants made a material misrepresentation or omission;
>
> (2) that the misrepresentation was in connection with the purchase or sale of a security;
>
> (3) that the misrepresentation caused plaintiff's loss;
>
> (4) that plaintiff relied on the misrepresentation or omission;
>
> (5) that defendants acted with scienter; and
>
> (6) that plaintiff suffered damages.

Id.

190. *Id.*

191. *Id.*

192. The court found that the elements of the § 10(b) and Rule 10b-5 claims were satisfactorily pled. *Id.* at 1013. The element of **material misstatement or omission** was successfully pled as both the CEO and CFO personally administered option grants and knowingly signed false and misleading financial statements and SOX certifications. *Id.* at 1011. As a result of these misstatements, several financial statements were restated, resulting in a "charge of twelve to fifteen million dollars in compensation expenses." *Id.*

The element of **transactional causation or reliance** was successfully pled as all stock options were pre-approved by the CEO before granted, and witnesses indicated that the CFO was "integral [to] every aspect." *Id.* at 1012. The corporation, in turn, then relied on the representations made to it by its executive officers and issued shares for prices that were below the fair market price the corporation would have otherwise received. *Id.*

The element of **scienter** was successfully pled as not only were the CEO and CFO "involved" in the granting of backdated options and therefore should have known of the backdating, but the CEO and CFO gave approval of the option-granting process and in fact oversaw the process. *Id.* at 1013. In addition, the CEO and CFO prepared and signed false proxy statements. *Id.*

The claim was timely filed under the **statute of limitations**, as the action was filed within five years of the violation. *Id.* at 1013-1014.

193. *Id.* at 1015 (discussing 15 U.S.C. § 78t (2008)). In the Ninth Circuit, "plaintiff must allege that: (1) there was a primary violation of the securities laws; and (2) that the defendant exercised actual power or control over the violator." *Id. Compare Take-Two* 20(a) element test, *infra* note 248.

194. In the Ninth Circuit, plaintiff must first successfully plead a violation of the securities law, and then successfully pled that the defendant had "control over the violator." *Id.*

195. *Id.* at 1016.

196. *Id*. *See Belova v. Sharp*, 2008 U.S. Dist. LEXIS 19880 at *20 (D. Or. 2008) (Plaintiff successfully pled the "essential link" element in a § 14(a) allegation). *Compare Engel v. Sexton*, 2009 U.S. Dist. LEXIS 12778 (E.D. La. 2009) (14(a) complaint dismissed); *In re Marsh & McLennan Cos. Sec. Litig.*, 536 F. Supp. 2d 313 (S.D.N.Y. 2007) (14(a) complaint dismissed without prejudice). To plead a claim under § 14(a) in the Ninth Circuit, plaintiff must allege that:

> (1) defendants made a material misrepresentation or omission in a proxy statement;
>
> (2) with the requisite state of mind; and
>
> (3) that the proxy statement was the transactional cause of harm of which the plaintiff complains.

Zoran, 511 F. Supp 2d at 1015 (interpreting 34 Act, 15 U.S.C. § 78n(a) (2008)).

197. *Id.* at 1016. The elements of **misstatement and state of mind** were successfully pled as plaintiff argued that a reasonable shareholder would consider self-dealing material in regards to voting, and that the proxy statements for an eight-year period misstated not only option grant dates, compensation expenses, and financial results, but also falsely stated that the board had compliedwith the shareholder approved stock option plans. *Id.* at 1015.

The **statute of limitations** element was successfully pled as to proxy statements issued between 2003 and 2005, as they fell within the three-year statute of repose. *Id.* at 1017.

198. *Id.* at 1016.

199. *Compare In re iBasis, Inc. Derivative Litigation*, 2007 WL 4287591 (D. Mass. 2007) (Shareholders also argued, via derivative action, that § 14(a) of the 1934 Act was violated by false or misleading proxy statements. The court dismissed the claim for several reasons. First, the court considered the claim untimely. Second, the court dismissed the claim because the alleged backdating occurred prior to the issued proxy statement, and therefore there was no connection between the injury to the company and the statements and transactions approved by shareholder vote based on the information in that proxy.).

200. *Zoran*, 511 F. Supp. 2d at 1016. *Compare Fisher v. Kanas*, 467 F. Supp. 2d 275, 281-284 (E.D.N.Y. 2007) (plaintiff failed to allege that the proxies contained specific misstatements regarding compensation; that causation existed, as there was no allegation that the proxy votes would have been different; and there were no allegations that there was a plaintiff injury as a result of the misstatements).

201. *Zoran*, 511 F. Supp. 2d at 1016.

202. *Id.*

203. *Id.*

204. *Id.*

205. *Id.*

206. *See, e.g., Plymouth*, 576 F. Supp. 2d 360, 369, 374-375, 378-380, 383 (E.D.N.Y. 2008) (discussing the various requirements a plaintiff derivative action must satisfy in a federal court, including the demand futility test, statute of limitations requirements, and sufficiency of the pleadings under, *inter alia*, the Private Securities Litigation Reform Act of 1995 ("PSLRA")).

207. New York Business Corporation Law § 626(c) (2009).

208. *Marx v. Akers*, 88 N.Y.2d 189 (N.Y. 1996). The Court in *Comverse* elaborated on this third test, finding a demand on the board futile "when [the] complaint alleges with particularity that the challenged transaction was so egregious on its face that it could not have been the product of sound business judgment of the directors." *In re Comverse Technology Inc., Derivative Litigation*, 866 N.Y.S.2d 10, 16-17 (quoting *Ryan v. Gifford*, 918 A.2d 341, 354-356 (Del. Ch. 2007)).

209. *Comverse*, 866 N.Y.S.2d 10.

210. *Id.* at 17.

211. *Id.*

212. *Id.* (citing *Katz v. Renyi*, 722 N.Y.S.2d 860 (2001)).

213. *Id.* The Court found a number of problems with the special committee. First, one of the special committee members was a director and compensation committee member for the period of interest in the litigation, suggesting a serious conflict of interest. *Id.* Too, the Court found the actions taken by the special committee "tepid." *Id.* at 17-18. For example, once the perpetrators of the fraud were found, they were kept on with the corporation as

"advisors" until the SEC filed charges seeking restitution of $51 million. *Id.* at 18. *Compare Wandel, Derivatively on Behalf of Bed Bath & Beyond, Inc.* v. *Eisenberg, et al.*, 871 N.Y.S.2d 102 (N.Y. App. Divs. 1st Dep't 2009) (plaintiffs failed to plead with particularity what the egregious behavior was, and the corporation and its special committee had remedied the matter with repricing unvested options and adopting new controls).

214. *Comverse*, 866 N.Y.S.2d at 19.

215.

> (1) [A] district judge may certify a class only after making determination that each of the Rule 23 requirements has been met;
>
> (2) such determinations can be made only if the judge resolves factual disputes relevant to each Rule 23 requirement and finds that whatever underlying facts are relevant to a particular Rule 23 requirement have been established and is persuaded to rule, based on the relevant facts and the applicable legal standard, that the requirement is met;
>
> (3) the obligation to make such determinations is not lessened by overlap between a Rule 23 requirement and a merits issue, even a merits issue that is identical with a Rule 23 requirement."

In re Monster Worldwide, Inc. Sec. Litig., 251 F.R.D. 132, 133 (S.D.N.Y. 2008) (internal quotations and citations omitted). Class certification requires satisfaction of Rule 23(a)'s "familiar requirement." *Id.* (citing Fed. R. Civ. P. 23(a) (2008)). This requirement is "referred to as numerosity, commonality, typicality and adequacy of representation," and also must satisfy an additional 23(b) element. *Id.*

216. *In re Take-Two Interactive Securities Litigation*, 551 F. Supp. 2d 247 (S.D.N.Y. 2008).

217. *Id.* at 258-259. Count Three was for control person liability under § 20(a) for fraud unrelated to the options backdating. *Id.* at 259. Count Three was dismissed in its entirety. *Id.* at 306. Count Four alleged trading with inside information against several executives pursuant to § 20A(a), as these executives were alleged to have sold their shares timed to the release of negative Take-Two news. *Id.* at 259. Section 20A(a) of the '34 Act creates a private right of action for claims of trading with inside information. *Id.* at 308-309. This action was not based on the options backdating facts, however. *Id.* at 308-312. Section 20A(a) provides:

> Any person who violates any provision of [the '34 Act] or the rules or regulations thereunder by purchasing or selling a security while in possession of material, nonpublic information shall be liable… to any person who, contemporaneously with the purchase or sale of securities that is the subject of such violation, has purchased…securities of the same class.

15 U.S.C. § 78t-1(a) (2008).

A successful private right of action under § 20A(a) requires the moving party to:

> (1) plead a predicate insider trading violation of the ['34 Act] (*see Jackson Nat'l Life Ins. Co. v. Merrill Lynch & Co.*, 32 F.3d 697, 703 (2d Cir. 1994); *In re Refco, Inc. Sec. Litig*, 503 F. Supp. 2d 611, 664 (S.D.N.Y. 2007)); and
>
> (2) allege sufficient facts showing "that the defendant traded the security at issue 'contemporaneously' with the plaintiff." *In re Openwave Sys. Secs. Litig*, 528 F. Supp. 2d 236, 255 (S.D.N.Y. 2007).

Take-Two, 551 F. 2d at 309.

218. *Id.* at 258.

219. *Id.* at 259.

220. Loss causation is required under § 10(b) and Rule 10b-5. *Id.* at 282. A plaintiff must allege that losses were caused by defendant's misstatements or omissions that "concealed something from the market that, when disclosed, negatively affected the value of the security." *Id.* (citing *Lentel v. Merrill Lynch & Co.*, 396 F.3d 161, 173 (2d Cir. 2005)).

221. Materiality is required in Rule 10b-5 claims. *Take-Two*, 551 F. Supp. 2d at 290-291. A plaintiff must plead that a defendant's misstatements or omissions were such that a " 'reasonable investor would have considered [them] significant in making investment decisions.' " *Id.* (citing *Ganin v. Citizens Utils. Co.*, 228 F.3d 154, 161 (2d Cir. 2000)).

222. *Id.* at 282. Scienter is required for claims pursuant to § 10(b) and Rule 10b-5. *Id.* at 293. The plaintiff must allege facts "giving rise to a strong inference that the defendant acted with 'an intent to deceive, manipulate or defraud.'" *Id.* (citing *Kalnit v. Eichler*, 264 F.3d 131, 138 (2d Cir. 2001)). This inference of scienter can be based on facts showing the defendant had a motive and opportunity to commit the alleged acts, or alternatively, "strong circumstantial evidence of conscious misbehavior or recklessness." *Id.* (citing *ATSI Commc'ns v. Shaar Fund, Ltd.*, 493 F.3d 87, 99 (2d Cir. 2007)). The inference is considered "strong" if it is as plausible as other, non-fraudulent explanations for the defendant's behavior. *Id.* (citing *Tellabs Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2510 (2007)). To properly plead motive, "a plaintiff 'must assert a concrete and personal benefit to the individual defendants resulting from the fraud.'" *Id.* at 294 (citing *Kalnit*, 264 F.3d at 139). To properly plead opportunity, a plaintiff "must show that the [ ] defendants possessed 'the means and likely prospect of achieving concrete benefits by the means alleged.'" *Id.* at 297 (citing *Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1130 (2d Cir. 1994)).

223. *Take-Two*, 551 F. Supp. 2d at 282, 313.

224. *Id.* at 282.

225. *Id.* at 287.

226. *Id.* (citing *In re Dura Pharms, Inc. Secs. Litig.*, 452 F. Supp. 2d 1005, 1021-23 (S.D. Cal. 2006); *In re Openwave Sys. Secs. Litig.*, 528 F. Supp. 2d 236, 252-253 (S.D..N.Y. 2007) (4.5 % drop)).

227. *Id.* at 293 (earning percentages, as disclosed in Take-Two's 2006 restated Form 10k).

228. *Id.* at 291.

229. *Id.* (citing *Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 166 (2d Cir. 2000); *Sec. & Exch. Comm. v. Penthouse Int'l, Inc.*, 390 F. Supp. 2d 344, 354 (S.D.N.Y. 2005); *In re Kidder Peabody Sec. Litig*, 10 F. Supp. 2d 398, 409-12 (S.D.N.Y. 1998)). *Compare Basic Inc. v. Levinson,* 485 U.S. 224, 231-232 (1988) (material is judged at the time the misrepresentation or omission entered the market, as opposed to when the fraud was revealed); *Oran v. Stafford*, 226 F.3d 275, 282 (3d Cir. 2000) (different test for materiality, where the price of the stock is evaluated following the disclosure).

230. *Take-Two*, 551 F. Supp. 2d at 293.

231. *Id.* at 293-294.

232. *Id.* at 305-306. Scienter was also found as regards three directors who sat on Take-Two board's compensation committee. *Id.* at 294 (where each director had entered a private agreement with the company to repay Take-Two, *see infra* note 239).

233. *Id.* at 293 (former CEO Brant pled guilty in New York state court to falsifying business records; his plea agreement contained admissions of stock option backdating).

234. *Id.*

235. *Id.* at 294.

236. *Id.* at 294, 297.

237. *Id.* at 294 (defendant Emmel repaid $171,494, defendant Flug repaid $305,720, defendant Grace repaid $249,927).

238. *Id.* at 297.

239. *Id.* at 297-298.

240. *Id.* at 301.

241. *Id.* at 298.

242. *Id.* at 305 (citing *In re Marsh & McLennan Cos., Inc. Sec. Litig.,* 501 F. Supp. 2d 452, 481 (S.D.N.Y. 2006)).

243. *Id.* at 306.

244. *Id.*

245. *Id.* at 307 (citing *Sec. & Exch. Comm'n v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1472-1473 (2d Cir. 1996) (quoting 17 C.F.R. § 240.12b-2)). Section 20(a) provides:

> [e]very person who, directly or indirectly, controls any person liable under any provision of [the Exchange Act] or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

Id. at 306 (citing 15 U.S.C. § 78t(a)). In the Second Circuit, a plaintiff must plead:

> (1) there was an underlying primary violation,
>
> (2) the defendant exercised control over the primary violator, and
>
> (3) the defendant culpably participated in the primary violation.

Id. (citing *In re Marsh & McLennan*, 501 F. Supp. 2d at 493). This element test is slightly different from that used in *Zoran* (*See supra* note 193).

246. *Take-Two*, 551 F. Supp. 2d at 307.

247. *Id.* (lead plaintiffs pled successfully against defendant Brant only).

248. *Id.* at 308 (as required by § 10(b) and Rule 10b-5, citing *Marsh*, 501 F. Supp. 2d at 494). Plaintiffs also must satisfy the stringent pleading requirements of the PSLRA, pleading their allegations with particularity. *Take-Two*, 551 F. Supp. 2d at 308 (discussing 15 U.S.C. § 78u-4(b)(2) (2008)).

249. *Id.* (citing *In re AOL Time Warner, Inc. Sec. & "ERISA" Litig.*, 381 F. Supp. 2d 192, 235 (S.D.N.Y. 2004)).

250. *Id.* at 309

251. *Id.*

252. Associated Press, TheStreet.com, *Take-Two Settles Stock Options Backdating Case* ¶¶ 2, 7, http://www.thestreet.com/story/10480741/1/take-two-settles-stock-options-backdating-case.html (Apr. 1, 2009).

253. Former CEO Ryan Brant pled guilty in 2007 to first-degree felony of falsification of business records, paying $7.2 million in restitution. *Id.* at ¶ 3. Several other executives pled guilty that same summer to falsifying company records. *Id.* at ¶ 4.

254. Take-Two Interactive, *Take-Two Interactive Software, Inc. Announces Settlement of Securities Class Action*, http://ir.take2games.com/releasedetail.cfm?ReleaseID=406450 (Sept. 1 2009).

255. Most courts, however, allowed for a later amended complaint, dismissing the claims without prejudice. *See generally, e.g., In re Hansen Natural Corp. Sec. Litigation*, 527 F. Supp. 2d 1142 (C.D. Cal. 2007) (class action dismissed because allegations did not include financial detail assessing impact); *In re CNET Networks, Inc., Derivative Litigation*, 2008 U.S. Dist. LEXIS 51309 (N.D. Cal. 2008) (derivative action which failed to properly allege demand futility, even after third amended complaint); *In re Openwave Sys.*, 2008 U.S. Dist. LEXIS 32589 (N.D. Cal. 2008) (derivative action where statistical analyses provided were insufficient to reasonably infer backdating); *Rudolph v. UT Starcom*, 2008 U.S. Dist. LEXIS 63990 at **19-20 (N.D. Cal. 2008) (class action that was dismissed in part because plaintiff failed to make the "essential link" argument required in allegations that involve proxy statements); *Britton v. Parker*, 2008 U.S. Dist. LEXIS 70430 (D. Colo. 2008) (derivative action dismissed because allegations were insufficiently specific); *Edward J. Goodman Life Income Trust v. Jabil Circuit, Inc.*, 595 F. Supp. 2d 1253 (M.D. Fla. 2008) (class action dismissed upon third amended complaint for, *inter alia*, insufficient fraud admissions and insufficient detail as to misconduct); *In re Keithley Instruments, Inc., Derivative Litigation,* 2008 U.S. Dist. LEXIS 107781 (N.D. Ohio 2008) (derivative action dismissed for failure to make a demand upon the board); *Winters v. Stemberg*, 529 F. Supp. 2d 237 (D. Mass. 2008) (derivative action did not adequately allege scienter); *In re Comverse Technology, Inc. Securities Litigation*, 543 F. Supp. 2d 134, 155-156 (E.D.N.Y. 2008) (class action where claims were dismissed in part, *inter alia*, for failure to satisfy the PSLRA), accounting claims independent of backdating claims dismissed, 2008 U.S. Dist. LEXIS 55032 at **2-3 (2008); *In re Openwave Systems Securities Litigation*, 528 F. Supp. 2d 236 (S.D.N.Y. 2007) (class action dismissed in part because control person liability and scienter were mispled as to some defendants); *Pedroli v. Bartek*, 564 F. Supp. 2d 683, 689 (E.D. Tex. 2008) (derivative action "scatter-gun" pleading insufficient).

See also Kevin M. LaCroix, D&O Diary, *Options Backdating Lawsuits: Settlements, Dismissals, Denials,* http://www.oakbridgeins.com/clients/blog/optionsbackdatingtable.doc (last updated Apr. 24, 2009).

256. Settlements include Mercury Interactive options class action settlement for $177.5 million; KLA-Tencor options class action settlement for $65 million; and Brocade options class action settlement for $160 million. *Id.* at 1-2.

257. *See, e.g., SEC v. Mercury Interactive, LLC*, 2008 U.S. Dist. LEXIS 107706 at **6, 26 (N.D. Cal. 2008). After having settled with the corporation itself for a fine of $28 million, the SEC pursued four high-level executives with the following allegations:

> (1) fraud in connection with the offer or sale of Mercury stock in violation of Section 17(a) of the Securities Act; (2) fraud in the purchase or sale of Mercury stock in violation of section 10(b) of the Exchange Act and Rule 10b-5 thereunder; (3) recordkeeping violations in Section 13(b)(2) of the Exchange Act and Rule 13b2-1 thereunder; (4) making false or misleading statements or omissions in connection with an audit in violation of Exchange Act Rule 13b2-2; (5) fraud in the filing of annual and quarterly reports in violation of Section 13(a) of the Exchange Act and Rules 12b-20, 13a-1 and 13a-13 thereunder; (6) providing false certifications of Forms 10-K and 10-Q in violation of Exchange Act Rule 13a-14; (7) record-keeping violations of Section 13(b)(2)(A) of the Exchange Act; (8) failure to maintain internal accounting controls in violation of Section 13(b)(2)(B) of the Exchange Act; (9) violation of reporting requirements of Section 16(a) of the Exchange Act and Rule 16a-3 thereunder; and (10) fraud in the solicitation of proxies in violation of Section14(a) of the Exchange Act and Rule 14a-9 thereunder. The SEC seeks permanent injunctive relief, disgorgement of wrongfully obtained benefits plus prejudgment interest, civil monetary penalties, an order precluding the Individual Defendants from serving as officers or directors of any public company, and repayment of bonuses and stock profits.

The court dismissed all but claims (1), (2), and (6)). *Id.* at *26. It should be noted, however, that claims made against former Mercury General Counsel Susan Skaer, now Tanner, were recently dismissed. Dan Levine, Law.com, *Judge Dismisses SEC Case Against Mercury Interactive's Former GC*, http://www.law.com/jsp/cc/PubArticleCC.jsp?id=1202433875438&Judge_Dismisses_SEC_Case_Against_Mercury_Interactives_Former_Legal_Chief=&src=EMC-Email&et=editorial&bu=Corporate%20Counsel&pt=Corporate%20Counsel%20Daily%20Alerts&cn=cc20090918&kw=Judge%20Dismisses%20SEC%20Case%20Against%20Mercury%20Interactive's%20Former%20Legal%20Chief (Sept. 18, 2009).

The Brocade cases are interesting in the breadth of litigation undertaken from the same backdating fact pattern. To date, there have been separate shareholder derivative and class actions, criminal indictments against Brocade executives, and civil enforcement actions by the SEC. *See, e.g., In re Brocade Derivative Litig.*, 2009 U.S. Dist. LEXIS 295 (N.D. Cal. 2009) (dismissed claims in part against defendants because, *inter alia*, the 10(b) allegations were flawed as evidence was insufficient regarding Canova and the reliance element was not met regarding Reyes); *SEC v. Reyes*, 2008 U.S. Dist. LEXIS 65895 (N.D. Cal. 2008) (action is against then-CEO Reyes, VP Jensen, and CFO Canova; pending); *SEC v. Byrd*, No. 07-4223-CRB (N.D. Cal. filed Aug. 17, 2007) (action is against then CFO and COO Byrd; pending); *Roth v. Reyes*, 2007 U.S. Dist. LEXIS 66066 (N.D. Cal. 2007) (dismissed for failure to state a claim upon which relief could be granted); *Smajlaj v. Brocade*, 2006 U.S. Dist. LEXIS 97618 (N.D. Cal. 2005), *defendant motion to dismiss denied*, 2007 U.S. Dist. LEXIS 64968 (N.D. Cal. 2007); *U.S. v. Reyes*, 2007 U.S. Dist. LEXIS 27427 (N.D. Cal. 2007), *criminal conviction against CEO Reyes overturned*, *U.S. v. Reyes*, No. 08-10047 (N.D. Cal. Aug. 18, 2009), *criminal conviction of human resource executive Reyes upheld with resentencing*, *U.S. v. Jensen*, No. 08-10140 (N.D. Cal. 2009). The Brocade corporation released a press release in 2008 announcing a preliminary settlement of $160 million to resolve the class action against it. Brocade Communications Systems, http://phx.corporate-ir.net/phoenix.zhtml?c=90440&p=irol-newsArticle_print&ID=1161494&highlight= (June 2, 2008). The corporation also settled with the SEC, paying a $7 million penalty without either admitting or denying the backdating allegations. SEC, *Litigation Release No. 20137*, http://www.sec.gov/litigation/litreleases/2007/lr20137.htm (May 31, 2007).

See **Section 17(a) of the Securities Act of 1933**, 18 U.S.C. § 77q(a) (2009), which prohibits fraudulent interstate transactions, and is frequently used along with § 10(b) and Rule 10b-5 in the context of options backdating. *See, e.g., SEC v. Schroeder*, 2008 U.S. Dist. LEXIS 46465 at *2 (N.D. Cal. 2008) (§ 17(a) in context of stock options backdating); *Goldman v. McMahan*, 1987 U.S. Dist. LEXIS 5356 at *39 (S.D.N.Y. 1987) (§ 17(a) private right of action exists). Section 17(a) provides:

> Anti-fraud and anti-manipulation enforcement authority. It shall be unlawful for any person in the offer or sale of any securities or any security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act [15 U.S.C.S. § 78c note]) by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly –
>
> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

Although **federal criminal charges** do little to effectuate the shareholder goal of recouping executive compensation and are therefore beyond the scope of this article, it is relevant to note that various possible criminal charges that could be brought against defendants.

Section 32 of the '34 Act provides for a criminal penalty for any willful violation of any '34 Act provision, or any rule or regulation passed pursuant to such Act; any false or misleading statement as to a material fact that is made, where the '34 Act requires a statement by the public corporation. Taylor, *supra* note 152, at 43 (citing '34 Act § 32(a), 15 U.S.C.A. § 78ff(a)) (West Supp. 2007). If a person is convicted under the '34 Act, fines of up to $5,000,000 for an individual, or $25,000,000 for a corporation, can be imposed. *Id.* at 43-44 (citing SOX § 1106, 15 U.S.C.A. § 78ff(a)). Incarceration is also possible for up to twenty years. *Id.* at 43 (citing SOX § 1106, 15 U.S.C.A. § 78ff(a). Ignorance of the law can be used as a defense against incarceration. *Id.* at 43-44.

SOX also has criminal provisions. Taylor, *supra* note 152, at 44 (citing SOX § 807, 18 U.S.C.A. § 1348 (West 2002)). Fines and imprisonment are provided for, including incarceration for up to twenty-five years. *Id.* at 44. One, of several, SOX certifications requires an executive to certify that the corporation's financial reports are in compliance with the periodic reporting requirements of the '34 Act and that the information contained in the reports fairly represents in all material respects the company's financial health. *Id.* at 45 (citing SOX § 906, 18 U.S.C.A. § 1350(b) (West 2002)). Willful violation of this certification can be punishable by both fine and imprisonment: a $5,000,000 fine and up to twenty years incarceration. *Id.* (citing 18 U.S.C.A. § 1350(c)). A knowing violation can also be punished by both fine and imprisonment a $1,000,000 fine and up to ten years in prison. *Id.* (citing 18 U.S.C.A. § 1350(c)).

Mail and wire fraud under **federal criminal law** may also be used in the backdating context. Taylor, *supra* note 152, at 44. Mail fraud is the use of interstate mail to deliver or receive any item in furtherance of a fraudulent scheme. *Id.* (citing 18 U.S.C.A. § 1341 (West 2002)). Wire fraud, then, is the transmission of fraudulent "writings, signs, signals, pictures or sounds, by means of wire, radio or television," in furtherance of a fraudulent scheme. *Id.* (citing 18 U.S.C.A. § 1343 (West 2002)). Possible backdating could conceivably include behavior such as using interstate mail to come into compliance with SEC reporting requirements; making a telephone call to communicate fraudulent statements in furtherance of a backdating scheme. *Id.* at 44-45.

Racketeering charges have also been brought in the backdating context. *See, e.g., In re Brocade Communs. Sys. Derivative Litig.*, 2009 Dist. LEXIS 295 at **42-43 (2009) (citing 18 U.S.C. § 1962 (2009)). Treble damages can be awarded. *Id.* citing 18 U.S.C. § 1964(c) (2009). **Conspiracy** charges have also been pursued. *See, e.g., U.S. v. Treacy*, 2008 U.S. Dist. LEXIS 94082 at *1 (S.D.N.Y. 2008) (Count One conspiracy to commit securities fraud and Count Two securities fraud), *Count Two reinstated, U.S. v. Treacy*, 2009 U.S. Dist. LEXIS 938 (S.D.N.Y. 2009) (Count Two was not time-barred).

258. This section is not intended to be an exhaustive investigation of the Bankruptcy Code or creditor rights, but rather is a fair representation of possible actions brought under the circumstances of a corporation facing bankruptcy.

259. Jesse Fried, The Harvard Law School Corporate Governance Forum, *Uncle Sam Should Claw Back Wall Street Bonuses* ¶ 4, http://blogs.law.harvard.edu/corpgov/2008/10/04/uncle-sam-should-claw-back-wall-street-bonuses/ (Oct. 4, 2008); *infra* note 296 (Madoff); *infra* note 416 (Connecticut Attorney General Blumenthal).

260. *See generally* Melissa C. King, *Are KERPs Alive in Essence? The Viability of Executive Incentive Bonus Plans After 11 U.S.C. § 503(c)(1)*, 82 St. John's L. Rev. 1509, 1514-1521 (2008).

261. *See generally* Rebecca Revich, *The KERP Revolution*, 81 Am. Bankr. L.J. 87, 88-93 (2007).

262. *See generally* Raymond M. Patella, *Bankruptcy Law Reform: A Primer for the General Practitioner: Business Bankruptcies*, 77 PA Bar Assn. Quarterly 100, 103 (2006).

263. McDermott Will & Emery, McDermott Newsletters, *New Bankruptcy Act—Employee Benefits and Executive Compensation Provisions*, "Executive Compensation Provisions" http://www.mwe.com/index.cfm/fuseaction/publications.nldetail/object_id/30f82c89-c809-48c8-8f1b-3728eb30bcea.cfm (Mar. 10, 2005).

264. David A. Skeel, Jr., *Doctrines and Markets: Creditors' Ball: The "New" Corporate Governance in Chapter 11,"* 152 U. Pa. L. Rev. 917, 926-927 (Dec. 2003) (also referred to as "pay-to-stay" bonuses).

265. *Id.* at 927.

266. *Id.* at 926-927.

267. *Id.* at 927.

268. *Id.*

269. Bonuses ranged between $20,000 and $125,000 for approximately 329 of these key employees. *Id.*

270. Creditors in Enron failed to recover over $120 million in executive compensation, paid months before the 2001 Enron bankruptcy. Linda Sandler and Tiffany Kary, Bloomberg, *Lehman Creditors Can Try to Recover Fuld's Pay* ¶ 5, http://www.bloomberg.com/apps/news?pid=20601103&sid=aM8r4dakjoQk&refer=news (Sept. 19, 2008).

271. King, *supra* note 260, at 1509 (citing Ien Cheng, *Survivors Who Laughed All the Way to the Bank: Barons of Bankruptcy Part I*, Fin. Times, London, at 10 (July 31, 2002)).

272. McDermott, *supra* note 263, at ¶ 1.

273. Nichole Wong, Student Author, *Note and Comment: Chapter 11 Bankruptcy Under the Bankruptcy Abuse Prevention and Consumer Protection Act: The Need for Big Brother*, 29 Whittier L. Rev. 237, 242 (2007).

274. *Id.* at 246.

275. *Id.*

276. *Id.* at 246-258.

277. *Id.* at 253.

278. *Id.* at 254. *See also id.* at 98-114 (discussion of post-BAPCPA opinions illustrating various courts' treatment and understanding of 503(c) application).

279. *Id.* at 254 (where "compensation plan" here refers to any transfer of funds to an upper level management employee).

280. The statutory test provides that a transfer:

> To, or…for the benefit of, an insider of the debtor for the purpose of inducing such person to remain with the debtor's business,…[unless]…(A) the transfer…is essential to retention of the person because the individual has a bona fide job offer from another business at the same or greater rate of compensation; (B) the services provided by the person are essential to the survival of the business; and (C) either—(i) the amount of the transfer…is not greater than an amount equal to ten times the amount of the mean transfer or obligation of a similar kind given to nonmanagement employees for any purpose during the calendar year in which the transfer is made…or (ii) if no such similar transfers were made to…non-management employees during such calendar year, the amount of the transfer … is not greater than an amount equal to 25 percent of the amount of any similar transfer … made to … such insider for any purpose during the calendar year before the year in which such transfer is made.

11 U.S.C. § 503(c)(1)(A-C) (2007).

281. Wong, *supra* note 273, at 256.

282. *Id.*

283. Section 331 provides:

> The payment is part of a program that is generally applicable to all full-time employees; and…the amount of the payment is not greater than 10 times the amount of the mean severance pay given to non-management employees during the calendar year in which the payment is made.

11 U.S.C. § 503(c)(2)(A-B) (2007).

284. Wong, *supra* note 273, at 246-247. BAPCPA also affected preferential transfers. *Id.* Executive compensation is typically pursued as a fraudulent conveyance, however, and therefore preference actions will not be discussed in detail in this section. Shaked & Posner, *Preference Litigation and Fraudulent Transfer Litigation*, "What Is Fraudulent Transfer Litigation?", http://www.shakedandposner.com/Practice-Areas/Preference-Litigation-Fraudulent-Transfer-Litigation.shtml (accessed May 14, 2009).

Academia has questioned whether executive compensation can be avoided by the trustee as a preferential transfer, in that it may or may not be an antecedent debt (where "antecedent debt" is required by 11 U.S.C. § 547(b)(2) (2007)). Steven H. Kropp, *Corporate Governance, Executive Compensation, Corporate Performance, and Worker Rights in Bankruptcy: Some Lessons from Game Theory*, 57 DePaul L. Rev. 1, 38 n. 178 (2007). *Compare id.* at 37 n. 171 (citing *Barnhill v. Johnson*, 503 U.S. 393 (1992) (debtor checks to executives as compensation are antecedent debt)). Section 547(b) provides in part:

Except as provided in subsection (c) of this section, the trustee may avoid any transfer of an interest of the debtor in property—

> (1) to or for the benefit of a creditor;
>
> (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
>
> (3) made while the debtor was insolvent;
>
> (4) made –
>
> (A) on or within ninety days before the date of the filing of the petition; or
>
> (B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and
>
> (5) that enables such creditor to receive more than such creditor would receive if—
>
> (A) the case were a case under chapter 7 of this title;
>
> (B) the transfer had not been made; and
>
> (C) such creditor received payment of such debt to the extent provided by the provisions of this title.

285. Wong, *supra* note 273, at 247. BAPCPA also allows a trustee to "avoid any transfer of an interest of the debtor in property…made…within 10 years before the date of the filing," where the debtor is the beneficiary, and the intent of the debtor in the transfer is to defraud a creditor. *Id.* at 247-148 (discussing addition of subsection (e) to § 548). Section 548 provides:

> The trustee may avoid any transfer of an interest of the debtor...made...with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted.

Section 548 (a)(1)(A) (2007).

> The trustee may avoid any transfer of an interest of the debtor in property...that was made or incurred on or within [two] years before the date of the filing of the petition, if the debtor ... received less than a reasonably equivalent value in exchange for such transfer...and...was insolvent on the date that such

> transfer was made...or became insolvent as a result of such transfer...

Section 548(a)(1)(B) (2007).

286. 11 U.S.C. § 548(a)(1)(A).

287. 11 U.S.C. § 548(a)(1)(B).

288. Wong, *supra* note 273, at 247.

289. 11 U.S.C. § 548(a)(1).

290. Kropp, *supra* note 284, at 37 n. 170 (citing 11 U.S.C. § 101(31)(b) (Supp. 2007), which defines a corporate insider to include any officer, director, or relatives of any officer or director).

291. 11 U.S.C. § 548(a)(1). This language is repeated in subsection § 548(a)(1)(B)(ii)(IV), suggesting Congress is reinforcing its intent to eliminate the historical abuses that provided impetus to BAPCPA, namely the abuses arising from a debtor freely distributing its assets prior to bankruptcy. Wong, *supra* note 273, at 247.

292. *Savage & Assocs. v. Mandl (In re Teligent Inc.)*, 380 B.R. 324 (S.D.N.Y. 2008).

293. *Id.* at 328, 336, 344 (the complaining party also requested relief, and was awarded avoidance, from a debtor transfer for $40,000 as preferential, pursuant to § 547).

A current and hotly watched issue of alleged fraudulent transfer is the **Madoff** matter. The trustee for the Madoff brokerage firm, Irving Picard, has recently written hundreds of former investors, requesting they return profits and principal withdrawn from as far back as December 2002. Andrew Longstreth, Editor, The AmLaw Daily Litigation Update, *Picard Sends Out Madoff Clawback Letters but, So Far, Stops Short of Suing*, www.litigationdaily.com (Apr. 23, 2009). Although formal litigation has not yet been filed, practitioners are hypothesizing two possible theories of recovery should litigation ensue. Philip Bentley, The Deal Magazine, *Legal Battle Looms for Madoff Early Exiters* ¶ 2, http://www.thedeal.com/newsweekly/community/legal-battle-looms-for-madoff.php#bottom (Jan. 7, 2009). The trustee could attempt recovery of preferential transfers made between September 15 and December 15, 2008. *Id.* at ¶ 2-3. Investors who relied on an investment intermediary may have a strong defense of holder-in-due course. *Id.* at ¶ 4. Alternatively, the trustee may litigate to recover alleged fraudulent transfers. *Id.* at ¶ 2 (Where fraudulent transfers can be further categorized into intentional fraud—transfers for the purpose of specifically avoiding creditors—or constructive fraud—payments made while the firm was insolvent that were for less than fair value). Conjecture exists that *Bayou* will be followed if Madoff litigation ensues. *Id.* at ¶ 8 (discussing *Bayou Accredited Fund, LLC v. Redwood Growth Partners, L.P.*, 396 B.R. 810 (S.D.N.Y. 2008)). *Bayou* involved a decade-long Ponzi scheme, that upon discovery of such and ultimate bankruptcy filing, the court ordered investors to forfeit their profit and principal. *Id.* (discussing *Bayou*, 396 B.R. at 843). This included investors who had redeemed their interests years in advance of the bankruptcy filing, if at the time the investor redeemed he or she "should have known" of the fraud. *Id.* at ¶ 9 (discussing *Bayou*, 396 B.R. at 845). This argument is anticipated to be problematic if applied to the Madoff matter: if sophisticated investigations by the SEC and institutional investors did not discover fraud over the course of years, how would an individual investor reasonably suspect fraud? *Id.* at ¶ 13. The Bayou trustee claimed intentional fraudulent transfer, and the court ordered those investors who withdrew their funds after discovering "red flags" to forfeit profit and principal. *Id.* at 10 (discussing *Bayou*, 396 B.R. at 845). The court stated the red flags should have caused further investigation on the investors' part, and absent that, the redemptions were not protected by a "good faith" transfer defense. *Id.* at 11 (discussing *Bayou*, 396 B.R. at 845). *See generally* Law.com, *Madoff Watch*, http://www.law.com/jsp/law/madoff.jsp (accessed May 21, 2009).

294. *In re Teligent*, 380 B.R. at 328.

295. *Id.* at 329.

296. *Id.*

297. *Id.*

298. *Id.*

299. *Id.*

300. *Id.* at 330.

301. *Id.*

302. *Id.* at 335 (where the CEO left for no "good reason").

303. *Id.* at 330-331.

304. *Id.* at 332.

305. *Id.* at 333-336. The Court considered whether the CEO had forfeited claims against the company, etc., as a matter of equivalent value, but found none. *Id.* at 333.

306. *Id.* at 336.

307. Other transfer defenses, new under BAPCPA, allow the debtor to include an unavoidable transfer, or perfected security interest. Wong, *supra* note 276, at 251-252. Section 1222 of BAPCPA increases the number of days available to a debtor to perfect a security interest to avoid the trustee blocking the transfer of funds later to pay the same security interest. *Id.* at 252. An additional defense includes the unavoidable transfer under $5,000. *Id.* Section 409 of BAPCPA amends provision nine to subsection (c) of § 547 to permit a transfer that is less than $5,000 and is not wholly consumer debt. *Id.* Lastly, a trustee is prohibited from avoiding a transfer of a real property interest to a "good faith purchaser" if the purchaser had no knowledge of the bankruptcy and paid "fair equivalent value. *Id.* at 252-253 (discussing how § 1214 of BAPCPA changed 549(c)).

308. 11 U.S.C. § 547(c)(2)(A-B). Section 547(c)(2)(A-B) provides:

> To the extent that such transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, and such transfer was—
>
> (A) made in the ordinary course of business or financial affairs of the debtor and the transferee; or
>
> (B) made according to ordinary business terms.

The defense can also be used to combat claims of preferential transfers. Wong, *supra* note 276, at 248.

309. 11 U.S.C. § 547(c)(2)(A-B).

310. *In re Natl. Gas Distributors, LLC*, 346 B.R. 394 (Bankr. E.D.N.C. 2006) (trustee won a motion for summary judgment to recover a note payment by debtor to a bank as a preferential transfer).

311. *Id.* at 405.

312. Robert S. Bernstein, Bernstein Law Firm, *A Primer on Preferential Transfers in Bankruptcy* ¶ 2, http://www.bernsteinlaw.com/publications/preferential/pref8.htm (accessed May 06, 2009). In the matter of preference litigation, a party could also rely on the Subsequent New Value defense. Shaked & Posner, *supra* note 284, at "What Is Preference Litigation?" A party must receive full payment from the debtor in the ninety-day period, and then continue to provide services or goods without receiving any subsequent debtor payment. *Id.*

313. *Id.* at ¶ 2.

314. Kropp, *supra* note 287, at 37-38 n. 173 (citing 11 U.S.C. § 547(c)(1) (Supp. 2007)).

315. Revich, *supra* note 264, at 114-116 (discusses "creative lawyering").

316. Matt Miller, The Deal, KERP Your Enthusiasm ¶ 6, http://thedeal.com/servlet/Satellite?cid=1181188647067&pagename=BI%2FBIArticle&c=TDDArticle (June 22, 2007) (accessed Apr. 25, 2009) (copy on file with author).

317. Kyle Matthews, Sheppard Mullin Bankruptcy and Restructuring Blog, *If It Looks Like a Duck (KERP) and Quacks Like a Duck (KERP), It's a Duck (KERP)* ¶ 1, http://www.bankruptcylawblog.com/other-nationally-significant-cases-if-it-looks-like-a-duck-kerp-and-quacks-like-a-duck-kerp-its-a-duck-kerp-1.html (Sept. 2006).

318. *See generally* Emily Watson Harring, *Note: Walking and Talking Like a KERP: Implications of BAPCPA § 503(c) for Effective Leadership at Troubled Companies*, 2008 U. Ill. L. Rev. 1285, 1293 (2008) (discussion of § 363(b)). Section 105(a) of the Code gives courts jurisdiction over debtors and debtor assets. *Id.* at 1293 n. 46 (citing 11 U.S.C. § 105(a) (2008)). Section 363(b)(1) authorizes the trustee to "use, sell, or lease, other than in the ordinary course of business, property of the estate." *Id.* at 1293 n. 48 (citing 11 U.S.C. § 363(b)(1) (2008)). Section 363(b) requires that uses of the debtor's property outside of the ordinary course must be approved by the court. *Id.* n. 51 (citing 11 U.S.C. § 363(b)(1)). The courts developed a two-prong test to approve KERPs under § 363(b): did the debtor use "proper business judgment" in creating the KERP, and was the KERP "fair and reasonable." *See, e.g.*, *In re Aerovox, Inc*., 269 B.R. 74, 80-81 (Bankr. D. Mass. 2001); *In re Montgomery Ward Holding Corp.*, 242 B.R. 147, 154 (Bankr. D. Del. 1999); *In re Am. W. Airlines, Inc.*, 171 B.R. 674, 678 (Bankr. D. Ariz. 1994); *In re Interco, Inc.*, 128 B.R. 229, 234 (Bankr. E.D. Mo. 1991). Anything passed unless the KERP was "so manifestly unreasonable that it could not be based upon sound business judgment, but only on bad faith, or whim or caprice." *In re Aerovox*, 269 B.R. at 80.

319. *In re Dana Corporation*, 351 B.R. 96 (S.D.N.Y. 2006), *executive compensation motion modified and approved,* 358 B.R. 567 (S.D.N.Y. 2008) (approved on condition of a ceiling for senior executive pay during the course of the bankruptcy).

320. *Id.* at 102 n. 3 ("If it walks like a duck (KERP) and quacks like a duck (KERP), it's a duck (KERP)."). *Compare In re Pilgrim's Pride Corporation*, 401 B.R. 229, *12-13 (N.D. Tex. 2009) (Trustee argued payments for a non-compete agreement were tied to severance, based on *Dana*. The *Pilgrim's* Court distinguished *Dana* in that : it was a pre-termination agreement and not a post-severance agreement; the *Dana* non-compete agreement was included among the severance terms; and the *Dana* plaintiffs failed to properly plead to that Court that their payments were not severance per § 503(c)(2).).

321. *Id.* at 100 (debtors sought relief under §§ 101(31) (definition of an insider), 105 (jurisdiction over debtor assets), 363(b) (ordinary course of business defense), 365 (administrative powers over executory contracts)).

322. *Id.* at 100-101 ("to the extent a proposed transfer falls within §§ 503(c)(1) or (c)(2)"). Section 503(c)(1) provides:

> There shall neither be allowed, nor paid—(1) a transfer made to, or an obligation incurred for the benefit of, an insider of the debtor for the purpose of inducing such person to remain with the debtor's business, absent a finding by the court based on evidence in the record that—
>
> (A) the transfer or obligation is essential to retention of the person because the individual has a bona fide job offer from another business at the same or greater rate of compensation;
>
> (B) the services provided by the person are essential to the survival of the business; and
>
> (C) either—(i) the amount of the transfer made to, or obligation incurred for the benefit of, the person is not greater than an amount equal to 10 [sic] times the amount of the mean transfer or obligation of a similar kind given to nonmanagement employees for any purpose during the calendar year in which the transfer is made or the obligation incurred; or (ii) if no such similar transfers were made to, or obligations were incurred for the benefit of, such non-management employees during such calendar year, the amount of the transfer or obligation is not greater than an amount equal to 25 percent [sic] of the amount of any similar transfer or obligation made to or incurred for the benefit of such insider for any purpose during the calendar year before the year in which such transfer is made or obligation is incurred.

Id. at 101 n. 1 (citing 11 U.S.C. § 503(c)(1)). Section 503(c)(2) provides:

> There shall neither be allowed, nor paid—(2) a severance payment to an insider of the debtor, unless—
>
> (A) the payment is part of a program that is generally applicable to all full-time employees; and
>
> (B) the amount of the payment is not greater than 10 [sic] times the amount of the mean severance pay given to nonmanagement employees during the calendar year in which the payment is made.

Id. at 101 n. 2 (citing 11 U.S.C. § 503(c)(2)).

323. *Id.* at 101 ("[even if] a sound business purpose may actually exist"). Debtors had argued, in the alternative, that if the Court felt so compelled to use § 503(c), the Court should then use § 503(c)(3). *Id.* The trustee objected to this use, arguing that § 503(c)(3) applies to high-level employees hired after the bankruptcy petition is filed. *Id.* The Court, however, did not feel the statute's language "prohibited" its analysis of prepetition hires under § 503(c)(3). *Id.* Section § 503(c)(3) provides:

> There shall neither be allowed, nor paid—(3) other transfers or obligations that are outside the ordinary course of business and not justified by the facts and circumstances of the case, including transfers made to, or obligations incurred for the benefit of, officers, managers, or consultants hired after the date of filing of the petition.

Id. (citing 11 U.S.C. § 503(c)(3)). Debtor company also argued that the Court should rely on its earlier reasoning and decision in *In re Calpine. Id.* at 102 (citing *In re Calpine Corp.*, No. 05-60200 (Bankr. S.D.N.Y. 2005) (the Court there found a compensation proposal incentivizing, and the decision suggests that § 503(c)(1) should be used only in circumstances where retention is the focus). The Court distinguished *Calpine* as the objections raised in *Dana* were not raised in *Calpine*, and therefore the Court was not asked to address the same issues. *Id.* at 101-102. Too, the Court insisted that any analysis of a compensation proposal under 503(c) must be a case-by-case, debtor-by-debtor, fact-specific inquiry. *Id.* The Court did indicate, however, that the business judgment rule could be used to consider a compensation motion under § 503(c)(3). *Id.* at 102. *See also* Revich, *supra* note 264, at 104 (discussing a hearing transcript from *In re Nobex Corp.*, 2006 Bankr. LEXIS 417 (Bankr. D. Del. Jan. 30, 2006) (No. 05-20050) that suggests § 503(c)(1) is to be used only for strict retentive compensation).

324. *In re Dana*, 351 B.R. at 103 (The Court indicated, broadly, that the compensation proposal would not have survived § 363 scrutiny, either.).

325. *Id.* at 102.

326. *Id.*

327. *Id.* at 102-103.

328. *Id.* at 102.

329. *Id.* (citing *Straus-Duparquet, Inc. v. International Brotherhood of Electrical Workers*, 386 F.2d 649, 651 (2d Cir. 1967)).

330. *Id.* at 102-103.

331. *In re Ownit Mortgage Solutions, Inc.,* Case No. 06-12579 (KT) (N.D. Cal. filed Dec. 28, 2006).

332. Miller, *supra* note 316, at ¶ 5.

333. *In re Delphi*, Case No. 05-44481 (RDD) (S.D.N.Y. filed Oct. 8, 2005).

334. Workforce, *Delphi Judge Orders Bankruptcy Emergence Bonuses Slashed, Cuts Exec Payout by 80 Percent* ¶ 4, 6, http://www.workforce.com/section/00/article/25/33/46.php (Jan. 29, 2008).

335. *In re Lehman Brothers Holdings Inc.*, Case No. 08-13555 (S.D.N.Y. 2008); *In re Securities Investor Protection Corp. v. Lehman Brothers Inc.*, 2008 Bankr. LEXIS 3543 (S.D.N.Y. 2008) (winding-down broker-dealer business). *See relatedly Bay Harbour Mgmt., L.C. v. Lehman Bros. Holdings*, 2009 U.S. Dist. LEXIS 20893 (S.D.N.Y. 2009) (investment funds that maintained prime brokerage accounts with Lehman challenged a sale order to Barclays of Lehman's investment banking and capital markets operations and infrastructure; the court affirmed the sale order).

See also, *infra* note 413 (discussing Connecticut Attorney General Blumenthal's objection to debtor corporation compensation proposal).

336. *See* Sandler and Kary, *supra* note 270, at 3 (Sept. 19, 2008); Adam Levitin, Credit Slips, *Lehman 2007 Bonuses?* ¶ 1, http://www.creditslips.org/creditslips/2008/09/lehman-2007-bon.html (Sept. 14, 2008).

337. Sandler and Kary, *supra* note 270, at "Most to Give Up." Then Chief Operating Officer ("COO") J.M. Gregory made $26 million in 2008; then Chief Legal Officer ("CLO") Thomas A. Russo made $12.1 million; then Chief Financial Officer ("CFO ") C.M. O'Meara made $3.7 million, and then Co-Chief Administrative Officer ("Co-CAO") Ian Lowitt made $4.9 million. *Id.*

338. *Id.*

339. *Id.* at ¶ 2 (reasoning "the value of the services of a CEO who runs a company into bankruptcy is less than $34 million").

340. Directors and officers owe a fiduciary duty to the corporation. *TJI Realty, Inc. v. Harris*, 250 A.D.2d 596, 598 (N.Y. App. Div. 2d Dep't 1998) (citing Business Corporation Law §§ 717, 720); *Limmer v. Medallion Group*, 75 A.D.2d 299, 303 (N.Y. App. Div. 2d Dep't 1980).

341. "All corporate responsibilities [will] be discharged in good faith and with 'conscientious fairness, morality, and honesty in purpose.' " *Alpert v. 28 Williams St. Corp.*, 63 N.Y.2d 557, 569 (N.Y. 1984)).

342. The business judgment rule prohibits judicial examination into decisions made by corporate directors, where those decisions are the result of " 'good faith and in the exercise of honest judgment in the lawful and legitimate furtherance of corporate purposes.' " *Owen v. Hamilton*, 44 A.D.3d 452, 456 (N.Y. App. Div. 1st Dep't 2007); *Lippman v. Shaffer*, 836 N.Y.S.2d 766, 772 (2006).

343. This section will not discuss, however, state criminal actions to combat matters of executive compensation, although such criminal prosecution has been suggested as a possible remedy. *See e.g.* Pitofsky and Tulchin, *supra* note 94, at "State Laws." *See e.g. Kozlowski*, 47 A.D.3d 111 (table), 2007 N.Y. App. Div. LEXIS 11780 (N.Y. App. Div. 1st Dep't 2007), *affirmed*, 11 N.Y.3d 223 (table), 2008 N.Y. LEXIS 3202 (N.Y. 2008). *Kozlowski* is one of the seemingly endless cases involving the CEO and CFO of Tyco international, Dennis Kozlowski and Mark Swartz. *Id.* at 113. The Appellate Division found the defendants had taken unauthorized bonuses, and affirmed lower court convictions for larceny, conspiracy, securities fraud contrary to General Business Law § 352-c(b), and falsifying business records. *Id.* at 120-121. *Kozlowski* also involved claims arising under the Martin Act. *Id.* at 230.

344. The *Grasso* procedural history is quite lengthy, in that not only did the matter reach each level of the New York judiciary, but the various parties made repeated claims, counter claims, and motions over the course of the multiple-year litigation (roughly 2003 to 2008). Two principal opinions, discussed throughout this section, are: *People v. Grasso*, 11 N.Y.3d 64 (N.Y. 2008) ("*Grasso II,*" as nicknamed in *People v. Grasso*, 54 A.D. 3d 180, 184 (N.Y. App. Div. 1st Dep't 2008)) and *Grasso*, 54 A.D.3d 180.

345. *Grasso II*, 11 N.Y.3d at 66.

346. *Id.*

347. *Id.*

348. *Id.*

349. *Id.*

350. *Id.* at 68 (In total, eight actions were filed; six against Grasso, one against Kenneth Langone (then Chairman of the NYSE's compensation committee), and one requesting injunctive relief against the NYSE):

> (1) against Mr. Grasso for annual compensation, SERP [Supplemental Executive Retirement Program] and SESP [Supplemental Executive Savings Plan] benefits, which were unlawful and ultra vires [sic] violating the New York Not-for-Profit Law ("N-PCL"). Plaintiff seeks imposition of a constructive trust on and restitution of Mr. Grasso's compensation;
>
> (2) for an unlawful conveyance against Mr. Grasso under N-PCL §§ 720 (a)(2) and 720 (b) for knowingly receiving annual compensation and SERP benefits that were not reasonable and unlawful. Plaintiff seeks to set aside the annual compensation and SERP payments;
>
> (3) against Mr. Grasso for breach of fiduciary duty under N-PCL §§ 717, 720 (a) and (b) by accepting unlawful ultra vires payments. Plaintiff seeks a judgment directing Mr. Grasso to account for his official conduct and to make restitution;
>
> (4) against Mr. Grasso for payment had and received. Plaintiff alleges that Mr. Grasso's compensation and benefits were not reasonable or commensurate with services Mr. Grasso performed and thus constitute unjust enrichment. Plaintiff seeks return of excessive compensation;
>
> (5) against Mr. Grasso for violation of N-PCL § 715 (f) because the NYSE Board did not approve his CAP [Capital Accumulation Plan] and SERP payments. Plaintiff seeks a declaration that any obligation by the NYSE to make future payments lacking the required N-PCL § 715 (f) board approval is void and restitution by Mr. Grasso of all CAP and SERP payments;
>
> (6) against Mr. Grasso under N-PCL § 716 for unlawful loans to Mr. Grasso made on May 11, 1995 in the amount of $6,571,397 and May 3, 1999 in the amount of $29,928,062;
>
> (7) against Langone for breach of fiduciary duty under N-PCL §§ 717, 720(a) and (b), by failing to explain Mr. Grasso's proposed compensation. Plaintiff seeks an order directing Langone to account for his official conduct and to make restitution of the unlawful payments to Mr. Grasso; and
>
> (8) against the NYSE under N-PCL §§ 202(a)(12) and 515(b) for payment of compensation and SERP benefits that were not reasonable and ultra vires. Plaintiff seeks a declaration that the NYSE paid Mr. Grasso compensation and SERP benefits that were unlawful and ultra vires. In addition, plaintiff seeks to enjoin the NYSE to adopt and implement safeguards to ensure compliance with the N-PCL.

People v. Grasso, 831 N.Y.S.2d 349, *2 (table), 2006 N.Y. Misc. LEXIS 3023 (2006) ("*Grasso 2006*").

351. *Grasso II*, 11 N.Y.3d at 68-69 (arguing the Attorney General lacked standing; the court denied the motion) (*see People v. Grasso*, 816 N.Y.S.2d 863 (2006)). This Court of Appeals opinion resolved actions one, four, five, and six. *Grasso II*, 11 N.Y.3d at 71-72. The

Supreme Court had denied defendant's motion to dismiss, but was reversed at the Appellate level. *Id.* at 68-69. The Court of Appeals affirmed the Appellate level ruling regarding all four claims. *Id.* at 69.

352. *Grasso II*, 11 N.Y. 3d at 72. The Court acknowledged that although such was beyond the scope of its opinion here, the appeal did rest on the Attorney General's "assertion of *parens patriae* authority to vindicate the public's interest in an honest marketplace." *Id.* at 70 (*See supra* text accompanying notes 35-37, detailing the later Appellate Division opinion resolving the remainder of Defendant Grasso's claims, and discussing the *parens patriae* authority in greater detail).

353. *Id.* at 70 (citing N-PCL § 717). Officers and directors must discharge "the duties of their respective positions in good faith and with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions." *Id.* (citing N-PCL § 717(a)). "Officers and directors are permitted to rely on information, opinions or reports of reasonable reliability so long as the officer or director acts in good faith." *Id.* (citing N-PCL § 717(b)). Moreover, the statute dictates that persons "who so perform their duties shall have no liability by reason of being or having been directors or officers of the corporation." *Id.* (citing N-PCL § 717(b)).

354. *Grasso II*, 11 N.Y.3d at 71.

355. *Id.* at 70.

356. *Id.* at 71.

357. *Id.*

358. *Id.* at 72.

359. *Id.* at 70.

360. *Id.* at 72.

361. *Grasso*, 54 A.D.3d at 210, 213-214 (this opinion resolved actions two and three against Grasso). The two claims asserted against Kenneth Langone and the NYSE itself, *see supra* note 350 (the seventh and eighth causes of action, respectively), were also addressed in this opinion. *Id.* at 210, 213-214.

Langone had made a motion to the Supreme Court to dismiss the action against him, which was denied. *Grasso 2006*, 831 N.Y.S.2d 349. The Appellate Division, however, reversed the Supreme Court and granted Langone's motion and dismissed the action. *Grasso*, 54 A.D.3d at 214. The Appellate Division reasoned the Attorney General had lost his standing when the NYSE changed from a not-for-profit corporation to a for-profit corporation. *See supra* text accompanying note 36; *Grasso*, 54 A.D.3d at 198-199.

The Supreme Court granted Grasso's motion to dismiss the Attorney General's claim, as regards injunctive relief against the NYSE. *Grasso*, 54 A.D.3d at 210 (discussing *Grasso 2006*, 831 N.Y.S.2d at *30). The Supreme Court reasoned that the NYSE's new for-profit status rendered the action "moot." *Id.* Grasso had also asked for declaratory relief regarding the eighth cause of action, which the Supreme Court denied. *Id.* The Appellate Division agreed with this ruling, but for different reasons: Grasso had no standing vis-à-vis the Exchange to be bound by the dismissal, and therefore had no standing to seek this dismissal. *Id.*

The NYSE entity change was dispositive as to actions two, three, and seven in this opinion. *Id.* at 189-190. The Court, however, also gave separate reasons as to why the Supreme Court's treatment of the third action against Grasso, alleging that he violated his fiduciary duties by influencing and accepting excessive compensation contrary to N-PCL 717(a) and 720(a)(1)(A-B), was incorrect. *Id.* at 185. The Supreme Court had ruled Grasso violated this duty. *Id.* at 189. Grasso participated in two NYSE benefit programs. *Id.* at 185. One was a retirement plan referred to as the Supplemental Executive Retirement Plan ("SERP"). *Id.* (Grasso did not participate in NYSE's formal SERP program, but an equivalent program). The second was a savings plan referred to as the Supplemental Executive Savings Plan ("SESP"). *Id.* As regards the SERP, the Supreme Court ruled that the compensation committee and board of directors were not "fully informed" of Grasso's benefits, and that Grasso knew or should have known this. *Id.* at 186. The Appellate Division found evidence, however, that a reasonable trier of fact could have concluded that the board had knowledge of Grasso's benefits and that Grasso believed this. *Id.* As regards the SESP, the Appellate Division rejected the Supreme Court's characterization of Grasso's early pay-out as ultra-vires, and therefore a breach of Grasso's fiduciary duty in accepting such. *Id.* at 187. The Appellate Division found the board had not committed the NYSE indefinitely to the terms adopted under the SESP, and that the Exchange had the power to amend the SESP via Grasso's 2003 compensation agreement. *Id.*

362. *Id.* at 190-191.

Regarding the for-profit transformation the then-lead seat owner sued the NYSE to halt a proposed acquisition that would make the not-for-profit NYSE a for-profit corporation. *See Higgins v. New York Stock Exch., Inc.*, 10 Misc. 3d 257 (2005). The suit was ultimately settled out of court. Michael J. Martinez, The Seattle Times, *NYSE Dissidents Settling Their Suit to Block Archipelago Deal* ¶ 1, http://community.seattletimes.nwsource.com/archive/?date=20051115&slug=webnyse15 (Nov. 15, 2005).

363. *Id.* at 191, 193-194. The issue of a not-for-profit organization's becoming a new for-profit entity during litigation, and whether the Attorney General's power under N-PCL 720(b) was affected thereby, was a matter of first impression that divided the court. *Grasso*, 54 A.D. 3d at 183.

364. *Id.* at 191 (citing Business Corporation Law 906(b)(3), as enforced by N-PCL 908(i)(A-B)).

365. *Id.* (citing *Rubinstein v. Catacosinos*, 91 A.D.2d 445 (1983); *aff'd*, 60 N.Y.2d 890 (1983)). The Court continued this reasoning, indicating that it is not enough for standing to exist at the onset of litigation, but that such standing must continue until the matter is concluded. *Id.* at 197 (citing *Stark v. Goldberg*, 297 A.D.2d 203, 204 (2002)).

366. *Id.* at 191.

367. *Id.* at 193-194.

368. *People v. Grasso*, 12 Misc. 3d 384, 393 (citing *Hawaii v. Standard Oil Co. of Cal.*, 405 U.S. 251, 257 (1972)). There are three requirements for an Attorney General to rely on his or her *parens patriae* authority. *Id.* at 395 (citing *Alfred L. Snapp & Son, Inc. v. Puerto Rico ex rel. Barez*, 458 U.S. 592, 607 (1982)). The sovereign must be a sovereign or quasi-sovereign of the public; that interest must affect a "substantial segment" of the citizenry; and the sovereign must have an interest in the litigation separate from the interests of the involved private parties. *Id.* at 394 (citing *Snapp*, 458 U.S. at 607).

369. *Grasso,* 54 A.D.3d at 198 (citing *Snapp*, 458 U.S. at 607).

370. *Id.* at 194.

371. *Id.* at 193 (citing *People v. Ingersoll*, 58 N.Y. 1, 30 (1874)).

372. *Id.* at 193-194 (citing *People v. Lowe*, 117 N.Y. 185, 195 (1889)).

373. *Id.* at 197.

374. *Id.* at 192 n. 7, 194-196.

375. *Id.* at 197 n. 10 (citing *New York v. Seneci*, 817 F.2.d 1015, 1017-1018 (2nd Cir. 1987) (money damages were rejected as an appropriate remedy for private parties where the state injury was the "integrity of the state's marketplace and economic well-being of all citizens").

376. A director or officer is liable for misconduct with corporate assets, as regards the "acquisition by [her]self, transfer to others, loss or waste of corporate assets due to any neglect of, or failure to perform, or other violation of her duties." *Kossoff v. Samsung Co.*, 123 Misc. 2d 177, 179 (1984). Claims for "excessive compensation" belong to the corporation and must be brought derivatively via the corporate waste action. *Savage & Assocs., P.C. v. Mandl (In re*

Teligent, Inc.), 358 B.R. 45, 56 (S.D.N.Y. 2006) (citing *Marx v. Akers*, 88 N.Y.2d 189 (N.Y. 1996)).

377. *Kossoff*, 123 Misc. 2d at 179.

378. *Fischbein v. Beitzel,* 281 721 N.Y.S.2d 515, 516 (N.Y. App. Div. 1st Dep't 2001) (citing *Marx,* 88 N.Y.2d at 198 (though in all fairness, *Marx* is typically cited by New York courts for the demand futility test it established for plaintiffs in a derivative action, *see supra* text accompanying note 25). *Marx* went further, indicating that at trial, if the directors involved were disinterested, a plaintiff would have to prove wrongdoing or waste. *Marx*, 88 N.Y.2d at 204 n. 6. Too, if the directors approved their own compensation, the burden of proof shifted to those directors to prove the transactions were fair to the corporation. *Marx,* 88 N.Y.2d at 204 n. 6. In *Marx,* the pleadings failed to make any fact-based allegations, and were considered by the court to be conclusory. *Marx*, 88 N.Y.2d at 204 (plaintiffs had in fact pled generally, that the compensation bore little resemblance to the services provided, that those services had not improved the company's performance, or that the compensation increase was larger than that required by the cost of living).

379. *Marx*, 88 N.Y.2d at 203.

380. *Id.* at 203.

> The courts will not undertake to review the fairness of official salaries, at the suit of a shareholder attacking them as excessive, unless wrongdoing and oppression or possible abuse of a fiduciary position are shown. However, the courts will take a hand in the matter at the instance of the corporation or of shareholders in extreme cases.

Id. Marx is further weakened by a number of other factors. First, *Marx* cited secondary sources in order to form the element test. *Id.* at 203-204 (citing, respectively, Fletcher, *Cyclopedia of Private Corporations* 5A, § 2122, 46-47 (1995); Block, Barton, Radin, *Business Judgment Rule*, 149 (4th ed.); Fletcher, *Cyclopedia of Private Corporations* 2, § 514.1, 632 (1990); 1 ALI, *Principles of Corporate Governance* § 5.03). Also, the claim in *Marx* was ultimately dismissed for conclusory allegations. *Id.* at 204 ("bare allegations that the compensation set lacked a relationship to duties performed or to the cost of living are insufficient").

381. *See generally, e.g., Bansbach v. Zinn*, 1 N.Y.3d 1, 12 (N.Y. 2003); *In re Omnicom Group Inc.*, 842 N.Y.S.2d 408, 410 (N.Y. App. Div. 1st Dep't 2007); *Billings v. Bridgepoint LLC,* 863 N.Y.S.2d 591, 593 (2008).

382. *Baker v. Cohn*, 42 N.Y.S.2d 159 (1942), *modified*, 266 A.D. 715 (N.Y. App. Div. 1943), *aff'd*, 292 N.Y. 570 (N.Y. 1944).

383. *Id.* at 167.

384. *Id.* at 167-168.

385. *Id.* at 165-166 (citing a district court case in the eighth circuit, *Backus et al. v. Finkelstein et al.*, 23 F.2d 531, 537 (D. Minn. 1924)).

386. *Id.* at 166. *N.B.*

> There is no presumption of actual or constructive fraud that arises solely from the amount of compensation paid to an officer of a corporation. However, the compensation may be so large under the circumstances involved in a particular case as to constitute spoliation or waste of corporate property, in which an investigation in equity is warranted. If a bonus payment has no relation to the value of services for which it is given, it is in reality a gift in part, and the majority stockholders have no power to give away corporate property against the protest of the minority.

Winkelman et al. v. General Motors Corporation et al.; Kahn v. Same, 39 F. Supp. 826, 833 (S.D.N.Y. 1940) (citing *Rogers v, Hill,* 289 U.S. 582, 591 (1933)). The *Winkelman* court found an investigation was warranted by trial, where salaries of $100,000 per year were enhanced by bonuses of $150,000 to $400,000 per year. *Winkelman*, 39 F. Supp. at 834-835. As with *Marx*, however, *Winkelman* is almost exclusively cited within the Second Circuit for procedural matters. *See supra* text accompanying note 26.

387. *Baker*, 42, N.Y.S.2d at 167.

388. *Stearns v. Dudley*, 76 N.Y.S.2d 106 (1947), *aff'd*, 274 A.D. 1028 (N.Y. App. Div. 4th Dep't 1948).

389. *Id.* at 112.

390. *Id.* at 127-128.

391. *Id.* at 129-130 (note that although the opinion is focused on the directors who continued the compensation program, one executive also repaid money to the corporation).

392. *Id.* at 129.

393. *Epstein v. Schenck*, 35 N.Y.S.2d 969 (1939).

394. *Id.* at 977 (citing *Rogers*, 289 U.S. at 591-592). *See also* the *Gallin* factors:

> To come within the rule of reason the compensation must be in proportion to the executive's ability, services and time devoted to the company, difficulties involved, responsibilities assumed, success achieved, amounts under jurisdiction, corporation earnings, profits and prosperity, increase in volume or quality of business or both, and all other relevant facts and circumstances; nor should it be unfair to stockholders in unduly diminishing dividends properly payable.

Mann v. Luke 272 A.D. 19, 24-25 (N.Y. App. Div. 1st Dep't 1947) (citing *Gallin v. National City Bank*, 152 Misc. 679, 703 (1934)). *See also Heller v. Boylan*, 29 N.Y.S.2d 653 (1941), *aff'd*, 263 A.D. 815 (N.Y. App. Div. 1st Dep't 1941) (same principle, though as applied to bonuses). *Heller* has been represented as the modern approach to executive compensation. Kropp, *supra* note 284, at 31.

395. Though the court did discuss possible fraud in relation to the compensation, it found none and the discussion was not dispositive. *Epstein*, 33 N.Y.S.2d at 978-980. *See also Meyers v. Cowdin*, 47 N.Y.S.2d 471, 476-477 (1944), *aff'd*, 296 N.Y. 755 (N.Y. 1946). Although executive pay was increased each year over a period of years, the court did not find the increases "excessive [ ] or out of proportion to the value of the services performed." *Meyers*, 47 N.Y.S.2d at 476. The court concluded that plaintiffs failed in that "no bad faith, collusion or illegality [was] established." *Meyers*, 47 N.Y.S.2d at 477. Alternatively, the discussion can also focus on directors approving their own pay increases. *See Godley v. Crandall & Godley Co.*, 212 N.Y. 121, 131-133 (N.Y. 1914) (the court held that the directors acted in fraud and bad faith as regards diversion of corporate profits to enhance their own compensation).

396. *Epstein*, 33 N.Y.S.2d at 977. Plaintiff-favorable settlements do occur, however. *See Diamond v. Davis*, 62 N.Y.S.2d 181, 185 (1945) (settlement modified the bonus system and its computation).

397. *Fischbein*, 721 N.Y.S.2d at 516.

398. *Id.*

399. *Id.* (the court affirmed the trial court's dismissal of the claim because the plaintiff lacked standing and had engaged in improper pleading).

400. For information on the federal investigation into the matter, *see generally* Sarah O'Connor and Greg Farrell, Financial Times, *SEC Eyes Whether BofA Broke Law on Merrill Bonuses,* http://www.ft.com/cms/s/0/d3bcd4c4-2878-11de-8dbf-00144feabdc0.html?ftcamp=rss&nclick_check=1 (Apr. 14, 2009); Zachary A. Goldfarb and Amit R. Paley, The Washington Post, *SEC Reviewing Omission of Merrill Bonuses from Filing*, http://www.washingtonpost.com/wp-dyn/content/article/2009/04/13/AR2009041302745.html?hpid=moreheadlines (Apr. 14, 2009).

401. Heidi N. Moore, The Wall Street Journal, *Deal Journal*, "Bank of America-Merrill Lynch: A $50 Billion Deal From Hell" ¶¶ 1-2, http://blogs.wsj.com/deals/2009/01/22/bank-of-america-merrill-lynch-a-50-billion-deal-from-hell/ (Jan. 22, 2009).

402. O'Connor and Farrell, *supra* note 400, at ¶ 6.

403. *Id.* at ¶ 1.

404. *Id.*

405. *Id.* at ¶ 3.

406. Apart from the various shareholder suits, litigation has been pursued by the government at the federal level via the SEC. *SEC v. Bank of America Corp.*, Case No. 09 civ 6829 (S.D.N.Y. Filed Aug. 3, 2009). It is also widely rumored that the Federal Bureau of Investigation ("FBI") is working closely with the Department of Justice ("DOJ") to bring criminal charges against BofA actors. Rick Rothacker, CharlotteObserver.com, *FBI Looking Into BofA-Merill Deal*, http://www.charlotteobserver.com/business/story/954477.html (Sept. 18, 2009). State actors are also pursuing BofA. In addition to New York Attorney General Cuomo, North Carolina Attorney General Cooper has also launched a formal investigation into the matter. Rick Rothacker, The News & Observer, *N.C. Demands BofA's Records on Bonuses*, http://www.newsobserver.com/business/story/1395981.html (Feb. 06, 2009). Ohio Attorney General Richard Cordray has also filed litigation against Bank of America, as a member of a plaintiff's class action, and on behalf of several pension funds. *In re Bank of America Corp.*, Case No. 09 MDL 2058 (DC) (S.D.N.Y. Sept. 25, 2009) (the complaint can be found at http://www.ohioattorneygeneral.gov/Briefing-Room/News-Releases/September-2009/Securities-Litigation-Briefing-Documents/Consolidated-Amended-Bank-of-America-Complaint).

The BofA and Merrill merger has posed competing legal issues in need of resolution. For example, in light of the defense BofA has pursued before Judge Rakoff of the S.D.N.Y., legal practitioners are questioning the parameters of the attorney-client privilege and advice of counsel defense. *See, e.g.*, Zach Lowe, Law.com, *Did Bank of American Waive Attorney-Client Privilege in Merrill Bonus Flap?*, http://www.law.com/jsp/article.jsp?id=1202433336204&rss=newswire (Aug. 26, 2009). As another example, both federal and state agencies have publicly reported that a component of their investigation is to determine if the federal government unduly pressured BofA to proceed with the merger despite knowledge of Merrill's fourth quarter losses. *See, e.g.*, Louise Story, The New York Times, *Congress Presses for Details From Bank of America on Talks*, http://www.nytimes.com/2009/09/21/business/21bank.html?_r=2&adxnnl=1&adxnnlx=1253546944-lvJIVLPkPNZ4ZX9BSzR2ew (Sept. 20, 2009). And of course, BofA is subject to a number of shareholder suits seeking remedy for alleged loss in shareholder value. *See, e.g.*, *Bahnmaier v. BofA*, Case No. 09-CV-2099 JWL/DJW (D. Kan. Feb. 27, 2009) (the complaint can be found at http://securities.stanford.edu/1042/BAC_01/2009227_o01c_092099.pdf).

BofA is also facing increased scrutiny by Congress. Louise Story, The New York Times, *Congress Presses for Details From Bank of America on Talks*, http://www.nytimes.com/2009/09/21/business/21bank.html?_r=1&adxnnl=1&adxnnlx=1253546944-lvJIVLPkPNZ4ZX9BSzR2ew (Sept. 20, 2009). In particular, BofA is under investigation by the House Committee on Oversight and Reform and its Chairman, Edolphus Towns (D–NY). *Id.*

407. Goldfarb and Paley, *supra* note 400, at ¶ 6 (as to whether any federal securities laws were in fact violated).

408. SEC, Litigation Release No. 21164, http://www.sec.gov/litigation/litreleases/2009/lr21164.htm (Aug. 3, 2009).

409. Ross Todd, Law.com, *Rakoff Wants More Briefing from BofA and SEC on Merrill Bonuses, Asks About Lawyers' Role in Drafting Proxy Statement*, http://www.law.com/jsp/tal/digestTAL.jsp?id=1202432932461&Rakoff_Wants_More_Briefing_from_BofA_and_SEC_on_Merrill_Bonuses_Asks_About_Lawyers_Role_in_Drafting_Proxy_Statement (Aug. 10, 2009).

410. Memorandum Order, *SEC v. Bank of America*, 09 Civ. 6829 (JSR) (Sept. 14, 2009) (among the key issues Judge Rakoff continues to press with both parties, but which neither party has adequately been able to answer, is who in fact advised BofA to structure the Merrill acquisition).

411. Reply Memorandum of Law on Behalf of Bank of America Corporation, *SEC v. Bank of America*, No. 09 Civ. 6829 (JSR) (Sept. 9, 2009).

412. Memorandum, *supra* note 410.

413. New York's Attorney General Cuomo is not the only state attorney general litigating matters involving executive compensation. Connecticut Attorney General Richard Blumenthal is trying to block a newspaper publisher from awarding executive bonuses of $1.7 million in light of layoffs and Chapter 11 proceedings. Baldas, *supra* note 2, at ¶ 8. Blumenthal is quoted as saying the executive payout "'illegally detracts from money owed to creditors like the state of Connecticut.'" Associated Press, Pennsylvania Local News, *Attorney General Objects to Journal Register Newspaper Company's Bonus Plan* ¶ 1, http://www.pennlive.com/midstate/index.ssf/2009/03/attorney_general_objects_to_jo.html (Mar. 4, 2009). The Attorney General has filed an objection to the executive payout in bankruptcy court. Associated Press, Editor & Publisher, *State Attorney General Files Objection to Journal Register Execs' Bonuses* ¶ 1, http://www.editorandpublisher.com/eandp/news/article_display.jsp?vnu_content_id=1003947871 (Mar. 4, 2009).

414. Goldfarb and Paley, *supra* note 400 at ¶ 11.

415. Earlier this year, Attorney General Cuomo went to the Supreme Court in New York County to compel former Merrill CEO John Thain to divulge who received the $3.6 billion in bonuses. *People of the State of New York v. John Thain*, 2009 NY Slip Op. 29114 (table), 2009 N.Y. Misc. LEXIS 591 (2009) (court denied a third party's right to intervene). Thain ultimately provided the subpoenaed information to Cuomo, subject to a stipulation of confidentiality pending resolution of the third party litigation to intervene. *Id.* at **2. The court found that among the discretionary powers of the Attorney General under the Martin Act is the decision whether to divulge information gathered during his investigation. *Id.* at **8-9.

N.B. The Martin Act has also been used in claims of financial statement and reporting fraud. *Markewich v. Adikes*, 422 F. Supp. 1144, 1146 (E.D.N.Y. 1976) (the motion to dismiss the Martin Act claim was denied; no subsequent procedural history suggests the parties settled out of court).

416. Nicholas Thompson, Legal Affairs, *The Sword of Spitzer* ¶ 3, http://www.legalaffairs.org/issues/May-June-2004/feature_thompson_mayjun04.msp (June 2004). The Martin Act, Article 23-A, provides:

> 1. It shall be illegal and prohibited for any person, partnership, corporation, company, trust or association, or any agent or employee thereof, to use or employ any of the following acts or practices:
>
> (a) Any fraud, deception, concealment, suppression, false pretence or fictitious or pretended purchase or sale;…
>
> where engaged in to induce or promote the issuance, distribution, exchange, sale, negotiation or purchase within or from this state of any securities or commodities, as defined in section three hundred fifty-two of this article, regardless of whether issuance, distribution, exchange, sale, negotiation or purchase resulted.

New York General Business Law §§ 352-c (2009). *See also* §§ 339-a, 352-353.

417.

> The purpose of the [Act] is to prevent all kinds of fraud in connection with the sale of securities and commodities and to defeat all related schemes whereby the public is exploited, the terms "fraud"

> and "fraudulent practices" to be given a wide meaning so as to embrace all deceitful practices contrary to the plain rules of common honesty, including all acts, even though not originating in any actual evil design to perpetrate fraud or injury upon others, which do tend to deceive or mislead the purchasing public.

People v. Lexington Sixty-first Associates, 381 N.Y.S.2d 836, 840 (N.Y. 1976).

418. *Thain*, 2009 N.Y. Misc. LEXIS 591 at **1-2 (citing §§ 352(1-2)).

419. *Loengard v. Santa Fe Industries, Inc.*, 573 F. Supp. 1355 (S.D.N.Y. 1983), *later proceeding*, 639 F. Supp. 673 (S.D.N.Y. 1986). Though in all fairness, *Loengard* is cited by subsequent courts for holding that the statute of limitations is six years for Martin Act claims, and three years for fiduciary claims (*See, e.g., Grosso v. Radice*, 2009 U.S. Dist. LEXIS 21233 at *25 (E.D.N.Y. Mar. 16, 2009)).

420. *Id.* at 1356.

421. *Id.* at 1359; *Leongard v. Santa Fe Industries, Inc.*, 639 F. Supp. 673, 674 (S.D.N.Y. 1986) ("*Leongard II*").

422. *Loengard*, 573 F. Supp. at 1359; *Leongard II*, 639 F. Supp. at 674.

423. *Leongard II*, 639 F. Supp. at 674 (previous decisions listed in n. 2).

424. *Id.* at 676-677.

425. *Id.* at 675.

426. *Id.* at 675-676.

427. *Id.* at 676. The court also rejected plaintiffs' allegations that the merger was for a fraudulent purpose, as under Delaware law a merger is proper if it is undertaken for the purpose of consolidating power or to simply take the entity in question private. *Id.* Still construing Delaware law, the court found the merger was completed in full compliance with Delaware law, and without any material misstatements or omissions. *Id.*

428. *People v. Federated Radio*, 244 N.Y. 33, 38-40 (1926) (followed *by People v. Bradick*, 16 Misc. 2d 1080, 1081-1082 (1959)).

429. Sidley Austin LLP, *Securities Law Update*, "Proposed Legislation Would Provide Private Right of Action for Certain Plaintiffs Under New York's Martin Act," 3 n. 17, http://www.sidley.com/files/News/ad373261-e9d9-43ef-b74b-04f29c308567/Presentation/NewsAttachment/ae098a6b-f507-4e45-87bd-009f5b417984/SecuritiesLaw607.pdf (June 19, 2007) (citing *Rego Park Gardens Owners Ass'n v. Rego Park Gardens Assocs.*, 595 N.Y.S.2d 492, 494 (2d Dep't 1993); *Pro Bono Invs. v.* Gerry, 2005 WL 2429787, 16 (S.D.N.Y. 2005); *CPC Int'l Inc. v. McKesson Corp.*, 70 N.Y.2d 268, 276 (N.Y. 1987)).

430. *Id.* It should also be noted that New York courts show deference to federal precedent when dealing with Martin Act claims. *People of the State of New York v. Clark E. McLeod*, 819 N.Y.S.2d 213 (2006) (citing *All Seasons Resorts, Inc. v. Abrams*, 68 N.Y.2d 81, 87 (1986); *People v. First Meridian Planning Corp.*, 201 A.D.2d 145 (3d Dep't 1994)).

431. Zachary Goldfarb, The Washington Post, *SEC Gets Tougher With Bank of America*, http://www.washingtonpost.com/wp-dyn/content/article/2009/09/21/AR2009092103671.html (Sept. 22, 2009).

432. *Id.* at 3 n. 18 (citing *Sterling Nat'l Bank v. The Park Ave. Branch*, 2006 N.Y. Misc. LEXIS 2888 (2006)). The suggestion was made as an alternative to inducing the New York state government to use the Martin Act to litigate violations. *Id.*. Conceivably, however, if an attorney general could use the Martin Act to investigate bonuses, a plaintiff could then use common law fraud regarding stock option grants and backdating, where proxies are involved. *See supra* text accompanying note 39 (Martin Act used to investigate bonuses), 21-29 (stock option grants, backdating, and proxies).

433. *Sterling*, 2006 N.Y. Misc. LEXIS 2888.

434. *Id.* at *13 (citing *Lama Holding Company v. Smith Barney, Inc.*, 88 N.Y.2d 413 (1996); *New York University v. Continental Ins. Co.*, 87 N.Y.2d 308, 318 (1995); *Friedman v. Anderson*, 23 A.D.3d 163, 166 (N.Y. App. Div. 1st Dep't 2005)).

435. *Id.* (discussing Civil Practice Law and Rules, Article 30 Remedies and Pleading, Rule 3016(b) (2006)).

436. *State of New York v. McLeod*, 819 N.Y.S.2d 213, *15 (2006) (table), 2006 N.Y. Misc. LEXIS 1227 at *15 (citing *Wiener*, 241 A.D.2d at 120). *See also supra* note 350 (New York Attorney General claim four against Richard Grasso contained restitution language based on unjust enrichment).

437. *Korff v. Corbett*, 18 A.D.3d 248, 251 (N.Y. App. Div. 1st Dep't 2005) (citing *Wiener v. Lazard Freres & Co.*, 241 A.D.2d 114, 119 (1998).

438. *McLeod*, 819 N.Y.S.2d at *15 (citing *Wiener*, 241 A.D.2d at 120).

439. *People v. Marcus*, 261 N.Y. 268 (1933). Followed by *People v. Calandra*, 164 A.D.2d 638 (N.Y. App. Div. 1st Dep't 1991).

440. New York Business Corporation Law § 720(b) (2009) provides:

> An action may be brought for the relief provided in this section, and in paragraph (a) of section 719 (Liability of directors in certain cases) by a corporation, or a receiver, trustee in bankruptcy, officer, director or judgment creditor thereof, or, under section 626 (Shareholders' derivative action brought in the right of the corporation to procure a judgment in its favor), by a shareholder, voting trust certificate holder, or the owner of a beneficial interest in shares thereof.

441. *New York Credit Men's Adjustment Bureau v. Weiss*, 278 A.D. 501 (N.Y. App. Div. 1st Dep't 1951); *aff'd*, 305 N.Y. 1 (1953); *see also Heimbinder v. Berkovitz*, 175 Misc. 2d 808, 816 (1998); *judgment modified on other grounds*, 263 A.D.2d 466 (N.Y. App. Div. 2d Dep't 1999).

442. *Studley v. Lefrak*, 66 A.D.2d 208, 213 (N.Y. App. Div. 2d Dep't 1979) ("transfer of all of the assets of a corporation to a sole stockholder or to a corporation controlled by the stockholder may be set aside when made in derogation of the rights of creditors"); *aff'd*, 48 N.Y.2d 954 (1979); *cf. In re Banister*, 737 F.2d 225, 228-229 (2d. Cir. 1984) (breach of fiduciary duty can occur when directors and officers benefit personally at creditors' expense).

443. *Brenner v. Philips, Appel & Walden, Inc.*, 1997 U.S. Dist. LEXIS 11539 at **9-10 (S.D.N.Y. 1997) (citing N.Y. Fraudulent Conveyance Act §§ 270-281 (1997)).

444. *Geren v. Quantum Chemical Corp.*, 1995 U.S. App. LEXIS 39912 at *4 (2d Cir. 1995) (citing, *inter alia,* N.Y. Debtor & Creditor Law § 273).

445. *Brenner*, 1997 U.S. Dist. LEXIS 11539 at *14 (citing *Federal Deposit Insurance Corp. v. Porco,* 75 N.Y.2d 840, 842 (1990)).

446. *Foufas v. Leventhal*, 1995 U.S. Dist. LEXIS 7641, **9-10 (S.D.N.Y. 1995).

447. Kevin LaCroix, The D & O Diary, *Bailouts, Bonuses and Clawbacks* ¶ 13, http://www.dandodiary.com/2009/01/articles/corporate-governance/bailouts-bonuses-and-clawbacks/ (Jan. 30, 2009) (citing Jonathan D. Glater and Vikas Bajaj, The New York Times, *Cuomo Seeks Recovery of Bonuses at A.I.G.*, http://www.nytimes.com/2008/10/16/business/16pay.html?_r=2&ref=business (Oct. 15, 2008) (discussing the attorney general's letter and providing an active link to review it)).

448. AIG received $85 billion to avoid bankruptcy in September of 2008. David Cutler, Reuters UK, *TIMELINE: AIG Developments Since U.S. Rescue*, http://uk.reuters.com/article/innovationNews/idUKTRE53G46U20090417?pageNumber=1&virtualBrandChannel=0 (Apr. 17, 2009). Plans to make $30 billion more available to AIG were announced in March of 2009. *Id.* It was publicly discovered as this time that AIG was under pre-existing contractual obligations to pay $165 million in retention payments by March 15, 2009. *Id.*

449. Andrew Ross Sorkin, The New York Times, *Cuomo Seeks A.I.G. Bonus Information* ¶ 4, http://dealbook.blogs.nytimes.com/2009/03/16/cuomo-seeks-aig-bonus-information/ (Mar. 16, 2009).

450. Cutler, *supra* note 448, at 3.

451. Kevin LaCroix, D & O Diary, *Executive Compensation: The New Front Line in the Litigation Wars?* at ¶ 1, http://www.dandodiary.com/2009/04/articles/corporate-governance/executive-compensation-the-new-front-line-in-the-litigation-wars/ (Apr. 8, 2009).

452. *Id.* at ¶ 3 (discussing *AIG v. Liddy, et al.*, Civil Action No.: BC410879 (Apr. 1, 2009)). The complaint is *available at* http://www.cpmlegal.com/pdf/AIG_Bonus_Complaint.pdf .

453. *Id*.

454. *Id.*

455. *In re Citigroup Inc. Shareholder Deriv. Litig.*, 964 A.2d 106, 138 (Del. Ch. 2009). The Delaware General Corporation Law grants every corporation the power to pay or otherwise provide officers and agents of the business with suitable compensation. DEL. CODE ANN. tit. 8, § 122(5).

456. The business judgment rule is a presumption which protects directors from liability so long as in making the decision, the directors "acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984). The presumption can be rebutted if the plaintiffs show that the directors breached their fiduciary duty of care or of loyalty or acted in bad faith. If that is shown, the burden shifts to the director defendants to demonstrate that the challenged act was entirely fair to the corporation and its shareholders. *Brehm v. Eisner*, 746 A.2d 244, 264 n. 66 (Del. 2000).

457. *Grimes v. Donald*, 673 A.2d 1207, 1215 (Del. 1996).

458. *Brehm v. Eisner*, 731 A.2d 342, 350 (Del. Ch. 1998). "Sufficient consideration to the corporation may be, *inter alia*, the retention of the services of an employee, or the gaining of the services of a new employee, provided there is a reasonable relationship between the value of the services to be rendered by the employee and the value of the options granted as an inducement or compensation." *Kerbs v. California E. Airways*, 90 A.2d 652, 656 (Del. 1952).

459. *Brehm*, 746 A.2d at 262 n.56 (Del. 2000) (citing *Saxe v. Brady*, 184 A.2d 602, 610 (Del. Ch. 1962)).

460. *In re Walt Disney Co. Deriv. Litig.*, 907 A.2d 693, 697 (Del. Ch. 2005). The most notable case in which plaintiff shareholders made these claims was the long-running dispute over the lavish severance package paid to Michael Ovitz when he was terminated as President of The Walt Disney Company after serving for little over a year.

461. The fiduciary duty of due care requires that directors "use that amount of care which ordinarily careful and prudent men would use in similar circumstances." *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963). Directors must also "consider all material information reasonably available" in making business decisions. *Brehm*, 746 A.2d at 259. Shortcomings in the directors' process are actionable only if the directors' actions are grossly negligent. *Id.*

462. The fiduciary duty of loyalty "mandates that the best interest of the corporation and its shareholders take [ ] precedence over any interest possessed by a director, officer or controlling shareholder and not shared by the stockholders generally." *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993) (citing *Pogostin v. Rice*, 480 A.2d 619, 624 (Del. 1984)).

463. Until the Delaware Supreme Court decided *Stone v. Ritter* in 2006, there was much discussion among the bar, the courts and academics whether the duty of good faith was a fiduciary duty separate and in addition to the fiduciary duties of care and loyalty, or whether the duty of good faith was subsumed under the fiduciary duty of loyalty. *In re Walt Disney Co. Deriv. Litig.*, 907 A.2d at 745. The Supreme Court clarified that the duty of good faith is a component of the duty of loyalty. *Stone v. Ritter*, 911 A.2d 362, 269-70 (Del. 2006).

464. The Delaware General Corporation Law allows a Delaware corporation to include in its certificate of incorporation a provision eliminating or limiting the personal liability of a director for monetary damages for breach of fiduciary duty, except for breach of the duty of loyalty, for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of the law, or for any transaction from which the director derived an improper personal benefit. DEL. CODE ANN. tit. 8, § 102(b)(7).

465. *See*, *infra*, *Valeant Pharms. Int'l*, 921 A.2d 732 (Del. Ch. 2007) and *Julian v. E. States Constr. Serv., Inc.*, 2008 WL 267330 (Del. Ch.).

466. *In re Walt Disney Co. Deriv. Litig.*, 907 A.2d 693 at 756-57. Additionally, Delaware law does not allow corporations to limit liability for breaches of the duty of loyalty. *See supra*, note 464.

467. *In re Walt Disney Co. Deriv. Litig.*, 907 A.2d 693 at 748.

468. Chancellor Chandler, in his 2005 decision following trial, stated that "there are many aspects of defendants' conduct that fell significantly short of the best practices of ideal corporate governance," but that "[u]nlike ideals of corporate governance, a fiduciary's duties do not change over time." *Id.* at 697.

469. The plaintiff shareholders' original complaint computed the value of the severance package at $140 million, *Brehm*, 746 A.2d at 253, while the Supreme Court approximated the value of the package at $130 million. *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27, 35 (Del. 2006).

470. *In re Walt Disney Co. Deriv. Litig.*, 825 A.2d 275, 277 (Del. Ch. 2003).

471. *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d at 46-47. The claim for waste is rooted in the doctrine adopted by the Delaware courts that a plaintiff who fails to rebut the presumptions of the business judgment rule is not entitled to any remedy unless the transaction constitutes waste. *In re Walt Disney Co. Deriv. Litig.*, 907 A.2d 693 at 747.

472. *In re Walt Disney Co. Deriv. Litig*., 825 A.2d at 278. On appeal from the Chancellor's decision for the defendants after the 2004-05 bench trial, the plaintiffs did not contend that the Disney defendants were directly liable as a result of their breach of fiduciary duties. Rather, plaintiffs argued that the Disney defendants' breach of fiduciary duties deprived them of the protections of the business judgment rule, and required the defendants to prove that their acts were entirely fair to Disney. *In re Walt Disney Co. Deriv. Litig*., 906 A.2d at 46. The plaintiffs apparently structured their argument this way because the Disney Certificate of Incorporation contained a provision that precluded monetary damages against Disney directors for breaches of the duty of care. *Id.* at 46, n. 37.

473. *In re Walt Disney Co. Deriv. Litig*., 906 A.2d at 73. As a result of this ruling, the Supreme Court did not need to consider plaintiffs' argument that the Disney defendants needed to prove that the severance payments to Ovitz were entirely fair. *Id.*

474. *Id.* at 75.

475. *In re Walt Disney Co. Deriv. Litig.*, 907 A.2d 693 at 772.

476. *Id.* at 776.

477. *Id.* at 775-77.

478. *Id.*, affirmed in *In re Walt Disney Co. Deriv. Litig*., 906 A.2d at 69-70.

479. *In re Walt Disney Co. Deriv. Litig*., 907 A.2d 693 at 748. However, in the ongoing Citigroup shareholder derivative litigation, the court denied the defendants' motion to dismiss plaintiffs' claim for waste in approving the retiring CEO's compensation package. The company, pursuant to a letter agreement, paid out $68 million to the former CEO, including bonus, salary, and accumulated stockholdings. Additionally, he was provided with an office, an administrative assistant, and a car and driver. In return, the retiring CEO contracted to sign a non-compete agreement, a non-disparagement agreement, a non-solicitation agreement, and a release of claims against the company. The Chancellor noted that he was left with very little information regarding (1) how much additional compensation the former CEO actually received as

a result of the letter agreement, and (2) the real value, if any, of the various promises given by the former CEO. Without more information, and taking plaintiffs' well-pleaded allegations as true, the Chancellor concluded that there was reasonable doubt as to whether the letter agreement constituted waste. *In re Citigroup Inc. Shareholder Deriv. Litig.*, 964 A.2d at 138.

480. *Brehm*, 746 A.2d at 263. In another formulation of the test which must be satisfied to prevail on corporate waste, "the plaintiff must overcome the general presumption of good faith by showing that the board's decision was so egregious or irrational that it could not have been based on a valid assessment of the corporation's best interests." *White v. Panic*, 783 A.2d 543, 554 n. 36 (Del. 2001).

481. *Brehm,* 746 A.2d at 263.

482. *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d at 75.

483. *Id.* at 74.

484. *Id.*

485. *Id.*

486. *Id.* at 75.

487. *In re Walt Disney Co. Deriv. Litig.*, 907 A.2d 693 at 759.

488. *Id.*

489. *Id.*

490. *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983). Such directors "are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain." *Id.*

491. *Valeant Pharms.*, 921 A.2d at 745. On the other hand, where an independent compensation committee sets director compensation, the courts do not apply the entire fairness standard. *Id.* at 746. Similarly, a self-interested transaction that is approved by a committee of disinterested directors potentially brings the transaction within the scope of the business judgment rule. DEL. CODE ANN. tit. 8, § 144(a)(1). Alternatively, a self-interested transaction may be ratified by a fully informed majority vote of the disinterested stockholders. *Id.* at (a)(2).

492. *Weinberger*, 457 A.2d at 711. The two components of the entire fairness standard are not independent. Rather, "the fair dealing prong informs the court as to the fairness of the price obtained through that process. The court does not focus on the components individually, but determines entire fairness based on all aspects of the entire transaction." *Valeant Phar*ms., 921 A.2d at 746.

493. *Weinberger*, 457 A.2d at 711.

494. *Valeant Pharms.*, 921 A.2d at 746 (quoting *Weinberger*, 457 A.2d at 711).

495. *Wilderman v. Wilderman*, 315 A.2d 610 (Del. Ch. 1974). This case from 1974 was decided before the more recent development by the Delaware courts of the entire fairness standard for self-interested transactions.

496. *Wilderman* at 615.

497. *Id.*

498. *Id*. at 615-16.

499. *Id.*

500. *Valeant Pharms*., 921 A.2d at 735-36.

501. *Id.* at 739.

502. *Id.* at 744.

503. *Id.* at 746-47.

504. *Id.* at 748.

505. *Id.* The court's finding that the process was unfair does not end its inquiry because the transaction could be deemed entirely fair if the defendant proves that the price was fair. However, unless the price can be justified by reference to reliable markets or substantial and dependable comparable transactions, the burden for proving fair price would be "exceptionally difficult" to satisfy. *Id.*

506. *Id.* at 749-50.

507. *Id.* at 750. An outside expert opined that a 2% award might be appropriate in a smaller transaction, such as an incubator IPO or spin-off of a small division of a larger company. *Id.*

508. *Id.*

509. *Id.* In another recent Delaware case, *Julian v. E. States Constr. Service, Inc.*, directors awarded themselves substantial bonuses. The directors thus had the burden to prove that the payments were entirely fair. Three brothers owned shares in closely held corporations when one brother announced his retirement. The court held that the payout of the bonuses resulted from an unfair process. Just eleven days after the brother submitted his letter of retirement, the board of one of the corporations, composed of the other two brothers and a third man, approved the bonuses after discussing the concept for fifteen minutes and consulting no outside experts. The court also held that the price was unfair. The size of the bonuses greatly exceeded any prior awards. The challenged bonuses represented 22.28% of adjusted income while bonuses in previous years constituted approximately 3.3% of adjusted income. The court also noted that the bonuses decreased the net book value of the corporation, thus reducing the value of the shares that the retiring brother would have to sell back to the corporation. *Julian*, 2008 WL 267330 at *1, *18, *19.

510. *Valeant Pharms*., 921 A.2d at 752.

511. *Id.* In another formulation of the available remedies when a transaction fails the entire fairness standard, a court may fashion any form of equitable and monetary relief that may be appropriate. *Weinberger*, 457 A.2d at 714.

512. *Valeant Pharms.*, 921 A.2d at 752. The court refused the defendant's request to allow him to keep the portion of the bonus that the court deemed "fair" and return only the excess. The court also noted that there was no suggestion that the return of the defendant's bonus would unjustly enrich the company. *Id.* at 752-53*;* In *Julian*, discussed *supra* note 509, the court ordered the defendants to disgorge the bonuses and return them with interest to the company. *Julian*, 2008 WL 267330 at *19.

513. *Valeant Pharms*., 921 A.2d at 754. The company did not seek the return of the bonuses paid to the non-director employees. Rather, the company sought to recover the defendant's pro-rata share of the bonuses paid to non-directors. *Id.*

514. *Id.* Delaware law allows for the recovery of special litigation committee expenses for a breach of fiduciary duty when the plaintiff corporation prevails in court and the special litigation committee expenses were necessary to prosecute the suit. *Id.*

515. The Delaware Supreme Court explained the theories of restitution and unjust enrichment as follows:

> For a court to order restitution it must first find the defendant was unjustly enriched at the expense of the plaintiff. "Unjust enrichment is defined as 'the unjust retention of a benefit to the loss of another, or the retention of money or property of another against the fundamental principles of justice or equity and good conscience.'" *Fleer Corp. v. Topps Chewing Gum, Inc.*, 539 A.2d 1060, 1062 (Del. 1988) (quoting 66 Am.Jur.2d Restitution and Implied Contracts §3945 (1973)). To obtain restitution, the plaintiffs were required to show that the defendants were unjustly enriched, that the defendants secured a benefit, and that it would be unconscionable to allow them to retain that benefit. *Id.* at 1063. Restitution is permitted even when the defendant retaining the benefit is not a wrongdoer. *Id.* "Restitution serves to 'deprive the defendant of benefits that in equity and good conscience he ought not to keep, even though he may have received those benefits honestly in the first instance, and even though the plaintiff may have suffered no demonstrable losses."' *Id.* at

1063. *Schock v. Nash,* 732 A.2d 217, 232-33 (Del. 1999) (footnotes omitted; citations added).

516. *Scrushy v. Tucker*, 955 So.2d 988, 1012 (Ala. 2006).

517. *Id.* at 1004.

518. *Id.*

519. *Id.* at 1012.

520. *Id.* at 1007.

521. *Id.* at 1008-09.

522. *Id.* at 1008.

523. *Id.* at 1008-09.

524. *Id.* at 1012.

525. *Id.* at 1011 (quoting *In re HealthSouth Shareholders Litig.*, 845 A.2d 1096, 1106 (Del. Ch. 2003)).

526. *Id.* at 1012.

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Arbitration Agreements and Bankruptcy—Which Law Trumps When?

By Edna Sussman, with the assistance of Osata Tonia Tongo

As reported by the Office of Administration of the U.S. Courts, in the 12-month period ending June 30, 2009, there was a 35% increase in bankruptcy filings compared to the 12-month period ending June 30, 2008. Business bankruptcy filings rose 63% while non-business filings rose 34%. Chapter 11 filings rose 91% during that period.[1] In light of these statistics and recent economic conditions, we review the principal cases that address what happens to arbitration agreements in the context of a bankruptcy proceeding. The short answer: there is no bright line.[2]

The Competing Policies

The Federal Arbitration Act (FAA) provides that arbitration agreements "shall be valid, irrevocable, and enforceable, save upon grounds as exist at law or in equity for the revocation of any contract." [3] The Supreme Court has repeatedly stated that questions of arbitrability must be addressed with a "healthy regard for the federal policy favoring arbitration."[4] To accomplish the goals of the FAA, "the enforcement of private agreements to arbitrate and encouragement of efficient and speedy resolution," the courts must "rigorously enforce agreements to arbitrate even if the result is piecemeal litigation, at least absent a countervailing policy manifested in another federal statute."[5]

A principal purpose of the Bankruptcy Code[6] is to allow the bankruptcy court to centralize all disputes concerning all property of the debtor's estate so that the reorganization can proceed efficiently, protecting creditors and reorganizing debtors from piecemeal litigation and supporting the power of the bankruptcy court to enforce its own orders.[7]

The Second Circuit recognized the inherent tension between these statutes in commenting that there will be occasions where a dispute involving the Bankruptcy Code and the Arbitration Act presents "a conflict of near polar extremes" as "bankruptcy policy exerts an inexorable pull towards centralization while arbitration policy advocates a decentralized approach towards dispute resolution."[8]

Case Law Developments

The first significant case to deal with the tension between the FAA and the Bankruptcy Code was the Third Circuit's decision in *Zimmerman v. Continental Airlines.*[9] The court recognized that both the FAA and the Bankruptcy Reform Act represented important congressional concerns. Following a careful analysis, the court placed greater emphasis on the bankruptcy laws and stated that the intention of Congress would be better realized if the bankruptcy laws were read "to impliedly modify the Arbitration Act."[10] The court concluded that while the bankruptcy court could stay proceedings in favor of arbitration, the use of the power was to be left to the sound discretion of the bankruptcy court and established a series of considerations for the exercise of that discretion.

> *"[I]n the 12-month period ending June 30, 2009…business bankruptcy filings rose 63% while non-business filings rose 34% [and] Chapter 11 filings rose 91%…"*

Subsequent to the *Zimmerman* decision, in *Shearson/American Express Inc. v. McMahon,*[11] the Supreme Court addressed the question of whether a claim brought under § 10(b) of the securities laws and under RICO must be sent to arbitration in accordance with the terms of an arbitration agreement. In its review the court established the test to be used to review challenges to an arbitration clause based on another statutory imperative. The Court held that, to overcome the federal policy favoring arbitration, the burden is on the party opposing arbitration to show that Congress intended to limit or prohibit waiver of a judicial forum for a particular claim. The Court said that this intent will be "deducible from the statute's text or legislative history . . . or from an inherent conflict between arbitration and the statute's underlying purpose."[12]

There is general agreement in the case law that there is no indication of a congressional intent to override the FAA in the text or legislative history of the bankruptcy laws, although as discussed below, this conclusion has been questioned by some courts. Accordingly, the third prong of the Supreme Court test—whether there is "an inherent conflict between arbitration and the statute's underlying purpose"—has been the test applied by the courts.

In the wake of the *McMahon* decision, a series of other Supreme Court decisions strongly supporting arbitration, and the 1984 amendments to the Bankruptcy Code which scaled back the jurisdiction of the bankruptcy courts,[13] the Third Circuit revisited the issue in *Hays and Co. v. Merrill Lynch Pierce Fenner & Smith Inc.*[14] The court found an arbitration agreement to be a non-executory contract, which like other contracts cannot be rejected by a trustee in bankruptcy. The court held that the trustee is "bound to arbitrate all of its claims that are derived from the rights of the debtor" as of the commencement of the case, but not bound to arbitrate other claims that are not derivative but are rather statutory rights created by the bankruptcy code.[15] The court then considered whether, having found that the trustee is bound, the court had discretion to refuse to enforce the arbitration clause. Guided by the developments in the Supreme Court and in Congress, the court held that an arbitration clause should be enforced for a non-core proceeding unless "it would seriously jeopardize the objectives of the [Bankruptcy] Code."[16] Where a trustee seeks to enforce a claim inherited from the debtor in court, the court "perceived no adverse effect on the underlying purpose of the Code from enforcing arbitration."[17] The *Hays* decision has been cited often for the proposition that where a party seeks to enforce a non-core pre-petition debtor derivative contract claim, a court does not have discretion to deny enforcement of an otherwise valid arbitration clause.[18]

As courts generally begin by determining whether the proceeding is core or non-core in deciding whether to compel arbitration or stay the bankruptcy proceeding, a brief explanation of that dichotomy is necessary. The core / non-core distinction derives from the Supreme Court decision in *Northern Pipeline Construction Company v. Marathon Pipeline Company*,[19] in which the Court struck down the provision of the 1978 Bankruptcy Act which gave broad powers to the bankruptcy courts. The Court found that the statute vested authority in Article I bankruptcy courts to decide cases that, without party consent, constitutionally could only be heard by Article III courts. To address this issue, Congress in the amendments to the Bankruptcy Code in 1984 divided claims into core and non-core, 28 U.S.C. § 157, giving bankruptcy judges authority to hear and determine "all core proceedings arising under title 11 or arising in a case under title 11." Non-core matters are only "related to" the bankruptcy proceeding. With respect to non-core matters, the bankruptcy judges can only recommend findings of fact and conclusions of law to the district court. The Bankruptcy Code provides a non-exclusive list of core proceedings.[20] As the list is not exclusive, the courts have developed additional frameworks for the core / non-core analysis.

Extensive case law and confusion over the distinction between core and non-core have followed. Indeed, the difficulties in deciding whether a matter is core or non-core have been described by one commentator as a "most difficult area of constitutional law," in which "the precedents are horribly murky, doctrinal confusion abounds, and the constitutional text is by no means clear."[21]

In *In re U.S. Lines Inc.*[22] the Second Circuit stated that whether a proceeding is core depends on whether "(1) the contract is antecedent to the reorganization petition; and (2) the degree to which the proceeding is independent of the reorganization."[23] Proceedings can be core by "virtue of their nature if either (1) the type of proceeding is unique to or uniquely affected by the bankruptcy proceedings, or (2) the proceedings directly affect a core bankruptcy function. . . ."[24] Other circuits have their own variations on the test to be applied to the core / non-core determination. A review of the cases demonstrates the difficulties the courts have with this issue as decisions by both the bankruptcy courts and the district courts are often reversed upon review.

"[T]he difficulties in deciding whether a matter is core or non-core have been described…as a 'most difficult area of constitutional law,' in which 'the precedents are horribly murky, doctrinal confusion abounds, and the constitutional text is by no means clear.'"

The Fifth Circuit in *In re National Gypsum*[25] dealt with the question of how arbitration agreements in core proceedings should be handled. The court was urged to adopt a position that categorically found arbitration of core proceedings to be inherently irreconcilable with the Bankruptcy Code. The court refused, finding that doing so "conflates the inquiry" required by *McMahon* and is "too broad."[26] The court stated that not all core proceedings are premised on provisions of the code that inherently conflict with the FAA or jeopardize the objectives of the Bankruptcy Code. The court held that "non-enforcement of an otherwise applicable arbitration provision turns on the underlying nature of the proceeding, i.e. whether the proceeding derives exclusively from the provisions of the Bankruptcy Code and if so whether arbitration of the proceeding would conflict with the purposes of the Code."[27]

The Second Circuit's decision in *In re United States Lines, Inc.*[28] similarly concluded that arbitration of core proceedings does not necessarily conflict with the Bankruptcy Code. The case involved P&I insurance policies issued by several carriers that were the only source for payment of claims by thousands of employees for asbestos-related injuries. The Trust, as successor in interest to the debtor, began an adversary proceeding in bankruptcy court for a declaratory judgment on the insurance coverage. The bankruptcy court held that the proceeding was core and denied the motion to compel arbitration. The district court reversed both determinations.

The Second Circuit looked first to whether the proceeding was core or non-core as a non-core proceeding is "unlikely to present a conflict sufficient to override by implication the presumption in favor of arbitration."[29] The court held that the matter was a core proceeding. The court further held that the mere fact that a proceeding is core will not automatically give the bankruptcy court discretion to stay arbitration. On the facts before it concerning insurance coverage which the court found to be integral to the bankruptcy court's ability to preserve and equitably distribute the assets, the Second Circuit found the bankruptcy court's refusal to refer the proceeding to arbitration to be proper.[30]

In *MBNA American Bank, N.A. v. Hill*,[31] the Second Circuit reiterated its position that bankruptcy courts generally do not have discretion to refuse to compel arbitration of non-core bankruptcy matters or matters that are simply "related to" rather than "arising under" bankruptcy cases. Nor do bankruptcy courts have absolute discretion to refuse to compel arbitration of core proceedings. Rather that determination requires "a particularized inquiry into the nature of the claim and the facts of the specific bankruptcy."[32] Although finding the action before it to be a core proceeding, the court concluded that arbitration of the dispute would not jeopardize the objectives of the Bankruptcy Code and that the bankruptcy court did not have discretion to deny the motion to stay the proceeding in favor of arbitration.

"[T]here will be little certainty in some cases as to whether an arbitration agreement will be enforced in a bankruptcy."

Some years later, in *In re Mintze*,[33] the Third Circuit clarified its holding in *Hays*, stating that the decision applied equally to core and non-core proceedings and that the analysis requires a review under the *McMahon* standard for both. The analysis as to the arbitration clause thus raises both the complexity of deciding whether the proceeding is core or non-core and the complexity of deciding whether referring the proceeding to arbitration would jeopardize the objectives of the bankruptcy code.

Complicating the situation further, some courts have challenged the basic premise that the Bankruptcy Code does not itself evidence congressional intent to override the FAA. For example, in *In re White Mountain Mining Company*[34] the Fourth Circuit followed the precedents discussed above in reaching its holding. However, the court suggested, without deciding the point, that, at least with respect to core proceedings, it could be argued from the statutory text that in granting bankruptcy courts jurisdiction over "core proceedings arising under title 11" Congress "reveal[ed] a Congressional intent to choose those courts in exclusive preference to all other adjudicative bodies, including boards of arbitration, to decide core claims."[35]

In a recent decision, *In re Payton Construction Company*,[36] the court's discussion also questioned the prevailing analysis of congressional intent and urged a presumption that Congress "intended for the bankruptcy courts to be the principal and usual, if not exclusive, forum for most matters in bankruptcy."[37] The court cited the creation by Congress of bankruptcy's "centralized, collective proceeding to facilitate the expeditious and relatively inexpensive resolution of all matters relating to bankruptcy so as to make reorganization possible, enable the debtor's fresh start and maximize value and expedite recovery of creditors."[38]

Conclusion

The case-by-case approach in the case law and the difficult analysis required where the matter is not clearly core and integral to the bankruptcy have led to a lack of predictability and costly and time-consuming litigation. Indeed, the extensive litigation that can take place over the enforceability of arbitration clauses in bankruptcy can deprive the parties of the common goals of both legal regimes: efficiency, speed, and avoidance of costs.

The Supreme Court has dealt with the interplay of several statutory claims and the FAA but has not yet directly provided guidance to the courts by addressing the tension between the Bankruptcy Code and the FAA. Many commentators have urged that the Supreme Court or Congress should step in to clarify this area of the law.[39] Commentators have expressed various views as to how the question should be resolved. One commentator suggests that arbitration of core claims should be precluded by the Bankruptcy Code, argues against a *per se* rule in favor of arbitration for non-core proceedings, and urges that debtors be permitted to reject the arbitration agreement[40] pursuant to § 365 of the Bankruptcy Code.[41] Another commentator urges that the filing of a proof of claim in the bankruptcy should be deemed to be a waiver of the contractual right set forth in the arbitration clause.[42] Yet others favor a more nuanced approach that creates presumptions but allows exceptions for both core and non-core proceedings.[43]

The correct solution requires careful thought and analysis and must continue to give due deference not only to the needs of the debtor and the creditors but also to the contractual choice made by the parties to have any disputes resolved in the forum selected by the parties, a choice that can have significant impact on whether a deal is struck and on the economics of the transaction.[44]

The case-by-case analysis of the facts and of the impacts on the bankruptcy in each proceeding in which the enforceability of the arbitration clause can in good faith be debated has created a fertile field for arguments by both those who seek to enforce an arbitration agreement and those who seek to block it. Creative litigants will doubtless find many arguments to support their position.[45] Until such time as Congress or the Supreme Court steps in to simplify the task and create a more predictable litmus test, there will be little certainty in some cases as to whether an arbitration agreement will be enforced in a bankruptcy.

Endnotes

1. Administrative Office of the U.S. Courts, News Release August 13, 2009, *available at* http://www.uscourts.gov/Press_Releases/2009/BankruptcyFilingsJun2009.cfm.
2. For an overview on the subject, see 8 Norton Bankr. L. & Prac. 3d § 169:4 (2009).
3. Federal Arbitration Act, which comprises Chapter 1 of Title 9, is codified at 9 U.S.C. §§ 1-16 (2000). *See* § 2.
4. *See, e.g., Gilmer v. Interstate Johnson Lane Corp.,* 500 U.S. 20, 26 (1991).
5. *Dean Witter Reynolds Inc. v. Byrd,* 470 U.S. 213, 221 (1985).
6. 11 U.S.C. §§ 101 *et seq.*
7. *See, e.g.*, *In re United States Lines*, 197 F. 3d 631, 640 (1999).
8. *Id.* at 640 (citations omitted).
9. 712 F.2d 55 (3d Cir. 1983).
10. *Id.* at 56.
11. 482 U.S. 220 (1987).
12. *Id.* at 227.
13. See discussion in *Hays and Co. v. Merrill Lynch Pierce Fenner & Smith Inc.*, 885 F.22d 1149, 1157 (1989) of the scope of the bankruptcy court's jurisdiction.
14. *Id.*
15. *Id.* at 1154.
16. *Id.* at 1161.
17. *Id.*
18. *See, e.g.*, *In re Crysen/Montenay Energy Co.* 226 F.3d 160, 166 (2d Cir. 2000) ("Bankruptcy courts generally do not have discretion to decline to stay non-core proceedings in favor of arbitration"); *In re Electric Machinery Enterprises Inc.*, 479 F.3d 791 (11th Cir. 2007).
19. 458 U.S. 50 (1982).
20. *See* 28 U.S.C. § 157 (b)(A)-(O).
21. Jason C. Matson, *Running Circles Around Marathon: The Effects of Accounts Receivable as Core or Non-core Proceedings in Article III Courts,* 20 Emory Bankr. Dev. J. 451, (2004).
22. *Supra* note 7.
23. *Id.* at 637.
24. *Id.*
25. 118 F. 3d 1056 (5th Cir. 1997).
26. *Id.* at 1067.
27. *Id.*
28. *Supra* note 7.
29. *Id.* at 640.
30. However, the Second Circuit did not look to whether the claim derived exclusively from the provisions of the Bankruptcy Code as seems to be required by the *In re National Gypsum* decision. See discussion of this point in *Jurisdiction in Bankruptcy Proceedings: A Test Case for Implied Repeal of the Federal Arbitration Act,* 117 Harv. L. Rev. 2296 (2004).
31. 436 F.3d 104 (2d Cir. 2006).
32. *Id.* at 108.
33. 434 F.3d 222 (3d Cir. 2006).
34. 403 F.3d 164 (4th Cir 2005).
35. *Id.* at 168.
36. Bnkrtcy No. 07-11522-HB, Adv. No. 08-1173, 2009 WL 86968 (Bkrtcy. D. Mass., Jan 13, 2009); there is no First Circuit precedent on this issue.
37. *Id.* at 8.
38. *Id.*
39. *See, e.g.*, Mette H. Kurth, *Comment: An Unstoppable Mandate and an Immovable Policy: The Arbitration Act and the Bankruptcy Code Collide,* 43 UCLA L. Rev. 999 (1999); Matthew Dameron, *Stop the Stay: Interrupting Bankruptcy to Conduct Arbitration,* 2001 J. Disp. Resol. 337 (2001).
40. The arbitration agreement is viewed in the case law as a separate agreement from the rest of the contract. *See, e.g., Prima Paint v. Flood & Conklin,* 388 U.S. 395 (1967).
41. *Note: Jurisdiction in Bankruptcy Proceedings: A Test Case for Implied Repeal of the Federal Arbitration Act,* 117 Harv. L. Rev. 2296 (2004).
42. Michael Fielding, *Elevating Business Above the Constitution: Arbitration and Bankruptcy Proofs of Claim,* 16 Am. Bankr. Inst. L. Rev. 563 (2008).
43. Alan Resnick, *The Enforceability of Arbitration Clauses in Bankruptcy,* 15 Am. Bankr. L. Rev. 183 (2007).
44. *14 Penn Plaza LLC v. Pyett,* 129 S. Ct. 1456, 1464 (2009); *Bremen v. Zapata Off-Shore Company,* 407 U.S. 1, 14 (1972); *Roby v. Corporation Lloyd's,* 996 F.2d 1353, 1363 (2d Cir. 1993).
45. For a discussion of some of the strategies for avoiding arbitration in bankruptcy, see Michael Fielding, *How to Avoid Arbitration in Bankruptcy*, 26-6 American Bankruptcy Institute Journal 24 (July 2007).

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E-discovery "Worst Practices": Ten Sure-Fire Ways to Mismanage a Litigation Hold

By Jack E. Pace III and John D. Rue*

Two years after the "new" e-discovery rules became effective, the cases show some trends.[1] Consequently, many litigators are developing best practices regarding the preservation of electronically stored information ("ESI") in connection with civil litigation in the United States. These may include the adoption of demonstrably reasonable document retention policies, implementation of a "litigation hold" intended to preserve relevant documents at the earliest practical time, measures to assess the likelihood that any given transaction or dispute will escalate to litigation, and so on.

When drafting this article, the authors considered creating a "best practices" guide, but the field is crowded with options for the practitioner seeking "best practices." In fact, a Google search for "e-discovery best practices" yields 27,400,000 hits.[2] Thus, rather than offering yet another in an already overcrowded field, we offer here what we believe to be a far more useful approach based on common practices—e-discovery "worst practices." Such a perspective may be more effective for practitioners because with e-discovery, as with many practice areas, "best practices" are better understood in their breach than in their observance.

Moreover, long before the Federal Rules of Civil Procedure were revised in 2006 to more directly address the discovery of ESI and, indeed, ever since the use of computers in business became commonplace, responsible and diligent litigators routinely have taken appropriate steps to preserve, review, and produce relevant ESI. But those are not the settings in which the best lessons (or, at least, the stories that get the attention of the practitioner trying to make sense out of this area of the law) emerge. Rather, it is the headlines shouting of exorbitant sanctions for infractions of the rules (intentional or accidental) that cause litigators everywhere to sit up and take notice (or lose sleep).

In that spirit, the authors set out to describe below a set of e-discovery "Worst Practices" or, with apologies to David Letterman, the Top Ten Ways to Mismanage a Litigation Hold.[3] For each "rule," we have selected one or two illustrative examples from case law, with additional citations in endnotes where the wealth of examples made it difficult to choose only one. We offer special thanks to those involved in the cases discussed herein, in the spirit of the admonition of Catherine the Great: "If you can't be a good example, then you'll just have to be a horrible warning."

1. Don't worry, be happy (Part I)—As long as you have a good retention policy in place, a litigation hold is icing on the cake.

If you already have a document retention policy, isn't that enough? Why go to the trouble of creating individual litigation holds for each matter which, for some clients, may number in the hundreds? Many parties and counsel already appear to follow this rule.

For example, in a breach of contract action, the plaintiff deposed an employee of the defendant, during which the witness testified that she had never received a litigation hold notice or any request to search for relevant documents. Instead, she decided on her own initiative to search for documents that would be useful to the defendant in the dispute, and she sent a batch of such documents to the company's CEO.[4] The federal district court in Kansas (apparently unaware of this rule) held that the failure to issue a litigation hold was a breach of defendant's preservation obligation and, although the defendant already had produced all of the documents found on the witness's computer, the judge ordered the defendant to certify that it had produced all relevant information within its possession, custody, or control.[5] In fact, the court likely would have gone further and issued an even harsher sanction if the defendant had not been able to produce a sufficient number of documents from the witness's files.

Despite the risk of sanctions, parties in other cases have obeyed this worst practice rule as well.[6] For example, in a suit by a student alleging sexual harassment by a professor, testimony from various employees of the defendant revealed that (i) the general retention policy was not followed with respect to former employees; (ii) the college registrar was unaware of the case until recently and had never been asked to search for records relevant to the case; and (iii) the college's head of human resources had never heard of a "litigation hold" and never received any preservation instructions regarding the case.[7] The judge entered an adverse inference instruction against the defendant and awarded costs to the plaintiff.[8]

For parties following this worst practice rule, individual litigation holds seem especially unimportant where a general document retention policy is in place—even one that allows for the regular, periodic destruction of documents without review for relevance to ongoing or anticipated litigation.[9] After all, if the documents have been destroyed, what problems can they cause?

2. Don't worry, be happy (Part II)—Until a complaint is filed, there is no need for a litigation hold.

Lawyers implementing these worst practices need not worry about taking any preservation action until after a complaint has been filed. Why jump the gun and do work that may not be necessary?

Consider a patent infringement case recently litigated in Delaware federal court.[10] There, the court found that the plaintiff had instituted a document retention policy under which the company would destroy many categories of documents after a period of three months. Well after devising a long-term litigation strategy to enforce numerous patents against several defendants, the company instructed its outside counsel to "clear out" electronic (and hard copy) files directly relevant to the patents it intended to enforce.[11] This spoliation (combined with post-litigation commencement shredding of 480 boxes of hard copy documents) led to a finding of inequitable conduct, which in turn operated to invalidate (and deem unenforceable) the 12 patents asserted as infringed. As this case illustrates, a worst practice counsel for a defendant will wait to be hit over the head by a complaint, while worst practice counsel advising potential plaintiffs will advise their clients to proactively pursue a "destroy, then litigate" strategy.[12]

Further, attorneys following this rule not only will studiously ignore the possibility that a preservation duty might arise before a complaint is filed, but also will disregard the possibility that the preservation duty may extend to related transactions that occur after a complaint has been filed. For example, in *Toussie v. County of Suffolk*, the court held that where a preservation duty had been implicated by a transaction executed in 2001, the obligation extended to subsequent related transactions which occurred in 2002, 2003, and 2004.[13] Similarly, worst practice devotees should assume that dismissal of a lawsuit always ends the preservation obligation despite the likelihood of further litigation.[14]

3. It's not my fault—If opposing counsel doesn't request documents, they don't have to be preserved.

Why should you have to do the hard work of figuring out which documents are relevant to the pending litigation? Why not wait to see the document requests before deciding what to preserve?

In *Ferron v. Search Cactus, LLC*, the plaintiff saved and preserved all of his e-mail since the beginning of the litigation. Defendants, however, wanted not only his e-mail, but also the records of what Web sites he had visited, which data had been destroyed through the "routine alteration and deletion of information that attends ordinary use of [a] computer."[15] The plaintiff argued, in apparent observance of this rule, that he was under no obligation to preserve other electronic data because "no Defendant in this case ha[d] ever requested that he place a litigation hold on any other type of electronically stored information…on his computers."[16] The court rejected this argument, citing *Zubulake* for the proposition that parties have a duty to preserve all evidence that "may be relevant to future litigation."[17] Therefore, the court held, inexplicably, and seeming to ignore the "rules" discussed herein, that plaintiff's preservation duty is "independent of whether Defendants requested a litigation hold."[18]

As another court held in describing the best practice rule, "[t]he duty to preserve documents does not need a formal discovery request to be triggered, the complaint itself can be sufficient when it alerts a party that certain information is relevant and likely to be sought in discovery."[19] So the worst practice in this regard is to avoid proactively considering which materials may be relevant to a litigation. In other words, why not just wait and see what ESI opposing counsel actually requests? Doing so may even allow you to avoid preserving material that will never be requested.

4. It depends on what the definition of "is" is (Part I)—Construe "document" extremely narrowly.

No matter how lengthy the definition of "document" concocted by opposing counsel,[20] lawyers who faithfully follow this rule will always be able to argue later that if something is not printed on 8.5 x 11 paper, it is not a "document" for purposes of preservation.[21]

Nursing Home Pension Fund v. Oracle Corp. was a securities class action lawsuit against Oracle and several of its corporate officers, including Larry Ellison, Oracle's co-founder and CEO.[22] In March and April 2001, Matthew Symonds, an editor for *The Economist*, conducted and digitally recorded 135 hours of interviews with Ellison in preparation for a book about Ellison and Oracle, storing the audio files on Symonds' computer.[23] The court found that Ellison controlled the files, and that Symonds (a third party) subsequently ordered his computer repair shop to "dispose" of the computer.[24] The court ordered an adverse inference sanction against the defendants because Ellison had an obligation to preserve the recordings but took no steps to do so.[25]

Other courts have also held that various forms of electronic material should have been subject to litigation holds, including metadata indicating whether certain Web sites had been visited,[26] usage logs for an electronic database,[27] computer source code,[28] and even a computer's random access memory (RAM).[29] Although lawyers who impose a narrow definition of the types of formats and materials to preserve run the risk of sanctions, such as those granted in *Arista Records*, *Ferron*, *Keithley*, and *Oracle Corp.*,[30] that will not dissuade the worst-practice lawyer—even controlling case law can always be distinguished.

5. It depends on what the definition of "is" is (Part II)—Construe relevance extremely narrowly.

Those attorneys aspiring to spectacularly mismanage a litigation hold will always define extremely narrowly the parameters of the universe of documents relevant to the pending litigation. In *3M Innovative Properties Company v. Tomar Electronics*, 3M sued Tomar for patent infringement relating to traffic control systems. An employee of the defendant claimed that he was the sole inventor of defendant's relevant system. In response to various discovery requests, the employee claimed that he was the only person at the company with relevant documents. Defendant did not issue a retention policy or litigation hold, because the witness believed it would apply only to him. He neither inquired whether other employees had relevant documents nor implemented any preservation procedures.[31] However, the court pointed out that even if the witness was the sole inventor, additional data still would be relevant to the lawsuit, including sales data, research and development documents, and testing information.[32] The court found, therefore, that the defendant had "failed to conduct a reasonable inquiry or investigation for information or documents responsive to 3M's discovery requests."[33] Although the court imposed various sanctions, including negative evidentiary findings, adverse inference instructions, additional discovery for 3M, and an award of attorneys' fees, it was probably just being conservative.[34]

Besides narrowly construing which document custodians may have relevant materials for purposes of preservation, the same worst practice may be applied to topical categories of documents. In *Metropolitan Opera Association, Inc. v. Local 100, Hotel Employees and Restaurant Employees International*, the defendant failed to preserve documents relating to its public and media campaign and argued that those categories of documents were irrelevant. The court responded, "[t]o suggest that these documents are irrelevant is, charitably, incorrect."[35] As shown here, careful observation of worst practices requires attorneys to rely on *ex post* semantic deconstruction of document requests rather than casting a wide net for preservation purposes.

6. Ignorance is bliss—Once the hold is drafted, a lawyer's work is done.

Judging by some of the cases discussed above, one might conclude that lawyers who go so far as to at least *impose* a litigation hold are less likely than average to become "horrible warnings." However, even those lawyers still may aspire to personally prove Catherine's admonition.

In the *Metropolitan Opera* case, the Met sued a labor union and two individual labor leaders, alleging tortious interference and a secondary boycott. Although the individuals each received discovery requests directed to them specifically, neither appears to have made much effort to comply. One of the union leaders received from his staff a list of documents that he should look for, but he delegated the task to other staff members. One of his offices was never searched at all for relevant documents. When asked about several categories of documents at his deposition, he testified that his lawyer had asked him for the first time the previous day to look for such documents.[36] The other individual defendant was also approached by staff regarding documents; he directed them to search a single file drawer in his office, which they did, but made no further efforts to locate relevant materials.[37] The court (unaware, like so many others, of the "Rules" discussed herein) sanctioned both individual defendants and their counsel for failure to conduct adequate searches for responsive materials and entered a judgment of liability against the defendants, writing "defendants and their counsel may not engage in parallel know-nothing, do-nothing, head-in-the-sand behavior in an effort consciously to avoid knowledge of or responsibility for their discovery obligations."[38]

Likewise, in *Treppel v. Biovail Corporation*, the defendant's general counsel orally instructed the CEO and the vice president of corporate affairs to preserve documents relevant to the litigation. However, the general counsel never issued any written instructions, nor did he follow up with either executive to see what measures they had implemented or whether they were continuing to preserve relevant materials.[39] The court wrote that "[c]ounsel must take affirmative steps to monitor compliance so that all sources of discoverable information are identified and searched."[40] The court ordered a forensic investigation at the defendant's expense.[41] Despite such a sanction, and the fact that sanctions in other cases have sometimes been even more severe,[42] the worst practices lawyer will assume his or her work is over once the initial hold letter goes out.

Thus, the rule is to forsake any responsibility for the effective implementation of legal holds and retention policies. In addition, when assisting with general retention policies, the worst practice lawyer will ignore any potential or threatened litigation, regardless of the risk that relying on only the standard retention policy would cause potentially relevant material to be destroyed.[43]

7. Keep the hold on a "need to know" basis only (and only the lawyers need to know).

This is also known as the "007 Rule," because it involves handling legal hold information as a secret agent might treat top-secret instructions. For example, in *Nursing Home Pension Fund v. Oracle Corporation*, defendants prepared a preservation notice, which they sent to 30 of the company's employees—out of 40,000. These thirty employees did not include some senior corporate officers who likely would have possessed relevant information, but must not have qualified as need-to-know.[44] The court entered an order for adverse inferences as a sanction against the defendant.[45]

So the electronic discovery worst practice here is to cast a very narrow net when it comes to the distribution of the litigation hold to employees.[46] In particular, counsel seeking to adhere to these "Rules" will ensure that support staff, such as secretaries and other assistants to relevant custodians, are unaware of the hold policy.[47] Keeping IT staff in the dark on retention obligations is of particular importance in this regard, as is scrupulously refraining from making any follow-up inquiries with document custodians after distributing a hold memo.[48]

8. Out of sight, out of mind—Don't worry about documents not on the network.

This rule is observed most commonly by inaction, when counsel fail to consider ESI that is stored only locally, rather than on clients' network servers. However, attorneys seeking to observe this "Rule" diligently also can be proactive. In one particularly admirable example, in *Southern New England Telephone Company v. Global NAPs, Inc.*, the defendants not only attempted to keep the electronic files stored on key computers "out of sight" of plaintiffs, they also took similar steps for documents stored in less common places, just in case such document sources might later be discovered. Besides arranging for one computer to "crash" (to the floor)[49] and employing "Window Washer" software (which had a "Shred (wash with bleach)" option)[50] on another, the defendants apparently made it more difficult to retrieve certain documents stored at the home of the deceased treasurer of the company. A company director orchestrated the removal of a filing cabinet from the dead man's home, after which the defendants claimed they could not produce the documents since the treasurer had died intestate.[51] Concluding enigmatically that "lesser sanctions would not deter the defendants," the court found that the "ultimate sanction" was warranted, and entered a default judgment.[52]

Relevant documents may be found in many locations other than network servers, but this rule exhorts worst practitioners to avoid looking. For example, e-mail that is downloaded to computers automatically may be deleted from servers, thus obviating the need to ever produce it.[53] Personal and home computers can be ignored,[54] and server back-up tapes always can be overlooked.[55] If any "outside" documents are identified, they can be destroyed.[56] If you are not willing to go the extra mile and take preemptive action, just remember to try as much as possible to avoid considering where *else* relevant documents may be located.

9. Computers don't make mistakes—Search terms are flawless and always enough.

Always assume that technology is flawless. One of the best applications of this rule is the exclusive reliance on search terms to identify relevant documents for preservation purposes. For example, in *Victor Stanley, Inc. v. Creative Pipe, Inc.*, defendants requested that the court approve a "clawback agreement" to cover the inadvertent disclosure of privileged documents, because they said they did not have time to individually review all responsive documents.[57] However, after the judge extended the discovery deadline by four months, the defendants decided they might make it through all the documents after all and abandoned the proposed clawback agreement.[58] Their goal proved to be overly ambitious, and they ended up reviewing text-searchable documents only where selected search terms showed up in the document and non-searchable documents only by page titles.[59] After plaintiff's counsel discovered a number of privileged documents in the production, the court found that the keyword searches had not been reasonable and held that the defendants had waived any privilege for the documents that had been produced.[60]

The *Victor Stanley* court apparently was skeptical of modern technology (or at least of human ability to employ such technology). The court wrote:

> [W]hile it is universally acknowledged that keyword searches are useful tools for search and retrieval of ESI, all keyword searches are not created equal; and there is a growing body of literature that highlights the risks associated with conducting an unreliable or inadequate keyword search or relying exclusively on such searches for privilege review…. Use of search and information retrieval methodology…requires the utmost care in selecting methodology that is appropriate for the task….[61]

Of course, besides the inadvertent production of privileged material, adherence to the maxim that "computers don't make mistakes" can also lead to the failure to preserve relevant documents if keyword searches are relied upon to identify what needs to be produced, leading to yet another possibility of sanctions—a "worst practices" lawyer's badge of honor.

10. Hide out in the Safe Harbor—The benefits of frequent and indiscriminate automated deletion.

Any list of the most instructive worst practices (and most severe examples of sanctions for discovery misconduct) would certainly have to include a discussion of one of the most reliable worst practice tools: the auto-delete function. In *U.S. v. Philip Morris USA, Inc.*, the defendant's system deleted all e-mail older than 60 days old on a monthly basis.[62] The system-wide automated deletion continued for two years following the court's entry of the first case management order, which specifically required preservation of all relevant documents "and other records."[63] The automated deletion was apparently also in violation of the defendant's own internal policy and many of the employees identified as having failed to follow applicable policies came from the highest echelons of the company. Deleted documents included e-mail regarding demographics of cigarette purchasers (including age), yearly marketing plans, advertising events, research on individual smokers, and media relations.[64] But while such an automated system may seem efficient to readers and followers of the "Rules" discussed here, the court did not appear to agree. In addition to prohibiting the defendant from calling as a witness anyone who violated the internal document retention program, the court imposed a total monetary sanction of $2,750,000 on the corporate defendant, consisting of a $250,000 fine imposed on each of eleven individual corporate managers and/or officers.[65]

Although Federal Rule of Civil Procedure 37(e) creates a "safe harbor" for "failing to provide electronically stored information lost as a result of the routine, good-faith operation of an electronic information system," Rule 37(e) does not benefit "a party who fails to stop the operation of a system that is obliterating information that may be discoverable in litigation."[66] Therefore, while such a holding does not remove or clarify the ambiguity in the meaning of "good faith" in the Rule, taking advantage of frequent and indiscriminate automated[67] deletion of relevant material is nonetheless clearly grounds for sanctions, in spite of Rule 37(e) (and this "worst practice" rule).[68] In the *Napster* case, an investment firm which had invested in Napster and was, at various times, party to suits against Napster, had a formal policy to the effect that "we do not retain e-mails, it is your responsibility to delete your handled e-mails immediately."[69] The court stated that notwithstanding this policy, the firm "was required to cease deleting e-mails once the duty to preserve attached."[70] Unthinkingly permitting the continued auto-deletion of documents is not a "get out of jail free" card for spoliation. But it is an excellent road to a place in the worst practices hall of fame.

Best Practices

Although perhaps not nearly so interesting as worst practices, we cannot conclude this article without a few affirmative recommendations. As an initial matter, counsel interested in "best practices" in the area of litigation holds and document preservation generally should consult the Sedona Principles and the Sedona Proclamation, very useful sources of which every litigator confronting e-discovery issues should be aware.[71] The careful and diligent litigator also can review the Top Ten list discussed above, and simply do the opposite. Synthesized into best practices for litigation holds, our Top Ten list can be translated into the following three simple rules, When, What, and Who:

1. When: Impose a litigation hold at the earliest practical time after realistically anticipating litigation, and regularly monitor compliance thereafter.
2. What: Preserve documents broadly, in terms of document type, location, date of document, format, and content.
3. Who: Distribute the hold notice broadly, but do not rely solely on support staff, IT staff, junior lawyers, co-counsel, or automated systems for implementation.

Endnotes

1. *See, e.g.*, Jack E. Pace III & John D. Rue, *Early Reflections On e-Discovery in Antitrust Litigation: Ten Months into the New Regime*, 22 ANTITRUST 67 (Fall, 2007).
2. As discussed below, perhaps the best guide to "best practices" is published by the Sedona Conference. *See* http://www.thesedonaconference.org.
3. In a subsequent article in this publication, we will discuss the best ways to mismanage the review and production of electronic documents.
4. *School-Link Techs., Inc. v. Applied Res., Inc.*, No. 05-2088, 2007 WL 677647, at *1-2 (D. Kan. Feb. 28, 2007).
5. *Id.* at *3-5.
6. *See, e.g.*, *Toussie v. County of Suffolk*, No. CV 01-6716, 2007 WL 4565160, at *7, 10 (E.D.N.Y. Dec. 21, 2007) (no formal litigation hold issued); *Keithley v. Home Store.com, Inc.*, No. C-03-04447, 2008 WL 3833384, at *12, 18-19 (N.D. Cal. Aug. 12, 2008) (no proper litigation hold).
7. *Doe v. Norwalk Cmty. College*, 248 F.R.D. 372, 378 (D. Conn. 2007).
8. *Id.* at 381-82.
9. *See, e.g.*, *Micron Tech., Inc. v. Rambus, Inc.*, 255 F.R.D. 135, 150-51 (D. Del. 2009) (documents destroyed according to general retention policy included materials relevant to planned litigation).
10. *Id.*
11. *Id.* at 144.
12. *See KCH Servs., Inc. v. Vanaire, Inc.*, No. 05-777-C, 2009 WL 2216601 (W.D. Ky. July 22, 2009) (granting adverse inference based on finding that defendant had deleted relevant software immediately after a pre-litigation phone call from plaintiff about the dispute); *see also Phillip M. Adams & Assocs., L.L.C. v. Dell, Inc.*, No. 1:05-CV-64, 2009 WL 910801, at *12-13 (D. Utah Mar. 30, 2009) (preservation duty arose eight years prior to lawsuit because defendant should have been aware that relevant industry-wide issue could lead to litigation).
13. *Toussie*, 2007 WL 4565160, at *6 n.5.
14. *In re Napster, Inc. Copyright Litig.*, 462 F. Supp. 2d 1060, 1070 (N.D. Cal. 2006).
15. *Ferron v. Search Cactus*, LLC, No. 2:06-cv-327, 2008 U.S. Dist. LEXIS 34599, at *5 (S.D. Ohio Apr. 28, 2008).
16. *Id.* at *8-9.
17. *Id.* at *9 (*citing Zubulake*).
18. *Id.*
19. *Porche v. Oden*, No. 02-C-7707, 2009 WL 500622, at *6 (N.D. Ill. Feb. 27, 2009).
20. In *Mosaid Techs. Inc. v. Samsung Elecs. Co., Ltd.*, the court rejected arguments that emails were not subject to discovery since the term "e-mail" was not used in discovery requests, where the definitions included "letters," "correspondence," and "communications." 348 F. Supp. 2d 332, 336-37 (D. N.J. 2004).
21. C.f. *Clinton to contest Supreme Court suspension*, CNN, Oct. 2, 2001, *available at* http://archives.cnn.com/2001/LAW/10/01/scotus.clinton/.
22. *Nursing Home Pension Fund v. Oracle Corp.*, No. C-01-00988, 2008 U.S. Dist. LEXIS, at *6 (N.D. Cal. Sept. 2, 2008).
23. *Id.* at *9-10.
24. *Id.* at *24-25.
25. *Id.* at *26.
26. *Ferron*, 2008 U.S. Dist. LEXIS 34599, at *4-10 (merely preserving email does not fulfill preservation duty).
27. *Arista Records LLC v. Usenet.com, Inc.*, No. 07-Civ.-8822, 2009 U.S. Dist. LEXIS 5185, at *7-8, 93-95 (S.D.N.Y. Jan. 26, 2009). *See also Arista Records LLC v. Usenet.com, Inc.*, 633 F. Supp. 2d 124, No. 07-Civ.-8822, 2009 WL 1873589 (S.D.N.Y. June 30, 2009) (imposing additional sanctions in the same case after additional spoliation and discovery abuses were discovered).
28. *Keithley*, 2008 WL 3833384, at *12.
29. *Columbia Pictures, Inc. v. Bunnell*, 245 F.R.D. 443 (C.D. Cal. 2007).

30. *Arista Records*, 2009 U.S. Dist. LEXIS 5185, at *93-95 (evidentiary sanctions); *Ferron*, 2008 U.S. Dist. LEXIS 34599, at *13-16 (forensic discovery); *Keithley*, 2008 WL 3833384, at *20 (magistrate awarded monetary sanctions and recommended the district court give adverse inference instruction); *Oracle Corp.*, 2008 U.S. Dist. LEXIS, at *28-32 (adverse inferences).

31. *3M Innovative Props. Co. v. Tomar Elecs.*, No. 05-756, 2006 WL 2670038, at *6-7 (D. Minn. Sept. 18, 2006). *Cf. Toussie*, 2007 WL 4565160, at *7 (only "key players" preserved relevant materials).

32. *3M*, 2006 WL 2670038, at *7.

33. *Id.* at *11**.**

34. *Id.* at *1-2.

35. *Metro. Opera Ass'n, Inc. v. Local 100, Hotel Employees and Rest. Employees Int'l*, No. 00-Civ.-3613, 2004 WL 1943099, at *8 (S.D.N.Y. Aug. 27, 2004).

36. *Id.* at *22-23.

37. *Id.* at *23.

38. *Id.* at *25.

39. *Treppel v. Biovail Corp.*, 249 F.R.D. 111, 115 (S.D.N.Y. 2008).

40. *Id.* at 118.

41. *Id.* at 124.

42. In *In re NTL, Inc. Sec. Litig.*, two of the relevant entities had put hold memos in place; however, the hold memos were later ignored by both entities. The court granted an adverse inference request and awarded attorneys' fees. 244 F.R.D. 179, 195, 201-02 (S.D.N.Y. 2007) ("Counsel must take affirmative steps to monitor compliance."). In *Porche v. Oden*, defendants failed to follow a retention policy already in place; as a sanction, the court forbade defendants from presenting any evidence from documents that should have been produced, but had not yet been, and granted an adverse inference jury instruction. 2009 WL 500622, at *7, 9. Finally, in *Cache La Poudre Feeds, LLC v. Land O'Lakes, Inc.*, defendant and its lawyers were fined for "counsels' failure to properly monitor the discovery process," including permitting improper application of the retention policy. 244 F.R.D. 614, 636-37 (D. Colo. 2007) (collecting examples of monetary sanctions).

43. *Micron*, 255 F.R.D. at 150-51.

44. *Oracle Corp.*, 2008 U.S. Dist. LEXIS 66740, at *7-8. *Cf. Wachtel v. Health Net, Inc.*, 239 F.R.D. 81, 95 (D.N.J. 2006) (many high-level employees "entirely unaware of either…litigation or their obligation to preserve documents"); *Toussie*, 2007 WL 4565160, at *7 (only "key players" involved in preservation efforts, leaving "several…key departments unaccounted for"). *See also* discussion of *3M*, *supra* note 31.

45. *See also Bray & Gillespie Mgmt. LLC v. Lexington Ins. Co.*, __ F.R.D. __, 2009 WL 2407754 (precluding plaintiff from presenting any evidence in support of its most significant claim as sanction for failure to produce relevant documents as a result of failing to request the appropriate personnel to search in certain locations).

46. *In re NTL, Inc.*, 244 F.R.D. at 198 (many employees never received hold memo and those who did receive it were never reminded of their obligation).

47. *Treppel*, 249 F.R.D. at 118-19 (in-house counsel did not make support staff to high-level executives aware of preservation obligation, although he had reason to believe they may have had discoverable information).

48. *Keithley*, 2008 WL 3833384, at *12 (technical personnel were not made aware of significance of computer code data nor the obligation to preserve it). Additional inquiries to document custodians were ordered by a magistrate judge in *Wachtel v. Health Net, Inc.*, after it became clear during depositions that many employees had relevant documents that had not been produced. 239 F.R.D. at 94-95. *See also Major Tours, Inc. v. Colorel*, No. 05-3091, 2009 WL 2413631 (D.N.J. Aug. 4, 2009) (holding that plaintiff had made a preliminary showing of spoliation where one of defendant's Rule 30(b)(6) witnesses testified that she did not even know what a litigation hold was).

49. *S. New England Tel. Co. v. Global NAPs, Inc.*, 251 F.R.D. 82, 87 (D. Conn. 2008). An alternate method is the corporate version of "the dog ate my homework": a thief stole my laptop from my unlocked car. *Gutman v. Klein*, No. 03-CV-1570, 2008 WL 4682208, at * 10 (E.D.N.Y. Oct. 15, 2008).

50. *S. New England Tel.*, 251 F.R.D. at 88-89.

51. *Id.* at 85, 89, 94.

52. *Id.* at 96; *see also Chevron v. M&M Petrol. Servs., Inc.*, No. SACV 07-0818, 2009 WL 2431926 (C.D. Cal. Aug. 6, 2009) (granting adverse inferences, monetary sanctions, and reasonable attorneys' fees against party that kept "secret books" on a separate computer system in order to avoid producing relevant documents).

53. *Treppel*, 249 F.R.D. at 119.

54. *Smith v. Slifer Smith & Frampton*, No. 06-cv-02206, 2009 WL 482603, at *12 (D. Colo. Feb. 25, 2009) (failure to retain evidence on home and office computers).

55. *Wachtel*, 239 F.R.D. at 95 (old emails removed to back-up disks not searched).

56. *Micron*, 255 F.R.D. at 150-51 (relevant files identified by outside counsel when litigation was reasonably foreseeable were "intentionally destroyed…in bad faith").

57. *Victor Stanley, Inc. v. Creative Pipe, Inc.*, 250 F.R.D. 251, 254-55 (D. Md. 2008).

58. *Victor Stanley, Inc.*, 250 F.R.D. at 255.

59. *Id.* at 255-56.

60. *Id.* at 267-68.

61. *Id.* at 256-57, 262.

62. *U.S. v. Philip Morris USA, Inc.*, 327 F. Supp. 2d 21, 23 (D. D.C. 2004).

63. *Id.* at 23-24.

64. *Id.* at 24.

65. *Id.* at 25-26 and n.1.

66. *Disability Rights Council of Greater Wash. v. Wash. Metro. Transit Auth.*, 242 F.R.D. 139, 146, 148 (D. D.C. 2007) (ordering that defendant pay for searches of back-up tapes, where emails were automatically deleted periodically).

67. Routine deletion that is not automatic is also not protected by Rule 37(e). *Cache La Poudre Feeds*, 244 F.R.D. at 624, 629, 636-37 (erasure of former employees' electronic records without determining relevancy grounds for monetary sanctions); *Micron*, 255 F.R.D. at 148 (routine purge of documents by outside counsel not appropriate where party knew that some material may be relevant to impending litigation).

68. *Peskoff v. Faber*, 244 F.R.D. 54, 60 (D. D.C. 2007) (referring to "amended Rule 37(f)").

69. *In re Napster*, 462 F. Supp. 2d at 1064.

70. *Id.* at 1070.

71. *The Sedona Guidelines: Best Practice Guidelines & Commentary for Managing Information & Records in the Electronic Age* (The Sedona Conference Working Group Series, Sept. 2005 Version), *available at* http://www.thesedonaconference.org.

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"Inside the Courts: Key Securities Cases"

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A) Class Certification

1) Fifth Circuit Reinforces Its Stringent Requirements at Class Certification Stage

Fener v. Belo Corp., No. 08-10576 (5th Cir. Aug. 12, 2009)

The U.S. Court of Appeals for the Fifth Circuit, in an opinion authored by Circuit Judge Jerry E. Smith, applied its stringent loss causation test at the class certification stage in affirming the district court's denial of shareholder-plaintiffs' motion for class certification in an action brought against Belo Corporation and five of its officers and directors (collectively, Belo). In the underlying action, plaintiffs alleged that Belo, a publicly traded media company that owns television stations, Web sites and newspapers, violated Section 10(b) of the Securities Exchange Act and Rule 10b-5 promulgated thereunder by fraudulently increasing the recorded circulation of one of its newspapers, the *Dallas Morning News*. Belo had issued a press release that admitted that an internal investigation revealed questionable circulation practices that would, upon correction, result in a 1.5 percent daily paper circulation decline and a 5 percent Sunday decline. The press release also predicted that there would be additional declines in circulation from, among other things, lower-than-anticipated demand in the next six months. The next day, Belo's stock price declined by $1.66 from the previous day's close, and several securities analysts lowered their ratings and earnings estimates. Plaintiff-shareholders brought a securities fraud suit and moved to certify a class of Belo shareholders, which the district court denied.

The Fifth Circuit affirmed the district court's order denying plaintiffs' motion for class certification because plaintiff-shareholders failed to make the requisite showing, under Fifth Circuit law, of loss causation. To satisfy the Fifth Circuit's loss causation test at the class certification stage, a plaintiff must show "(1) that the negative truthful information causing the decrease in price is related to an allegedly false, non-confirmatory positive statement made earlier and (2) that it was more probable than not that it was this negative statement, and not other unrelated negative statements, that caused a significant amount of the decline." Fifth Circuit law requires plaintiffs to present "the testimony of an expert…along with some kind of analytical research or event study…to show loss causation."

Emphasizing the *in terrorem* effect of class certification, the court found that plaintiffs failed to make the necessary showing that the disclosure of the "negative truthful information" caused the reduction in Belo's stock price. As an initial matter, plaintiffs did not present expert testimony in their original motion, as required by Fifth Circuit law. Putting aside this deficiency, the court further found that plaintiffs failed to prove loss causation. First, the court found that the expert testimony that plaintiffs ultimately presented, with their reply brief, rather than moving brief, "was fatally flawed" because it did not examine how Belo's stock price responded to each of the negative pieces of information contained in the press release. Second, the court found that plaintiffs' expert's testimony relating to analyst opinions about Belo's stock decline also was "insufficient" because it was not supported by "reference to any post-mortem data [the analysts]…reviewed or conducted." Third, the court rejected plaintiffs' argument that it could be assumed that the negative truthful information caused nearly one-third of the stock decline because the disclosure was responsible for nearly one-third of the decline in circulation. Finally, the court observed that, even assuming that the market was previously aware of all information in the press release, plaintiffs must still prove loss causation in accordance with the rigors of Fifth Circuit precedent.

2) Ninth Circuit Affirms Denial of Class Certification in GENI Securities Fraud Action

Desai v. Deutsche Bank Sec. Ltd., No. 08-55081 (9th Cir. July 29, 2009)

The U.S. Court of Appeals for the Ninth Circuit, *per curiam*, affirmed the district court's denial of class certification in a shareholder action brought against Deutsche Bank Securities Ltd., Deutsche Bank Securities Inc. and Deutsche Bank AG (collectively, Deutsche Bank), the "last defendant standing" in a seven-year-long consolidated class action stemming from the collapse of GenesisIntermedia, Inc. (GENI), a Delaware corporation, the shares of which were formerly sold on NASDAQ. In the underlying lawsuit, plaintiffs sued under Sections 10(b) and 20(a) of the Securities Exchange Act. Deutsche Bank purportedly violated the federal securities laws by participating in securities loans in GENI stock that artificially inflated its share price. The district court denied plaintiffs' motion for class certification, and plaintiffs appealed.

The Ninth Circuit affirmed the district court's denial of class certification because plaintiffs did not satisfy the "predominance" requirement for Rule 23(b)(3) class actions. Plaintiffs could not prove reliance—a necessary element for a Section 10(b) claim—on a classwide basis. Plaintiffs could not rely on the presumption of classwide reliance available for omissions cases (the so-called "*Affiliated Ute* presumption") because, while plaintiffs alleged wrongful omissions, the case "was not primarily an omissions case." Nor could the plaintiffs rely on the "fraud-on-the-market theory" because, by plaintiffs' own admissions, GENI's shares were not sold on an efficient market.

Finally, the court held that the district court acted within its discretion in rejecting plaintiffs' "invitation to create a novel presumption of reliance on 'the integrity of the market' in the context of manipulation cases." No authority required such a new presumption of reliance, and the Supreme Court has cautioned against expanding Section 10(b). Circuit Judge Diarmuid O'Scannlain, in a concurring opinion, stated that the district court not only acted within its discretion by rejecting plaintiffs' "integrity of the market" theory of classwide reliance, it was required to do so as a matter of law.

3) Second Circuit Affirms Class But Rules That Members Who Sold Stock Before the End of the Class Period Were Improperly Included

In re Flag Telecom Holdings, Ltd. Sec. Litig., Nos. 07-4017-cv (L), 07-4025-cv (CON) (2d Cir. July 22, 2009)

In a consolidated securities class action alleging violations of Sections 11, 12(a)(2) and 15 of the Securities Act of 1933 (concerning misstatements in the offering prospectus) and Sections 10(b) and 20(a) of the Securities Exchange Act (concerning false statements about profitability), the U.S. Court of Appeals for the Second Circuit (with Judge Robert Sweet of the Southern District of New York writing for the panel) affirmed the district court's certification of a class but concluded that the district court improperly included individuals who sold their stock before the end of the class period. The panel concluded that a class including both Securities Act plaintiffs—who were subject to a negative causation defense—and Securities Exchange Act plaintiffs—who had to prove loss causation— was not subject to a "fundamental" conflict that would preclude certification. Under *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005) loss causation and negative causation were not a "zero-sum game," and the Securities Exchange Act plaintiffs could prove loss causation without making the class representatives atypical or inadequate to represent the Securities Act class because both the prospectus misstatements and the company's subsequent statements could operate as the proximate causes of the class's losses. However, the class improperly included individuals—including a class representative—who sold their stock before the end of the class period, because there was no evidence that those individuals could "conceivably" prove loss causation, as their theory that the true facts began to leak out prior to the corrective disclosure was based on statements about other similar companies made in the context of Flag Telecom's misleading statements. The plaintiffs could not simultaneously claim that Flag Telecom's statements were misleading and that the truth was leaking out based on statements about other similar companies in the same context (nor could they show any resulting corrective disclosure before the end of the class period). Even though those individuals' ability to prove loss causation would normally be a merits issue, the district court was required to consider it—and the panel could review it—because a class representative was one of those individuals, and the courts had to determine by a preponderance of the evidence that he was adequate, typical and not subject to any unique defenses (such as the failure to prove loss causation on a leaking theory).

4) Seventh Circuit Affirms Class Certification in 'Market Cornering' Action Against PIMCO

Kohen v. Pacific Investment Mgmt. Co., No. 08-1075 (7th Cir. July 7, 2009)

The U.S. Court of Appeals for the Seventh Circuit, in an opinion authored by Circuit Judge Richard A. Posner, affirmed the district court's order certifying a class consisting of persons who purchased a futures contract on the Chicago Board of Trade in 10-year U.S. Treasury notes (the Notes). The complaint alleged that Pacific Investment Management Company LLC and PIMCO Funds (collectively, PIMCO) violated Section 9(a) of the Commodity Exchange Act by purportedly "influenc[ing] the price of a futures contract by intentionally acquiring market power in the [Notes]…while simultaneously acquiring a large long futures position." Specifically, plaintiffs alleged that PIMCO increased the amount of Notes it owned from 12 to 42 percent over a two-week span to force the plaintiffs to pay a monopoly price to get enough Notes to close out their futures contracts with PIMCO. The district court granted plaintiffs' class certification motion, and defendants appealed.

Without commenting on the merits of the complaint's allegations, the Seventh Circuit rejected PIMCO's argument that the class could not be certified because some of the class representatives and class members suffered no injury and, accordingly, lacked standing. As for the class representatives, the court found that, even assuming that two of the three named class representatives suffered no injury, the district court properly certified the class because at least one of the class representatives had standing. As for the class members, the court similarly held that a class may be certified "as long as one member of a certified class has a plausible claim to have suffered damages." Nonetheless, the court cautioned that "a class should not be certified if it is apparent that it contains a great many persons who have suffered no injury at the hands of the defendant, if only because of the *in terrorem* character of a class action." Finally, the court rejected PIMCO's argument that class conflicts precluded certification, holding that "[i]f and when [conflicts in the class] become real, the district court can certify subclasses with separate representation of each." The court, in denying PIMCO's appeal of the class certification order, concluded that "PIMCO's attempt to derail this suit at the outset is ill timed, ill conceived, and must fail."

5) Georgia Federal Court Rules That Class Satisfies Rule 23 Requirements

In re NetBank, Inc. Sec. Litig., No. 1:07-CV-2298-BBM (N.D. Ga. Aug. 7, 2009)

Judge Beverly B. Martin of the U.S. District Court for the Northern District of Georgia certified a class of individuals who purchased NetBank, Inc. stock in a suit alleging the defendants violated Section 10(b) of the Securities Exchange Act by misrepresenting or omitting material facts about NetBank in public statements. The proposed class satisfied Rule 23(a)'s requirements of numerosity, commonality, typicality and adequacy. In deciding that plaintiff satisfied Rule 23(b)(3)'s predominance and superiority requirements, the court determined that the proposed class was entitled to a fraud-on-the-market presumption of reliance. The proposed class was entitled to this presumption because the plaintiff's expert established that NetBank's stock was traded in an efficient market according to the eight factors identified in *Unger v. Amedisys, Inc.*, 401 F.3d 316 (5th Cir. 2005). The stock had a "'substantial weekly trading volume'" (more than 2 percent of the stock was traded in a given week), both Thomson Financial's and Reuters' databases of analyst reports showed 114 reports on NetBank during the proposed class period, NetBank qualified for filing an S-3 registration statement (which "'presumed'" the stock was actively traded), NetBank's market capitalization varied between the 30th and 52nd percentile for stocks listed on the NASDAQ, the average daily bid-ask spread for the stock was 0.29 percent, and more than 90 percent of the stock was held by the public (indicating that the price was more likely to accurately reflect all available information). Two of the factors—the number of market makers and the reaction of NetBank's stock price to unexpected news—did not affect the court's decision because the plaintiff's expert did not provide sufficient information about the volume or price of NetBank shares traded by the major NASDAQ market makers; and, although the defendant's expert argued that the plaintiff's expert's analysis was incorrect, the court declined to engage in a "battle of the experts" when deciding class certification. The court additionally decided several discovery disputes, including ordering plaintiff to identify the confidential informants named in the complaint.

6) S.D.N.Y. Certifies Class Against Defendants Over Allegedly Misleading Analyst Reports

Fogarazzo v. Lehman Bros., Inc., No. 03 Civ. 5194 (SAS) (S.D.N.Y. Aug. 4, 2009)

Judge Shira A. Scheindlin of the U.S. District Court for the Southern District of New York certified a class of RSL Communications, Inc. stockholders in a suit alleging Lehman Brothers, Goldman Sachs and Morgan Stanley violated Section 10(b) of the Securities Exchange Act by issuing misleading analyst reports for RSL. The plaintiffs alleged that those materially misleading analyst reports artificially inflated RSL's stock price and were issued in an attempt to receive investment banking business from RSL. In addition to finding that the plaintiffs satisfied the numerosity and typicality requirements of Rule 23(a), the court also determined that the plaintiffs had satisfied Rule 23(b)(3)'s predominance requirement because the class was entitled to the fraud-on-the-market presumption and a presumption that transaction causation was satisfied by the defendants' failure to disclose material information they were required to disclose under *Affiliated Ute Citizens of the State of Utah v. United States*, 406 U.S. 128 (1972). By showing that analysts repeatedly recommended buying RSL stock while not being optimistic about the stock, the plaintiffs were entitled to a fraud-on-the-market presumption, which the defendants did not rebut, because the difference between the defendants' and the plaintiffs' experts' conclusions were the result of different analytical methodologies, and the plaintiffs' expert "convincingly" defended his methodology. Similarly, the plaintiffs were entitled to the *Affiliated Ute* presumption because a reasonable investor would have been less likely to rely upon the analyst reports if that investor knew they were tainted by the defendants' attempts to get investment banking business from RSL. Further, the court determined that the plaintiffs could prove loss causation because their expert proposed five techniques to control for alternative effects on RSL's stock price to isolate the effect of the defendants' analysts' reports. Finally, individual class members' damages could be calculated from a formula derivable from the plaintiffs' expert's analysis.

7) Pennsylvania Federal Court Declines Class Certification Based on Rule 23's Predominance Requirement

Malack v. BDO Seidman, LLP, No. 08-0784 (E.D. Pa. Aug. 3, 2009)

In a suit alleging BDO Seidman, LLP violated Section 10(b) of the Securities Exchange Act by improperly issuing unqualified opinions in connection with its audit of American Business Financial Services, Inc. (ABFS), Judge Thomas N. O'Neill, Jr. of the U.S. District Court for the Eastern District of Pennsylvania declined to certify a class of individuals who purchased notes issued by ABFS from October 2002 until its bankruptcy filing in January 2005. The plaintiffs claimed that they relied upon ABFS's registration statements and prospectuses (which included BDO Seidman's audit reports) in purchasing notes from ABFS. The notes represented securitized mortgages sold by ABFS. The court explained that the only issue for class certification was if the class satisfied Rule 23's predominance requirement, which would require classwide reliance upon BDO Seidman's audit reports. Because there was "no open and developed market for ABFS notes" and therefore no efficient market for those notes, the plaintiffs could not show reliance through a fraud-on-the-market theory. Further, the plaintiffs could not rely upon a fraud-created-the-market theory established by the Fifth Circuit in *Shores v. Sklar*, 647 F.2d 462 (5th Cir. 1981). Although it was an unsuccessful business, ABFS was not a sham business—the mortgages underlying the notes existed—and therefore purchasers could not be presumed to have relied upon there not having been a fraud that would render the notes unmarketable at any price or render the notes "'unworthy of trading in a regulated securities market.'" Further, because the plaintiffs failed to show that had ABFS's fraud been disclosed by BDO Seidman the SEC would have barred the sale of the notes, purchasers could not have relied upon a theory that had the fraud been disclosed, the SEC would have refused to allow ABFS to register the registration statements governing the sale of the notes.

B) Confidential Informants

Fourth Circuit Affirms Order Allowing Disclosure of the Identity of a Nonparty Witness in Purported Class Action

Lefkoe v. Jos. A. Bank Clothiers, Inc., No. 08-2059 (4th Cir. Aug. 13, 2009)

In a proposed class action claiming that Jos. A. Bank Clothiers, Inc. and three of its officers violated federal securities laws through false and misleading statements, the U.S. Court of Appeals for the Fourth Circuit (with Judge Paul V. Niemeyer writing for a panel that included Associate Justice Sandra Day O'Connor) affirmed the U.S. District Court for the District of Maryland's order modifying a protective order and allowing Jos. A. Bank's counsel to disclose the identity of a nonparty witness. During the class period, the audit committee of the Jos. A. Bank board of directors had received a letter from Foley & Lardner LLP on behalf of an anonymous client, raising concerns about how Jos. A. Bank reported its inventory; the investigation of those concerns (which concluded that they were "'without substance'") delayed Jos. A. Bank's earnings report, resulting in a more than 5 percent decline in its stock. Jos. A Bank subsequently subpoenaed Foley & Lardner in Massachusetts, and Foley & Lardner moved to quash the subpoena because its client was entitled to anonymity under the First Amendment. When Jos. A. Bank took the deposition under the supervision of the U.S. District Court for the District of Massachusetts, Foley & Lardner produced the anonymous client. Upon conclusion of the deposition, the court entered a protective order, sealed the deposition and barred Jos. A. Bank's counsel from informing the company of the identity of the deponent, but allowed the Maryland court to modify the protective order. After Jos. A. Bank's counsel determined that the nonparty witness was a "known 'short seller'" who had a significant number of "puts" on Jos. A. Bank's stock and requested the Maryland court unseal the deposition, the Maryland court allowed Jos. A. Bank's counsel to reveal the nonparty witness's identity to Jos. A. Bank to pursue further discovery. The panel explained that the Maryland court had the authority to amend the protective order because the Massachusetts court had left the First Amendment issues to the Maryland court to decide in the first instance and explicitly noted that the Maryland court could amend its order. Further, because the nonparty witness's letter was commercial speech—it related solely to its economic interest—it was subject to less protection than other forms of speech under the First Amendment. Although the Supreme Court has recognized an implicit limited right of anonymity in the First Amendment, the panel explained that the substantial government interest in allowing Jos. A. Bank "a fair opportunity to defend itself in court" mandated limited disclosure of the nonparty witness's identity and further discovery. Disclosure and discovery were warranted because there was evidence that the nonparty witness sent the letter to deliberately drive down Jos. A. Bank's stock, and, as a short seller, its conduct may have caused the decline in Jos. A. Bank's stock price, not Jos. A. Bank's alleged fraud of malfeasance. Further, a significant amount of short selling is relevant to class certification issues in that Jos. A. Bank could argue that there was not an efficient market for its stock during the class period.

C) Derivative Suits

1) D.C. Federal Court Dismisses Derivative Suit Because Plaintiff's Claim That He Is a Relevant Shareholder Is Insufficiently Particular

DiLorenzo v. Norton, No. 07-144 (RJL) (D.D.C. July 31, 2009)

Judge Richard J. Leon of the U.S. District Court for the District of Columbia dismissed a derivative suit based upon ePlus Inc.'s stock option granting practices because the plaintiff only had standing under Rule 23.1 to challenge one of the nine stock option awards at issue (occurring between ePlus and eight of the company's directors and / or officers) and, as to that particular award, failed to adequately allege that demand was futile. The plaintiff's allegation that he "'is and at relevant times was' a shareholder" is insufficiently particular to satisfy Rule 23.1's requirement that plaintiff be a shareholder at the time of the challenged transaction; this requirement is particularly significant in options cases because each grant is treated as a separate, discrete transaction. Plaintiff did not become a shareholder until after all but one of ePlus's allegedly backdated grants (a 2004 option grant). The court applied the Delaware Supreme Court's *Aronson* test (*i.e.*, requiring particularized facts showing that (1) the directors are not disinterested and independent, or (2) the challenged transaction was not the product of business judgment) to determine if demand was excused, because the 2004 option grant was made by a four-director compensation committee. Directorial interest was not adequately pled, however, because the complaint did not establish a substantial threat of liability by showing that "the directors *knowingly* participated in the granting and / or concealment of backdated options," especially as ePlus's audit committee concluded that the 2004 option grant was unintentionally backdated. Similarly, because the complaint did not plead with sufficient particularity that the compensation committee knew that it backdated the 2004 option grant, the complaint did not adequately plead that the 2004 option grant was not the result of ordinary business judgment under *Aronson*.

2) Alabama Federal Court Dismisses Derivative Complaint for Failure to Adequately Plead Demand Futility

Playford v. Lowder, No. 2:09cv182-MHT (WO) (M.D. Ala. July 20, 2009)

Judge Myron H. Thompson of the U.S. District Court for the Middle District of Alabama dismissed a derivative suit against Colonial BancGroup, Inc. because the complaint did not adequately plead demand futility. (The complaint alleged that the defendants withheld material information about conditions for TARP funding and failed to oversee Colonial's mortgage-related exposure.) The complaint's allegation that a presuit demand was excused because the directors were named defendants in the lawsuit was insufficient because it did not show "'a substantial likelihood of director liability.'" The complaint did not allege any facts suggesting that the board "'utterly failed'" to have financial controls in place (*e.g.*, there was no allegation how the controls were insufficient, what the board should have done differently or how defendants were involved in the alleged failures), nor did it allege any particularized facts showing defendants consciously disregarded their duties or even knew they were violating them. Similarly, the complaint did not plead with particularity that any directors (aside from the chairman / CEO) were involved in the release of allegedly false or misleading statements or knew that those statements were false. Further, under Delaware law, members of the audit and compensation committees did not face a substantial likelihood of liability because they should have known public statements were false or misleading by virtue of their membership on those committees. Additionally, the complaint did not allege particularized facts that a majority of the board was not independent. Judge Thompson rejected the allegation that the directors associated with Auburn University were not independent because the complaint did not provide any explanation why their ties to Auburn undermined their independence. Similarly, the complaint did not explain why directors' contributions to Colonial's Federal Political Action Committee undermined their independence; those contributions suggested instead that directors were "invested" in Colonial's success.

D) Fed. R. Civ. P. 9(b) Pleading Standards

S.D.N.Y. Dismisses Claims Relating to Investment Banks' Cash Sweep Programs

DeBlasio v. Merrill Lynch & Co., Inc., No. 07 Civ. 318 (RJS) (S.D.N.Y. July 27, 2009)

Judge Richard J. Sullivan of the U.S. District Court for the Southern District of New York dismissed claims related to cash sweep programs offered by five investment banks, their retail brokerages and associated FDIC-insured banks. The claims were based upon violations of the Investment Advisors Act, Section 349 of the New York General Business Law, and common law breach of fiduciary duty, aiding and abetting breach of fiduciary duty, breach of contract, negligent misrepresentation and unjust enrichment. Through the cash sweep programs, the investment banks would invest their customers' uninvested balances into mutual funds or FDIC accounts (and award the interest to the clients) while still making those balances available for investment or withdrawal upon demand; the plaintiffs challenged the change from investing those balances in mutual funds to investing those funds in accounts at FDIC-insured banks, where the funds earned less interest but could be used by the banks for loans. Each investment bank was sued, along with its retail brokerage subsidiary and the bank at which those FDIC-insured accounts were placed. Judge Sullivan dismissed all of the claims except the Section 349 claim (which was not subject to Rule 9(b), according to the Second Circuit, but was dismissed on other grounds) for failure to plead fraud with the specificity required by Rule 9(b) because those claims all sounded in fraud. The complaint did not specifically allege any statements by the FDIC-insured banks (which is required by Rule 9(b)), connect the allegedly fraudulent conduct to a specific investment bank or retail brokerage (which is contrary to Rule 9(b)'s requirement that fraudulent conduct must be tied to specific defendants), or identify when or where the allegedly fraudulent statements were made. In addition, the allegations as to why those statements were misleading were deficient because there were no allegations that the investment banks were obligated to give investment advice in this context or why those statements made the cash sweep programs fraudulent. Further, the claims were all dismissed under Rule 12(b)(6) because none had the facial plausibility required by *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544 (2007) and *Ashcroft v. Iqbal* 129 S. Ct. 1937 (2009). The Investment Advisors Act claim failed because the cash sweep program agreements were not investment advisory contracts within the scope of that act, as the defendants did not provide investment advice in connection with uninvested cash. The fraud and negligent misrepresentations claims failed because the challenged statements — relating to putting the investor first—were mere puffery not constituting promises of future conduct, and the investment banks had disclosed how they would profit from the cash sweep programs. The fiduciary duty and negligence claims failed because there was no fiduciary duty breached by the cash sweep programs, nor were the defendants under a duty to maximize their investors' returns on uninvested balances. The breach of contract claim failed because the complaint did not identify a contract-based expectation that the cash sweep programs may have violated, and the Section 349 claim failed because there were no allegations of materially misleading statements likely to mislead a reasonable consumer. Finally, the complaint did not plead a proper nexus between the investment bank's alleged enrichment and the plaintiffs' expense to support an unjust enrichment claim.

E) Fiduciary Duties

1) Court of Chancery Refuses to Dismiss Complaint, Concluding That Controlling Shareholder Used His Influence to the Detriment of Minority Stockholders

Louisiana Municipal Police Employees' Retirement System v. Fertitta, No. 4339-VCL (Del. Ch. July 28, 2009)

In *Louisiana Municipal Police Employees' Retirement System v. Fertitta*, the Delaware Court of Chancery refused to dismiss a complaint that alleged breaches of the duty of loyalty and waste by a board of directors and its special committee in connection with an attempted leveraged buyout involving a controlling stockholder. Specifically, Landry's Restaurants, Inc. entered into a cash-out merger agreement with a subsidiary controlled by its chairman, CEO and 39 percent stockholder, Tilman J. Fertitta. Fertitta subsequently purchased enough additional stock on the open market—at a significantly lower price than the merger price—to become the majority shareholder of Landry's. Fertitta also negotiated on behalf of the company the refinancing of debt commitment letters that financed his purchase of Landry's. When Fertitta's banks asked for a routine information disclosure from the company, the Landry's board replied by terminating the merger agreement, and by doing so waived Fertitta's $15 million reverse termination fee. Plaintiffs sued Fertitta, Landry's board and the special committee charged with negotiating the buyout for breaches of the duty of loyalty and waste. The plaintiffs argued that Landry's board allowed Fertitta, as controlling stockholder, to control the board, and that the board breached its fiduciary duties of loyalty by failing to enact defensive devices to prevent Fertitta from harming the interests of the minority shareholders.

Vice Chancellor Stephen P. Lamb found that the complaint adequately alleged breaches of the duty of loyalty and excused demand for the plaintiffs' waste claim. The court held that taken together, three key allegations made it impossible to dismiss the complaint: (1) Fertitta's negotiation of the refinancing for the debt commitment letter (and the board's agreement to allow him to lead the negotiations); (2) "the board's apparent and inexplicable impotence in the face of Fertitta's obvious intention to engage in a creeping takeover;" and (3) the board's decision to terminate the merger agreement and thereby excuse Fertitta from paying the $15 million termination fee. According to the court, "[e]ach of these [allegations], taken individually, might raise the eyebrows of the court to varying degrees. But taken in the aggregate, they make it impossible for the court to state that to a 'reasonable certainty' there is no set of facts which may be inferred from the well-pleaded allegations in the complaint that would allow the plaintiff to prevail." Under the circumstances, the court found that the recent Delaware Supreme Court opinion in *Lyondell Chemical Co. v. Ryan*, 970 A.2d 235 (Del. 2009) did not apply because the complaint here alleged more than *Caremark* breaches of the duty of care. Rather, the board's refusal to employ a poison pill or other defensive devices to prevent Fertitta from avoiding paying a control premium, to the detriment of the minority stockholders, was a "failure to act in the face of an obvious threat" that supported a reasonable inference that the board breached its duty of loyalty. Though the court noted that directors do not have a *per se* duty to enact specific defensive measures in response to a stockholder's additional stock purchases, the court pointed out that "[t]o say there is no *per se* duty to employ a poison pill to block a 46% stockholder from engaging in a creeping takeover does not refute the conclusion that the board's failure to employ a pill, together with other suspect conduct, supports a reasonable inference at the motion to dismiss stage that the board breached its duty of loyalty in permitting the creeping takeover." In addition to refusing to employ a pill or other defensive device to prevent Fertitta's takeover, the board's choice to terminate the merger agreement and relieve Fertitta from paying the reverse termination fee "raises a question whether the board's decision to terminate and entirely excuse Fertitta's performance constituted a rational exercise of business judgment" that could not be resolved on a motion to dismiss.

The Court of Chancery concluded that it was reasonable to infer that "Fertitta used his influence on the corporation as controlling stockholder and / or corporate officer to his own benefit and to the detriment of the interests of the minority stockholders. The same facts also lead to the reasonable inference that the board and / or the special committee willingly acquiesced to Fertitta's scheming because he was the controlling stockholder." Significantly, the court held that *Lyondell* did not apply to a claim that "the board knowingly preferred the interest of the majority stockholder to those of the corporation or the minority."

2) Chancery Court Applies *Lyondell* in Case Challenging Activision-Vivendi Merger

Wayne County Employees' Retirement System v. Corti, No. 3534-CC (Del. Ch. July 24, 2009)

In this case, the Delaware Court of Chancery applied for the first time the Delaware Supreme Court's recent *Lyondell* analysis to dismiss *Revlon* claims. The court also provided guidance on issues such as the role of inside management in connection with the negotiation process, and whether a transaction involving a sale of control must provide a specific type of control premium. Specifically, in July 2008, the shareholders of Activision, Inc. (Activision) voted to approve the combination of Activision with Vivendi Games, Inc., (Games) in which Games' ultimate parent, Vivendi, S.A. became the majority shareholder of Activision. The $18 billion transaction combined Activision's interactive entertainment publishing business, which owns such breakout hits as Guitar Hero, Call of Duty and Tony Hawk, with Games' massively multiplayer online game (MMOG) business, which includes, through Games' subsidiary Blizzard Entertainment, the popular World of Warcraft franchise. The stockholder vote went forward as scheduled after defendants defeated the plaintiffs' application for an injunction of the vote to allow additional disclosures to be made to Activision's shareholders. The plaintiff shareholders then amended their complaint, asserting the same disclosure claims raised at the preliminary injunction hearing, as well as several other allegations challenging the conduct of the Activision board of directors in negotiating and approving the transaction. Specifically, plaintiffs alleged that Activision's directors breached their fiduciary duty of loyalty by allowing two Activision managers who were also directors to lead negotiations with both Vivendi and Activision's advisors. The defendants moved to dismiss the amended complaint.

Chancellor William Chandler found that the amended complaint failed to state a claim under Delaware law and dismissed all of the plaintiffs' claims in their entirety. The court found that plaintiffs failed to allege that the outside directors breached their duty of loyalty and failed to act in good faith because, as alleged, they "met several times in the months leading up to the transaction, regularly evaluated financial reports and analyses, and considered several facts and analyses in reaching a decision to approve the Combination." Citing *Lyondell*, the court held that alleging that a board failed to "probe for alternatives" does not state a claim for a breach of the duty of loyalty under *Revlon*. Furthermore, alleging that the directors did not obtain a "'control premium' or other protective devices for Activision shareholders" did not state a claim for breach of the duty of loyalty. The court also dismissed the plaintiffs' disclosure claims, finding that there were no material omissions in the company's 300-page proxy statement.

The court also found that in these circumstances, it was appropriate for a board to allow board members who were also managers to control negotiations. The court noted that "[w]hile a board cannot completely abdicate its role in a change of control transaction, Delaware law is clear that in certain circumstances it is appropriate for a board to enlist the efforts of management in negotiating a sale of control." Importantly, it was appropriate for management to aid negotiations because they did not have a debilitating conflict of interest in the transaction, and they did not control or dominate the outside directors. During the negotiations, the committee and board "met regularly" and "received updates on the status of the negotiations from [the two management members] and from professional financial and legal advisors." Taken together these facts "belie an inference that the outside directors completely abdicated their role in negotiating and approving the Combination."

The court also held that there is no *per se* rule requiring that in all cases, "the board obtain some separate consideration that could be separately identified as a 'control premium.'" The court emphasized once again that "Delaware law does not hold directors liable for failing to carry out a perfect process in a sale of control," and that the "relevant question" in a sale of control is whether directors "*utterly failed to attempt* to obtain the best sale price." The court also found that the plaintiffs' challenges to the Certificate of Incorporation of the new company were not ripe for judicial determination. Ultimately, the court dismissed the entire case pursuant to Rule 12(b)(6).

3) Chancery Court Holds That Insiders May Have a Duty to Speak When They Possess Material Information Not Known to the Counterparty in a Transaction

Latesco, L.P. v. Wayport, Inc., No. 4167-VCL (Del. Ch. July 24, 2009)

The Delaware Court of Chancery recently considered the following issue of first impression in both Delaware and elsewhere: What disclosures must an insider who is a party to a right of first refusal agreement make to an outsider who exercises that right of first refusal when selling a corporation's stock? In this case, a stockholder sought to monetize his minority investment in a private company he co-founded but in which he was no longer an insider. His stock sales were governed by an agreement giving the corporation and certain insiders' rights of first refusal. In one set of challenged transactions, the stockholder's sale of shares to a third party fell within the context of the right of first refusal agreement, and the company and insiders waived their rights of first refusal. In the second challenged transaction, which was not squarely governed by the right of first refusal agreement, two of the company's private equity investors exercised their rights of first refusal and the stockholder agreed to sell them more shares than he originally negotiated with the third party, but at a somewhat lower price than the first transaction. Thereafter, the selling stockholder learned that the company sold less than 10 percent of its assets at an advantageous price, and later the entire company was sold to a strategic buyer for a price substantially higher than the price of either of the selling stockholders' two sales transactions. The selling stockholder then sued the company, certain of its directors and officers and the two private equity investors for breach of fiduciary duty and fraud, claiming that the insiders should have disclosed certain information to him that the insiders allegedly knew about when purchasing his shares.

The Court of Chancery held that "[t]he performance of a stockholder agreement giving corporations or corporate insiders rights of first refusal over other stockholders' shares is not governed by any generalized fiduciary duty of disclosure like that known to exist when a corporation asks its stockholders to engage in some discretionary action (such as granting a proxy, voting or tendering shares). Nor is performance governed by any generalized application of the duty of loyalty. Instead, the contours of such an insider's duty to the selling stockholder is defined by the terms of the agreement itself and the normal prohibitions against fraud." Accordingly, the court dismissed the claims relating to the first transaction that fell within the agreement. As to the second transaction that was not squarely governed by the agreement, the court stated that, "[i]n contrast, where transactions are made outside of the confines of such an agreement, insiders should expect to observe the normal obligations of fiduciaries not to engage in transactions with stockholders while in possession of material information known to be unavailable to sellers." Because the complaint adequately alleged that certain portions of the second sales transaction fell outside the four corners of the agreement, the court declined to dismiss the claims for breach of fiduciary duty of loyalty and fraud arising from those transactions as against the two private equity investors, the company and its general counsel (all of whom had some role in the transactions). The duty of loyalty and fraud claims against the remaining individual director defendants (who had no role in the transactions) were dismissed.

In sum, the court noted that the fraud standard is a scienter-based standard that, in the case of a fiduciary like the insiders in this case, may include a duty to speak when, in purchasing or selling stock, the fiduciary is aware that material information is known to him but not to the counterparty in the transaction. The court emphasized that this standard for fraud "is not an instance of the fiduciary duty of disclosure that results from a call for stockholder action. The rule requiring calls for stockholder action to be accompanied by full and fair disclosure of all material information regarding the decision presented to the stockholders is premised on the collective action problem that stockholders, in the aggregate, are faced with when asked to vote or tender their shares."

4) Court of Chancery Refuses to Dismiss Claim That Directors Favored Preferred Over Common Stockholders in Approving Transaction

In re Trados Inc. S'holder Litig., No. 1512-CC (Del. Ch. July 24, 2009)

In *In re Trados Inc. Shareholder Litigation*, a former Trados, Inc. stockholder brought a class action for breach of fiduciary duty arising from a transaction whereby Trados became a wholly owned subsidiary of SDL plc. Of the $60 million merger consideration, Trados' preferred stockholders received approximately $52 million, and Trados executives received the remainder pursuant to a previously approved bonus plan. The common stockholders received no part of the merger consideration. Plaintiffs alleged that the merger "was undertaken at the behest of certain preferred stockholders that desired a transaction that would trigger their large liquidation preference and allow them to exit their investment in Trados," and argued that "there was no need to sell Trados at the time because the Company was well-financed, profitable, and beating revenue projections." Plaintiff alleged that in choosing to sell the company, the Trados board favored the interests of the preferred stockholders at the expense of the common stockholders. Moreover, plaintiffs alleged that the four directors designated by the preferred stockholders were incapable of exercising disinterested and independent business judgment, and that two Trados directors who were also employees received material personal benefits in the merger and were thereby incapable of exercising disinterested business judgment.

The Court of Chancery held that the plaintiff alleged sufficient facts at the motion to dismiss stage to "demonstrate that at least a majority of the members of Trados' seven member board were unable to exercise independent and disinterested business judgment in deciding whether to approve the merger." Under the well-pleaded facts of the complaint, it was reasonable to infer that the common stockholders would have received consideration for their Trados shares at some point in the future, and thus it was reasonable to infer that the interests of the preferred and common stockholders were not aligned with respect to the decision to pursue a transaction that would trigger the liquidation preference for the preferred and result in no consideration for the common.

The opinion suggests that, given a divergence of interests between preferred and common shareholders, a plaintiff can avoid dismissal if the complaint contains well-pleaded allegations that demonstrate that the director-defendants were interested or lacked independence with respect to a decision to pursue a merger. According to the court, while "[n]othing in this Opinion is intended to suggest that it would necessarily be a breach of fiduciary duty for a board to approve a transaction that, as a result of liquidation preferences, does not provide any consideration to the common stockholders." Rather, "in circumstances where the interests of the common stockholders diverge from those of the preferred stockholders, it is *possible* that a director could breach her duty by improperly favoring the interests of the preferred stockholders over those of the common stockholders." Here, the court found that "allegations of the ownership and other relationships of each of [the four directors] to preferred stockholders, combined with the fact that each was a board designee of one of these entities, is sufficient, under the plaintiff-friendly pleading standard on a motion to dismiss, to rebut the business judgment presumption with respect to the decision to approve the merger with SDL." Taken together, these facts suggested that the Trados board was not disinterested, and the court denied the defendants' motion to dismiss on this claim. The court did, however, dismiss other claims related to alleged improper revenue deferral for failure to state a claim.

F) Fixed-Income Annuities

D.C. Circuit Determines That Rule 151A Is Reasonable But That SEC Must Consider Section 2(b) Requirements

Am. Equity Inv. Life Ins. Co. v. Sec. & Exch. Comm'n, 572 F.3d 923 (D.C. Cir. 2009)

In a challenge to agency rulemaking, the U.S. Court of Appeals for the District of Columbia Circuit (with Chief Judge David Sentelle writing for the panel) determined that Rule 151A—promulgated by the SEC to include fixed indexed annuities (FIAs) in the scope of the Securities Act—was reasonable, but remanded the rule to the SEC because its consideration of the efficiency, competition and capital formation effects of the rule, required by Section 2(b) of the Securities Act, was arbitrary and capricious. FIAs are hybrid financial products that combine some of the benefits of traditional fixed annuities with payments based on the retrospective performance of securities indexes. Under the analysis required by the Supreme Court's decision in *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), the panel determined first that the Securities Act was ambiguous on what constituted an annuity contract excluded from the scope of the Securities Act. Second, the SEC's determination that FIAs were not annuity contracts excluded from the scope of the Securities Act was reasonable, because of FIAs' security-like qualities (*e.g.*, an FIA annuity payment can only be determined retrospectively), exposing purchasers to significant securities-like investment risk. The SEC's consideration of Rule 151A's effect on "efficiency, competition, and capital formation," however, was "arbitrary and capricious," because the SEC did not consider the current level of state regulation in its analysis. Because the SEC did not assert that Section 2(b) did not apply during its rulemaking process and merely analyzed the benefits of having a rule, the panel remanded Rule 151A to the SEC to analyze if, under Section 2(b), the "specific rule" would promote efficiency, competition and capital formation.

G) Indemnification

Delaware Court of Chancery Interprets Partnership Agreement to Require Advancement of Directors and Officers' Legal Fees

Stockman v. Heartland Industrial Partners, L.P., No. 4227-VCS (Del. Ch. July 14, 2009)

In *Stockman v. Heartland Industrial Partners, L.P.*, the Delaware Court of Chancery interpreted indemnification and advancement provisions in a limited partnership agreement to require mandatory advancement of directors and officers' legal fees. Plaintiffs David Stockman and J. Michael Stepp, former officers and directors of defendant Heartland Industrial Partners, L.P., a significant investor in Collins & Aikman Corporation (C&A), sought advancement and indemnification from Heartland under Heartland's partnership agreement for a dismissed criminal action against them in their capacity as former C&A directors and officers.

The Court of Chancery held that, with respect to the advancement claims, there was only one reasonable interpretation of the partnership agreement, which is that Heartland's general partner did not have discretion to withhold its written approval and defeat the contractual right to mandatory advancement. Any ambiguity in the partnership agreement was to be read against Heartland. As to indemnification, the Court of Chancery denied Heartland's motion to dismiss, holding that the partnership agreement did not clearly require an indemnitee to plead and demonstrate good faith, lawfulness and scienter where, as here, the criminal claims against the indemnitees had been dismissed without prejudice and thus the dismissal could be considered a success. The court also commented that to the extent that there was any doubt about whether the indemnification provisions required mandatory indemnification, important principles of contract interpretation and public policy would weigh in favor of providing the indemnification. In dicta, the Court of Chancery indicated support for the plaintiffs' reading of the partnership agreement, consistent with 8 *Del. C.* § 145, that indemnification was mandatory for legal fees in actions dismissed without prejudice. The court reasoned that "turning an indemnification case into a hypothetical trial on the merits of a dismissed case is a bizarre notion to propose and would be counterproductive to Delaware's policy goal of assuring indemnitees that their reasonable expenses will be borne by the corporation they have served if they are vindicated."

H) Jurisdiction

Eleventh Circuit Determines Federal Courts Have Jurisdiction Over Foreign Class Claims Because Conduct Occurred in Florida

In re CP Ships Ltd. Sec. Litig., No. 08-16334 (11th Cir. Aug. 13, 2009)

In an appeal of a class action settlement in the Middle District of Florida, the U.S. Court of Appeals for the Eleventh Circuit (with Judge R. Lanier Anderson writing for the panel) determined that the federal courts had jurisdiction over Section 10(b) claims brought by foreign class members who purchased stock in CP Ships, which is organized under the laws of Canada and officially headquartered in England, on the Toronto Stock Exchange. The class alleged that CP Ships understated its operational costs when it transitioned to a single accounting platform for the nine different businesses it had acquired. The panel explained that, although courts normally considered both "'whether the wrongful conduct occurred in the United States'" (*i.e.*, the conduct test) and "'whether the wrongful conduct had a substantial effect in the United States or upon United States citizens'" (*i.e.*, the effects test), enough facts were pled to establish jurisdiction over the foreign class members' claims under the conduct test alone, requiring that the activities within the United States "'were more than merely preparatory'" and "'directly caused the claimed losses.'" As in *Sec. & Exch. Comm'n v. Berger*, 332 F.3d 187 (2d Cir. 2003), the manipulation and falsification occurred in CP Ship's Florida offices, where the accounting transition occurred and where CP Ship's COO (later CEO)—who masterminded the scheme, made several of the challenged statements and bore "primary responsibility" for ensuring "accuracy of financial information"—was located. Because the operations "'central to the misconduct'" were located in Florida and the COO was located in Florida, the alleged Section 10(b) violations were "direct[ly] and immediate[ly]" caused by conduct in the United States, even though other defendants operated out of England and made other challenged statements. The panel determined that the notice was reasonably given to foreign class members about the effect of the proposed settlement on a pending class action in Canada (by expressly informing class members about that action, providing contact information for inquiries and explaining that not opting-out "might" preclude participating in that action), and that, because notice of the pending Canadian class action was reasonable, the district court did not abuse its discretion in approving the class action settlement.

I) Loss Causation

California Federal Court Largely Dismisses Maxim Shareholder Action

In re Maxim Integrated Products, Inc. Sec. Litig., No. C 08-00832 JW (N.D. Cal. July 16, 2009)

District Judge James Ware of the U.S. District Court for the Northern District of California largely dismissed a Section 10(b) claim against Maxim Integrated Products, Inc. because plaintiffs failed to plead adequately that their losses were caused by Maxim's purported disclosure of the misleading information. In the underlying action, plaintiffs brought a putative class action alleging violations of Sections 10(b) and 20(a) of the Securities Exchange Act and Rule 10b-5 thereunder against Maxim and several former Maxim officers and directors. Plaintiffs alleged that, from 1994 to 2008, defendants artificially inflated Maxim's stock price through large-scale and systematic backdating of Maxim stock options, coupled with false and misleading statements regarding their backdating practices in financial statements, press releases and conference calls. Maxim moved to dismiss the complaint primarily on the ground that plaintiffs failed to adequately plead loss causation.

Judge Ware partially granted Maxim's motion to dismiss, in large part because plaintiffs failed to adequately plead that many of the purported corrective statements caused Maxim's share price to decline. The court explained that, although corrective statements "need not identify an actual admission or finding of fraud," they must reveal "more than a "'risk" or "potential" for widespread fraudulent conduct'" and "must reveal some aspect of the alleged fraud to the market." Based on this standard, the court held that plaintiffs could not prove loss causation based on many of the purported curative disclosures, because "[w]hile each of the[] disclosures provide[d] notice that Maxim *may* have illicitly backdated stock options, none of them [went] beyond speculation." At most, many of the purported curative disclosures identified a "risk for potential earnings restatement," that Maxim "may have engaged in aggressive practices," and that backdating could be expected to be a "contentious issue" when being rated by other analysts. Similarly, the court concluded that Maxim's "disclosures regarding compliance with an SEC investigation, subpoenas from the United States Attorney's office, and the formation of its own Special Committee to investigate options granting practices…are not corrective disclosures for which Plaintiffs can plead loss causation." Nor could plaintiffs state a claim based on Maxim's corrective disclosure on January 31, 2007, because the alleged economic loss resulted from a stock price drop on August 28, 2007, which defeated any "plausible connection between corrective information and Plaintiffs' economic loss." The court did, however, hold that plaintiffs stated a claim based on a January 17, 2008, press release that disclosed the "scope and magnitude of Defendants' fraudulent conduct that was not previously disclosed."

J) Penalties

Georgia Federal Court Levies Tier-One Financial Penalties Against Merchant Capital

Sec. & Exch. Comm'n v. Merchant Capital, LLC, No. 1:02-CV-2984-MHS (N.D. Ga. July 28, 2009)

Judge Marvin H. Shoob of the U.S. District Court for the Northern District of Georgia found that Merchant Capital and its two principals were strictly liable for violations of Sections 5(a) and (c) of the Securities Act and Section 15(a) of the Securities Exchange Act and had violated Sections 17(a)(2) and (3) of the Securities Act through their negligent conduct, and thus were subject to tier-one financial penalties. The judge declined to enter an injunction or order disgorgement, and determined that the defendants did not have scienter and thus did not violate Section 17(a)(1) of the Securities Act or Section 10(b) of the Securities Exchange Act. The case arose when Merchant sold interests in Colorado registered limited liability partnerships formed to collect debt pools of freshly charged-off consumer debt. For the Section 10(b) and 17(a)(1) claims, Judge Shoob determined that the defendants did not have scienter because their statements were true or not known to be false, and, at most, defendants acted negligently. Further, Merchant's failure to disclose that some of the partnerships were performing below expectations or that one of the principals had previously declared personal bankruptcy was not "'highly unreasonable'" because the partnerships were in their infancy, and Merchant had disclosed the high-risk nature of the venture and based the projections on a reasonable business model. Similarly, it was not "'highly unreasonable'" not to disclose a California cease-and-desist order when Merchant had only learned of it within 30 days and was disputing the findings. Consequently, Judge Shoob declined to grant injunctive relief because the SEC did not offer evidence that the defendants were likely to violate securities laws in the future, as the defendants acted in good faith and following seven years of litigation by the SEC, "defendants would have to be crazy to risk incurring the wrath of the SEC again." (In fact, the judge noted that the SEC's "relentless pursuit," costing the defendants "untold amounts in attorney's fees," was "much more egregious" than the defendants' conduct.) Disgorgement also was unnecessary because the investors recovered approximately two-thirds of their capital contributions and the defendants acted in good faith, fully disclosed the risk of the partnerships and were merely negligent. Finally, in light of defendants' good faith conduct, only first-tier penalties under Section 20(d) of the Securities Act and Section 21(d)(3) of the Securities Exchange Act were appropriate.

K) Prosecutorial Misconduct

Ninth Circuit Reverses Reyes' Backdating Conviction Due to Prosecutorial Misconduct

United States v. Reyes, No. 08-10047 (9th Cir. Aug. 18, 2009)

The U.S. Court of Appeals for the Ninth Circuit, in an opinion authored by Circuit Judge Mary M. Schroeder, reversed a jury conviction of Gregory Reyes, former chief executive officer of Brocade Communication Systems, Inc., for his alleged role in Brocade's backdating of stock options. The jury had convicted Reyes of conspiracy, securities fraud, making false filings to the SEC, falsifying corporate books and records, and making false statements to auditors. Following the conviction, Reyes was sentenced to 21 months of imprisonment and fined $15 million. Reyes appealed the decision.

The Ninth Circuit reversed Reyes' conviction because "the record demonstrates that the prosecution argued to the jury material facts that the prosecution knew were false, or at the very least had strong reason to doubt." Specifically, the prosecution told the jury in its closing argument that no one in Brocade's finance department knew about the backdating. As the prosecution was aware, certain Brocade employees in the finance department had previously made statements to the FBI that established that executives in the finance department had known about the backdating. In addition, the SEC alleged in parallel civil suits that members of the finance department had known about the backdating. The court found that the prosecution's knowing misstatements were not harmless because, among other things, a key defense during the trial was that Reyes signed off on the backdated options without any intent to deceive and acted in reliance on Brocade's finance department to properly account for the stock options. As the Ninth Circuit explained, "[w]e do not lightly tolerate a prosecutor asserting as a fact to the jury something known to be untrue or, at the very least, that the prosecution had very strong reason to doubt. There is no reason to tolerate such misconduct here."

L) PSLRA Lead Plaintiffs

S.D.N.Y. Follows Second Circuit Decision in Naming New Lead Plaintiff Under the PSLRA

In re IMAX Sec. Litig., No. 06 Civ. 6128 (NRB) (S.D.N.Y. June 29, 2009)

In January 2007, Judge Naomi Reice Buchwald of the Southern District of New York appointed Westchester Capital Management, Inc., an investment advisor suing on behalf of client funds, as the proposed class action lead plaintiff under the Private Securities Litigation Reform Act (PSLRA) over Snow Capital Investment Partners, L.P. However, in light of the Second Circuit's decision in *W.R. Huff Asset Management Co., LLC v. Deloitte & Touche LLP*, 549 F.3d 100 (2d Cir. 2008), *cert. denied*, 129 S. Ct. 2011 (2009), Judge Buchwald granted Snow Capital's motion for reconsideration and appointed it as the lead plaintiff and its counsel, Coughlin Stoia Geller Rudman & Robbins, as lead counsel. Under *W.R. Huff*, because Westchester Capital only held power-of-attorney to assert a claim on behalf of the actual owners of the securities, and thus did not have "'legal title to, or a [proprietary] interest in, the claim,'" it lacked a sufficient ownership interest and consequently the requisite injury-in-fact to have Article III standing. Westchester Capital subsequently executed assignments of claims with its client funds assigning it the property rights in those funds' claims against the defendants to address its lack of standing. However, upon analyzing Westchester Capital's typicality and adequacy (as required by the PSLRA), Judge Buchwald concluded that Westchester Capital no longer could serve as lead plaintiff because the assignments of claim subjected it to "'unique legal issues'" that "could ultimately severely prejudice the class," even if those assignments of claim addressed its standing issue. Applying the PSLRA's presumptions of the proper lead plaintiff, the judge appointed Snow Capital as the lead plaintiff because it had the largest financial interest after Westchester Capital. The court also rejected the application of another party that claimed its helping draft the initial complaint and participating in class certification proceedings made it better suited to be appointed the lead plaintiff.

M) Registration Statements

Connecticut Federal Court Dismisses Registration Statement Claims Because Complaint Did Not Plead That Omissions Were Material

Hutchison v. CBRE Realty Fin., Inc., No. 3:07CV1599 (SRU) (D. Conn. July 29, 2009)

Applying *Iqbal* and *Twombly*'s requirement that a plaintiff must state a "plausible" claim based on its factual allegations, Judge Stefan R. Underhill of the U.S. District Court for the District of Connecticut dismissed claims that CBRE Realty Finance, Inc.'s IPO registration statement and sales prospectus violated Sections 11, 12(a)(2) and 15 of the Securities Act by failing to disclose the risks associated with secured loans provided to debtors experiencing "severe financial distress" because the complaint did not plead that that omission was material. Although *Zirkin v. Quanta Capital Holdings Ltd.*, No. 07 Civ. 851(RPP), 2009 WL 185940 (S.D.N.Y. Jan. 23, 2009) (*Coronel v. Quanta Capital Holdings Ltd.*, No. 07 Civ. 1405(RPP), 2009 WL 174656 (S.D.N.Y. Jan. 26 2009), *Lin v. Interactive Brokers Group, Inc.*, 574 F. Supp. 2d 408 (S.D.N.Y. 2008), and *Panther Partners, Inc. v. Ikanos Communications, Inc.*, 538 F. Supp. 2d 662 (S.D.N.Y. 2008) suggest that securities issuers could escape liability under Sections 11 and 12(a)(2) if they did not know or have reason to know that an offering statement was materially misleading, Judge Underhill concluded that "current prevailing law" — most notably the Supreme Court's decision in *Herman & MacLean v. Huddleston*, 459 U.S. 375 (1983) — subjects issuers to strict liability for misstatements in offering statements, "regardless of whether the material omitted facts were known or knowable or not." However, those misstatements must be material, *i.e.*, they would "alter[] the total mix of information available to a reasonable potential investor." Consequently, the plaintiffs were required to plead that CBRE's omission of the possibility of default on those loans was material by alleging that default, if it occurred, could result in a loss for CBRE. Because plaintiffs did not do so (and also failed to allege that the collateral securing those loans was insufficient to cover the amount owed on those loans), CBRE's failure to disclose the potential default in those secured loans was not a material misstatement and did not alter the total mix of information available to a reasonable potential investor. Judge Underhill dismissed the Section 15 controlling-person claims because the complaint failed to allege the Sections 11 and 12(a)(2) predicate violations.

N) Remedies

S.D.N.Y. Dismisses Purported Class in Auction Rate Securities Case Because Purchaser Alleged No Recoverable Damages

Aimis Art Corp. v. Northern Trust Sec., Inc., No. 08 Civ. 8057 (VM) (S.D.N.Y. Aug. 6, 2009)

Judge Victor Marrero of the U.S. District Court for the Southern District of New York dismissed a purported class action brought by an auction-rate-securities purchaser claiming that the defendants violated Section 10(b) of the Securities Exchange Act by misrepresenting the risks inherent in auction rate securities, because the purchaser had not alleged any recoverable damages. The purchaser had invested in auction rate securities at the defendants' recommendation and, following the collapse of the market in February 2008, was unable to liquidate the investment; however, in December 2008, the purchaser received its investment back. Consequently, because the purchaser effectively rescinded the transaction when it received its investment back and because Section 10(b) plaintiffs—like the purchaser—are required to select between rescission and compensatory damages, the purchaser could not recover additional damages through its Section 10(b) claims. Similarly, the purchaser could not recover damages for not being able to liquidate its investment between February and December 2008 and put it to alternative uses because Section 28(a) of the Securities Exchange Act limited the purchaser to only its actual damages, not "speculative" damages such as the purchaser's theory. While the purchaser had rescinded the transaction, other members of the purported class had not and still held the securities. Therefore, the court determined that the purchaser could not represent class members who did not redeem their auction rate securities because the purchaser had not suffered the injury that those class members suffered.

O) SEC Practice Disbarment

D.C. Circuit Affirms SEC's Barring of Deloitte Engagement Partner

Dearlove v. Sec. & Exch. Comm'n, No. 08-1132 (D.C. Cir. July 24, 2009)

The U.S. Court of Appeals for the District of Columbia Circuit (with Judge Douglas Ginsburg writing for the panel) affirmed the SEC's decision that the engagement partner in charge of Deloitte & Touche's 2000 audit of Adelphia Communications (Dearlove) had engaged in repeated unreasonable conduct violating accounting and auditing standards, thereby violating SEC Rule 102, and therefore barring him from practicing before the SEC. The panel explained that Rule 102 required the SEC to determine only if Dearlove's conduct was unreasonable under the facts at issue and if that conduct violated GAAP or GAAS; there was no requirement that Dearlove's conduct be negligent or that the standard of care be established through expert testimony. Adelphia was owed money by entities controlled by Adelphia's controlling shareholders and owed money to other entities also controlled by those same shareholders, totaling more than $1 billion. Adelphia netted all of the money it was owed by entities controlled by those shareholders against the money it owed to other entities controlled by those shareholders, showing only a "'Related Party Receivable'" of $3 million on its balance sheet in violation of GAAP. Even though previous Deloitte engagement partners had approved Adelphia's netting practice, Dearlove's conduct in supervising Adelphia's audit was unreasonable, because he approved Adelphia's netting practice after determining that the audit was high-risk due to the number of related-party transactions between Adelphia and other entities controlled by its controlling shareholders.

P) Securities Fraud Pleading Standards

1) Second Circuit Affirms Dismissal of 10(b) Claim That Hinged on an Oral Agreement

South Cherry Street, LLC v. Hennessee Group LLC, No. 07-3658-cv (2d Cir. July 14, 2009)

The U.S. Court of Appeals for the Second Circuit, with Judge Amalya Kearse writing for the panel, concluded that the district court properly dismissed an investor's claims that Hennessee Group—which advises on hedge funds investments—breached its oral agreement with the investor and violated Section 10(b) of the Securities Exchange Act by recommending the investor invest in Bayou Accredited Fund, LLC. (Bayou Accredited Fund, LLC was part of the Ponzi scheme run by Samuel Israel III and Daniel Marino.) The Southern District of New York had dismissed the claims because the complaint failed to adequately plead scienter and attempted to enforce an unenforceable contract under the statute of frauds. The investor claimed that Hennessee Group falsely represented Israel's and Marino's prior experience and that Bayou Accredited Fund "'passed all stages of Hennessee Group's due diligence process.'" However, because Hennessee Group's obligation to perform ongoing due diligence on hedge funds was part of an oral agreement not evidenced by a writing, the investor's claim for a breach of that oral agreement was properly dismissed as unenforceable under New York's statute of frauds (which prohibits enforcement of oral agreements that cannot be completed in one year) as Hennessee Group could not cease performing ongoing due diligence within one year without breaching the oral agreement. The panel determined that the Section 10(b) claim was properly dismissed, because the investor did not plead sufficiently that Hennessee Group intentionally or recklessly misled the investor in recommending that it invest in Bayou Accredited Fund to support an inference of scienter under the PSLRA's heightened pleading standards. The complaint did not allege that Hennessee Group made intentional misrepresentations, because it also alleged that it "'would' have learned the truth…if [it] had performed the 'due diligence' it promised." Similarly, the complaint failed to allege recklessness by not including any allegations showing that Hennessee Group acted in such a way as to "approximate" an intent to mislead the investor. The closest was an allegation that if Hennessee Group had verified Bayou Accredited Fund's auditors, it would have discovered that those auditors were controlled by Marino. The panel, however, concluded that, at most, "it would be plausible to infer that Hennessee Group had been negligent," and "far less plausible" to infer that Hennessee Group (which prides itself on its expertise, its principal's testifying before Congress, and its "thorough due diligence process") would have recommended to the investor and other clients a hedge fund into which it had made "little or no inquiry." Finally, even though the investor suggested on appeal that Hennessee Group may have received undisclosed payments from Bayou Accredited Fund, the panel noted that *Twombly*'s and *Iqbal*'s prohibitions on discovery without prior allegations of facts "'suggestive of illegal conduct'" "underscore[d]… the deficiency in the Complaint" and did not salvage the complaint.

2) Fourth Circuit Rules Claims Were Properly Dismissed But Vacates Denial of Plaintiff's Motion for Leave to Amend

Matrix Capital Mgmt. Fund LP v. BearingPoint, Inc., No. 08-1035 (4th Cir. July 31, 2009)

The United States Court of Appeals for the Fourth Circuit (with Judge M. Blane Michael writing for the panel) determined that the district court properly dismissed claims that BearingPoint, its former chairman and CEO, and its former CFO violated Section 10(b) of the Securities Exchange Act, but vacated the district court's decision denying the plaintiffs' motion for leave to amend the complaint. The case arose out of BearingPoint's 8-K, 10-Q and 10-K filings about its financial condition as it struggled to integrate foreign consulting groups it had acquired and to implement proper internal controls and financial accounting systems. The panel concluded that the operative complaint did not adequately plead scienter, because the facts alleged—taken collectively—did not support a strong inference that either of the individual defendants or any other corporate agent acted knowingly or recklessly with respect to the alleged misstatements. Further, the panel concluded that the district court erred in denying the plaintiffs' motion to amend the complaint, because it did not apply the three factors in *Laber v. Harvey*, 438 F.3d 404 (4th Cir. 2006) (en banc) (whether amendment would be prejudicial to the defendants, if the plaintiffs acted in bad faith and if amendment would be futile), in determining whether to permit amendment. The panel determined that the proposed amended complaint would not prejudice the defendants because the plaintiffs sought only to "add specificity" to their scienter allegations, and that amendment may not have been futile as those additional allegations could affect the analysis of whether the plaintiffs had satisfied the PSLRA's scienter pleading requirements. Further, although the case had been pending for nearly 2 1/2 years when the plaintiffs sought leave to amend, their delay was not in bad faith because "[n]othing in the case history" supported a finding that the delays were the plaintiffs' fault or that they "wasted any opportunity" to file an adequate complaint. The plaintiffs had "promptly" filed an amended complaint once BearingPoint filed its earnings restatement. Then, while BearingPoint's motion to dismiss was pending, the district court stayed the case *sua sponte* pending the Supreme Court's decision in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007), and the district court held oral argument three months after *Tellabs* — while courts were "just beginning to explore" *Tellabs*. The plaintiffs' strategy to attempt to support their operative complaint instead of filing a formal motion to amend similarly did not amount to bad faith.

3) Pennsylvania Federal Court Dismisses Complaint Over Mortgage-Backed Securities

Luminent Mortgage Capital, Inc. v. Merrill Lynch & Co., No. 07-5423 (E.D. Pa. Aug. 20, 2009)

Judge Barclay Surrick of the U.S. District Court for the Eastern District of Pennsylvania dismissed the complaint of plaintiffs Luminent Mortgage Capital, *et al.*, alleging that defendants Merrill Lynch & Co. and six Merrill Lynch subsidiaries misrepresented and failed to disclose material information relating to the mortgage-backed securities that plaintiffs purchased. In August 2005, plaintiffs purchased three classes of Mortgage Loan Asset-Backed Certificates. In advance of the sale, defendants received an Excel spreadsheet that described the characteristics of the mortgage loans underlying the certificates. Plaintiffs alleged that in April 2007, they discovered misrepresentations concerning the terms of the loans and a lack of due diligence by defendants on the underlying loans. Plaintiffs allege that because of defendants' misrepresentations, the mortgage-backed securities that plaintiffs purchased carried a higher risk and offered less return than expected. Plaintiffs' claims under Section 10(b) and Rule 10b-5 of the Securities Exchange Act were dismissed. Plaintiffs' complaint failed to give rise to a strong inference of scienter because although plaintiffs claimed that the discrepancies between the spreadsheet and the actual loans could only be explained through recklessness, there were no facts alleged to distinguish between recklessness or an intent to defraud and mere negligence. Further, shortly after plaintiffs purchased the mortgage-backed securities, they sold them back to defendants as collateral for a loan. Thus, the court indicated that "[t]o find that Defendants acted with scienter in selling securities to Plaintiffs based on the same underlying mortgage loans that Defendants accepted as collateral would be 'to assume that the Defendants intentionally defrauded the Plaintiffs to their own ultimate detriment.'" Plaintiffs also failed to adequately plead economic loss because the complaint was silent as to how any loss could be distinguished from the marketwide losses in mortgage-backed securities generally. Similarly, plaintiffs failed to adequately plead loss causation because plaintiffs failed to show how the loss was caused by the purported fraud and not the collapse of the real estate and mortgage markets. Further, the alleged injury was not sufficiently close in time to the alleged misrepresentations to show causation. Plaintiffs' claim under Section 12(a)(2) of the Securities Act was dismissed because Section 12(a)(2) does not apply to the private sale of securities. The issuing trust issued 11 of 14 classes to the public pursuant to a prospectus and prospectus supplement. Plaintiffs' three classes were not among those offered to the public but were purchased in a private offering. The court rejected plaintiffs' argument that because the certificates "were issued simultaneously with, and as an integral part of a public offering," Section 12(a)(2) should apply.

Q) Settlements

1) Court of Chancery Approves Class Settlement in Countrywide/Bank of America Merger

In re Countrywide Corp. S'holders Litig., No. 3464-VCN (Del. Ch. Aug. 24, 2009)

In this opinion, the Delaware Court of Chancery approved a proposed settlement of class action claims related to the Countrywide / Bank of America (BOA) merger. In a previous opinion, the court had rejected a proposed settlement that provided for a release of virtually all of the claims raised in connection with the merger in exchange for supplemental disclosures in advance of the stockholder vote on the merger, but no additional monetary consideration. The court had refused to approve the settlement because it released certain common law fraud claims based on statements made by BOA's chief executive officer in a speech to the Delaware State Chamber of Commerce where the CEO dismissed rumors of Countrywide's impending bankruptcy (the CEO statements). The parties revised the settlement to explicitly carve out those common law fraud claims. SRM, a potential class member, objected to the new proposed settlement on three grounds: (1) that it provided no monetary compensation for the release of federal securities claims based on the CEO statements, (2) that money damages claims predominated and a mandatory class action was impermissible and (3) the general release provision of the proposed settlement was overbroad because it released claims based on different operative facts from the underlying action. SRM also requested the court to require common law fraud claims related to recently discovered statements by BOA's CEO to be carved out of the proposed settlement.

The Court of Chancery held that, as to SRM's first objection, the absence of monetary consideration did not render the settlement unfair. The court ruled that "the absence of a monetary benefit is not fatal to a settlement which, almost by definition, confers only a therapeutic benefit." The court noted that there was no evidence that the price paid by BOA was unfair, or that there was any other potential acquiror. Rather, where a challenged transaction is fairly priced, a settlement does not have to include monetary consideration to be fair and reasonable. The court also found that because the federal securities claims based on the CEO statements were likely not valid, "surrendering them in the context of this settlement for only therapeutic disclosures is neither unfair nor unreasonable." As to the second objection, the court found that the federal securities law claims based on the CEO statements did not predominate over equitable claims. Because courts "have recognized the validity of executing a general release that encompasses federal claims in the settlement of a state law class action," it was appropriate to foreclose federal securities claims arising out of the statements. The court also held that the release provision was not overbroad, because the BOA / Countrywide merger was the event upon which the complaint was based, and the CEO statement was part of the same set of operative facts. The court found that "[t]here is no legal requirement that a cause of action be the subject of a claim for specific relief or actually litigated in order to be released. Because the [CEO] statements cannot be characterized as 'unrelated, or tangential to, or remote from, the conduct that forms the basis for the specific claims for relief asserted,' approving the parties' inclusion of claims arising from them in the Proposed Settlement's general release provision is not improper."

The court also found that the settlement did not have to carve out additional common law fraud claims based on recently identified statements by BOA's CEO about the long-term value of Countrywide. The court held that the recently identified common law fraud claims required proof of individual reliance, and SRM could not have relied on those statements in making a decision to hold, instead of selling, Countrywide stock, since SRM was not a shareholder at the time the statement was discovered. Ultimately, the court approved the class action settlement and awarded attorneys fees based on therapeutic disclosures.

2) Sixth Circuit Holds That Settlement Payments to Defendants Are Exempt From Avoidance Under Bankruptcy Law

In re QSI Holdings, Inc., No. 08-1176 (6th Cir. July 6, 2009)

In an issue of first impression in the circuit, the U.S. Court of Appeals for the Sixth Circuit, in an opinion authored by Circuit Judge Alan E. Norris, held that the "settlement payment defense" provided by Section 546(e) of the Bankruptcy Code in fraudulent conveyance actions "extends to transactions, such as the leveraged buyout at issue here, involving privately held securities." In the underlying adversary proceeding, plaintiffs QSI Holdings, Inc. and debtor Quality Stores Inc. (Quality) sought to avoid and recover payments made to 170 defendant-shareholders of Quality in connection with Quality's leveraged buyout. Plaintiffs claimed that the defendant-shareholders received too much cash for their Quality shares as part of the leveraged buyout. The bankruptcy court held that Section 546(e) barred plaintiffs' ability to recover from the defendant-shareholders in a fraudulent conveyance action. Plaintiffs appealed to the district court, which affirmed the bankruptcy court. Plaintiffs further appealed. As a bankruptcy appeal, the Sixth Circuit reviewed the bankruptcy court's order directly and gave no deference to the district court's decision.

The Sixth Circuit affirmed that Section 546(e) barred plaintiffs' claim for avoidance because the challenged transaction involved a "settlement payment…made by or to a…financial institution." In deciding whether the payment was a "settlement payment," the court described the pertinent statutory test as whether the payment was one "'commonly used in the securities trade.'" The court concluded, contrary to the holdings in other circuits, that transactions involving privately held securities could qualify as a "settlement payment" under this test. Next, the court held that the settlement payments were exempt under Section 546(e) because they involved a "transfer" to a "financial institution." Creating a further circuit split, the court held that a transaction may involve a "transfer" to a "financial institution" even if the financial institution does not obtain a financial interest in the funds or the shares. According to the Sixth Circuit, it was enough that a bank, HSBC Bank USA, collected the shares of Quality stock from individual shareholders and distributed the cash. The court held that "[t]he role played by HSBC Bank in the LBO at issue was sufficient to satisfy the requirement that the transfer was made to a financial institution."

R) Short-Swing Profits

Ninth Circuit Refuses to Expand Beneficial Ownership Status for Section 16(b) Liability

Dreiling v. America Online Inc., No. 08-35095 (9th Cir. Aug. 19, 2009)

The U.S. Court of Appeals for the Ninth Circuit, in an opinion authored by Circuit Judge N. Randy Smith, affirmed a summary judgment order disposing of a derivative action brought by a former shareholder of InfoSpace, Inc. against America Online, Inc. (AOL), because AOL was not subject to insider trading liability under Section 16(b) of the Securities Exchange Act of 1934 as a beneficial owner of more than 10 percent of InfoSpace shares. In the underlying action, plaintiff sought disgorgement of AOL's profits derived from the sale of its InfoSpace stock pursuant to Section 16(b). AOL acquired InfoSpace stock as part of a 1998 agreement to jointly operate an online telephone directory, the "AOL White Pages." While AOL owned some InfoSpace stock, it did not individually own 10 percent of InfoSpace's stock. The district court granted summary judgment because AOL was not a beneficial owner of 10 percent of InfoSpace, and plaintiff appealed.

The Ninth Circuit, reviewing the district court's opinion *de novo*, affirmed that AOL could not be held liable under Section 16(b) because it was neither an officer nor director, nor did it own more than 10 percent of InfoSpace's stock. In so holding, it rejected the investor's argument that AOL could be considered a beneficial owner of more than 10 percent of InfoSpace shares by way of its relationship with InfoSpace's CEO and shareholder, Naveen Jain. While acknowledging that a court may impute beneficial ownership to a "group" when the group's members "agree to act together for the purpose of acquiring, holding, voting or disposing of equity securities of an issuer," no such agreement existed here. Rather, the court found that "[t]he record demonstrate[d] that AOL entered into its Agreement with InfoSpace in order to 'jointly operate the AOL White Pages.'" The court concluded that "[b]y bringing a Section 16(b) action against AOL, [plaintiff] attempt[ed] to shoehorn facts that at worst may [have] shown aiding and abetting accounting fraud—a theory for which [plaintiff] would have no recovery—into an ill-fitting theory he hope[d] to broaden."

S) Whistleblower Protections

Ninth Circuit Issues Its First Opinion on Requirements of SOX Whistleblower Claim

Van Asdale v. International Game Technology, No. 07-16597 (9th Cir. Aug. 13, 2009)

The U.S. Court of Appeals for the Ninth Circuit, in an opinion authored by Circuit Judge Jay S. Bybee, recently explored for the first time the substantive requirements necessary to establish a claim under the whistleblower-protection provisions of the Sarbanes-Oxley Act (SOX). In the underlying action, plaintiffs Shawn and Lena Van Asdale, two in-house lawyers at International Game Technology (IGT), asserted claims for, among other things, retaliatory discharge under Section 806 of the Sarbanes-Oxley Act, 15 U.S.C. § 1514A. The plaintiffs claimed that they were terminated for reporting possible shareholder fraud in connection with a merger. The district court granted defendants' motion for summary judgment, and plaintiffs appealed.

The court reversed the district court's summary judgment order because issues of disputed fact precluded summary judgment. A retaliatory discharge claim under Section 806 of the Sarbanes-Oxley Act requires a showing, among other things, that the employee's communications that purportedly caused the retaliatory discharge "definitively and specifically related to shareholder fraud." In this case, plaintiffs satisfied the requirement at the summary judgment stage, even if they did not use the words "fraud," "fraud on shareholders" or "stock fraud," because they reported, among other things, that information had been intentionally concealed that, if disclosed, would have thwarted the merger. The Ninth Circuit, rejecting the district court's analysis, also found that there were issues of disputed fact whether the plaintiffs reasonably believed that the reported conduct constituted fraud. It was enough, according to the Ninth Circuit, that plaintiffs believed that an investigation needed to be done, not that a fraud necessarily had occurred. The court also found that plaintiffs created a triable issue of fact on whether the reporting resulted in their termination based on the timing and the "factual setting" of the discharge. Because IGT did not present clear and convincing evidence that it would have terminated the Van Asdales absent their reporting the concealment, plaintiffs' case survived summary judgment.

The court also held that the action could proceed, despite plaintiffs' status as former attorneys of the defendant IGT. There were no ethical bars against the in-house lawyers' bringing a federal claim of retaliatory discharge, and the district court could use its equitable powers to minimize any harm from the disclosure of attorney-client privileged information.

A Functionalist Perspective on the Effectiveness of the Gramm-Leach-Bliley Networking Exception and Its Related Regulation R Provisions

By Vlad Frants

Introduction

On November 12, 1999, President Clinton signed into law the Gramm-Leach-Bliley Act[1] ("GLB"). The principal objective of the GLB was to authorize and facilitate affiliations of commercial banks with insurance companies, investment banks, and other financial entities.[2] This Act repealed statutory impediments under the Glass-Steagall Act that restricted affiliations between banks and companies engaged in securities dealings.[3] The GLB has important registration consequences for banks having to register with the SEC under the SEC registration requirement.[4]

The Securities Exchange Act of 1934, Section 15,[5] covers the registration of brokers and dealers and specifically states under Section 15(a)(1) that

> It shall be unlawful for any broker or dealer which is either a person other than a natural person or a natural person not associated with a broker or dealer…to make use of the mails or any means or instrumentality of interstate commerce to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security [other than certain exempted securities] unless such broker or dealer is registered.…[6]

Historically, this section was read differently to expressly exclude banks from the definitions of "broker" and "dealer." Thus, banks were not under any obligation to register with the SEC if they "[made] use of the mails or any means or instrumentality of interstate commerce to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security."[7] This was because at the time that the broker-dealer provisions were enacted in the Exchange Act, "there was little need for banks to be subject to broker-dealer regulation."[8] This was because the Glass-Steagall Act, which has now been repealed by the GLB, statutorily limited banks' ability to deal in securities and prevented banks' affiliation with securities firms.[9] Thus, as Professor Fanto points outs, "[t]he exclusion of banks from the definitions of *broker* and *dealer* thus did not at first present any significant regulatory problems."[10] However, as banks and broker-dealers became more competitive with one another in the financial services industry, and "banks and bank holding companies developed [their securities business] to the extent they were allowed by sympathetic bank regulators,"[11] the SEC, and, eventually, Congress, started to come to the conclusion that "in the interests both of investor protection and fair competition, the securities activities allowed for banks, particularly their brokerage activities, should be regulated in the same manner as when registered broker-dealers conducted them."[12]

Thus, GLB not only repealed Glass-Steagall, in effect ending the separation of commercial banking and investment banking, but GLB also amended the law to eliminate the complete exemption for banks and replaced it with detailed exclusions for bank broker activities; GLB eliminated the "blanket exception"[13] for banks from both the broker and dealer definitions.[14] At the same time that Congress gave banks expanded flexibility and freedom to affiliate with investment banks to conduct their business affairs, Congress was nevertheless concerned about the regulatory implications, particularly for banks, and was faced with the question: how should banks, given their expansive new rights, be regulated?[15] Congress posited that commercial and investment banks should be regulated "by the regulator with the most competence and expertise in their business," and thus, Congress created the concept of "functional regulation."[16] Moreover, while the GLB eliminated the blanket exception for banks from both the broker and dealer definitions, the Act amended those definitions to provide banks with certain exceptions—one of which is the Networking Exception.[17] Generally speaking, "[a]s part of a third party brokerage (or "networking" arrangement), the Act permits bank employees to participate to a limited extent in referring customers and receiving compensation consisting of a "nominal one-time cash fee" that is not contingent on the referral resulting in a transaction."[18]

Prior to discussing the Networking Exception in further detail and proceeding with an analysis of its effectiveness through the functionalist lens, I will now discuss functionalism generally, as well as what exactly I mean by a functionalist perspective.

Functional Regulation

"Functional regulation" is the colloquial term describing the bifurcated regulatory system of U.S. markets.[19] The present regulatory structures of the financial services industries were created over half a century ago on the basis of industry classifications; separate groups of state and federal agencies were created to regulate the securities industry, banks, savings and loan associations, and the insurance industry.[20] However, "as a result of new economic opportunities and telecommunication technology, the traditional gaps between these industries have been bridged through major mergers and acquisitions and by new financial products and services."[21] Consistent with these developments, today approximately 10 federal and over 100 state agencies regulate various aspects of the securities markets alone.[22] Regulation of the securities registration and reporting requirements of about 400 publicly owned banks and 300 savings and loan associations is divided among four federal agencies.[23] Over 1,000 bank and S&L holding companies and 10,000 other publicly owned corporations file with the SEC.[24]

In its simplest form, functional regulation rests on the principle that like functions should be regulated alike, regardless of the type of entity performing the function.[25] Functional regulation seeks to promote competitive equality, regulatory efficiency, and investor / consumer protection.[26] Former SEC Chairman John Shad laid out four policy arguments supporting the use of functional regulation, particularly in the banking and securities industries context.[27] First, functional regulation allocates to each regulatory agency jurisdiction over those economic functions it knows best.[28] Second, allocating regulatory jurisdiction by function permits the application of a constituent regulatory philosophy.[29] Third, a functionally-based system minimizes regulatory conflict, duplication and overlap.[30] Finally, functional regulation has the distinct advantage that it assures equal treatment of competitors.[31] Functional regulation is not without its disadvantages. For example, it can result in a particular type of firm, such as a savings and loan firm or a credit union, having to deal with a variety of special-purpose agencies rather than a single agency, which can result in added regulatory costs.[32] This is because the firms will have to deal with more than one agency.[33] To be clear, functional regulation is aimed at reforming the regulation of financial institutions in order to promote three critical goals: (1) competitive equality; (2) regulatory efficiency; and (3) investor / consumer protection. I will now discuss these goals in more depth. A functionalist perspective, in my view, is one in which these three specific goals figure prominently into any analysis.

A. Competitive Equality

Proponents of functional regulation argue that "under true functional regulation, entities engaged in similar transactions and products are subject to the same rules interpreted and administered consistently by the same regulators."[34] As a result, so goes the logic, "regulatory advantages will not be afforded different entities competing in the same transactions."[35] "Proponents of entity regulation…suggest that the agency responsible for the entity can adequately administer the appropriate rules and regulations for the various transactions in which the entity may engage."[36]

B. Regulatory Efficiency

Proponents of functional regulation argue that such regulation would promote regulatory efficiency by reducing conflict, duplication, and overlap of the regulatory function.[37] The concept is that, under a functional regulator scheme, regardless of the regulatory agency that ultimately oversees a certain financial product, the product will be regulated the same.[38] The hope is that the potential for confusion and conflict will be greatly reduced by clarifying the regulator's jurisdictional line.[39] Such clearly drawn lines, the thinking goes, will "eliminate the uncertainty that can hinder effective strategic planning and stifle development and marketing of innovative products that could benefit business and consumers."[40] In addition to reducing regulatory conflict, proponents of functional regulation suggest that it will decrease overlap and duplication of the regulatory function.[41] Moreover, proponents of functional regulation also urge that it will result in more effective and consistent oversight.[42] Arguably, this is achieved by allowing those with the greatest experience in assessing the risks associated with a product's activities to continue to regulate those products by applying a consistent regulatory philosophy.[43]

C. Investor/Consumer Protection

Given that, for example, banking regulators are primarily interested in protecting depositors, while state insurance regulators are focused on the well-being of policyholders, proponents of functional regulation urge that, because of these different objectives, a federal regulator responsible for both industries may be forced to sacrifice the interests of policyholders in order to boost bank profits and protect depositors.[44] Proponents contend that functional regulation will ensure that consumer protection of both depositors and policyholders is preserved.[45] The theory is that functional, rather than entity, regulation will encourage the availability of the widest range of financial products at the lowest cost to the public.[46] Thus, if a financial service firm fails, it will be on its merits rather than because of arbitrary differences in government regulation.[47] "Consumers and industry alike will profit from the new and innovative products encouraged by a market-driven system rather than by arbitrary differences in entity regulation."[48]

I will now turn to the networking exception.

The Networking Exception

The networking exception is set out in Section (3)(a)(4)(B)(i) of the Exchange Act.[49] It permits a bank to enter into an arrangement with a registered broker-dealer to offer the bank's customers certain kinds of financial services.[50] Generally speaking, a bank can do this under the networking exception "provided appropriate disclosures are given such that customers are aware services are being provided by the broker-dealer and not the bank."[51] Moreover, brokerage activities that occur must be clearly marked and physically separated from the bank's routine business activities such as deposit-taking, if practicable.[52] Broadly speaking, there are numerous other conditions, such as the fact that bank employees must perform only clerical or ministerial functions in connection with brokerage transactions and that unregistered bank employees may not receive incentive compensation, other than nominal one-time cash fee payments which are not contingent on the success of the referral, for any brokerage transaction.[53] Conditions such as these are designed to ensure that bank customers are clear on who actually offers the brokerage services and that bank employees do not become too involved in offering brokerage services.[54]

Specifically, the conditions or restrictions are as follows:[55]

I. Such broker or dealer is clearly identified as the person performing the brokerage services;

II. The broker or dealer performs brokerage services in an area that is clearly marked and, to the extent practicable, physically separate from the routine deposit-taking activities of the bank;

III. Any materials used by the bank to advertise or promote generally the availability of brokerage services under the arrangement clearly indicate that the brokerage services are being provided by the broker or dealer and not by the bank;

IV. Any materials used by the bank to advertise or promote generally the availability of brokerage services under the arrangement are in compliance with the Federal securities laws before distribution;

V. Bank employees (other than associated persons of a broker or dealer who are qualified pursuant to the rules of a self-regulatory organization) perform only clerical or ministerial functions in connection with brokerage transactions, including scheduling appointments with the associated persons of a broker or dealer, except that bank employees may forward customer funds or securities and may describe in general terms the types of investment vehicles available from the bank and the broker or dealer under the arrangement;

VI. Bank employees do not receive incentive compensation for any brokerage transaction unless such employees are associated persons of a broker or dealer and are qualified pursuant to the rules of a self-regulatory organization, except that the bank employees may receive compensation for the referral of any customer if the compensation is a nominal one-time cash fee of a fixed dollar amount and the payment of the fee is not contingent on whether the referral results in a transaction;

VII. Such services are provided by the broker or dealer on a basis in which all customers that receive any services are fully disclosed to the broker or dealer;

VIII. The bank does not carry a securities account of the customer except as permitted under [trust or safekeeping arrangements]; and

IX. The bank, broker, or dealer informs each customer that the brokerage services are provided by the broker or dealer and not by the bank and that the securities are not deposits or other obligations of the bank, are not guaranteed by the bank, and are not insured by the Federal Deposit Insurance Corporation.

In October 2006, the Financial Services Regulatory Relief Act of 2006[56] became effective, which, among other things, required that the Securities and Exchange Commission and the Board of Governors of the Federal Reserve System jointly adopt a single set of rules to implement the bank broker exceptions in Section 3(a)(4) of the Exchange Act[57] and also required that the Agencies issue a single set of proposed rules to implement these exceptions.[58]

In December 2006, the Agencies jointly issued, and requested public comment on, a single set of proposed rules to implement the broker exceptions for banks, including the exception involving third-party networking arrangements.[59] In developing the proposed rules, "the Agencies considered, among other things, the language and legislative history of the 'broker' exceptions for banks adopted in the [Gramm-Leach-Bliley Act], the rules previously issued or proposed by the Commission relating to these exceptions, and the comments received in connection with those prior rulemakings."[60] The Agencies received comments from 58 organizations and individuals on the proposed rules; commenters included 22 trade associations, 20 banking organizations, seven other organizations in the financial services industry, three community and nonprofit groups, two credit unions, one state government, one self-regulatory organization, one association of state securities administrators, and one individual.[61] In developing the final rules, called Regulation R, the Board and the SEC carefully considered all the comments and consulted extensively with the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision.[62]

Thus, under the networking exception, a bank may refer a bank customer to an affiliated or third-party broker-dealer in exchange for a share of the commissions earned from the customer's securities account without being deemed a "broker" under the Exchange Act, so long as the above conditions are met.[63] Regulation R contains detailed provisions concerning compensation of the bank employee who makes such a referral.[64] In particular, "[r] ule 700 defines the type and limit of compensation that a bank employee may receive for making a customer referral under the statutory exception [in particular a nominal one-time cash fee of a fixed dollar amount] as well as the conditions under which bank employee bonus plans will be exempt from the restrictions on payment of referral fees to bank employees. In addition, exemptive Rule 701 allows payment of higher-than-nominal fees to bank employees for referral of high net worth and institutional customers, subject to certain conditions."[65]

1. Nominal Fees

Condition VI listed above makes it clear that bank employees who are not also associated persons of a registered-broker dealer generally may not receive incentive compensation for making referrals other than a "nominal one-time cash fee of a fixed dollar amount." "Rule 700(c)(1) defines 'nominal one-time cash fee of a fixed dollar amount' to mean any amount paid only once for a referral not exceeding the greatest of: (1) $25 (adjusted for inflation every five years beginning on April 1, 2012); (2) twice the average hourly wage for the employee's "job family" (such as loan officers); (3) 1/1000th of the average annual base salary for the employee's job family; (4) twice the employee's actual base hourly wage; or (5) 1/1000th of the employee's actual annual base salary."[66]

2. Bonus Plans

"To accommodate banks' bonus plans, the definition of 'incentive compensation' excludes discretionary bonuses based on multiple factors or variables."[67] Rule 700(b)(1) provides that "a bonus is excluded from incentive compensation if it is paid on a discretionary basis and based on multiple factors or variables, provided that: (i) those factors or variables include multiple, significant factors or variables that are not related to securities transactions at a broker-dealer; (ii) a referral made by the employee receiving the bonus is not a factor or variable in determining the employee's compensation; and (iii) the employee's compensation is not determined by reference to referrals made by other persons [such as the employee's subordinates]."[68]

Additionally, "Regulation R includes a safe harbor intended to allow banks to avoid having to analyze whether a particular bonus program meets the multiple factors and variables test described above."[69] "Rule 700(b)(2) allows banks to pay bonuses based on overall profitability or revenue of: (i) the bank, either on a stand-alone or consolidated basis; (ii) any affiliate of the bank [other than a broker-dealer] or any operating unit of the bank or an affiliate [other than a broker-dealer], provided that the affiliate or operating unit does not over time predominantly engage in the business of making referrals to a broker-dealer; or (iii) a broker-dealer."[70]

3. Exemption for Referrals of High Net Worth and Institutional Customers

Rule 701 introduces a new exemption that allows banks to pay contingent, higher than nominal fees for referrals of high net worth and institutional customers.[71] Rule 701(d)(1) defines "high net worth" customers as individuals (or couples) with $5 million or more of net worth, excluding their primary residence and associated liabilities.[72] Rule 701(d)(2) defines "institutional customers" as entities with $10 million in investments, or $20 million in revenues (or $15 million in revenues if the customer is referred for investment banking services).[73] Since this rule does not limit the fees to nominal amounts, "the exemption is subject to several conditions intended to address the SEC's concerns about unregistered bank employees having a salesman's stake in securities transactions."[74] The bank and the networking broker-dealer are required by Rule 701 to enter into a written agreement "that includes provisions addressing these conditions of the exemption."[75]

Pairing an understanding of the Networking Exception through a close reading of the relevant language in the Exchange Act and the final rules set out by the Board and the SEC with the exception's theoretical and practical application, viewed through a functionalist lens, as based on a reading of the comments to the proposed rules and exploration of the available materials which discuss the exception in practice, is the goal of the following analysis.

Analysis

In enacting the GLB, "Congress adopted functional regulation for bank securities activities, with certain exceptions from Commission oversight for specified securities activities."[76] These exceptions are, in essence, exceptions from functional regulation. Nevertheless, because Congress embraced a system of functional regulation for the industry, and functional regulation is aimed at promoting three critical goals: (1) competitive equality; (2) regulatory efficiency; and (3) investor/consumer protection, I assume that Congress both hoped and assumed that the Networking Exception would nevertheless promote these three goals despite the fact that the exception is an exemption from functional regulation itself. Ultimately the question becomes whether the Networking Exception is not a form of functional regulation itself, and is in fact an exclusion from functional regulation, despite the fact that the exception nevertheless promotes the functionalist goals of competitive equality, regulatory efficiency, and investor / consumer protection. If it does, then this would be an argument for keeping the exception in place and not instituting functional regulation in lieu of providing the exception to banks. If these three goals are not being promoted, then an argument can be made for eliminating the exception and for instituting functional regulation in lieu of it.

Bonus Plans—Rule 700(B)(1)

Regulatory Efficiency

While the Networking Exception, as interpreted by Regulation R, provides banks with "welcome flexibility in structuring employee referral and bonus arrangements,"[77] the new rules under Rule 700(b)(1) "still will not be fully harmonious with many banks' current incentive-based compensation programs, including bonus and rewards programs"[78] and will be unlikely to result in regulatory efficiency. The Networking Exception does not adequately accommodate current bank bonus programs since most of these plans are based on transaction revenues rather than overall profitability.[79] Most banks will now be required to substantially restructure their bonus plans in order to comply with Regulation R.[80] Regulatory efficiency seeks a reduction in confusion and conflict of the regulatory function, but where a rule is inconsistent with many banks' current compensation programs, as is the case here, there is more likely to be confusion and possible regulatory conflict as between the regulators and bank management's regulation of the compensation structure.

Competitive Equality

Whereas "incentivised compensation programs have become the norm in the banking industry,"[81] certainly not every bank has an identical compensation system. Since most banks will now be required under Rule 700(b)(1) to substantially restructure their bonus plans in order to comply with Regulation R, and different banks may have varying incentives to do so, "[u]ltimately, a bank may have to make a choice between three economically unattractive choices: (1) pushing out its securities business to a registered broker-dealer; (2) maintaining the activities within the bank, but losing the benefits of an incentive based sales program; or (3) simply dropping the line of business."[82] The principle of competitive equality states that entities engaged in similar transactions and products should be subject to the same rules interpreted and administered consistently by the same regulators. Here, while banks may be engaged in similar transactions and products, they will not necessarily be subject to the same rules—and, ironically, will be forced to make a conscious decision about whether or not they want to be subject to certain types of regulation, merely because of the nature of their compensation structure.

Investor/Consumer Protection

The requirements under Rule 700 (b)(1) will likewise hurt investor / consumer protection. Since the theory of investor / consumer protection under functional regulation is that the availability of the widest range of financial products at the lowest cost to the public should be encouraged and that new and innovative products should be encouraged by a market-driven system rather than by arbitrary differences in entity regulation, Rule 700 (b)(1) will hurt investor / consumer protection. Because banks will now be forced to substantially restructure their compensation systems, banks will have to choose between pushing out their securities business to a registered broker-dealer, maintaining the activities within the bank, but losing the benefits of an incentive-based sales program, or simply dropping the line of business. Any of these choices will hurt investor / consumer protection because pushing out the securities business to a registered broker-dealer may increase costs to the public for obtaining services, giving up the benefits of an incentive-based sales program may deter top-notch personnel from taking on certain jobs, in turn potentially decreasing the number of innovative products on the market, and, finally, banks dropping the line of business would lead to decreased competition among service providers and in turn to an increase in prices.

Nominal Fees—Rule 700(c)(1)

Regulatory Efficiency and Competitive Equality

The biggest issue here is in terms of investor / consumer protection, not the regulatory efficiency or competitive equality principles. I assume that the Networking Exception section pertaining to nominal fees, and in particular Rule 700(c)(1) of Regulation R, has no impact on regulatory efficiency or competitive equality. I now turn to how investor / consumer protection is affected by the Nominal Fees sections of Gramm-Leach-Bliley and Regulation R, where the real concerns lay.

Investor/Consumer Protection

In its March 26, 2007 letter to the Securities and Exchange Commission, the Pace Investor Rights Project at Pace University School of Law argued that the three alternatives by which the meaning of a "nominal one-time cash fee of a fixed dollar amount" is calculated for purposes of determining referral incentive compensation of certain bank employees, all create an inappropriate incentive for retaining bank employees who refer customers to broker-dealers.[83] The alternatives the letter refers to were adopted in Rule 700(c)(1). As previously stated, the rule defines "nominal one-time cash fee of a fixed dollar amount" to mean any amount paid only once for a referral not exceeding the greatest of: (1) $25 (adjusted for inflation every five years beginning on April 1, 2012); (2) twice the average hourly wage for the employee's "job family" (such as loan officers); (3) 1/1000th of the average annual base salary for the employee's job family; (4) twice the employee's actual base hourly wage; or (5) 1/1000th of the employee's actual annual base salary.

The Pace Investor Rights Project argued that the alternatives are inconsistent with the "nominal" fee requirement because "the actual value of the referral fee ignores the cumulative effect of making multiple referrals,"[84] and all of the alternatives create the potential for banking employees to collect excessive referral fees to the detriment of unsophisticated bank customers.[85] The Project argued that "banker salesmanship" poses a problem for small investors because over a period of time overzealous banker salesmanship could result in a cumulative payment that is far more than nominal and would motivate a degree of salesmanship that goes beyond the intended scope of the referral fee contemplated by Congress.[86] In other words, because of the fact that there is no cumulative cap on the maximum referral fee that could be collected, the practice of collecting fees would eventually result in a referral fee that goes far beyond "nominal." This, arguably, may have the effect of reducing investor/consumer protection because a bank employee who seeks to make as many referrals as possible, given that there is no cumulative cap, may do so in an overzealous manner—and perhaps unethical manner—and may "contribute to the confusion that leads to brokers recommending unsuitable products to unsophisticated investors."[87] If there were a maximum cap on cumulative collectable referral fees, bank employees would not have much incentive to pursue the "sell to everyone and sell at all costs" business model. Thus, consumer/investor protection would not be put at risk.

Another argument against this "shotgun approach," whereby an incentive is created for bank employees to make referrals in large volumes because the referral fee for each referral is so small, is that this approach to referrals not only results in the payment of undeserved referral fees, but also causes the securities firm receiving the referrals to waste resources following up on referrals that are not likely to be productive, thereby impairing the productivity of the securities firm.[88] Potentially, this can cause the personnel of the securities firm to be spread too thin and thus impair the ability of the firm to proficiently handle its accounts, possibly placing consumer/investor protection at risk.

Moreover, looking at only one specific example illuminates the problem. One alternative, where a referral fee would be considered nominal if it does not exceed either twice the average of the minimum and maximum hourly wage established by the bank for the current or prior year for the job family that includes the relevant employee, has the potential to pay certain bank employees more than double their hourly wages for each referral.[89] An example offered by the Pace Investor Rights Project is the following: where a bank manager and teller are in the same job family (and this is possible because of the ambiguous definition of the term), and the average hourly salary for a bank teller is $11.20 and the average hourly manager salary is $45.33, the combined total is $56.53.[90] The average of that combination is $28.26, which provides a referral fee that is more than double the base hourly rate of the teller and is therefore not "nominal."[91]

Exemption for Referrals of High Net Worth and Institutional Customers

Regulatory Efficiency and Investor/Consumer Protection

I assume that the Networking Exception section pertaining to referrals of high net worth and institutional customers, and in particular Rule 701(d), does not in any way hurt regulatory efficiency or investor/consumer protection. I now turn to how this particular exemption affects competitive equality.

Competitive Equality

As previously discussed, the principle of competitive equality states that entities engaged in similar transactions and products should be subject to the same rules interpreted and administered consistently by the same regulators. The exemption for referral of high net worth and institutional customers, or the "institutional exemption," permits larger and non-contingent referral fees for large sophisticated customers. However, "the definition of the term 'high net worth customer' triggering the exemption in the case of referrals of natural persons requires a net worth of $5 million excluding primary residence and associated liabilities."[92] There is an argument that this amount is too high and that it discriminates against smaller banks that compete in smaller, less affluent markets.[93] "While large New York City banks may serve enormous numbers of individuals with a net worth of $5 million or more, a bank in Detroit or in small rural communities is not likely to be able to do so."[94] Moreover, banks typically treat customers with $1 million or more in liquid assets as high net worth customers, eligible for bank programs limited to only such customers.[95] There is a particular geographical disparity in the application of this definition, and this is something that undoubtedly takes away from competitive equality.

Conclusion

With the passage of the GLB, most of the separation of investment and commercial banking imposed by the Glass-Steagall Act was repealed, and the provisions of the Exchange Act that had completely excluded banks from broker-dealer registration requirements were revised. By enacting the GLB, Congress adopted functional regulation for bank securities activities and created certain exceptions from Commission oversight for certain securities activities.

"Functional regulation" is the colloquial term describing the bifurcated regulatory system of U.S. markets and is aimed at reforming the regulation of financial institutions in order to promote three critical goals: (1) competitive equality; (2) regulatory efficiency; and (3) investor / consumer protection. A functionalist perspective is one in which these three goals are used as a measuring stick for the determination of whether a particular piece of functionalist legislation has met its goals. The principle of competitive equality states that entities engaged in similar transactions and products should be subject to the same rules interpreted and administered consistently by the same regulators. In addition to reducing regulatory conflict, proponents of functional regulation suggest that it will decrease overlap and duplication of the regulatory function. Finally, the theory of investor / consumer protection under functional regulation is that the availability of the widest range of financial products at the lowest cost to the public should be encouraged and that new and innovative products should be encouraged by a market-driven system rather than by arbitrary differences in entity regulation.

With respect to the definition of "broker," the GLB amended the Exchange Act to provide eleven specific exceptions for banks, each of which permits a bank to act as a broker or agent in securities transactions that meet specific statutory conditions. One such exception is the Networking Exception, which permits bank employees to participate to a limited extent in referring customers and receiving compensation consisting of a "nominal one-time cash fee."

Thereafter, after opening the floor to the public for discussion, evaluating the comments received, and collaborating with various agencies, the Securities and Exchange Commission and the Board of Governors of the Federal Reserve System jointly adopted a single set of rules to implement the bank broker exceptions, including the Networking Exception. These rules addressed and refined particular aspects of the Exchange Act's section discussing the Networking Exception. Of particular relevance to this paper were the Rules on nominal fees, bonus plans, and the exemption for referrals of high net worth and institutional customers.

Bank employees who are not also associated persons of a registered-broker dealer generally may not receive incentive compensation for making referrals other than a "nominal one-time cash fee of a fixed dollar amount," and the applicable rule on nominal fees defines "nominal one-time cash fee of a fixed dollar amount" to mean any amount paid only once for a referral not exceeding the greatest of one of four alternatives. In terms of bonus plans, the definition of "incentive compensation" excludes discretionary bonuses based on multiple factors or variables and the applicable Rule provides that a bonus is excluded from incentive compensation if it is paid on a discretionary basis and based on multiple factors or variables, subject to certain conditions. Finally, as for the exemption for referrals of high net worth and institutional customers, the rules introduce a new exemption that allows banks to pay contingent, higher than nominal fees for referrals of high net worth and institutional customers and defines "high net worth" customers as individuals with $5 million or more of net worth, excluding their primary residence and associated liabilities.

Combining an understanding of the Networking Exception through a close reading of the relevant language in the Exchange Act and the final rules set out by the Board and the SEC with the exception's theoretical and practical application, viewed through a functionalist lens, as based on a reading of the comments to the proposed rules and exploration of the available materials which discuss the exception in practice, was the goal of this article's analysis.

The question I posed was whether the Networking Exception promotes the functionalist goals of competitive equality, regulatory efficiency and investor / consumer protection despite the fact that the exception itself is an exception to functional regulation. I posited that if these goals were being met, then the exception is working and additional regulation is unnecessary; however, if these goals were not being met, then the Networking Exception would need to be reevaluated and additional (or different) regulation may be needed.

Focusing specifically on the bonus plan and nominal fees, as well as on the exemption for referrals of high net worth and institutional customers, aspects of the Networking Exception and accompanying Rules, I analyzed the extent to which each of these promoted competitive equality, regulatory efficiency, and investor / consumer protection.

I concluded that the Networking Exception's section on bonus plans failed on the regulatory efficiency front, failed on the competitive equality front, and failed on the investor / consumer protection front as well. Under this exception and its accompanying rules, there is more likely to be confusion and possible regulatory conflict between the regulators and bank management's regulation of the compensation structure. There is a failure to promote competitive equality because, while banks may be engaged in similar transactions and products, they will now not necessarily be subject to the same rules. Finally, investor / consumer protection will be hurt because, due to the rules on bonus plans, banks will have to choose one of the following options: push out the securities business to a registered broker-dealer, which may increase the cost to the public of obtaining services; give up the benefits of an incentive-based sales program, which may deter top-notch personnel from taking on certain jobs, in turn potentially decreasing the number of innovative products on the market; and, finally, banks may drop the line of business entirely, leading to decreased competition among service providers and in turn to an increase in prices. Therefore, based on the functional perspective, the bonus plan aspect of the Networking Exception needs to be reevaluated.

The Networking Exception's section on nominal fees made no difference on the regulatory efficiency and competitive equality front, but failed on the investor / consumer protection front. The nominal fees section puts consumer / investor protection at risk because under the applicable rule, a bank employee who seeks to make as many referrals as possible, given that there is no cumulative cap, may do so in an overzealous manner—and perhaps unethical manner—and may contribute to the confusion that leads to brokers recommending unsuitable products to unsophisticated investors. Because there is no maximum cap on cumulative collectable referral fees, bank employees have every incentive to pursue the "sell to everyone and sell at all costs" business model, which in turn puts consumer / investor protection at risk.

Finally, the Networking Exception Rules' section on the exemption for referrals of high net worth and institutional customers made no difference on the regulatory efficiency or investor / consumer protection fronts, but hurt competitive equality because the amounts under the rule are too high and clearly discriminate against smaller banks that compete in smaller, less affluent markets, thus hurting competitive equality.

Endnotes

1. Gramm-Leach-Bliley Financial Modernization Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999).
2. Financial Services Modernization: the Impact of the Gramm-Leach-Bliley Act, 1 (Feb. 17, 2000) (materials prepared by the Association of the Bar of the City of New York).
3. *Id.*
4. *See* Norman S. Poser & James A. Fanto, *Registration and Exemptions*, in Broker-Dealer Law and Regulation 21 (Aspen Publishers 2007).
5. This was enacted as part of the 1936 amendments to the Exchange Act, 2-3.
6. An interesting quote from *Regional Props., Inc. v. Financial and Real Estate Consulting Co.*, 678 F.2d 552, 561 (5th Cir. 1982), sheds some light on the justification for this requirement: "[t]he registration requirement [enables the SEC (and private citizens, through the implied right of action) to exercise discipline] over those who may engage in the securities business and [it establishes necessary standards with respect to training, experience, and records."
7. *See* Norman S. Poser & James A. Fanto, *Registration and Exemptions*, in Broker-Dealer Law and Regulation 21 (Aspen Publishers 2007).
8. *Id.*
9. *Id.*
10. *Id.*
11. *See* Norman S. Poser & James A. Fanto, *Registration and Exemptions*, in Broker-Dealer Law and Regulation 21 (Aspen Publishers 2007).
12. *Id.*
13. *Id* at 24.
14. *Id.*
15. *See id.*
16. *See* Norman S. Poser & James A. Fanto, *Registration and Exemptions, in Broker-Dealer Law and Regulation* 24-25 (Aspen Publishers 2007).
17. *Id* at 24.
18. Financial Services Modernization: The Impact of the Gramm-Leach-Bliley Act, 47 (Feb. 17, 2000) (materials prepared by the Association of the Bar of the City of New York).
19. Richard Carlucci, *Harmonizing U.S. Securities and Futures Regulations*, 2 Brook. J. Corp. Fin. & Com. L. 461, 462. Interestingly, "Federal functional regulator" is defined in Section 509 of the Gramm-Leach Bliley Act, and includes, among others, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Reserve Board and the Federal Deposit Insurance Corporation. American Law Institute-American Bar Association Continuing Legal Education (July 24-25, 2008).
20. John Shad, U.S. Sec. & Exch. Comm'n. Functional Regulation—The Concept and Its Applications, Address at Exchequer Club (May 21, 1986), *available at* http: / / www.sec.gov / news / speech / 1986 / 052186shad.pdf.
21. *Id.*
22. Richard Carlucci, *supra* note 19.
23. John Shad, *supra* note 20.
24. *Id.*
25. *See* Melanie L. Fein, *Functional Regulation: A Concept for Glass-Steagall Reform?* 2 Stan. J.L. Bus. & Fin. 89, 89 (1995). "Examples of functional regulation in current law include zoning laws, fire codes, and tax laws. Such functional regulations apply to all businesses regardless of whether the entity is a restaurant, department store, or pet shop." *Id.*
26. *Id.*
27. *See* Melanie L. Fein, *Functional Regulation: A Concept for Glass-Steagall Reform?* 2 Stan. J.L. Bus. & Fin. 89, 90-91 (1995).
28. *Id.*
29. *Id* at 91. Interestingly, "[a] major thrust of the securities laws is full disclosure. By contrast, bank regulators are concerned about the need for public confidence in banks, and therefore tend more toward confidentiality." *Id* at 92.
30. *Id.*
31. *See* Melanie L. Fein, *Functional Regulation: A Concept for Glass-Steagall Reform?*, 2 Stan. J.L. Bus. & Fin. 89, 91 (1995). The Bush Task Group Report contained the following interesting information,

> As direct competition among different types of financial firms has increased, the problem of regulatory inequities has grown rapidly. As banks, securities firms, thrifts and insurance companies increasingly offer equivalent product and services to the consumer, their ability to be successful competitively may be affected by differences in the regulatory scheme applicable to them based on their historic type of business. Therefore, to an increasing degree the caprice of historic forms of regulation may interfere directly with the operation of a market-driven system because consumer preferences are not expressed solely on the basis of the underlying investment merits. The application of interest rate controls to time deposits in depository institutions, while no such controls were applicable to money market funds, was a classic case of the regulatory system failing to regulate fungible products in an equivalent manner, thereby dictating the success of one type of product in the marketplace due to

> arbitrary differences in regulatory controls. By contrast, functional regulation attempts to regulate each common activity or product by a single agency under a common set of rules, irrespective of the type of institution involved.

Id at 93.

32. *Id.*
33. *Id.*
34. Linda Birkin Tigges, *Functional Regulation of Bank Insurance Activities: The Time Has Come*, 2 N.C. BANKING INST. 455, 477 (1998). Whether this assumption is true is an important question. As will be discussed later,

> [t]his logic ignores the potential for inconsistent application of the rules and regulations by various regulators operating under different motives and philosophies. Furthermore, it shows the lack of appreciation for the complex transactions and unique risks involved in those transactions that would require more than a simple training session taught by those with inadequate experience in the particular industry.

Id.

35. *Id.*
36. *Id.*
37. Linda Birkin Tigges, *Functional Regulation of Bank Insurance Activities: The Time Has Come*, 2 N.C. BANKING INST. 455, 480 (1998).
38. *Id.*
39. *Id.*
40. *Id.* "Opponents of functional regulation argue that an entity engaged in various financial services activities would be dealing with several different regulators. Because an entity may have to report to numerous regulators, this may result in additional costs." *Id.*
41. Linda Birkin Tigges, *supra* note 37.
42. *Id.*
43. *Id.*
44. Linda Birkin Tigges, Functional *Regulation of Bank Insurance Activities: The Time Has Come*, 2 N.C. BANKING INST. 455, 465-66 (1998).
45. *See id.*
46. *Id.*
47. *Id.*
48. *Id.* As will be discussed later, "some argue…that functional regulation and particularly the state regulatory scheme will actually act as a disincentive to develop new products. Varying state regulations will make it difficult for a bank to offer its products on an interstate basis. This is not a new problem, however, since insurance companies operating in more than one state are faced with the same concerns. Furthermore, the benefits in focused consumer protection laws tailored to the needs of each state outweigh the regulatory inconvenience facing all of those who chose to engage in insurance transactions." *Id* at 467.
49. *See* Regulation B, Exchange Act Release No. 49,879, 69 Fed. Reg. at 39,686.
50. *See id; also see* Norman S. Poser & James A. Fanto, *Registration and Exemptions*, in Broker-Dealer Law and Regulation 30 (Aspen Publishers 2007).
51. Financial Services Modernization: The Impact of the Gramm-Leach-Bliley Act, 98 (Feb. 17, 2000) (materials prepared by the Association of the Bar of the City of New York).
52. *Id.*
53. *Id.*
54. *See* Norman S. Poser & James A. Fanto, *Registration and Exemptions*, in Broker-Dealer Law and Regulation 30 (Aspen Publishers 2007).
55. Norman S. Poser & James A. Fanto, *Registration and Exemptions,* in Broker-Dealer Law and Regulation 30-31 (Aspen Publishers 2007).
56. Pub. L. No. 109-351, 120 Stat. 1966 (2006).
57. *See* Exchange Act Section 3(a)(4)(F), as added by Section 101 of the Regulatory Relief Act.
58. *See* U.S. Sec. & Exch. Comm'n., Release No. 34-56501 File No. S7-22-06, *Definitions of Terms and Exceptions Relating to the "Broker" Exceptions for Banks*, 8-9, *available at* http://www.sec.gov/rules/final/2007/34-56501.pdf.
59. *Id* at 9.
60. *Id.*
61. *Id.*
62. *Id.* at 11.
63. Jerome J. Roche & Babback Sabahi, *Regulation R: The Beginning of the End or the End of the Beginning of Bank Securities Brokerage Activities?,* 12 N.C. BANKING INST. 141, 142 (2008).
64. *Id.*
65. *Id.* at 145-46.
66. Jerome J. Roche & Babback Sabahi, *Regulation R: The Beginning of the End or the End of the Beginning of Bank Securities Brokerage Activities?,* 12 N.C. Banking Inst. 146 (2008).
67. *Id.* at 147.
68. *Id.*
69. *Id.*
70. *Id.*
71. Jerome J. Roche & Babback Sabahi, *Regulation R: The Beginning of the End or the End of the Beginning of Bank Securities Brokerage Activities?,* 12 N.C. BANKING INST. 147-48 (2008).
72. *Id.*
73. *Id.*
74. *Id.*
75. *Id.*

First, the rule imposes an affirmative obligation on banks and networking broker-dealers to evaluate a customer's eligibility as a high net worth or institutional customer. Banks must have a "reasonable basis to believe" that a customer is high net worth customer at or before the time that a customer is referred to the broker-dealer or that a customer is an institutional customer before a referral fee is paid to a bank employee.

Second, Rule 701(d)(4) places limits on the types, but not the amount, of referral fees that bank employees may receive. Under this provision, bank employees may receive a fixed percentage of the revenue received by the broker- dealer for providing investment banking services to the customer. In addition, bank employees may receive fixed referral fees or referral fees that are based upon a fixed formula so long as the formula does not permit the amount of the fee to vary based on the revenue generated by, or the profitability of a transaction, the price or volume of any securities transactions effected for the customer, the identity of any securities purchased or sold for the customer, or the number of referrals made by the employee.

Third, if the payment of a referral fee is contingent upon the completion of a transaction, then the broker-dealer must determine, prior to effecting a securities transaction, that the transaction is suitable for the customer pursuant to the standards that are applicable to recommendations made by the broker-dealer under existing self-regulatory organization rules. If payment of a referral fee is not contingent on completion of a transaction, the broker-dealer must either: (a) determine that the customer is sophisticated and has the ability to make an independent assessment of the risks associated with the transaction; or (b) assess the suitability of the transaction requested by the customer at the time of the referral. In any event, the broker-dealer must notify the customer (but not the bank) if it determines that the customer or the requested transaction does not satisfy the suitability or sophistication requirements set forth above.

Fourth, a referring employee: (1) must not be qualified, or required to be qualified, with a self-regulatory organization; (2) must not be statutorily disqualified from associating with a broker-dealer under Section 3(a)(39) of the Exchange Act (except under paragraph (E) of that section); (3) must be engaged predominantly in banking activities; and (4) must encounter the referred customer in the normal course of his or her duties.

Fifth, the bank must make certain disclosures to a customer that its employee referred under this exemption. A bank has two options under Rule 701 (a) (2) for disclosing referral fee arrangements to a high net worth or institutional customer. Under the first option, the bank may elect to provide the high net worth or institutional customer the disclosure in writing prior to or at the time of the referral.

Under the second option, the bank may provide the disclosure to the customer orally prior to or at the time of the referral. However, if the bank provides the customer the required disclosures only orally, then either: (i) the bank must provide the disclosure to the customer in writing within three business days of the date of the referral; or (ii) the broker-dealer must be obligated, under the terms of its written agreement with the bank, to provide the disclosures in writing to the customer. *Id.* at 148-51.

76. *See* U.S. Sec. & Exch. Comm'n., Release No. 34-56501 File No. S7-22-06, *Definitions of Terms and Exceptions Relating to the "Broker" Exceptions for Banks*, 8-9, *available at* http://www.sec.gov/rules/final/2007/34-56501.pdf.
77. Jerome J. Roche & Babback Sabahi, *Regulation R: The Beginning of the End or the End of the Beginning of Bank Securities Brokerage Activities?*, 12 N.C. BANKING INST. 150 (2008).
78. *Id.* at 145
79. *Id.* at 150.
80. *Id.*
81. Kevin A. Zambrowicz, et al., *Regulation B: SEC Rules Governing Certain Bank Securities Broker Activities*, 49 A.L.I.-A.B.A. 90 (2006).
82. *Id.*
83. Letter from the Pace Investor Rights Project at Pace University School of Law, to Nancy M. Morris, Secretary, Securities and Exchange Commission (Mar. 26, 2007), *available at* http://www.sec.gov/comments/s7-22-06/s72206-18.pdf.
84. *Id.*
85. *Id.*
86. *Id.*
87. *Id.*
88. Letter from Julius L. Loeser, Chief Regulatory and Compliance Counsel, Comerica Tower at Detroit Center, to the Board of Governors of the Federal Reserve System and the SEC (Mar. 26, 2007), *available at* http://www.sec.gov/comments/s7-22-06/s72206-8.pdf.
89. Letter from the Pace Investor Rights Project at Pace University School of Law, to Nancy M. Morris, Secretary, Securities and Exchange Commission (Mar. 26, 2007), *available at* http://www.sec.gov/comments/s7-22-06/s72206-18.pdf.
90. *Id.*
91. *Id.*
92. Letter from Julius L. Loeser, Chief Regulatory and Compliance Counsel, Comerica Tower at Detroit Center, to the Board of Governors of the Federal Reserve System and the SEC (Mar. 26, 2007), *available at* http://www.sec.gov/comments/s7-22-06/s72206-8.pdf.
93. *Id.*
94. *Id.*
95. Letter from the Bank Insurance & Securities Association to the Secretary of the Board of Governors of the Federal Reserve System (Mar. 22, 2007), *available at* http://www.bisanet.org/gc/pdf/Scan001.pdf. In fact, $1million is the SEC's standard for "accredited investor" status, which permits individuals to invest in private offerings under Regulation D. *Id.*

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New York's New Ethics Rules: What You Don't Know Can Hurt You!

By C. Evan Stewart

In 2009, New York State's new legal ethics standards were ushered in to great fanfare (e.g., an "extraordinarily positive result," "a major achievement for New York," "a big step forward," etc.). For legal academics there was much to ponder and comment upon. For everyday transactional lawyers and litigators, however, there are a few key provisions that need to be highlighted and for which note (and caution) needs to be taken. This article is directed to those provisions.

> *"The SEC has been clear in its view that any state's lesser, inconsistent disclosure standards are pre-empted by the Sarbanes-Oxley legislation and the rules and regulations promulgated thereunder by the Commission…"*

A Brave "New" World?

When many of us "older" lawyers started practicing, the standards for attorney disclosure of client confidences were pretty clear—you were supposed to guard such confidences at all costs and in virtually all circumstances. That edifice, of which the New York State legal establishment was a strong supporter,[1] cracked significantly in the aftermath of the Enron, Tyco, Worldcom, etc. scandals.

Because there was a widespread belief among the politigencia that Enron, et al. represented a wide-scale failure of capitalism,[2] Congress passed the Sarbanes-Oxley legislation in 2002 and empowered the Securities and Exchange Commission, among other things, to federalize lawyer conduct for the first time in U.S. history. Asserting jurisdiction over lawyers with capital markets practices and those who "appear" before the Commission, the SEC promulgated *permissive* disclosure standards whereby a lawyer would be *permitted* to disclose a client's "material violation" (current, prospective, or past) to the SEC; and a lawyer would be *permitted* to withdraw his or her work product where an issuer's material violation had utilized that lawyer's services / work product. Failure to permissively disclose (where, in hindsight, a "reasonable lawyer" would have made the disclosure) would subject lawyers to the entire panoply of sanctions under the Securities Exchange Act of 1934.[3]

Not stopping there, the SEC went on to "jawbone" the American Bar Association in 2003 so as to bring the ABA's Model Rules into line with the SEC's new confidentiality / disclosure standards. The Model Rules are only aspirational in nature, however, and the various states reacted to this directive with striking non-conformity.

Some states adopted the ABA's changes without substantive amendment.[4] Other states tinkered with the various disclosure obligations.[5] Another group of states simply chose to follow the old version of the Model Rules,[6] while still others retained their long-standing idiosyncratic views of lawyer disclosure obligations.[7] Finally, a few states decided not to significantly change lawyers' confidentiality / disclosure obligations to bring them into line with the Model Rules.[8]

With all that as background, what did New York State decide to do? Under New York's new Rule 1.6, New York lawyers may now use their discretion to make *permissive* disclosure (i) to prevent death or substantial bodily harm, or (ii) to prevent a crime. New York lawyers may also now withdraw an opinion which *was* based upon "materially inaccurate information or *is being* used to *further* a crime or fraud" (emphasis added). These are expansions of lawyer disclosure obligations, but not nearly as far as those mandated by the SEC (and endorsed by the ABA). How so? Well, for example, New York specifically carved out financial fraud from permissive disclosure; furthermore, disclosure of past client conduct remains unaffected, and New York appears to have carved out permissive withdrawal of work product from a number of areas. As a further deviation from the SEC and the ABA, New York declined to adopt in Rule 1.13, a provision that would allow a lawyer representing a corporation to "report out" if he or she was unable to get the corporation to "do the right thing" (i.e., follow his or her advice) and the corporation faced "substantial injury" relating to the advice (taken or not taken).[9]

So what if a New York lawyer follows the new New York State disclosure rules, but his or her conduct is inconsistent with the SEC's standards? The SEC has been clear in its view that any state's lesser, inconsistent disclosure standards are pre-empted by the Sarbanes-Oxley legislation and the rules and regulations promulgated thereunder by the Commission; in fact, the SEC has already explicitly warned two confrontationally non-compliant state bars (Washington and California) that they may well be in "deep do-do" unless they change their tune(s).[10] New York's action (or non-action vis-à-vis full compliance) comes with full knowledge of the SEC's warnings on that front.[11] And while there are numerous grounds to argue that the SEC's position on preemption is not well-grounded,[12] this is clearly an area where New

York lawyers need to be extremely careful **not** to become guinea pigs in a test of wills between the SEC and the New York State Bar.[13]

A "No" to Screening?

In our current world of mega-sized, multi-jurisdictional law firms, with partners moving laterally between firms like pinballs, conflicts issues are often front and center. And lawyers, being both risk-averse *and* highly creative, have tried mightily to jump over, under, and through various conflicts hoops.[14] One of these creative mechanisms is the ethical screen, whereby lawyers are "screened" off from seeing any and all information from a client in conflict with another client.[15]

Traditionally, the courts have been negative on screening techniques which have *not* included informed client consent;[16] under pressure from the Bar, however, more and more states have been approving rules permitting some kind of non-consensual screening.[17] And at the beginning of 2009, the ABA did a 180˚ turn on its long-standing opposition to screening, adopting an amended version to Model Rule 1.10 to allow for law firm screening without client consent.[18] So where does New York stand vis-à-vis this changing landscape?

In 2007, the New York State Bar's Committee on Standards of Professional Conduct, which spent several years studying the issues and then formulating comprehensive recommendations for the recent overhaul of the ethics rule, proposed a standard by which non-consensual screening would be part of New York's Rule 1.10.[19] The presiding justices of the four Appellate Divisions, however, specifically *declined* to include any non-consensual screening protocol to Rule 1.10.[20] That action has created the anomalous situation where New York State's new ethics rules appear to be directly at odds with a decision by the New York Court of Appeals.[21] Whether lawyers should utilize non-consensual screening in New York with this institutional conflict in place seems like a profound and disturbing question.[22]

The Unauthorized Practice of Law?

In 1998, the California Supreme Court gave a rude wake-up call to lawyers who blithely assumed they could practice law anywhere and everywhere. In *Birbrower v. Superior Court of Santa Clara*,[23] the court ruled that a California client was justified in not paying New York lawyers for their work at a San Francisco-based arbitration; the court's ruling was grounded on the fact that the New York lawyers were not licensed to practice law in California.

Birbrower caused a big brouhaha, mainly among transactional lawyers, whose clients and practice have no geographic boundaries.[24] As a consequence of *Birbrower* and the angst it caused, the ABA appointed a Commission on Multijurisdictional Practice. The Commission was deluged with a host of less than practical solutions;[25] notwithstanding, the ABA ultimately promulgated two new Model Rules (5.5 and 8.5), which provide a fairly sensible approach to the issue of multijurisdictional practice ("MJP").

> *"The presiding justices of the four Appellate Divisions specifically* declined *to include any non-consensual screening protocol to Rule 1.10."*

Model Rule 5.5(c) sets forth a number of "safe harbors" whereby an out-of-state lawyer "may provide legal services on a *temporary* basis" in a state in which he or she is not licensed.[26] And section (d)(1) of that same Model Rule allows for a special carve-out for in-house lawyers working at a corporation in a state in which they are not licensed.[27] As to Model Rule 8.5, that was tweaked to make a "temporary" lawyer's "host" state jurisdiction co-equal to the lawyer's "home" state, in order to provide for the disciplining of said lawyer for any ethical lapses in the "host" state (i.e., lawyers could be subjected to two bites of ethical sanctions).

Unfortunately, the aftermath of these two rules is less than perfect clarity. A number of states adopted the two rules wholesale, with a number of others adopting them but also making many different amendments / permutations thereto, with still others having not yet acted or having specifically declined to weigh in. And while this may seem like a great testament to our federalist system,[28] it in fact represents a trap for the unwary lawyer who does not carefully study the rules of each state in which he or she plans to give advice or close deals.[29] This is especially true insofar as the states give different priorities to (and commit disparate resources to) the enforcement of out-of-state lawyers' unauthorized practice of law.[30]

So where does New York State fit into this puzzle? Twice, there have been proposals to have something in place like the ABA's Model Rules approach; the most recent of these came from the Committee on Standards of Professional Conduct. As with the screening proposal, however, the presiding justices of the four Appellate Divisions declined to adopt any MJP rule.[31] Does this mean (as some have suggested) that non-New York lawyers enter New York State at their peril with no guidance, while allowing the New York Bar to go out to other states that have MJP rules and act as "freeriders"?[32] No, not really. First of all, as noted above, there is the non-uniformity of MJP rules that exists from state to state and about which *all* lawyers must worry. There are, moreover, well-reasoned judicial decisions by the New York courts upon which out-of-state lawyers can reasonably rely.[33] Still, it is a bit odd to have the nation's commercial hub an outlier on this subject (especially given the number of in-house lawyers working at major corporations based in New York); it seems safe to assume that there will be further efforts to enact some set of MJP standards for New York State in the near future.[34]

> *"[T]he ethics standards governing New York State lawyers' conduct have been changed, and we must all—if not embrace them—be sure that we know what they cover (and do not cover)."*

Conclusion

It is said that the only person who readily embraces change is a baby in need of a new diaper. Be that as it may, the ethics standards governing New York State lawyers' conduct have been changed, and we must all—if not embrace them—be sure that we know what they cover (and do not cover).

Endnotes

1. *See* S. Rifkind, *The Lawyer's Role and Responsibility in Modern Society*, 30 The Record 534, 1975. With respect to a client's past conduct, the governing standards were relatively clear (if not uniform). With respect to future or ongoing conduct, as well as past conduct in which a lawyer's services were utilized, the standards were quite disparate (*compare* California *with* Illinois). In New York, a lawyer had the *discretion* to violate a client's confidences to prevent a client from committing a crime, but could not violate that confidence in the case of a non-criminal act (*e.g.*, a tort, a / k / a a fraud); similarly, a lawyer could not rat out a client to rectify a client's crime or fraud where the lawyer's services had been used.

   Under the "old" ABA Model Rule (which a number of states followed in whole or in part), a lawyer had the *discretion* to violate a client's confidences to prevent imminent death or the likelihood of substantial bodily harm: as to a client's non-criminal act, the Model Rules barred disclosure; and as to rectifying crime or fraud where a lawyer's services were used, it was safe to say that the ABA's then-existing view was extremely muddled.
2. Of course, those "failures of capitalism" pale by comparison to what occurred in the latter half of 2008. *See* J. Nocera, *Lehman Had to Die, It Seems, So Global Finance Could Live*, N.Y. Times, Sept. 12, 2009, at A1; D. Wessel, *Government's Trial and Error Helped Stem Financial Panic*, Wall St J., Sept. 14, 2009, at A1 . *See also* C. Stewart, *Casablanca and the Crisis in Capitalism: Which 'Reforms' Will Save Us?*, BNA Securities Regulation & Law Report, Nov. 17, 2008.
3. The Commission proposed, but then tabled (indefinitely), the notion of attorneys engaging in "noisy withdrawals." *See* C. Stewart, *The Pit, the Pendulum, and the Legal Profession: Where Do We Stand After Five Years of Sarbanes-Oxley?*, BNA Securities Regulation & Law Report, Feb. 18, 2008.
4. *E.g.*, Alaska, Arizona, Arkansas, Connecticut, Hawaii, Idaho, Indiana, Iowa, Louisiana, Massachusetts, Nebraska, South Carolina, and Vermont.
5. *E.g.*, District of Columbia, Kentucky, Maryland, Minnesota, North Dakota, Tennessee, Texas, Utah, and Virginia.
6. *E.g.*, Alabama, Colorado, Delaware, Florida, Georgia, Kansas, Michigan, Mississippi, Missouri, Montana, Nevada, New Hampshire, New Mexico, North Carolina, Oklahoma, Pennsylvania, Rhode Island, South Dakota, West Virginia, Wisconsin, and Wyoming. *See supra* note 1 for the "old" ABA Model Rule standard.
7. Both Illinois and New Jersey, for example, required *mandatory* disclosure in certain circumstances.
8. *E.g.*, California, Kansas, Maine, Ohio, and Washington.
9. New York also did not adopt the "reasonable lawyer" standard, opting instead to judge lawyers' behavior on an actual knowledge standard. This is a *very* important safeguard for lawyers, protecting them from harsh, 20-20 hindsight judgment.
10. *See* Stewart, *supra* note 3.
11. See J. Rogers, *New York State Bar Parts Ways with ABA on Disclosure of Fraud, Use of Screening*, ABA / BNA Lawyers' Manual on Professional Conduct, Nov. 14, 2007.
12. *See* Stewart, *supra* note 3.
13. Former SEC general counsel, Giovanni Prezioso, who led the Commission's pre-emptive efforts vis-à-vis Washington and California, gave this advice to lawyers in an April 3, 2004 speech to the ABA's Section of Business Law:

    > I would urge any lawyer who would like to make a disclosure under the Commission's rules, but who is concerned with a potential conflict with state bar rules, to consult with us, either directly or through counsel. We on the staff would appreciate the opportunity to work with a lawyer facing such a conflict, either in addressing the issues before state bar authorities or, if necessary, in court. My expectation is that the Commission would be favorably disposed to supporting attorneys seeking to rely on the preemptive effect of its rules.

    (*available at* http: / / www.sec.gov / news / speech / spch040304gpp.htm).
14. *See* C. Stewart, *The Legal Profession and Conflicts: Ain't No Mountain High Enough?*, N.Y. Bus. L. J. , Fall 2007.
15. Some have dubbed this the "cone of silence," based upon a sight gag from the 1960s television sitcom "Get Smart." *See Atasi Corp. v. Seagate Technology*, 847 F.2d 826, 831 (Fed. Cir. 1988).
16. For an excellent summary of the history of screening and the courts' general reluctance to buy into it, *see* G. Hazzard, S. Koniak, R. Cramton, G. Cohen, The Law and Ethics of Lawyering 487-90 (4th Ed. 2005). *See also Westinghouse Electric Corp. v. Kerr-McGee Corp.*, 580 F.2d 1311 (7th Cir. 1978). *But see Schiessle v. Stephens*, 717 F.2d 417 (7th Cir. 1983).
17. At present, 24 states allow for some type of screening.
18. *See* R. Valliere, *ABA* Delegates Modify Conflicts Rule, Allow Screens When Lawyers Change Firms, ABA / BNA Lawyers' Manual on Professional Conduct, Feb. 18, 2009.
19. *See* J. Rogers, *New York State Bar Parts Ways With ABA On Disclosure of Fraud, Use of Screening*, ABA / BNA Lawyers' Manual on Professional Conduct, Nov. 14, 2007.
20. *See* J. Rogers, *New York Adopts Format of Model Rules, but Keeps Much From Code and Omits MJP*, ABA / BNA Lawyers' Manual on Professional Conduct, Dec. 24, 2008. The judges took this action without explanation as to why the Committee's recommendation was not accepted.
21. *See Kassis v. Teacher's Ins. & Annuity Ass'n*, 93 N.Y.2d 611, 717 N.E.2d 674, 695 N.Y.S.2d 515 (N.Y. 1999) (law firm disqualified for having faulty screening, but screening as a concept endorsed).

22. The issue of which institution is (or should be) the preeminent determiner of ethics issues is addressed in James Bernard's recent article *The Role of Courts in Deciding Ethics Issues*, Fed. Bar Council Q., Aug. 2009.

23. 949 P.2d 1 (1998).

24. *See* T. Loomis, *Unauthorized Practice: Many Lawyers Do Not Know They Are in Violation*, N. Y. L. J., Mar. 22, 2001; D. Baker, *Lawyer, Go Home*, ABA J., May 1998 (quoting ethics professor Charles Wolfson, "[*Birbrower*] sets the legal field back a quarter of a century at least…. [I]t's insane. It won't be followed and it shouldn't be.").

25. *See* C. Stewart, *Corporate Counsel and the Unauthorized Practice of Law: 'Special' Is Not Necessarily Better*, N.Y.L.J., Aug. 28, 2001.

26. Emphasis added. Model Rule 5.5(c) reads as follows:

> (c) A lawyer admitted in another United States jurisdiction, and not disbarred or suspended from practice in any jurisdiction, may provide legal services on a temporary basis in this jurisdiction that:
> (1) are undertaken in association with a lawyer who is admitted to practice in this jurisdiction and who actively participates in this matter;
> (2) are in or reasonably related to a pending or potential proceeding before a tribunal in this or another jurisdiction, if the lawyer, or a person the lawyer is assisting, is authorized by law or order to appear in such proceeding or reasonably expects to be so authorized;
> (3) are in or reasonably related to a pending or potential arbitration, mediation, or other alternative dispute resolution proceeding in this or another jurisdiction, if the services arise out of or are reasonably related to the lawyer's practice in a jurisdiction in which the lawyer is admitted to practice and are not services for which the forum requires pro hac vice admission; or
> (4) are not within paragraphs (c)(2) or (c)(3) and arise out of or are reasonably related to the lawyer's practice in a jurisdiction in which the lawyer is admitted to practice.

27. In the aftermath of creating this in-house exception, the ABA adopted a new Model Rule in 2008 whereby there would be a "registration" requirement for in-house lawyers; they would be mandated to "sign-in" and pay their "host" state a fee. *See* L. Rogers, *Corporate Counsel Must Be Mindful of Proliferating State Licensing Regulations*, ABA / BNA Lawyers' Manual on Professional Conduct, Feb. 18, 2009. *See also Special Admission of In-House Counsel Requires Payment of Fee in Most States*, ABA / BNA Lawyers' Manual on Professional Conduct, Feb. 18, 2009 (collection of various states' practices).

28. *See* L. Rogers, *Most States Now Allow Limited Legal Services by Attorneys Licensed Elsewhere*, ABA / BNA Lawyers' Manual on Professional Conduct, Sept. 16, 2009 (survey of various states' rules and practices).

29. *See supra* notes 27 & 28. *See also Motion Filed by Out-of-State Lawyers Constituted UPL That Nullified Result*, ABA / BNA Lawyers' Manual on Professional Conduct, May 27, 2009; *Courts Split as to Whether UPL Rule Covers Practice in Federal Court in Licensing State*, ABA / BNA Lawyers' Manual on Professional Conduct, Aug. 22, 2007; S. Kilman & J. Lubin, *Southfield's General Counsel Becomes Focus of Union Drive*, Wall St. J., Aug. 16, 2006, at B9 (August 16, 2006); *New ABA Survey of UPL Enforcement Funds Varied Findings, Predicts Increased Activity*, ABA / BNA Lawyer's Manual on Professional Conduct, Jan. 12, 2005.

30. *See* Latest *ABA Review of UPL Enforcement Finds More Regulation, More Prosecution*, ABA / BNA Lawyer's Manual on Professional Conduct, May 27, 2009.

31. *See supra* note 20.

32. *Id.*

33. *See, e.g.*, *Prudential Equity Group, LLC v. Ajamie*, 2008 U.S. Dist. LEXIS 14108 (S.D.N.Y. Feb. 27, 2008); *Williamson, P.A. v. John D. Quinn Construction Corp.*, 537 F. Supp. 613 (S.D.N.Y. 1982); *El Gemayel v. Seaman*, 72 N.Y.2d 701, 533 N.E.2d 245, 536 N.Y.S.2d 701, 533 N.E.2d 406 (1988). *See also Unauthorized Practice of Law and the Representation of Parties in Arbitrations in New York by Lawyers Not Licensed to Practice in New York*, The Record 700 (2008).

34. *See supra* note 20.

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When Is a Foreign Corporation Doing Business in New York?

By Stuart B. Newman and Ari Spett

One of the most vexing questions lawyers are frequently asked is whether the activities of a corporation may constitute "doing business" in another state, requiring it to apply for a certificate of authority to do business in that state.

The question usually arises in one of two contexts: (1) opinion letters, where lawyers are required to opine as to whether a corporation is qualified to do business in all foreign jurisdictions where its activities or ownership of property require it to be so qualified; and, (2) litigation, where most states, including New York, require non-domestic corporations to be qualified as a condition for access to the judicial system to assert a claim in litigation.

"According to the opinion in this case, non-domestic businesses may meet the test for 'doing business' in New York, even if none of the standard indicia are there."

Traditionally, the issue is decided by posing a series of questions to the client to gauge the weight of contacts the foreign business has with the state. "Do you own any property in that state? Do you lease property in that state? Do you have an office there? Do you have a telephone number listed in that state? Do you have any employees residing there? Do you have any bank accounts in the state?" The more affirmative answers a lawyer receives, the more objective the analysis a lawyer can provide.

However, a recent New York case, *Schwarz Supply Source v. Redi Bag USA LLC*, N.Y.L.J. Jan 8, 2009, Index No. 016733/08 (Sup. Ct., Nassau Co. Dec. 22, 2008) (Bucaria, J.S.C.), suggests that this vexing question may be much more difficult to answer than previously thought, because the analysis used by the court was far more subjective. According to the opinion in this case, non-domestic businesses may meet the test for "doing business" in New York, even if none of the standard indicia are there.

On December 22, 2008, Justice Stephen A. Bucaria, New York State Supreme Court, Nassau County, rendered his decision in *Schwarz Supply Source v. Redi Bag USA LLC*. This case arose out of a dispute between the plaintiff foreign corporation, a distributor of plastic shopping bags, and the defendant New York limited liability company, a manufacturer who produced the plastic shopping bags.

Plaintiff Schwarz Supply Source filed suit for breach of contract. Defendant Redi Bag moved to dismiss Plaintiff's suit on grounds which included, pursuant to Business Corporation Law § 1312(a), that plaintiff was a foreign corporation not authorized to do business in New York.

Plaintiff responded to this argument by asserting that: (i) it had neither an office nor a distribution center in New York; (ii) it did not have any employees based in New York; (iii) it did not maintain a New York telephone number; (iv) it did not have any bank accounts in New York; (v) it did not own any New York real estate; (vi) it did not advertise its services in New York; and, (vii) its business activities in New York were limited to buying goods from vendors, incidentally located in New York, for distribution to customers located across the country. Nevertheless, Justice Bucaria granted Defendant's motion, in part because the way in which Plaintiff did business appeared to "sidestep" the traditional requirements for "doing business." He therefore concluded that Plaintiff Schwarz Supply Source was prohibited under New York Business Corporation Law § 1312 from maintaining the action at bar.

In 1963, the New York State Legislature enacted BCL § 1312 relating to actions or special proceedings brought by unauthorized foreign corporations.[1]

Essentially, the statute prevents an unauthorized foreign business corporation that does business in New York State from maintaining an action in New York State courts. The purpose of the statute was "to protect domestic corporations from unfair competition and to place them on an equal footing with corporations who are using the facilities provided by the state of New York in the conduct of their business," *Dixie Dinettes, Inc. v. Schaller's Furniture, Inc.*, 71 Misc.2d 102 (Civ. Ct., Kings Co. 1972)[2].

However, the statute begs one very important question: What constitutes "doing business" in the State of New York for the purpose of the BCL?

Traditionally, "doing business" under BCL § 1312(a) requires a greater amount of local activity by a foreign corporation than the "transacts any business" standard of CPLR 302(a)(1), which gives "long-arm" jurisdiction over foreign entities for acts done in New York.[3] Under the BCL, when a foreign entity *does business*, its activities within New York must be systematic and regular in order to be barred from maintaining an action.[4]

For example, the solicitation of sales and delivery of merchandise within New York, where the foreign corporation had neither an office, employees, property, nor a telephone listing within the state, was held not to constitute "doing business" under the BCL in *Uribe v. Merchants Bank of New York*, A.D.2d 21 (App. Div. 1st 1999), *see also S&T Bank v. Spectrum Cabinet Sales, Inc.*, 247 A.D.2d 373 (App. Div. 2nd 1998).

Yet, no single measure of "doing business" seems to be uniformly applied statewide. In *Great White Whale Advertising, Inc. v. First Festival Productions*, 81 A.D.2d 704, 706 (App. Div. 3rd 1981), the court proclaimed that "whether a company is 'doing business' within the purview of section 1312 of the Business Corporation Law, so as to foreclose access to our courts, depends on the particular facts of each case with an inquiry into the type of business activities being conducted."

However, the courts have maintained that there are certain traditional indicia for doing business in New York for the purpose of BCL § 1312. These indicia include, but are not limited to, whether plaintiff: is headquartered in New York; has a New York office; has any New York-based employees; has a New York phone listing; has any New York bank accounts; owns any New York real estate; or advertises in New York.

In the instant case, however, the plaintiff Schwarz Supply Source had none of these traditional contacts with New York. The plaintiff was a Delaware corporation, headquartered in Chicago. The parties had a manufacturer-distributor relationship. Defendant Redi Bag participated in an online auction conducted by Bed Bath & Beyond for an opportunity to be chosen to manufacture plastic shopping bags for its stores to be distributed by and through Schwarz Supply Source. After it was chosen as the manufacturer, Redi Bag contracted to supply the bags to Schwarz Supply Source for distribution to Bed Bath & Beyond retail stores throughout the country.

The court, however, declared that the nature of Schwarz Supply Source's distribution operation avoids the traditional requirements for "doing business" in New York State, stating that a company that supplies material to retail stores "would not include such case law indicia as advertising, and the plaintiff's practice does not require an office, telephone or a sales representative in New York State, instead…the relationship arises out of an internet auction, initiated by Bed Bath & Beyond and utilized by the plaintiff to provide services to, *inter alia*, New York businesses." (emphasis added)

The court opined that the "[a]greement which forms the basis of this and the Redi Bag action clearly describes the plaintiff as a distributor of the defendant's products and essentially creates an agency relationship between the parties on the aspect of Market Development Support set forth in the agreement. Similarly, the business relationship created by the agreement demonstrates indicia, e.g., Insurance requirements, indemnification and a trade secret and confidentiality disclosure, that manifests a working relationship between the parties that leads to a categorization of the plaintiff as a distributor to Bed Bath & Beyond, at least."

Such provisions concerning insurance, indemnification and trade secret confidentiality are standard components of many commercial contracts. The court appears to set a new threshold for "doing business" under the BCL for a non-domestic entity, crossed merely by having a "working relationship" with a New York business. This would vastly broaden the class of foreign entities that would be seemingly required to qualify in New York.

"Where once there may have been clarity, now the threshold for contacts with New York that would sufficiently constitute 'doing business' under the Business Corporation Law is now far more vague and expansive in scope than it ever has been."

The court seems to equate having any business activity with New York-based companies with having business activities of localized or intrastate character.[5] Even if we accept the court's proposition that Plaintiff had "substantial" business contacts with New York-based companies on its face, that still falls short of the "wholly intrastate" standard of *Domino Media, Inc.* or the "localization or intrastate character" standard of the United States Supreme Court in *Allenberg Cotton Co.*

It should also be noted that the court failed to take into account the directionality of the flow of commercial activity. If a foreign distributor, acting on behalf of a New York retail store or statewide retail chain, channels goods produced elsewhere *into* New York, a court may theoretically construe such activity to be a business contact of sufficiently local or intrastate character. Here, however, Schwarz Supply Source channeled the product of a local manufacturer *out* of New York and into venues around the country. It does not follow that, under the traditional standard, such business contact would have the local or intrastate character sufficient to be deemed as "doing business" in this state.

To do business within the meaning of BCL § 1312 an unauthorized foreign entity's business contacts with the state must be so systematic and regular that the entity establishes a continuity of activity within the state. The United States Supreme Court added that such activity must have a localized or intrastate character, or else the state's "door closing" statute runs afoul of the commerce clause of the United States Constitution.

Where once there may have been clarity, now the threshold for contacts with New York that would sufficiently constitute "doing business" under the Business

Corporation Law is far more vague and expansive in scope than it ever has been.

Endnotes

1. BCL §1312 was amended by 1990 N.Y. Laws 190. With the state in the depths of a recession and hungry for revenue, the Assembly passed Bill No. 11693, which primarily amended the State's Tax Law but also amended subdivision (a) of Section 1312 of the Business Corporation Law. The statute's original language stated that if an unauthorized foreign corporation doing business in New York wanted to maintain an action within the state, it merely needed to file for authorization, pay the fees associated with the filing and pay any penalties and franchise taxes for the period of time that it did business in New York without authority. The new amended language broadened the amount of revenue that the state could collect by eliminating the language limiting the time-frame for penalties, imposing taxes and tacking on interest.
2. While the rationale expressed in *Dixie Dinettes* may have been true in 1972, the fact that the statute, in its current form, serves as a broadly expanded mechanism for streaming capital into the state's coffers should not be overlooked. Note that this is not a statute that directly deals with unfair competition. It neither penalizes the business practices of foreign corporations, nor does it even penalize an unauthorized foreign business corporation for doing business in the State of New York per se. What the statute does do, however, is to coerce foreign business corporations into paying the state the costs and fees of authority to do business, if they feel the need to avail themselves of our court system. This point is made quite clear by subdivision (b) of the statute, which states, in part, "The failure of a foreign corporation to obtain authority to do business in this state shall not impair the validity of any contract or act of the foreign corporation…"
3. *Maro Leather Co. v. Aerolineas Argentinas*, 161 Misc.2d 920, 924 (Sup. Ct., App. Term 1st 1994).
4. In *Airline Exchange, Inc. v. Bag*, 266 A.D.2d 414 (App. Div. 2nd 1999), a foreign entity that maintained its office and received its mail in Florida, and whose president had a New York bank account for his other business, was not considered to be systematically or regularly conducting business activities in the state.
5. *Allenberg Cotton Co. v. Pittman*, 419 U.S. 20, 33 (1974). Here, the United States Supreme Court voted 8-1 to overturn a Mississippi Supreme Court decision barring appellant cotton distributor from maintaining an action in its state court on the ground that it was doing business in the state without authorization. The majority decision stated that since appellant had no office in Mississippi, nor a warehouse in the state, nor did it have employees soliciting business in Mississippi, nor did it operate within the state on a regular basis, "[a]ppellant's contacts with Mississippi do not exhibit the sort of localization or intrastate character which we have required in situations where a state seeks to require a foreign corporation to qualify to do business."

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What Every Attorney Should Know About the New Durable Power of Attorney Form

By Anthony J. Enea

At first glance the most obvious difference between the old statutory durable general power of attorney form and the new statutory short form power of attorney (the "New Form POA" or the "New Form")[1] that became effective on September 1, 2009 is the length of the new form—it is considerably longer than the old form. Then there is the addition of the Statutory Major Gifts Rider (SMGR).[2] Beyond these obvious differences, the major distinction, in my opinion, is that the New Form poses significant execution problems, especially for seniors and a small firm or sole practitioners who have difficulty obtaining witnesses for the execution of documents. In their zeal to protect the elderly from financial abuse, the drafters may have created a document that is so complicated and difficult to execute that it may end up being underutilized.[3] For example, at a recent seminar a prominent attorney suggested that he is strongly considering recommending to his clients that they execute and fund a revocable living trust, thereby avoiding the complexities of the New Form and what are likely to be the continuation of problems associated with recognition and acceptance of powers of attorney by financial institutions and banks.

I will highlight for you what I believe are some of the most important aspects / provisions of the New Form which necessitate your attention:[4]

1. The New Form must be in at least 12-point size font.

2. If more than one agent is designated, they must act together unless the principal initials the box permitting the agents to act separately.

3. If successor agents are designated, they must act together unless the principal initials the box permitting the successor agents to act separately.

4. The execution of the New Form automatically revokes any and all prior powers of attorney executed by the principal, unless otherwise stated in the "modifications" section of the New Form. Arguably, this would include any banking and financial institution powers of attorney previously executed by the principal. Certainly, other types of preexisting powers of attorney would also be revoked. Practitioners are urged to address this issue with the principal, and provide for previously executed and existing powers of attorney in the "modifications" section of the New Form.

5. Part (f), entitled "Grant of Authority," lists the specific powers—lettered "A" through "P"—that the principal may grant to the agent. The principal may either initial each of the letters corresponding to the specific power he or she wants to grant or he or she may initial the letter "P" and can then list each of the specific letters for each power to be granted.

   Letter "M" of the old form, as you may recall, contained a gifting provision. No gifting provisions are contained within letters "A" through "P" of the New Form. The sole exception is that under letter "I," entitled "Personal and Family Maintenance," the agent may continue making gifts the principal made to individuals and charities prior to the POA being signed, in an amount not to exceed $500 per recipient in any one calendar year.[5]

   Letters "A" through "O" of the New Form should not be modified in any way, shape or form. I also believe that no additional lettered matters should be added in Part (f). For an explanation of each of the powers granted a thorough reading of GOL §§ 5-1502A through 5-1502O is a must.[6]

6. Part (g) of the New Form permits the principal to state any "modifications" to the authority granted in Part (f) and otherwise modify some of the other default provisions of the New Form. However, it is important to note that any "modifications" stated in Part (g) should not be provisions which allow the agent to make gifts of the principal's assets or change the principal's interest in property. Any gifting other than the minimal gifting provided for in letter "I" must be provided for in the SMGR. For example, in Part (g), the principal could provide that the execution of the New Form does not revoke a prior banking or financial institution POA. The principal can also define the "reasonable compensation" he or she would like the agent to receive or he or she may limit the powers of a "monitor" (a newly created party under Part (i) of the New Form). Part (g) is also the section where many elder law planning techniques can be provided for, such as entering into a personal service contract. As long as the modifications do not involve gifts of the principal's assets or changes to his or

her interest in property, it appears that a variety of modifications are permissible in Part (g).

7. If the principal wishes to allow the agent to make gifts in excess of the $500 provided for in letter "I" of the powers, he or she would need to initial both Part (h) of the form and complete and execute the SMGR.

8. Part (i) of the New Form allows the agent to appoint a "monitor" who may demand accountings by the agent, including records and documents of all transactions, and also obtain documents from third parties. Caution here. If we counsel a principal to appoint one family member as agent and another family member as monitor, we may be leading our clients down a slippery slope toward family power struggles that can detrimentally impact the agent's ability to act under the New Form. It may be wise to specifically delineate the monitor's authority and the extent that he or she can seek and demand records. For example, you may wish to limit the ability to demand records to once or twice per year. This is so especially as monitors are also permitted to commence a lawsuit against the agent(s).[7]

9. Part (j) of the New Form provides that the agent may be reimbursed for reasonable expenses incurred on the principal's behalf. If the principal wishes to allow the agent to receive "reasonable compensation," he or she must initial the box in Part (j). If the principal wishes to limit or define "reasonable compensation" he or she should do so in the modification section, Part (g).

   As you can see, the number of times the principal is required to place his or her initials has significantly increased from the old POA form. For many seniors this will be another hurdle to executing the New Form.

10. Part (l) of the form concerns the revocation and termination of the authority of the agent. Of course, the New Form POA terminates when the principal dies or becomes incapacitated if the POA is not durable.[8] The New Form is durable unless the principal states otherwise.[9] Under the new law, as in the past, delivery of a written instrument to both the agent(s) and any third party who may have relied on the POA as to the revocation of a POA is sufficient notice of revocation.[10]

11. The new POA form must be dated and signed by the principal and acknowledged by the principal before a notary public.

12. Part (n) of the New Form provides the agent with a statement of his or her legal obligations, duties and liabilities as an agent. It clearly places a significant burden and responsibility upon the agent for record keeping.

    In my opinion, the agent under the New Form POA is now in a similar fiduciary position as the trustee of a trust. Part (n) also places the attorney representing the principal in the unenviable position of having to advise the agent that there may exist a potential conflict of interest, and that he or she may wish to seek separate legal counsel before executing the New Form. If the agent does not obtain separate legal counsel, it may be wise to obtain from him or her some written acknowledgement of the waiver of the potential conflict of interest and the decision not to retain counsel.

    I believe a significant number of prospective and named agents will decide that they don't want the responsibility of being an agent, once they have read the notice provisions of the New Form and consulted with an attorney.

13. The agents must sign and have their signatures acknowledged before a notary public in Part (o) of the New Form; the New Form POA is not valid until all of the agents have signed and had their signatures acknowledged before a notary public. Multiple agents, however, do not need to sign at the same time and do not need to sign at the same time as the principal.

14. The SMGR must be executed simultaneously with the POA form by the principal. When both documents have been fully executed, they will then be read as one document.

    Gifting under the SMGR is authorized only if the principal has initialed Part (h) of the New Form POA. Clearly, the SMGR is intended to alert the principal of the gravity and importance of granting gifting powers to the agent, particularly if the agent is to have the authority to gift to him or herself. However, when one analyzes both the execution requirements of the SMGR and the legislative provisions relevant to the powers enumerated in the "modifications" section—Part (b)—of the SMGR, there are enough ambiguities and contradictions, in my opinion, to devote a full-day seminar to. Nevertheless, here are highlights:

    A. If the principal wishes to allow the agent to make gifts to others, not including him or herself up to the federal annual gift tax exclusion ($13,000 for 2009), he or she will need to initial the box in Part (a) of the SMGR.

B. Part (b) of the SMGR must contain any "modifications" or expansion of the gifting powers the principal wishes to give to the agent(s), and the box in Part (b) must be initialed by the principal. The Part (b) modifications relate to any expansion or modification of the power of the agent to gift beyond the annual exclusion amount ($13,000) to third parties. The powers in Part (b) *do not* include the powers to the agent to gift to him or herself (emphasis added). That authority must be provided in Part (c) of the SMGR. The gifting to third parties in Part (b) can be unlimited or limited to a specific amount. Sample modifications of the gifting powers that can be inserted in Part (b) can be found in GOL § 5-1514(3). It does not appear that GOL § 1514(3) limits the modifications that can be made.[11] However, this seems to be another area of ambiguity.

C. Part (c) of the SMGR also has to be initialed by the principal if he or she wishes to grant the agent the authority to gift to him or herself, to the extent or limited as delineated therein.

   Thus, it appears that the boxes in Part (a), (b) and (c) of the SMGR will have to be initialed by the principal if he or she wishes to grant expanded gifting powers to the agent with respect to third parties and him or herself. The principal will also have to clearly state his or her modifications of these powers.

D. In Part (e), the SMGR must be dated and signed by the principal with his or her signature acknowledged before a notary public.

E. In Part (f), the SMGR must be witnessed by two people who are not *potential* recipients of gifts under the SMGR and the witnesses' statement must indicate that they observed the principal sign the SMGR.

F. And finally, Part (g) of the SMGR must state the name(s) and address(s) of the person or persons who prepared the SMGR.

Conclusion

This article is by no means an exhaustive review of the New Form POA and the SMGR that went into effect on September 1, 2009. More changes in the form of technical corrections are imminent, once the legislature is back in session. Hopefully, I have made the reader aware that the New Form POA and the SMGR have many complexities that must be carefully studied, understood and followed or modified depending on each client's situation. I wish you and your clients the best of luck in doing so.

Endnotes

1. 2008 N.Y. Laws ch. 644. On January 27, 2009, Governor Patterson signed into law Chapter 644 of the N.Y. Laws of 2008. *See* 2009 N.Y. Laws ch. 4. All statutory references herein are to the amendments to the N.Y. General Obligations Law §§ 1-1501, *et seq.*, and are referred to for convenience and ease of use as GOL.
2. GOL § 5-1514.
3. The author wishes to acknowledge all of the hard work and efforts of the drafters of the new form and of all the sections and committees involved. He is hopeful that the statute and form are viewed as works in progress.
4. At the time this article was written, there were at least two bills pending—A.8392 and S.5589—that propose technical corrections to the New Form with respect to the revocation or termination of the POA. While these technical corrections address some of the concerns raised in this article, it was not likely that these amendments would be enacted before the New Form became effective on September 1, 2009.
5. GOL § 5-1502I.
6. *See* GOL §§ 5-1502A–5-1502O.
7. GOL § 5-1509.
8. *See* GOL § 5-1511.
9. GOL § 5-1501A.
10. *See* GOL § 5-1511(3).
11. *See* GOL § 5-1503.

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New York Employment Law Update

By James R. Grasso

Supreme Court Raises Burden to Prove Age Discrimination

In a 5-4 decision issued on June 18, 2009, the U.S. Supreme Court held that a plaintiff alleging a disparate treatment age discrimination claim under the Age Discrimination in Employment Act (ADEA) cannot prevail by merely proving that age was a motivating factor in the challenged adverse employment action, but must prove that age was the "but for" cause of the action. Writing for the majority in *Gross v. FBL Financial Services, Inc.*, No. 08-441, Justice Thomas wrote that under the ADEA the burden of persuasion never shifts to the employer in a disparate treatment claim, even in mixed-motive cases where the employer may have been motivated by both age and permissible non-age factors.

In April 2004, Jack Gross sued his employer, FBL Financial Group, Inc. (FBL), alleging that his reassignment to another position was a demotion and was because of his age (he was 53). Gross won at trial and the jury awarded him $46,945. On appeal, the Eighth Circuit Court of Appeals overturned the jury award, holding that the trial court gave an improper jury instruction on the burden of proof. Gross appealed to the Supreme Court.

In his decision, Justice Thomas rejected the argument that the burden of persuasion in ADEA cases should be governed by the "motivating factor" standard applicable under Title VII. Stating that Title VII and the ADEA are "materially different with respect to the relevant burden of persuasion" the Court reasoned that its interpretation of the ADEA is not governed by its decisions under Title VII, such as *Price Waterhouse v. Hopkins*. The Court also found relevant that when Congress amended Title VII to add the "motivating factor" standard it neglected to add such a provision to the ADEA. Justice Thomas then interpreted "because of" age to mean that a plaintiff must show that age was the "but for" reason for the employer's adverse action. As a result, to prevail under the ADEA a plaintiff will now have to meet the higher burden of proving that age was the deciding factor for taking the adverse employment action, not just one of several motivating factors.

Supreme Court Limits Employers' Ability to Disregard Employment Test Results

In a 5-4 decision, the Supreme Court ruled that the City of New Haven engaged in disparate treatment discrimination against white firefighters when it discarded promotional test results because no African-American firefighters would have been promoted under the test. *Ricci v. DeStefano*, No. 07-1428 (June 29, 2009). In *Ricci*, the white firefighter plaintiffs alleged that the City's conduct constituted "reverse" race discrimination. In ruling for the white firefighters, the Supreme Court rejected the City's defense that it legally discarded the test results based on its fear that, if it accepted them, African-American firefighters would have sued for disparate impact discrimination. In essence, the City was arguing that it was justified in intentionally discriminating against the white firefighters because it feared liability based on the unintentional disparate impact of the test on the African-American firefighters.

The Supreme Court held that "[f]ear of litigation alone cannot justify an employer's reliance on race." Recognizing that there might be situations where an employer was required to engage in intentional discrimination to avoid liability for disparate impact discrimination, the Court held that "an employer can engage in intentional discrimination for the asserted purpose of avoiding or remedying an unintentional disparate impact" only if the employer has a "strong basis in evidence to believe it will be subject to disparate-impact liability if it fails to take the race-conscious, discriminatory action." Applying this standard to the facts of the case, the Supreme Court found that the City lacked a strong basis in evidence to justify discarding the test results because there was no evidence that the test was not job-related and consistent with business necessity, or that a less-discriminatory alternative test was available. As a result, the Court concluded that the City was not justified in discarding the test results.

As result of the *Ricci* decision, an employer's fear alone of litigation resulting from a business-related test that is job-related and consistent with business necessity, but which disproportionately impacts a particular group of employees, will no longer justify disregarding the test results. Rather, employers will now need an evidentiary basis to believe that they will be subject to disparate-impact liability before disregarding test results.

New York Employers Required to Provide Written Notice of Terms and Conditions of Employment Upon Hire

New York Labor Law § 195 requires employers to notify employees upon hire of their rate of pay and regular pay day. Verbal notice was previously acceptable under § 195. Section 195 was recently amended, effective October 26, 2009, to require that employers now provide **written notice** to new hires of their rate of pay and regular pay day. If a newly hired employee is eligible for overtime, the written notice must also include the employee's regular hourly rate and overtime pay rate. In addition, employers must obtain a written acknowledgement, which must conform to requirements established by the Commissioner of Labor, from each employee of receipt of this notice.

New York Expands Wage and Hour Protections and Increases Penalties for Violations

On August 26, 2009, Governor Paterson signed into law a bill (A06963) that expands employee wage and hour protections and increases penalties against employers for violation of wage and hour laws. The bill amends §§ 198 (1-a) and 663(1) and (2) of the New York Labor Law to allow the Commission of Labor to initiate an administrative proceeding (rather than only a court action) on behalf of employees for violations of wage payment laws. The bill amendments also allow the Commissioner and the courts to assess against the employer liquidated damages in an amount equal to 25% of the total amount of wages found to be due, unless the employer can prove that it had a good faith basis for believing that its underpayment of wages was in compliance with the law. Previously, the employee had to prove that the employer willfully underpaid his or her wages to recover liquidated damages.

The bill also amends Labor Law § 215(1) to expand the kinds of wage-and-hour-related conduct for which employees are protected from retaliation to include: (1) providing information to the Commissioner of Labor or his or her authorized representative; (2) exercising rights protected under that chapter; and (3) the employer receiving an adverse determination from the Commissioner involving the employee. Employees were already protected from retaliation for making a complaint to their employer or the Department of Law, commencing a proceeding under the law and testifying in an investigation or proceeding under the law. The new law also increases the minimum penalty that can be assessed for retaliation from $200 to $1,000 and increases the maximum penalty from $2,000 to $10,000, and allows the Commissioner to order an employer to pay lost compensation to an employee who has suffered from retaliation. The bill also extended the coverage of § 215(1) to limited liability companies and partnerships.

The above changes become effective on November 24, 2009.

New York Human Rights Law Amended to Protect Domestic Violence Victims and Provide for Civil Penalties

Effective July 7, 2009, the New York Human Rights Law ("HRL") was amended to protect domestic violence victims from employment discrimination. As a result, New York employers are prohibited from discriminating against any employee who is a victim of an act that would constitute a "family offense" under § 812(1) of the New York Family Court Act. Family offenses include disorderly conduct, harassment, stalking, criminal mischief, menacing, reckless endangerment, assault or attempted assault between spouses or former spouses, between parent and child, or between members of the same family or household, including persons who are not related, but who are or have been in an intimate relationship without regard to whether such persons have lived together at any time. This change brings the HRL in line with similar laws already in effect in New York City and Westchester County.

As the result of another recent amendment (contained in Chapter 57 of the Laws of 2009), effective July 6, 2009, civil penalties may now be imposed against employers found to have engaged in unlawful employment discrimination in violation of the HRL. Previously, only equitable relief (such as hiring, promotion or reinstatement) and compensatory damages (e.g., economic damages and emotional distress) were available. Penalties of up to $50,000 can be imposed in any discrimination case and up to $100,000 for "wanton, willful or malicious" violations. Penalties may be imposed in both court actions and administrative proceedings before the New York State Division of Human Rights ("SDHR"). The SDHR is developing guidelines for its Administrative Law Judges to use in assessing civil penalties. The HRL already allowed civil penalties in housing discrimination cases, and it is expected that the existing standards for those cases will guide the development of standards for employment cases. Although punitive damages and attorneys' fees are not now available under the HRL, legislation is pending to add those remedies.

New York "Mini-COBRA" Benefits Extended to 36 Months and Health Insurers Required to Offer Extended Dependent Care Coverage to Age 29

Effective July 1, 2009, as the result of an amendment to § 3221 of the New York Insurance Law, group health insurance plans subject to coverage under New York's "mini-COBRA" law must now offer continuation coverage upon termination or the occurrence of another qualifying event for 36 months, rather than the previous 18 months. New York's "mini-COBRA" law applies to employers with fewer than 20 employees. The new law also allows an employee who has exhausted continuation coverage under federal COBRA law to maintain coverage for up to 36 months, if the employee is entitled to less than 36 months of federal COBRA benefits.

As the result of other amendments to the Insurance Law that became effective on September 1, 2009, insurers are now required to provide employers the opportunity to extend coverage to "dependent children" to age 29, without regard to financial dependence. To qualify as a "dependent child," the child must be unmarried and live, work or reside in New York State or in the service area of the insurer and not be eligible for coverage under Medicare or through his or her employer. The law does not require employers to extend coverage to "dependent children" to age 29. Rather, it only requires insurers to offer such coverage as an option to employers. (These amendments are contained in Assembly bill A9038).

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Ethics Flu: Legal Ethics Concerns for New York-Licensed Cross-Border Transactional Attorneys

Why New York's New Rules of Professional Conduct Put New York-Licensed Cross-Border Transactional Attorneys at Risk and Recommendations for Immunizing New York Attorneys from Potential Liability, Using China as an Example

By Megan Burke

Introduction

Despite the recent global economic crisis, the deal landscape continues to become more and more globalized each quarter. Today's economy relies on the fact that business transactions take place around the world and that often large, New York City-based law firms dispatch their top talent to work on deals worldwide.[1]

"In the absence of a global set of legal ethics standards, New York attorneys are left to address individual legal ethics concerns as they arise, a process that can be daunting and, ultimately, may subject New York attorneys to liability."

Ethically speaking, when New York attorneys work on cross-border transactions in (or which involve) a foreign jurisdiction, either from a firm's New York office or from a New York firm's branch office abroad, significant legal ethics considerations arise.[2] Though New York has adopted the Rules of Professional Conduct,[3] it is unclear what a New York attorney's ethical obligations are when he or she is practicing abroad. In the absence of a global set of legal ethics standards, New York attorneys are left to address individual legal ethics concerns as they arise,[4] a process that can be daunting and, ultimately, may subject New York attorneys to liability.[5]

New York attorneys practicing in a foreign jurisdiction, and the New York and foreign law firms that supervise them, may find abiding by all of the New York Rules of Professional Conduct to be difficult, if not impossible. Though this article focuses on transactional work in China, by analogy, the ethical challenges discussed and the proposed recommendations for resolving such challenges may shed some light on how New York attorneys can confront legal ethics challenges in other foreign jurisdictions.

The article will emphasize how important it is for an attorney to (1) take into account pervasive cultural factors which influence a deal, (2) realize that local choice of law restrictions might not recognize New York's Rules of Professional Conduct, and (3) abide by the New York Rules to the best of his or her ability, without compromising the transaction or offending local counsel to such an extent that the viability of the transaction is compromised. The article will examine these ethical considerations within the context of transactions that take place in China or that involve either Chinese entities or companies that have significant Chinese holdings,[6] while drawing from examples in other foreign jurisdictions.

Lastly, the article will examine some specific ways in which global transactional practice presents ethical concerns for New York attorneys and suggestions for how those concerns can be resolved. It will emphasize the New York Rules of Professional Conduct that are implicated when a New York law firm engages in cross-border transactional law in a foreign jurisdiction, most often in a branch office that the firm establishes in that foreign jurisdiction, using China as the primary example.

Both because such a considerable amount of transactional work done abroad is done by New York law firms and their affiliate offices and because significant Chinese M&A regulations come into play, this article relies predominantly on the New York Rules and the ethics opinions which analyze them, placing less emphasis on the ABA Model Rules and the opinions that have been written in response to them.

When the Foreign Jurisdiction Has Different Legal Ethics Standards

As a result of the lack of uniform guidance that currently exists for New York attorneys who work on cross-border transactions, many New York attorneys find themselves in the difficult position of trying to determine (a) which jurisdiction's rules apply and whether, by engaging in the practice of law (authorized or unauthorized), he or she is running afoul of the New York Rules,[7] (b) if he or she is even allowed to practice law in the foreign jurisdiction,[8] (c) if the foreign jurisdiction's different legal ethics standards conflict with the New York Rules, and (d) whether adherence to the New York Rules culturally rocks the boat and kills the deal.

When the Foreign Jurisdiction Lacks a Uniform Legal Ethics Standard for All Practicing Attorneys Within That Jurisdiction

Similar challenges arise for New York attorneys when the foreign jurisdiction in which they practice lacks a uniform legal ethics standard altogether. In such instances, the New York attorney is left to wonder (a) whether he or she can use the New York Rules in the absence of local jurisdictional rules, and (b) how a New York attorney should handle ethical issues that arise. Currently, China lacks a uniform legal ethics standard analogous to either the New York Rules or the ABA Model Rules that are widely used by attorneys and enforced by the government. Some multi-national law firms are beginning to establish their own legal ethics guidelines. Though law students in China learn about legal ethics in law school, these same ethical concepts are neither emphasized nor enforced in practice.[9]

Lack of Guidance Regarding the Regulation of Cross-Border Transactional Attorneys

A Spring 2000 article in the *Texas International Law Journal* explains that "the [Chinese legal] academic community [has] not honed in on the ethical dimensions of cross-border practice."[10] Almost ten years later, it appears as though little progress has been made. As the deal landscape becomes more and more globalized and attorneys at New York law firms work on transactional matters all over the world, many questions regarding the ethical challenges that such attorneys face have been left unanswered.

Though some New York attorneys might argue that a New York lawyer is unquestionably bound by the New York Rules of Professional Conduct, practically speaking, because some foreign jurisdictions have legal ethics standards that differ significantly from New York's Rules and because other jurisdictions do not have any uniform legal ethics standards at all, there are many plausible scenarios in which, during the course of a proposed deal in a foreign jurisdiction, a New York attorney might have to engage in practices that violate the New York Rules, but which would kill the deal without such violation. This is especially true in China.

As a direct result of this lack of guidance and the fact that legal ethics can be said sometimes to take a "back seat" to personal gain,[11] there are practices that pervade the Chinese business environment and subsequently the Chinese legal environment which at the very least violate New York Ethics Rules and at most violate U.S. and international law.[12]

Specific Legal Ethics Challenges

New York transactional attorneys[13] who work on deals involving foreign entities or deals which take place in foreign jurisdictions encounter myriad ethical challenges at all stages of the deal. These challenges include:

1. Difficulty adhering to the New York Rules because of jurisdiction-specific legal practice norms.
2. Difficulty adhering to the New York Rules because of jurisdiction-specific cultural norms.
3. Difficulty completing the deal because local counsel engages in behavior that violates New York's ethical rules.
4. Difficulty due to differences in jurisdiction-by-jurisdiction approaches to preventing client liability.

These ethical challenges, among others, come into play for New York attorneys when the foreign jurisdiction either (1) has enacted legal ethics standards that vary significantly from the New York Rules, or (2) has not yet enacted a uniform legal ethics standard.

China's Approach to Regulating Foreign Lawyers

As discussed throughout this article, the status of foreign attorneys practicing transactional law in China further complicates the already existing confusion that results from the lack of a uniform ethics standard. In an attempt to retain control over foreign law firms' practices in China, and some would argue, in an effort to prevent foreign law firms from gaining too much market share over Chinese law firms, the Chinese government, and more specifically, the Ministry of Justice and the State Administration for Industry and Commerce (SAIC), instituted rules aimed at regulating the practice of foreign law firms in China.[14]

As a result of these rules, five key restrictions were enacted:

1. **Geographic restriction**: foreign law firms could only have branch offices in certain Chinese cities.[15]
2. **Restriction on number of offices**: foreign law firms could only establish a branch office in **one** of the approved Chinese cities.[16]
3. **Restriction on practicing Chinese law**: foreign firms could not practice or interpret Chinese law.[17] "What this means has never been clarified by the Chinese authorities."[18]
4. **Jurisdiction restriction**: "in principle," foreign law firms could only advise on matters pertaining to their home jurisdiction and international laws.[19]
5. **Hiring restriction**: foreign firms are prohibited from hiring Chinese lawyers to work in the foreign firms' Chinese branch offices.[20]

This level of restriction might lead some New York attorneys to ask the following: "Since foreign attorneys are so restricted and limited as to the scope of what they can and cannot do in China, what is the purpose of a New York law firm establishing a branch office in a Chinese city?" The primary reason why it is profitable for New York-based law firms to open branch offices in Chinese cities is because despite such heavy regulation, foreign lawyers are allowed to engage in a wide array of transactional types of legal practice in China, and currently China's deal environment is quite robust.[21]

Areas of the Law in Which Legal Ethics Challenges Arise

Many areas of the law are implicated by the legal ethics challenges that arise when a New York law firm chooses to open a branch office in China. This section will discuss some specific challenges associated with the following areas of law: Choice of Law, Client Confidentiality, Fee Sharing and Referrals.

Choice of Law

New York-licensed transactional attorneys who effect deals in foreign jurisdictions (or on behalf of multi-national corporations that have significant holdings in foreign jurisdictions) are often presented with choice of law challenges. This leaves the attorneys to wonder which ethical standards apply, what to do if the foreign jurisdiction's ethical standards vary significantly from New York's Rules, and how to handle situations in which (i) the foreign jurisdiction does not have ethical standards which are practiced by attorneys in that particular jurisdiction, and / or (ii) if the New York attorney attempts to adhere to the New York Rules of Professional Conduct, the deal dies.[22] In China, choice of law challenges are particularly significant as there is no choice: Chinese law prevails.

Client Confidentiality

Client confidentiality also presents challenges for New York attorneys practicing in China. Within the context of the extensive rules that the Chinese Ministry of Justice ("MOJ") has placed on foreign law firms, the MOJ demands "quarterly reports from foreign lawyers and request[s] information usually considered [by New York attorneys to be] confidential."[23]

Fee Sharing and Referrals

Fee sharing and referrals are two additional areas in which both the existence of a New York law firm's cross-border transactional practice and the presence of a branch office in a foreign jurisdiction present significant legal ethics challenges for New York attorneys. New York State Bar Association Ethics Opinion 806 addresses (i) how New York law firms should handle referrals from foreign lawyers, and (ii) the mechanics of fee sharing between a New York law firm and a foreign firm with which the New York firm is affiliated.[24] The opinion draws upon the New York Rules that pertain to fee sharing and referrals.[25]

The facts used as the basis of addressing the question asked in this opinion are as follows: a New York law firm was affiliated with an Italian law firm. None of the Italian lawyers lived in or were licensed to practice in the U.S. None of the New York attorneys was licensed to practice in Italy. The New York law firm and the Italian law firm were affiliated, which, for purposes of the opinion's analysis, meant that they referred matters to each other. One of the New York lawyers traveled to Italy to assist on matters. None of the Italian attorneys ever came to New York to help, but they did consult from Italy. The New York firm knew that the Italian firm was comprised of attorneys licensed to practice in Italy.[26]

Similar to the practice in China discussed throughout this article, whereby New York attorneys are considered legal consultants and are not allowed to practice Chinese law, and New York law firms that have branch offices in China are not allowed to hire lawyers who are authorized to practice law in China, Opinion 806 first asks "whether the lawyers of the Italian law firm are 'lawyers' within the meaning of 2-107 or are 'non-lawyers' within the meaning of DR 3-102(a)."[27]

The opinion goes through an analysis of 3-103(a),[28] the impact of which the committee finds to be mitigated by 2-102(d), which states that "if a partnership is formed between lawyers of different jurisdictions, the partnership's letterhead must clearly state the jurisdiction in which each lawyer is licensed to practice law."[29] Relying on New York State Ethics Opinions 542,[30] 646,[31] and 658,[32] as well as the ABA / BNA *Lawyer's Manual on Professional Conduct*,[33] Opinion 806 concludes that partnerships formed "between lawyers of different jurisdictions [even]…jurisdictions outside the United States…"[34]are not prohibited by the New York code as long as an initial standard and a subsequent five-part test are met.[35]

This opinion should be considered by analogy only when assessing the legal ethics challenges that New York lawyers face when working in China. Though the opinion and the sources on which it relies offer guidance regarding Italy, the U.K., Japan and Sweden, the committee stops short of applying its findings to all foreign jurisdictions and even goes as far as to state that "although…we have in the past made such a determination with respect to the legal systems of several other nations, we decline to do so here or in the future, as we believe it is not necessary or appropriate for this committee to continue to do so."[36] Additionally, though a partnership like the one described in Opinion 806 may be permitted under the New York rules, it is highly unlikely that the Chinese government would permit such a partnership, given the extent to which the MOJ regulates foreign law firms.

Relevant New York Rules

Relevant New York Rules: 8.5(b)(2)(i), 5.1, 5.5, 1.8(b) and 1.7(b)(3)

There are five New York Rules of Professional Conduct which most closely relate to the research question on which this article is based: 22 N.Y.C.R.R. part 1200, Rule 8.5(b)(2)(i), Rule 5.1, Rule 5.5, Rule 1.8(b) and Rule 1.7(b)(3), though other rules are also implicated.

New York Rule 8.5(b)(2)(i)

NY Rule 8.5, *Disciplinary Authority and Choice of Law,* explains which jurisdictions have authority to discipline an attorney who is licensed to practice in New York State.[37] More specifically, 8.5(b)(2)(i) addresses which rules are supposed to govern when a New York attorney is practicing in another jurisdiction and is only licensed in New York, explaining that "in any exercise of the disciplinary authority of this state, the rules of professional conduct to be applied shall be as follows: (2) For any other conduct: If the lawyer is licensed to practice only in this state, the rules to be applied shall be the rules of [New York]."[38]

However, what this rule ignores is the fact that many foreign jurisdictions, including China, place trust and relationship building above absolute adherence to the utmost ethical legal standards, leaving New York attorneys in a precarious position. Such a lack of cohesive guidance on legal ethics, as pertains to such a widely practiced area of the law (cross-border transactional work) necessitates that the New York State Bar Association should make clearer the ethical implications and procedures for New York transactional attorneys working on deals worldwide, especially as the deal playground continues to become more and more globalized at such a rapid pace. This may require that the New York State Bar Association and the American Bar Association both work with the All China Lawyer's Association to draft and implement a uniform set of legal ethics guidelines.

The New York State Bar Association has acknowledged the significance of this 8.5-related problem in two opinions: New York State Bar Association Ethics Opinion 762: *Supervision by New York Lawyers and Law Firms of Lawyers Licensed in Foreign Countries,* and New York State Bar Association Ethics Opinion 815: *Practice of a New York Lawyer in a Foreign Jurisdiction*.

New York State Bar Association Ethics Opinion 762

Opinion 762 asks "to what extent…a New York attorney or the attorney's law firm [must] supervise associates, partners and non-lawyers who are admitted to practice in foreign jurisdictions but not in New York?" This question is particularly relevant to New York transactional attorneys who work on deals that involve Chinese entities or multi-national corporations with significant holdings in China, because in China, foreign lawyers (including New York attorneys) are not allowed to officially practice law and thus many New York-based law firms that have offices in China have to work with local, China-trained legal counsel in order to engage in the actual practice of law. To complicate matters further, New York law firms are prohibited from hiring China-licensed attorneys to practice Chinese law.

Within the context of Opinion 762, there are three significant factors that influence a New York attorney's ability to practice ethically while working on a deal in China or that involves an entity that has significant holdings in China:

1. Foreign attorneys (including U.S.-trained attorneys) who work for U.S. law firms in China are prohibited from practicing Chinese law.[39] This presents a significant N.Y. Rule 5.5 problem.
2. In China, Guanxi[40] pervades. Guanxi relies more on concepts of honor, trust and relationship building than on clear and enforceable legal ethics requirements or deal terms.
3. As a result of the Chinese government's prohibition against foreign law firms hiring China-licensed attorneys to practice Chinese law in foreign branch offices, Chinese attorneys who join the Chinese offices of U.S.-based law firms "have to relinquish their Chinese law licenses, becoming advisers or consultants, sort of becoming superparalegals."[41]

New York Rule 8.5(b)(2)(i) states that "if the lawyer is licensed to practice only in [New York], the rules to be applied shall be the rules of "New York."[42] New York Rule 5.1 states "(a) A law firm shall make reasonable efforts to ensure that all lawyers in the firm conform to these Rules."[43] Given the complexities of working on a deal in China (including legal complexities such as compliance and regulatory concerns and cultural complexities such as Guanxi[44]), it may not be practical for a New York-trained attorney to apply only the rules of New York when working on a deal with a Chinese entity because that attorney may instead have to abide by Chinese cultural norms of relationship building, Guanxi and Chinese law.[45]

Additionally, given how significantly some of the top U.S. law firms have expanded their global reach, practically speaking, it is nearly impossible for a law firm to make "reasonable efforts to ensure that all lawyers in the firm conform to these rules" for two reasons: (1) law firms are large and globalized and it may be impossible for firm management to make even reasonable efforts to ensure that all lawyers in the firm conform, and (2) with licensing restrictions in particular foreign jurisdictions, U.S.-trained attorneys cannot actually practice, leaving one to wonder whether the U.S. firm's management is required to make reasonable efforts to ensure that all people who have U.S. law degrees who are in a foreign jurisdiction in which they are not allowed to practice law conform to the New York Rules.

These legal professionals do not constitute "lawyers" in China, and they are not "non-lawyers" in New York.

Though Rule 5.5 appears to govern here,[46] practically speaking, the rule may be said to be moot when one considers the actual practice of New York attorneys who work as legal consultants in Chinese branch offices of New York law firms.

In the context of a New York law firm's branch office in China, one is left to wonder "who is a lawyer?" If U.S.-trained attorneys are located in a Chinese office of a New York-based law firm, then those attorneys cannot legally practice law in China. Similarly, if China-trained attorneys who join the New York law firm's Chinese offices are required to relinquish their legal license (thus becoming "superparalegals"), then are they considered to be attorneys for purposes of the New York Rules and thus, under Rule 5.1, will management of the U.S.-based law firm be responsible for making reasonable efforts to ensure that all lawyers in the firm conform to these Rules?

Additionally, if the New York attorneys cannot practice in China and the China-trained attorneys relinquish their ability to practice law when they join the U.S. firm, then who, in a Chinese branch office, is actually permitted to legally engage in the practice of law, or more succinctly, "who is a lawyer?"

NYSBA Ethics Opinion 762 grappled with this question, ultimately attempting to answer it within a DR 1-104 framework, because DR 1-104 (which corresponds to current rule 5.1, *Responsibilities of Law Firms, Partners, Managers & Supervisory Lawyers*), suggests how New York law firms should address this issue.

One key distinction between DR 1-104 and Rule 5.1 is that 1-104 covered[47] a firm's supervision of non-lawyers. Though the new rules bifurcate firm supervisory duties into two separate rules (5.1 for supervision of lawyers and 5.3(a) for the supervision of non-lawyers), NYSBA Ethics Opinion 762 remains directly on point when it comes to assessing how firm managers supervise adherence to the New York rules. As mentioned above, what is not clear within the context of the Chinese branch office of a New York law firm example is who is considered to be a lawyer and who is considered to be a non-lawyer.

According to Opinion 762, DR 1-104(a), which mirrors 5.1(a), "requires a New York firm to make reasonable efforts to ensure that all lawyers in the firm conform to the disciplinary rules."[48] The opinion dispels a strictly textual reading of this rule, asserting that though one might literally conclude that the wording of 1-104(a) implies "that partners and associates of a New York firm who are licensed in a foreign country but not admitted in New York must conform to the New York Code[.] We believe this broad reading is unintended."[49]

This stance by the New York State Bar Association is particularly interesting when one considers how branch locations of New York-based law firms operate in China (e.g., that New York attorneys who are not licensed in China are considered to be legal consultants, and only attorneys who have passed the bar in China can practice law, although not in the foreign branch offices of U.S. law firms).

Another issue must be addressed here. New York attorneys are in theory bound by New York ethical rules when working in the Chinese branch office of a New York law firm. Likewise, theoretically, the management of a New York law firm is responsible for supervising attorneys and non-attorneys who are located in branch offices in other countries.

Practically speaking, however, New York attorneys cannot practice in China. Branch offices are located far from headquarters offices and foreign jurisdictions may either have (i) no recognizable set of legal ethics standards, (ii) localized, non-uniform standards which are regional or provincial in nature, or (iii) law firm-based standards (which create an entirely different level of confusion among legal professionals and perpetuate a lack of understanding and uniformity among attorneys).

Furthermore, local law firms in China and other foreign jurisdictions sometimes rely more heavily on the basic tenets of honor and respect (embodied in Guanxi) than on whether every decision an attorney makes is considered to be professionally responsible.

New York Rule 5.1

Rule 5.1(a) (formerly DR 1-104) addresses a law firm's supervisory obligations within the context of a firm's responsibility to supervise attorneys, requiring that the management of a New York law firm make "reasonable efforts to ensure that every attorney at the firm conforms to the disciplinary rules,"[50] leaving one to consider whether a New York attorney working in China (who cannot be said to be practicing law there, but who works as a legal consultant) is an attorney for purposes of Rule 5.1's supervision requirements.

According to New York Rule 5.1(b)(1), a lawyer who has "management responsibility in a law firm shall make reasonable efforts to ensure that other lawyers in the firm conform to" the New York Rules.[51] This rule presents the following significant challenges for a New York attorney practicing in a Chinese branch office of a New York-based law firm:

First, if firm management is located in New York, it is not always practical for managing partners to ensure that attorneys in China are conforming to the New York Rules. Second, if firm management is actually the head attorney of the branch office, that attorney may or may not be a New York lawyer, and third, China's (a) approach to Choice of Law, (b) restrictions placed on foreign law firms, and (c) cultural norms, may make it impractical for New York attorneys to ensure that all attorneys at the firm are abiding by the New York Rules.

New York Rule 5.5

The potential relevance of Rule 5.5 is discussed above in the section entitled "New York State Bar Association Ethics Opinion 762."

New York Rule 1.8(b)

New York Rule 1.8(b)[52] may have particular relevance when a U.S.-trained attorney is working on a deal with opposing counsel who works for a Chinese law firm, because in the absence of an equivalent to the New York State Bar Association Rules or the ABA Model Rules, many Chinese law firms uphold their own firm-based standards for legal ethics which are created and implemented by the firm's management.[53] This presents numerous challenges for New York attorneys.

First, the variability that results from ethics standards developed and implemented on a firm-by-firm basis makes it difficult for New York attorneys to know what the relevant legal ethics standard is and whether or not the particular firm with whom the New York attorneys are dealing abides by that particular standard. Variability among standards between firms can cause significant concerns for attorneys for two reasons: (1) because if one firm has particularly loose or rigid standards and the other does not, problems may arise, and (2) overall, the lack of a standard creates a potential for client liability and attorney liability.[54]

Second, some of the ethics standards at particular firms directly contradict the NYSBA rules and the ABA rules.[55] This puts New York attorneys in the particularly precarious position of not knowing by which legal ethics standard to abide.

Rule 1.8(b) states that "a lawyer shall not use information relating to the representation of a client to the disadvantage of the client unless the client gives informed consent, except as permitted or required by the rules."[56] Even assuming 1.7 is not clear regarding the representation of opposing parties in a transactional context (this is not the position this article takes, but for purposes of this argument, such an assumption should be made),[57] the practice of representing parties that oppose each other raises 1.8(b) concerns. If law firm X (and thus, its lawyers) is representing Corporation A and Corporation B in an M&A transaction in China, the potential is quite significant that an attorney at the firm would have access to information (advertently or inadvertently) pertaining either to Corporation A or Corporation B, which could potentially disadvantage one client over the other.

New York Rule 1.7(b)

Some foreign jurisdictions do not have ethics rules which address when conflicts of interest arise within the context of legal representation. New York Rule 1.7(b)(3) states "notwithstanding the existence of a concurrent conflict of interest under paragraph (a),[58] a lawyer may represent a client if (1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client and,…(3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal."[59]

Transactional practice in China presents challenges to New York attorneys who are working on deals that take place in China or which involve entities that have significant holdings in China and therefore fall within the regulatory control of Chinese M&A regulations.[60] These challenges implicate both 1.7(b)(1) and 1.7(b)(3).

Under 1.7(b)(1), an attorney has to believe that he or she will be able to provide competent and diligent legal representation to each affected client. Chinese law firms sometimes represent parties that are directly opposed to each other. A couple of issues arise in this context. For purposes of this analysis and according to the comments to the rules, it is important to distinguish between the conflicts that arise when an attorney or firm represents parties that oppose each other in litigation, versus parties who oppose each other within the context of a transaction.

First, though the rule seems to distinguish between a transactional matter and a litigation matter, the two are not mutually exclusive (e.g., with every transaction, there is significant risk of litigation, especially in China, for reasons that will be explained below). Second, the rule includes the language "or other proceeding before a tribunal."[61] In China, in order for a transaction to be completed, there are many layers of regulatory approval that parties are required to obtain before a deal can go through.[62] Within the context of such regulatory approval, one might say that the attorneys involved in the deal have to go before "another tribunal," that is, a regulatory body such as MOFCOM or the MOJ. Additionally, transactional documents relating to deals which take place in China or which involve a Chinese entity often end up in court, resulting in the judge making determinations about whether a document is acceptable, before the deal can close. For these two reasons, the fact that a firm would represent two opposing parties presents significant 1.7 (b)(1) and 1.7(b)(3) problems.

Though some individual law firms (both Chinese and American) that have offices in China are working to establish firm-based ethical standards which strictly prohibit representing clients who are directly adverse to each other, currently there are no country-wide or province-wide rules in China that are uniformly practiced and enforced and that would directly prohibit such practice. As a result, a New York attorney who works for a Chinese law firm might encounter a situation in which the firm is engaging in legal practice which violates 1.7(b)(1), because if that particular law firm represents opposing parties, then that individual attorney (and by association, the attorney's firm) may be said to have a conflict under the New York Rules. To date, no NYSBA ethical opinions have been written about 1.7(b)(1) or 1.7(b)(3).

> *"At a time when the markets have experienced unprecedented tumult and unprecedented levels of economic disruption caused by unethical business practices, a set of global legal ethics standards must be established soon."*

Strategies for Avoiding Legal Ethics Challenges/ Recommendations

Since foreign jurisdictions are not bound by New York's ethics standards or the ABA Model Rules, one way in which a New York attorney can ensure that New York ethics rules will govern within the context of the transaction is by negotiating a "choice of ethics clause within an international lawyer-client contract."[63] However, a strong argument can be made that the New York Rules do not have any relevance to New York attorneys when practicing abroad (or rather that it is impracticable to think that New York-licensed attorneys and the firms which employ them can abide by each and every one of the rules), but rather sound legal judgment, respect for local cultural factors that influence cross-border transactional legal practice, and adherence to more global regulations (such as the Foreign Corrupt Practices Act) are the way in which New York attorneys should be governed while working in a foreign jurisdiction.

Conclusion

Relying on New York deal lawyers to exercise sound judgment in the absence of a clear legal ethics standard is not enough. For the reasons discussed throughout this article, and given the numerous and extensive murky legal ethics gaps that exist for New York attorneys who practice cross-border transactional law, one thing remains clear: the flawed and global legal ethics framework that has infected deal practice worldwide must be cured, in order to protect New York attorneys, their firms and their clients from serious potential consequences.

At a time when the markets have experienced unprecedented tumult and unprecedented levels of economic disruption caused by unethical business practices, a set of global legal ethics standards must be established soon. Such a standard should recognize the nuances of transactional legal practice and might even take into account some jurisdiction-specific requirements. The New York State Bar Association, the American Bar Association, the All China Lawyer's Association (and comparable organizations in other foreign jurisdictions in which significant amounts of deal work take place) should work together to create and implement such a set of global legal ethics standards.

Unless a global set of legal ethics standards is created and implemented, the infectious cross-border legal ethics flu epidemic will only continue to spread.

Endnotes

1. Justin Evans, *The Magical Confluence: American Attorneys, China's Rise, and the Global Value Chain*, 18 Ind. INT'L COMP. L. REV. 277, 278 (2008) (explaining "[b]ecause the law is fundamental to doing business in the modern world and additional complexities are created in doing business across borders, attorneys hold a unique position in global commerce").
2. For purposes of this article, "foreign jurisdiction(s)" shall refer to jurisdictions located in countries other than the United States. The term shall not refer to U.S. states other than New York State.
3. 22 N.Y.C.R.R part 1200 (2009).
4. Michael J. Maloney & Allison Taylor Blizzard, *Ethical Issues in the Context of International Litigation: Where Angels Fear to Tread*, 36 S. Tex. L. Rev. 933, 942 (1995) (explaining "in a transnational case…an attorney must often make original decisions on ethical matters").
5. As the markets grow more and more globalized, this presents a huge problem for New York-licensed attorneys specifically and U.S.-licensed attorneys more broadly. Robert M. Jarvis, *Cross-Border Legal Practice and Ethics Rule 4-8.5—Why Greater Guidance Is Needed*, 72-FEB Fla. B.J. 59, 59 (1998) (noting the lack of regulation as follows: "[a]lthough the practice of international law has grown substantially since the end of World War II, no global entity currently regulates transnational lawyers").
6. Chinese entities almost always fall within the reach of Chinese M&A regulations; additionally, non-Chinese entities which have a significant stake in China (the percentage of which varies by industry) often will be held to fall within the grasp of Chinese M&A regulations.
7. This has N.Y. Rule 8.5 implications. 22 N.Y.C.R.R. part 1200, Rule 8.5 (2009); N.Y. St. Bar Ass'n. Comm. on Prof'l Ethics, N.Y. Eth. Op. 806 (2007) (discussing referrals by foreign lawyers and the permissibility of fee sharing).
8. Due to restrictions put in place by the Ministry of Justice and the State Administration for Industry and Commerce, American-licensed attorneys are not allowed to practice or interpret Chinese law, Michael J. Moser, *Globalization and Legal Services in China: Current Status and Future Directions*, *in* The Internationalization of the Practice of Law, 134 (Jens Drolshammer & Michael Pfeifer, eds., Kluwer Law International) (2001).

Additionally, attorneys who are licensed to practice in China are prohibited from practicing for a foreign law firm. Though this is officially the rule, practically speaking, foreign attorneys working in China may enjoy the title of "legal consultant," and many of them do practice and interpret Chinese law (especially within a transactional context).

9. *Id.* at 133. (noting significantly that "[l]egal ethics are only briefly referred to in the Lawyers' Law and are taught in Chinese law schools but not reinforced...rapid social and economic change in China has created an atmosphere where ethics often take a back seat to personal gain").

10. See M. McCary, *Bridging Ethical Borders: International Legal Ethics with an Islamic Perspective,* 35 Tex. Int'l L. J. 289 (Spring 2000).

11. Moser, *supra* note 8, at 133.

12. *Id.* (explaining Guanxi: "the use of personal connections, bribery and other forms of corruption are pervasive in the Chinese Business World"). This poses obvious challenges to New York attorneys practicing in China, from both a personal liability perspective and from a client liability perspective.

13. Either as New York-licensed attorneys based in a law firm's New York office or as New York-licensed attorneys who work in a New York law firm's branch office located in an international city.

14. Moser, *supra* note 8, at 134 (describing regulations enacted to control foreign law firms that opened branch offices in China: "on May 26, 1992, the MOJ [Ministry of Justice] and the State Administration for Industry and Commerce (SAIC) issued the *Provisional Regulations on the Establishment of Representative Offices in the PRC by Foreign Law Firms* providing for the establishment of offices in China by foreign law firms").

15. *Id.*

16. *Id.*

17. *Id.*

18. *Id.*

19. *Id.* ("In principle, foreign law firms are limited to advising on the laws of their home jurisdiction and international laws and assisting clients who require legal services abroad. Foreign lawyers and law firms are prohibited from appearing in the People's Courts or issuing opinions in respect of PRC law.").

20. *Id.* ("Another consequence of the restriction prohibiting foreign lawyers from 'interpreting' Chinese law is that foreign firms are not permitted to hire PRC lawyers or even anyone qualified as a lawyer.").

21. *Id.* There are many types of transactional matters on which foreign attorneys in China are allowed to work. ("Notwithstanding the various restrictions on foreign lawyers in China, many firms maintain a robust, if limited, practice there. The majority of work in foreign law firms involves foreign direct investment including the establishment of joint ventures, holding companies, wholly foreign-owned enterprises and representative offices. More recently, securities work has drawn many international firms to China. Other areas of [permissible] practice include arbitration, intellectual property matters and mergers and acquisitions work."). Thus, officially and according to the black letter law, foreign attorneys cannot practice Chinese law, but they can practice the law of their home jurisdiction and other foreign jurisdictions, within the context of transactional matters. Unofficially, N.Y. attorneys practicing in China likely practice law. This leads to the following questions: Which jurisdiction's ethics apply? Who is obligated to make reasonable efforts to ensure that the rules are followed and What are the consequences if the rules are not followed?

22. Either because adhering to New York's Rules directly conflicts with the way in which business is conducted in the foreign jurisdiction or because culturally, the N.Y. attorney's adherence to the N.Y. Rules results in a presumption by the other side that the N.Y. attorney is merely exhibiting American legal arrogance.

23. Patricia Ginsberg, *An Ethical Dilemma of American Attorneys in China: The Conflict Between the Duty of Confidentiality to Clients and the Requirement of Disclosure to the Chinese Government*, *in* Rights, Liability and Ethics in International Legal Practice 403 (Mary C. Daly & Roger J. Goebel, eds. 2d ed., 2004). Ginsberg further explains the extent of the MOJ's information requests:. "Information requested included client lists, locations of projects under consideration, affiliations with Chinese law firms, business references and the value of deals in negotiation."

24. N.Y. Eth. Op. 806, *supra* note 7, at 1. The opinion addresses a realistic scenario, *e.g.*, "[w]here New York and Italian law firms, neither of whose attorneys reside in or are licensed to practice in the other's country, refer legal matters to each other, may the New York firm share a percentage of its fees with the Italian law firm for matters referred to the New York firm, and if so, under what conditions and in what proportions?"

25. The opinion refers to the following rules (in this footnote, note that the old rules are not bolded and the new rules appear in bold text: DR 2-102(d) [**7.5(d)**]; DR 2-107(a) [**1.5(g)**]; DR 3-102(a) [**5.4(a)**]; DR 3-103(A) [**5.4(b)**]).

26. N.Y. Eth. Op. 806, *supra* note 7, at 1.

27. N.Y. Eth. Op. 806, *supra* note 7, at 2.

28. 22 N.Y.C.R.R. part 1200, Rule 3-103(a) (2007).

29. N.Y. Eth. Op. 806, *supra* note 7, at 2.

30. N.Y. St. Bar Ass'n Comm. on Prof'l Ethics, N.Y. Eth. Op. 542 (1982) (discussing when a foreign law firm opens a local office).

31. N.Y. St. Bar Ass'n Comm. on Prof'l Ethics, N.Y. Eth. Op. 646 (1993) (entitled *Employment By Foreign Legal Consultant; Partnership with Foreign Lawyer*).

32. N.Y. St. Bar Ass'n Comm. on Prof'l Ethics, N.Y. Eth. Op. 658 (1994) (New York law firm may enter into partnership with Swedish law firm provided that the partnership will not compromise the New York lawyer's ability to uphold ethical standards).

33. ABA BNA Lawyer's Manual on Professional Conduct [41:712 (2007)].

34. N.Y. Eth. Op. 806, *supra* note 7, at 2.

35. The standard and test are laid out in N.Y. Eth. Op. 806, *supra* note 7, at 2-3.

Initial standard: "Accordingly, if the Italian legal system is determined upon inquiry to provide persons admitted or licensed to practice law with education, training and ethical standards comparable to those of American lawyers, Italian lawyers may be considered "lawyers" within the meaning of DR 2-107(A)".

Five Part Test: "if (1) lawyers admitted or licensed to practice law in Italy meet the standard set forth above, (2) the New York firm fully discloses to the client the firm's intent in a matter to share its fees with the Italian firm and has obtained the client's consent to such arrangement pursuant to DR 2-107(A)(1), (3) the total fee in the matter will not exceed reasonable compensation for all legal services rendered to the client (DR 2-107(A)(3)), (4) the Italian law firm takes joint responsibility for the matter or the portion of the fee it earns is in proportion to the services it performs, and (5) the Italian law firm's work on, or taking joint responsibility for, the matter is not otherwise barred, [FN6] we find no Code prohibition on the New York firm's sharing a percentage of its legal fees with the Italian firm."

36. *Id.* at 2.

37. *See generally*, 22 N.Y.C.R.R. part 1200, Rule 8.5 (2009).

38. 22 N.Y.C.R.R. part 1200, Rule 8.5(b)(2)(i) (2009).

39. Terry Carter, *A Chinese Puzzle*, ABA Journal E-Report, June 8, 2007, at 1.

40. Guanxi is a Chinese concept that relies on personal connections, reputation and honor when conducting business in China. To a Westerner, Guanxi may seem unethical, even corrupt at the highest level (and vague and difficult to discern on the most basic level). Regardless of one's interpretation of Guanxi, it is essential to getting any deal done in China, and New York attorneys must be well-versed in Guanxi to represent clients on Chinese matters. That said, as noted above in note 12, "the use of personal connections, bribery and other forms of corruption are pervasive in the Chinese Business World," Moser, 133. This requires that New York attorneys engage in a juggling act that requires keeping at least four balls up in the air: the New York ethical rules, the Foreign Corrupt Practices Act, Guanxi, and the objective of getting the deal done, among others.

41. *Id.* at 1.

42. Rule 8.5(b)(2)(i).

43. Rule 8.5(b)(2)(i), *supra* note 38.

44. Moser, *supra* note 40.

45. The term *Guanxi* is inexact and varies in meaning from person to person.

46. 22 N.Y.C.R.R. part 1200, Rule 8.5(b)(2)(i) (2009).

47. 22 N.Y.C.R.R. part 1200, Rule 5.1 (2009), which corresponds to 22 N.Y.C.R.R. part 1200, Rule DR-1-104 (2007) (both of which require that "a law firm shall adequately supervise, as appropriate, the work of partners, associates and non-lawyers who work at the firm").

48. N.Y. Eth. Op. 762, *supra* note 47, at 2.

49. *Id.* at 3.

50. 22 N.Y.C.R.R. 1200, Rule 5.1(b)(2)(2009).

51. 22 N.Y.C.R.R. part 1200, Rule 5.1(b)(1) (2009). This rule is further supported by § 11 of the *Restatement of the Law Governing Lawyers*. According to § 11(1), a partner in a law firm can be disciplined for failing to "make reasonable efforts to ensure that the firm has in effect measures giving reasonable assurance that the firm conform to applicable lawyer-code requirements." A Concise Restatement of the Law Governing Lawyers (The Am. L. Inst., 2007).

52. New Rule 1.8(b) corresponds primarily to old N.Y. rule 4-101(b)(2), as well as to 4-101(b)(1) and 4-101(b)(3).

53. Telephone Interview with Jerry Kong, Partner, Shanghai office of Grandall Legal Group (April 10, 2009) [hereinafter Interview with Jerry Kong].

54. China is not completely without a legal ethics structure. There are rules on the books; these rules are just not enforced nor practiced widely. In fact, when asked about them during a recent interview, Jerry Kong did not even mention that there was a uniform set of rules. However, in 1997, the NPC's first comprehensive law governing the legal profession became effective. Regardless of the rules existence, even rules on the books do not regulate New York-licensed attorneys who practice in China as legal consultants, because foreign attorneys are not even considered to be lawyers in China.

55. Interview with Jerry Kong. Mr. Kong went on to describe an overall "serious problem" for Chinese law firms to vet conflicts.

56. 22 N.Y.C.R.R. part 1200, Rule 1.8(b) (2009).

57. Though deals are transactional, transaction documents are often brought before judges in China, for purposes of both ensuring that a particular transaction has met the rigorous regulatory standards set forth by the 2006 M&A Rules and the 2008 Anti-Monopoly Rules. Also, judges often review particular transactional documents that have come into question (either because of document length, specificity of terms, etc.), so that although New York Rule 1.7 seems to have been interpreted as applying primarily to litigation matters, transactional deals in China have a significant court-related component to them.

58. 22 N.Y.C.R.R. part 1200, Rule 1.7(a) (2009).

59. 22 N.Y.C.R.R. part 1200, Rule 1.7(b)(3) (2009).

60. 2006 Regulations on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors ("the 2006 M&A Rules"); 2008 Provisions of the State Council on the Standard for Declaration of Concentration of Business Operators ("the 2008 Merger Provisions to the Anti-Monopoly Law"), both issued by the Chinese government.

61. Rule 1.7(b)(3), *supra* note 59.

62. Chuan Li, Tai Hsia, & David Patrick Eich, *New Rules for Chinese Company M&A Transactions Involving Foreign Investors*, Kirkland Private Equity Newsletter, Sept. 1, 2006, at 1; Freshfields Bruckhaus Deringer, *China Consults on Merger Control Implementing Regulations*, Freshfields.com, Mar. 28, 2008, at 2; Final Version Joint Comments of the American Bar Association Section of Antitrust Law and Section of International Law on the MOFCOM Draft Guidelines for Definition of Relevant Markets, Jan. 30, 2009. Note that these comments are not official ABA Policy. They are "technical legal assistance comments approved by the participating ABA sections pursuant to something called blanket authority."

63. McCary, *supra* note 10, at Footnote 108.

Megan Burke is a JD/MBA Candidate at Albany Law School in the Class of 2010. This article is a follow-up to her piece *Adapt or Die: A Comparative Analysis of the American and Chinese Legal Approaches to the M&A Deal*, published in the Spring 2009 issue of this *Journal*. She hopes to practice securities law after graduation and continues to write about the regulatory challenges for American attorneys who work on deals in China.

Consumer Financial Services Committee

The Consumer Financial Services Committee continues its analysis of legal issues, legislative and regulatory developments, and case law relating to federal and state consumer protection initiatives. The Committee placed two members on the President's Privacy Task Force Initiative and wrote the Consumer Financial Services section of the Committee's report.

The Committee has worked to inform members concerning reforms in mortgage and credit card legislation, including the CARD Act and Federal Reserve Board regulations that have prohibited abusive credit card practices such as dual cycle billing, universal default clauses, and the application of punitive pricing to outstanding balances. As the card companies rush to impose higher rates before the effective date of the legislation (February 1, 2010, although Senator Dodd has promised legislation by December 1, 2009), we will continue to inform members and public interest lawyers of legislative and business developments relating to this issue.

The Committee has also engaged in an active discussion over the merits of the Treasury's proposed Consumer Financial Protection Agency. Lax regulatory enforcement of consumer protection laws on the federal level and the OCC's attempt to negate state consumer protection laws by expanding federal preemption (an initiative that was scaled back by the Supreme Court in the *Clearing House v. Cuomo* case, decided last June) make the case for an independent regulatory enforcement agency that is not motivated by attracting charter changes through effective repeal of consumer rights. Other members view the Consumer Financial Protection Agency as an unnecessary duplication of existing regulatory powers that risks a compliance burden if federally regulated institutions are compelled to comply with the laws of multiple state jurisdictions. As the legislation has evolved, we have continued to keep members apprised of changes such as exempting banks with less than $10 billion in assets, qualifying the applicability of state laws to those that do not significantly interfere with federal regulation, and removing entities such as credit bureaus and auto dealers from the jurisdiction of the proposed agency.

We have also worked with the New York City Department of Consumer Affairs and community lawyers to identify issues such as collection and mortgage foreclosure abuses that affect New York consumers. We have provided legal assistance to community lawyers on legal and regulatory issues and business practices of entities such as auto dealers, collection agencies, and banks attempting to foreclose on mortgages rather than take advantage of federal renegotiation initiatives.

The current economic recession was caused in large part by abusive lending practices, rubber-stamped credit agency approvals, and investments unregulated from a safety and soundness perspective. Consumer confidence and job creation will be keys to any recovery, and the legislative climate in Washington and Albany appears favorable to consumer protection initiatives. Our Committee will continue to play an important role in considering solutions, analyzing legislation, contacting regulators and legislators, and assisting community lawyers in this critical area of the law.

—Randy Henrick, Chair

Corporations Law Committee

At the May 7, 2009 meeting, Melissa Sawyer and Simeon Gold updated the Committee regarding their April 2009 meeting with Assemblyman Brodsky and his chief aide, Kelly McMillan, at which they (together with the City Bar's Corporations Committee) discussed Assemblyman Brodsky's legislative agenda and potential ways for his office to work more closely with the bar association committees.

Fred Attea updated the Committee regarding the status of amendments to the Not-for-Profit Corporations Law. Mr. Attea noted that the bill had been introduced through Assemblyman Brodsky's office but that Assemblyman Brodsky wanted to hear from the Attorney General's office regarding the proposed legislation. After further discussion, Mr. Attea agreed to raise the matter with Ron Kennedy in the NYSBA's legislative liaison office to try to make it a higher legislative priority.

Richard Runes provided an update regarding the proposed Franchise Act amendments. Mr. Runes noted that the Assembly sponsor (Adam Bradley) was leaving to become Mayor of White Plains, so it was likely the bill would have to start over in the Assembly.

Janet Geldzahler updated the Committee regarding a bill relating to remote access at shareholder meetings, which the Committee was opposing the adoption of because it mandated remote access at shareholder meetings of New York corporations, unlike the permissive provisions in Delaware law.

Bruce Rich updated the Committee regarding RULLCA. He suggested that an e-mail questionnaire to solicit feedback regarding the best approach to amending the Act would be useful. Mr. Runes recommended preparing a subcommittee report and then scheduling a joint meeting with the City Bar to reach consensus on the best approach.

Mark Gentile made a presentation regarding Recent Developments in Delaware Corporate Law.

—Janet Geldzahler, Chair

Franchise, Distribution and Licensing Committee

In a meeting on April 28, 2009, the Franchise, Distribution and Licensing Committee appointed a legislative subcommittee to develop and recommend changes to the New York Franchise Act and regulations. The subcommittee issued its report in November 2009, together with comprehensive proposed changes in the Act and regulations. The full committee approved this report and proposed changes.

The proposed changes are necessary in light of the Federal Trade Commission's 2008 trade regulation rule on franchising, which preempts a large portion of the New York Franchise Act. The Subcommittee drafted revisions to remove and revise the preempted provisions and made a number of other revisions intended to improve the legal environment for franchising in the state. These changes would align the scope of coverage of New York franchise law more closely with the franchise laws of other states, eliminating traps for the unwary and making New York a friendlier place to do business.

Specifically, the proposed Act and regulations together would accomplish the following improvements, among others:

- conform the required contents of a franchise disclosure document to the requirements of the amended FTC Rule;
- conform the registration and disclosure procedures more closely to the requirements of the amended FTC Rule;
- conform the definition of a franchise more closely to federal law and to the franchise laws of other states; and
- add exemptions to conform to those of the amended FTC Rule and the laws of other states, including offers and sales:
  - of franchises outside the U.S.;
  - of single master franchises within the state;
  - that require an initial investment of at least one million dollars;
  - to franchisees that have a net worth of at least five million dollars; and
  - to former franchisor insiders.

The subcommittee members are: Thomas M. Pitegoff (Chair), Andre R. Jaglom, David J. Kaufmann, Harold L. Kestenbaum, David W. Oppenheim and Richard L. Rosen.

For copies of the report and proposed changes in the Act and regulations, contact the Committee Chair at pitegoff@pitlaw.com.

—Thomas M. Pitegoff, Chair

Securities Regulation Committee

The Securities Regulation Committee of the Business Law Section has had a robust series of meetings these past few months, especially in view of the recent SEC initiatives and changes affecting the capital markets. We have monthly dinner meetings, followed by a review of recent developments in securities law and a program portion. At our June meeting, Colin Diamond of White & Case LLP discussed "New Media and Retail Shareholder Participation" and Eric Robinson of Wachtell Lipton discussed "The SEC's Shareholder Access Proposals and Senator Schumer's Shareholder Bill of Rights." In July, we moved to presentations regarding the implications of state law developments to securities practitioners. Michael Allen of Richards, Layton & Finger spoke about recent Delaware law changes, and Keith Bishop of Allen Matkins Leck Gample Mallory & Natsis spoke about developments in California law. In September, Robert Messineo of Weil Gotshal discussed further developments in connection with the SEC's proxy access proposal, including the comments of the American Bar Association, and Howard Dicker of Weil Gotshal discussed the SEC's proposals regarding proxy disclosure and solicitation enhancements. Also at the meeting, Rhonda Brauer of Georgeson Inc. discussed the recent report of the ABA Task Force on Delineation of Governance Roles and Responsibilities. In October, Luigi De Ghenghi, John Brandow and Reena Sahni of Davis Polk & Wardwell discussed certain of the legislative and regulatory responses to the financial crisis, and Matthew Kaplan of Debevoise & Plimpton spoke about developments in insider trading and the SEC's misappropriation theory, focusing on the action brought by the SEC against Mark Cuban. Looking forward, we are planning to have our November meeting hosted by the New York Stock Exchange.

At our meetings we generally have an active and engaging dialogue among the speakers and attendees regarding the discussion topics. We have made continuing efforts to encourage younger attorneys to join the Committee and to participate in its activities.

—Jeffrey Rubin, Chair

Technology and Venture Law Committee

The Technology and Venture Law Committee has organized rich and varied programs addressing topics including viral marketing and promotions, social networking, user generated content, digital media, eDiscovery, and early stage venture basics. Panelists have included speakers from MasurLaw, Virgin Mobile USA, Joost, Deloitte, Weltman & Moskowitz, Fish & Richardson, Herrick, Feinstein LLP, TheFunded.com, DFJ Gotham Ventures, Progress Partners, BigStar Entertainment, and more. The Committee has launched an initiative to oppose New York's LLC publication requirement in order to align New York with the 47-state majority and encourage new business growth. Next on the agenda is an initiative to organize events with other business organizations in New York's technology scene. The committee has also expanded its NYSBA web page to include a timeline of past committee achievements and events, and has launched a listserv to facilitate member interaction.

—Steven Masur, Chair

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

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

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Business Law Section

ANNUAL STUDENT WRITING COMPETITION

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

Articles submitted will be judged on the following criteria:

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

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

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

NEW YORK STATE BAR ASSOCIATION
BUSINESS LAW SECTION
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NEW YORK STATE BAR ASSOCIATION

Annual Meeting location has been *moved*—

Hilton New York
1335 Avenue of the Americas
New York City

January 25-30, 2010

**Business Law Section
Annual Meeting Program**

Wednesday, January 27, 2010

Register online: www.nysba.org/AM2010