NYSBA
FALL 2007 | VOL. 11 | NO. 2

NY Business Law Journal

A publication of the Business Law Section
of the New York State Bar Association

Inside

HeadNotes 5
(David L. Glass)

The Legal Profession and Conflicts: Ain't No Mountain High Enough? **7**
(C. Evan Stewart)

Banking Agencies Issue Bank Secrecy Act Enforcement Guidance **12**
(Clifford S. Weber)

Franchising in New York After the Revised FTC Rule **14**
(Thomas M. Pitegoff)

Reining in Subprime Mortgage Abuses: New York State Banking Department Adopts Guidance on Nontraditional Mortgage Product **20**
(Catherine M. Brennan)

Safeco—The Supreme Court Applies a Statute in a Commercially Reasonable Manner **25**
(Ernest T. Patrikis and Glen R. Cuccinello)

U.S. Supreme Court Upholds FLSA's Home Healthcare Aide Exemption **28**
(Andrew J. Lauer and Ronit M. Gurtman)

Commercial SMS Text Messages and the Telephone Consumer Protection Act **31**
(Jeffrey D. Neuburger and Jonathan P. Mollod)

Vessel Environmental Issues—The Lessor's Perspective **35**
(Nancy L. Hengen and Dennis Bryant)

Formation by Estoppel: Non-Compliant Limited Partnerships and Limited Liability Companies **42**
(Bruce A. Rich and Kamilah Holder)

Committee Reports **47**

NYSBA

NY BUSINESS LAW JOURNAL

FALL 2007

Vol. 11, No. 2

THE BUSINESS LAW SECTION
NEW YORK STATE BAR ASSOCIATION

in cooperation with

PACE UNIVERSITY SCHOOL OF LAW

ISSN 1521-7183 (print) ISSN 1933-8562 (online)

BUSINESS LAW SECTION—OFFICERS

Chair	David L. Glass Macquarie Holdings (USA) Inc. 125 West 55th Street New York, NY 10019 david.glass@macquarie.com
First Vice-Chair and Fiscal Officer	James W. Orband Hinman Howard & Kattell, LLP 80 Exchange Street P.O. Box 5250 Binghamton, NY 13901 jworband@hhk.com
Second Vice-Chair	Rebecca J. Simmons Sullivan & Cromwell LLP 125 Broad Street New York, NY 10004 simmonsr@sullcrom.com
Secretary	Bruce J. Baker Nixon Peabody, LLP P.O. Box 31051 Rochester, NY 14603 bbaker@nixonpeabody.com

Business Law Section Committees

Committee	Chair
Banking Law Committee	Clifford S. Weber Hinman Howard & Kattell, LLP 106 Corporate Park Drive, Suite 317 White Plains, NY 10604 cweber@hhk.com
Bankruptcy Law Committee	Paul H. Silverman McLaughlin & Stern LLP 260 Madison Avenue, 21st Floor New York, NY 10016 psilverman@mclaughlinstern.com
Consumer Financial Services Committee	Geoffrey C. Rogers Hudson Cook, LLP 636 Plank Road, Suite 107 Clifton Park, NY 12065 grogers@hudco.com
Corporations Law Committee	Janet Thiele Geldzahler Sullivan & Cromwell LLP 1701 Pennsylvania Avenue, NW Washington, DC 20006 geldzahlerj@sullcrom.com
Derivatives and Structured Products Law Committee	Ilene K. Froom JP Morgan Chase and Company 270 Park Avenue, 41st Floor New York, NY 10017 ilene.k.froom@jpmchase.com
Franchise, Distribution and Licensing Law Committee	Thomas M. Pitegoff Pitegoff Law Office Ten Bank Street, Suite 540 White Plains, NY 10606-1933 pitegoff@pitlaw.com
Information and Technology Law Committee	Martin J. Ricciardi Whiteman Osterman and Hanna LLP One Commerce Plaza Albany, NY 12260 mricciardi@woh.com
Legislative Affairs Committee	Peter W. LaVigne Sullivan & Cromwell LLP 125 Broad Street New York, NY 10004-2498 lavignep@sullcrom.com
Membership Committee	Andrea M. Elder-Howell Sempra Energy Trading Corp. 58 Commerce Drive Stamford, CT 06902 aelder@sempratrading.com
Securities Regulation Committee	Jeffrey W. Rubin Hogan & Hartson LLP 875 Third Avenue New York, NY 10022 jwrubin@hhlaw.com

NY BUSINESS LAW JOURNAL

HeadNotes

Our Fall issue spotlights the diversity of business law practice in New York, with contributions ranging from the regulation of subprime mortgage lending, to the doctrine of estoppel in the formation of limited partnerships and limited liability companies, to cell phone advertising, to environmental issues in vessel leasing, to recent Supreme Court cases regarding the application of the Fair Credit Reporting Act (FCRA) in the pricing of insurance policies to consumers and the exemption of home health care workers from the Fair Labor Standards Act (FLSA), to new federal regulations affecting offerings of franchises in New York and the prevention of money laundering through the banking system—not to mention a trenchant and insightful discussion of that bane of the modern law firm's existence, conflicts of interest.

C. Evan Stewart, a prolific contributor to the *Journal* and to the Section's programs, contributes another thoughtful and provocative article on the troubled state of the legal profession in relation to its constituencies. As firms continue to grow in size and geographic reach, through merger or otherwise, and to specialize in selected practice areas for which their services may be sought by business competitors, the potential for conflicts of interest has increased significantly. In "The Legal Profession and Conflicts: Ain't No Mountain High Enough?" Mr. Stewart discusses such thorny issues as advance waivers—i.e., getting the client to consent in advance to a possible future conflict—and the "hot potato" rule, regarding the circumstances in which a firm faced with a conflict may, or may not, drop one client in favor of another. The author foresees a bumpy ride, as firms increasingly try to reconcile the traditional duty of loyalty with the increasing complexities of corporate practice and the economic pressures on law firms generally.

The Chairs of two Section standing committees contribute two useful and practical articles regarding federal regulatory developments that affect practitioners in their respective areas. In "Banking Agencies Issue Bank Secrecy Act Enforcement Guidance," Clifford Weber of Hinman Howard & Kattell, LLP, the current Chair of the Section's Banking Law Committee, discusses new guidance released over the summer by the bank regulatory authorities. Far from promoting secrecy, the Bank Secrecy Act (BSA) actually compels financial institutions to monitor transactions by their customers and disclose to regulators when a customer engages in a transaction that may be suspicious. The guidance clarifies the specific deficiencies in an institution's BSA program that will trigger a cease-and-desist order, which is a serious enforcement action that can adversely affect the institution's reputation and ability to operate effectively. The author notes that, while the guidelines are phrased in mandatory terms, they do give the regulators some leeway to take into account the institution's compliance efforts as a whole.

Next up is Thomas Pitegoff, head of the Pitegoff Law Office PLLC and Chair of the Section's Franchise, Distribution and Licensing Law Committee. In "Franchising in New York After the Revised FTC Rule," Mr. Pitegoff reexamines the New York Franchise Act (NYFA), which mandates registration of franchise offerings in New York, in light of new rule-making by the Federal Trade Commission (FTC). While the FTC rules regulate the disclosures that must be made by franchisors to prospective franchisees, they specifically do not preempt state laws, such as the NYFA, that are more protective. In light of the new FTC rules, the author makes specific recommendations for improvements in the NYFA and offers practical guidance to New York practitioners.

The long boom in residential housing has been financed by cheap and plentiful mortgage credit. But recent publicity regarding the high, and increasing, default rate in the so-called "subprime" market—the market for borrowers who do not meet traditional underwriting criteria—has highlighted the abuses and increasingly lax standards in this market. Catherine Brennan, an attorney with Hudson Cook, LLP, analyzes and discusses guidance recently adopted by the New York State Banking Department aimed at reining in the potential abuse of "nontraditional" mortgage products, such as interest-only mortgages and adjustable rate mortgages (ARMs) that give the borrower a variety of payment options.

Two cases decided in the Supreme Court's spring 2007 term attract comment from our contributors. In the first, Ernest Patrikis and Glen Cuccinello of Pillsbury Winthrop Shaw Pittman analyze the Court's decision in *Safeco Insurance Company of America v. Burr*, concerning the application of the Fair Credit Reporting Act (FCRA) to the pricing of insurance policies. The FCRA generally requires that, if any party takes "adverse action" against a consumer based upon his or her credit report, the consumer must be notified. In the *Safeco* case the insurer interpreted the term "adverse action" as not applying to an initial application, since there was no standard against which to compare the action taken. The question was whether the insurer's interpretation, which may not have been correct, should be deemed to have been "willful"—giving rise to punitive damages—notwithstanding that it was a reasonable interpretation of the statute at the time. The authors note that the Court's commercially reasonable application of the statute gives comfort to companies seeking ways to comply in introducing new products.

In the second case from the Court's recently ended term, Andrew Lauer and Ronit Gurtman of Thelen Reid Brown Raysman & Steiner LLP discuss the case of *Long Island Care at Home v. Coke*, which addressed the question whether the exemption from minimum wage laws under the Fair Labor Standards Act (FLSA) for home health care workers applies to workers employed by a third-party employment service. In 1974, Congress expanded the scope of the FLSA to include more workers. However, the Department of Labor (DOL) adopted rules which continued to exclude home health care workers, including those employed through third-party agencies. Overturning the Second Circuit Court of Appeals, the Supreme Court ruled unanimously that the DOL's regulation was valid. The authors note a possible attempt in the Congress to overturn the ruling. But apart from the specific FLSA issue, the case is significant for highlighting the Court's consistency in upholding the doctrine that courts should defer to reasonable interpretations of statutes by the agencies empowered to administer those statutes.

With the proliferation of multi-function cellular telephones that can take pictures, play music and surf the Internet, rapid growth of the mobile phone as a means of reaching consumers with advertising seems inevitable. In "Commercial SMS Text Messages and the Telephone Consumer Protection Act," Jeffrey Neuburger and Jonathan Mollod, also of Thelen Reid, focus on whether the "prior consent" requirement under the Telephone Consumer Protection Act (TCPA) applies to the Short Messaging Service (SMS) text messaging capability of mobile handsets. Arizona's highest court held that it did; however, recently a federal district court in California held that it does not. The authors analyze the different approach of the two courts to addressing the threshold issues: whether the message was a "call," and whether the means by which it was sent is an "automatic telephone dialing system" under the TCPA. More generally, the article illustrates the types of problems presented in applying a statute to a technology that was unknown when it was passed.

Next up are Nancy Hengen and Dennis Bryant of Holland & Knight LLP. In "Vessel Environmental Issues—the Lessor's Perspective," they discuss the potential environmental liability of lessors of vessels, including liability for petroleum spills, air emissions, and scrapping of the vessel itself. In addition, the article will be of interest to attorneys for banks and other lenders, in that it analyzes the "secured creditor" exemption under the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA), also known as the Superfund law. CERCLA imposes liability for environmental cleanup on, among others, all "owners" of property, but exempts lenders who hold indicia of ownership primarily to protect a security interest. The article gives useful background on the secured creditor exemption and analyzes its applicability to lessors of vessels.

Concluding this issue is an article by Bruce Rich of Thelen Reid and Kamilah Holder, a student at New York Law School, regarding a recent New York Court of Appeals case addressing the legal status of New York limited partnerships (LPs) and limited liability companies (LLCs) that have not completed all the formal requirements to be properly established under the law. In *Boslow Family Limited Partnership v. Glickenhaus and Co.*, a limited partnership had operated as such for six years, notwithstanding that the formal requirements of filing a certificate of limited partnership and fulfilling the newspaper publication requirement had never been met. The Court rejected the defendant's argument that the plaintiff thereby lacked capacity. The authors analyze the case and, more generally, the doctrine of estoppel as applied in cases where an LP or LLC has failed to complete the formal requirements to establish itself under New York law.

David L. Glass
Editor-in-Chief

The Legal Profession and Conflicts: Ain't No Mountain High Enough?

By C. Evan Stewart

On the eve of the Civil War, William Henry Seward (one of the 19th century's greatest statesmen), proclaimed that the issue of slavery represented "an irrepressible conflict between opposing and enduring forces." In the legal profession, conflicts of interest may (or may not) be "irrepressible," but they are often the bane of lawyers' existence, specifically for lawyers who practice in large, national or international firms. Notwithstanding that fact (or perhaps because of it), one of the leading professors in the field of professional responsibility and legal ethics has observed that big firm lawyers "are some of the biggest risk-takers that I run into" when it comes to conflicts issues.[1]

As Don Corleone once asked: "How did things ever get this far?" This article will attempt to answer that (and related) question(s).

Two Leading Cases

To put the current conflicts environment in proper context, two recent, leading cases are a helpful guide. The first involves the Pennie & Edmonds law firm.

1. Pennie & Edmonds

In 1980, Pennie & Edmonds (P & E)—a leading intellectual property firm—began representing Pfizer; and in 1992, P & E also started representing Searle. Both Pfizer and Searle were in the forefront of developing a new type of drug: Cox-2 inhibitors (an anti-inflammatory drug); Pfizer and Searle entered into cooperative marketing agreements with respect to a specific Cox-2 drug called Celecoxib (P & E knew of this cooperative arrangement at least as of 1998).

In 1995, P & E began representing the University of Rochester (Rochester) for purposes of prosecuting a patent application for Cox-2 inhibitors before the Patent and Trademark Office (PTO). In March 1998, as P & E was proceeding with its Rochester patent prosecution, the firm circulated an internal conflicts memo which stated that Searle was retaining P & E specifically for Cox-2 patent matters. None of the Rochester partners at P & E responded to that memo; those same Rochester partners knew that Rochester (assuming the PTO granted the patent) intended to sue, or license, potential infringers, including Pfizer (and further knew that Rochester wanted P & E to represent Rochester for those purposes).

In April 2000, as P & E was advising Rochester on prospective litigation strategies, the PTO issued Rochester a patent for Cox-2; Rochester then brought an infringement action against Pfizer. Not surprisingly, Pfizer and Searle then sued Pennie & Edmonds.

The issue before New York Supreme Court Justice Charles Ramos was whether P & E violated DR 5-105 by representing two different patent clients in connection with related (but not necessarily identical) applications pending before the PTO, with knowledge that it was likely that one client would sue, or attempt to license the other.[2] P & E defended itself on the ground that there was no conflict until "actual adversity" existed between two (or more) clients; it took this position (in the main) because by the time Rochester actually sued Pfizer, P & E was no longer Rochester's counsel.

"In the legal profession, conflicts of interest may (or may not) be 'irrepressible,' but they are often the bane of lawyers' existence, specifically for lawyers who practice in large, national or international firms."

Justice Ramos rejected P & E's defense, found that the firm's conduct ran afoul of the "appearance of impropriety" standard, ruled that there had been a violation of DR 5-105(C) by the firm's failure to disclose the multiple representations and failure to obtain client consent to said representations, and reported P & E to the New York disciplinary authorities.[3] One practical impact of the litigation: The law firm of Pennie & Edmonds is no more.[4]

2. Duane Morris

Duane Morris is a 600-plus-lawyer firm with 18 offices spanning the globe. The ethical problem facing that firm came into being when Duane Morris found itself on various sides of a medical conglomerate, the McKesson Corporation.

Initially, Duane Morris was hired to represent two McKesson subsidiaries, McKesson Automation Inc. (MAI) and McKesson Medication Management Inc. (MMM), in a bankruptcy proceeding in Pennsylvania. The April 27, 2006 engagement letter prepared by Duane Morris' Harrisburg, Pennsylvania, office and presented to MAI and MMM sought to protect the firm with respect to potential future conflicts. The relevant "advance waiver" language was as follows:

> Given the scope of our business and the scope of our client representations through our various offices in the United States and abroad, it is possible that some of our present or future clients will have matters adverse to McKesson while we are representing McKesson. We understand that McKesson has no objection to our representation of parties with interests adverse to McKesson and waives any actual or potential conflict of interest as long as those other engagements are not substantially related to our services to McKesson.
>
> We agree, however, that McKesson's consent to, and waiver of, such representation shall not apply in any instance where, as a result of our representation of McKesson, we have obtained proprietary or other confidential information of a non-public nature, that, if known to such other client, could be used in any such other matter by such client to McKesson's material disadvantage or potential material disadvantage. By agreeing to this waiver of any claim of conflicts as to matters unrelated to the subject matter of our services to McKesson, McKesson also agrees that we are not obligated to notify McKesson when we undertake such a matter that may be adverse to McKesson.

A few months later, Duane Morris' Atlanta office was hired to represent two individuals in an arbitration proceeding against a different McKesson subsidiary, McKesson Information Systems (MIS). As soon as MIS learned of opposing counsel, it wrote Duane Morris, demanding that the firm withdraw. Duane Morris refused, citing the advance waiver language of the Pennsylvania retainer letter which allowed for the firm to represent clients in cases adverse to McKesson on matters not substantially related to the businesses of MAI and MMM. Duane Morris also said that if McKesson insisted on its conflicts position, the firm would withdraw from representing MAI and MMM in Pennsylvania.

McKesson's response? It sued Duane Morris in Georgia state court, claiming that the firm's threat to withdraw in Pennsylvania's constituted "extortion," and seeking Duane Morris' disqualification from the MIS litigation. At a hearing at the end of October 2006, the Georgia court was presented with a battle of experts. For McKesson, Professor Clark Cunningham of the Georgia State College of Law testified that Duane Morris' advance waiver provisions were impermissibly broad under Georgia's rules governing lawyers' professional conduct. Steven Krane, a partner at New York's Proskauer Rose and the current chair of the ABA's Standing Committee on Ethics and Professional Responsibility, testified "at great length" for Duane Morris, contending that Pennsylvania law applied to the MAI/MMM engagement letter, that Pennsylvania's attorney rules permitted a waiver of this kind, and that large conglomerates such as McKesson could not reasonably expect law firms to have a single engagement with one small part of the entity govern its ability to take on unrelated matters for other corporate family members.

After noting that Georgia's and Pennsylvania's advance waiver rules "are very similar," the Georgia court came down on the side of Professor Cunningham and ruled that Georgia law was applicable to the dispute at hand.[5] Georgia's Rule 1.7(a) reads, in pertinent part, "A lawyer shall not represent or continue to represent a client if there is a significant risk that the lawyer's own interests or the lawyer's duties to another client, a former client, or a third person will materially and adversely affect the representation of the client. . . ."[6] To Duane Morris' contention that their conduct was not improper because the matters were unrelated, the court cited to Comment 8 of Rule 1.7, which says that a lawyer cannot act as an advocate against a client the lawyer represents in another matter, even if the other matter is wholly unrelated. As to the written consensual waiver contemplated by Rule 1.7(b), the court ruled that the MAI/MMM engagement letter was "not a knowing waiver that identifies the specific adverse clients and details of adverse representations."[7] In light of those determinations, Duane Morris was ruled to be disqualified in its case against MIS.[8]

Advance Waivers

As the Duane Morris litigation makes evident, the issue of advance waivers can be a pretty sticky wicket.[9] And yet, law firms regularly use language not dissimilar to that which Duane Morris put in its McKesson retainer letter.[10] So what gives?

Under the revised ABA Model Rules (2002), advance waivers can in fact work—so long as the waiving client gives "informed" consent (Rule 1.7). But what is "informed" consent? According to ABA Comment 22 to Rule 1.7, in order to give such consent a waiving client must "reasonably understand [] the material risk that the waiver entails." Such an understanding may be gleaned, *inter alia*, from: (i) a (more) detailed statement of the types of future engagements that might be undertaken; (ii) a (more) detailed statement of the "reasonably foreseeable adverse consequences" of said engagements; (iii) if the "particular type of conflict" is one with which the waiving client is familiar; (iv) if the waiving client is "an experienced user of the legal services" at issue; (v) if the waiving client is represented by the other counsel for purposes of giving consent; and (vi) if the consent is limited to prospective engagements unrelated to the current representation.[11]

The ABA's "revised" Rule 1.7 (and Comment 22 thereto) constituted a shift toward being more embracing of advance waivers. And just to make sure that shift was crystal clear, the ABA issued ABA Opinion 05-436 (May 11, 2005), which both withdrew ABA Opinion 93-372 (a more skeptical view of advance waivers) and endorsed "open-ended" waivers where the waiving client is sophisticated or represented by counsel.[12]

Perhaps the *Duane Morris* court did not get the message; it is more likely that the language of the Duane Morris engagement letter did not capture enough of the factors set forth in Comment 22 to Rule 1.7.[13] Other courts do appear to be getting the message. Thus, where the waiver has been explicit and the waiving client was sophisticated, for example, courts have shown an increased appetite for approving these provisions.[14]

A "Hot Potato"

Not so long ago, the spelling of potato was a political issue.[15] Now, the concept of the "hot potato" has entered the lexicon of legal ethics.

The "hot potato" rule stands for the salutary proposition that a lawyer may not drop one client in favor of another client, "especially if it is in order to keep happy a far more lucrative client."[16] Despite the broad prohibition of that rule, the legal profession has been quick (and creative) in finding ways around it.

For example, there is a growing line of cases that allows a lawyer to ethically drop one client in favor of another, if the "dropped" client can be characterized as an "accommodation" client. In the securities litigation arising out of problems at the Rite Aid Corporation,[17] outside counsel to the corporation and the CEO determined after an internal investigation that it could no longer defend the interests of both clients and told the company that the CEO (by now terminated) needed his own lawyer. The court, on the CEO's motion to disqualify his former firm, deemed the CEO to be an accommodation client who had impliedly consented to the outside counsel's primary allegiance to the company.[18]

There is another line of cases, strongly encouraged by bar groups, where courts have applied a flexible approach to "thrust upon" situations.[19] Essentially, the view is that the "hot potato" rule should not kick in where it is not the lawyer who seeks to drop a client to pursue a better client, but rather where the lawyer gets the conflict "thrust upon" her (for example, by a corporate merger). Factors to be used in applying this flexible approach include:

- The prejudice the withdrawal or continued representation would cause the parties (including whether continuing representation of one party would give it an unfair advantage to the detriment of the other party [this is the most important factor]);
- What caused the conflict to occur;
- Whether the conflict was created or is being used to effect an advantage; and
- The costs and convenience to the party required to retain new counsel.

Perhaps the most interesting take on the "hot potato" rule has come from the Northern District of Ohio in *Pioneer-Standard Electronics Inc. v. Cap Gemini America Inc.*[20] There, the New York–based firm of Shearman & Sterling was representing Pioneer on a pending European Commission matter when Cap Gemini retained the firm to defend it against Pioneer in an Ohio federal action. Shearman sought a waiver from Pioneer, but Pioneer refused that request. Shearman then told Pioneer it was dropping the company as a client.

When Pioneer moved to disqualify Shearman as Cap Gemini's counsel in Ohio on the ground that the law firm's professional judgment was likely to be "adversely affected" by the multiple representations, Shearman's defense was that there was no such problem since it had dropped Pioneer as a client before appearing in the Ohio litigation. The court rejected Shearman's position as being in violation of the "hot potato" rule—i.e., it could not drop Pioneer as a client. At the same time, the court also ruled that there was no reason why Shearman could not represent *both* Cap Gemini in Ohio (against Pioneer) *and* Pioneer in Europe "with equal vigor" and without violating client confidences to the detriment of the other.[21]

Corporate Affiliates and Subsidiaries

One area where the *Duane Morris* court might have focused its attention (but did not) was on whether corporate affiliates and subsidiaries may be considered as different entities for conflicts purposes. According to ABA Opinion 95-390 (January 25, 1995), a lawyer representing a corporate client "is not by that fact alone necessarily barred from representation that is adverse to a corporate affiliate of that client in an unrelated matter." Put another way (and according to 95-390), said lawyer for the corporate client may, under many/most circumstances, sue the client's wholly owned subsidiary without obtaining the client's informed consent.

Well, what is wrong with that? First off, as the vociferous dissents to 95-390 pointed out (the ABA committee split 6-4), this approach has a few flaws: (i) it seems directly at odds with traditional notions of client loyalty;

(ii) it exalts corporate form and structure over corporate substance and reality; (iii) it makes it hard to understand the distinction between direct and indirect economic harm to the corporation; and (iv) it seems to be a trap for non-Fortune 500 companies (i.e., those who just assume lawyer loyalty and are without sufficient resources to hire scores of in-house lawyers to protect against such circumstances).[22] Even more important is the fact that any corporate lawyer proceeding in the fashion envisioned by the 95-390 majority (i.e., suing a subsidiary without, at a minimum, consulting and getting consent from the parent company) would likely be fired by the company's general counsel as soon as she discovered the perfidious act of the outside lawyer.[23]

Courts traditionally have not embraced the view or rationale of 95-390's majority.[24] But increasingly courts are starting to experiment in this area, especially if a subsidiary can be shown to be independent of another corporate entity, so that the transmittal of client confidences and other information would not be presumed.[25] Suffice it to say that predicting how this niche of the conflicts market will play out would be problematic, at best.

Conclusion

In his seminal article in 1975 on lawyers and their role in the adversarial system, Simon Rifkind passionately expressed his faith in that system, and in the lawyer's singular duty of client loyalty—to represent clients' interests as zealously as legally permissible.[26] To the extent conflicts of interest played a role in Judge Rifkind's article, it was to take strenuous issue with the notion that lawyers might have divided loyalties between clients and non-clients (and/or the general public).

The legal profession thirty-two years later seems a very different place in many respects. The organized bar's imaginative, multi-headed attempts to circumvent or evade existing conflicts of interest rules (as set forth above) appear to be motivated primarily by the economic needs and pressures of an increasingly competitive business. Where this ride will end, who knows. Until then, as Bette Davis once emoted: "Fasten your seat belts, it is going to be a bumpy night!"

Endnotes

1. Karen Donovan, *When Big Law Firms Trip Over Their Own Clients*, N.Y. Times, October 3, 2004, at B5.
2. *The Lawyer's Code of Prof'l Responsibility*, DR 5-105 (hereinafter "*Code*"); Model Rules of Prof'l Conduct R. 1.7.
3. Justice Ramos' decision, rendered on July 14, 2004, seems actually quite restrained, finding only the "appearance of impropriety" and a violation of DR 5-105(C). Given the clear and predictable adversity of P & E's multiple clients, DR 5-105(A) ("A lawyer shall decline proferred employment . . . if it would be likely to involve the lawyer in representing differing interests. . . .") would appear to have been the more appropriate ethical rule. Interestingly, the ABA's Model Rules of Prof'l Conduct and the ALI's Restatement (Third) of the Law Governing Lawyers (2000) (hereinafter "ALI's Restatement") do not provide for the "appearance of impropriety" as an appropriate standard for conflicts of interest. And most states have followed that approach. *See, e.g., Addam v. Super. Court*, 10 Cal. Rptr. 3d 39, 42-43 (2004).
4. A similar, if even more "egregious" case, recently involved Wilson Elser Moskowitz Edelman & Dicker. *See Ulico Casualty Co. v. Wilson, Elser, Moskowitz, Edelman & Dicker*, No. 602229/99, 2007 WL 2142299 (New York Sup. Ct. March 29, 2007). There, the court granted partial summary judgment for liability insurer Ulico, which sued its former law firm for breach of fiduciary duty by participating in a scheme to transfer Ulico's policy holders to another insurer client of the firm's. Citing DR 5-105, the court ruled that the case involved "conduct by an attorney which fostered the business interests and advanced the competitive position of certain clients not over a former client but over a client which the attorney was still representing." *Id.* at *6. As a result, the court (i) ordered the law firm to disgorge to Ulico $3.4 million in fees paid by Ulico, and (ii) allowed Ulico to proceed to trial on other damage claims totaling more than $100 million. *Id.* at *15.
5. The court looked to Georgia's Rule 8.5, by which, *inter alia*, the law of the jurisdiction in which the lawyer's conduct took place governs. Query whether Duane Morris made the right tactical decision in choosing a New York based lawyer (regardless of expertise) to face off in a Georgia state court against a local Georgia professor on this issue.
6. GA Rules of Prof'l Conduct R. 1.7(a).
7. The court's cited authority for its ultimate holding was *Worldspan, L.P. v. Sabre Group Holdings, Inc.*, 5 F. Supp. 2d 1356 (N.D. Ga. 1998) and *Snapping Shoals Electric Membership Corp. v. RLI Insurance Corp.*, No. 1:05 CV 1714-GET, 2006 WL 1877078 (N.D. Ga. 2006).
8. Interestingly, on March 6, 2007, the trial judge lifted the bar on Duane Morris representing parties adverse to MIS because its representation of MIA and MMM in the bankruptcy proceeding had ended in a proper manner at the conclusion of that proceeding. As such, Rule 1.9, instead of Rule 1.7, was the now-applicable ethics rule; the court, emphasizing the right of clients to choose counsel, then allowed Duane Morris to re-institute its representation. *See* ABA & BNA, ABA/BNA Lawyers' Manual on Professional Conduct 132-33 (2007).
9. *Compare Westinghouse Elec. Corp. v. Gulf Oil Corp.*, 558 F.2d 221 (7th Cir. 1978) *with Interstate Prop. v. Pyramid Co.,* 547 F. Supp. 178 (S.D.N.Y. 1982); *Unified Sewage Agency of Washington County v. Jelco Co.*, 646 F. 2d 1339 (9th Cir. 1981).
10. *See* Richard W. Painter, *Advance Waiver of Conflicts*, 13 Geo. J. Legal Ethics 289 (2000).
11. Model Rules of Prof'l Conduct R. 1.7 cmt. 22. ALI's Restatement is generally in accord with the Model Rule, although it does say that advance waivers are subject to "special scrutiny." The bar in the District of Columbia has long been favorably disposed toward advance waivers. *See* D.C. Legal Ethics Comm., Op. 309 (Sept. 20, 2001). *See also* N.Y.C., Op. 2006-1 (Feb. 17, 2006).
12. ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 05-436. Op. 93-372 warned that "no lawyer can rely with ethical certainty on prospective waiver. . . ."
13. *See also Concat LP v. Unilever, PLC*, 350 F. Supp. 2d 796 (N.D. Cal. 2004).
14. *See Visa U.S.A., Inc. v. First Data Corp.*, 241 F. Supp 2d 1100 (N.D. Cal. 2003); *General Cigar Holdings v. Altadis*, 144 F. Supp. 2d 1334 (S.D. Fla. 2001); *St. Barnabas Hosp. v. New York City Health & Hosp. Corp.*, 7 A.D.3d 83, 775 N.Y.S.2d 9 (1st Dep't 2004). Even with this shift, many lawyers experienced in this area continue to be uncertain how uniformly supportive courts will be to advance waivers. *See* ABA & BNA, ABA/BNA Lawyers' Manual on Professional Conduct, APRL Speakers and Audience Debate

Possibility of Model Advance Waiver Form 96 (February 23, 2005) ("Advance consents are uniformly being used in large law firms, even though lawyers are doubtful that they'll hold up." Comments of Diane Karpman).

15. During the administration of Bush 41, then Vice President Dan Quayle got into hot water when he told a school child how to spell "potatoe"!

16. *Picker Int'l, Inc. v. Varian Assoc., Inc.*, 670 F. Supp. 1363, 1365 (N.D. Ohio 1987), *aff'd*, 869 F.2d 578 (6th Cir. 1989); *Santacroce v. Neff*, 134 F. Supp. 2d 366 (D.N.J. 2001); *Argue v. David Davis Enter, Inc.*, No. Civ.A. 02-9521, 2004 WL 2480836 (E.D.Pa. Nov. 4, 2004).

17. *See In re Rite Aid Corp. Sec. Litig.*, 139 F. Supp. 649 (E.D. Pa. 2001).

18. *See also Universal City Studios, Inc. v. Reimerde*, 98 F. Supp. 2d 449 (S.D.N.Y. 2000) (court allowed adverse representation to accommodation client, notwithstanding the affirmance of the "hot potato" rule). And while ALI's Restatement endorses the concept of an accommodation client, not all commentators are enthusiastic. *See* Douglas R. Richmond, *Accommodation Clients*, 35 Akron L. Rev. 80 (2001) (critical of creating a new breed of client that is unnecessary, confusing, and imprudent).

19. *See Argue v. David Davis Enter. Inc.*, No. Civ.A. 02-9521, 2004 WL 2480836 (E.D. Pa. Nov. 4, 2004).; *Univ. of Rochester v. G.D. Searle & Co.*, No. 00-CV-6161L B., 2000 WL 1922271 (W.D.N.Y. 2000); N.Y.C., Op. 2005-5 (June 2005); D.C. Legal Ethics Comm., Op. 272 (May 21, 1997). ALI's Restatement also recognizes the "thrust upon" conflict exception to the "hot potato" rule.

20. No. 1:01CV2185, 2002 WL 553460 (N.D. Ohio 2002).

21. The court determined that (in Ohio, at least) there "is not a per se rule against an attorney representing clients adverse to each other." *Id.*

22. In one of the dissents, a devastating attack on the majority's view used Ford Motor Company's structure (it would be okay to sue Jaguar, a subsidiary—this would cause only an "indirect" harm; it would not be okay to sue Escort, a division—this would cause a "direct" harm) to highlight the highly dubious logic of points (ii) and (iii). ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 95-390.

23. The 95-390 majority did point out that "as a matter of prudence and good practice," it would in fact make sense to check with the client prior to taking on a representation adverse to a corporate affiliate. ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 95-390.

24. *See Strategen Dev. Corp. v. Heron Int'l N.V.*, 756 F. Supp. 789 (S.D.N.Y. 1991); *Cincinnati Bell, Inc. v. Anixter Bros.*, No. C1-93-0871, 1994 WL 1877173 (S.D. Ohio 1994).

25. *See J.P. Morgan Chase Bank ex rel. Mahonia Ltd. v. Liberty Mut. Ins. Co.*, 189 F. Supp. 2d 20 (S.D.N.Y. 2002); *Goodlett v. Paul Revere Life Ins. Co.*, No. C97-0089, 2000 WL 34027916 (N.D. Iowa 2000). And some academic commentators have endorsed loosening up the "unduly formalistic" approach to conflicts vis-à-vis complex corporate structures. *See* Ronald D. Rotunda, *Conflict Problems When Representing Members of Corporate Families*, 72 Notre Dame L. Rev. 655 (1997); T. Morgan, *Suing Current Clients*, 1 J. Inst. Studs. Leg. Ethics 8 (1994). *See also* Model Rules of Prof'l Conduct R. 1.7, cmt. 34 (2004)..

26. 30 The Record 534 (1975).

Banking Agencies Issue Bank Secrecy Act Enforcement Guidance

By Clifford S. Weber

New BSA Guidance

The Bank Secrecy Act,[1] or BSA, requires American financial institutions to assist governmental detection and prevention of money laundering. Since its adoption in 1970, the four federal banking agencies and FinCEN have adopted BSA regulations and issued comprehensive BSA *compliance* guidance, including the FFIEC "Bank Secrecy Act/Anti-Money Laundering Examination Manual."

On July 19, 2007, the FDIC, FRB, OCC and OTS, along with the NCUA, issued joint BSA *enforcement* guidance, entitled "Interagency Statement on Enforcement of Bank Secrecy Act/Anti-Money Laundering Requirements."[2]

The Interagency Statement, summarized below, doesn't offer new BSA advice or interpretation, or otherwise break new ground. Instead, as the agencies note in their issuing releases, it reflects current enforcement practice, and is designed to provide consistency in BSA enforcement decisions and insight into the considerations that ground them. Reading between the lines, the agencies may also want to use the Interagency Statement to deflect the oft-heard criticism that BSA examinations sometimes focus on minutiae and emphasize form over substance.

Legal Background

The Federal Deposit Insurance Act[3] directs the federal banking agencies to: i) prescribe regulations requiring depository institutions to adopt BSA compliance procedures; ii) review the procedures and identify any problems discovered during examination; and iii) issue a cease and desist order if the institution fails to establish or maintain the procedures or correct an identified problem.[4]

The agencies' BSA regulations require institutions to establish and maintain a BSA Compliance Program, which must include, at a minimum: (i) a system of internal controls; (ii) independent BSA/AML compliance testing; (iii) a designated BSA/AML compliance person; and (iv) BSA/AML training.[5]

Summary

In the Interagency Statement, the agencies identify the findings that will trigger the issuance of a cease and desist order, which include:

Failure to establish and maintain a BSA Compliance Program:

- Lack of a written program, including a know-your-customer policy.
- Failure to implement the program.
- Ineffective implementation or aggravating factors, including evidence of structuring patterns or systemic failure to file SARs or CTRs.

Failure to correct a previously reported BSA Compliance Program problem:

- Problem must be serious and previously identified by the regulator, such as failure to take any action in response to an examination identifying the lack of a qualified BSA compliance officer.
- Examination comments identifying less serious issues, suggesting areas for improvement and not requiring communication to the board of directors or senior management are not considered problems warranting the issuance of a C&D order.
- A C&D order will not be issued where the institution has made substantial, good faith progress towards correcting the previously identified problem, such as computer systems faults which may not have been correctable since the last examination.
- Other BSA violations, including SAR and other record-keeping deficiencies.[6]

Discussion

The statutory directive is straightforward: The regulators *must* issue a C&D order where an institution fails to establish or maintain the required BSA procedures or correct an identified BSA problem.[7] Under this mandate, the regulators have little wiggle room in cases of clear violations.

Nonetheless, the regulators have some leeway for judgment, and throughout the Interagency Statement, they identify the circumstances and factors that could temper the harsh sanction of a C&D order. These include viewing the BSA Compliance Program's effectiveness as a whole, and consideration of the totality of an institution's individual circumstances, including the presence or absence of mitigating or aggravating factors, such as management's capabilities and cooperation, the severity of the non-compliance and the regulator's confidence in the institution's willingness to remedy the deficiencies.[8] The agencies note that in appropriate cases, they will issue formal written directives or impose sanctions less severe than C&D orders.[9] Note too, that in egregious cases, they can impose additional sanctions, such as civil money penalties.[10]

Post-9/11, BSA/AML compliance has become a permanent and prominent focus of regulatory attention. In this environment, be proactive, not reactive, with BSA/AML compliance. This includes: (i) comprehensive understanding of the "BSA/AML Examination Manual"; (ii) ongoing training; (iii) detailed policies and procedures tailored to the institution's risk assessment; (iv) a compliance audit program; and (v) adequate compliance staffing.

C&D orders distract management's energies, divert employee resources and can tarnish regulatory relationships. They can also cause public and investor relations issues because they are disclosed to the public via the agencies' Web sites and some orders require explicit disclosure to shareholders.

Of course, in the real world, time, financial and resource constraints can combine to produce BSA/AML oversights for the best-intentioned and prepared institutions. When these lapses cause adverse examination comments, consider engaging professional assistance to formulate responses, revise or enhance policies and procedures and negotiate the least punitive resolution. Experienced compliance consultants and, in appropriate cases, regulatory counsel can help you achieve a successful outcome.

Endnotes

1. 31 U.S.C. §§ 5311-30.
2. Press Release, Bd. of Governors of the Fed. Reserve Sys., Fed. Deposit Ins. Corp., Office of the Comptroller of the Currency, Office of Thrift Supervision, & Nat'l Credit Union Admin., Interagency Statement on Enforcement of Bank Secrecy Act/Anti-Money Laundering Requirements (July 19, 2007) (*available at* http://www.fdic.gov/news/news/press/2007/pr07061a.html#_ftnref4).
3. 12 U.S.C. §§ 1811-31.
4. § 1818(s).
5. 12 C.F.R. §§ 208.63 (Board of Governors); 326.8(c) (FDIC); 21.21 (OCC); 563.177 (OTS); 748.2 (NCUA).
6. Press Release, *supra* note 2.
7. 12 U.S.C. § 1818(s)(3)(B).
8. Press Release, *supra* note 2.
9. *Id.*
10. 12 U.S.C. § 1818(b)(6)(A).

Cliff Weber handles regulatory, corporate, securities and transactional matters for financial institutions. He currently serves as Chairman of the New York State Bar Association's Banking Law Committee. Previously, he served as General Counsel to the Community Bankers Association of New York State and as Counsel to the New York State Assembly Insurance Committee.

Franchising in New York After the Revised FTC Rule

By Thomas M. Pitegoff

Franchise sales in New York are regulated by federal and state laws. Under the franchise sales laws, a franchisor must make disclosures to a prospective franchisee before a franchise is sold. The laws requiring franchisors to make detailed disclosures to franchise buyers in a uniform format are generally patterned after the securities laws, which require disclosure to investors and prohibit fraud. In New York, the Bureau of Investor Protection and Securities of the Department of Law enforces both the franchise and securities laws.[1]

The New York Franchise Act (NYFA) became effective in 1981.[2] In addition to requiring presale disclosure, the NYFA requires franchisors to register their franchise offerings with the Department of Law and to keep those registrations current. State examiners can require changes in proposed offering circulars to bring them into compliance with state law before approving applications for franchise registration. New York is one of fourteen states that require registration of the franchise offering.[3]

The Federal Trade Commission's recent approval of a revised trade regulation rule on franchising has created a need for a change in New York's franchise laws. This need for change makes this a good time to take a fresh look at the NYFA to see what is working and what can be improved. How does the NYFA differ from the federal requirements and the laws of other states? Do these differences serve a useful purpose? Do they meet a specific need to protect franchisees? Is there evidence of such a need? Do the differences actually provide greater protection? If not, then a change in the statute may be in order to conform more closely to the revised federal rule. The continued existence of state differences serves as a trap for the unwary and an unnecessary compliance burden.

This subject is important because companies commonly franchise their businesses across state lines, and franchising has become a major sector of the U.S. economy.[4] The objective of this analysis is to make New York State and the NYFA friendlier to franchise businesses and to business generally, while preserving New York's enforcement capabilities in the field of franchising so that franchisee protection is not diminished. The recommendations outlined below are essentially technical corrections that would greatly improve New York law.

The NYFA Differs from the UFOC Guidelines

Franchisors currently make the required disclosures in the form of a "Uniform Franchise Offering Circular," or "UFOC." The UFOC Guidelines were first formulated and adopted in 1975 by the Midwest Securities Commissioners Association, the predecessor to the North American Securities Administrators Association (NASAA).[5] NASAA adopted the current UFOC Guidelines in 1993. The UFOC format meets the current Federal Trade Commission disclosure requirements.

The NYFA differs in minor respects from the UFOC Guidelines. New York has a few additional disclosure requirements that are not contained in the UFOC Guidelines. Franchisors deal with these differences by adding a state-specific addendum to their franchise offering circular in New York.

Section 683.2 of the NYFA lists the disclosures required by the statute. The regulations substantially follow the UFOC Guidelines.[6] However, New York imposes broader disclosure requirements for Item 3 (litigation) than those required by the UFOC Guidelines and by every other registration state.[7] New York imposes the additional requirement of disclosing allegations and convictions involving embezzlement, fraudulent conversion and misappropriation of property. These differences derive from the language of the NYFA itself, which could not be changed by regulation when the state adopted the UFOC Guidelines by regulation. New York also requires franchisors to include a more detailed Item 4 disclosure (bankruptcy). Another difference is that Section 683.2(s) of the NYFA requires the franchisor to represent that the disclosure document "does not knowingly omit any material fact or contain any untrue statement of a material fact."

It is not at all clear that these state differences provide additional protection to franchisees or that they serve any other necessary purpose. They do act as a trap for the unwary and increase the compliance burden for franchisors.

The Revised FTC Rule

The Federal Trade Commission has regulated the sale of franchises throughout the U.S. since 1979 under its Trade Regulation Rule on Franchising (the "FTC Rule").[8] Unlike the NYFA, the FTC Rule does not require registration and it does not allow for a private right of action. It coexists with state franchise sales laws because it specifically does not preempt state franchise laws that provide equal or greater protection to franchisees.

In January 2007, the Federal Trade Commission approved a revised FTC Rule replacing the one that had governed franchise sales nationally since 1979.[9] The content of the disclosures under the revised FTC Rule closely tracks the UFOC guidelines, but reflects a number of changes that most industry observers view as enhancements and improvements.

Steven Toporoff, franchise program coordinator at the Federal Trade Commission, stated that one goal of updating the FTC Rule "was to learn from experience . . . how the Rule has been working in the real world."[10] The review process lasted for twelve years and involved extensive hearings. As a result, the revised Rule reflects the latest thinking of franchise regulators.

The revised Rule became effective July 1, 2007. During a twelve-month phase-in period, the Federal Trade Commission gives franchisors the option of complying with either the 1979 FTC Rule or the revised FTC Rule. Compliance with the revised FTC Rule becomes mandatory July 1, 2008. In practice, this means that new franchisors are likely to use the revised FTC Rule format from the start, and franchisors who are already using the UFOC format will convert to the new format when they renew their state franchise registrations.

The revised FTC Rule, like the 1979 FTC Rule, allows state regulators to require additional disclosures.[11] It also allows states to impose additional protection for franchisees by continuing to require state registration and to allow for state enforcement and a private right of action by aggrieved franchisees. States can also be more restrictive in the required mechanism of disclosure. For example, states can require franchisors to make the disclosures sooner than the FTC Rule would require.

In an Interim Statement adopted on June 22, 2007, NASAA recommended that registration states permit franchisors to file franchise disclosure documents prepared under the revised FTC Rule, with the addition of a state risk factor cover page, during the twelve-month phase-in period of the revised FTC Rule.[12]

It appears that New York will follow the NASAA recommendation and will accept franchise disclosure documents for registration in New York that follow the format of the revised FTC Rule during the phase-in period, even though New York regulations essentially follow the UFOC Guidelines. When the revised FTC Rule format becomes mandatory, July 1, 2008, it will supersede the New York disclosure requirements. This means that the New York regulations need to be revised if they are to be meaningful. New York can have additional disclosure requirements, which can appear on the cover page or a state-specific addendum, but the basic document must conform to the requirements of the revised FTC Rule.

State Differences with the Revised FTC Rule

New York would be a friendlier place for franchising if New York franchise law were more consistent with federal law and the laws of other states. Based on an exhaustive national study over several years, the Federal Trade Commission has determined that the revised FTC Rule provides adequate federal protection for franchisees and prospective franchisees. New York can continue to impose additional sanctions for violations of the revised FTC Rule, namely state enforcement and the private right of action. New York need not lose these additional sanctions by revising the NYFA to remove the unnecessary differences with the revised FTC Rule. Below is a list of these differences.

A. The Content of the Disclosure Document

Much of the content required by the revised FTC Rule differs from the UFOC Guidelines, which New York has adopted with minor variations. The NYFA has slight differences from the UFOC Guidelines that require New York franchisors to prepare state-specific language for New York, as explained above. Unless the NYFA is revised, the same differences will continue to require New York franchisors to prepare state-specific addenda under the format of the revised FTC Rule. If New York law remains unchanged, the content of the disclosure document that is required by New York law will be substantially superseded by the revised FTC Rule, rendering the New York requirements obsolete and ineffective. Accordingly, the disclosure requirements in New York need to be revised.

B. Time of Disclosure

Under the NYFA, a franchisor in New York must disclose its offering document to a prospective franchisee at the earlier of the first personal meeting or 10 business days before an agreement is signed or money is paid.[13] This is consistent with the UFOC Guidelines but inconsistent with the revised FTC Rule.

The revised FTC Rule replaces the 10 business day rule with a simpler 14 calendar day rule. Under the revised FTC Rule, the offering document must be disclosed to a prospective franchisee at least 14 calendar days before any agreement is signed or any money is paid, rather than 10 business days.

In some cases, 10 business days or the date of the first personal meeting can be more than 14 calendar days. New York can leave this requirement unchanged because it may be a higher standard than the FTC Rule requirement. However, to do so would make it a trap for the unwary franchisor without any corresponding benefit for prospective franchisees. A better solution would be to revise and modernize the NYFA.

C. Name of Disclosure Document

New York is the only state whose law refers to the franchise disclosure document as an "Offering Prospectus" rather than a Uniform Franchise Offering Circular, or UFOC. While New York law continues to refer to a "Prospectus," New York regulations stipulate, somewhat inconsistently, that the document be called a "Franchise Offering Circular."[14]

Now the Federal Trade Commission has changed the name of the document by referring to it in the revised FTC Rule as a "Franchise Disclosure Document." With this change at the federal level, a simple gesture toward uniformity would be to change the name to a "Franchise Disclosure Document" in the NYFA.

D. International Transactions

New York does not limit the application of its franchise sales law to offerings of franchises physically located within the state. The NYFA specifically states that an offer to sell is made in the state "when the offer either originated from this state or is directed by the offeror to this state and received at the place to which it is directed."[15] The extraterritorial application of the Act was upheld in the case of *Mon-Shore Management v. Family Media*,[16] where the court held that the NYFA applies when the offer merely originates in New York, even if the offeree and the franchised businesses are outside the state.

In fact, nothing in the NYFA or the regulations or cases limits the application of the NYFA to sales within the U.S. It would appear that New York is the only jurisdiction in the U.S. that regulates international franchise sales.

Even the revised FTC Rule explicitly excludes sales of franchises located outside the U.S.[17] The Federal Trade Commission found that such a requirement would put American franchisors at a competitive disadvantage abroad and that the possible benefits of international regulation would not outweigh the burdens.

It is difficult to see why New York has an interest in regulating the sale of franchises abroad, even if the offer originates in New York. Adding an exemption for international sales would greatly improve the NYFA. An out-of-state sales exemption, discussed below, would accomplish the same end.

E. The Definition of a "Franchise"

The NYFA has a unique definition of a "franchise," which requires just two elements.[18] The revised FTC Rule and each state franchise sales law other than the NYFA has a three-element definition. The New York definition requires a fee and either a marketing plan prescribed in substantial part by the franchisor or the right to use the franchisor's trademark. All other definitions include a fee, a marketing plan and a trademark.[19] This makes the New York definition of a franchise broader than that in any other franchise sales law.

The broad definition of a franchise in New York can create a franchise in New York that would not be a franchise anywhere else. This overly broad definition can discourage some companies from doing business in New York or from setting up operations in New York. It certainly leads a cautious business lawyer to recommend that approach to companies whose business arrangements may fall within this definition and who do not want to prepare franchise offering circulars or register with the state.

Both prongs of the NYFA's definition of a "franchise" raise issues. Starting with the first prong, what does it mean to grant "the right to engage in the business of offering, selling, or distributing goods or services under a marketing plan or system prescribed in substantial part by a franchisor" without a trademark? A marketing consultant may provide a marketing plan to a client to enable that client to launch a business. Certainly the client will pay a fee. Is this a franchise? How does it constitute a "grant" of the "right" to engage in a business? What type of grant does fall within this prong of the definition? The statute is not at all clear on this point.

The second prong is easier to understand but is extremely broad. The plain language of the statute covers many license and distribution arrangements that would not be considered franchises in other states. Any trademark license granting someone a right to engage in a business in consideration for a royalty would fall within the definition of a "franchise" under the NYFA. This is not the type of business arrangement that anyone unfamiliar with New York law would expect to be a franchise. Many business people and even lawyers are surprised and shocked when they learn how broad the scope of coverage is.

There is a large "gray" area under the NYFA in which it is not clear whether a business arrangement is a franchise. Most business people want to comply with the law. In order to do so, they need clarity on what the law means. Even in New York, no one seriously expects a simple trademark license to be regulated as a franchise. Yet the law says it is a franchise. An overly broad law that is not enforced can lead to disrespect for the law. Even if there is no enforcement activity in this gray area, its existence creates uncertainty and risk, which discourages business. There is no assurance that an aggressive Attorney General in the future would not begin to read the law literally. Why would a distributor or licensor choose to be arguably subject to the extensive registration and disclosure requirements imposed on franchisors in New York when the company can avoid these requirements by going to any other state?

Narrowing New York's broad definition of a "franchise" to conform to the definition under the revised FTC Rule or the definition used by other states, such as California or Illinois, would not diminish New York's ability to prosecute franchise fraud, nor would it eliminate the private right of action. The Attorney General's Office would continue to enforce the law and aggrieved franchisees would continue to be able to initiate lawsuits. Companies that know they are franchisors and hold themselves out as franchisors in New York and other states would not be affected. At the same time, this change would make for better law and would eliminate a potential barrier to doing business in New York.

F. Exemptions

The Federal Trade Commission sought to reduce compliance burdens by adding three new sophisticated investor exemptions to the revised FTC Rule. The NYFA includes none of these exemptions.

One new exemption is for large investments.[20] Disclosure is not required if: (1) the estimated investment exceeds $1 million, excluding (a) financing from the franchisor or its affiliate, and (b) real estate costs, and (2) the franchisee signs an acknowledgment verifying the grounds for the exemption. A prospective franchisee's level of investment is one measure of sophistication.[21] This exemption provides a bright-line standard that offers tangible benefits to franchisors in transactions that are likely to be negotiated. Maryland and Wisconsin also exempt large investments.[22]

Another new exemption is for large franchisees. Transactions with large franchisees are often negotiated by sophisticated counsel.[23] This exemption applies if the prospective franchisee has been in business for 5 years and has a net worth of at least $5 million.[24] California and Rhode Island also exempt large franchisees.[25]

A third new exemption is for franchisor insiders. When an insider buys a franchise, one can reasonably assume that the prospective franchisee is already familiar with the franchise system and its risks.[26] Disclosure in this case would serve little purpose. This exemption applies if one or more purchasers with combined ownership of at least 50% has either (1) two years of management responsibility for the sale of the franchisor's franchises or the administration of the franchised network, or (2) for two years has been an owner of at least 25% of the franchisor.[27] California also exempts franchisor insiders.[28]

New York can benefit by the Federal Trade Commission's exhaustive study of franchising nationally. Adding exemptions in New York that conform to the exemptions in the revised FTC Rule would make New York a more business-friendly state and would not diminish New York's protection of franchisees.

New York does allow certain exemptions in its statute and regulations.[29] Several of these exemptions are specifically exemptions "from the registration requirements" of Section 683. This implies that the disclosure requirements continue to apply. A company whose offering is exempt from registration must nevertheless prepare a franchise disclosure document. The lion's share of the legal compliance work in establishing a new franchise is preparing the franchise disclosure document. Registration is relatively simple once the disclosure document is completed.

Because these "exemptions" do not relieve companies of the burden of disclosure compliance, they merely serve as traps for the unwary. A far better approach would be to exempt these transactions in their entirety.

G. The Single Trademark Exclusion

The revised FTC Rule excludes a single trademark license from its scope.[30] Adding a similar exclusion to New York law would make it clear that simple trademark licenses are not franchises. This change would also facilitate international franchising, particularly when a foreign franchisor seeks to enter the U.S. by granting a single license to one company that will act as its master franchisee for the entire U.S. market, with the right to grant franchises to others. The NYFA today exempts a single license from the registration requirements but not the disclosure requirements of the law, and this exemption does not apply when the licensee has the right to sublicense.[31]

H. Brokers

Under the revised FTC Rule, franchise brokers are no longer obligated to furnish disclosure documents. This is the sole responsibility of the franchisor.[32] Brokers must be disclosed only if they fall within the definition of a "franchise seller" under the revised FTC Rule.

New York imposes a technical requirement of a one-time registration of "franchise sales agents."[33] This requirement is confusing. Most franchisors disclose franchise brokers in the disclosure document to the extent required by the UFOC Guidelines, and the Attorney General's Office rarely asks for more, other than sometimes charging a small additional fee.

The requirement to register franchise brokers is peculiar to New York and two other states.[34] It creates an unnecessary burden that has no corresponding benefit.

Other Changes

If the NYFA is to be revised to conform more closely to the revised FTC Rule, it can also be improved in several other ways, as noted below.

A. Out-of-State Sales Exemption

The NYFA would no longer apply to international transactions if New York were to adopt an out-of-state sales exemption. Several states have out-of-state sales exemptions, including California, Hawaii, Illinois, Maryland, Michigan, Minnesota, Rhode Island and Wisconsin. A franchisor based in one of these states can sell franchises in other states without registering in the franchisor's state as well as the franchisee's state. The existence of the exemption does not appear to have had an adverse effect on any of these states.

The extraterritorial application of the NYFA discourages companies from establishing their offices in this state. A company may decide to establish an office in another state to test its franchise concept before opening an office in New York. This enables the company to postpone registering the franchise offering in New York. Conversely, a company that is based in New York would not be able to postpone registration, even if all of its franchisees are outside of the state. Accordingly, the addition of an out-of-state sales exemption would improve the NYFA.

B. Consent to Process

New York requires franchisors to file a consent to service of process with the office of the Secretary of State at the time they register their franchise offerings with the Department of Law. Other franchise registration states require franchisors to file the consent to process with the same administrative office that handles the franchise registration.

Franchisors and franchise attorneys outside of New York would be grateful if New York were to change its law so that a franchisor registering in New York is required to file a consent to service of process only with the Department of Law, and not with the office of the Secretary of State. The dual filing requirement is a minor annoyance for franchisors that is of questionable value to franchisees.

C. Advertising

New York requires franchisors to file their advertisements of franchise offerings with the Department of Law before their use, and all such advertisements must bear a prescribed legend.[35] While a few other states require a similar filing, no other state requires a similar legend.

It is not clear that the filing of the advertisements or the addition of the legend provides any additional protection for prospective franchisees. These requirements constitute an unnecessary burden for franchisors. Their removal would be a welcome change.

D. Sales by Franchisees

The revised FTC Rule specifically exempts franchise resales,[36] as do the franchise laws of several other states. These states include California, Hawaii, Illinois, Indiana, Maryland, Minnesota, North Dakota, Rhode Island, South Dakota, Washington and Wisconsin. Only New York specifically requires a franchisee to make disclosures to the prospective buyer of its business. Section 684.5 of the NYFA exempts from the registration provisions of Section 683 (but not the disclosure provisions) the offer or sale of a franchise by a franchisee for his own account.[37]

This disclosure requirement poses a problem for franchisees. The franchisee is not in a position to have the latest version of the offering circular currently registered with the Department of Law, especially if a new filing is made during the course of the sale process. Moreover, the franchisee cannot possibly have the current offering circular if the franchise registration has lapsed. In that case, compliance is impossible. In actual practice, it appears that the requirement that a franchisee disclose when the franchisee sells the business is not enforced. Nevertheless, it remains the law, creating uncertainty and risk. Its removal would improve the New York law.

E. Filing vs. Registration

One possible change in the NYFA can reduce government cost without reducing franchisee protection. The Attorney General's office might act only as an enforcer of the law rather than a reviewer of franchise documents. In Wisconsin, Indiana, Hawaii and South Dakota, franchise registration is effective upon filing or a certain time period shortly after filing. Michigan also requires a simple filing of a notice of sale. This change would ease the administrative burden of the Department of Law without diminishing its ability to prosecute those who violate the NYFA and without eliminating the private right of action. It would also allow franchisors to begin doing business in New York more quickly.

As an alternative, New York might take an approach similar to that of Illinois. New York might continue to require an initial registration review but allow franchisors to amend their registrations by filing without awaiting the examiner's approval. This approach allows the franchisor to deliver an amended disclosure document to a prospective franchisee as soon as the document is ready. It eliminates the need to wait for approval. It also eliminates the current requirement under the NYFA to use the old disclosure document while the amended one is pending.[38]

The Case for Revising the NYFA

New York needs to conform its franchise sales law to the revised FTC Rule. This need creates an opportunity to modernize and improve the NYFA generally.

The NYFA might be revised to provide that the content of the disclosures will be those required by the revised FTC Rule as amended occasionally, or as otherwise set forth in the regulations. The regulations can include the NASAA cover page and anything else that New York determines from time to time. This approach would allow for flexibility over time and would eliminate unnecessary anomalies.

Narrowing the scope of the NYFA would add clarity to a law whose scope creates a great deal of uncertainty and risk, and arguably is far broader than necessary to achieve its purpose of protecting franchisees. This change would entail a narrowing of the definition of a franchise and the addition of exemptions and exclusions.

Reducing the geographic coverage of the NYFA to franchise sales where the franchisee or the franchised business is located in the state would eliminate the international application of the NYFA and the need for franchisors to comply with two or more sets of laws when they sell to franchisees outside the state.

Changes in the timing of the disclosure requirements to conform to the revised FTC Rule would eliminate unnecessary traps for the unwary.

If changes are to be made, they should also include eliminating requirements that serve little or no purpose while creating a burden for franchisors. These include the requirements to register franchise sales brokers, to file a consent to process with the Department of State rather than the Department of Law, and to include a legend in franchise advertising. Removal of the requirement that franchisees disclose when they sell their business would also be a great relief to franchisees, especially those that are unable to comply.

Revisions to modernize and clarify the NYFA and make it more consistent with federal law and with the franchise laws of other states would make New York a friendlier place to do business. At the same time, these revisions would not diminish the protection that New York law already affords to franchisees. These are technical improvements, but they would enhance respect for the law. They would also greatly facilitate the work of New York lawyers who advise business clients on how to comply with the NYFA.

Endnotes

1. *See* <http://www.oag.state.ny.us/franchise/franchise.html>.
2. N.Y. General Business Law §§ 680-695 (GBL); Business Franchise Guide (CCH) ¶ 3320; N.Y. Comp. Codes R. & Regs. tit. 13, §§ 200.1 *et seq.* (N.Y.C.R.R.); Business Franchise Guide (CCH) ¶ 5320.
3. The states that conduct a full review are California, Illinois, Maryland, Minnesota, New York, North Dakota, Rhode Island, Virginia and Washington. The states that require simple filings without a full review are Hawaii, Indiana, South Dakota and Wisconsin. Michigan only requires that a notice of sale be filed; the disclosure document itself is not registered. Some other states have disclosure laws with no filing requirements at all, and others may require filings under business opportunity laws. *See generally* CCH ¶¶ 3000 *et seq*.
4. National Economic Consulting Practice, Price Waterhouse Coopers, Economic Impact of Franchised Businesses: A Study for the Educational Foundation of the International Franchise Association (2004), <http://www.franchise.org/files/EIS6_1.pdf >.
5. <http://www.nasaa.org>.
6. N.Y.C.R.R. § 200.2..
7. GBL § 683(2)(e)(1); N.Y.C.R.R. § 200.2(c)(3).
8. 16 CFR pt. 436.
9. Disclosure Requirements and Prohibitions Concerning Franchising, 72 Fed. Reg. 15,544 (March 30, 2007) (to be codified at 16 C.F.R. pt. 436), *available at* <http://www.ftc.gov/os/2007/01/R511003FranchiseRuleFRNotice.pdf>.
10. *Q&A with Steven Toporoff, Franchise Program Coordinator, FTC,* LJN's Franchising Bus. & L. Alert (Am. Lawyer Media, New York, N.Y.), Mar. 2007.
11. Disclosure Requirements and Prohibitions Concerning Franchising, 72 Fed. Reg. at 15,473.
12. Instructions for Filing a Unif. Franchise Registration Application using the "New FTC Franchise Rule" After July 1, 2007 (June 22, 2007), <http://www.oag.state.ny.us/franchise/interim.franchise.state.guidelines.pdf>.
13. GBL § 683(8).
14. N.Y.C.R.R. § 200.2(a)(1).
15. GBL § 681.12(b).
16. 584 F. Supp. 186 (S.D.N.Y. 1984); CCH ¶ 8150.
17. 16 C.F.R. § 436.2; Disclosure Requirements and Prohibitions Concerning Franchising, 72 Fed. Reg. at 15,468.
18. GBL § 681.3.
19. The revised FTC Rule defines a franchise to include significant control or assistance by the franchisor rather than a marketing plan. 16 C.F.R. § 436.1(h).
20. 16 C.F.R. § 436.8(5)(1).
21. Disclosure Requirements and Prohibitions Concerning Franchising, 72 Fed. Reg. at 15,522.
22. Md. Code Regs. 02.02.08.10(E); Wis. Stat. Ann. § 553.235.
23. Disclosure Requirements and Prohibitions Concerning Franchising, 72 Fed. Reg. at 15,527.
24. 16 C.F.R. § 436.8(6).
25. Cal. Corp. Code § 31109 (2007); R.I. Gen Laws §§ 19-28.1(d).
26. Disclosure Requirements and Prohibitions Concerning Franchising, 72 Fed. Reg. at 15,528.
27. 16 C.F.R. § 436.8(a)(6).
28. Cal. Corp. Code § 31106.
29. GBL § 684; N.Y.C.R.R. § 200.10.
30. Disclosure Requirements and Prohibitions Concerning Franchising, 72 Fed. Reg. at 15,529.
31. GBL § 684.3(c).
32. Disclosure Requirements and Prohibitions Concerning Franchising, 72 Fed. Reg. at 15,461.
33. GBL § 683.13; N.Y.C.R.R. § 200.11.
34. Illinois and Washington.
35. GBL § 683.12 and N.Y.C.R.R. § 200.9(d) require this legend: "This advertisement is not an offering. An offering can only be made by a prospectus filed first with the Department of Law of the State of New York. Such filing does not constitute approval by the Department of Law." A smaller notice is permitted for classified advertisements.
36. Disclosure Requirements and Prohibitions Concerning Franchising, 72 Fed. Reg. at 15,461.
37. This exemption has three conditions: (a) The sale must be an isolated sale and not part of a plan of distribution of franchises. (b) It cannot be effected by or through a franchisor. (c) The franchisee must furnish to the prospective purchaser a copy of the offering prospectus of the franchisor currently registered with the Department of Law.
38. N.Y.C.R.R. § 200.3(3).

Thomas M. Pitegoff is the founder of Pitegoff Law Office PLLC in White Plains. He is Chair of the Franchise, Distribution and Licensing Law Committee of the NYSBA's Business Law Section and a member of the Section's Executive Committee. He is a former member of the Governing Board of the American Bar Association's Forum on Franchising. The views expressed in this article are his own. Special thanks to John R. F. Baer, a partner at Sonnenschein Nath & Rosenthal LLP in Chicago, for his assistance in preparing this article. Mr. Pitegoff's e-mail is pitegoff@pitlaw.com.

Reining in Subprime Mortgage Abuses: New York State Banking Department Adopts Guidance on Nontraditional Mortgage Product

By Catherine M. Brennan

Since the mid-1990s, the rate of homeownership has steadily increased each year in the United States.[1] According to Ben Bernanke, the chairman of the Federal Reserve Board, the expansion of subprime mortgage lending has made homeownership possible for households that in the past might not have qualified for a mortgage and has contributed to this rise in the homeownership rate.[2] However, this increase in homeownership rates has not been without controversy over the products used by some consumers to finance their piece of the American Dream. The controversy clearly reaches those directly involved with consumer advocacy and consumer lending. But the controversy, fueled by economic fall-out in some sectors of the mortgage lending industry, as evidenced by the recent bankruptcy filing of New Century Financial Corporation, and further fueled by concerns about the potential impact on mortgage loan securitizations, has more far-reaching implications. In October 2006, responding to concerns about mortgage products that allow consumers to defer payment of the principal, and sometimes the interest, on a mortgage loan ("nontraditional mortgage loans"), the federal banking agencies adopted the Interagency Guidance on Nontraditional Mortgage Product Risks (the "Federal Guidance") to rein in some of the practices that caused the regulators concern, including negative amortization and the use of prepayment penalties, balloon payments and no- or low-documentation in connection with nontraditional mortgage loans.[3] One month later, the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators, the associations that represent regulators of state banks and state licensed lenders, adopted parallel guidance (the "State Guidance")[4] to reach those lenders not regulated by the federal banking agencies. In May 2007, the New York State Banking Department (the "Department") announced its adoption of the State Guidance.[5]

Like the Federal Guidance, the State Guidance targets nontraditional mortgage loans, including "interest-only" mortgages[6] and "payment option" adjustable rate mortgages (ARMs).[7] The State Guidance notes that lenders traditionally underwrite nontraditional mortgage loans with less stringent income and asset verification requirements ("reduced documentation") and combine them with simultaneous second-lien loans. These practices can lead to increased risk of borrower default, the State Guidance advises. To minimize risk, the State Guidance encourages lenders to make loan terms and underwriting standards consistent with prudent lending practices, including consideration of a borrower's repayment capacity. The State Guidance also encourages lenders to provide consumers with sufficient information so that they can clearly understand loan terms and associated risks prior to making a product choice.

Both the Federal Guidance and the State Guidance provide that interest-only and payment option ARMs are "variations of conventional ARMs, hybrid ARMs and fixed rate products." The carve-out of these products as "variations" from the normal ARMs suggests that neither the Federal Guidance nor the State Guidance applies to conventional ARMs, hybrid ARMs or fixed rate products. In response to this perceived loophole, the federal banking agencies issued their final Statement on Subprime Mortgage Lending ("Subprime Statement") in July 2007 to address issues relating to these other ARM products that can also cause payment shock.[8] The Subprime Statement establishes prudent safety and soundness and consumer protection standards depository institutions should follow to ensure that consumers, especially subprime borrowers, obtain loans they can afford to repay and receive information that adequately describes product features. The Subprime Statement's recommendations parallel those found in the State Guidance. The Subprime Statement does not define "subprime." The federal banking agencies note in the Subprime Statement that because the marketplace does not consistently define the term "subprime," incorporating the subprime borrower characteristics from the 2001 Expanded Guidance for Subprime Lending Programs[9] provides sufficient clarity with regard to the purpose of the Final Statement.

In addition to adopting the State Guidance in May 2007, the Department also announced its support of both the Subprime Statement and yet another federal banking agencies' product, the Statement on Working with Mortgage Borrowers.[10] Note that the Department affirmed the Subprime Statement in its proposed, rather than final, form. It appears likely that the Department would similarly affirm the finalized Subprime Statement, which varies little from the proposed statement. The Department noted that both statements encourage lenders to adopt best practices when lending to subprime borrowers and further encourage them to avoid foreclosure whenever possible, and work with borrowers who are unable to meet their monthly payment obligations. The bottom line for lenders supervised by the Department is that the Department will now give heightened scrutiny to lenders that originate ARM loans. Such enhanced scrutiny will require additional diligence on the part of those lenders in order to avoid running afoul of the various pronouncements found in these documents.

In an Industry Letter issued to its supervised institutions in connection with the adoption of the State Guidance, the Department reminded licensed New York mortgage bankers and brokers that it views the State Guidance as a minimum standard that neither supersedes existing Department laws and regulations nor prevents the Department from issuing additional guidance or regulations when appropriate.[11] Thus, the Department's adoption of the State Guidance and the Department's affirmation of both federal statements will add a new and, at the moment, unknown dimension to examinations of the lenders the Department supervises.

I. State Guidance

The State Guidance contains detailed information regarding the underwriting and consumer protection standards supervised lenders should observe.[12] The State Guidance also sets forth certain recommended practices for lenders.

A. Underwriting Standards

The State Guidance stresses the importance of underwriting standards that address the effect of a substantial payment increase on the borrower's capacity to repay when loan amortization begins. Underwriting standards should minimize payment shock to the borrower and reduce the likelihood of borrower default. The lender's analysis of a borrower's repayment capacity should include an evaluation of his or her ability to repay the debt by final maturity at the loan's fully indexed rate.[13] Qualifying standards should recognize the potential impact of payment shock, especially for borrowers who have high loan-to-value (LTV) ratios, high debt-to-income (DTI) ratios and low credit scores.[14]

The State Guidance urges lenders to consider multiple underwriting factors jointly in the qualification process and to develop a range of reasonable tolerances for each factor. Lenders should base underwriting criteria on prudent and appropriate underwriting standards, considering both the borrower's characteristics and the product's attributes.[15] The State Guidance further discourages overreliance on credit scores as a substitute for income verification when lenders determine the borrower's repayment capacity. The State Guidance stresses that the higher the loan's credit risk, either from loan features or borrower characteristics, the more important it is for the lender to verify the borrower's income, assets and outstanding liabilities.[16]

Importantly, the State Guidance encourages lenders to avoid collateral-dependent loans, or loans where the borrower's ability to repay derives primarily from the collateral. Consumer advocates have long decried the practice of making loans primarily on the foreclosure value of the collateral as predatory, abusive or unfair lending. This admonition against collateral-based lending is not new under federal law. The federal Home Ownership Equity Protection Act (HOEPA)[17] and its implementing regulations,[18] for example, prohibit a lender from engaging in a pattern or practice of extending HOEPA loans to a consumer based on the consumer's collateral without regard to the consumer's repayment ability, including the consumer's current and expected income, current obligations, and employment.[19] In collateral-dependent loans, the collateral constitutes the majority of the borrower's assets, and borrowers in collateral-dependent loans often need to sell or refinance the property once the nontraditional loan begins to amortize.[20] The State Guidance warns lenders against this practice.

The State Guidance also urges lenders to avoid risk layering, or combining nontraditional loan features with other high-risk practices, such as a simultaneous second-lien loan[21] or use of reduced documentation.[22] If lenders do layer risk, they should offset such risk layering with mitigating factors to support the underwriting decision and validate the borrower's repayment capacity. Mitigating factors could include, but do not appear limited to, higher credit scores, lower LTV and DTI ratios, significant liquid assets, mortgage insurance or other credit enhancements. The State Guidance makes clear that higher pricing alone does not mitigate higher risk levels and does not substitute for sound underwriting practices.[23]

The State Guidance also takes aim at reduced documentation loans, particularly stated income documentation loans, sometimes referred to as "Liar Loans." A lender using reduced documentation relies on assumptions and unverified information rather than conducting a thorough analysis of a borrower's repayment capacity and creditworthiness. As a consumer's credit risk increases, lenders should more diligently verify that consumer's income and repayment capacity. The State Guidance recommends that lenders adopt clear policies regarding the use of reduced documentation loans. For example, lenders should accept stated or unverified income only if mitigating factors exist that minimize the need for a more robust verification of the consumer's income and repayment capacity. The State Guidance suggests that most lenders generally have the ability to readily document most borrowers' income using recent W-2 statements, pay stubs or tax returns.[24]

The State Guidance further advises lenders offering nontraditional mortgage products to consider the spread between the introductory rate and the fully indexed rate and take steps to reduce the likelihood of negative amortization and other outcomes that jeopardize the consumer's ability to maintain the mortgage payments. Because lenders base the initial and subsequent monthly payments on these low introductory rates, a wide initial spread makes it more likely that borrowers will experience negative amortization, severe payment shock, and an earlier-than-scheduled recasting of monthly payments. The State Guidance encourages lenders to minimize the likelihood of disruptive early restructurings and extraordinary payment shock when setting introductory rates.[25]

B. Consumer Protection

The State Guidance cautions that consumers sometimes enter into nontraditional mortgage transactions without fully understanding the implications of the nontraditional loan features. That is, consumers may look at the initial monthly payment amount without comprehending that such amount will increase—sometimes dramatically—over time. Consumers may not fully understand, for example, that their payment options will increase substantially at the end of an interest-only period or that negative amortization results in reduced or negative equity in their home. The lower monthly payments, of course, account for some of the popularity of nontraditional mortgage products among consumers. Because lenders know that lower initial monthly payments attract consumers to nontraditional mortgage products, lenders often focus on these features in their advertising and marketing efforts. To more fully educate consumers about the implications of nontraditional mortgage features, the State Guidance urges lenders to alert consumers to the risks, including increased future payment obligations. The State Guidance suggests that lenders provide this information at such a time that it will assist the consumer in the mortgage product selection process—even before the lender must give Truth in Lending or other disclosures.[26]

C. Recommended Practices

Most of the recommended practices in the State Guidance concern the provision of information to the consumer at different stages of the lender-consumer relationship, including in marketing, prior to application and during the servicing of the loan. When promoting or describing nontraditional mortgage products, lenders should provide consumers information that will help them make informed decisions when selecting and using these products. The State Guidance encourages lenders to provide helpful consumer information not just upon the submission of an application or at consummation. Opportunities to provide this information can occur when the consumer makes an inquiry to the lender about a mortgage product and receives information about nontraditional products, or when the lender targets marketing relating to nontraditional mortgage products to the consumer. In all instances, lenders should offer clear and balanced product descriptions to consumers.[27]

Lenders must focus on information important to consumer decision making; highlight key information so that borrowers will notice it; employ a user-friendly and readily navigable format for presenting the information and use plain language, with concrete and realistic examples. For example, the State Guidance notes that borrowers may find comparative tables and information describing key features of available loan products, including reduced documentation programs, useful when they shop for nontraditional mortgage products. The State Guidance recognizes that this might vary with the media used to advertise the products but that lenders should provide clear and balanced information about the risks of these products in all forms of advertising.[28] Promotional materials and product descriptions should provide information about the costs, terms, features and risks associated with nontraditional mortgage products that can assist consumers in their product selection decisions, including information about payment shock, negative amortization, prepayment penalties and the cost of a reduced documentation loan.[29]

A key recommendation in the State Guidance is that monthly statements provided to consumers on payment option ARMs should provide information that enables consumers to make informed payment choices, including an explanation of each payment option available and the impact of that choice on loan balances. For example, the monthly payment statement should contain an explanation, as applicable, next to the minimum payment amount that making this payment would result in an increase to the consumer's outstanding loan balance. Payment statements could also provide the consumer's current loan balance, what portion of the consumer's previous payment the lender allocated to principal and to interest, and, if applicable, the amount by which the principal balance increased. The State Guidance makes clear that lenders should avoid encouraging payment option ARM borrowers to select a non-amortizing or negatively amortizing payment.[30]

The State Guidance provides that lenders should avoid practices that obscure significant risks on nontraditional mortgage loans to the consumer. For example, if a lender advertises or promotes a nontraditional mortgage loan by emphasizing its comparatively lower initial monthly payments, the lender should also clearly and prominently alert the consumer to the risks of such a loan. Such information should explain, as applicable, that these payment amounts will increase, that a consumer may have to pay a balloon payment, or that the loan balance will not decrease or may increase because of deferral of interest or principal payments, or both. Similarly, lenders should avoid promoting payment patterns structurally unlikely to occur. For example, an advertisement for a payment option ARM should not promote payments so low they would reach negative amortization caps. The State Guidance also steers lenders away from providing consumers assurances or predictions about future interest rates, making one-sided representations about cash savings or expanded buying power that will result from nontraditional mortgage products, suggesting that initial minimum payments in a payment option ARM will cover accrued interest charges, and making misleading claims that these products have “fixed” interest rates or payment obligations.[31] All of these recommendations intend to guide lenders in their contacts with consumers so that consumers receive both helpful and hurtful information concerning nontraditional mortgage products.

II. Practical Guidance for Supervised Lenders

In announcing the Department’s adoption of the State Guidance, New York State Superintendent of Banks Richard H. Neiman noted the fact that the Department supports a consistent set of regulatory standards for all state-licensed mortgage bankers and brokers. “While the Banking Department supports the ability of our institutions to innovate mortgage products that address a wide range of consumer needs,” Neiman stated, “it is essential that our lenders take appropriate steps to manage the risks associated with these products. Even more importantly, lending institutions must understand their responsibility to evaluate the capacity of the borrowers to repay the loan.”[32] What the Department did not state in either its press release announcing the adoption of the State Guidance or its Industry Letter is precisely how supervised lenders should implement the State Guidance or how much of the State Guidance such lenders must implement in order to avoid negative examination findings from the Department. The Department simply “strongly encourages” its lenders to refer to the State Guidance when soliciting or originating nontraditional mortgage loans.[33] At the same time, the Industry Letter states the State Guidance establishes a floor that does not replace existing Department laws and regulations or preclude the Department from issuing additional guidance or regulations as needed.[34] The Industry Letter seems to suggest that the Department will take a safety and soundness approach to enforcement, rather than a consumer protection approach.[35] The safety and soundness approach is more common in the banking industry than in the licensed mortgage banker world, and represents a new area of concern for licensed lenders. However, by addressing the safety and soundness issues associated with the nontraditional mortgage products, a lender arguably can reduce the risk of borrower default, a win-win situation. Further, although the State Guidance arose in part because of the crisis in the subprime mortgage market, prime credit lenders must also develop procedures to monitor their nontraditional mortgage products, as the State Guidance itself is not limited to loans to subprime borrowers. The Department will likely issue additional guidance, probably in the form of feedback to its licensees stemming from examinations, as it begins to examine its licensed lenders through the lens of the State Guidance.

Endnotes

1. *See* Hous. & Household Econ. Statistics Div., U.S. Census Bureau, Housing Vacancies and Homeownership (2007), http://www.census.gov/hhes/www/housing/hvs/qtr107/q107ind.html. In 2006, 69 percent of households owned their homes; in 1995, 65 percent did.

2. Benjamin S. Bernanke, Chairman, Fed. Reserve Bd. Address at the Federal Reserve Bank of Chicago’s 43rd Annual Conference on Bank Structure and Competition (May 17, 2007), transcript *available at* http://www.federalreserve.gov/Boarddocs/speeches/2007/20070517/default.htm.

3. Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. 58,609 (Oct. 4, 2006).

4. Conference of State Bank Supervisors & Am. Ass’n of Residential Mortgage Regulators, Nontraditional Mortgage Product Risks (2006), http://www.banking.state.ny.us/pr070525.pdf.

5. Press Release, New York State Banking Department, Banking Department Adopts Guidance on Nontraditional Mortgage Products (May 25, 2007), *available at* http://www.banking.state.ny.us/pr070525.htm.

6. A nontraditional mortgage on which, for a specified number of years (e.g., three or five years), the borrower is required to pay only the interest due on the loan during which time the rate may fluctuate or may be fixed. After the interest-only period, the rate may be fixed or fluctuate based on the prescribed index and payments include both principal and interest.

7. A nontraditional mortgage that allows the borrower to choose from a number of different payment options. For example, each month, the borrower may choose a minimum payment option based on a “start” or introductory interest rate, an interest-only payment option based on the fully indexed interest rate, or a fully amortizing principal and interest payment option based on a 15-year or 30-year loan term, plus any required escrow payments. The minimum payment option can be less than the interest accruing on the loan, resulting in negative amortization. The interest-only option avoids negative amortization but does not provide for principal amortization. After a specified number of years, or if the loan reaches a certain negative amortization cap, the required monthly payment amount is recast to require payments that will fully amortize the outstanding balance over the remaining term. In contrast, the Federal Guidance and State Guidance expressly do not apply to reverse mortgages, HELOCs (except with regard to simultaneous second-lien loans), or fully amortizing residential mortgage loan products.

8. Statement on Subprime Mortgage Lending, 72 Fed. Reg. 37,569 (July 10, 2007). Also in July 2007, the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators issued their own Statement on Subprime Lending (the “State Subprime Statement”) that mirrors the federal Subprime Statement. The State Subprime Statement modified the federal Subprime Statement to address certain issues particular to nondepository mortgage lenders and brokers who originate loans but do not hold them. To further complicate matters, the State Subprime Statement does define “subprime” and notes that:

   > Subprime borrowers typically have weakened credit histories that include payment delinquencies, and possibly more severe problems such as charge-offs, judgments, and bankruptcies. They may also display reduced repayment capacity as measured by credit scores, debt-to-income (DTI) ratios, or other criteria that may encompass borrowers with incomplete credit histories.

   Conference of State Bank Supervisors, Am. Ass’n of Residential Mortgage Regulators & Nat’l Ass’n of Consumer Credit Adm’rs, Statement on Subprime Lending 3 (2007), http://www.csbs.org/

Content/NavigationMenu/RegulatoryAffairs/MortgagePolicy/Final_CSBS-AARMR-NACCA_StatementonSubprimeLending.pdf. Given that the Department indicated its support for the federal Subprime Statement, New York lenders should follow the federal Subprime Statement.

9. Office of the Comptroller of the Currency, Bd. of Governors of the Fed. Reserve Sys., Fed. Deposit Ins. Corp., Office of Thrift Supervision, Expanded Guidance for Subprime Lending Programs (2001), http://www.federalreserve.gov/boarddocs/srletters/2001/sr0104a1.pdf.
10. Office of the Comptroller of the Currency, Bd. of Governors of the Fed. Reserve Sys., Fed. Deposit Ins. Corp., Nat'l Credit Union Admin., Office of Thrift Supervision, Statement on Working with Mortgage Borrowers (2007), http://www.federalreserve.gov/boarddocs/press/bcreg/ 2007/20070417/attachment.pdf.
11. Letter from N.Y. State Banking Department to Various Financial Institutions (May 25, 2007), http://www.banking.state.ny.us mb070525.pdf.
12. The State Guidance also contains information regarding portfolio and risk management that we do not discuss in this article.
13. The fully indexed rate is the index rate prevailing at origination plus the margin that will apply at the expiration of an introductory interest rate; the margin is the number of percentage points a lender adds to the index value to calculate the ARM interest rate at each adjustment period.
14. Conference of State Bank Supervisors & Am. Ass'n of Residential Mortgage Regulators, Nontraditional Mortgage Product Risks 4 (2006), http://www.banking.state.ny.us/pr070525.pdf.
15. *Id.*
16. *Id.*
17. 15 U.S.C.A. §§ 1602(aa), 1610, 1639, 1640.
18. 12 C.F.R. §§ 226.32, 226.34.
19. 12 C.F.R. § 226.32(a)(3). There is a presumption that a creditor has violated this restriction if the creditor engages in a pattern or practice of making loans subject to HOEPA without verifying and documenting consumers' repayment ability. *Id.*
20. Conference of State Bank Supervisors & Am. Ass'n of Residential Mortgage Regulators, Nontraditional Mortgage Product Risks 5 (2006), http://www.banking.state.ny.us/pr070525.pdf.
21. A lending arrangement where either a closed-end second-lien or a HELOC is originated simultaneously with the first lien mortgage, typically in lieu of a higher down payment.
22. A loan feature commonly referred to as "low doc/no doc," "no income/no asset," "stated income" or "stated assets." For mortgage loans with this feature, a provider sets reduced or minimal documentation standards to substantiate the borrower's income and assets.
23. Conference of State Bank Supervisors & Am. Ass'n of Residential Mortgage Regulators, Nontraditional Mortgage Product Risks 5 (2006), http://www.banking.state.ny.us/pr070525.pdf.
24. *Id.*
25. *Id.*
26. Conference of State Bank Supervisors & Am. Ass'n of Residential Mortgage Regulators, Nontraditional Mortgage Product Risks 8 (2006), http://www.banking.state.ny.us/pr070525.pdf.
27. The federal banking agencies have developed illustrations for their entities to use. *See* Illustrations of Consumer Information for Nontraditional Mortgage Products, 72 Fed. Reg. 31,825, 31,829-31 (June 8, 2007). The New York State Banking Department has not adopted these or other illustrations.
28. Conference of State Bank Supervisors & Am. Ass'n of Residential Mortgage Regulators, Nontraditional Mortgage Product Risks 9 (2006), http://www.banking.state.ny.us/pr070525.pdf.
29. Conference of State Bank Supervisors & Am. Ass'n of Residential Mortgage Regulators, Nontraditional Mortgage Product Risks 10 (2006), http://www.banking.state.ny.us/pr070525.pdf.
30. Conference of State Bank Supervisors & Am. Ass'n of Residential Mortgage Regulators, Nontraditional Mortgage Product Risks 10-11 (2006), http://www.banking.state.ny.us/pr070525.pdf.
31. Conference of State Bank Supervisors & Am. Ass'n of Residential Mortgage Regulators, Nontraditional Mortgage Product Risks 11 (2006), http://www.banking.state.ny.us/pr070525.pdf.
32. Press Release, New York State Banking Department, Banking Department Adopts Guidance on Nontraditional Mortgage Products (May 25, 2007), *available at* http://www.banking.state.ny.us/ pr070525.htm.
33. Letter from N.Y. State Banking Department to Various Financial Institutions (May 25, 2007), http://www.banking.state.ny.us mb070525.pdf, at 3.
34. *Id.*
35. *Id.*

Catherine M. Brennan, a 1995 University of Buffalo Law School graduate, is an associate at Hudson Cook LLP where she assists national and state banks, investment banks, commercial finance companies, savings associations, mortgage bankers and other licensed lenders in the development and maintenance of nationwide consumer mortgage and automobile finance programs. Ms. Brennan can be reached at cbrennan@hudco.com.

Safeco—The Supreme Court Applies a Statute in a Commercially Reasonable Manner

By Ernest T. Patrikis and Glen R. Cuccinello

On June 4, 2007, the United States Supreme Court rendered its opinion in *Safeco Insurance Company of America v. Burr*.[1] This opinion will be of particular interest to insurance counsel for personal lines auto insurers. But this Supreme Court opinion should also be of interest to a broader group of attorneys practicing in the areas of financial services and other heavily regulated industries. Although, in this case, the Supreme Court interpreted the relevant statute—the Fair Credit Reporting Act[2] (FCRA)—in a traditional manner, the Court adopted a commercially reasonable approach in applying the statute to the matters under dispute. In other words, faced with a series of possible interpretations, all of which were consistent with the statute, the Court adopted a commercially reasonable approach. In addition, while construing the willfulness standard in the FCRA in the traditional manner where willfulness is a statutory condition for civil liability—i.e., as applying not only to knowing violations but also to reckless ones—the Court looked to see whether the insurer's interpretation of the statute was reasonable, not correct but reasonable. The Court then concluded that the insurer's action taken consistent with its reasonable interpretation was not a willful failure to comply with the statute's notice requirement. Finally, the Court left for another day the question whether reliance on legal advice should render companies immune to claims under the statute.

Attorneys are frequently faced with applying statutes which are ambiguous and where there is no guiding agency or court interpretation to help guide the client. Attorneys and clients can take some comfort that their reasonable interpretation and application of a statute with a "willfully" standard might provide protection from liability.

The Fair Credit Reporting Act

The FCRA, a federal statute regulating the collection, reporting and use of consumer credit information, requires that a party taking "adverse action with respect to any consumer that is based in whole or in part on any information contained in a consumer [credit] report" provide notice to the consumer of the adverse action.[3] Insurance companies have been using credit scores in setting rates for their customers for some time. This has been a controversial state insurance regulatory issue.[4] A consumer receiving notice of an adverse action from an insurer is informed about how to reach the credit agency issuing the credit report or score, obtain a free copy of the report, and dispute its accuracy with the agency.

With respect to insurance, "adverse action" means "a denial or cancellation of, an increase in any charge for, or a reduction in the terms of coverage or amount of, any insurance, existing or applied for, in connection with the underwriting of insurance."[5] The consumer is granted a private right of action for actual damages against any person who is negligent in complying with the provisions of the FCRA.[6] However, if a person "*willfully*" fails to comply with the FCRA, the consumer may be granted: (i) actual damages or statutory damages ranging from $100 to $1,000, (ii) punitive damages, and (iii) if successful in an action to enforce liability, the costs of the action and reasonable attorneys' fees.[7]

Brief Statement of the Facts

GEICO used the applicant's credit score to select the subsidiary insurance company and rate at which the policy would be issued. GEICO did not send the applicant an adverse action notice because it only sent adverse action notices if a neutral credit score would put an applicant into "a lower price tier or company" and, in this case, the subject applicant's did not. GEICO developed a way to neutralize the credit scores of applicants, by comparing the tier and company the applicant was assigned to with the tier and company the applicant would have been assigned to with a neutral credit score. Unless a neutral credit score would have been beneficial to the consumer, GEICO would not send the consumer an adverse action notice. This means that GEICO would not send adverse action notices to consumers informing them that if their consumer report had contained more favorable information (such as a better credit report rather than a neutral one), they would have received a more favorable policy.

Safeco offered rates to two subject applicants that were higher than the best possible rates without sending adverse action notices to the applicants. Safeco took this position as a result of its interpretation of the FCRA term "adverse action"—adverse action did not apply to first-time applicants as there was nothing to compare the action to; therefore it could not be deemed adverse in comparison to anything else.

The District Court granted GEICO summary judgment, finding no adverse action under the FCRA, because the premium would have been the same if the applicant's credit score had not been considered. The District Court also granted Safeco summary judgment on the ground that offering a single, initial rate cannot be adverse action. The Ninth Circuit Court of Appeals reversed both judgments.[8] With respect to the claim against GEICO, the Ninth Circuit held that GEICO's failure to give notice was adverse action and remanded for a determination whether GEICO's action was reckless. Based on its GEICO decision, the Ninth Circuit rejected the District Court's opinion and also remanded for further proceedings.

"Willfully"

The Court, in an opinion by Justice Souter, joined to varying degrees by the other Justices, went to great pains to describe how it usually interprets the term "willfully" in both civil and criminal statutes penalizing willful conduct. The Court stated that when "willful" or "willfully" is used in a criminal statute, the Court has regularly read the modifier as limiting liability to knowing violations. The Court went on to state that use of these terms in civil statutes typically presents neither textual nor substantive reasons for pegging the threshold of liability at knowledge of wrongdoing. The Court concluded that it had generally taken "willfully" in a civil context to cover not only knowing violations, but reckless ones as well.

But Before Addressing Whether Action Was Reckless, the Court Looked to See Whether the Statute Had Been Violated

Both the Safeco and GEICO claims involved the question whether the actions taken by the insurers with respect to new insurance policies were "adverse actions" (i.e., an increase in premium or narrower coverage) under FCRA § 1681a(k)(1)(B)(i). This question arises because the statute refers to a quote or charge for a first-time premium as "an increase in any charge for . . . any insurance, existing or applied for. . . . "[9] The Court concluded that "increase" speaks to a disadvantageous rate even with no prior dealing. Simply stated, "increase" reaches initial rates for new applicants. Justices Thomas and Alito, in their concurring opinion, saw no need for the court to address the "increase" issue because, as set out below, Safeco's interpretation of the statute was reasonable.

The Court went on to conclude that the statute contained a causation requirement (a view not shared by concurring Justices Stevens and Ginsburg). The Court noted that the statute calls for notice of adverse action only when that action is "based in whole or in part on" a credit report. Consideration of the credit report must, therefore, be a necessary condition for the increased rate. The Government and respondent-plaintiffs argued that the baseline for determining adverse action should be the rate the applicant would have received if he or she had the best credit rating. It is here that the Court raised the flag of commercial reasonableness, stating: "Congress was . . . more likely concerned with the practical question whether the consumer's rate actually suffered when the company took his credit report into account than the theoretical question whether the consumer would have gotten a better rate with perfect credit."[10]

The Court virtually used a cost/benefit analysis to support its conclusion, stating:

> Since the best rates (the Government's preferred baseline) presumably go only to a minority of consumers, adopting the Government's view would require insurers to send slews of adverse action notices; every young applicant who had yet to establish a gilt-edge credit report, for example, would get a notice that his charge has been "increased" based on his credit report. We think that the consequence of sending out notices on this scale would undercut the obvious policy behind the notice requirement, for notices as common as these would take on the character of formalities, and formalities tend to be ignored. It would get around that new insurance usually comes with an adverse action notice, owing to some legal quirk, and instead of piquing an applicant's interest about the accuracy of his credit record, the commonplace notices would mean just about nothing and go the way of junk mail. Assuming that Congress meant a notice of adverse action to get some attention, we think that the cost of closing the loophole would be too high.[11]

A Not Objectively Unreasonable Reading of the Statute

The above discussion eliminated the claim against GEICO without a need to ascertain whether its action was done willfully. The Court then went on to address Safeco's issue, an issue commonly faced by those operating in a heavily regulated sphere where willful misconduct can result in a remedial proceeding. Safeco read the statute as not applying to initial applications for insurance. As set out above, we now know that Safeco's reading of the statute may not have been correct. The Court concluded: "it is clear enough that if Safeco did violate the statute, the company was not reckless in falling down in its duty."[12] The Court, quoting *Farmer v. Brennan*,[13] stated that "the common law has generally understood [reckless] in the sphere of civil liability as conduct violating an objective standard: action entailing 'an unjustifiably high risk of harm that is either known or so obvious that it should be known.'"[14]

The Court went on to flesh out the standard:

> Thus, a company subject to FCRA does not act in reckless disregard of it unless the action is not only a violation under a reasonable reading of the statute's terms, but shows that the company ran a risk of violating the law substantially greater than the risk associated with a reading that was merely careless. Here, there is no need to pinpoint the negligence/recklessness line, for Safeco's reading of the statute, albeit erroneous, was not objectively unreasonable. . . . [W]e recognize that its reading has a foundation in the statutory text . . . and a sufficiently convincing justification to have persuaded the District Court to adopt it and rule in Safeco's favor.[15]

The Court also noted that neither a court of appeals nor the Federal Trade Commission had given guidance on this issue.

The respondent-plaintiffs unsuccessfully argued that evidence of subjective bad faith should be taken into account in determining whether a company acted knowingly or recklessly for the purposes of FCRA § 1618n(a). The Court cut off that line of argument, noting it would defy history and current thinking to treat a defendant who merely adopts one reasonable interpretation as a knowing or reckless violator. The Court also observed that both Safeco and GEICO argued that good-faith reliance on legal advice should render companies immune from claims raised under § 1681n(a). The Court did not foreclose that possibility but saw no need to address that issue in light of its holding.

Concluding Observations

It is heartening to see an opinion in matters involving creative and reasonable ways of complying with a consumer protection statute not being saddled with punitive damages. In creating new products or reviewing compliance concerning existing products, it may well be prudent to build a record showing the effort to comply with the statute's provisions. Although the Court did not rule on the issue, it seemed to suggest that supplementing that effort with the assistance of outside counsel may also be helpful in demonstrating the reasonableness of the company's efforts.

Endnotes

1. 127 S. Ct. 2201 (2007).
2. 15 U.S.C. §§ 1681–81u.
3. 15 U.S.C. § 1681m(a)(1).
4. *See* Sara Lapham, What Is Insurance Credit Scoring? (June 1, 2005), http://www.insurancescored.com; Insurance Information Institute, Credit Scoring (Sept. 2007), http://www.iii.org/media/hottopics/insurance /creditscoring; F.M. Fitzgerald, Office of Fin. & Ins. Serv., Insurance Credit Scoring in Automobile & Homeowners Insurance (2002), http://www.michigan.gov/documents/ cis_ofis_credit_ scoring_report_52885_7.pdf.
5. 15 U.S.C. § 1681a(k)(1)(B)(i).
6. 15 U.S.C. § 1681o(a).
7. 15 U.S.C. § 1681n(a).
8. *Spano v. Safeco Ins. Co. of Am.*, 140 F. App. 746 (9th Cir. 2005); *Reynolds v. Hartford Fin. Serv. Group*, 435 F.3d 1081 (9th Cir. 2005).
9. 15 U.S.C. § 1681a(k)(1)(B)(i).
10. *Safeco Ins. Co. of America v. Burr*, 127 S. Ct. 2201, 2204 (2007).
11. *Id*. at 2214.
12. *Id*. at 2215.
13. 511 U.S. 825 (1994).
14. *Id*. at 836.
15. *Safeco*, 127 S. Ct. at 2215-16.

Ernest T. Patrikis can be contacted at 212.858.1317 or ernest.patrikis@pillsburylaw.com. Glen R. Cuccinello can be contacted at 212.858.1435 or glen.cuccinello@pillsburylaw.com

U.S. Supreme Court Upholds FLSA's Home Healthcare Aide Exemption

By Andrew J. Lauer and Ronit M. Gurtman

Home healthcare agencies can now breathe a sigh of relief. Given that the minimum wage keeps increasing and insurance reimbursements keep declining, the spread that such agencies rely on to pay their bills could have all but vanished had the United States Supreme Court decided the other way in *Long Island Care at Home v. Coke*.[1] In *Coke*, the Court unanimously upheld a regulation exempting home healthcare aides employed by third parties from the federal minimum wage and overtime pay requirements of the Fair Labor Standards Act[2] (FLSA). The Court declared that courts must defer to the Department of Labor's (DOL) interpretation of the "companionship exemption," and enforce the regulation promulgated by the DOL that includes home healthcare workers employed by third parties within the exemption. The Court rejected the Second Circuit's position that the regulation is invalid and such employees are entitled to minimum wage and overtime payments under federal law.

In 1974, Congress amended the FLSA with the intention of increasing the application of its wage and hour laws to many "domestic services" workers who were previously exempt, and therefore did not benefit from the FLSA's minimum wage and overtime pay requirements. However, despite expanding the FLSA to cover more employees, at the same time Congress expressly created an exemption from the minimum wage and overtime requirements for "any employee employed in domestic service employment to provide companionship services for individuals who (because of age or infirmity) are unable to care for themselves."[3] The DOL subsequently issued regulations defining "domestic service employment," "companionship services," and extending the exemption to employees engaged in performing companionship services but "who are employed by an employer or agency other than the family or household using their services"[4] (the "third-party regulation"). In the past, the DOL had considered narrowing the exemption and rescinding the third-party regulation, but ultimately left it intact.

In 2002, Plaintiff Evelyn Coke, a home healthcare aide, filed suit against her employer, Long Island Care at Home, for its failure to pay her minimum wages and overtime wages to which she claimed she was entitled under the FLSA. She alleged that the regulations defining and interpreting the "companionship exemption" were inconsistent with Congressional intent to extend FLSA coverage to domestic service employees, and were unreasonable and unenforceable. The District Court found the third-party regulation valid and dismissed the case.[5] On appeal, the Second Circuit Court of Appeals set aside the dismissal, declaring the third-party regulation "unenforceable."[6] The court reasoned that because it was merely an "interpretive" regulation, the court need only defer to it if it was a "reasonable regulation," which they determined it was not.[7] According to the Second Circuit's interpretation, the "companionship exemption" was limited to those individuals employed directly by the recipient of services; home healthcare agencies and other third-party providers were held not to be covered by the exemption and would have to make minimum wage and overtime payments to their employees.[8]

In response to the Second Circuit's decision, the DOL issued an Advisory Memorandum on December 1, 2005, criticizing the Second Circuit's decision and instructing all Regional Administrators and District Directors outside of the Second Circuit to continue to apply the exemption.[9] The DOL explained that the applicability of the exemption depends on the nature of the work performed, without regard to the identity of the employer.[10] On January 23, 2006, the Supreme Court of the United States vacated the judgment of the Court of Appeals, and remanded the case to the Second Circuit for further consideration in light of the DOL's Advisory Memorandum.[11] However, on remand, the Second Circuit decided to adhere to its original decision, finding the "companionship exemption" inapplicable to individuals employed by third parties and once again holding 29 C.F.R. § 552.109(a) unenforceable.[12] The Supreme Court again granted Long Island Care at Home's petition for *certiorari*.[13]

In an opinion by Justice Breyer, a unanimous Supreme Court reversed the Second Circuit's decision, finding the third-party regulation valid and binding.[14] The Court rejected all four of Coke's arguments for the unenforceability of the third-party regulation: that the third-party regulation (1) falls outside the scope of Congress's delegation of power to the DOL; (2) is inconsistent with the "General Regulation" that defines the statutory term "domestic service employment"; (3) is an "interpretive" regulation which is not binding on courts; and (4) is invalid because of flawed rulemaking procedures.[15]

Coke first argued that the third-party regulation falls outside the scope of Congress's delegation of power to the DOL. Coke claimed that the words "domestic service employment" limited the scope of the provision to those directly employed by the receiver of services. Coke argued that the purpose of the 1974 Amendments was to expand FLSA coverage—not contract it. She argued that home-companion workers employed by larger corporations were already covered by the FLSA, under the unrelated "enterprise coverage" provision.[16] Coke also relied on the language of the Social Security statute, which defines "domestic service employment" as domestic work performed in "a private home of the employer."[17] Drawing from the language of these other statutes, Coke argued that a regulation removing third-party-paid home-companion workers from the FLSA's coverage would have been contrary to Congressional intent. The Court, however, soundly rejected this argument, pointing out that the statutory language of the Amendment instructed the DOL, not Congress, to decide the terms of the exemption through agency rulemaking.[18] Whether to include workers paid by third parties within the scope of the exemption is within the scope of the agency's decision-making authority.[19] Furthermore, agency expertise makes the DOL far better suited than Congress or the courts for determining the specifics of any FLSA exemptions.[20]

Coke also argued that the third-party regulation is inconsistent with the "General Regulation" that defines the statutory term "domestic service employment," and therefore the latter should control. While the Court agreed with Coke that the literal language of the regulations are contradictory, it disagreed with her contention that the General Regulation should control.[21] First, if the literal definition of the term "domestic service employment" were to be applied uniformly across the FLSA, it would expand the scope of the FLSA exemption, and withdraw from FLSA coverage many employees who were previously covered by the FLSA.[22] Such result would surely conflict with Congressional intent to broaden the FLSA's coverage.[23] If the literal definition of the term "domestic service employment" were to be applied narrowly and only to the statute's exemption provision, even those workers paid by family members living in a different household would be covered by the FLSA.[24] This distinction, based on where the family member resides, seems to contradict Congressional intent to exempt home healthcare aides from FLSA coverage.[25] Secondly, the Court noted that a statutory clause that is more specific to an issue usually demands more weight than a more general one, and in this instance the third-party regulation is more specific than the General Regulation.[26] Finally, the Court spurned the notion that the DOL's flip-flop on the issue eroded the legitimacy of its current stance.[27] Rather, the long history of changing statutory interpretations prevents any unfair surprise and reflects reasoned decision-making.[28] Furthermore, the DOL's extensive consideration of the issue, as set forth in its "Advisory Memorandum," reflects the agency's "fair and considered judgment on the matter."[29]

Coke argued further that even if the third-party regulation is within the scope of the statute's delegation to the DOL, is reasonable and is otherwise lawful, it is not binding on courts as it is merely an "interpretive" regulation that is not entitled to the highest standard of deference. The Court rejected this contention, finding the third-party regulation to be a substantive rule, entitled to full *Chevron* deference from the courts.[30] Under the landmark Supreme Court ruling in *Chevron v. Natural Resources Defense Council*,[31] courts must give maximum deference to the properly promulgated rules of an agency.[32] The Court rejected Coke's assertion that the third-party regulation is merely an interpretation of its General Regulations, and only entitled to the lesser *Skidmore*[33] deference.[34] The Court insisted that the DOL intended its third-party regulation as "a binding exercise of its rulemaking authority," relying on the fact that the regulation drastically affects individual rights and obligations.[35] Furthermore, when promulgating the rule, the agency employed the full public notice-and-comment procedure, which is not required for mere interpretive rules.[36] The Court found the categorization of the third-party regulation in Subpart B, under the heading "Interpretations," to be uninformative. The Court explained that the heading may have been meant to indicate that the latter group of regulations contains more details than those in Subpart A, "General Regulations."[37] Finally, the Court reasoned that under the circumstances, Congress must have intended for courts to treat the regulation as within its delegation of authority to the DOL.[38]

Coke's last argument, that the third-party regulation is invalid because of flawed rulemaking procedures, was also rejected by the Court.[39] Coke argued that because the proposed rule originally called for a regulation that would bring employees of third parties into the FLSA's domain, the notice portion of the rulemaking procedure was inadequate because the public could not have predicted that the resulting rule would be the exact opposite of the proposed rule. The Court held, however, that the resulting regulation need not mirror the proposed rule; it only need be a "logical outgrowth" of the proposal, so as to give fair notice to the public.[40] The Court believed that the final regulation was foreseeable.[41] In fact, the DOL's reversal demonstrated the effectiveness of the notice-and-comment procedure—the DOL changed its position based on the comments received from the public.

Finding the regulation valid, the Court reasoned that:

> Where an agency rule sets forth important individual rights and duties, where the agency focuses fully and directly upon the issue, where the agency uses full notice-and-comment procedures to promulgate a rule, where the resulting rule falls within the statutory grant of authority, and where the rule itself is reasonable, then a court ordinarily assumes that Congress intended it to defer to the agency's determination.

This unanimous decision may be viewed as a sweeping victory for home healthcare agencies, which might otherwise have been forced to expend hundreds of millions of dollars each year in overtime wage payments to their home healthcare workers.

Others view this decision as a major blow to individual employee rights to fair pay that will have long-term detrimental effects on the quality of the available workforce. Following the decision, Sen. Tom Harkin (D-IA) captured this sentiment, stating, "[h]ome care workers are incredibly valuable resources for our nation's seniors and people with disabilities. Quality home care helps people to maintain independence and their ability to live and participate in the community, and fair pay helps attract a quality workforce."[42] Sen. Edward M. Kennedy (D-MA), chairman of the Senate Health, Education, Labor and Pensions Committee, said in a June 11 statement that he intended to look for a way to correct "the significant gap in the protections of our laws," by "work[ing] with my Senate colleagues on a fair solution that treats these hardworking caregivers with the dignity and respect they deserve."[43]

Regardless of how this decision is viewed, it is certain that the impact of the Court's decision may nonetheless be minimized by the various state laws that already often provide greater employee protections than the FLSA. While home healthcare workers paid by third parties may be exempt from the federal minimum wage and overtime requirements, they may be covered under similar, more expansive state laws. In California, for example, state law prevents this ruling from having any practical effect. All healthcare workers in California are covered by either Wage Order 5 or Wage Order 15, and neither exempts home healthcare workers from overtime pay. New York law provides that for those employees exempt from the FLSA wage and hour requirements under specified exemptions, including the "companionship exemption," the premium required to be paid for overtime hours worked is one and one-half times the basic minimum wage.[44] Therefore, a companion or home healthcare worker who qualifies for exemption under the FLSA, but not under New York state law, is still entitled to overtime at one and one-half times the minimum wage.

Between the divided sentiment towards the Supreme Court's decision, which may motivate Congressional action, and the state laws minimizing the real effects the decision will have, it is yet to be seen what the *Coke* case's impact on the home healthcare industry will actually be in the long run.

Endnotes

1. 127 S. Ct. 2339 (2007).
2. 29 U.S.C. §§ 201-19.
3. 29 U.S.C. § 213(a)(15).
4. 29 C.F.R. §§ 552.3, 552.6, 552.109(a).
5. *Coke v. Long Island Care at Home, Ltd.*, 267 F. Supp. 2d 332 (E.D.N.Y. 2003).
6. *Coke v. Long Island Care At Home, Ltd.*, 376 F.3d 118 (2d Cir. 2004).
7. *Id.* at 131-33.
8. *Id. at* 133-34.
9. Alfred B. Robinson, Jr. U.S. Dep't of Labor, Wage and Hour Advisory Memorandum No. 2005–1 (2005), http://www.dol.gov/esa/whd/FieldBulletins/AdvisoryMemoranda2005.pdf.
10. *Id.* at 1.
11. *Long Island Care at Home, Ltd. v. Coke*, 546 U.S. 1147 (2006).
12. *Coke v. Long Island Care at Home, Ltd.*, 462 F.3d 48 (2d Cir. 2006).
13. *Long Island Care at Home, Ltd. v. Coke*, 127 S. Ct. 853 (2007).
14. *Id. at* 2339.
15. *Id.* at 2346-51.
16. 29 U.S.C. §§ 206(a), 207(a)(1).
17. 26 U.S.C. § 3510(c)(1).
18. *Long Island Care at Home, Ltd. v. Coke*, 127 S. Ct. 2339, 2346-47 (2007).
19. *Id.* at 2347.
20. *Id.*
21. *Id.* at 2348.
22. *Id.*
23. *Id.*
24. *Id.*
25. *Id.*
26. *Id.* at 2348-49.
27. *Id.* at 2349.
28. *Id.*
29. *Id.*
30. *Id.* at 2350.
31. 467 U.S. 837 (1984).
32. *Id.* at 844-45.
33. *See Skidmore v. Swift & Co.*, 323 U.S. 134, 140 (1944).
34. *Long Island*, 127 S. Ct. at 2350.
35. *Id.*
36. *Id.*
37. *Id.*
38. *Id.* at 2350-51.
39. *Id.* at 2351.
40. *Id.*
41. *Id.*
42. Press Release, Senator Tom Harkin, Senator Harkin Statement on *Long Island Care at Home, Ltd. and Maryann Osborne v. Evelyn Coke* (June 11, 2007), *available at* http://harkin.senate.gov/news.cfm?id=276821.
43. Press Release, Senator Edward Kennedy, Kennedy on Supreme Court Decision on Home Health Care Providers (June 11, 2007), *available at* http://kennedy.senate.gov/newsroom/press_release.cfm?id=CD051774-7B92-4D2A-BF55-C0983F19CE11.
44. N.Y. Comp. Codes R. & Regs. tit. 12, § 142-2.2 (N.Y.C.R.R.).

Andrew J. Lauer is a Partner and Ronit M. Gurtman is an Associate in the Labor & Employment Law Group of Thelen Reid Brown Raysman & Steiner LLP. Mr. Lauer advises clients on a national level and works out of Thelen's New York City and Long Island offices. Ms. Gurtman is a resident of Thelen's New York City office. Mr. Lauer and Ms. Gurtman would like to thank Rowan T. Mason, a Thelen Summer Associate, for his assistance in the preparation of this article. Mr. Lauer can be reached at 212-895-2571 or alauer@thelen.com and Ms. Gurtman can be reached at 212-895-2033 or rgurtman@thelen.com.

Commercial SMS Text Messages and the Telephone Consumer Protection Act

By Jeffrey D. Neuburger and Jonathan P. Mollod

With more consumers purchasing third-generation or "3G" cellular phones, mobile advertising has been on the rise. It has been reported by *eMarketer* that approximately $421 million was spent on domestic mobile advertising in 2006, with the market projected to reach $4.8 billion by 2011.[1] In addition to sending and receiving wireless phone calls, these multi-function handsets allow users to play music, surf the Internet, send and receive text messages and access e-mail. From an advertiser's point of view, the mobile phone has become an ever-present pocket accessory, offering the ability to reach consumers everywhere, and in a variety of different media forms. Indeed, many analysts see the potential for more sophisticated methods of advertising via cellular phones, among which one should include mobile search engine and banner ads, audio and video spots (or MMS, Multimedia Messaging Service) or "bumpers," which are short ads that precede a video or news clip, not to mention location-based SMS advertising that would send sponsored entertainment suggestions and travel tips to phone subscribers who are out of their home area.[2]

One common form of mobile advertising utilizes the Short Messaging Service (SMS) text messaging capability of mobile handsets. For example, an SMS campaign may involve encouraging consumers to enter promotional contests or participate in informal polls via text message or to obtain free content such as ringtones in exchange for receiving mobile advertising.

Both federal and state laws place certain limitations on the sending of commercial messages by various means, including e-mail, facsimile machine and telephone. And the very multi-function nature of cellular handsets yields significant complexity with respect to the application of these laws, in particular to commercial SMS messages.[3]

One issue that is important to marketers and technology companies involved in the creation and transmission of promotional SMS messages is whether such messages are governed by the federal Telephone Consumer Protection Act[4] (TCPA), which requires "prior express consent" of the subscriber to the receipt of promotional messages sent by certain means, where the subscriber will be charged for the call. This issue is also important to cellular carriers, who, over the past several years, have brought actions against marketers who have sent mass, unsolicited SMS text messages to their subscribers.[5]

There are two conflicting opinions on the application of the TCPA to SMS text messaging. In 2005, in *Joffe v. Acacia Mortgage*,[6] the Arizona Court of Appeals held that the TCPA does apply to such messages. More recently, this past June, in *Satterfield v. Simon & Schuster*,[7] a federal district court held that it does not.

The TCPA and SMS Messages

The enactment of the TCPA long predates the widespread commercial availability of SMS text messaging. The Act was originally adopted in 1991 to, among other things, curb telemarketers from using auto-dialers to make millions of unsolicited calls to residential and business telephone numbers, including cellular telephone numbers. The TCPA prohibits any "call" using an "automatic dialing telephone system" to a number assigned to a "cellular telephone service" without the "prior express consent" of the party to whom the message will be sent, where that party will be charged for the call.[8] An "automatic telephone dialing system" is defined as "equipment which has the capacity to store or produce telephone numbers to be called, using a random or sequential number generator; and to dial such numbers."[9]

SMS Technology

As noted above, the TCPA was enacted well before the advent of SMS text messaging, so there is no discussion of SMS technology in the legislative history. Understanding that technology is essential, however, to understanding how the technical definitions in the TCPA might apply to promotional SMS messages.

Most SMS messages exchanged by cellular phone users are phone-to-phone SMS messages, which are text messages sent from one cellular telephone to another cellular telephone. The Internet is not involved when an SMS message is sent phone-to-phone.[10] In contrast, the sending of an Internet-to-phone SMS message involves different technology, as described in *Joffe v. Acacia Mortgage*:

> The text message is initially delivered over the Internet as an e-mail directed to an e-mail address assigned by a cellular telephone carrier to a subscriber. When the e-mail reaches the e-mail address, it is converted automatically by the carrier into a different format that can be transmitted to the customer's cellular telephone. To illustrate: assume cellular telephone carrier "Wireless" has assigned

> to its customer cellular telephone number (123) 456-7890 and has also given its customer an e-mail address made up of the customer's cellular telephone number and Wireless' domain name, wireless.com. An e-mail sent to that e-mail address, 1234567890@wireless.com, will travel from the sender's computer over the Internet to Wireless' domain. After the e-mail arrives at Wireless' domain, Wireless will automatically convert the text of the message into an SMS message and forward the SMS message to its customer's cellular telephone to be viewed as a text message. [citations omitted][11]

As the court concluded, the perception that a cellular phone can receive e-mail is accomplished by the cellular phone's service provider performing an automated message translation. Put simply, the content of an e-mail message is converted into a new message and format that the cellular telephone can understand.[12]

Threshold Issues

Two threshold issues are raised by the application of the TCPA's statutory language to SMS text messages, namely: (1) whether a text message sent to a cellular telephone is a "call" within the meaning of the TCPA; and (2) whether the technology used to send multiple text messages is an "automatic telephone dialing system" within the meaning of the TCPA.

In *Joffe v. Acacia Mortgage Corporation*, the Arizona Court of Appeals addressed both of these threshold issues. *Joffe* involved the transmission of 90,000 unsolicited messages advertising Acacia's mortgage services to cellular subscribers, one of which was received by the plaintiff, Joffe. Acacia moved to dismiss the complaint on the ground that the subject message was not governed by the TCPA, arguing among other things that an SMS message is not a "call" under the TCPA, that the sending technology did not involve the use of an "automatic telephone dialing system," and that the CAN-SPAM Act, rather than the TCPA, applies to SMS messages sent via the Internet.

First, the court ruled that the prohibition in the TCPA against the use of automatic dialing systems to make "any call" to a telephone number assigned to a cellular telephone service is not limited to two-way real time voice intercommunications.[13] The court noted that its interpretation of the term "call" was consistent with other provisions of the TCPA that prohibit making a call to a cellular or residential telephone number using an artificial or prerecorded voice message, a form of call that "has no potential for a real time voice intercommunication."[14] The court also rejected the argument that because Acacia's messages were sent from its computers in the form of an e-mail message directed to a cellular phone user's wireless e-mail address, the messages were not "calls" within the meaning of the TCPA.[15] The court concluded that the characterization of the messages as e-mails was "incomplete," and that the defendant, by sending the e-mails, "co-opted the SMS service" provided by the plaintiff's wireless carrier, and "attempted to communicate by telephone."[16] Therefore, the court concluded, the defendant "called" the plaintiff within the meaning of the TCPA.[17]

The court in *Joffe* also dealt briefly with the issue of whether the sending of the messages involved the use of an "automatic dialing system," but because Acacia conceded that its computers "randomly or sequentially produced telephone numbers," the discussion focused on the nature of the automatic telephone dialing system utilized by Acacia.[18] The court relied on the wording of the TCPA definition, which refers to "*any* automatic telephone dialing system," in concluding that Congress intended to reach the sending of messages by technologies not available in 1991, when the legislation was passed.[19] Therefore, the court ruled that Acacia's calls utilized an "automatic telephone dialing system" within the meaning of the TCPA.[20]

The court in *Satterfield v. Simon & Schuster* dealt with a slightly different scenario from a marketing perspective, although the technology underlying the transmission of the SMS text messages was the same as in *Joffe*. *Satterfield* involved the transmission of an SMS text message promoting a popular author's "mobile club" to a cellular phone used by a seven-year-old child. The subscriber, the child's mother, had consented to the transmission of promotional messages when, in order to receive a free ringtone, she checked the box in an online form labeled "Yes! I would like to receive promotions from Nextones affiliates and brands. . . ."

The SMS text message in *Satterfield* was transmitted as part of a book promotional campaign by publisher Simon & Schuster, which outsourced the campaign to co-defendant ipsh!, a mobile marketing firm, with directions to send promotional text messages to adults who had previously agreed to the receipt of such messages. Defendant ipsh! obtained a recipient list from Mobile Interactive Agency (MIA), which had contracted with various Web site operators, including Nextones. Nextones had collected consumer consents to receive promotional material on users' mobile devices, and provided the contact information to MIA, which in turn provided defendant ipsh! with contact information for the Nextones subscribers in the form of a database file. Defendant ipsh! provided the file to mBlox, Inc., an "aggregator," or mobile transaction networking services company, that handled the actual transmission of the messages to the wireless carriers.[21]

The defendants in *Satterfield v. Simon & Schuster* also argued that the SMS messages were not "calls" under the TCPA, but the court did not address that issue in its opinion. Instead, the court ruled that the transmission of the messages did not involve the use of an "automatic telephone dialing system" within the meaning of the TCPA. The court focused on the definition of that term, and ruled that the equipment used to send the messages did not "store, produce or call randomly or sequentially generated telephone numbers."[22] Rather, the court agreed with the defendants' characterization that the equipment had transmitted messages to a specific, finite, non-random and non-sequential list of numbers belonging to Nextones subscribers. Indeed, the plaintiff conceded that the equipment at issue did not contain or use a random or sequential number generator.

In narrowly construing the TCPA definition, the court also rejected the plaintiff's argument that the defendant's equipment is an automatic telephone dialing system because it has the "capacity to store numbers to be called and to dial numbers without human intervention."[23] The court recognized the statutory language and the legislative history suggested that Congress anticipated that the FCC, under its TCPA rulemaking authority, might need to consider changes in technologies,[24] yet the court found no published opinions or FCC regulations on point construing the "automatic telephone dialing system" portion of the TCPA.[25] The court's analysis contrasted with that of the *Joffe* court, which relied less on strict statutory construction and took a more liberal reading of Congress's intent in prohibiting calls made using "*any* automatic telephone dialing *system*," commenting that such wording demonstrates "Congress anticipated the TCPA would be applied to advances in automatic telephone dialing technology."[26]

Aside from the broader issue of whether SMS text messages are covered by the TCPA, Judge Wilkens's alternate ground for dismissing the plaintiff's complaint is of interest. Unlike the *Joffe* case, where the defendant had sent unsolicited SMS messages, the defendants in *Satterfield* sent messages to a finite list of cellular customers who had previously consented to receive promotional messages in some form from Nextones or its affiliates. Under the language of the consent in *Satterfield*, the subscriber agreed to receive promotions from "Nextones affiliates and brands." The message at issue stated that it was "PwdbyNexton," i.e., "Powered by Nextones." The district court concluded that regardless of whether Nextones and the publisher that sent the message were "affiliates," the inclusion of the "PwdbyNexton" language in the text message "branded the text message as coming from Nextones; it identified the message with a Nextones brand."[27] Summary judgment was therefore also granted on the issue of consent to receive the message at issue.

Conclusion

Advertisers interested in mobile phone marketing opportunities must be cognizant of applicable laws governing commercial SMS messages, including the TCPA, especially given the rise in claims being brought under the statute.[28] With two courts offering contrasting decisions on the applicability of the TCPA to e-mail-to-phone SMS messages, the law remains highly unsettled in this area. This confusion is further highlighted as mobile technology becomes more sophisticated, particularly with the advent of such multifunctional devices as the iPhone or Blackberry, which, at first glance, look more like mobile computers than mere cellular phones. In the future, as more mobile devices allow for the reading of e-mail and Web site surfing, the capability to receive additional commercial messages and e-mail spam will likely increase, and with it, additional privacy issues affecting businesses are likely to arise as well.

Endnotes

1. Rachael Metz, *Spam on Your Cell Phone*, LAPTOP, Mar. 25, 2007, http://laptopmag.com/News/Cell-Phones/Spam-on-Your-Cell-Phone.htm.
2. *See* Marguerite Reardon, *Advertising Seeps into the Cell Phone*, CNET NEWS.COM, Mar. 6, 2007, http://news.com.com/Advertising+seeps+into+the+cell+phone/2100-1039_3-6115617.html; Eric Sylvers, *Cellphone Ads May Take Off Soon*, N.Y. TIMES, Feb. 14, 2007, at C5, *available at* http://www.nytimes.com/ 2007/02/14/business/media/14adco.html?ex=1185595200&en=26baa88e59f44d68&ei=5070.
3. In addition to the TCPA, the CAN-SPAM Act also applies to certain mobile phone promotional activities. Under the Federal Communications Commission's wireless regulations (the "Wireless CAN-SPAM Regulations"), which the agency promulgated under the CAN-SPAM Act, before sending promotional e-mail messages to wireless devices, a company must first obtain the recipient's "express prior authorization." In addition, at least three states—California, Rhode Island and Washington—have also enacted statutes that specifically apply to promotional text messaging. *See* CAL. BUS. & PROF. CODE § 17538.41 (West 2006); R.I. GEN. LAWS §§ 5-61-3.5 (2006); WASH. REV. CODE §§ 19.190.010 *et seq.* The state laws generally prohibit the transmission of SMS promotional messages to a device assigned to a resident of the state unless the recipient has clearly given his or her consent.
4. 47 U.S.C. § 227.
5. *See, e.g.*, *Cellco Partnership v. John Does 1-50* (D. N.J. complaint filed Oct. 18, 2006). In addition, since 2001, Verizon Wireless has actively and successfully enforced the law against various individuals who have sent mass unsolicited text message spam to Verizon Wireless customers. In November 2005, for example, Verizon Wireless took legal action against Passport Holidays of Ormond Beach, Florida, for violating federal and state laws by sending more than 98,000 unsolicited text messages to Verizon Wireless customers, and eventually obtained a permanent injunction barring Passport Holidays from sending text messages to Verizon customers as well as a judgment of $10,000. *See* Robb Murray, *Verizon Claims Victory over Spammers*, WIRELESS WEEK, Feb. 2, 2006, http://www.wirelessweek.com/article.aspx?id= 88682&terms=.
6. 121 P.3d 831 (Ariz. App. 2005), *review denied* 2006 Ariz. LEXIS 68 (Ariz. 2006), *cert. denied* 127 S. Ct. 934 (2007).

7. No. C 06-2893 CW, 2007 U.S. Dist. LEXIS 46325 (N.D. Cal. June 26, 2007).

8. 47 U.S.C. § 227(b)(1)(A)(iii) makes it unlawful for any person within the United States "to make any call (other than a call made for emergency purposes or made with the prior express consent of the called party) using any automatic telephone dialing system or an artificial or prerecorded voice . . . to any telephone number assigned to a paging service, cellular telephone service, specialized mobile radio service, or other radio common carrier service, or any service for which the called party is charged for the call."

9. 47 U.S.C. § 227(a)(1).

10. *Joffe*, 121 P.3d at 837.

11. *Joffe*, 121 P.3d at 837-38.

12. *Id.* at 837, n.8.

13. *Id.* at 839.

14. *Id.* at 836.

15. *Id.* at 839.

16. *Id.* at 838.

17. *Id.* at 838-39.

18. *Id.* at 838.

19. *Id.*

20. The court also rejected the argument that the messages, because they were initiated via an e-mail transmission, were covered by the CAN-SPAM Act, and therefore could not be covered by the TCPA.

21. *Satterfield v. Simon & Schuster*, No. C 06-2893 CW, 2007 U.S. Dist. LEXIS 46325 at *6-7 (N.D. Cal. June 26, 2007).

22. *Id.* at *16-17.

23. *Id.* at *12.

24. *See* Rules and Regulations Implementing the TCPA, Report and Order, 18 FCC Rcd. 14014, 14092, ¶ 132 (2003).

25. The district court found the plaintiff's reliance on recent FCC guidance to be misplaced. In 2003, the FCC considered whether predictive dialers that use telephone numbers from a list that is not randomly or sequentially generated are automatic telephone dialing systems. *See* Rules and Regulations Implementing the TCPA, Report and Order, 18 FCC Rcd. 14014, 14091-93 (2003). As the court noted, although the FCC rejected the argument that predictive dialers were not automatic telephone dialing equipment merely because they used a list of numbers, it did not necessarily find that any program using a list of numbers is an automatic telephone dialing system, especially when that list is generated based on people who have agreed to receive promotions. *Satterfield*, 2007 U.S. Dist. LEXIS at *16. The court further noted that the FCC language was merely commentary, not a regulation that is entitled to deference by a reviewing court.

26. *Joffe*, 121 P.3d at 839.

27. *Satterfield*, 2007 U.S. Dist LEXIS at *18.

28. Other courts, in recent TCPA cases involving allegedly unlawful fax solicitations, have ruled on important issues regarding TCPA liability, namely individual liability for corporate officers, liability for common carriers, and insurance coverage for TCPA claims under advertising injury policies. *See e.g.*, *Weber v. U.S. Sterling Securities, Inc.*, SC 17623, 2007 Conn. LEXIS 235 (Conn. June 19, 2007) (individual members of Delaware limited liability company may be liable for TCPA violations*); State Ex Rel. Charvat v. Frye*, 868 N.E.2d 270 (Ohio June 27, 2007) (no duty to mitigate damages in TCPA case by registering on Do-Not-Call List); *Taylor v. XRG, Inc.*, No. 06AP-839, 2007 Ohio App. LEXIS 2846 (Ohio Ct. App. June 21, 2007) (common carrier responsible for removal of fax numbers not liable under TCPA, absent high degree of involvement); *Nautilus Insurance Co. v. Easy Drop Off, LLC*, No. 06 C 4286, 2007 U.S. Dist. LEXIS 42380 (N.D. Ill. June 4, 2007) ("advertising injury" insurance policy provides coverage for TCPA violations); *American States Ins. Co. v. Capital Assocs. of Jackson County, Inc.*, 392 F.3d 939 (7th Cir. 2004) (insurer had no duty to defend a TCPA suit under advertising injury policy).

Jeffrey D. Neuburger is a partner in the New York office of Thelen Reid Brown Raysman & Steiner LLP and is the Chair of the firm's Technology, Media and Communications Practice Group. Jonathan P. Mollod is an Associate at the firm and member of that practice group.

Vessel Environmental Issues—The Lessor's Perspective

By Nancy L. Hengen and Dennis Bryant

I. Introduction

A. Two Basic Maritime Principles

1. Owner/Bareboat Charterer

The primary risk of vessel ownership (beyond operating costs) is the personal liability of the owner for damages caused by the vessel to third parties, including oil pollution damage, non-pollution third-party tort damages and personal injuries, and damages caused to the vessel itself. Under basic maritime principles, personal liability of the owner for all but oil pollution legally can be transferred to the bareboat charterer/operator by a bareboat charter covering the vessel. A bareboat charter is a contract that transfers all operational control (including engagement of crew, maintenance and repair, insurance, and supplying necessaries, etc.) of the vessel to the bareboat charterer. In non-maritime terms, a bareboat charter is a net-net lease. The bareboat charterer (also called a demise charterer) takes on the legal liability for all operational functions and the owner is legally relieved from operational liability.

One crucial exception to this general rule relates to oil pollution liability. Under federal law, from 1990 to 2004, the Oil Pollution Act of 1990[1] ("Original OPA 90") placed strict liability jointly and severally on the owner, operator and bareboat charterer of a vessel for environmental damage resulting from oil pollution. Under Original OPA 90, a bareboat charter did not relieve the owner from liability for oil pollution under the statutory strict liability regime. Original OPA 90 was amended in 2004 to relieve qualifying financial lessors from oil pollution liability. However, even a qualifying financial lessor may have strict liability for oil pollution under the laws of a number of states. This is discussed further in Part II below.

2. *In Rem* Liability—Loss of Asset

Maritime law generally provides that a vessel itself is liable for contract and tort claims constituting maritime liens relating to it. This is called "*in rem*" liability. Such claims are enforceable by the lienor through arrest of the vessel by a U.S. Marshal and judicial sale of the vessel in the relevant U.S. District Court. The lienor's claims are transferred to the sales proceeds. The vessel is sold free and clear of liens. The vessel owner is entitled to any proceeds remaining after the payment of all maritime liens (including ship mortgages), non-maritime claims having statutory priority (such as certain tax liens), and court costs. Consequently, the lessor of a vessel should always anticipate that if a tort claim (including pollution) cannot be satisfied out of insurance proceeds, the vessel can be sold in an *in rem* proceeding to satisfy such claim. In such case, the lessor would lose its investment in the vessel.

B. Financial Lessor

For the financial lessor of a vessel, structuring a maritime transaction should include:

(i) being sure that any lease it enters into respecting the vessel would be characterized as a bareboat charter under maritime law so as to relieve the owner of the vessel of operational liability (except, potentially, under some state oil pollution laws);

(ii) being aware that the vessel is a juridical entity responsible for its own torts;

(iii) being comfortable with the level of liability insurance, normally placed through a protection and indemnity club; and

(iv) as the bareboat charterer normally indemnifies a financial lessor for all vessel related matters, being comfortable with the creditworthiness of its lessee, the bareboat charterer.

II. Oil Pollution

A. Original OPA 90

From 1990 to 2004, liability for oil pollution created by spillage from a vessel was by federal statute, Original OPA 90, both strict and joint and several among the owner, operator and bareboat charterer of a vessel. It was generally thought that any entity that held legal title to a vessel and who was the registered owner of a vessel would be considered an "owner" within the meaning of the statute. Consequently, a passive financial lessor who was the registered owner of a vessel was thought to have strict, joint and several liability with the operator and bareboat charterer for oil pollution emanating from that vessel in U.S. waters.

1. Secured Creditor Exemption

In 2004, Original OPA 90 was amended (as so amended, "OPA 90") to provide to financial lessors a CERCLA–like qualified exemption from liability.[2] The 2004 amendment was a change to *federal law only.* It did not address (nor does OPA 90 as a whole address) liability under relevant state law. The discussion below relating to Original OPA 90 is included here because the text of Original OPA 90 remains the text of oil pollution laws in a number of states, and case law developed under Original OPA 90 may have precedential value for a state court interpreting comparable state oil pollution laws.

2. Discussion

Each of Original OPA 90 and current OPA 90 provides that "each responsible party for a vessel . . . from which oil is discharged, or which poses the substantial threat of a discharge of oil, into or upon the navigable waters or adjoining shorelines or the exclusive economic zone [of the United States] is liable for the removal costs and damages . . . from such incident."[3] Responsible party is defined simply as any person owning, operating, or demise chartering the vessel.[4] There is no further definition or description of these key terms in the statute or in the legislative history.

Absent aggravating factors such as violation of law, rule or regulation, both Original OPA 90 and current OPA 90 by their express terms "limit the liability" of a responsible party. If an aggravating factor is present, however, limitation is said to be "broken," resulting in unlimited, joint and several liability on the responsible parties.

If limitation is *not* "broken," the aggregate liability of all responsible parties for removal costs and damages for an oil spill from a vessel are normally limited to $22 million (the maximum amount for a large tank vessel).[5] However, these limitations do not apply if the oil spill was proximately caused by one or more aggravating factors—gross negligence or willful misconduct, or violation of an applicable federal safety, construction, or operating regulation by a responsible party, an agent or employee of the responsible party, or a person acting pursuant to a contractual relationship with the responsible party.[6] Limitation of liability also does not apply if a responsible party fails or refuses to report the incident; to provide reasonable cooperation and assistance in connection with removal activities; or, without sufficient cause, to comply with an order issued under the Federal Water Pollution Control Act[7] (FWPCA) or the Intervention on the High Seas Act.[8]

Our advice under Original OPA 90 was that any financing lessor assumes in its risk analysis that an aggravating factor will be found, so no limitation of liability is applicable. No limitation of liability means that each responsible party— each of the owner, the operator and the demise charterer—is strictly liable, jointly and severally, for total clean-up costs and environmental damage. The Coast Guard and other governmental authorities in their discretion have always had the statutory authority to proceed against any one or more of the responsible parties. There is no statutory requirement that the operator or demise charterer be the initial parties against which claims are made.

While there has been concern regarding unlimited liability, there is only one reported case—the *Tug Ocean Prince*—in which limitation of liability was successfully broken by the federal government in a litigated case following an oil spill.[9] This case was decided under the FWPCA prior to enactment of Original OPA 90. The court found the owner to have negligently allowed control of the vessel to be assumed by an incompetent master and failed to post a lookout, each a violation of an applicable federal operating regulation. These factors were held to be sufficient to permit limitation to be "broken." Because limitation was "broken," the owner was required to pay the full amount of the removal costs and damages resulting from the oil spill. In this particular case, these costs were well within available insurance.

Prior to the enactment of the Secured Creditor Exemption in 2004, the likelihood of liability of a passive financial lessor was made all too clear by the various cases involving the tug *M/V EMILY S*, in which MetLife Capital Corporation, a lessor, was held to be an "owner" under Original OPA 90.[10] In those cases, the court held that the entity that was the legal title holder and documented owner of a U.S. flag vessel was an "owner" and therefore a "responsible party" under Original OPA 90. The operator's insurance in the minimum required amount of $10 million was insufficient to pay clean-up costs and damages, and after the single purpose operator filed for bankruptcy, MetLife was the only solvent defendant. Ultimately, it paid $60 million in settlement on a $120 million damage claim.

Of course, the lease documentation always could (and should) provide that as between the lessor on the one hand and the operator and/or demise charterer on the other hand, the lessor is protected by a full operational indemnity provided by the operator and/or demise charterer. Such an operational indemnity would certainly give comfort to a lessor but only to the extent the indemnitor had sufficient assets, including insurance, to pay damages in connection with a pollution event. Many potential lessors stopped doing vessel lease transactions for vessels that operated in U.S. waters, simply because those potential lessors were not willing to entertain the risk of pollution liability if the operator and/or demise charterer were bankrupt and insurance was unavailable or insufficient.

B. Secured Creditor Exemption

The 2004 amendment to Original OPA 90 introduced a qualified exemption for lenders, including lessors, from oil pollution liability.

The terminology of the amendment is somewhat confusing, as instead of "lessor" or "financial lessor," the amendment refers to a lender under a lease financing. It may not be the most accurate way of describing a passive financial lessor, but the concept of lender under a lease financing was taken deliberately from CERCLA[11] with the intention of making parallel a financial entity's liability under OPA 90 with that existing under CERCLA. The qualified Secured Creditor Exemption is made part of the new definition of "owner and operator." The terms "owner and operator" now exclude, *inter alia*, "*a person that is a lender that does not participate in management of a vessel or* *facility, but holds indicia of ownership primarily to protect the security interest of the person in the vessel or facility.*"[12]

The new definition of "owner and operator" is taken from CERCLA. The 2004 amendment to OPA explicitly states that certain terms used in the definition of and exclusions to "owner and operator" have the meanings provided in CERCLA. Under CERCLA, the term "lender" includes not only banks, but also any person "*that makes a bona fide extension of credit to or takes or acquires a security interest from a nonaffiliated person.*"[13] Additionally, under CERCLA, the term "extension of credit" includes a lease finance transaction "*in which the lessor does not initially select the leased vessel or facility and does not during the lease term control the daily operations or maintenance of the vessel or facility.*"[14] Finally, under CERCLA, the term "security interest" includes, *inter alia*, "*a lease and any other right accruing to a person to secure the repayment of money, the performance of a duty, or any other obligation by a nonaffiliated person*."[15] Taken together, these definitions provide a safe harbor to most passive financial lessors who are not involved in management or operation.

There are two points in the definition of "owner and operator" in CERCLA, now incorporated in OPA 90 by the Secured Creditor Exemption, that are particularly relevant to lease structures. The first of these is whether a lessor is a "lender" within the meaning of CERCLA. This is answered by CERCLA in the affirmative—the term "lender" includes passive financial lessors. Under CERCLA, specifically included in the definition of "lender" are entities not only affiliated with banks but also leasing companies and any person "*that makes a bona fide extension of credit to . . . a non-affiliated person.*"[16] This definition is broad enough to encompass most financial lessors, whether or not such lessors are affiliated with banks.

A second issue raised by the Secured Creditor Exemption is whether a lessor holds "*indicia of ownership [e.g., title] primarily to protect the security interest*"[17] of the lessor in the vessel. This issue is not answered quite so clearly as the first, but a broadly affirmative view seems more in keeping with the purpose of the Secured Creditor Exemption. The legislative history of the 1996 amendment to CERCLA,[18] which enacted the CERCLA counterpart of the OPA 90 Secured Creditor Exemption, and case law suggest that a passive financial lessor who holds legal title for multiple reasons, including in order to achieve the parties' desired tax and accounting treatment, may nevertheless enjoy the Secured Creditor Exemption if at least one of the reasons it holds legal title is to protect its security interest. The statutory text of the 1996 CERCLA amendment specifically includes within the definition of "lender" an entity that holds title "*in connection with a lease financing transaction.*"[19] The CERCLA legislative history has a useful example of a typical lease situation. It states that a financial institution that held title but "*also received tax benefits as a result of holding title would not be an owner for liability purposes.*"[20] The 1996 CERCLA amendment also defines "security interest" to include a "*lease and any other right accruing to a person to secure the repayment of money, the performance of a duty or any other obligation by a non-affiliated person.*"[21]

One question is whether the interpretation of "*primarily to protect the security interest*" is an accurate description of a lessor's interest in each of a true lease and in a synthetic lease transaction. In a true lease, the lessor (a) holds legal title to the vessel and is documented with the U.S. Coast Guard as the vessel owner, and (b) is the tax and economic owner of the vessel. Risk of residual value, for example, remains with the lessor. The lessor presumably holds title for multiple reasons, including making sure it is entitled to receive the tax and accounting treatment of an owner. It is a stretch to call this goal "protecting a security interest." However, because of the strong examples in CERCLA and its legislative history as described above, we feel comfortable that the Secured Creditor exemption will cover a passive lessor of a vessel in a true lease structure in an oil pollution scenario. In a so-called synthetic lease, the lessor has legal title and is the documented owner with the Coast Guard, but generally the lessee owns the vessel for tax purposes and, by contract (the demise charter), the residual value risk is with the lessee. Because the economics of a synthetic lease read like those of a loan, it is not difficult to ascribe to the lessor Article 9–type rights ("security interest") using Article 9 terminology.

C. State Laws

Original OPA 90 permitted each individual state to adopt its own oil pollution liability laws, and nearly all of the coastal or other states with or bordering navigable waters did so. Many of those states' laws parallel the structure of Original OPA 90, that is, providing for strict, joint and several liability of the owner, operator and bareboat charterer of a vessel for oil pollution from that vessel. Included among those states (although by no means an exhaustive list) are Alaska, Washington, Oregon, California, Florida, Virginia, Massachusetts, New York and New Jersey. The state laws set up in that manner likely created causes of action under such laws that were parallel to, but independent and distinct from, the federal law (Original OPA 90). However, because of the all-encompassing breadth of Original OPA 90, administrative proceedings and lawsuits did not as a practical matter separately include claims under state law, but rather all claims generally proceeded under federal law. The Secured Creditor Exemption of 2004 did not affect the applicability of any such state laws. Consequently, on the issue of potential lessor liability for oil pollution, federal and many state laws now diverge. The Secured Creditor Exemption available under OPA 90 after the 2004 amendment has not been imported automatically into parallel state pollution laws. Therefore, in the extremely unlikely situation of insufficient insurance and bankruptcy of all relevant entities except the financial lessor, claims against the financial lessor barred by the Secured Creditor Exemption under OPA 90 might be pursued under state law. Obviously this risk is quite remote, but nonetheless should be part of a risk analysis in any vessel lease financing.

California is an example of state law divergence from federal law respecting the Secured Creditor Exemption for oil pollution from a vessel. The California Oil Spill Liability Law, known as the Lempert-Keene-Seastrand Oil Spill Prevention and Response Act,[22] largely follows the structure of Original OPA 90, but with a somewhat broader definition of "responsible party" and a requirement for a California State Certificate of Financial Responsibility (California COFR) of $1 billion. In contrast, as described above, the federal OPA 90 COFR requirement even for a tank vessel is not greater than $22 million. Under California law, "responsible party" is defined as the owner or transporter of the oil or a person or entity accepting responsibility for the oil; and the owner, operator, or lessee of, or person who charters by demise, any vessel, or a person or entity accepting responsibility for the vessel.[23] The point for a passive lessor is that the "owner" is strictly liable for oil pollution damages, just as it was under Original OPA 90, jointly and severally with other entities. California has not enacted a parallel Secured Creditor Exemption. Note, however, on the plus side for the lessor in California, that a financial lessor may take some comfort from the fact that the California statutory definition also incorporates the owner of the oil as an additional responsible party. Ownership of oil is not a concept that gives rise to liability as a responsible party under Original OPA 90 or OPA 90 as currently in effect.

An additional difference between current OPA 90 and its California counterpart relates to the California COFR, which must be in effect at any time a vessel enters California waters. The OPA 90 COFR requirement is based on the type and tonnage of the vessel, but with an overall maximum COFR requirement of $22 million. In contrast, in order to receive a California COFR for a tank vessel, the applicant must demonstrate the financial ability to pay at least $1 billion for any damages that may arise during the term of the certificate.[24]

California law provides for an initial limitation of liability of $1 billion with provisions for "breaking limitation" somewhat the same as those found in OPA 90.[25]

III. Air Emissions

Vessel air emissions have come under increasing scrutiny over the past several years, and some state regulatory authorities, particularly in California, have actively sought to regulate air emissions from vessels beyond the traditional three-mile limit of state waters.

On the international level, the United States is likely to follow the international convention known as Annex VI to the International Convention on the Prevention of Pollution from Ships (MARPOL Annex VI). MARPOL Annex VI came into effect on May 19, 2005 in a number of jurisdictions, including Denmark, Germany, Liberia, Marshall Islands, Norway, Panama, Singapore and the United Kingdom. It is not currently in effect in the United States, although legislation to implement MARPOL Annex VI has been introduced in Congress this session (the Maritime Pollution Act of 2007, H.R. 802, reported by the House Transportation and Infrastructure Committee). Under MARPOL Annex VI, the flag state of a vessel has responsibility for monitoring compliance. In the U.S., compliance with MARPOL Annex VI is likely to be under the oversight of the Coast Guard, although the White House is pushing for the EPA to have the chief role.

MARPOL Annex VI applies to vessels of not less than 400 gross tons engaged in international trade and deals with various types of emissions, primarily from vessel engines. MARPOL Annex VI will be applied by requiring a vessel survey to establish that the vessel systems do not exceed established benchmarks for regulated emissions and, therefore, that the vessel qualifies for an International Air Pollution Prevention Certificate. For example, to reduce emissions of sulfur oxides, MARPOL Annex VI places limitations on the sulfur content of bunker fuel worldwide, with a lower allowable sulfur content in specified emission control areas. Limitations on emissions of nitrogen oxides from diesel engines are applicable to vessels constructed on or after January 1, 2000. Greater testing and certification of newer diesel engines are required, with the expectation that nitrogen oxides gradually will be thereby reduced.

MARPOL Annex VI also addresses ozone-depleting gases, banning deliberate emission of some types such as halon and CFC and regulating others. VOCs (volatile organic compounds) are also regulated. Restrictions are placed on shipboard incinerator operations and what can be burned in such an incinerator. Under MARPOL Annex VI, the burden of establishing compliance is on the vessel, and additional record-keeping will be required by the vessel operator. Failure to keep records for examination by appropriate port state control authorities may well provide a basis for liability, even criminal liability.

In March 2007, the EPA announced draft regulations to reduce particulate matter and nitrogen oxide emissions from diesel engines on recreational and other smaller U.S. registered ships, setting both near-term and long-term standards that begin to phase in starting in 2009. The EPA also announced its intention to issue draft regulations respecting ocean-going ships in the near future. Significant regulation with respect to air emissions from vessels that call at U.S. ports can be anticipated.

Compliance with MARPOL Annex VI will require a shipowner to modify electrical circuitry, to install various types of scrubbers, and to modify fuel lines and engines to deal with low-sulfur and ultra-low-sulfur fuels on each vessel.

Regulation of air emissions is also ongoing at the state level. California has been one of the most aggressive states. It has adopted regulations that encourage vessels to rely on shore power rather than engine power when in port (an ongoing issue is whether there will continue to be a sufficient electric power supply to carry out that policy) and voluntary speed reduction programs for vessels within 20 miles of ports, in order to reduce both adverse air and particulate emissions. In October 2005, the California Air Resources Board (CARB), part of the California Environmental Protection Agency, issued draft regulations to reduce engine emissions that would affect all vessels up to 24 nautical miles off the California coast, well beyond the normal three mile coastal limit, and that would purport to include vessels that do not call at California ports but that are only transiting those waters.[26] These proposed regulations have been implemented by final CARB regulations, and CARB recently has been sued by a West Coast shipping association for exceeding a state's authority to regulate activities outside state waters.

In the U.S., until MARPOL Annex VI comes into effect, the basic regime will remain the federal Clean Air Act.[27] California's attempt to regulate emissions beyond the accepted coastal three-mile limit raises issues that are just beginning to come before the courts.

IV. Scrapping

The issue of the environmental aspects of the scrapping of vessels is an emerging issue internationally and is an area to watch for in the future. With the phase-out of most single-hull tankers by 2010, scrapping rates are likely to increase. Vessels may contain a number of environmentally hazardous materials including asbestos, ozone-depleting substances, and heavy metals. A great deal of ship scrapping traditionally has been done in South Asia, particularly in India and Bangladesh, and the processes are the most elementary—taking apart the ship by hand. In December 2005, a joint working group on ship scrapping met in Geneva. The joint working group involved the International Maritime Organization, the International Labor Organization as well as the Conference of Parties to the 1989 Basel Convention on the Control of Transboundary Movements of Hazardous Waste and Their Disposal. These meetings likely will result in a new international treaty to govern the final disposition of ships. Even though the International Maritime Organization decided in October 2006 not to mandate pre-cleaning of vessels sent for scrapping, it would not be surprising to see the promulgation of international rules for the decontamination of ships prior to scrapping. In the interim, we believe the best approach for a lessor to mitigate its risks is by way of contract terms governing the final disposition of the vessel to put the scrapping obligation on the operator and to be sure liabilities associated with scrapping are picked up by the operator's general indemnity.

V. Criminalization

A. Increasing Criminalization

Increasingly, environmental incidents have become the basis for criminal (not just civil) prosecution of the operator as a corporate matter and of individuals involved, primarily vessel engineers but also occasionally vessel masters. One fact pattern has emerged as a lightning rod in the past few years. This relates broadly to oil—either the dumping of waste water containing oil residue (primarily from engine operations) not treated through the required oily water separator and/or falsification of entries in a vessel's oil record book. Both fact patterns constitute violations of the Act to Prevent Pollution from Ships[28] (APPS).

Although relevant statutes such as APPS and the Refuse Act of 1899[29] are broadly enough drafted to make the vessel owner liable, such liability against a passive financial lessor has not been pursued to date by the Department of Justice.

However, the political (and prosecutorial) sensitivity of this issue has resulted in increasing criminalization of certain vessel oil-related operations. Examples abound:

(i) Overseas Shipholding Group (OSG), a NYSE company, was indicted by a Beaumont, Texas federal grand jury in July 2003 in connection with discharge of oil wastes and false oil record books involving its owned and operated vessel *Pacific Ruby*. In December 2006, OSG pleaded guilty to 33 charges and agreed with DOJ to pay $37 million with respect to that vessel and 11 others. This was the termination of a DOJ investigation that commenced in 2003 and in which OSG cooperated. Imposition on OSG of a stricter environment compliance program was also part of the settlement.

(ii) On January 24, 2007, the Department of Justice issued a release (07-038) reporting that American-based operator Pacific-Gulf Marine, Inc. (PGM) was sentenced by a U.S. District Court to pay a criminal fine of $1 million and $500,000 for community service; in addition, the operator was put on a three-year probationary, court supervised environmental compliance program. Such a program is likely to be far more rigorous and administratively expensive than a self-imposed compliance program. PGM admitted that four car carriers it operated discharged hundreds of thousands of gallons of oily bilge water without passing them through the required oily water separator. The penalties imposed reflected substantial reductions, taking into consideration PGM's cooperation with DOJ after it learned of the investigation.

(iii) On January 29, 2007 a DOJ release (07-053) announced that a Greek vessel owner, Chian Spirit Maritime Enterprises, Inc., and the operator, Venetico Marine, pleaded guilty to misleading the Coast Guard through inaccurate entries in the oil record book that did not record dumping of waste oil into the ocean. A $1.25 million fine and an environmental compliance plan were imposed by the Delaware District Court. Note in particular that the dumping here occurred in international waters. The violation underlying the plea was not the dumping directly but rather the presentation to the U.S. Coast Guard of the vessel's oil record book when the owner and operator knew that the book did not reflect the improper dumping. In addition, in related matters, both the master and chief engineer of the vessel pleaded guilty to falsifying records and received probation sentences.

(iv) Also in January 2007, the chief engineer and second engineer of a Korean vessel were sentenced in connection with a similar fact pattern of presenting a false oil record book to the Coast Guard (see DOJ Release 07-049). The chief engineer was sentenced to five months in prison; the second engineer was put on probation for three years. The owner and operator of the vessel, Sun Ace Shipping Company, was fined $400,000 and banned from operating its ships in the United States for three years.

What is common to these and other similar incidents is the extremely heightened sensitivity of U.S. regulatory authorities and courts to environmental transgressions involving ships. While so far ship owners have not been targeted by DOJ except to the extent they are part of the operator group, a passive vessel lessor should be sure that the demise charter contains adequate covenants mandating compliance with law and strong indemnity provisions. In addition, specifically requiring the operator to have in place an adequate and complete environmental compliance plan at the outset of the financing may be warranted. The operator who has such a compliance program in place prior to the incident may well be the reason why a lessor does not find itself explaining to its board that its lessee has been convicted or has pled guilty to a crime.

B. Importance of Environmental Compliance Plans

Under U.S. law, the threat of criminal prosecution of the operator of a vessel (as well as the senior officials of the operator) is significantly reduced—if not eliminated—in those circumstances where the company has instituted a qualifying compliance program. A compliance program is designed to deter offenses by company personnel and promptly detect offenses when they do occur. Federal law guarantees a major sentence reduction if an operator with a qualifying compliance program is convicted. In addition, it is the written policy of the U.S. Department of Justice to seriously consider not prosecuting companies with qualifying compliance programs.

There are seven basic elements to a qualifying compliance program. The seven elements are: (1) establishment of written compliance standards and procedures; (2) assignment of program responsibility to a high-level person in the company; (3) establishment of a program to exercise due care to avoid assigning discretionary authority to a person with a propensity for misconduct; (4) implementation of a training program; (5) utilization of a monitoring and auditing program and establishment of a reporting system without fear of retribution; (6) utilization of disciplinary mechanisms for violations and for failure to detect violations; and (7) establishment of a program to report offenses to government officials, cooperate with those officials, and revise the compliance program as necessary to prevent further offenses.

A well-run operator should have in place standards that meet most, if not all, of the above elements, so that combining them into a coherent written program that meets guidelines should not be an arduous process.

A passive financial lessor is not likely to be held liable criminally for oil record book falsification or other false records with respect to operational matters. Relief from liability of the financial lessor is based on the legal shifting of all operational liability to the bareboat charter by the terms of the bareboat charter and maritime law's long-held recognition of such liability shifting. However, both because of the history of strict liability on the owner under Original OPA 90 and the criminalization of vessel-related environmental incidents, we believe financial lessors should consider whether the existence of a compliance program certified as adequate by a third party should be part of the covenants generally applicable to a demise charterer/lessee.

Endnotes

1. 33 U.S.C. §§ 2701-61.
2. Coast Guard and Maritime Transportation Act of 2004, Pub.L. No. 108-293, § 703(a), 118 Stat. 1028, 1069-71 (2004).
3. 33 U.S.C. § 2702(a).
4. 33 U.S.C. § 2701(32)(A).

5. 33 U.S.C. § 2704(a)(1).
6. 33 U.S.C. § 2704(c)(1).
7. 33 U.S.C. §§ 1251-1387.
8. 33 U.S.C.§ 2704(c)(2).
9. *Tug Ocean Prince, Inc. v. United States*, 584 F.2d 1151 (2d Cir. 1978), *cert. denied*, 440 U.S. 959 (1979).
10. *Com. of Puerto Rico v. M/V EMILY S*, 13 F. Supp. 2d 147 (D.P.R. 1998).
11. Comprehensive Environmental Response, Compensation, and Liability Act, 42 U.S.C. §§ 9601-75.
12. 33 U.S.C. § 2701(26)(B)(ii) (emphasis added).
13. 42 U.S.C. § 9601(20)(G)(iv)(V) (emphasis added).
14. 42 U.S.C. § 9601(20)(G)(i)(I) (emphasis added).
15. 42 U.S.C. § 9601(20)(G)(vi) (emphasis added).
16. 42 U.S.C. § 9601(20)(G)(iv)(V) (emphasis added).
17. 33 U.S.C. § 2701(26)(B)(ii) (emphasis added).
18. Asset Conservation, Lender Liability and Deposit Insurance Protection Act of 1996, Pub.L. 104-208, §§ 2501-02, 110 Stat. 3009-462, 3009-462–68.
19. *Id.* (emphasis added).
20. H.R. Rep. No. 96-172, pt. 1, at 36 (1980), *as reprinted in* 1980 U.S.C.C.A.N. 6119, 6181 (emphasis added).
21. 42 U.S.C. § 9601(20)(G)(vi) (emphasis added).
22. Calif. Gov't Code §§ 8670.1-8670.73.
23. Calif. Gov't Code § 8670.3(w).
24. Calif. Gov't Code § 8670.37.53(a). However, such financial responsibility may be demonstrated by vessel entry in a qualified insurance group, such as a protection and indemnity club. Calif. Gov't Code § 8670.37.54.
25. Calif. Gov't Code § 8670.56.5(c).
26. Cal. Code Regs. tit. 13, § 2299.1.
27. 42 U.S.C. §§ 7401-7515.
28. 33 U.S.C. §§ 1901-1915.
29. 33 U.S.C. §§ 407, 411.

Nancy L. Hengen is a Partner in the New York office of Holland & Knight LLP. Dennis Bryant is Senior Counsel in the Washington, D.C. office of Holland & Knight LLP.

Formation by Estoppel: Non-Compliant Limited Partnerships and Limited Liability Companies

By Bruce A. Rich and Kamilah Holder

The strict statutory New York formation requirements for limited partnerships and limited liability companies, as well as the express statutory consequence of non-compliance, may be disregarded in order to prevent an inequitable result in transactions engaged in by entities which have not completed all applicable formation requirements. In these circumstances, the formation requirements, including post-formation publication, are not jurisdictional defects, and in certain circumstances can be cured by the non-compliant entity prior to entry of a judgment, resulting in formation by estoppel.

In a December 2006 New York Court of Appeals decision, a defendant which had been sued for breach of a performed contract was estopped from arguing that plaintiff Boslow Family Limited Partnership lacked capacity to sue by reason of its failure to have filed a certificate of limited partnership and the related publication affidavit in advance of filing the complaint.[1] Prior to the *Boslow* decision, in several cases, lower New York courts had taken conflicting positions whether a limited partnership (LP) or a limited liability company (LLC) had the right to institute a proceeding in a New York court subsequent to filing its initial formation documents with the Department of State but prior to fulfilling its publication obligations. The *Boslow* case presented a more egregious degree of statutory non-compliance because the Boslow LP did not file its certificate of limited partnership until several months after having commenced the judicial action.

In New York, an LP and an LLC are formed at the time the certificate of limited partnership, and the articles of organization, respectively, are filed with the Department of State, or a later date as specified in the filing.[2] However, New York, unlike other states, imposes a publication requirement. Within 120 days after the effectiveness of the initial formation document, the entity must publish notice of publication for six weeks in two designated newspapers and then file a proof of publication with the Department of State. Until June 2006, both the New York Partnership Law and the Limited Liability Company Law had expressly provided that an entity which had filed its initial formation documents but had not fulfilled the publication requirement could not maintain an action or special proceeding in N.Y. "unless and until" it had filed proof of publication.[3] Since June 2006, the sanction for LPs and LLCs which are non-compliant with the publication requirement has been suspension of their authority to carry on, conduct or transact any business in New York.[4] Unfortunately, the consequence of the "suspension of authority" sanction is not defined in the statute, and the prior express sanction of prohibition on use of the N.Y. courts in the old law was not carried over to the new law. The new law does state that upon filing proof of publication, the suspension of the LP and the LLC "shall be annulled."

This article examines the *Boslow* case, the relevant statutory provisions and some of the prior judicial decisions in trying to determine whether a broad application of the estoppel doctrine to non-compliant LPs and LLCs would be inconsistent with the statutory intent which established strict formation provisions for LPs and LLCs, including the related publication provisions and the sanctions on non-compliant entities, and whether the test is should the party arguing lack of capacity be able to avoid liability and retain benefits it received even though the other party's statutory non-compliance had no effect on the relationship, in order to compel greater compliance with the formation requirements, and particularly the publication requirement?

Boslow Case

In June 1997, the Boslow family retained counsel to form an LP (the "Boslow LP"). Counsel prepared a certificate of limited partnership and a limited partnership agreement, but never filed the certificate of limited partnership. It thus followed that there was no publication of the filing as there was no filed certificate of limited partnership. However, the Boslow LP conducted its affairs as though it were a properly formed LP. In July 1997, the Boslow LP entered into an investment advisory agreement with the defendant. After a period of time, the Boslow LP became displeased with the defendant's performance, and terminated the agreement, having previously paid advisory fees to the defendant. In March 2002, the Boslow LP commenced an action against the defendant for breach of contract and negligent management of the account. In February 2003, almost six years after commencing business activities, the Boslow family learned that the Boslow LP was never legally formed under the New York Partnership Law. They immediately filed the certificate of limited partnership and subsequently fulfilled the publication requirement. These formation actions were completed prior to the court's decision on defendant's motion to dismiss on grounds of incapacity.

The New York Court of Appeals reversed the decisions of lower courts by reviewing the equities between the parties as opposed to following the prior approach of applying a purely technical analysis of whether the mandatory LP formation requirements had not been met at the time of entering into the agreement or commencing the action. The Court found that the defendant had derived a benefit from having entered into the advisory agreement with the Boslow LP and obtaining payment thereunder. Therefore, application of the estoppel doctrine was sought to prevent the defendant from unjust enrichment. Moreover, the Court also found that the nature of the defendant's investment advisory services to plaintiff was not dependent on the nature of the Boslow LP as a limited partnership. As a result, the defendant was estopped from arguing the validity of the Boslow LP.

It is noted that the major supporting cited case in the Court of Appeals opinion in *Boslow* was a 1973 decision of the Oregon state court, and the cited New York cases had been decided between 1889 and 1910. The Court of Appeals did not comment upon recent lower state court decisions in New York that had dealt with the maintenance of proceedings by an LP or LLC which had not completed the publication requirements nor did it reference estoppel concepts in New York.

Prior Proceedings Brought by Non-Compliant LPs and LLCs

In its analysis in the *Boslow* decision, the Court of Appeals remarked that the defendant had derived a benefit from its agreement with the Boslow LP. The reference to a benefit perhaps was to distinguish *Boslow* from *Bay Shore Family Partners L.P. v. Foundation of Jewish Philanthropies of the Jewish Federation of Greater Fort Lauderdale*.[5] The Appellate Division had relied upon the *Bay Shore* decision in holding for the defendant in the *Boslow* case. In the *Bay Shore* case, the parties entered into a contract for defendant to convey certain real property to plaintiff Bay Shore LP. The contract was entered into two months prior to Bay Shore LP filing its certificate of limited partnership with the Department of State. In advance of the proposed closing date, and prior to Bay Shore LP completing its publication requirement, the defendant conveyed the property to a third party pursuant to a right of first refusal. Bay Shore LP sought specific performance of the real estate contract claiming that it had substantially complied with the statutory requirements to constitute a properly created limited partnership. Defendant successfully argued that Bay Shore LP had lacked capacity to sue by reason of having entered into the contract of sale prior to its formation and also by reason of not having technically fulfilled the publication requirement prior to the scheduled closing date. The Appellate Division concluded that "the failure to strictly comply with the statutory publication requirement precludes the plaintiff from maintaining this action."[6]

The *Bay Shore* decision is silent with regard to an equitable or estoppel argument, although the decision mentions that the legislature had not included a "substantial compliance" provision when the legislature enacted the current limited partnership provisions in the Partnership Law. One factual distinction between the *Boslow* case and the *Bay Shore* case was that in *Bay Shore* the contract was executory, while in *Boslow* the contract had been performed and the defendant had received an economic benefit from the performed agreement. Should this factual distinction be the operative event to tip the scale when analyzing formation by estoppel?

In a subsequent case on facts substantially similar to those in the *Bay Shore* case, plaintiff, which had filed its articles of organization one month after having entered into a real estate sales contract, sought specific performance of the contract. Plaintiff was deemed a "purported entity" which could not acquire rights by contract or otherwise, and its complaint was dismissed.[7]

A separate line of New York cases addressed the issue of an LP's or an LLC's non-compliance with the State's publication requirement prior to commencing a legal proceeding. These courts found that such non-compliance was not a jurisdictional defect, but a procedural defect. Therefore, as long as the publication requirement was fulfilled prior to judgment in the proceeding, these courts determined that this would warrant *nunc pro tunc* application to avert dismissal of the initial proceeding.[8] The first court that examined this issue stated "there appears to be no New York authority on whether a limited liability company can cure a publication defect after having commenced a proceeding."[9] Subsequent cases looked at the "unless and until" clause in Section 206 of the Limited Liability Company Law. That clause also appears in Section 1312(a) of the Business Corporation Law covering the right of an unauthorized foreign corporation to maintain an action in New York. New York courts have held that under Section 1312(a) the failure of the foreign corporation to be authorized at the commencement of the action was not a jurisdictional defect, and have allowed the non-compliant entity to cure the publication defect.[10] The estoppel argument was not mentioned in any of these decisions.

The cases mentioned in this article dealing with an LP or an LLC that was non-compliant with the publication requirement when it entered into a business relationship with the other party involved the publication requirement in effect until June 2006. A major reason for the amendment changing the sanction from prohibition on the use of the courts to "suspension" as of June 2006 was to seek earlier and greater compliance by newly formed LPs and LLCs with the publication requirement. Under the prior law the supposed attitude of a number of practitioners was to delay the costly publication process until there was a possibility that the entity might have to institute a court proceeding in New York.

It is too early for there to be reported decisions interpreting the effect of the suspension sanction on a non-compliant entity's ability to use the New York courts. However, it is believed that the change in the sanction for not fulfilling the publication requirement should not change the present line of cases permitting the non-compliant party to cure the defect. As previously noted, the "suspension of authority" sanction is vague, and without specification of the non-compliance being a jurisdictional defect. Further, the new provision appears to contemplate a "cure" concept in providing that upon the suspended entity finally fulfilling the publication requirement, its suspension of authority to carry on, conduct or transact business "shall be annulled."[11]

The suspension sanction under the publication requirement follows a similar suspension sanction for LPs and LLCs, which fail to designate a new address for process within a prescribed period after resignation of a legal representative. Filing the new address with the Department of State "shall annul the suspension and the [entity's] authority to do business in [New York] shall be restored and continued as if no suspension had occurred."[12] That last clause may be implied in interpreting the effect of non-compliance with the publication requirement to support the "cure" concept.

Formation by Estoppel

General partnerships, unlike corporations, LPs and LLCs, do not have mandatory statutory formation requirements that specifically provide when the entity is formed.[13] Section 27 of the Partnership Law provides for a partnership by estoppel when a person, by words spoken or written or by conduct, leads a third party based upon the representation to give credit to the actual or apparent partnership. This principle has been applied to LPs where a person who had executed agreements in the capacity of a general partner was unsuccessful in arguing that the amended certificate of limited partnership did not list him as a general partner, and claiming that there had been a "scrivener's error." The court stated that "one who holds himself out as a partner cannot avoid liability on the ground that a recorded instrument would show he had no interest in the partnership."[14]

The formation by estoppel doctrine has also been previously applied to corporations. Recently, in a June 2007 Second Department decision, a corporation had filed its certificate of incorporation one day after the lease in question had been executed. The court relied upon the analysis in the *Boslow* decision in considering the prior business dealings between the parties during which the corporate status was recognized, and determined that the corporation existed and possessed the capacity to contract by reason of the doctrine of incorporation by estoppel.[15]

Another variation of the "estoppel" argument is a person claiming that he should be deemed a partner or a member of the entity based upon his activities in the formation process of an LP or LLC. Two 2007 federal court decisions interpreting New York law dealt with this issue under quite similar factual backgrounds.[16] In the *Stein* case, the defendant had invited the plaintiff, an acquaintance of long standing, to participate in the acquisition of a new business. While they were discussing the terms of plaintiff's participation, defendant formed an LLC and put the acquired business in the LLC. Although their discussions were extensive, no written agreement was ever reached. Plaintiff's arguments included promissory estoppel and unjust enrichment. The court examined the factors for unjust enrichment, including whether "the circumstances were such that equity and good conscience require defendant to make restitution," and found that plaintiff had not been willing to enter into a written agreement nor made any monetary contribution, the formation and organizational efforts were undertaken by the defendant and it was improbable that the defendant would have agreed to the terms requested by plaintiff.

Courts have shown a willingness to set aside the strict statutory New York formation requirements for LPs and LLCs and the express statutory sanction of non-compliance with the publication requirement to permit the non-compliant entity to cure the defects in situations when barring the non-compliant entity from the courts would result in unjust enrichment to a party who had not relied on the nature of the LP or LLC when dealing with the non-compliant entity. This judicial approach moderates the harshness of the statutory consequences of not adhering to the formation requirements, especially to the unnecessary and expensive publication requirement by entities which had timely filed their initial formation documents. The *Boslow* case extends this judicial attitude toward examining the equities where the entity has not even filed its initial formation documents.

Endnotes

1. *Boslow Family Ltd. P'ship v. Glickenhaus & Co.*, 7 N.Y.3d 664, 827 N.Y.S.2d 94 (2006).
2. *See* N.Y. Partnership Law § 121-201(b) (PTL); N.Y. Limited Liability Company Law § 203(d) (LLCL) for domestic LPs and LLCs. The LP and the LLCL provide similar formation requirements for foreign LPs and LLCs, domestic and foreign professional service limited liability companies and registered limited liability partnerships. The points in this article regarding the effect of non-compliance in the formation of domestic LPs and LLCs can be applied to these other entities, except *see* note 4 *infra*.
3. *See* PTL §121-201(c); LLCL § 206, prior to L. 2006, ch. 44.
4. *See* PTL § 121-201(c) of the PTL; LLCL § 206(a), as in effect on June 1, 2006. Foreign LPs and LLCs which filed their certificate or application for authority but failed to file their certificate of

publication are subject to the suspension sanction; *see* PTL § 121-902(d)(i); LLCL § 802(b)(i). However, foreign LPs or LLCs which do not file their certificate or application of authority are subject to a prohibition on the use of the New York courts; *see* PTL § 121-907(a); LLCL § 808(a).

5. *Bay Shore Family Partners L.P. v. Found. of Jewish Philanthropies of the Jewish Fed'n of Greater Fort Lauderdale*, 239 A.D.2d 373, 658 N.Y.S.2d 326 (2d Dep't 1997), *lv. denied*, 91 N.Y.2d 803, 668 N.Y.S.2d 558 (1997), *later proceeding*, 270 A.D.2d 374, 704 N.Y.S.2d 631 (2d Dep't 2000), *lv. denied*, 95 N.Y.2d 736, 712 N.Y.S.2d 447 (2000).

6. *Bay Shore*, 239 A.D.2d at 375.

7. *442 Decatur St., LLC v. Spheres Realty, Inc.*, 14 A.D.3d 535, 787 N.Y.S.2d 669 (2d Dep't 2005).

8. *Willoughby Rehab. & Health Care Ctr., LLC et al. v. Webster*, 13 Misc. 3d 1230(A), 831 N.Y.S.2d 357 (Sup. Ct., Nassau Co. 2006).

9. *Acquisition Am. VI, LLC v. Lamadore et al.*, 5 Misc. 3d 461, 784 N.Y.S.2d 329 (Civil Ct., N.Y. Co. 2004).

10. *Id.*; *see also Echelon Photography, LLC v. Dara Partners, L.P.*, 11 Misc. 3d 1064A, 816 N.Y.S.2d 695 (Civil Ct., N.Y. Co. 2006).

11. PTL § 121-201(c)(i); LLCL § 206(b)(5). There is similar language as to annulment in the publication sections for foreign LPs and LLCs, professional liability LLCs and registered limited liability partnerships.

12. PTL § 121-104-A; LLCL § 301-A. Another statutory "cure " provision allows registered limited liability partnerships to file a Certificate of Consent to annul the effect of a State proclamation revoking the registration of the RLLP. *See* PTL § 121-1500(g).

13. See PTL § 11 for rules determining the existence of a partnership. However, *see* General Business Law § 130(1)(a).

14. *The 1010 Co. LP v. M&S Mgmt. Assoc.*, No. 13259-06, 2007 WL 1695996, at *3 (Sup. Ct., Nassau Co. June 8, 2007).

15. *Rubenstein v. Mayor*, 41 A.D.3d 826, 839 N.Y.S.2d 170 (2d Dep't 2007).

16. *Stein v. Gelfand*, 476 F. Supp. 2d 427 (S.D.N.Y. 2007); *Colle v. Goldman*, No. 05 CV 3981(JG), 2007 WL 1395561 (E.D.N.Y. May 14, 2007).

Bruce A. Rich is a Senior Counsel at Thelen Reid Brown Raysman & Steiner LLP. He is the Commentator for McKinney's *Partnership Law* and *Limited Liability Company Law*, and has been a member of the Business Law Section of the New York State Bar Association for many years. Kamilah Holder was a 2007 summer associate at Thelen Reid Brown Raysman & Steiner LLP and is a third year law student at New York Law School.

Committee Reports

Report of the Business Law Section Chair

The Business Law Section has had a busy and productive year to date. Among the highlights:

- In January the Executive Committee voted unanimously to give a gift of $10,000 to the Coalition for Debtor Education, a not-for-profit New York corporation chaired by Barbara Kent, formerly Deputy Superintendent of Banks and a frequent speaker and contributor to Section programs. The Coalition provides financial literacy programs; training for debtor educators and bank staff in banking development districts; outreach programs to labor unions, colleges and law schools to provide financial literacy programs; and other measures to promote the responsible use of credit.

- In June we voted unanimously to give $20,000 to the New York State Bar Foundation, which provides funding to public interest legal programs in the State. Both of these gifts came from the Section's surplus funds and reflect the strong commitment of our members to contribute to the public good.

- Our constituent committees continue to be an active source of continuing legal education and practical guidance to business law practitioners around the State. The reports of the individual committees appear below.

- We established two new standing committees, Legislative Affairs and Membership. The Legislative Affairs Committee works actively with the parent Bar Association to provide input to the legislative process in areas of concern to our members. The Membership Committee is focused on outreach to new members, with an emphasis on enhancing diversity and encouraging young attorneys to participate.

- In September we hosted our Fall Cruise Connection, aimed at introducing the Section and its work to prospective new members during a pleasant cruise around New York Harbor.

- In October we had our annual meeting at the Breakers in Palm Beach, Florida, with CLE programs focused on corporations, securities law, project and structured finance, and the legal and ethical implications of anti-money laundering law.

- The Section remains strong and healthy, with nearly 4,500 members representing every discipline of business law and every part of the State.

—David L. Glass, Section Chair

Banking Committee

The Committee met on May 3. We had four substantive presentations, as follows:

(i) Roberta Kotkin, Esq., reported on *Watters v. Wachovia,* in which the United States Supreme Court applied federal preemption principles to uphold the exclusive visitation rights of the Office of the Comptroller of the Currency, as the regulator of national banks, over the operating subsidiaries of national banks, even though those subsidiaries are established under state law;

(ii) Jacob Zamansky, Esq., gave a presentation on subprime mortgage litigation;

(iii) Celeste Kaptur, Esq., Regional Counsel for the Small Business Administration, gave a presentation on small business lending; and

(iv) Louis Goodman, Esq., gave a presentation on workouts and restructuring.

Attendees uniformly found the presentations valuable and informative. They also received one hour of CLE credit. As Chair, I intend to arrange for CLE credit for all future meetings during my tenure, as a way to both increase attendance and make the meetings as relevant and helpful as possible for the members.

—Clifford S. Weber, Chair

Bankruptcy Committee

The Committee sponsored a reception to meet the three most recently appointed U.S. Bankruptcy Judges (Glenn, Peck and Cangilos-Ruiz) at the Penn Club in New York City on Thursday, September 20th. At the request of the Executive Committee of the Business Law Section, a sub-committee of the Bankruptcy Committee is reviewing the NYC Consumers Affairs Department's proposed new local law that would require lawyers who engage in collection activity in NYC to be specially licensed by NYC in addition to the State law license. After review, the sub-committee will develop a proposed position for the Executive Committee to consider for the Section to approve. Over the past six months members of the Committee participated as panelists on CLE daylong programs regarding the intersection of labor and bankruptcy law and enforcing and defending against money judgments. Each program was well attended and the panelists were commended for their informative presentations. If you are interested in being involved, writing, or presenting in a future CLE program, please contact the Committee Chair, Paul H. Silverman at psilverman@mclaughlinstern.com.

—Paul Silverman, Chair

Consumer Financial Services Committee

Once again, the hottest topics for the Consumer Financial Services ("CFS") Committee meetings in early 2007 were privacy, identity theft and data security. Having given fascinating presentations on these issues in 2006 for the CFS Committee, for the combined Banking and CFS Committees, and for the Business Law Section, William (Randy) Henrick provided a reprise and an update of his Privacy, Data Security and Identity Theft presentation at the Business Law Section's Annual Meeting in January. As "America's fastest growing crime," identity theft and the associated issues of privacy and data security were of interest to many attendees at the corporate level and to all who attended as consumers. Well done again, Randy!

At the January meeting of the CFS Committee, we discussed a number of topics currently on the radar screen for the consumer financial services industry. Phil Veltre led a discussion on the new Regulation "E" rules applicable to electronic check conversions; Phil also led a discussion of a recent home equity line of credit prepayment penalty case; Grace Sterrett gave us an analysis of the new rate cap for loans to the military and an overview of the new New York Mortgage Originators law; Warren Traiger provided an excellent summary of the status of Nontraditional Mortgage Guidance; and Geoff Rogers discussed (pre-decision) the preemption issues raised in *Watters v. Wachovia Bank*.

The CFS Committee has followed a policy of having its prospective attendees determine the topics for discussion at upcoming meetings. As outgoing Chair, I encourage members to continue their active participation in selecting discussion topics and leading those discussions. Beginning January 1, 2008, the CFS Committee will be under the able leadership of incoming Chair Randy Henrick. As always, the CFS Committee encourages participation by an even more diverse group of attorneys. Please contact me, Geoff Rogers, at grogers@hudco.com or 518.383.9591 if you are interested in attending a meeting or in joining our committee.

—Geoffrey C. Rogers, Chair

Corporations Law Committee

The Committee reviews new and proposed legislation and court cases involving the Business Corporation Law and other New York laws affecting corporations and other business entities, including partnerships, limited partnerships, and limited liability companies. It takes an active role in proposing legislation which affects corporations and other business entities.

—Janet T. Geldzahler, Chair

Derivatives and Structured Products Committee

The mission of the Derivatives and Structured Products Law Committee is to apprise members of developments in laws relating to the futures and derivatives markets and to maintain liaisons with trade associations, industry leaders, and representatives of governmental and regulatory bodies, such as the SEC, the CFTC, and the Federal Reserve System. Over the past year, the Committee has hosted meetings that brought the membership valuable information and interaction with important figures directly or indirectly involved in the futures and derivatives markets. Based on their positive experiences to date, members are seeking to expand membership by continuing to refine this mission and by sharing their experience with colleagues and contacts.

Our Committee meets one day each month, typically around lunchtime, during which time we have presentations by members and guest speakers covering a variety of intriguing topics relating to the futures and derivatives markets. We also seek out opportunities to prepare comment letters and articles.

If you are interested in joining our Committee, please contact the New York State Bar Association. When completing your membership in the Association, be sure to elect to join the Business Law Section and the Derivatives and Structured Products Law Committee.

—Ilene K. Froom, Chair

Franchise, Distribution and Licensing Committee

In its last two meetings, the Franchise, Distribution and Licensing Committee was privileged to hear presentations by and to have roundtable discussions with university professors who authored recent books on the economic and business aspects of franchising.

The topic of the May meeting was "The Economics of Franchising." The speaker was Francine Lafontaine, Professor of Business Economics at the University of Michigan and co-author of the book *The Economics of Franchising* (Cambridge University Press 2005) and of the article "Franchises as a Business Model" in the *ABA Franchise Law Journal* (Fall 2006). Professor Lafontaine discussed the pros and cons of franchising, the success rates of franchise companies over the years, the size of franchising in the U.S. economy, and related subjects.

The topic of the June meeting was "Using Franchising to Drive the Growth and Profits of a Business." The speaker was Scott A. Shane, Professor of Economics at Case Western Reserve University and author of the book *From Ice Cream to the Internet: Using Franchising to Drive the Growth and Profits of Your Company* (Prentice Hall 2005). Professor Shane identified the major issues a company should consider in deciding whether or not to grow by franchising, and, if so, how to design a successful franchise system.

The committee intends to hold future meetings with presentations by committee members and others. We are also planning a CLE program to introduce franchising to non-franchise lawyers. We welcome all suggestions from members and inquiries from potential new members. Contact the Committee Chair at pitegoff@pitlaw.com.

—Thomas M. Pitegoff, Chairir

Legislative Affairs Committee

The Legislative Affairs Committee has been established as a new standing Committee of the Business Law Section, effective June 2007. The Committee follows New York State legislation of interest to the Section and its constituent practice committees. The Committee reviews bills being proposed for vote in the State Senate or Assembly, provides memoranda in opposition or support and, where appropriate, meets with legislators or their staffs about the bills. The Committee will also, if needed, seek sponsors for proposed bills of interest to the Section. The Committee has one representative from each of the substantive committees of the Section.

The Committee's work is seasonal, following the legislative calendar, which is busiest from April to June. In the past year Committee members reviewed a list of proposed bills that had some likelihood of being reported out of legislative committee to identify those that should be opposed or supported. One bill, Senate 2152, was of special interest to the Corporations Law Committee, because it would have required all New York public corporations over a certain size to enable remote participation in shareholder meetings by all shareholders. Although the Legislative Affairs Committee and the Corporations Law Committee did not object to a law that would have permitted corporations to allow remote participation, the committees objected to a law which would have required corporations to facilitate remote participation. Information obtained from companies providing services in this area indicated, among other things, that telephone connections permitting remote participation, including voting, by potentially thousands of shareholders are not currently technologically feasible. After meeting with counsel to Senator Libous, the sponsor of the Senate bill, to explain the technological and other problems presented, the Section and the Corporations Law Committee submitted a memorandum in opposition, drafted by Janet Geldzahler and reviewed by David Glass and Peter LaVigne, to the Senate Committee on Corporations, Public Authorities and Commissions, where the bill had originated. The bill was not put to the vote of the Senate and indications are that it will be revised in response to comments of the Section.

—Peter W. LaVigne, Chair

Membership Committee

The Membership Committee has been established as a full standing Committee of the Business Law Section, effective June 2007. The Committee's mission is to increase and improve membership in the Business Law Section. Specifically, the Committee seeks to increase the membership in the Business Law Section by ten percent; retain existing members and encourage them to become more active in the work of the Section; promote and improve diversity among our membership to reflect the society in which we live and work; and develop a robust mentoring program for young lawyers. We endeavor to reach our goals by providing lunch and learning seminars to law students throughout all geographic regions of the state, developing partnerships with local and minority bar organizations, and providing venues such as the fall cruise for networking. On September 17, 2007, the Committee hosted a private evening cruise and reception aboard the luxury yacht *Zephyr* to promote networking and introduce non-members to the benefits of joining the Business Law Section.

—Andrea M. Elder-Howell, Chair

Securities Regulation Committee

The Committee on Securities Regulation has continued its monthly meeting programs addressing a wide range of matters of importance to securities law practitioners. Among the topics presented at our recent meetings were electronic proxy delivery, Moody's reviews of executive compensation and internal control disclosures, short sales, "empty voting," the U.S. Chamber of Commerce's report on U.S. capital markets, the Pink Sheets, and various SEC rule proposals. In addition, the Committee submitted a comment letter to the SEC on its proposed rules regarding the prohibition of fraud by advisers to certain pooled investment vehicles, and the accredited investor standards associated with certain private investment vehicles.

The Committee is currently drafting comment letters regarding a number of new SEC rule proposals.

Our dinner meetings tend to foster lively discussions, and afford Committee members an opportunity to discuss "hot topics" with persons closely associated with those topics.

—Jeffrey W. Rubin, Chair

Publication Policy and Manuscript Guidelines for Authors

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

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

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

A manuscript generally is published five to six months after being accepted. The *Journal* reserves the right (for space, budgetary, or other reasons) to publish the accepted manuscript in a later issue than the issue for which it was originally accepted.

Manuscripts are submitted at the sender's risk. The *Journal* assumes no responsibility for the return of the material. Material accepted for publication becomes the property of the Business Law Section of the New York State Bar Association. No compensation is paid for any manuscript.

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

Deadlines

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

David L. Glass
Editor-in-Chief
NY Business Law Journal
Macquarie Holdings (USA) Inc.
125 West 55th Street
New York, NY 10019
telephone: (212) 231-1583
e-mail: david.glass@macquarie.com

Subscriptions

Subscriptions to the *Journal* are available to non-attorneys, universities and other interested organizations. The 2008 subscription rate is $105.00. Please contact the Newsletter Department, New York State Bar Association, One Elk Street, Albany, NY 12207 or call (518/487-5671/5672) for more information.

NYSBA
NEW YORK STATE BAR ASSOCIATION
BUSINESS LAW SECTION
One Elk Street, Albany, New York 12207-1002

ADDRESS SERVICE REQUESTED