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Editor's Message

First, thank you to all of the contributors for their patience working with me, but more importantly for their informative articles that make up the Spring 2002 issue of the *NY Business Law Journal.* These individuals have taken time from their busy schedules to share their expertise with their fellow members of the Business Law Section of the New York State Bar. As always, we encourage you to consider submitting an article for consideration for future issues.

We begin this issue with a short tribute to one of the *Journal* Advisory Board's founding members, Michael Iovenko, who passed away last winter. Many of you have lasting memories of the important contributions he made not only to the Business Law Section, but also to the New York State Bar and the legal profession.

We continue with committee reports from the January meeting of the Committee on Bankruptcy Law and last year's meetings of the Committee on Corporations and Other Business Entities. The Committee on Bankruptcy Law notes that continuing education efforts continue with several seminars, including programs focused on the post-September 11 environment. Also, look for upcoming events sponsored by the committee on the Bar Association Web site. The Committee on Corporations reports on its ongoing work on new legislation governing business trusts and assumed names. In addition, the committee reports on its discussion of efforts to correct flaws in the law concerned with corporate shareholder voting and Not-For-Profit Corporation Law.

The first article considers the evolving role of audit committees in the wake of increased public scrutiny of accounting practices as a result of the Enron debacle. Gerald Backman, a partner in the corporate department at Weil, Gotshal & Manges LLP, discusses the responsibilities of audit committees and individual committee members in light of several recent pronouncements by the SEC. These statements cover disclosure of critical accounting policies, enhanced "Management's Discussion and Analysis of Financial Condition and Results of Operations" requirements, and the use of pro forma financial information in earnings releases.

Next, William J. Estes and Max Pastor of the New York State Office of the Attorney General (OAG) have contributed an informative piece on the state's exemption of Internet advertising from filing requirements for franchise sales offers. New York is the first state to adopt the North American Securities Administrators Association policy. The authors also discuss the "fractional franchise" exemption that the OAG adopted, bringing New York in line with the Federal Trade Commission and several other states. Finally, the article notes that New York has also adopted a definition of the term "marketing plan" and standardized forms that contribute to greater uniformity among franchise registration states.

In the next article, Paul A. Ferillo and Lanny J. Davis provide helpful advice to managers and advisors of companies that suddenly find themselves in the midst of a crisis. The crucial elements for crisis management are integration and planning. Mr. Ferillo and Mr. Davis urge companies to assemble a team that will work together and anticipate problems in order to prevent debilitating public relations and legal difficulties. The authors then discuss specific suggestions for managing through a crisis situation. They conclude by reminding us that although the truth may hurt, delays in getting out the truth are likely to increase the costs.

Micalyn S. Harris, Vice President, Secretary and General Counsel of Winpro, Inc., has contributed two articles on e-commerce for this issue. Both articles offer insight into the myriad issues that businesses might encounter as they look to expand or establish trade on the Internet and take advantage of potential cost-saving benefits. In the first article, Ms. Harris provides a helpful review of the jurisdiction issues posed by companies setting up business on the World Wide Web. She begins with a discussion of subject-matter jurisdiction, highlighting the problem that arises concerning copyright protection of Web page content. She follows this discussion with a detailed examination of personal jurisdiction issues that arise in connection with Internet activity.

In her second article, Ms. Harris focuses on practical issues for Web-based business operators seeking to satisfy obligations concerning Web site visitors' and employees' privacy. She provides a concise overview of the major issues facing Web-based businesses with respect to personal data the business collects while doing business over the Internet. She discusses legal obligations arising from the Electronic Communications Privacy Act and continues by observing that compliance with such legal requirements meets only half of the concerns for Web-based business operators, who must also attend to business needs.

Bruce A. Rich, a partner at Thelen Reid & Priest LLP, offers an analysis of the recent *Barklee Realty* case. The case, which enjoined the publication requirement under New York's Limited Liability Company Law, has potential far-reaching impact on the publication requirement for business entities in the state.

Our final contributor is Claudius O. Sokenu, an associate in the New York office of Mayer, Brown & Platt. Mr. Sokenu has contributed two articles pertaining to SEC regulation. In the first article, Mr. Sokenu discusses the factors involved in the SEC's decisions to impose monetary penalties against issuers for violations of the federal securities laws. He reviews several enforcement cases in order to shed some light on the ways to avoid monetary penalties and enforcement action.

Next, Mr. Sokenu examines the difficulties that arise when Web portals act as a conduit for securities trading. Financial portals are designed as a mechanism for bringing investors and broker-dealers together, but certain compensation arrangements between the broker-dealers and portal operators have pushed Web portals into the zone of SEC regulation. Mr. Sokenu highlights some of the problems that have emerged as a result of SEC scrutiny of these relationships.

Completion of this issue of the *NY Business Law Journal* would not have been possible without the fine editing and research assistance provided by Todd A. Ritschdorff, a second-year student at Albany Law School.

Finally, a reminder to committee chairpersons: beginning with the Fall 2002 issue, the Section's nine committees will alternate reporting and article contributions. The Banking, Bankruptcy, Consumer Financial Services, and Corporations committees will submit committee reports in the fall. The Franchise, Futures, Insurance, Internet, and Securities Regulation committees will submit articles for the spring issue.

Read and enjoy!

Nancy K. Ota
Professor of Law
Albany Law School

In Memoriam

Michael Iovenko

1930-2001

Founding Member of the Advisory Board of the *NY Business Law Journal*, Michael Iovenko, passed away on December 1, 2001. Mike gave generously of his time and attention to many pro bono activities and we are grateful for his valuable contributions to the *Journal* and the New York State Bar Association. He was a paragon for all members of the Bar.

Committee Reports

Committee on Bankruptcy Law

The Committee on Bankruptcy Law presented a CLE program at the Annual Meeting in January on the after-effects of September 11. The focus of the program was on the impact of 9/11 on bankruptcy filings and its effect on the proposed bankruptcy legislation. The Committee also sponsored a wine and cheese reception for bankruptcy judges at the Annual Meeting. Included among the attendees were Honorable Conrad B. Duberstein, Honorable Robert E. Gerber, Honorable Burton R. Lifland and Honorable Dennis E. Milton. Also in attendance was Kathleen Farrell, U.S. Bankruptcy Clerk for the Southern District of New York.

Under overall planning co-chairs, Ira Herman and Peg Cangilos-Ruiz, the Committee co-sponsored a practical skills CLE seminar on the Basics of Bankruptcy Practice on two successive evenings at six locations throughout the state on April 16 and April 17. We are grateful to the chairs and moderators of the panels and to all panel participants. The full spectrum of participants in a typical bankruptcy case were represented from debtors' and creditors' counsel, to Chapter 7/Chapter 13 trustees, assistant United States trustees, and the judges' chambers. Panels included the discussion of electronic filing by members of the clerks' offices in each of the respective districts. Chairing the respective panels were Peg Cangilos-Ruiz (Albany); Mark J. Schlant (Buffalo); Harold D. Jones (Uniondale, LI); Ira L. Herman (New York City); William S. Thomas, Jr. (Rochester); Jeffrey A. Dove (Syracuse); and Walter H. Curchack (Tarrytown).

The Committee is planning to make full use of the New York State Bar Association's Web site which went live on May 1. Log on to the Web site to keep abreast of upcoming events and notices.

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Committee on Corporations and Other Business Entities

In April 2001, a meeting of the Committee on Corporations and Other Business Entities of the Business Law Section of the New York State Bar Association was held in New York City.

The Committee was advised that the proposed Business Trust statute was progressing in the legislative process. The Committee anticipated the passage of the statute shortly. [Subsequently, there have been a number of hold-ups and passage has been delayed.]

The Committee reviewed New York's proposed assumed name legislation, which would create a central depository and filing system for all assumed names for the state of New York. The Committee reflected on the fact that currently there is no central system and, in addition, there is no penalty imposed on a corporation for filing in an incorrect county. The Committee agreed to reach out to county clerks to confirm that their respective counties were not concerned about the fiscal impact on their counties of the loss of filing fees.

The Committee received a report that many limited liability companies take their business to Delaware as a result of the publication requirement under New York Limited Liability Company Law, resulting in New York not being provided with the opportunity to generate the associated revenues. The Committee discussed whether this section should be repealed, but did not reach any conclusion as to actions to be taken.

The Committee discussed Section 903 of the BCL, which originally provided that a two-thirds vote of a company's shareholders was required to approve a plan of merger or consolidation. In connection with the 1998 BCL amendments, a majority vote of the shareholders was permitted to approve a plan of merger or consolidation (for corporations incorporated after the effective date or where the certificate of incorporation otherwise allowed). Section 803 of the BCL permits a company to amend its certification of incorporation based on a majority vote of its shareholders. The Committee believes that the unintended result is that a company incorporated prior to the effective date that had a two-thirds voting requirement could amend its certificate of incorporation by a majority vote of its shareholders to require a majority vote to approve a plan of merger or consolidation. The Committee is establishing a task force to clean up technical inconsistencies in the BCL.

The Committee continues its efforts to revise the Not-For-Profit Corporation Law and is reaching out to NFP practitioners for their input. Please contact Edward Cohen (ehcohen@rosenman.com or 212-940-8580) if you would like to contribute to this project.

Gary Trechel of the Department of State updated the Committee on the work of the Department.

In October 2001, the meeting of the Committee was held at the Equinox in Manchester, Vermont in conjunction with the Securities Regulation Committee.

New Demands on Audit Committees in the Post-Enron Era

By Gerald S. Backman

As we enter the annual report (10-K) and proxy statement season, it is important for company managements and audit committee members to be aware of recent developments in the business and regulatory environment affecting the role and responsibilities of audit committees that have occurred in the wake of the much publicized financial reporting problems of Enron and other well-known companies. While the rules governing audit committees have not (yet) changed since they were last revised in December 1999,[1] these developments may affect the activities which audit committees are undertaking with regard to these upcoming reports and will also affect future company disclosures. Managements and audit committee members should consider how these trends apply to their companies' circumstances.

> *"In this environment of heightened market and public concern with the completeness and quality of corporate financial reports, 'best practice' standards are evolving."*

The U.S. Securities and Exchange Commission (SEC) has recently issued three policy statements concerning the disclosures that it expects publicly-traded companies to make regarding their "critical" accounting policies, off-balance sheet obligations, related party transactions and certain other financial reporting matters, especially in the "Management's Discussion and Analysis of Financial Condition and Results of Operations" (MD&A) that is required to accompany their financial statements. Meeting these standards may have a significant impact on certain categories of information that are to be presented in some companies' financial reports.

Highlighting the importance it gives to these matters, the SEC Staff has announced that it will review the 10-Ks filed in 2002 by all Fortune 500 companies and on a targeted basis selected subjects in the reports of other companies. The SEC has also indicated that it will undertake further initiatives in the area and has made it clear that, given the role of audit committees in the financial reporting process, it expects these disclosure standards to impact audit committee activities. In this environment of heightened market and public concern with the completeness and quality of corporate financial reports, "best practice" standards are evolving. Several prominent public companies have elected to make greater disclosures in the areas the SEC has highlighted than customary in the past and more are expected to do so. These developments have important implications for audit committees as they undertake their review of financial reports.

Review of Audit Committee Processes and Procedures

Audit Committee Charter

Over the last couple of years all listed companies in the U.S. were required to adopt written charters for their audit committees which satisfy certain minimum requirements. In many cases these were the first formal charters adopted for the committee but codified a range of roles that went beyond the minimum requirements and reflected common practices or company-specific circumstances. Annual assessment by the audit committee of the adequacy of the charter is similarly required. In the current environment, it is imperative that audit committees (and boards of directors as a whole) carefully review with counsel—and, if necessary, update—their audit committee's charter to ensure that it not only meets the applicable requirements but also properly addresses the role the committee will in fact play in the financial reporting process. Audit committees should consider what, if anything, different from the past they will do. In addition, the audit committee should assure itself that in the course of its activities it in fact addresses the matters the charter contemplates that it will address.

For example, in many cases the charter gives the committee oversight responsibility over corporate codes of conduct concerning transactions between management and the company or trading by employees in the company's stock. These are matters that are likely to be subject to heightened scrutiny in the current environment and on which other board committees, such as the compensation committee, may also play an oversight role. This makes a clear delineation of the audit committee's role in reviewing these matters especially important. In addition, given (among other factors) the complexity of the disclosures that may be undertaken in the current environment on certain matters as to which generally accepted accounting principles (GAAP) currently do not mandate disclosure, the audit committee may wish to add an exculpatory paragraph specifying that in performing its oversight functions it does not provide any expert or special assurance as to the company's financial statements or any supplemental financial disclosures the company makes (in the MD&A or elsewhere), if the charter does not already include such language.[2]

Audit Committee Report

The audit committee should also confirm that its report to shareholders, as required by SEC rules to be included in the annual proxy statement for the election of directors, contains all of the items specifically required by the SEC and is complete and correct in all material respects. As a reminder, the audit committee annually must at a minimum report on whether or not it:

- has reviewed and discussed the audited financial statements with management;
- has discussed with the company's independent auditor the matters required to be discussed by Statement of Auditing Standards No. 61 (relating to the quality of financial statements);
- has received from the auditor the written confirmation of independence and the disclosure delineating all relationships between the company and its related entities and the auditor and its related entities which the auditor in its professional judgment considers may reasonably be thought to bear on its independence, as required by generally accepted auditing standards, and has discussed with the auditor its independence from the company; and
- based on the review and discussions referred to above, the members of the audit committee recommended to the board of directors that the audited financial statements be included in the company's annual report on Form 10-K.

Although proxy statements sometimes include discussion of audit committee activities beyond the required minimum, either in the committee's report or elsewhere, counsel generally has advised limiting to those that are required any statements which might be considered to express conclusions about the company's financial reports in the hope of limiting the committee's liability exposure. Only those statements in the committee's report responsive to the required disclosures qualify for the liability safe-harbor provided by the SEC'S rules. In the current environment, even as audit committees may be undertaking additional oversight activities, they should be especially careful that their reports and any other statements regarding the committees activities made in proxy statements or annual reports are carefully worded so as not to indicate that the committee has undertaken activities or reached conclusions that it has not in fact addressed. In any description of committee activities, it is important to avoid "over-promising" and any suggestion that the committee's role involves more oversight of management in the preparation of the company's financial reports. Consultation with counsel on the report is recommended.

Independence of Audit Committee Members and of Outside Auditors

Companies are required to disclose in their proxy statements whether the members of their audit committee are "independent" as defined in the applicable listing standards and certain disclosures are required where a member who is not "independent" is appointed.[3] Companies are also required to disclose in their proxy statements whether the audit committee considered whether the provision of non-audit services by the auditor is compatible with maintaining the auditor's independence and certain information about the magnitude of the non-audit services provided by the auditor.

It borders on understatement to say that auditor independence has become a "hot button" issue and that non-audit services are a subject of special attention. This is a complicated area addressed by lengthy rules first adopted by the SEC last year. Some audit committees have adopted or are considering their own policies concerning non-audit services and other aspects of auditor independence, supplemental to the prescriptions of the new rules. Some institutional investors have recently developed policies concerning these matters that they are urging portfolio companies to comply with, and may call on companies to explain departures from these policies. In terms of upcoming activities, many audit committees, after considering last year's audit, turn to the auditor engagement for the current year and many companies present in their proxy statement their selection of auditors for shareholder approval at their annual meeting. In this regard, in many cases auditors will soon be making their required reports on their relationships with the company as referred to above, and audit committees will be having the discussions about auditor independence that will be referred to in the audit committee report. Management and audit committees should be considering what auditor independence policies and standards they wish to apply and how they will respond to shareholder inquiries on the matter.

Recent Financial Disclosure Issues of Which Audit Committees Must Be Aware

In the last few months, the SEC has released several important statements regarding financial disclosure requirements which, while not directed specifically at disclosure of audit committee activities, should be considered by audit committees as they review the company's financial statements and financial reporting policies. We discuss these recent SEC statements on financial disclosure obligations and standards further in a related issue of *The Corporate Charter* and we only highlight below their likely impact on audit committee activities.

Critical Accounting Policies

The SEC recently issued a statement regarding disclosure of critical accounting policies. This "cautionary advice" was issued to "remind management, auditors, audit committees and their advisors that the selection and application of the company's accounting policies must be appropriately reasoned." The SEC urges the inclusion in the MD&A of full explanations of those accounting policies which are "both most important to the portrayal of the company's financial condition and results and . . . require management's most difficult, subjective and complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain."

This recommended disclosure is intended to supplement what GAAP would require in audited financial statements on the grounds that "even a technically accurate application of. . . GAAP. . . may nonetheless fail to communicate important information if it is not accompanied by appropriate and clear analytic disclosures to facilitate . . . understanding of the company's financial status, and the possibility, likelihood and implication of changes in . . . financial and operating status."

The SEC specifically states that audit committees should, "[p]rior to finalizing and filing annual reports . . . review the selection, application and disclosure of critical accounting policies." In exercising informed oversight of the company's financial reporting—in particular in its required discussion with management and auditors about the quality of financial reporting—the audit committee will need to become familiar with these matters.

Enhanced MD&A Disclosures

The SEC recently also issued a statement regarding the disclosure which should be contained in the MD&A. It reminds public companies of the existing disclosure requirements centering on the MD&A and suggests steps that companies should consider in meeting those requirements. The SEC emphasized that management should discuss all known trends, commitments and uncertainties that are reasonably likely to occur (a lower standard than the "more likely than not" standard commonly used in other areas) and that affect materially the company's financial condition. In particular, the MD&A should address matters that are likely to affect the quality of earnings or likely to make the historical financial statements not indicative of future performance, with the goal of presenting the company's financial position "through the eyes of management. The SEC's statement focuses on the following areas: liquidity and capital resources, including off-balance sheet arrangements and contingent obligations; certain trading activities involving non-exchange traded contracts accounted for at fair value; and, transactions with related and certain other parties.

Although the SEC did not specifically address the role which an audit committee should play regarding the MD&A, it does suggest that audit committees include the highlighted matters in their discussions with management and auditors relating to the committee's recommendation of the audited annual financial statements for inclusion in the 10-K. Management generally should be bringing to the committee's attention how each of these matters of heightened concern impacts the company and is being addressed in the MD&A and the committee should become aware of the company's disclosure policies and practices concerning such matters.

With regard to audit committee review of these matters, it is notable that the SEC statement seeks disclosure in the MD&A—at the least in instances where the matter is material to the company's financial reports—of detailed financial information on some subjects (such as off-balance sheet obligations) which is not required in financial statements (including footnotes) prepared in accordance with GAAP and that may include information that is unaudited and has not been "expertized" by the company's independent auditors. Similarly the SEC urges disclosure about related party transactions—again, at the least in instances where the matter is material to the company's financial reports—that goes beyond that required by GAAP and the SEC's other current rules regarding disclosure of company transactions with management, directors and controlling shareholders. In particular, the SEC urges an explanation of the business purposes of such transactions in comparison to dealing with arm's-length parties and the basis for determining the prices and other terms involved in such transactions and their fairness to the company. Audit committees should consider carefully how their oversight of such matters relates to their role with respect to the company's audited financial statements. In addition, many audit committees under their charters have responsibility for oversight of related party transactions that is in addition to their oversight of the company's financial reports. (Where this is not the case, another committee or the full board may have oversight responsibility and consideration of its activities in such regard may be appropriate.)

"Audit committee members, however are not expected to become accounting experts and are entitled to reasonably rely on experts in providing oversight of the company's financial reports."

Reporting of "Pro Forma" Financial Information

Recently in connection with taking related enforcement action, the SEC issued a statement, regarding the use of "pro forma" financial information in earnings releases. (Presentation of "pro forma" financial statements is required by the SEC in certain business combination and other situations, but this statement deals with the voluntary presentation of financial measures that are not required by GAAP.) The SEC cautioned that, while pro forma financial information can be useful to focus investors' attention on critical components of a company's financial results, it can also mislead investors if it obscures GAAP results or is presented in a way that mischaracterizes the company's financial performance. If a company decides to provide pro forma financial information, it should ensure that clear explanations are provided of how such information differs from the results that are presented in its GAAP-based financial statements.

Audit committees, as part of their oversight of the company's financial reporting and consideration of the quality of its financial reports, should become familiar with the company's reasons for and manner of presenting pro forma financial information, including the benefits of such additional disclosures as compared to a GAAP presentation. Even though the information is not audited, they may want to seek advice from the company's auditors about the quality and completeness of reports containing such information.

Other Key Points for Audit Committees to Remember

Finally, several other key points for consideration by a well-functioning audit committee bear repeating in the current environment.

- Audit committee members must be financially literate, able to understand a company's critical accounting policies and the implications of important matters such as off-balance sheet arrangements for the company's financial reports. They should develop familiarity with the company's SEC filings and how important financial reporting matters are presented in them. As standards develop in financial reporting areas important to the company, audit committee members should increase and renew their financial literacy with regular briefings from qualified accountants.
- Unusual and complex transactions require special attention and should be identified and pursued as part of each year's review.
- Audit committees must review the audit processes used to identify and evaluate the company's financial risks and come to understand the specific risks and issues including business risks pertinent to the company.
- Audit committees must reinforce and set a good "tone at the top" regarding the importance of adequate disclosure the quality of financial reporting and where the audit committee has oversight of the matter, compliance with codes of con duct, all in ways which trickle down through every level of a company.

Audit committee members, however are not expected to become accounting experts and are entitled to reasonably rely on experts in providing oversight of the company's financial reports. Accordingly committee members should not hesitate to seek advice and analysis from the company's in-house experts, independent auditor and counsel where needed in carrying out their oversight role.

As SEC Chairman Harvey Pitt stated in a recent op-ed piece in *The Wall Street Journal*, "audit committees must be proactive, not merely reactive, to ensure the quality and integrity of corporate financial reports. Especially critical is the need to improve interaction between audit committee members and senior management and outside auditors. Audit committees must understand why critical accounting principles were chosen, how they were applied, and have a basis for believing the end result fairly presents the company's actual status."

The recent, well-publicized accounting and disclosure failures have shaken investor confidence in the U.S. system of financial reporting and disclosure, with potentially important implications for the functioning of the capital markets. With so much at stake, public attention is focusing on the adequacy of our financial reporting requirements, the responsibilities of managements, independent auditors and company counsel and, also, on the audit committee's oversight role. Audit committees undertake significant responsibilities and are rightly seen as playing a key role in the financial reporting process. In this environment, increased diligence on the part of audit committee members is warranted and greater demands on the time and attention of audit committees should be anticipated.

Endnotes

1. In 1999, the New York Stock Exchange, Nasdaq and the American Stock Exchange promulgated listing standards regarding the composition and functions of audit committees (including charter requirements), the American Institute of Certified Public Accountants established certain auditing standards pertaining to communications between auditors and audit committees and the U.S. Securities and Exchange Commission promulgated disclosure requirements regarding audit committees, including disclosures relating to the new listing and auditing standards.
2. A copy of the audit committee's current charter must be appended to the annual proxy statement, unless this wad done within the past three fiscal years.
3. If the board has determined that it is in the best interests of the company and its shareholders to allow a non-"independent" director to serve on the audit committee, the company must disclose in the next proxy statement for the election of directors after such determination the nature of the relationship that makes the individual not independent and the reasons for the board's determination.

Gerald S. Backman, P.C. is a senior partner in the Corporate Department at Weil, Gotshal & Manges LLP and is a recognized expert in the Federal securities laws. His practice centers on transactions in the capital markets, both domestic and international. Mr. Backman's experience also includes corporate governance, complex mergers and acquisitions and the representation of international clients in a wide variety of transactions.

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New York Becomes the First State to Adopt New Franchise Registration Exemption

By William J. Estes and Max Pastor

New York has become the first franchise "registration state"[1] to adopt the North American Securities Administrators Association's (NASAA)[2] "Policy Regarding Franchise Advertising on the Internet."[3] The new exemption is found in Section 200.12 of the New York Franchise Regulations (the "Regulations")[4] and it exempts franchise sales offers made over the Internet from filing with the Office of the Attorney General (OAG). The exemption will provide a safe harbor to franchisors seeking to comply with Section 683 (11-12, & 15) of the New York Franchise Act (the "Act")[5] and Section 200.9 of the Regulations which mandate that franchise sales literature be filed with the OAG.

Section 200.9 of the Regulations requires that any communication intended for distribution to prospective franchisees be filed with the OAG at least seven days prior to distribution. This sales literature may not contain statements inconsistent with the franchisor's prospectus and must contain the following 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."[6] The OAG may reject advertisements that violate the Act.

In order to qualify for the new Internet exemption, a franchisor must disclose in its Uniform Franchise Offering Circular (UFOC), the Uniform Resource Locators (URLs) of the Internet site where the franchisor's offer to sell franchises is located. The exemption applies as long as the offer to sell franchises is not directed to any specific person in New York.

The Franchise and Business Opportunity Project Group of NASAA proposed the Statement of Policy, upon which New York's exemption is based, on the recommendation of members of the franchise bar—who communicated uncertainty as to whether they needed to file advertisements with state regulators for offers of franchises made over the Internet. Franchise practitioners expressed confusion as to whether advertisements to sell franchises over the Internet fell within an exemption found in many states—which exempts from filing advertisements in publications whose circulations are two-thirds or more outside the jurisdiction.[7] Consequently, some franchisors felt obligated to file their advertisements, while others felt they were covered by the exemption.

NASAA intended this policy statement to complement NASAA's 1998 Statement of Policy Regarding Offers and Sales of Franchises on the Internet, which was adopted by New York as an exemption in Section 200.13. According to Section 200.13, offers to sell a franchise over the Internet that are not intended for residents of New York are exempt from registration.

New York Adopts an Additional Exemption: The Fractional Franchise

The OAG also adopted the "fractional franchise" exemption used by the Federal Trade Commission (FTC), as well as other registration states.[8] Franchisors qualifying for the exemption include those who add a new product line or service to the existing business of a franchisee, and who "[f]or at least the last 24 months . . . has been engaged in a business offering products or services substantially similar or related to those to be offered by the franchised business."[9] The franchised business must be "substantially similar or related to the product or service being offered by the prospective franchisee's existing business"[10] and cannot "represent more than 20 percent of the total sales volume of the franchisee on an annual basis."[11]

The FTC originally adopted the fractional exemption under the belief that an individual who invests in a franchise, after having operated a similar business for two years, is familiar with the monetary realities and potential problems of the franchised business or service. A franchisee who is experienced in the franchised business will be less likely to be misled through a franchisor's incomplete or inaccurate pre-sale disclosure.[12] The experienced franchisee is considered more aware of the risks of investing in a franchise, and will rely less on the knowledge of the franchisor to run the business.

In the past, franchisors have been granted fractional-franchise type exemptions by the OAG when they have set forth the nature of the business to be franchised and requested a "no action letter." Franchisors qualifying for the fractional franchise exemption need to file a "sale to an existing franchisee" form and pay $150, the statutorily required amount for an amendment.[13]

New York Adopts a New Definition: Marketing Plan

The previously undefined term "marketing plan," as used in Section 681 of the Act, presently enjoys a widely accepted definition adopted by several other jurisdictions. The Regulations now label a "marketing plan" as "advice or training, provided to the franchisee by the franchisor, or a person recommended by the franchisor, pertaining to the sale of any product, equipment supplies or services and the advice or training includes, but is not limited to, preparing or providing (1) promotional literature, brochures, pamphlets, or advertising materials, (2) training regarding the promotion, operation or management of the franchise, (3) operational, managerial, technical or financial guidelines or assistance."[14]

New York Adopts Standardized Forms and Cover Page

In a significant step toward establishing greater uniformity among the other registration states, New York decided to replace its own specific registration forms with the uniform registration forms found in the UFOC. New York-specific forms, such as the Franchise Sales Agent Statement and the Supplemental Franchise Sales Agent Statement, have been completely eliminated. New York, like other registration states, has adopted the Sales Agent Disclosure Form (UFRA-E)[15] which requires franchisors to disclose salespersons working directly for the franchisor or individuals acting as brokers for the franchisor.

New York's newly adopted uniform forms include: Form A: Uniform Franchise Registration Application (UFRA-A); Form B: Supplemental Information (UFRA-B); Form C: Certification (UFRA-C); Form D: Uniform Consent to Service of Process (UFRA-D); Form E: Sales Agent Disclosure Form (UFRA-E); and Form F: Guarantee of Performance (UFRA-F).

Copies of the UFOC forms, as well as the newly promulgated New York Regulations and filing instructions, can be found near the bottom of the home page of the Attorney General's Web site,[16] under the heading "Ensuring the Integrity of Public Institutions," by clicking on the link "Franchise and Business Opportunities."[17] The Web site also features the Act, the FTC Franchise Rule, a booklet written by the OAG for franchisees entitled "What to Consider When Buying a Franchise," and a comprehensive list of links to other franchise-related Web sites.

Franchise practitioners nationwide will find their filings most affected by the eradication of a distinct New York requirement on offering circulars. Previously, New York was the only state to require a bold-faced legend informing franchisees that franchisors could negotiate the stated terms of the franchise, as they appeared in the prospectus, only if the negotiated terms were more favorable to the franchisee than the terms in the prospectus.

The current revision to the Regulations reflects the OAG's commitment to promulgate a disclosure policy that will afford the highest protection to franchisees while minimizing and easing franchisor registration requirements. The OAG staff stands ready to assist the public with any questions regarding franchise registration. Please direct all registration questions to the OAG's Principal Franchise Accountant, Barbara Lasoff at (212) 416-8326, or to Associate Franchise Accountant Judith Welsh at (212) 416-8233.

Endnotes

1. The states which statutorily require pre-sale disclosure to potential franchisees through the filing of a prospectus with state regulators include: California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington and Wisconsin.
2. NASAA promotes efficient capital formation and investor protection through its membership of state securities regulators in the United States. The NASAA Franchise and Business Opportunity Project Group, working closely with the Federal Trade Commission, creates model legislation and sets regulatory standards which are adopted by the separate states with franchise laws.
3. For the proposed (and later adopted) policy, see NASAA Library: Statements of Policy: Adopted: Statement of Policy Regarding Franchise Advertising on the Internet, *available at* http://www.nasaa.org/nasaa/scripts/fu_display_list.asp?ptid=72 (noting that the policy was adopted on September 9, 2001).
4. N.Y. Comp. Codes. R. & Regs. tit. 13, § 200.12 (2002) (hereinafter "N.Y.C.R.R."). Section 684 of the Act empowers the OAG to promulgate regulations that are necessary in carrying out the mandates of the Act.
5. N.Y. Gen. Bus. Law § 680, et seq (McKinney 1996) (hereinafter "GBL").
6. 13 N.Y.C.R.R. § 200.9(d).
7. In New York, this is found in GBL § 681(12)(c).
8. The other states offering a fractional franchise exemption include: California, Illinois, Indiana, Michigan, Minnesota, and Virginia.
9. 13 N.Y.C.R.R. § 200.10(2)(a).
10. *Id.* § 200.10(2)(b).
11. *Id.* § 200.10(2)(d).
12. *See* Statement of Basis and Purpose, Interpretive Guides, 16 C.F.R. § 436.2(h) n.5 at d. exemptions, Bus. Franchise Guide (CCH) ¶6350.
13. GBL § 694.
14. 13 N.Y.C.R.R. § 200.1(b)(1)-(3).
15. *See id.* § 200.3(a)(4).
16. *See* Office of New York State Attorney General Eliot Spitzer, *available at* www.oag.state.ny.us.
17. While New York does not have a separate business opportunity law, the broad sweep of New York's Franchise Act requires that many companies that fall under the business opportunity laws of other states register as franchises in New York.

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Being Prepared for Crisis May Stem Damage

By Paul A. Ferrillo and Lanny J. Davis

For many companies, the biggest crisis they might face is the retirement of a popular chief executive, or loss of a major contract due to the bankruptcy or downturn in fortunes of a major client. For others, principally technology companies, the downturn in the economy and/or the recent changes in revenue recognition principles, has created its own, and perhaps multiple, set of individual crises, including perhaps the need to restate the company's earnings for one or more quarters or years. Recent events remind us that even the most unanticipated of events can potentially disrupt or destroy a once vital business.

"Though a great deal has been written about effective crisis management, too often companies and their management fail to practice what is preached to them."

Though potentially and understandably irrelevant to some New Yorkers at the moment, we are always told that, "Life must go on." And how life goes on with respect to any of the above examples is truly a function of how the senior management of any organization and its advisers identify and deal with the crisis internally, and the communications they make to the public, press, regulators, bankers and investors externally. Properly managing a corporate crisis can help mitigate a financial loss and can generally allow a company to regain its business momentum, and, in many cases, its investor momentum much sooner than a corporation that mismanages what is potentially one of the defining moments in its existence. For example, in the case of a negative material event, a swift, strategic response can often mitigate the event's impact on its stock price, helping to avoid a potential lawsuit against management, or to potentially reduce the damages if such a suit does get filed.

Though a great deal has been written about effective crisis management, too often companies and their management fail to practice what is preached to them. This article will summarize certain guiding principles of effective crisis management.

Throughout the article, we will use the following hypothetical example. A president of High-Techinc.com, a publicly held, Nasdaq-listed company has just learned through his deputy controller, during the company's annual audit process and just prior to the filing of the company's 10K, that his company has apparently improperly (and perhaps fraudulently) accounted for certain computer hardware orders that were shipped to customers during the past year. The deputy controller discovered the problem by evaluating inventory levels at the company's multi-state product distribution centers. The computer hardware was returned on the basis of recently discovered side-letters between company salesmen and clients of the company. The President does not know the extent of the involvement of others within the company's accounting department, whether this problem is an isolated incident, or whether it goes back to previous years. The President does know, however, that he needs audited financial statements in order to co-exist with the company's lenders and Nasdaq.

Teamwork and Planning

The most important word in crisis management is integration and the most difficult challenge is accomplishing it.

Earlier this year, during the United Kingdom's first Business Continuity Awareness Week, a survey was conducted by the British Institute of Management of businesses that were affected in 2000 by Britain's fuel crisis and poor autumn weather. Over 93 percent of the managers surveyed admitted their businesses had been disrupted by the September 2000 fuel crisis, with 66 percent highlighting disruption from rail problems, and 64 percent from the autumn flooding. However, only 45 percent of the managers took steps thereafter to prepare their companies for the event of a future crisis of similar magnitude. Several years ago, a survey of the nation's chief executive officers of the Fortune 500 revealed that though 89 percent of those surveyed believed that "a crisis in business today is as inevitable as death and taxes," 50 percent admitted that they have not prepared a crisis management plan.[1] More shockingly, of those companies that had reported having a corporate crisis in the past, 42 percent of the respondents indicated that they still did not have a plan to deal with a future crisis.[2]

Like the chaotic struggle to find a working flashlight when a fuse blows in your house, the first step in any crisis is to build the integrated, coherent infrastructure ahead of time: a team comprising the CEO and usually the CFO, lawyers, business and marketing executives, investor relations experts, public relations and media consultants, and sometimes the independent auditors (unless they are part of the problem, rather than the solution).

By integration, we mean assembling a team of lawyers and nonlawyers and finding a way to get them to work together, rather than at cross-purposes. Lawyers are trained in law school that cases are decided in the courts, not in the court of public opinion; and that too often loose talk in the press can concede issues and even give up the case entirely. Public relations and investor relations experts know, from experience and common sense, that just the opposite is needed to salvage the company's reputation or at least minimize the damage from an embarrassing, high-profile scandal or outbreak of bad business news. A balance of both schools of thought will likely produce the best results.

In most cases, the company's CEO and/or CFO are well suited to be the "public face" of the company during the crisis. In other instances, the company's head of communications or head of investor relations are appropriate members of the crisis management team, given the need to effectively communicate with analysts and investors. A media or public relations firm might or might not be consulted. Contingencies should exist though, because in the above hypothetical, the company's CFO, if implicated in the alleged improper accounting, might not be the best company spokesperson.

In addition, given our above hypothetical, the company's general counsel or chief legal officer, along with the company's outside general counsel, are probably necessary team members given the potential for not only civil lawsuits to be commenced, but also for potentially related Securities and Exchange Commission (SEC) and criminal investigations.

An immediate challenge is taking steps to assure that legal privileges attorney-client communications as well as written work product generated in anticipation of or during litigation are privileged, and that nothing unintended is done that might result in a waiver of these privileges.

It used to be assumed that a lawyer or company retaining a public relations firm to assist on such matters would come under the penumbra of such legal privileges. However, two cases decided in the Southern District of New York within five months—*Calvin Klein Trademark (CTI) Trust v. Wachner*,[3] and *In re. Copper Market Antitrust Litigation v. Sumitomo Corporation*,[4]—suggests that privileges can be waived when confidential information is shared with an outside public relations firm or any other third party nonlawyer. *CTI* held that the attorney client privilege is always waived if a PR firm has access to otherwise privileged information. But the court in *Copper Market* found that the company retains such a privilege if the company hires the public relations firm (finding that, in such a case, the PR firm is the functional equivalent of an employee or agent of the company). Both cases raise the possibility of written documents retaining the work product privilege, but only if the parties establish a nexus between the work of the PR firm and legal issues that need to be addressed in anticipation of or during litigation. And that nexus between "spin" and the requirements of the anticipated or current litigation is not easy to establish, at least for the judge presiding in the *CTI* case.

Planning

As noted above, crisis management planning is also important and probably the most inexpensive part of crisis management.[5] Planning entails the crisis management team members first discussing the various crises that could affect the company and its operations. These could include:

- Environmental problems;
- Product recalls;
- Government regulatory problems;
- Union problems/strikes;
- Industry/economic downturns, loss of key customers or clients;
- Accounting problems.

Next, each member of the crisis management team should discuss his or her role in managing the crisis. Who are the investigators/doers of the group? Who are the decision-makers? Who will manage information distribution to the media? To the shareholders? How can the legal liabilities of each situation best be managed?

If a company's problems could be environmental ones, where is each company plant located, and where are the closest environmental engineers/emergency environmental response crews to each plant (and who has their phone numbers?). Who in local, state or federal government should be notified as quickly as possible after the company identifies the full import of the environmental problem, and what are their phone numbers? And finally, who is in charge of informing the media, and, most importantly, the public, of the nature of the problem? In sum, where are the flashlights kept, who keeps the spare batteries just in case, and where is the nearest Home Depot just in case. These are the types of questions that should be asked in the planning process.

The best part of planning is that if done before the crisis occurs, the crisis management team members will have thought about, and hopefully developed a plan to minimize the effects of the crisis, and get the company back to "normal" as soon as possible. In his well-received book on crisis management, author Stephen Fink notes, "The median length of the acute crises reported [in the Fortune 500 survey] was 8.5 weeks; a statistically shorter duration was reported by those companies that had a plan in place at the time of the crisis."[6]

Crisis Identification

Though some crises may start quietly and escalate over a period of days, weeks or months, most begin with a defining event (i.e. "Houston, we have a problem") and need to be managed effectively from moment one.

With respect to our hypothetical, given the timing of when the President of High-Techinc.com learned of a potential accounting problem, and the ultimate need for audited financial statements, time is of the essence. An immediate investigation is necessary to find out what happened.

> *"The best part of planning is that if done before the crisis occurs, the crisis management team members will have thought about, and hopefully developed a plan to minimize the effects of the crisis, and get the company back to 'normal' as soon as possible."*

Is it advisable for the General Counsel to attempt to undertake this investigation himself? Probably not. Accounting investigations can be incredibly complex and time-consuming, and so it is advisable that legal counsel well-schooled in accounting fraud investigations be retained by the Audit Committee to perform this task. If such counsel also has experience in dealing with the SEC on accounting related issues, so much the better. Furthermore, it is sometimes advisable that forensic accountants be hired to conduct the investigation as well.

In this early investigation stage, it is critically necessary that both the General Counsel and outside counsel for the Audit Committee institute an immediate process to secure all necessary documents, including electronic files, data tapes and laptops. This would include not only home office documents, but branch office and manufacturing facility documents as well. If it turns out in our hypothetical that indeed revenues from the computer hardware sales were inflated fraudulently, there exists an extreme potential for documents and information to be destroyed.

Depending upon the findings of the investigation done by audit committee counsel, conflict issues may also spring up. Counsel for the audit committee represents the audit committee, and that fact should be made clear to all those interviewed. If it becomes apparent that one or more insiders had knowledge of the accounting problems, then separate counsel must be considered.

Privilege and Disclosure

Two or three days after the President of High-Techinc.com first learns of the accounting issues his company potentially faces, certain other issues will spring up that will need to be dealt with. If the internal investigation performed by audit committee counsel reveals that internal company personnel (including perhaps members of senior management) are involved in the potential fraud, one immediate consideration is how to manage such employees. Should they be terminated, or at the least, put on leave so that the investigation can be concluded in the most expeditious fashion possible? There are no easy calls here, and decisions will need to be made on a case-by-case basis.

Another critical issue will deal with the investigatory paper trail that will inevitably be accumulated as audit committee counsel completes its investigation. The documents may point fingers. The documents may provide a roadmap as to how the fraud transpired.

Are the documents counsel obtains privileged? Maybe, but not always. What happens when the SEC, upon an announcement that High-Techinc.com will need to restate its earnings, also wants a copy of the investigatory documents, or any report that audit committee counsel may prepare for the full audit committee? Must the company documents be turned over forthwith? And if documents are turned over to the SEC pursuant to an informal information request, must they also be turned over to the plaintiffs' class action counsel because the attorney-work product privilege was waived by the SEC production?

There are potential answers to some of the above questions. Other questions do not have easy solutions. First, should the company comply with a document or information request from the SEC? Of course. It would be difficult to think of a reason not to give full and complete cooperation to the SEC. Getting competent counsel with both accounting fraud and SEC-related experience here is the key in order to get critical advice as to how to proceed when the SEC knocks on your door.

But does this document or information production waive any privilege associated with the documents? Again, there are no easy answers, but the answer is probably. There is some argument that early in any accounting fraud investigation both the SEC and the company have the same general interest, i.e. discovering what happened, and correcting the problem by whatever means necessary so that the investing public can rely upon the company's financial statements. Thus, counsel could seek some sort of cooperation agreement with the SEC to preserve the privilege for as long as possible. It may be very hard to get, but this type of agreement with the SEC is worth exploring at least initially.

Finally, one of the top priorities is the need to inform the public that High-techinc.com has accounting "problems" and is presently dealing with them. And there is a true need to do so. If the financial statements of High-Techinc.com are truly false, then every day that goes by without a public announcement will cause damages in the inevitable securities class action to mount.

We leave our language here vague, because there will need to be many judgment calls as to when to go public, and what to say. The investigation company's investigation might reveal that the accounting issues that High-Techinc.com is facing are due to "errors" made by the accounting department in recording revenue associated with the hardware sales. On the other hand, if there are truly side-letters associated with the hardware returns, then "accounting irregularities" may have occurred.

The former is a situation that would result in a restatement of High-techinc.com's financial statements, but hopefully not much else in terms of painful consequences. Given the propensities of the plaintiffs' class action bar, whether a lawsuit gets ultimately filed in this instance is, at the least, a probability.

The later situation would probably result in far direr consequences, including an accounting restatement, and governmental investigation, and, most likely shareholder lawsuits. Thus, despite the need for speed in terms of getting the news out to the investing public, information at this stage, when the picture of the problem becomes clearer, must be managed truthfully, candidly and carefully.

Conclusion

For any given situation, there is no universal playbook to guide the company through any given crisis. But having a crisis management team and plan in place will go a long way to help a company through a potential crisis. In truth, there is no way to fully prepare for the crisis. But there is a way to know what the rules are and to accept the fact that, in the final analysis, the truth may hurt, but the delay in getting the truth out will likely hurt and cost more.

Endnotes

1. Steven Fink, Crisis Management: Planning for the Inevitable, 67 (2000).
2. *Id.*
3. 198 F.R.D. 53 (S.D.N.Y. 2000).
4. 200 F.R.D. 213 (S.D.N.Y. 2001).
5. When assembling your crisis management team, there will be some costs associated with the use of outside media and legal team members. These costs are, in sum, nearly irrelevant when the company's existence is at stake, and have the potential to mount exponentially during the acute phase of a crisis. However, it is important to note that these costs could themselves be planned for and/or mitigated through the purchase of a crisis management insurance policy, which can sometimes be obtained as an adjunct to a company's director and officers' insurance policy.
6. Fink *supra* note 1, at 69.

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Update on E-Commerce—Jurisdiction

By Micalyn S. Harris

I. Introduction

The Internet makes it possible for almost anyone to set up an international business by setting up a Web site and using it as a base of operation that is accessible to customers everywhere in the world. Establishing a Web site is relatively inexpensive and, once a business establishes a Web site, that business can be operated from a desktop, or even an appropriately equipped laptop computer. Thus, e-commerce, that is, doing business from—and through—a Web site on the Internet, significantly lowers financial barriers to establishing and operating a global business.

Other barriers however, remain: among them, the concern that establishing a Web site will subject a business organization to the laws and courts of jurisdictions outside of the location of the operating company's or individual's place of operation. The implications of such broadening of a company's "doing business" location raises questions regarding what obligations may be owed under a variety of state and local laws, including tax laws, and what obligations regarding protection of the privacy are owed to Web site visitors' information, obtained in connection with both visits and transactions (see related article, "Update on E-Commerce—Privacy"). Discussion of these consequences is beyond the scope of this article, which focuses on personal jurisdiction over Internet businesses.

II. Subject Matter Jurisdiction

The basis for jurisdiction may be either subject matter or personal. Subject matter jurisdiction refers to the competence of a particular court to hear a particular issue. Because Web pages are protected by copyright—and transmission of intellectual property subject to copyrights is often involved in e-commerce—one likely area of subject matter jurisdiction involving e-commerce is illegal distribution of copyrighted materials. Such distribution constitutes infringement, giving U.S. federal courts potential subject matter jurisdiction.

U.S. federal courts have exclusive jurisdiction of infringement and other claims involving violation of the U.S. Copyright Act, but there are limits on their jurisdiction. If a U.S. court determines that infringement claims are invalid under U.S. law and only foreign litigants are involved, the U.S. court may decline jurisdiction. For example, in *Bridgeman Art Library, Ltd. v. Corel Corp.*,[1] once the court found that the infringement claims were invalid under U.S. law, leaving the foreign copyright claims as the only claims involved, and both litigants were foreign so there was no diversity jurisdiction, beyond the finding of invalidity under U.S. law, the court declined jurisdiction.

Personal jurisdiction, that is, whether the defendant can be brought into the court that claims to have subject matter jurisdiction, is the jurisdictional issue most likely to be involved in disputes involving cyberspace transactions.

III. Personal Jurisdiction

A. General

Personal jurisdiction can be either general or special. General jurisdiction subjects a party to the jurisdiction of a particular court regardless of subject matter. Special jurisdiction permits a court to exercise jurisdiction only over parties when that court's authority is foreseeable. For example, a corporation can generally be sued in the state of its incorporation regardless of the subject matter of the dispute. Both general and special jurisdiction require a showing of minimum contacts.

Mere presence on the Internet is generally not sufficient to create *general* personal jurisdiction in every place from which the operator's Web site can be accessed. Moreover, such presence may or may not be sufficient to create *special* jurisdiction relating to the content of the Internet activity that arises out of Web site access from within a state.

General or special jurisdiction may be conferred by contract. Where parties contractually agree to the jurisdiction of a particular court, their contractual choice of forum is generally enforced by U.S. and European courts provided the choice is "not unreasonable," which usually means there must be some commercial rationale for the choice of forum.[2] The choice also must be "not unfair," meaning it may not have the practical effect of depriving the plaintiff of a remedy.[3] In the U.S. at least, an argument that a breach of contract by one party vitiates the contractual choice of forum clause has not been persuasive. Courts generally will enforce a choice of forum clause even where the non-breaching party would prefer a different forum.[4]

Enforcement of a contractual choice of forum does, however, require an enforceable contract. *Specht v. Netscape Communications, Inc.*[5] is instructive. In *Specht*, Netscape made available several software applications from its Web site. Some required customers to pay for the right to use them. Before making these applications available to customers, Netscape required its customers to click through a license agreement and indicate assent to its terms. At least one application, "SmartDownload," could be downloaded without charge and customers were not required to click through—or agree to—any license agreement prior to receiving access to the application. The Web site displayed a button labeled "Please

Review," and behind that button was a license agreement, but the button was not visible on the first screen presented, and immediate downloading from that screen was possible.

Netscape sought to enforce the provisions of the license agreement behind the "Please Review" button—in particular, a provision requiring arbitration of disputes—on the grounds that downloading the software constituted assent to the license agreement. Netscape was unsuccessful because the court found that there was no contract. The court pointed out that Netscape had demonstrated its ability to advise its customers that certain applications were subject to the terms and conditions of a license agreement and to require its customers to assent to those terms and conditions prior to permitting the customer to obtain access to a software application. The court appeared to assume that the terms of such a consented-to license agreement would, subject to usual contract limitations, be enforceable. The court distinguished the situation at issue in *Specht*, because, in that case, it was possible to access the SmartDownload application without agreeing to the terms of a license agreement, or even being aware that one might be involved. The court concluded that, in the absence of requiring assent to the terms and conditions of a license agreement prior to granting access to computer information (in this case, a software application), there was no contract.

Based on the result in this case, it appears that if a Web site operator wants to conduct e-commerce pursuant to a contractual agreement entered into online, it is important to be sure that the Web site arrangement clearly *requires* customers to click through—and indicate assent to—any contractual terms and conditions on which the Web site operator wishes to rely *prior* to permitting customers to enter into the transaction the contract is intended to govern.

B. Special Jurisdiction: What Constitutes Minimum Contacts?

The scope of jurisdiction most likely to be of concern to clients considering establishing a Web-based business is the scope of expanded special jurisdiction, that is, whether and to what extent the courts of a state other than the state in which the Web site operator is incorporated or has its principal office, assert jurisdiction merely because the residents of that state (or country) can access the operator's Web site from outside its home state to obtain goods, services or access to computer information. Under U.S. law, due process requires a defendant to have at least "minimum contacts" within a state in order to be subject to the jurisdiction of its state courts and long arm or some other statutory means of service of process. It is worth noting that state long arm statutes are usually sufficient to obtain service of process when an opposing party is in the United States, but effective service on foreign entities doing business only from non-U.S. based Web sites can be a challenge. In those cases, it may be necessary to comply with international treaties or local (foreign) laws governing service of process.

". . . if a Web site operator wants to conduct e-commerce pursuant to a contractual agreement entered into online, it is important to be sure that the Web site arrangement clearly requires *customers to click through—and indicate assent to—any contractual terms and conditions on which the Web site operator wishes to rely* prior *to permitting customers to enter into the transaction the contract is intended to govern."*

While the specifics of state long arm statutes are usually set forth in easily accessed state statutes and are therefore fairly easy to review, state standards regarding the activities that constitute "minimum contacts" within a state in order to be subject to the jurisdiction of its state courts differ. Therefore, asserting the existence or absence of minimum contacts will require research into a particular state's standards. In most states, mere advertising, a so-called passive Web site, is usually insufficient to permit out-of-state plaintiffs to assert special jurisdiction.[6] Something more in the way of activity within the state is required to support minimum contacts.

Courts have accepted several theories for what "more" is required. Theories include: 1) the purposeful availment test, 2) the effects test, and 3) targeting. New York has accepted the "purposeful availment test." Thus, in New York, conduct that involves a foreign entity "purposefully availing itself of the benefits and protection" of New York's laws has been deemed sufficient to support special jurisdiction. For example, in *National Football League v. Miller*,[7] the court found Web site advertising where there was a reasonable expectation of an impact in New York and substantial revenue from national and international sales was sufficient to confer jurisdiction of New York courts.

New York has also accepted the "effects" test, on the rationale that New York courts will assert jurisdiction when wrongful conduct results in harm that occurs in New York. For example, in *American Network Inc. v. Access America/Connect Atlanta, Inc.*,[8] a Georgia Internet service provider was held subject to personal jurisdiction in New York when a New York ISP sued in New York for trademark infringement of the trademark "American.Net" by the Georgia ISP. The Georgia ISP used the infringing mark on its home page, six New York subscribers signed up, and the Georgia ISP was aware of the New York provider's mark and location. Given those facts, the court accepted plaintiff's rationale that the alleged infringement caused injury in New York.

The D.C. Circuit has used a "targeting" theory under similar circumstances to find jurisdiction. In *Blumenthal v. Drudge*,[9] a D.C. court held that an informational Web site that targets customers in other states and enables them to e-mail requests for subscriptions, has sufficient minimum contacts in D.C. to support special jurisdiction.

Courts are likely to stretch to find jurisdiction where behavior is wrongful or causes injury, as the Virginia court did in *Telco Communications v. An Apple a Day*.[10] In that case, the defendant, a non-resident telemarketer, posted on its Web site (operated from outside Virginia) defamatory press releases about a Virginia resident. The Virginia court found sufficient minimum contacts to support special jurisdiction.

As these cases illustrate, the distinction between active and passive Web sites can be fuzzy and can lead to inconsistency. For example, in *Mink v. AAAA Development, LLC*[11] the defendant company maintained a Web site which provided information about its products and services, provided users with a printable mail-in order form and mailing address, provided a toll-free number, and provided an e-mail address, but did not take orders through its Web site. The court concluded that the site was a passive Web site and therefore grounds for the exercise of personal jurisdiction over the Web site operator were absent. The emphasis on the inability to take orders through the Web site may not, however, be as key as the court's opinion may be read to indicate, as mere capability to engage in ordering via a Web site has not invariably resulted in a finding of jurisdiction. In *Millennium Enterprises, Inc. v. Millennium Music*,[12] the district court of Oregon found there was no jurisdiction over a retail music site that did permit orders to be placed through the Web site where there was no showing of routine sales into Oregon and the only sale in Oregon was shown to be by a person who made the purchase at the instigation of plaintiff.

In the absence of clear case law, the guiding principles used to determine whether a company is "doing business" in a particular state so as to be required to qualify to do business in the state and subject it to state franchise taxes may be a good guide as to when that state will find sufficient minimum contacts to support the jurisdiction of its courts. Note, however, that the standard remains flexible and that in the event of wrongdoing, a court is likely to stretch to find minimum contacts if a resident of its state has been injured.

IV. Conclusion

From the above, it appears possible to design a Web site and ordering procedure with a view to minimizing exposure to lawsuits outside of the Web site operator's home state. If, however, the operator wants to establish a Web-based business to conduct national or international business so as to maximize the cost advantages of conducting Web-based business operations, it is likely that the business will be exposed to the laws and the courts of foreign jurisdictions.

Despite the risks of expanded exposure to the laws and courts of foreign jurisdictions, the benefits of developing a Web-based business, including marketing advantages and improved efficiency of operations, can be considerable. A well-planned Web site will enable the Web-based business operator to minimize risks and maximize benefits, and thus enjoy expanded sales, decreased costs of operations, and ultimately, improved profitability.

Endnotes

1. 25 F. Supp. 2d 421 (S.D.N.Y. 1998).
2. *See Carnival Cruise Lines, Inc. v. Shute*, 499 U.S. 585 (1991).
3. *See* Restatement (Second) of Conflicts of Law, § 80 (1971 & 1988 Rev. Main Vol. Pkt. Pt).
4. *See Texas Source Group Inc. v. CCH, Inc*., 967 F. Supp. 234 (S.D. Texas 1997). In this case, the court enforced a choice of forum clause in a software contract on the grounds that the clause was prima facie enforceable unless enforcement was unreasonable. *Id.* at 239.
5. 150 F. Supp. 2d 585 (S.D.N.Y. 2001).
6. *See, e.g., Bensusan Rest. Corp. v. King*, 937 F.Supp. 295 (S.D.N.Y. 1996), *aff'd* 126 F.3d 25 (2d Cir. 1997); *see also, Zippo Mfg. Co. v. Zippo Dot Com, Inc.*, 952 F.Supp. 1119, 1122-23 (W.D. Pa. 1997).
7. 54 U.S.P.Q. 2d 1574, 2000 WL 335566 (S.D.N.Y. 2000).
8. 975 F. Supp. 494 (S.D.N.Y. 1997).
9. 992 F. Supp. 44 (D.D.C. 1998).
10. 977 F. Supp. 404 (E.D. Va. 1997).
11. 190 F.3d 333 (5th Cir. 1999).
12. 33 F. Supp. 2d 907 (D. Or. 1999).

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Update on E-Commerce—Privacy

By Micalyn S. Harris

I. Introduction

The Internet has made e-commerce—doing business from and through a Web site—a reality. The ability to reach more customers and service more orders at manageable costs has broadened opportunities for large and small businesses alike. Taking and filing orders via a Web site involves requesting, receiving, verifying and maintaining a considerable amount of data, including information such as name, address, telephone number, credit card number, and possibly other information customers regard as personal in nature.

While e-commerce is growing, customers continue to express concerns about disclosing such information in order to enjoy the benefits of Web-based shopping. Merchants, in turn, are increasingly aware that, in order to enjoy the benefits of Web-based shopping and ordering, they must deal with questions regarding what privacy obligations may be owed to Web site visitors regarding protection of the privacy of Web site visitors' information obtained in connection with both visits and transactions.

Web site businesses will be subject to all of the laws and standards to which the business would be subject if it were a "bricks and mortar" business. Web-based businesses, whatever their focus, will also share many of the challenges unique to conducting business over the Web. These include identification and verification of individual customers and orders, and, where appropriate, imposition of terms and conditions of sale, lease or license to assure limitations on use and limitations of liability. In addition, certain kinds of Web-based businesses may find it necessary or desirable to take special precautions. For example, broker-dealers offering online trading routinely take precautions to assure that persons entering into securities transactions are "qualified" under applicable U.S. and foreign laws to make the purchases and sales of securities which they seek to make online. Similarly, Web sites offering "adult" fare may want to take steps to assure that "inappropriate" visitors are not granted access to the site and that the business otherwise complies with the Children's Online Privacy Protection Act[1] if and where applicable.

The following discussion is intended as a starting point, focusing on some of the practical issues involving privacy obligations of Web-based business operators (i) as they look outward in their relations with customers and clients, (ii) as they look outward in responding to third parties seeking possibly private information about their customers and clients, and (iii) as they look inward, dealing with privacy expectations of employees within the organization's physical and virtual workplace.

II. Relations with Clients and Customers: How Much Privacy Must a Web Site Business Operator Provide?

Determining how much privacy a Web site operator "must" provide is a two-step process. The first step is to determine what legal requirements apply. The second step is to evaluate what policies must be established and implemented to meet business needs. Sometimes these business needs may conflict with one another. For example, a Web site business operator may believe that a significant number of potential customers are concerned about use of their names, addresses, telephone numbers, e-mail addresses and buying information, including credit card number, beyond the minimum use required in order to enter into the desired transactions. On the other hand, the Web site business operator may also be eager to obtain additional income from extended use of customer information, either for advertising of its own or as part of a customer list which it sells to third parties.

Web site operators may also be confronted with determining legal obligations and business needs in connection with their response to law enforcement officers, private litigants and others seeking information regarding particular individuals.

A. Legal Requirements

The most recent and extensive legislation dealing with protecting the privacy of electronic communications is the Electronic Communications Privacy Act (ECPA).[2] That act was passed with a view to assuring the general public that messages moving across the Internet would remain private by providing, in part:

> . . . a person or entity providing an electronic communication service to the public shall not knowingly divulge to any person or entity the contents of [the] communication while in electronic storage by that service.[3]

Several points are worth noting. First, these obligations only apply to "providers of electronic communications services," and merely operating a Web site does not make the operator such a provider.[4] Thus, non-government Web site operators do not have an obligation to protect the privacy of Web site visitors' personal information such as name, address, social security number, credit card number, and information relating to proof of Internet connection ("personal information"). Second, the law distinguishes between information concerning the identity of the author of information and the content of messages. In *U.S. v. Hambrick*,[5] the court held that neither the ECPA nor general law created a reasonable expectation of privacy on the part of an Internet customer with regard to that customer's personal information (specifically, name, address, social security number, credit card number and proof of Internet connection obtained by Internet providers). The court also indicated that the constitutional concern for privacy extends only to government invasions of privacy and stated, "ISPs (Internet Service Providers) are free to turn stored data and transactional records over to nongovernmental entities."[6]

> *"Web site operators will want to take precautions to prevent unauthorized entry into their systems, but can take comfort from the fact that government agencies (even under the relaxed standards of the U.S.A. Patriot Act) as well as private parties, must obtain access to information honestly."*

B. Responding to Requests for Information

In addition to establishing policies regarding disclosure of customers' personal information for commercial purposes, Web site operators will want to establish policies and implement procedures for responding to third party requests for information. Such requests may come from a government entity, in which case, the entity must comply with applicable procedures. Requests to an ISP, for example, must comply with the ECPA's warrant or subpoena procedures in obtaining the desired information from online services. Thus, in *McVeigh v. Cohen*,[7] where a government agency obtained information without identifying itself, use of the information was barred on the grounds that it was improperly obtained. The standards and procedures with which government entities must comply were broadly modified and relaxed, and disclosure of information to government entities was significantly expanded, by the recent U.S.A. Patriot Act.[8]

The standards applicable to disclosure of information to non-government entities may be quite different. For example, in *Jessup-Morgan v. America Online Inc.*,[9] the court held that disclosure of information by AOL (an ISP) about its subscriber/user did not violate the ECPA. Note, however, that the disclosure was pursuant to AOL's subscriber contract and terms of service. In order to give themselves maximum freedom to use personal information and minimize the risk of claims of "unauthorized" disclosure, most ISPs set up their Web-based transactions in a manner that requires users, before entering into any computer information transaction, to manifest assent to disclosed conditions and terms of service. By extension, non-ISPs are also well-advised to require customers to "click through" and manifest assent to any terms and conditions the Web-based business operator wishes to impose. In the absence of an effective procedure, no contract is created, and any attempt of the Web site operator to enforce desired terms and conditions is likely to be severely hampered.[10]

There are additional benefits. By disclosing the use that will be made of information that customers provide and obtaining assent to any use, including especially any disclosure, beyond that required in order to enter into the specifically requested transaction involved, even if not legally required, a Web-based business may allay fears of use the customer regards as misuse, and thus enhance customer relations.

Web site operators will want to take precautions to prevent unauthorized entry into their systems, but can take comfort from the fact that government agencies (even under the relaxed standards of the U.S.A. Patriot Act) as well as private parties, must obtain access to information honestly. For example, in *Konop v. Hawaiian Airlines*,[11] where Hawaiian Airlines, in its capacity as an employer, obtained access to a limited-access Web site under false pretenses, its actions were found to constitute "interception" under the ECPA, and Hawaiian was punished accordingly.[12] In that case, Hawaiian's management obtained access to a limited-access Web site established in connection with attempts to organize a pilots' union. The Web site included procedural steps to assure that Web site visitors were, in fact, Hawaiian pilots. Hawaiian's management obtained access by identifying itself as a member of an authorized group, the company's pilots, on several occasions. On one occasion, it actually had the permission of the pilot whose name was used. On another, management did not obtain the permission of the pilot whose name it used to gain access. Regardless of the "permission" given, the court held that, in both instances, Hawaiian obtained access under false pretenses and that its actions constituted interception.

Web site business operators can take comfort in the fact that where disclosure is made by a party other than an entity providing electronic communications service to the public, and access to the disclosed information was not gained illegally or under false pretenses, such disclosure appears not to be prohibited either by the ECPA or under general law. An illustration of the point can be seen in *Andersen Consulting LLP v. UOP*.[13] In that case, Andersen Consulting was hired to perform a systems integration project on defendant UOP's internal e-mail system. While conducting its duties, Andersen had access to, and use of, that e-mail system. UOP was dissatisfied with Anderson's performance, terminated the project, and sued Anderson for breach of contract, negligence, and fraud. While the case was pending, UOP's attorneys divulged the contents of Anderson's e-mail messages on UOP's system to the *Wall Street Journal*. Anderson sued under the ECPA, citing the provision that "a person or entity providing an electronic communication service to the public shall not knowingly divulge to any person or entity the contents of a communication while in electronic storage by that service."[14] The court concluded that the statute did not apply, because merely using the UOP system to communicate over the Internet with third parties did not mean that UOP was providing communications services to the public.

The case law to date indicates that, apart from search and seizure issues by government agencies, Web site business operators are not obligated to treat customers' personal information as private unless they obtain permission to disclose it. Customers' desire for privacy has prompted several efforts to pass regulations requiring ISPs, and others acquiring certain kinds of personal information from Web site visitors or customers, to treat that information as private—unless the visitor or customer grants permission to disclose it. The Federal Communications Commission adopted regulations imposing confidential treatment of Web site customers' personal information in the absence of customers "opting in" to permitting disclosure, on the grounds that it is in the general public interest to protect privacy, and therefore, it is appropriate to require telecommunications companies to obtain affirmative approval from customers before using their customer information for marketing purposes. The regulations were successfully challenged by U.S. West in *US West, Inc. v. FCC*,[15] on the grounds that such regulations constituted an unacceptable impingement on free speech. The court, citing the test set forth in *Central Hudson Gas & Elec. Corp. v. Public Serv. Comm'n of NY*, held that the government may restrict speech only if it proves that "(1) there is a substantial state interest in regulating the speech, (2) the regulation directly and materially advances that interest, and (3) the regulation is no more extensive than necessary to serve that interest."[16] The court concluded that the general interest rationale on which the FCC based its regulations was insufficient to support the regulatory restriction.

III. Workplace Privacy

To the extent that a Web site based business has a physical as well as a "virtual" workplace, privacy issues in the workplace may also require attention and consideration. Much has been written on these issues. The following is intended only to indicate some areas appropriate for further consideration.

Typically, companies include, in their e-mail policies, a statement to the effect that e-mail communications on company computers belong to the company and employees have no reasonable expectation of privacy regarding communications using those computers or computer systems. Where privacy is important, as for example in communications of trade secret information or communications the company will want to be able to assert are attorney-client privileged, additional steps such as encryption or password protection may be advisable both to enhance confidentiality and to evidence confidential treatment.

"Courts have consistently concluded that employees do not have a reasonable expectation of privacy regarding the content of messages or Web visits made while using company computers . . ."

Written policies on the use of e-mail and Web "surfing" for non-work-related activities (research, shopping, solitaire and other games, etc.) are advisable even in small companies. Well-written and publicized policies clearly stating that e-mail creates documents that belong to the company and that employees have no reasonable expectation of privacy regarding their e-mail messages—unless special steps are taken for legitimate protection of confidential information—can assist in avoiding production of unpleasant and unfortunate messages, thus reducing the risk of harassment suits, loss of attorney-client privilege, and loss of employee productivity resulting from personal use of computers.[17]

Courts have consistently concluded that employees do not have a reasonable expectation of privacy regarding the content of messages or Web visits made while using company computers, and arguments seeking to suppress evidence in the form of messages stored on, and retrieved from, an employer's computer files have generally been unsuccessful. For example, in *Bohach v. City of Reno*,[18] an employee argued that he had a reasonable expectation of privacy regarding storage of his computer files on his employer's computer, and that the retrieval of his computer files from computer files owned by the employer constituted a violation of the federal wiretap laws and a violation of his constitutional rights to privacy under the Fourth Amendment right to due process. The argument failed. The court was not persuaded by that argument, nor was it persuaded by the argument that accessing stored electronic communications constituted “interception” which required a search warrant.[19]

While there is no general expectation of privacy regarding use of an employer’s computers or computer system and, in general, privacy is not violated by recording or observing activities in public or quasi-public places, including workplaces, there is a reasonable expectation of privacy in personal office space. Thus, privacy regarding physical space as well as information on company computers used only by a particular individual may also become an issue. What constitutes quasi-public vs. personal space can be subtle. The Supreme Court has recognized a reasonable expectation of privacy in office desk cabinets not shared with others, where they are used to store personal materials and the employer has no policy discouraging such use.[20] On the other hand, employers have been found free to review materials on employees’ computers without obtaining a search warrant, at least where corporate policies regulate use of the company’s systems and state that the company monitors use of its systems.[21] Thus, employers are well-advised to establish and publicize company policies regulating the use of company computers and computer systems and stating that the company monitors or reserves the right to monitor and audit their use.

The state of New York does not recognize a general right of privacy under common law, but other laws may protect various aspects of personal privacy. For example, in *Dana v. Oak Park Marina*,[22] the plaintiff discovered that the defendant, a marina, had installed a videotape camera in the women’s rest room and that she had been taped. She sued for violation of privacy. The court found that the marina had no general obligation to protect women from such installations but noted that New York State has a state law prohibiting installing a videotape camera in a women’s rest room, dressing room, etc. for the purposes of surreptitiously observing the interior of those facilities. Based on that law, the court concluded that while the plaintiff had no cause of action for a common law violation of privacy, she might have a basis for negligent infliction of emotional distress in connection with such an installation.

In general, expectations matter. A Web-based business operator will want to consider the issues of its particular business and circumstances, formulate and articulate an appropriate company policy, and then implement that policy with publicity and reminders. Such a three-step process will enhance the likelihood that a thoughtful policy will be established and that whatever policy is deemed appropriate will be effectively implemented and honored.

IV. Conclusion

Web-based businesses can expect to continue to grapple with the need to assure customers that the privacy of their personal information will not be compromised if they do business via a Web site. Despite the risks to loss of privacy and lack of legal protection for much personal information,[23] Web-based business transactions are growing, as more and more companies seek to avail themselves of the opportunity to expand their business operations and marketing scope at reduced cost. Customers and potential customers however, are increasingly aware that there is little in the way of legal protection for the information they make available to a Web-based business, and their concern regarding the potential loss of privacy of this information continues to be a barrier to e-commerce. As a result, an organization that is considering operating a Web-based business may wish to institute a stricter policy regarding the protection of its Web site visitors’ and customers’ personal information than required by law. A company’s efforts to establish, implement compliance with, and publicize its privacy policies can assuage Web site visitors’ concerns regarding the handling of their personal information, thus making them more comfortable about entering into Web-based business transactions.

To the extent that a Web-based business outsources some or all of its computer information management, fulfillment, or other activities that give third parties access to customer information, Web-based businesses (as well as other businesses), will want to “close the loop” by making sure that contracts governing the provision of such services obligate the service providers to honor the company’s privacy policies and procedures, as the company may from time to time amend them. In addition, if the company has rights to disclose and/or resell customer information, it will want to reserve those rights to use and disclose to itself, in order to ensure it receives appropriate compensation for use by third parties.

Responsible use of customers’ personal information can serve administrative convenience, and even provide a source of information and additional revenue, but the potential benefits of freedom to use personal information of customers must be balanced with possible need to meet customers’ desire for privacy.

Formulating policies that balance the needs of the Web-based business operator and those of potential customers entering into online transactions, stating those policies clearly on the e-commerce Web site, and reviewing them regularly to assure that they continue to meet the needs and desires of both the vendor and its customers will enhance the Web-based business experience for all.

Endnotes

1. 15 U.S.C. §§ 6501-6506 (2000).
2. 18 U.S.C. §§ 2702-2703 (2000).
3. 18 U.S.C. § 2702(a)(1) (2000).
4. *See Andersen Consulting LLP v. UOP*, 991 F. Supp. 1041, 1042-43 (N.D. Ill. 1998).
5. 55 F. Supp. 2d 504 (W.D. Va. 1999).
6. *Id*. at 507.
7. 983 F. Supp. 215 (D.D.C. 1998).
8. Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT) Act of 2001 Pub. L. No. 107-56, 115 Stat. 272.
9. 20 F. Supp. 2d 1105 (E.D. Mich. 1998).
10. *See Specht v. Netscape Communications, Inc.*, 150 F. Supp. 2d 585 (S.D.N.Y. 2001).
11. 236 F.3d 1035 (9th Cir. 2001).
12. *See Konop v. Hawaiian Airlines, Inc.*, 236 F.3d 1035 (9th Cir. 2001).
13. *See Andersen Consulting LLP*, 991 F. Supp. at 1042-43.
14. 18 U.S.C. § 2702(a)(1) (2000).
15. 182 F.3d 1224 (10th Cir. 1999).
16. *Id.* at 1233 (*citing Central Hudson Gas & Elec. Corp. v. Public Serv. Comm'n of NY*, 447 U.S. 557 (1980)).
17. *See, e.g.,* Micalyn S. Harris, *Of Gold Mines and Land Mines: Protecting Corporate Communications, in* Securities in the Electronic Age: A Practical Guide to the Law and Regulation 14-1ff (John F. Olson & Harvey L. Pitt, eds., 2001).
18. 932 F. Supp. 1232 (D. Nev. 1996)
19. Interestingly, where a search warrant is obtained for only the computer, and a computer seized pursuant to a warrant contains e-mail, authority to seize the computer expands, at least temporarily, to authorize seizure of the e-mail as well. *See Davis v. Gracey*, 111 F.3d 1472, 1480-81 (10th Cir. 1997).
20. *See, e.g., O'Connor v. Ortega*, 480 US 709, 718 (1987).
21. *See U.S. v. Simons*, 206 F.3d 392, 398 (4th Cir. 2000).
22. 660 N.Y.S.2d 906 (1977).
23. There are some exceptions (e.g., for medical information and certain kinds of financial information).

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Perish the Publication: The Possible Effect of *Barklee Realty*

By Bruce A. Rich

I. Introduction

The *Barklee Realty* case[1] could be the beginning of the final assault in the battle seeking to tear down the publication barrier which has constrained the formation of limited liability companies, limited partnerships and limited liability partnerships in the state of New York. The expensive and legally useless publication of the formation announcement or qualification certificate has led many practitioners to advise their clients to avoid New York when forming these entities.[2] On November 16, 2001, Judge Alice Schlesinger of the Supreme Court, New York County decided that the publication requirement in Section 206 of the New York Limited Liability Company Law (LLCL) for forming domestic limited liability companies (LLCs) was unconstitutional as it violated the "plaintiffs' right to due process, right to equal protection of the laws, and right to access to New York courts," and enjoined New York State from enforcing Section 206.[3]

Within three weeks after the *Barklee Realty* decision, the Department of State (DOS) issued a Notice Regarding Publication.[4] In addition, the Attorney General later filed a Notice of Appeal and obtained a stay of the order pending the appeal.[5] In its initial notice, the DOS noted the decision and stated that it expressed no opinion with regard to the possible outcome of any appeal that might be filed in the case nor with regard to the application of the decision to the publication requirements to other forms of LLCs under the LLCL, to limited partnerships or to registered limited liability partnerships, and that it would not provide legal advice regarding publication. However, the DOS stated that it would continue to accept affidavits of publication presented for filing.[6] This ambivalent response leaves open the possibility for repeal of the publication requirement not just for domestic LLCs under Section 206, but also under the seven additional statutory sections that impose almost identical publication requirements for other types of LLCs, limited partnerships and registered limited liability partnerships (RLLP).[7]

This article describes the historical background of the publication requirement, discusses the *Barklee Realty* case and predicts the demise of the publication requirement for LLCs and partnerships in New York. This demise should result in increases in registration of domestic and foreign LLCs and limited partnerships, with corresponding increases in fee revenues to New York State, and reduced formation costs to the entities.

II. Publication Requirement

Section 206 requires that within 120 days after the effective date for filing the initial Articles of Organization for the formation of a domestic LLC, the LLC must file with the DOS an affidavit of publication setting forth that the information in its Articles of Organization appeared weekly for six weeks in two newspapers in the county where the office of the LLC is located. The publication provision in Section 206 is identical to the publication provisions for seven other types of LLCs, limited partnerships and RLLPs.[8] Indeed, the requirement originated in the law governing limited partnerships. As such, New York's changing policy toward publication can be seen by examining amendments over the past century to the limited partnership publication provisions.

In 1919, the New York Partnership Law was completely revised to reflect the changes in the 1914 Uniform Partnership Act and, to a lesser degree, the 1916 Uniform Limited Partnership Act. Article 8 covered limited partnerships. Publication was required immediately after the filing of the Certificate of Limited Partnership. The consequence of a failure to publish would be to make all limited partners liable as general partners.[9] In addition, the partnership was required to "cause to be placed in a conspicuous place on the outside and in front of the building in which is its principal place of business, a sign on which is printed in legible English, the names in full, of all the members of such partnership, designating which are general and which are special [limited] partners."[10] At that time, limited partnerships were local entities. Creditors and other persons doing business with a limited partnership needed notice that some of its partners would not have unlimited liability for the debts of the partnership beyond their capital contributions.

In 1922, Article 8 was greatly liberalized, based upon the Uniform Limited Partnership Act. Publication was abolished, the signage listing of partners also was abolished and the limited partnership was formed "if there had been substantial compliance in good faith" with the requirements for filing the Certificate of Limited Partnership.[11] However, in 1939, the publication requirement was reinstated, based upon the recommendation of the Law Revision Commission.[12] Many years later, publication was again tied to formation upon amendment of Section 91(2) of the Partnership Law (PL). The amended section postponed formation of the limited partnership and commencement of its business until completion of the first weekly publication, and then conditioned the existence upon completion of the six weekly publications and the filing of the affidavit of publication.[13]

Until 1991, New York limited partnerships were formed by filing a long form Certificate of Limited Partnership with the county clerk for the principal county in which they planned to engage in business. The Certificate of Limited Partnership was an extensive document that included the names and residence addresses of each partner, the nature of the respective capital contributions and the profit and loss interests. The county clerks did not consistently maintain and index the filings by limited partnerships filed in their respective counties. At that time, a search of a limited partnership could have been a very difficult, if not impossible, task. Therefore, one may argue that there was a purpose for local newspaper publication of the formation of domestic limited partnerships.

New York's Revised Limited Partnership Act of 1991 ("Revised LP Act") completely overhauled limited partnership law. There was no publication requirement in the original bill for the Revised LP Act. The drafters had argued that publication was archaic in light of the change to a central filing of short form Certificates of Limited Partnership with the DOS, and without further filings with the county clerks. The DOS was to maintain an index of all filings by limited partnerships which could be conveniently accessed by the public. During the discussions with the legislative committees regarding the need for publication in the Revised LP Act, the author noted that when the PL was amended in 1979 to permit the qualification of foreign limited partnerships, the application for qualification was to be centrally filed with the DOS and no publication was required. Unfortunately, the newspaper lobby sought to correct this "oversight." They prevailed upon the legislature to add a chapter bill to the original bill that required publication not just when forming domestic limited partnerships, but also when qualifying foreign limited partnerships. The Revised LP Act was passed by the Assembly and the Senate in late June 1990, but not signed into law by the Governor until December 31, 1990—as a debate had ensued as to whether having the Revised LP Act with publication was preferable to not revising the outdated existing act. The Memorandum issued on December 31, 1990 by the Governor's office announcing the ultimate approval of the Revised LP Act expressed that the act was "a progressive statute" and then added that ". . . chapter amendment that requires publication of useless boilerplate information, including information without any relevance under the new law, is unnecessary."[14]

Under the Revised LP Act, as adopted, a limited partnership was to be deemed formed at the time its Certificate of Limited Partnership was filed with the DOS and the publication was to commence immediately after filing the certificate. There was no reference regarding the effect of publication or of the failure to publish. To remedy this omission, in 1991, two amendments were made to the Revised LP Act—to take effect prior to the effective date of the Revised LP Act.[15] The first amendment supplemented the time of formation provision to note that there must be subsequent compliance with the publication requirement. The second amendment defined the consequence of failure to file—that being denial of the use of the New York courts until the proof of publication is filed. However, notwithstanding that consequence, the limited partnership was a legal entity that could conduct business. The following sentence was added to the publication provision: "The failure of a limited partnership . . . to file proof of publication shall not impair the validity of any contract or act of the limited partnership or the right of any other party to the contract to maintain any action or special proceeding thereon, and shall not prevent the limited partnership from defending any action or special proceeding in this state."[16]

The statutory concept of when a limited partnership is legally formed has become simplified, and formation is no longer linked to publication. Now the entity can just file with the DOS a short form Certificate of Limited Partnership setting forth its name, the county where it will do business and an address to which process served on the DOS would be forwarded. The filing, in absence of actual fraud, is conclusive evidence of the formation of the entity.[17] The statutory consequence of not publishing has been reduced to preclusion from the state judiciary system until the affidavit of publication is filed. Nevertheless, the support of the newspaper interests has permitted the requirement to publish to survive as an expensive vestigial remnant at a time of Internet access to information regarding the formation and subsequent existence of the entity.

With the history of LP law as a backdrop, in the early 1990s New York joined the wave of other states enacting limited liability company laws to permit the formation of LLCs in their states. Many commentators described LLCs as "hybrids" between limited partnerships and corporations.[18] Like corporate shareholders, business people select LLCs for the limited liability that their members would have; and, like partners, members could obtain pass-through tax treatment. The drafters of the LLCL proposed "default" provisions in the statute to help ensure that the LLC would avoid excessive corporate characteristics in order to be treated as a partnership for tax purposes.[19] Accordingly, there were many statutory similarities between the proposed LLCL and the Revised LP Act. These similarities enabled the legislature to include publication requirements in the final version of the LLCL identical to the publication provisions contained in the Revised LP Act. Thus, the New York statute, unlike the statutes in other states, imposed a publication requirement.

III. The *Barklee* Case

Barbara Krabel set up three LLCs. The first, Barklee 147 LLC, formed in 1998, cost her $1,645 in publication expenses. In 1999, she filed Articles of Organization for Barklee Realty Company LLC and Barklee 94 LLC. The service company told her that it would cost $1,328 to publish for each LLC. Rather than publish, she commenced a pro se action against Governor Pataki, claiming Section 206 of the LLCL "served no useful purpose"[20] and that it was unconstitutional under the United States Constitution and the New York State Constitution. To the surprise of most observers, especially the supporters of the publication requirement, she won. The court's analysis of the publication requirement exposed it for the empty purpose it was serving.

The three Barklee LLCs were single-member entities: two companies owned small walkup apartment buildings in Manhattan and the third managed the two buildings. According to the amended complaint and the memoranda of law, Ms. Krabel formed the LLCs as protection against personal liability and also for the tax benefits, which she might not have received had she been using the corporate form. Some local landlord-tenant laws set short statutes of limitations or require summary proceedings for certain proceedings by landlords. The plaintiffs claimed that they would be severely prejudiced if barred or delayed in bringing legal proceedings due to the publication requirements.[21] It was also noted that the information in the publication could be easily obtained from the DOS with minimal cost, or for nothing over the Internet, and that it was unlikely that an actual litigant would have seen the published material in the classified section of the newspaper.[22]

The plaintiffs' due process argument was that in balancing the parties' respective interests, the degree of risk that the statutory provision would result in unfair treatment and the probable value and efficacy of substitute measures, there was fundamental unfairness to the plaintiffs, and therefore no need for publication. The equal protection argument stated that all litigants should have equal access to the courts, and any exclusion from such equal access must be rationally related to the purpose of the statute. The publication requirement bore no rational relationship to court access. The plaintiffs added that they also were seeking declaratory judgment to question the legality and construction of statutes and the propriety of official acts.

The Attorney General first tried to claim that the plaintiffs did not have standing. He first presented a circular argument that a statutorily created entity needs statutory authority to sue, and because the plaintiffs did not publish by statute they had no right to maintain an action. His second point was that the plaintiffs had not pointed to any actual injury-in-fact that they had sustained. Plaintiffs responded to the first argument by claiming the state cannot have it both ways; and, as to the second point, the plaintiffs claimed their injury was based upon a fear of giving up rights, which forced them to comply with the publication requirement "under exigencies of litigation which are certain to occur."[23]

The Attorney General never argued that Section 206 served any beneficial purpose other than one of ensuring that the public is given notice of the information which the section requires to be disclosed. He did assert a theory of statutory construction that a plaintiff must satisfy an extremely heavy burden in order to sustain its challenge to the constitutionality of Section 206.

Judge Schlesinger took a realistic approach in examining the need for publication. After searching for a state interest in the statute, she found that "the only coffers enriched by the publication requirement is the newspapers [sic]."[24] She deemed that the notice "does not in any way enhance the adjudication of justice"; in fact, it could have the opposite effect by depriving an LLC from commencing an action by reason of the expiration of a short statute of limitation.[25]

IV. Possible Effect of the Decision

One possible effect of the *Barklee Realty* decision is for the legislature to amend the LLCL and the PL to repeal the eight publication requirements for formation or qualification of LLCs, limited partnerships and RLLPs in New York. Judge Schlesinger's decision presents clear judicial recognition of the fact that the publication requirement lacks legal justification and operates as a barrier to business formation in New York. The judge mentioned that the LLCL "was meant to expand business opportunities and to make this state a more amenable place to do business."[26] Given the *Barklee Realty* decision and the ambivalent notice from the DOS, proposals will be made to the legislature seeking repeal of the publication requirement in those eight statutory sections.

The second possible effect of repeal of publication requirements is the increased state revenues from fees paid by LLCs and limited partnerships, which have avoided registering in New York because of the costly requirement. In 2000 in New York, there were 75,992 registrations as domestic corporations, 824 registrations as limited partnerships, 20,818 registrations as domestic LLCs and 8,912 qualifications as foreign LLCs.[27] In contrast, in 2000, 59,071 domestic corporations and 47,904 LLCs were registered in Delaware.[28] Assuming that the Delaware ratio of new corporations to new LLCs is a more accurate reflection of the relationship between the formation of the two entities, because Delaware LLCs do not bear the time and the expense of publication, then extrapolating the Delaware ratio to New York, after repeal of publication, on an annual basis at least an additional 20,000 LLCs would be formed and 5,000 foreign LLCs qualified in New York. Applying the current $200 filing fee for domestic LLCs and $250 filing fee for foreign LLCs to the estimated additional filings, and subtracting the $25 filing fee for the affidavit of publication to the calendar-year 2000 filings of domestic and foreign LLCs, New York State would have received an additional $4.5 million in filing fees. The foregoing estimates do not consider other fees payable to New York that such LLCs would generate from filing certificates of amendment and other documents, requests for certified copies and good standing certificates, plus additional revenues from UCC filing fees and related search fees. Moreover, the overall formation costs for the LLCs and limited partnerships will be substantially reduced without the publication requirement.

V. Conclusion

The *Barklee Realty* decision eliminates the publication requirement for formation of New York LLCs. Because the formation of other business entities requires similar notice publication, the repeal of Section 206 of the NY LLCL and the seven other statutory sections imposing publication will have far-reaching effect. The reduction in cost of formation will encourage more people to create these business entities and this increase will result in additional revenue for the state. Moreover, assuming the *Barklee Realty* decision withstands the DOS appeal, business formation requirements in New York will reflect the reality of modern information channels.

Endnotes

1. *Barklee Realty Co. v. Pataki*, N.Y.L.J., Dec. 3, 2001, p. 20 (Sup. Ct., N.Y. Co. 2001).
2. It has been noted that costs can approach $2,000 per filing.
3. *See Barklee Realty Co.*, N.Y.L.J., Dec. 3, 2001, p. 20.
4. For a copy of the notice regarding publication, *see* U.S. Registered Agents, *available at* http://www.us-registered-agents.com/nypf.htm (last modified Apr. 12, 2002) [hereinafter *"Notice"*].
5. *See* Scott E. Mollen, *Realty Law Digest*, N.Y.L.J., Feb. 13, 2002, p. 5.
6. *Notice*, *supra* note 4.
7. *See* N.Y. Ltd. Liab. Co. Law §§ 802(b), 1203(c)(2), and 1306(b) (McKinney 2001-2002 Interim Pamphlet) (discussing foreign LLCs in § 802(b), professional service LLCs in § 1203(c)(2), and foreign professional service LLCs in § 1306(b)). *See* N.Y. Partnership Law §§ 121-201(c), § 121-902, 121-1500(d), and 121-1502(f) (McKinney 1988 & Supp. 2001-2002) (addressing domestic limited partnerships in § 121-201(c), foreign limited partnerships in § 121-902, domestic RLLPs in § 121-1500(d), and foreign RLLPs in § 121-1502(f)). However, a domestic or foreign limited partnership formed for a syndication of a theatrical production company is exempt from publication. *See* Arts & Cult. Aff. Law § 23.03(4) (McKinney 1984 & Supp. 2001-2002). *See also* N.Y. Partnership Law § 81 (McKinney 1988 & Supp. 2001-2002) (requiring publication for four weeks in one newspaper of the certificate for continuing use of partnership name under § 80).
8. *Id.*
9. *See O'Connor v. Graff*, 186 A.D. 116, 173 N.Y.S. 730 (3rd Dep't 1919), *aff'd* 230 N.Y. 552, 130 N.E. 890 (1920). In *O'Connor*, the limited partnership in question did not publish or file a certificate of limited partnership in the second county in which it operated, although it had published in its principal county. Prior to the 1919 enactment of the Uniform Partnership Act, § 30 had provided that if the limited partnership had places of business in more than one county, its Certificate of Limited Partnership must be filed and recorded with the county clerk of each such county. Section 30 became part of § 90 of the 1919 Act. L.1919, c. 408.
10. Section 95 of the 1919 Act.
11. Section 90 of the 1922 Act, L.1922, c. 640.
12. L.1939, c. 580, § 2.
13. L.1980, c. 499. This amendment may have been a reaction to a case decided the previous year that held "although publication of the certificate is an essential element of the proper formation of a limited partnership, the failure to file the affidavits of publication is not a fatal defect." *Micheli Contracting Corp. v. Fairwood Associates*, 68 A.D.2d 460, 418 N.Y.S.2d 164 (3rd Dep't 1979) (quoting *Buckle v. Iler*, 40 Misc. 214, 81 N.Y.S. 631 (1903)).
14. L.1990, c. 950, c. 951, and c. 952. Memorandum filed with Senate Number 8542, Executive Chamber, Press Office, dated Dec. 31, 1990.
15. L.1991, c. 33.
16. N.Y. Partnership Law § 121-201(c).
17. *Id.* § 121-201(b). That section of the Partnership Law is akin to a section in the Limited Liability Company Law. *See* N.Y. Ltd. Liab. Co. Law § 203(d).
18. Bruce A. Rich, Practice Commentaries to Limited Liability Company Law, Book 32A, 2001-2002 Interim Pamphlet (McKinney 2001-2002).
19. Since the "check the box" regulations (IRS Regs. 301.7701-1) became effective on Jan. 1, 1997, the need for statutory non-corporate characteristics was reduced. In 1999, §§ 606, 701 and 705 of the LLCL were amended to remove the "statutory default" portions of the withdrawal and dissolution provisions. L.1999, c. 420.
20. Part 11 of Amended Complaint, dated Jan. 12, 2000.
21. Part 23 of Amended Complaint.
22. *Barklee Realty Co.*, N.Y.L.J., Dec. 3, 2001, p. 20.
23. Plaintiffs' brief, Jan. 12, 2000, at vi.
24. *Barklee Realty Co.*, N.Y.L.J., Dec. 3, 2001, p. 20.
25. *Id.*
26. *Id.*
27. *Workload Comparison*, Dep't. of State, Div. of Corp. (2000–2001) (on file with author).
28. Telephone interview with representative from Del. Div. of Corp.

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Avoiding Civil Monetary Penalties in SEC Enforcement Actions

By Claudius O. Sokenu

I. Introduction

The Securities Law Enforcement Remedies Act of 1990 (the "Remedies Act") amended the Securities Act of 1933 (the "Securities Act") and the Securities and Exchange Act of 1934 (the "Exchange Act") to provide for the imposition of monetary penalties on any person[1] violating the federal securities laws. Specifically, the Remedies Act added Sections 20(d)[2] to the Securities Act and 21(d)(3) and 21B[3] to the Exchange Act. Both 21(d)(3) and 21B confer upon federal courts jurisdiction to impose monetary penalties on any person violating the federal securities laws. Section 21B of the Exchange Act provides the Securities and Exchange Commission (the "SEC" or "Commission") with authority to impose monetary penalties in any administrative proceeding instituted pursuant to Sections 15(b)(4), 15(b)(6), 15B, 15C or 17A of the Exchange Act against any person. Section 21B, however, mandates that such penalties are to be imposed only in the public interest. It is important to emphasize that neither Section 20(d) of the Securities Act nor Section 21(d)(3) of the Exchange Act include the public interest provision of Section 21B.

Questions often arise as to what guidelines the SEC's Division of Enforcement (the "Division" or "staff") considers before recommending monetary penalties against issuers. This article discusses a number of the factors that are likely to influence the Division's decision to recommend monetary penalties against an issuer. Following this discussion, this article will review several enforcement cases and attempt to make sense of how the enumerated factors were applied in those cases.

II. Factors Considered in Assessing Civil Monetary Penalties

A. Two-Step Analysis

The Remedies Act requires courts to present a "proper showing" in order to impose civil monetary penalties.[4] Providing a guidepost, the legislative history suggests that the decision to impose a penalty, and the amount of such a penalty, should be determined by the court in light of all the facts and circumstances of a particular case.[5]

Thus, any decision to recommend a monetary penalty is premised on a two-step analysis. In light of the legislative history, the staff must first determine whether the violation resulted in an improper benefit to shareholders, or whether shareholders were victimized by the violation. For example, if an investigation establishes that an issuer has engaged in an accounting fraud involving the manipulation of income over a period of time, one could reasonably conclude that the shareholders derived an economic benefit from an artificially inflated share price as a result of the fraud. Once that determination is made, the staff, in order to make a "proper showing," must then assess the appropriateness of a monetary penalty, taking into account all of the facts and circumstances of the case.[6]

Unlike administrative proceedings, Congress did not outline any factors for the courts to consider in assessing whether the imposition of a monetary penalty is appropriate, apart from noting that courts should take into account all of the facts and circumstances.[7] The following list of factors, though by no means exhaustive, provides a general framework an issuer must be cognizant of if it intends to avoid the imposition of monetary penalties when faced with an enforcement action in federal court.

B. Factors

As an equitable matter, and in harmony with Congressional intent, the Commission does not generally seek the imposition of civil monetary penalties against issuers because it could unfairly harm shareholders. However, there are a number of factors the staff can use to support its decision to recommend monetary penalties as an appropriate sanction against issuers. These factors include: (1) whether the issuer promptly brought the misconduct to the Commission's attention; (2) whether the issuer made prompt and accurate public disclosure; (3) whether the issuer conducted a thorough internal investigation and made its findings available to the staff; (4) whether management was involved in the misconduct; (5) whether the issuer took prompt and adequate remedial steps to deal with the misconduct; (6) the egregious nature of the wrongdoing; (7) whether the issuer is a recidivist; (8) whether the penalty is needed to underscore a significant enforcement policy or highlight a focus area; (9) whether the imposition of a penalty would impose an undue hardship on shareholders; (10) whether significant monetary penalties have been imposed by criminal, state, self-regulatory organization or foreign regulatory authorities; (11) whether the issuer demonstrates an inability to pay; (12) whether the issuer provided restitution to investors; (13) the duration of the wrongdoing; and

(14) whether the issuer has filed for bankruptcy protection.

In a recent Section 21(a) report of investigation, the Commission addressed what factors it considers important in deciding whether to bring an enforcement action at the completion of an investigation.[8] A substantial number of those outlined above are also prominently featured on the Commission's list of factors. Generally, a Section 21(a) report provides the Commission with an opportunity to signal its future enforcement posture on an issue without having to allege any violation of the securities laws. While such reports are of little precedential value, the Commission's statement does provide anyone facing SEC investigation with a roadmap to avoid both monetary penalties, and possible enforcement action.

III. Enforcement Cases

On average, the SEC brings between 400 and 500 enforcement proceedings yearly to address violations of the federal securities laws.[9] Between 1997 and 1998, the SEC brought approximately 1,000 cases.[10] In this period, monetary penalties were imposed in 117 cases against regulated entities. In contrast, during the same period, the Commission brought approximately six civil actions in which monetary penalties were sought.[11] This small number of federal court cases reflects the underlying premise that the SEC will not ordinarily seek monetary penalties against corporate issuers. In making the decision to recommend civil monetary penalties against publicly traded companies, the above stated factors are typically applied, on a case-by-case basis, in light of all the facts and circumstances attendant in each case. Revisiting some cases best elucidates these factors.

The first of these cases is *In re Livent Inc.*[12] Livent's former management allegedly involved themselves in a diverse and pervasive accounting fraud scheme spanning eight years from 1990 through the first quarter of 1998. Garth Drabinsky, Livent's former chairman and chief executive officer, and Myron Gottlieb, the former president, were allegedly the architects of the fraud which included a multimillion dollar kickback scheme, improper shifting of preproduction cost to fixed assets, and the improper recording of revenue. Livent's new management conducted an extensive internal investigation that uncovered certain aspects of the fraud, publicly disclosed the findings, reported those findings to the Commission, and cooperated with the Division's investigation. The financial statements were reinstated and Livent declared bankruptcy and terminated all of the individuals responsible for the orchestration and implementation of the fraud. Under these circumstances, Livent would have presented a good argument to the staff that it took all the necessary remedial steps, and thus, the staff ought not to recommend the imposition of monetary penalties to the Commission.

If Livent had not terminated all of the individuals responsible for the fraud, the staff might have recommended, despite all the other factors, that the Commission seek the imposition of monetary penalties. In such a situation, the Commission wants to send a strong message that it expects issuers to conduct their affairs as good corporate citizens. Failure to "clean house" in an SEC enforcement action almost always results in severe sanctions, including civil monetary penalties, regardless of other mitigating factors. Monetary penalties in such cases serve mostly as a deterrent measure designed to prevent future violations, and to alert shareholders to the conduct of its directors and officers.

In *SEC v. Golden Eagle Int'l Inc.*,[13] there were violations of the antifraud, registration, periodic filing, internal accounting and controls provisions of the federal securities laws. From 1994 through 1996, Golden Eagle, Ronald Knittle and Mary Erickson, Golden Eagle's majority shareholders and top officers, produced and disseminated brochures, press releases and newspaper advertisements which falsely claimed that Golden Eagle owned and operated mining properties and misrepresented the properties' mineral reserves. Many of these materially false and misleading statements also appeared in Golden Eagle's annual and quarterly reports, which were filed with the Commission. The Commission sought monetary penalties against all the participants in the fraud, except Golden Eagle. Golden Eagle's filings indicated that it had a negative net worth, thereby demonstrating an inability to pay. Typically, the Commission does not seek the imposition of monetary penalties where a proposed defendant demonstrates an inability to pay.

In re Corrpro Companies[14] involved a series of improper accounting entries on the books and records of Corrpro. These improper entries consistently caused Corrpro's assets and revenues to be overstated, and its expenses to be understated. As a result of the deceiving entries, Corrpro's financial statements contained in its Forms 10-Q for the quarters ended September 30 and December 31, 1994 a pretax income overstatement. In addition, Corrpro failed to maintain its books and records in accordance with generally accepted accounting practice. Notwithstanding the gravity of the foregoing violations, the Commission did not seek to impose monetary penalties against Corrpro. Rather, a cease-and-desist order was deemed appropriate, presumably because of the $6,075,000 restitution Corrpro made to investors harmed as a result of the accounting problems. Corrpro also conducted an internal investigation, publicly disclosed the problems, and implemented procedures to ensure that the problems would not reoccur.

In re Cambridge Biotech Corp.[15] involved the company's chief executive officer and former chief financial officer engaging in a series of activities that resulted in the overstatement of CBC's revenue and income between 1991 and 1993. A cease-and-desist order, the sanction imposed in this case, was appropriate because: (1) the principal violators had resigned from the company; (2) CBC had filed for Chapter 11 bankruptcy protection in an attempt to reorganize its business; and (3) CBC cooperated with the staff's investigation. Under these facts, seeking a monetary penalty against CBC would have been detrimental to CBC's current shareholders, without serving any corresponding public interest. Consequently, it is not surprising that the staff did not recommend that the Commission seek monetary penalties against CBC.

In *SEC v. Sony Corp.*,[16] Sony violated the periodic reporting provisions applicable to foreign private issuers under Section 13(a) of the Securities Exchange Act.[17] Specifically, the Commission alleged that Sony made inadequate disclosures about the nature and extent of its Sony Pictures' subsidiary net losses and their impact on the consolidated results Sony reported in its filings with the Commission. In the settled civil action that followed the staff's investigation, Sony paid a monetary penalty of $1 million, while settling to a cease-and-desist order for making a series of inadequate and incomplete disclosures about its financial condition and results of operations. Sony violated a well-articulated standard as expressed in *In re Caterpillar, Inc*.,[18] and as a result, a monetary penalty was appropriate to send a strong message to Sony and other issuers regarding the seriousness of the Management Disclosure & Analysis disclosure obligations. This is an area of great interest to the Commission.

In *SEC v. The Cooper Companies Inc.*,[19] three distinct fraudulent activities occurred. The first was a "frontrunning" scheme that occurred in the market for high yield bonds and involved senior management officials. The second involved a scheme to manipulate the trading prices of Cooper's debentures to avoid an interest rate reset obligation contained in the indenture. The third involved a scheme in which Gary Singer, a Cooper director and co-chairman, caused high yield bonds to be traded between Cooper's account and accounts in the names of his wife and aunt.

Cooper settled the injunctive action by, among other things, agreeing to pay $1.1 million in monetary penalties. A severe monetary penalty was justified in this case because Cooper's board was controlled by two of the individuals responsible for the fraud, and the board failed to terminate those individuals. The failure to seek a monetary penalty against Cooper in this case would have conveyed the erroneous message that a board of directors has no duty to ferret out individuals responsible for planning and implementing such a complex fraudulent scheme. The Commission's report of investigation stated that the "Commission considers it essential for board members to move aggressively to fulfill their responsibilities to oversee the conduct and performance of management and to ensure that the company's public statements [and press releases] are candid and complete."[20] By failing to take immediate and decisive corrective action in this case, the Cooper board appeared to prefer management's interest in keeping the facts secret over the investor's interest in full, fair and accurate disclosure under the federal securities laws.

SEC v. W.R. Grace & Co.[21] involves the Commission's allegation that from 1991 through 1995, W.R. Grace's senior management improperly caused W.R. Grace to defer income earned by National Medical Care, Inc., its main health care subsidiary and the major component of its Health Care Group segment, primarily to smooth the earnings of its Health Care Group. This caused W.R. Grace to file materially false and misleading periodic reports with the Commission from 1991 through 1996. W.R. Grace also made materially false and misleading statements in press releases, and during analyst teleconferences. The pervasive and extensive nature of the fraud in this case necessitated the imposition of monetary penalties. In addition, it was important to send a strong deterrent message to issuers about the importance of filing accurate financial statements. Furthermore, W.R. Grace's conduct involved systemic violations over several years, regarding Commission filings numbering a dozen or more. Such an endemic problem was best addressed by the imposition of civil monetary penalties.

In *SEC v. Policy Mgmt. Sys. Corp.*,[22] it was alleged that Policy Management Systems Corporation (PMSC) and many of its employees engaged in a number of improper accounting practices. Through the use of these unacceptable practices, PMSC made material misstatements in its audited financial statements for the fiscal years ended December 31, 1991 and December 31, 1992, its unaudited quarterly financial statements for each of those years, as well as the quarter ended March 31, 1993. PMSC's senior management knew of these practices, encouraged employees to engage in them, and took no steps to bring the fraudulent activities to an end. PMSC agreed to pay a $1 million civil penalty. The penalty was appropriate in this case because the violations were both actively encouraged and committed by senior managers, several of whom remained in their positions with PMSC after the fraud was discovered. Furthermore, the books and records and internal controls violations were egregious, repeated, and widespread. The large penalty was appropriate to emphasize the importance of maintaining accurate internal accounting records and reliable systems of internal control.

SEC v. Healthcare Services Group, Inc.[23] involved violations of the antifraud, periodic reporting and books and records provisions of the Exchange Act between 1990 and 1992 by Healthcare Services Group (HSG), its president, its chief financial officer, and an executive vice president. Among other alleged violations, HSG, in connection with a $22 million public offering of common stock in July 1990, failed to disclose information known to management that clients representing approximately 35 percent of HSG's gross revenues had either canceled their contracts, or had indicated their intention to do so. HSG settled the Commission's enforcement action by agreeing to the entry of an order of permanent injunction prohibiting future violations of the antifraud, periodic reporting and books and records provisions of the Exchange Act, and the payment of $650,000 in a civil monetary penalty. The imposition of a monetary penalty in this case can be justified in light of the egregious and extended nature of the frauds committed.

In *SEC v. Triton Energy Corp.,*[24] Triton made payments to certain Indonesian government officials in violation of the Foreign Corrupt Practices Act (FCPA), and concealed the payments by falsely documenting and recording the transactions as routine business expenditures on its books and records. The remedial measures taken by Triton included adopting more rigid accounting controls to prevent any further violations of the federal securities laws. In addition, Triton installed a new management team. Nonetheless, the Commission sought to impose monetary penalties against Triton, perhaps because the Triton case was the first antibribery case brought by the Commission under the FCPA. Consequently, it was important for the Commission to send a strong message to issuers that the practice of making illicit payments to foreign officials would be met with severe sanctions. Triton settled the injunctive action and agreed to pay $300,000 in monetary penalties.

SEC v. Omnigene Dev., Inc.[25] involved a "pump and dump" scheme by Omnigene, an OTC Bulletin Board company, Dominic Scacci, Omnigene's president and chief executive officer, and Jerome Wenger, a stock promoter and host of "The Next Superstock," a nationally syndicated radio talk-show. The Commission alleged that Scacci caused Omnigene to issue stock in a bogus private placement offering to nominee accounts he controlled. Omnigene, Scacci, and Wenger, as part of the "pump and dump" scheme, then made false and misleading statements of material fact concerning Omnigene's past and projected revenues, certain purported patent rights, and contracts and laboratory staff in order to create demand and artificially inflate Omnigene's share price. These misrepresentations and omissions were broadcast to the investing public through Wenger's radio talk show and repeated through messages posted on the Internet. The Commission sought monetary penalties in this case primarily to underscore their commitment to addressing microcap fraud, and to emphasize the importance of monitoring new channels of stock manipulation.

"The large penalty was appropriate to emphasize the importance of maintaining accurate internal accounting records and reliable systems of internal control."

In *SEC v. Montedison, S.p.A.*,[26] also pending litigation, the Commission alleged that Montedison, an Italian corporation, engaged in a financial fraud scheme by falsifying documents to artificially inflate the company's financial statements. The Commission's complaint also charged Montedison with violating the reporting, books and records, and internal control provisions of the Exchange Act. This fraudulent scheme continued from at least 1988 through the first half of 1993. The Commission alleged that the scheme was designed to conceal hundreds of millions of dollars of payments that, among other things, were used to bribe politicians in Italy. The scheme concealed losses of at least $398 million. As a result of the foregoing, Montedison's assets were materially overstated on its books and records, and in its financial statements for its fiscal years 1988 through 1991. The Commission sought monetary penalties because Montedison's conduct involved a systemic violation of the federal securities laws over several years. In addition, Montedison failed to conduct a thorough internal investigation to ferret out all of the responsible employees. Such a failure to "clean house " warranted the imposition of monetary penalties.

IV. Conclusion

There are a number of instances in which the Commission has sought civil monetary penalties against issuers. In each case, the staff must attempt to consider all of the factors relevant to whether a civil monetary penalty is warranted. Although the factors described above are by no means intended to be all-inclusive, they are representative of the issues considered in evaluating the appropriateness of imposing civil monetary penalties on publicly traded companies. While it would be difficult, and inadvisable, to create any bright-line analysis for determining when civil penalties should be recommended, each matter must be reviewed on its merits, taking into consideration all factors relevant to that issuer, the marketplace, and the public interest.

Endnotes

1. The Remedies Act does not define the term "person;" however, both the Securities Act and the Exchange Act have provisions containing a definition. *See* 15 U.S.C. § 77b(a)(2) and 15 U.S.C. § 78(c)(a)(9) (2000).
2. *Id.* § 78u (d).
3. *Id.* § 78u-2 (c) and (d).
4. *Id.* § 78u (d)(3)(A).
5. S. Rep. No. 101-377, at 17 (1990).
6. Of course, the next step would be to determine the appropriate amount of the penalty. This purpose of this article is not to explore how such penalties are quantified.
7. S. Rep. No. 101-337, at 17.
8. Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exchange Act Release No. 44969, 2001 WL 1301408 (Oct. 23, 2001).
9. *See* William R. McLucas et al., A Practitioner's Guide to the SEC's Investigative and Enforcement Process, 70 Temp L. Rev. 53, 53 (1997).
10. *See* 1997-1998 U.S. SEC Annual Report.
11. Neither the Division of Enforcement, nor the Commission itself, quantifies or tracks cases in which monetary penalties are sought. Consequently, this number reflects the results of a review of Commission releases generated over the past 27 months.
12. Exchange Act Release No. 7627, 1999 WL 10265 (Jan. 13, 1999).
13. Litigation Release No. 15733, 1998 WL 227640 (May 7, 1998).
14. SEC Act Release No. 40476, 1998 WL 654492 (Sept. 24, 1998).
15. SEC Act Release No. 7358, 1996 WL 595674 (Oct. 17, 1996).
16. Litigation Release No. 15832, 1998 WL 439897 (Aug. 5, 1998).
17. For a list of these reporting requirements, see 15 U.S.C. § 78m.
18. Exchange Act Release No. 30532, 1992 WL 71907 at *7-8 (Mar. 31, 1992) (holding that where a subsidiary's earnings materially affect the parent corporation's reported income, those revenues should be identified to accurately reflect the parent corporation's financial statement).
19. Litigation Release No. 14351, 1994 WL 707201 (Dec. 12, 1994).
20. *Report of Investigation In the Matter of The Cooper Companies, Inc. as it Relates to the Conduct of Cooper's Board of Directors*, Exchange Act Release No. 35082, 1994 WL 707149 at *6 (Dec. 12, 1994).
21. Litigation Release No. 16008, 1998 WL 887247 (Dec. 22, 1998).
22. Litigation Release No. 15417, 1997 WL 411683 (Jul. 23, 1997).
23. Litigation Release No. 15124, 1996 WL 593032 (Oct. 16, 1996).
24. Litigation Release No. 15266, 1997 WL 94191 (Feb. 27, 1997).
25. Litigation Release No. 15899, 1998 WL 652102 (Sept. 24, 1998).
26. Litigation Release No. 15164, 1996 WL 673757 (Nov. 21, 1996).

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Web Portals: Caught in the Web of Broker-Dealer Regulation

By Claudius O. Sokenu

As technology continues to transform the business world, Web portals, particularly financial portals, are increasingly struggling with the notion that they could get caught in the regulatory web of the Securities and Exchange Commission (the "Commission" or "SEC"). The past few years have seen a rapid growth in online investing, and Web portals have played an integral role in furthering this expansion. The instantaneous availability of investment-related information, and the ability of portals to bring investors and broker-dealers together, have propelled portals onto the Commission's radar. Specifically, the Commission and its staff have expressed concerns over the manner in which brokerage firms structure compensation arrangements with portals that help promote and market their services. The staff appears to have adopted the narrow view that where a Web portal receives transaction-based compensation, rather than a flat or nominal fee, such a portal is acting as a broker-dealer, and is required to register with the Commission or become "associated" with a broker-dealer. This rather restrictive view encumbers the ability of portals to effectively structure compensation agreements with broker-dealers. From an economic standpoint, broker-dealers want to see a correlation between what they pay portals and what they receive in return. On the other hand, the staff's adherence to securities laws tenets severely restricts the ability of broker-dealers and Web portals to serve the best interests of the very investors the Commission seeks to protect. As the Commission struggles with these and other issues concerning the new frontier, the answer to one question remains both unclear and unsettling: when is a portal, financial or otherwise, engaged in the business of effecting transactions in securities?

Generally, Section 15(a) of the Securities and Exchange Act (the "Exchange Act") makes it unlawful for a broker-dealer to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security unless such broker or dealer is registered with the Commission.[1] Section 3(a)(4) of the Exchange Act defines a "broker" as any person, other than a bank, engaged in the business of effecting transactions in securities for the account of others.[2] Section 3(a)(5) of the Exchange Act defines a "dealer" as any person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise.[3] A person effects transactions in securities if he or she participates in such transactions "at key points in the chain of distribution."[4] Such participation can include assisting an issuer to structure prospective securities transactions, helping an issuer identify potential investors, soliciting securities transactions, and participating in the order-taking or order-routing process. Factors indicating that a person is "engaged in the business" include, among others: receiving transaction-related compensation; holding oneself out as a broker; executing trades; assisting in settling securities transactions; and participating in the securities business with some degree of regularity. In addition to indicating that a person is "effecting transactions," soliciting securities transactions is also evidence of being "engaged in the business."[5]

Over the years, the SEC staff has identified certain factors that are indicative of broker-dealer status through the use of no-action letters.[6] These enumerated factors include: (i) facilitating the opening, closing or maintenance and administration of accounts; (ii) endorsing or recommending specific investments; (iii) executing trades; (iv) assisting in or settling securities transactions; (v) holding funds or securities of others; (vi) soliciting securities transactions (including advertising); (vii) performing back office functions; (viii) helping an issuer to identify potential investors; (ix) participating in order-taking or order-routing; (x) receiving transaction-based compensation; (xi) assisting an issuer to structure prospective securities transactions; (xii) actively soliciting investors; (xiii) regularly participating in securities transactions; and (xiv) directly or indirectly holding oneself out as a broker-dealer.[7] While no one factor is determinative, as the staff has not outlined a definitive list, the presence of several of these factors will increase the likelihood that a person or entity would be viewed by the staff as acting as a broker-dealer.

For example, a broker-dealer enters into an agreement with a portal that specifically restricts the activities of the portal to merely marketing and promoting the broker-dealer by placing a hyperlink to the broker-dealer's Web site on its home page. In addition, the portal occasionally sends unsolicited e-mails to its site viewers recommending the broker-dealer's services. The portal will not take part in brokerage services offered by the broker-dealer, including the opening, maintenance, administration, or closing of customer accounts, or the solicitation of trades. The portal will not provide specialized assistance in resolving problems, discrepancies, or disputes involving brokerage accounts or related securities transactions. The portal will not recommend or endorse specific securities. Further, the portal will not engage in negotiations involving brokerage accounts or related securities transactions, nor accept orders, route orders, effect clearance, or settle trades. The portal will not extend credit to any customer for the purpose of purchasing securities through, or carrying securities with, the broker-dealer. The broker-dealer will be responsible for the accuracy of all marketing and promotional materials relative to its brokerage services, and for all account-related inquiries. In return, for every account the broker-dealer acquires as a result of its relationship with the portal, the broker-dealer will compensate the portal by paying a one-time acquisition fee. The one-time fee will be based on the value of each account at the end of the first month following the opening of the account. This type of transaction-based compensation arrangement is fairly typical between brokerage firms and non-profit organizations.

Although in this example the agreement restricts the involvement of the portal to merely marketing and promoting the broker-dealer, there is still a strong likelihood that the staff would view the portal as engaged in the business of effecting transactions in securities because of the transaction-based compensation. The Commission and its staff have expressed concerns about transaction-based compensation agreements based upon a "finder"[8] receiving compensation connected in some way to the value or size of a securities transaction, or the value of a brokerage account.[9]

In a series of no-action letters issued under Section 15(a) of the Exchange Act, the staff has opined on these types of agreements and the implications of the fee arrangements involved. The SEC staff issued the most prominent of these letters in 1996 and 1997 to Charles Schwab & Co. Inc. (Schwab). In the 1996 Schwab no-action letter (Schwab I), Schwab agreed to pay two Internet service providers (ISPs) a nominal flat fee per order transmitted to their Web site through the ISPs' Web sites. The fee Schwab would pay for these referrals would remain the same, regardless of the value of the order transmitted or whether the order was executed. In granting Schwab no-action assurances, the staff noted "Schwab will pay a nominal flat fee . . . for each transmission of an order to Schwab without regard to the number of shares or the value of the underlying securities comprising each order or whether the order results in an executed trade."[10] In a more recent no-action letter, the staff reiterated the scope of the Schwab I letter by stating: "[t]he Schwab letter addressed the situation raised by broad-based portals . . . that would take an essentially passive role toward the interaction between the brokerage and customers, other than routing messages. In that context the portal could receive a 'nominal flat fee' for each order transmitted. The staff has never extended the Schwab letter beyond that narrow context."[11]

In the 1997 Schwab no-action letter (Schwab II), the staff again focused on the compensation structure between Schwab and the information providers who would make their content available to customers through Schwab's Web site. The SEC staff permitted Schwab to pay the providers the greater of a base monthly fee, or a variable fee calculated by multiplying the number of active customer households by a nominal fixed dollar amount. Schwab contended that the compensation received by the providers should fall outside the boundaries of the broker-dealer registration process because such compensation was "only in a remote way based on executed trades."[12] The staff agreed, and the plan involving the providers was secured.

In addition to Schwab II, the staff has allowed other variable and transaction-based types of compensation schemes, as long as the compensation is only in a remote way related to executed trades. In no-action letters issued to non-profit organizations and affinity groups, the staff has approved transaction-based compensation plans. For example, Security Pacific Brokers, Inc. (SPBI), entered into agreements with certain non-profit organizations whereby the organizations endorsed the use of the broker's services in written communications with their members, and allowed their organization's name to be used for co-branding and marketing purposes. SPBI planned to compensate the non-profit organizations by paying a percentage of revenues generated by the brokerage activities of their members.[13] In granting no-action letters of this breed, it would appear that the staff concluded that these non-profit organizations and affinity groups are engaged in serving the interests of their members. As such, the financial benefits accruing to these organizations would invariably benefit members of the organization.

In 1985, the Commission reasoned that because compensation based on securities transactions can induce high-pressure sales tactics and other problems of investor protection, persons receiving transaction-based compensation are required to register as broker-dealers under the Exchange Act.[14] More recently, in a report addressing on-line brokerage, former SEC Commissioner Laura S. Unger asserted that "an entity . . . compensated in a way that gives that entity a salesperson's stake in [a] transaction is generally considered to be acting as a broker-dealer."[15] A person is considered to have a salesperson's stake in a transaction "if he receives any number of fees, including a referral fee or a fee based on the number of shares or dollar value of an executed order."[16] The Unger Report went on to opine that where a portal is paid a "referral fee . . . based on the number of new customer accounts that the broker-dealer opens as a result of the placement of the broker-dealer's hyperlink on a portal, [this] could cause the portal to be a broker-dealer."[17]

Based on the foregoing, the staff may take the view that portals entering into agreements similar to the above example are engaged in the business of effecting transactions in securities solely because of the transaction-based compensation agreement. Presumably, the staff would reason that the compensation agreement gives the portal a salesperson's stake in the agreement because its compensation is directly related to the value of the customer's account.[18]

Conversely, a portal might be able to persuade the staff that, while its compensation is related to the overall value of a customer's account, such compensation is in no way related to any particular securities transaction. In addition, the portal could stress that, as in Schwab I, it takes no more than a passive role toward the interaction between the broker-dealer and its customers, other than routing messages. Thus, the compensation structure contemplated by the prior example would not raise investor protection issues that require registration under the Exchange Act.

Nothing in the above instance indicates that portals engaged in these types of marketing and promotional activities are engaged in traditional broker-dealer activities. As discussed previously, the portals typically do not take any part in the financial services offered by the brokerage firms. While transaction-based compensation may be a factor to be considered in deciding whether a portal is engaged in the business of effecting transactions in securities, none of the other traditional indicia of broker-dealer activities are present. Thus, it becomes clear that no policy or purpose would be served by requiring broker-dealer registration. Moreover, by granting no-action letters to non-profit organizations and affinity groups engaged in similar activities, the staff has implicitly indicated that these activities can be performed by unregulated entities. The Commission and its staff should clarify what framework it uses to determine whether a Web portal is engaged in the business of effecting transactions in securities. Such a framework should balance the Commission's desire to protect investors, while enabling businesses to engage in legitimate arrangements that ultimately benefit the very investors the Commission seeks to safeguard.

Endnotes

1. 15 U.S.C. § 78o.
2. *Id.* § 78c(a)(4).
3. *Id.* § 78c(a)(5).
4. *See Massachusetts Fin. Services, Inc. v. Securities Investor Prot. Corp.*, 411 F. Supp. 411, 415 (D. Mass. 1976), *aff'd*, 545 F.2d 754 (1st Cir. 1976), *cert. denied*, 431 U.S. 904 (1977); *SEC v. Nat'l Executive Planners, Ltd.*, 503 F. Supp. 1066, 1073 (M.D.N.C. 1980); *SEC v. Zubkis*, No. 97 Civ. 8086, 2000 WL 218393, at *9 (S.D.N.Y. Feb. 23, 2000); *MuniAuction, Inc.*, SEC No-Action Letter, 2000 WL 291007 (Mar. 13, 2000).
5. *See SEC v. Century Inv. Transfer Corp.*, No. 71 Civ. 3384, 1971 U.S. Dist. LEXIS 11364, at *13 (S.D.N.Y. Oct. 5, 1971).
6. A SEC no-action letter is one issued by the staff, sought by a party contemplating a particular conduct, to help assure that such conduct will not result in enforcement action by the Commission. After a no-action letter has been issued, the SEC is not precluded from subsequently bringing an enforcement action; but, as a practical matter, the chance of such action being initiated is very slim. No-action letters are illustrative of the staff's views, and as such, are excellent sources of instruction for others contemplating the same or similar conduct.
7. *See generally, Century Inv. Transfer Corp.*, 1971 U.S. Dist. LEXIS 11364; *SEC v. Hansen*, No. 83 Civ. 3692, 1984 U.S. Dist. LEXIS 17835 (S.D. N.Y. Apr. 6, 1984); *Zubkis*, 2000 WL 218393; *MuniAuction, Inc.*, SEC No-Action Letter, 2000 WL 291007.
8. A finder is defined as one who undertakes none of the traditional activities of a broker-dealer but, rather, merely provides information concerning potential investors to an issuer or a broker-dealer and facilitates interaction between them. *See Dana Investment Advisors, Inc.*, SEC No-Action Letter, 1994 WL 718968 (Oct. 12, 1994) (citation omitted).
9. *See Computer Brokerage Systems*, Exchange Act Release No. 34-21383, 17 C.F.R. pt. 241, at *n.4, 1984 SEC LEXIS 571 (Oct. 9, 1984); Laura S. Unger, *Online Brokerage: Keeping Apace of Cyberspace*, at § IX (Nov. 1999) [hereinafter *Unger Report*], *available at* www.sec.gov/news/spstindx.htm.
10. *See Charles Schwab & Co. Inc.*, SEC No-Action Letter, 1996 SEC No-Act. LEXIS 976, at *25 (Nov. 27, 1996).
11. *See BondGlobe, Inc.*, SEC No-Action Letter, 2001 SEC No-Act. LEXIS 140, at *4 (Feb. 6, 2001).
12. *See Charles Schwab & Co. Inc.*, SEC No-Action Letter, 1997 SEC No-Act. LEXIS 920, at *4-6 (Sept. 18, 1997).
13. *See Security Pacific Brokers, Inc.*, SEC No-Action Letter, 1985 SEC No-Act. Lexis 1961, at *5 (Mar. 5, 1985). Other non-profit organizations and affinity groups have had similar compensation plans validated by the SEC. *See Attkisson, Carter, and Akers*, SEC No-Action Letter, 1998 SEC No-Act. LEXIS 674, at *7-8 (June 23, 1998) (allowing compensation in the form of a fixed amount for every brokerage account opened by the group member and as a predetermined fixed percentage of the revenue generated from transactions in equities).
14. *See Persons Deemed Not to be Brokers*, Exchange Act Release No. 34-22172, 17 C.F.R. pt. 240 at *4, 1985 WL 634795 (June 27, 1985).
15. *See Unger Report*, at § IX.
16. *Id.*
17. *Id.*
18. *Cf. Oil-N-Gas, Inc.*, SEC No-Action Letter, 2000 WL 1119244, at *7 (June 8, 2000) (identifying, as a reason for refusing to grant a no-action letter, the somewhat unclear nature of the fees Oil-N-Gas would receive according to their plan). The staff also noted that the "info posted on the website suggest[ed] that these fees [would] increase as Oil-N-Gas bec[a]me more successful in 'marketing' securities to potential investors." *Id.*

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