NY BUSINESS LAW JOURNAL

FALL 2004

Vol. 8, No. 2

THE BUSINESS LAW SECTION
NEW YORK STATE BAR ASSOCIATION

in cooperation with

ALBANY LAW SCHOOL

ISSN 1521-7183

BUSINESS LAW SECTION—OFFICERS—2004-2005

Chair .... Gregory J. Blasi
Nixon Peabody LLP
437 Madison Avenue
New York, NY 10022
gblasi@nixonpeabody.com

First Vice-Chair .... Samuel F. Abernethy
Menaker & Herrmann LLP
10 East 40th Street
New York, NY 10016
sfa@mhjur.com

Second Vice-Chair and Fiscal Officer .... David L. Glass
Clifford Chance US LLP
31 West 52nd Street
New York, NY 10019
david.glass@cliffordchance.com

Secretary .... James W. Orband
Hinman Howard & Kattell, LLP
80 Exchange Street
Binghamton, NY 13901
jworband@hhk.com

NY BUSINESS LAW JOURNAL

Advisory Board

Editorial Board

Business Law Section Committees

	Chair:
Banking Law	Bruce J. Baker Nixon Peabody LLP Clinton Square, PO Box 31051 Rochester, NY 14603 (585) 381-6555 bbaker@nixonpeabody.com
Bankruptcy Law	Paul H. Silverman Alston & Bird LLP 90 Park Avenue New York, NY 10016 (212) 210-9562 phsilverman@alston.com
Consumer Financial Services	Geoffrey C. Rogers Hudson Cook, LLP 71 Orchardview Drive Clifton Park, NY 12065 (518) 383-9591 grogers@hudco.com
Corporations and Other Business Entities	Frederick G. Attea Phillips, Lytle, Hitchcock, Blaine & Huber LLP 3400 HSBC Center Buffalo, NY 14203 (716) 847-7010 fattea@phillipslytle.com
Franchise, Distribution and Licensing Law	Harold L. Kestenbaum Farrell Fritz EAB Plaza, West Tower, 14th Floor Uniondale, NY 11556 (516) 745-0099 hkestenbaum@farrelfritz.com
Futures and Derivatives Law	Sherri Venokur Stroock Stroock & Lavan LLP 180 Maiden Lane New York, NY 10038 (212) 806-5855 svenokur@stroock.com
Insurance Law	Jeffrey R. Gaylord Lewis, Brisbois, Bisgaard & Smith 100 Wall Street, 9th Floor New York, NY 10005 (212) 232-1302 gaylord@lbbslaw.com
Internet and Technology Law	Martin J. Ricciardi Whiteman Osterman and Hanna LLP 1 Commerce Plaza Albany, NY 12260 (518) 487-7618 mricciardi@woh.com
Securities Regulation	Michael J. Holliday 327 Jefferson Avenue Westfield, NJ 07090 (908) 654-9038 mjhollliday@worldnet.att.net

Editor's Note

Welcome to the Fall 2004 issue of the *New York Business Law Journal*, which has now arrived at the advanced old age of eight. It is my pleasure to return as your editor and to encourage all Business Law Section members to take an active part in this, the publication which represents your interests and attempts to keep you up-to-date on developments in the business law area twice every year. I hope that all of you will consider submitting articles for our future issues; the deadline for submissions for the Spring 2005 issue is December 31, 2004. Submissions may be sent to me directly at Albany Law School, via e-mail attachment, fax, or regular mail.

This Fall issue has a number of timely items which should be of interest to our diverse membership. We start with a brief article by Stuart B. Newman, the diligent and tireless Chair of the Advisory Board of this *Journal* and a partner with Salon, Marrow, Dyckman & Newman, LLP, which alerts readers to a recent change in New York law that, as of August 10, 2004, prohibits the use of similar business names for different types of business organizations. Unless protected by a grandfather provision also adopted as part of the revision, for example, an LLC may not adopt a name which is closely similar or identical to the name of an already-existing corporation or partnership. This important change should alleviate the problem of business name confusion which existed prior to the amendment.

We next proceed with an article by Jamila Roos, Claude G. Szyfer and Sherri Venokur of Stroock & Stroock & Lavan LLP, entitled "The Enforceability of Electronic Confirmations in Derivatives Contracts." This article compares United States, specifically New York, law, and international law on the validity of electronic "John Hancocks" in derivatives confirmations, and discusses critical issues such as what types of signatures bind counterparties and the security and technological ramifications of non-handwritten signatures.

I am delighted to be able to print, as our third article, an excerpt from a lengthy treatment of "Directors' Fiduciary Duties in Takeovers and Mergers," by Arthur Fleischer, Jr. and Alexander Sussman, of Fried, Frank, Harris, Shriver & Jacobson LLP. As anyone who either practices or teaches corporate law knows, the fiduciary duty area is vitally important, perhaps today more so than ever, and the Fleischer and Sussman article provides an excellent overview of the major topics and cases in Delaware law with which one needs to be familiar.

Our next two items consist of a reprint of an article by David Glass, counsel with Clifford Chance US LLP, entitled "Are You a Dolphin? Or a Financial Institution?" which originally appeared in the Fall 2002 issue of this *Journal*, preceded by an important update to the earlier piece ("*NYSBA v. FTC*: The Dolphins Escape! (Or Do They?)"). The articles deal with the FTC's interpretation of the Gramm-Leach-Bliley Act as requiring attorneys to provide clients with written notice regarding the attorneys' policy on disclosure of client information to third parties. The FTC took the novel position that such attorneys are a "financial institution" subject to the privacy requirements of the federal statute, and a federal district judge has now held the FTC's interpretation to be incorrect. These articles should generate a high degree of interest among Section members, and indeed all attorneys who are engaged in the daily practice of law.

Latham & Watkins has provided us with an excellent piece on SEC expansion of its Form 8-K special corporate events filing requirements. The article, entitled "SEC Expands and Reorganizes Form 8-K, Providing for Significant Additional Disclosures and Shorter Filing Deadlines," analyzes amendments to the Form which require disclosure of eight new items and some increased disclosure of information already mandated by the SEC. The article also notes the shortened filing deadline now incorporated into the Form.

The Fried Frank firm has also authored a timely article on golden parachute arrangements, entitled "Internal Revenue Service Clarifies Treatment of Golden Parachute Rules in Bankruptcy." The article discusses new rules governing deductions for such payments and their application to four hypothetical situations which arise in bankruptcy proceedings. This excellent treatment should be of interest to anyone practicing tax or bankruptcy law and should also interest those advising clients who are negotiating a golden parachute arrangement with their employer.

Laura B. Hoguet and Randi B. May, of the law firm of Hoguet Newman & Regal, LLP, next discuss the controversial new overtime regulations promulgated by the U.S. Department of Labor. The article, "New Overtime Regulations Became Effective on August 20, 2004," talks about some basic concepts under the Fair Labor Standards Act and then gives an overview of the new regulations, discussing who is subject to them and who is exempt. Finally, the article discusses the consequences of violations of the new standard. This piece should pique the interest of labor lawyers and many businesses in New York.

Robert D. Bring, writing from New York City, analyzes the need for attorneys and indeed all persons to bring the same care and attention to their personal records that they bring to their business records ("The Value of Important Papers"). Mr. Bring provides startling evidence of the carelessness with which people who should know better treat their personal records, given their professional emphasis on proper documentation and authentication, and he chides us all for failing to take proper steps to ensure the availability, accuracy, and completeness of these very important papers. Mea culpa.

Finally, Alice Joseffer, of the Hodgson Russ firm in Buffalo, provides us with a brief discussion entitled "Circular 230: Changes for Tax Opinions and Best Practices for Tax Advisors." Her article notes recent proposed changes to Treasury Department rules governing tax practice before the IRS, including changes to the definition and treatment of tax shelters, and it outlines suggested steps which should be taken by tax practitioners to comply with the proposed changes so as to ensure that the highest quality legal advice is made available to the client.

Once again, let me encourage all Business Law Section members to join in helping to make your *Business Law Journal* a continued success and a journal of which you can be justly proud. Please contribute!

James D. Redwood
Editor

The Name's the Same? Not Anymore!

By Stuart B. Newman

A lawyer who wanted to form a New York limited liability company to be called "Acme Enterprises LLC" could do so if there were no existing LLCs, either domestic or foreign, by that name in New York—even if a New York corporation with the name "Acme Enterprises *Inc*." already existed!

How could that be? Because under section 204(b) of the New York Limited Liability Company Law, the name of each limited liability company need only be distinguishable from the name of any existing domestic or foreign authorized *limited liability company* as such names appeared on the Department of State's index of names of existing limited liability companies. Similarly, under section 301(a)(2) of the New York Business Corporation Law, the name of a domestic or foreign corporation need only be distinguishable from names of existing *corporations* on the index of names maintained by the Department of State.

This could lead to some embarrassing and complicated results if Acme Enterprises LLC ever crossed paths with Acme Enterprises Inc. With such situations in mind, the legislature this year enacted Chapter 344 of the Laws of 2004, which amends relevant provisions of the Limited Liability Company Law, Business Corporation Law, Not-For-Profit Corporation Law and Partnership Law to require that the names of *all* such entities be distinguishable from the names of any other domestic or authorized foreign LLC, corporation (both business and not-for-profit) or partnership on file with the Department of State. The new law became effective as of August 10, 2004.

Does this mean that Acme Enterprises LLC must now change its name? No. With due regard for the chaos that might result if an exception were not made for existing entities, these new provisions specifically "grandfather" the names of existing entities.

Note also that there is no provision in the statute for the Department of State to grant exemptions based on consent should your client specifically request the formation of both an LLC and a corporation with the same name.

While considering the impact of the new statute, practitioners should also note that, as has always been the case, the acceptance of a name by the Department of State, either as a corporation or an LLC, is not a guaranty that the name of the entity will not infringe an existing trademark or service mark. Practitioners should always consider the possibility that an entity name the client is considering might, in fact, infringe an existing trademark. The cost of a trademark search would be worth the investment before a client spends heavily to form a corporation and promote its name only to find out that the entity name of his business infringes someone else's registered service mark or trademark.

Stuart B. Newman is the Chair of the Advisory Board of the *New York Business Law Journal* and a partner with Salon, Marrow, Dyckman & Newman, LLP in New York City.

Stroock Special Bulletin (March 2, 2004)

The Enforceability of Electronic Confirmations in Derivatives Contracts

By Jamila Roos, Claude G. Szyfer and Sherri Venokur

Background

Is an electronic "John Hancock" enforceable in a derivatives confirmation? The question is not one of idle curiosity, as the search for greater efficiency (and profitability) has led derivatives market participants to rely increasingly on technology for the documentation and execution of derivatives transactions. One example is the automated exchange of confirmations. Although there are potential benefits from such automation, the transition from paper to electronic confirmations has raised numerous legal questions for derivatives practitioners. Key among these is whether an electronic signature or other electronically generated symbol on the confirmation will bind the counterparty. This article examines that issue in the context of current electronic records and signatures law.

The Enforceability of Electronic Signatures under United States Law

Electronic Signatures under E-Sign

When confirmations are exchanged electronically, whether by facsimile, e-mail, or a secure website, a threshold question is whether electronic transmission of the confirmation affects the extent to which the confirmation may be relied upon to evidence the existence and terms of the underlying transaction. That question is answered, at least in part, by the Electronic Signatures in Global and National Commerce Act (E-Sign), enacted by Congress in 2000.[1] Under E-Sign, signatures, contracts, and records relating to any transaction affecting interstate or foreign commerce do not lose their legal effect solely due to their electronic format.[2] However, E-Sign also provides that if any law or regulation requires a contract or record relating to a transaction to be in writing, such contract or record's legal effect, validity, or enforceability may be denied if the contract or record is in a form that cannot be retained and accurately reproduced for later reference by all parties entitled to retain it.[3]

Electronic Signatures under State Law and UETA

Before the enactment of E-Sign, many state legislatures already had developed standards pertaining to electronic records. These state standards govern so long as they are consistent with E-Sign and do not accord a higher legal status to the use of any particular technology for storing or authenticating electronic records over the use of any other technology. Nor does E-Sign preempt state law to the extent the state law adopts the Uniform Electronic Transactions Act ("UETA").[4]

Electronic Signatures under New York Law

New York State has not adopted or introduced UETA. The enforceability of electronic confirmations under New York law is governed by two statutes: the Electronic Signatures and Records Act ("ESRA"), which governs the use of electronic records and electronic signatures in transactions that are purely intrastate, and the New York General Obligations Law (the "N.Y.G.O.L."). ESRA is largely consistent with E-Sign and therefore is likely to be applicable to interstate transactions, including derivatives transactions, governed by New York Law. The definition of an electronic signature under ESRA is the same as under E-Sign.

The N.Y.G.O.L. does not require a "qualified financial contract"[5] (a term that includes a derivatives contract), to be evidenced by a signed writing in order for it to be valid and enforceable. However, N.Y.G.O.L. § 5-701(b)(1)(a) requires that there be "sufficient evidence to indicate that a contract has been made." Under N.Y.G.O.L. § 5-701(b)(3), there is "sufficient evidence" of the making of a contract if:

> (a) there is evidence of electronic communication (including, without limitation, the recording of a telephone call or the tangible written text produced by computer retrieval), admissible in evidence under the laws of New York, sufficient to indicate that in such communication a contract was made between the parties;
>
> (b) a confirmation in writing sufficient to indicate that a contract has been made between the parties and sufficient against the sender is received by the party against whom enforcement is sought no later than the fifth business day after such contract is made (or such other period of time as the parties may agree in writing) and the sender does not receive, on or before the third business day after such receipt (or such

other period of time as the parties may agree in writing), a written objection to a material term of the confirmation . . .;

(c) the party against whom enforcement is sought admits in its pleading, testimony, or otherwise in court that a contract was made; or

(d) there is a note, memorandum or other writing sufficient to indicate that a contract has been made, signed by the party against whom enforcement is sought or by its authorized agent or broker.[6]

Section 5-701(b)(3) provides that such evidence of the making of a contract "is not insufficient because it omits or incorrectly states one or more material terms agreed upon, so long as such evidence provides a reasonable basis for concluding that a contract was made."

Though it is not uncommon for parties to record the telephone conversations of their derivatives marketers and traders (in fact, the 2002 ISDA Master Agreement includes an optional provision—Recording of Conversations—in its form of Schedule), it is not standard practice on all derivatives desks, so that some form of signed writing may be necessary if a derivatives contract governed by New York law is to satisfy the requirements of N.Y.G.O.L. § 5-701(b) for qualified financial contracts. Electronically generated signatures, or electronically generated symbols or logos, should suffice to support an intention to be bound, and therefore should uphold a finding that a contract was created and entered into.

International Law

United States domiciled companies engaging in derivatives transactions with counterparties in foreign jurisdictions also need to consider the impact of international laws relating to the use of electronic records and signatures. Among these is the European Union Directive on a Community Framework for Electronic Signatures (the EU Directive),[7] which is intended to facilitate the use of electronic signatures and to ensure that an electronic signature meeting certain authenticity requirements will be given the same legal effect as a handwritten signature.

The EU Directive distinguishes between the legal significance of "electronic signatures" and "advanced electronic signatures," based on the level of security attached to the signature. Under the EU Directive, an electronic signature is "data in electronic form which [is] attached to or logically associated with other electronic data and which [serves] as a method of authentication."[8] In contrast, an advanced electronic signature is an electronic signature that:

- Is uniquely linked to the signatory;
- Can identify the signatory;
- Is created by means that the signatory can maintain under his or her sole control; and
- Is linked to the data to which it relates in such a manner that any subsequent change of data is detectable.[9]

As in the United States, courts in EU member states cannot deny the legal effectiveness or admissibility of an electronic signature as evidence based solely on its electronic form or the fact that it was not created through the use of what is referred to as a "secure signature-creation device."[10] They can, however, deny effectiveness or admissibility on other grounds, such as that the electronic signature does not meet the traditional requirements of a signature. Advanced electronic signatures automatically are admissible in evidence in courts of EU member countries and are presumed to meet the legal requirements of a signature.

Derivatives counterparties subject to the EU Directive may stipulate in their agreements that only advanced electronic signatures will be considered effective. If admissibility of a document signed electronically will be determined by reference to the laws of an EU jurisdiction, it is advisable to use advanced electronic signatures in order to render moot arguments over authenticity and admissibility. In contrast, under United States federal and state law, the fact that a signature meets the requirements for an advanced electronic signature will not foreclose dispute over the admissibility of an electronically signed document. Derivatives market participants in the United States will have to weigh whether the goals of heightened security and documentation consistency across trading regions justify the cost of implementing infrastructure for advanced electronic signatures that meets the EU standard.

What Types of "Signatures" Can Bind the Counterparty?

Intent as an Important Determinant of Effectiveness

Intent is an important determinant of whether a signature is effective against the signer. Intent, however, can be problematic for confirmations of derivatives trades, which are created and exchanged within short time frames, typically by non-lawyers. Those responsible for reviewing counterparty confirmations, including signature validity, must be able to determine quickly whether the counterparty has evidenced an intent to be bound to the terms of the transaction.

Under general contract law, the requisite intent for valid manual signatures is inferred merely from the fact that the person to whom they are attributed has made them. When using an electronic format, one must consider whether that signature can be attributed to the correct person—that is, someone who is authorized to create a binding agreement between the parties.

Defining "Electronic Signature"

E-Sign defines "electronic signature" as:

> an electronic sound, symbol, or process attached to or logically associated with a contract or other record and executed or adopted by a person with the intent to sign the record.[11]

It may be difficult to determine intent in the context of an electronic signature, which may be in a form that is not readily recognizable and that is not unique in the same way as is a handwritten signature. Just as a court may question the intent behind, and authenticity of, a handwritten "X" or other similar mark that is offered as a signature in the pen and paper medium, certain electronic marks or actions have less integrity than others, based on the level of intent and degree of security that can be inferred.

Under New York Law, Complete Signature Not Necessary for Authentication

New York courts have held that markings other than manual signatures can be effective as signatures. A signature can be any symbol executed or adopted by a party with the present intention to authenticate the writing. For example, a typed subscription and the letterhead of the party on the confirmation or a name typed at the end of an e-mail message could indicate the requisite intent to be bound.[12] Similarly, comments to UETA suggest that leaving one's voice on an answering machine, pressing a particular number on a telephone keypad, clicking a web site button labeled "I Accept" or entering a PIN number or an encrypted digital signature, may be sufficient to constitute agreement if the required intention is present.[13]

This is underscored by the inclusion of the term "authentication" in the definition of the term "signed" in Section 1-201(39) of the New York Uniform Commercial Code (the "UCC"). As Official Uniform Comment Number 39 to Section 1-201 explains:

> The inclusion of authentication in the definition of "signed" is to make clear that as the term is used in [the UCC] a complete signature is not necessary. Authentication may be printed, stamped or written; it may be by initials or by thumbprint. It may be on any part of the document and in appropriate cases may be found in a billhead or letterhead. No catalog of possible authentications can be complete and the court must use common sense and commercial experience passing upon these matters. The question always is whether the symbol was executed or adopted by the party with present intention to authenticate the writing.

Attribution to Authorized Signatory

Even if one concludes that the intent of the signatory was to authenticate the writing, the question remains whether the signature may be attributed to an authorized representative of the party. For example, in the context of an ongoing derivatives trading relationship, a password may be provided to a counterparty and certain authorized persons for access to a secure website. If an authorized person leaves his or her computer unattended while the website is open, making it possible for an unauthorized person to make changes to a confirmation and then electronically sign and send the documents to the other party, the counterparty might be bound to the terms included in the signed confirmation even though such terms were not actually agreed to by an authorized person.

E-Sign does not include criteria for attributing the source of a signature. On the state level, UETA explains that an electronic signature will be attributed to a person if it resulted from his or her action, including the actions of his or her human or electronic agent (e.g., the person's computer, programmed to perform certain tasks on his or her behalf).[14] Thus, in the example of the unattended computer, it may be difficult to prove that the electronic signature of the person making the change was not that of the authorized person. In a paper format, handwriting samples would make it easier to disclaim the allegedly authorized signature on the basis that the recipient's reliance on the handwritten signature was not reasonable.

Security and Technological Issues

The core question for transactions conducted electronically is whether they are trustworthy. Laws like E-Sign and the UETA have buoyed the confidence of commercial parties that these transactions will be enforced, but when transactions are highly structured and embedded with a number of carefully matched commercial positions, the concern is whether the electronic document will accurately reflect the agreed-upon terms. Precautions may be taken in the form of physical or technological security measures to minimize the operational risks that arise in an electronic context.

The use of computer screen locks, firewalls, and encryption makes an electronic environment for transactions more secure. For routine, lower-margin contracts, the use of passwords coupled with a reliable firewall system may suffice. For larger or more complex deals, using a secure website or exchanging read-only documents minimizes the opportunity for data manipulation. For the greatest level of protection, parties may consider the use of public key cryptography, because it dramatically improves the ability to authenticate both content and source of electronic communications.

Endnotes

1. Electronic Signatures in Global and National Commerce Act ("E-Sign"), S. 761, P.L. 106-229, 15 U.S.C. §§ 7001 et. seq. effective October 1, 2000.
2. E-Sign, 15 U.S.C. § 7001(a).
3. *Id.*, § 7001(e). *See supra* n. 1.
4. E-Sign, 15 U.S.C. § 7002(a).
5. *See* N.Y.G.O.L. § 5-701(b)(1)-5-701(b)(2).
6. N.Y.G.O.L. § 5-701(b)(3)(a)-(d).
7. A copy of the European Directive on a Community Framework for Electronic Signatures is available at <http://www.fs.dk/uk/acts/eu/esign-uk.htm.>.
8. EU Directive, Article 2(1).
9. EU Directive, Article 2(2).
10. EU Directive, Article 5(2). A "secure signature-creation device" must ensure the secrecy of the data used to create the electronic signature and must protect against forgery of the electronic signature. EU Directive, Annex III.
11. E-Sign, 15 U.S.C. § 7006(5).
12. *See Leising v. Multiple R. Development*, 249 A.D.2d 920 (4th Dep't 1998) (printed corporation name on the top of writing is sufficient to constitute a "signature" under the N.Y.G.O.L.); *Pearlman v. Levisohn*, 182 N.Y.S. 615, 112 Misc. 95 (2d Dep't 1920) (holding that a party's name printed on the memorandum of agreement satisfies the statute of frauds if it is shown to have been adopted for the purpose of providing a signature); and *Cohen v. Wolgel*, 176 N.Y.S. 764, 107 Misc. 505 (1st Dep't 1919) (holding that the inscription of a party's name, which was assigned to the particular transaction, is a sufficient signature).
13. UETA § 2, comment 7.
14. UETA § 9(a) and comment 1.

Jamila Roos was formerly an associate with Stroock & Stroock & Lavan LLP; Claude G. Szyfer is a litigation partner with Stroock & Stroock & Lavan LLP; and Sherri Venokur is a Special Counsel in the Commodities and Derivatives Practice Group of Stroock & Stroock & Lavan LLP.

Reprinted by permission.

Directors' Fiduciary Duties in Takeovers and Mergers

By Arthur Fleischer, Jr. and Alexander R. Sussman

Directors' responsibilities in Delaware and most jurisdictions are measured primarily by the business judgment rule, a principle that essentially defers to the decision-making process of the directors themselves and that, absent special circumstances such as personal gain, presumes the propriety of the directors' actions.[1] The Delaware Supreme Court has explained that, under the business judgment rule, "directors are entitled to a presumption that they were faithful to their fiduciary duties," i.e., "[i]t is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[2] In one of its decisions in the Technicolor cases, the Delaware Supreme Court identified good faith, loyalty and due care as the "triads of [directors'] fiduciary duties."[3] In order to rebut the business judgment rule, a stockholder must show that the board breached one of those duties.

As explained by prominent Delaware jurists in a 2001 article,[4] "[i]n the cases, a standard formulation of the business judgment rule in Delaware is that it creates a presumption that (i) a decision was made by directors who (ii) were disinterested and independent, (iii) acted in subjective good faith, and (iv) employed a reasonable decision making process. Under those circumstances, the directors' decision is reviewed not for reasonableness but for rationality."[5] Furthermore, "[w]here the business judgment standard applies, a director will not be held liable for a decision—even one that is unreasonable—that results in a loss to the corporation, so long as the decision is rational."[6]

In a 1996 ruling, Delaware Chancellor Allen commented on the traditional business judgment rule that generally applies to board decisions as follows:

> What should be understood, but may not widely be understood by courts or commentators who are not often required to face such questions, is that compliance with a director's duty of care can never appropriately be judicially determined by reference to *the content of the board decision* that leads to a corporate loss, apart from consideration of the good faith *or* rationality of the process employed. That is, whether a judge or jury considering the matter after the fact, believes a decision substantively wrong, or degrees of wrong extending through "stupid" or "egregious" or "irrational," provides no ground for director liability, so long as the court determines that the process employed was either rational or employed in *a good faith* effort to advance corporate interests. . . . Thus, the business judgment rule is process oriented and informed by a deep respect for all *good faith* board decisions.[7]

The traditional business judgment rule has been modified in Delaware and some other jurisdictions as it applies to defensive actions by a target board to resist an unsolicited offer and to board actions in the context of a sale of control of the company. Because of the adversarial nature of contested takeovers and mergers and the very substantial financial stakes involved, target board actions in those contexts are frequently challenged in the courts. Thus, numerous cases have adjudicated the nature of a board's fiduciary responsibilities in evaluating and reacting to an unsolicited offer and in entering into a merger or sale of control, and a sizeable body of law has developed.

We here summarize the key principles, focusing primarily on Delaware law. Some state legislatures have amended their corporate laws, and other states' laws have been interpreted to expressly reject Delaware principles and to apply the traditional business judgment rule, or, in some cases, rules even more protective of target boards, in the merger and takeover context.[8]

Duties in Opposing Takeover Attempts

In general, the fiduciary obligation of target management and directors in a change of control context is to act in good faith, with due care and loyalty, in what they believe to be the best interests of the corporation and its constituents.

Duty of Care: The board will not lose its business judgment rule protection for lack of due care, unless the board's conduct amounts to gross negligence.[9] As the Delaware Supreme Court has emphasized, "the concept of gross negligence is also the proper standard for determining whether a business judgment reached by a board of directors was an informed one."[10]

In many cases, the Delaware Supreme Court has ruled that "director liability for breaching the duty of care 'is predicated upon concepts of gross negligence,'"[11] but it has not specifically defined those "concepts of gross negligence." In *McMillan v. Intercargo*

Corp.,[12] Vice Chancellor Strine gave content to the term in observing that, "[s]econd-guessing about whether a board's strategy was 'reasonable' or 'appropriate'" is not sufficient to show gross negligence; rather a plaintiff must "set forth facts from which one could infer that the defendants' lack of care was so egregious as to meet Delaware's onerous gross negligence standard."[13]

Duty of Loyalty: The duty of loyalty requires that a director may not act solely or primarily for a personal or noncorporate purpose, such as to preserve a position as a director or officer. However, the type of self-interest which precludes reliance on the business judgment rule does not include the alleged self-interest with which every director in a takeover situation is faced. A board's decision will not be set aside merely because it has the collateral effect of enhancing the power of incumbent management. Furthermore, a claim that a director is self-interested, standing alone without evidence of disloyalty, does not rebut the business judgment rule presumption.[14]

The self-interest of a single director does not taint the business judgment protection for the board's action, unless it "would have affected the collective decision of the board."[15] A subjective "actual person" standard applies in determining whether any self-interest was material to the allegedly conflicted director's decision.[16] In *Technicolor*, the Delaware Supreme Court affirmed the Chancery Court's conclusions that under the subjective test only one of nine directors had a material conflict of interest and, notwithstanding this self-interest, the board as a whole remained a "neutral decision-making body."[17]

In *Parnes v. Bally Entertainment Corp.*,[18] the plaintiff challenged the merger of Bally with Hilton Hotels. The court observed that, to overcome the presumption of the business judgment rule, the plaintiff had to prove that "a majority of the directors will receive a personal benefit from a transaction that is not equally shared by the stockholders . . . [or] where a corporate decision will have a materially detrimental impact on a director, but not on the corporation and the stockholders" or "that a majority of the directors were 'beholden' to an interested party or so under the influence of an interested party that the directors' discretion would be sterilized."[19] Following a trial, the court found that the outside board members were "completely disinterested and independent" and dismissed the claims.[20]

Duty of Good Faith: Directors will not be personally liable in damages even for gross negligence if the shareholders of the company have adopted a charter provision, as authorized by DGCL § 102(b)(7), limiting liability to acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law. Historically, challenges to a director's good faith were subsumed in a court's inquiry into the director's satisfaction of her duties of care and loyalty. Where a violation of either of those duties was found, there was no particular significance to determining whether there was a separate violation of the director's duty of good faith; and where there was no breach of those duties, it was uncommon to have an issue of the director's good faith. As noted above, however, DGCL § 102(b)(7) removes the exculpatory protection of that statute for violations of the duty of care for "acts or omissions not in good faith." Recent cases have therefore inquired into whether directors' alleged due care or loyalty violations also constituted bad faith conduct and have raised the question of whether directors should be separately concerned with meeting their duty of good faith.

Notably, in two opinions issued in derivative suits in 2003, *In re Walt Disney Co. Derivative Litig.*[21] and *In re Abbott Labs. Derivative S'holders Litig.*,[22] the courts found that plaintiffs sufficiently pleaded allegations of breaches of the duty of good faith, not only to survive defendants' motion to dismiss, but also to preclude the protection of Section 102(b)(7).[23] Those cases offer sharp warnings that the protections afforded by the business judgment rule and exculpatory charter provisions will not extend to instances in which directors "*consciously and intentionally disregarded their responsibilities*, adopting a 'we don't care about the risks' attitude concerning a material corporate decision."[24]

Furthermore, the business judgment rule applies to the decision to accept or reject an offer, and the board is not obligated to negotiate with third parties, or to sell the corporation just because a premium price is offered, if the board makes a good faith, informed decision that it would be in the corporation's best interests to reject the offer.[25] Specifically under the business judgment rule, directors are not under any obligation to negotiate with another company because it has indicated an interest in a merger or acquisition, even if it proposes a price that is at a significant premium to the market price of the company's stock. An invitation to negotiate a premium merger does not suspend the business judgment rule of the directors' authority to accept or reject the invitation in good faith and on an informed basis.

These principles were applied by the Delaware Chancery Court in its 1998 opinion in *Kahn v. MSB Bancorp, Inc.*, a ruling that was affirmed without opinion by the Delaware Supreme Court.[26] The target in *MSB* received two unsolicited offers to merge with a bidder. The first letter contained no proposed price, but simply invited the target to enter into merger discussions, while the second letter suggested a price for the target's stock, but contained no other specific terms.[27] The target's board, after having considered its investment banker's analysis of the offer, rejected it.[28] Shareholders of the target sued, claiming that the target's board breached its fiduciary duties of loyalty and care by having rejected those offers and by failing to disclose them to the shareholders.

The court granted the defendant directors summary judgment dismissing the complaint, holding that since the target "merely voted not to negotiate the merger offer," no enhanced standard of judicial review applied to that decision, because "there was no defensive action [by the target's board of directors]."[29] Therefore, the court held, the board's decisions were protected by the business judgment rule and the plaintiff failed to present a triable issue that the board breached its fiduciary duties because it was "self-interested, because the directors were motivated to entrench themselves in office" or because the board's "behavior amounted to gross negligence."[30]

Similarly, in *Minzer v. Keegan*,[31] a federal court interpreting New York law held that the ordinary business judgment rule applies when a target determines whether to pursue a merger proposal. In that case, plaintiffs charged the board of The Greater New York Savings Bank with a breach of fiduciary duty when it accepted a merger proposal from the Astoria Financial Corporation rather than seeking a higher price from a competing bidder, North Fork Bancorporation. The court held that it was a business judgment question for the directors whether to approve the Astoria merger "rather than conducting an auction for the highest bidder."[32] Furthermore, the court ruled, "whether the [directors'] conduct complied with their obligations turns not on the price at which they arrived but on whether their actions complied with the business judgment rule,"[33] under which "a court will not overturn an informed decision of directors absent some showing of 'fraud, illegality or self-dealing.'"[34]

The district court later granted defendants' motion to dismiss the case and the Second Circuit affirmed the dismissal.[35] The Second Circuit panel rejected plaintiffs' federal securities claim that the merger proxy failed to disclose the target's bad faith favoritism of Astoria over North Fork, because, even if disclosed, a reasonable Greater New York shareholder would not have been less likely to vote for the Astoria merger. In explaining its reasoning, the panel observed:

> [E]ven if North Fork's desire for Greater New York led it to offer more favorable terms than Astoria's bid, a reasonable shareholder would anticipate that Greater New York's board and management would mount defensive measures effectively thwarting any offer by North Fork. The complaint alleged that the board and management did not want to talk with North Fork "under any circumstances," and there is little in New York law that would force them to abandon that stance. For example, there is no statutory law or case law requiring the board to consider merger offers or, in the presence of such offers, to conduct a fair auction. Indeed, there are New York statutes that allow management considerable leeway in defending against hostile takeovers, . . . and there is no case law that would enable shareholders to compel Greater New York's board to negotiate with North Fork. [Citations omitted.] Were New York courts to follow leading precedents from other states, *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140, 1152 (Del. 1990)(holding in favor of board's "defense-motivated" actions against plaintiff Paramount's takeover attempts), it would not require much ingenuity on Greater New York's board or management's part to thwart North Fork's advances, however favorable they might seem to shareholders.[36]

Once the board determines to reject an offer, it may authorize management to oppose it. A complaining shareholder has the burden of rebutting the business judgment rule presumption[37] and of proving that the directors acted other than in good faith.[38] Indeed, it is now settled that, as fiduciaries, the directors are required to oppose offers that in their judgment are not in the best interests of the corporation and its constituents. In *Gilbert v. El Paso Co.*,[39] for example, the Delaware Supreme Court pointedly observed:

> Supported by the opinion of their advisors, the directors found that the bid threatened the corporate enterprise. Their prompt adoption of defensive measures in an attempt to meet this imminent threat was hardly improvident. Given the injunction of Unocal that the duties of care and loyalty prevent a board from being a passive instrumentality in the face of a perceived threat to corporate control, one would have expected nothing less from the directors under the circumstances.[40]

Unocal/Unitrin Principles for Defensive Measures

One of the most critical developments in business judgment rule jurisprudence has been the gradual evolution of more rigorous judicial scrutiny of board decisions to block hostile takeover attempts. A heightened standard of business judgment review was first formally articulated in Delaware in the 1985 decision in *Unocal Corp. v. Mesa Petroleum Co.*[41] Under *Unocal* and its progeny, the invocation of defensive tactics imposes a special burden on directors prior to their enjoying the benefits of the business judgment rule. First, the board must inform itself fully, and any decision to take defensive action must be the result of a careful evaluation of the hostile bid and of the various alternative courses of action available. As suggested by the Delaware Supreme Court's interpretation of the *Unocal* test in *El Paso* and *Time-Warner* and later cases, however, the board, particularly a board with a majority of disinterested directors, will be afforded latitude in determining whether an unsolicited bid may be deemed to constitute a threat to corporate policy and effectiveness, the first prong of the *Unocal* test.

Second, the board must justify the reasonableness of specific defensive tactics employed in relation to the nature of the particular hostile threat to corporate interests. This proportionality requirement tends to focus primarily on the overall impact of the board's action on stockholders as well as on its other constituents. In general, a defensive measure will be found improper or "disproportionate" if it is either "draconian" (coercive or preclusive) or falls outside a range of reasonable responses. Again, however, the case law suggests that the board enjoys latitude with respect to the satisfaction of this aspect of the *Unocal* standard as well. The Delaware Supreme court also explained in *El Paso*, in responding to the directors' apparent fear, that board conduct "might somehow wither under enhanced judicial scrutiny." Like the traditional business judgment analysis, however, *Unocal* also implicitly acknowledges that courts should not impose their own business judgment upon independent directors who reasonably respond to a threat to the corporate enterprise in good faith and on an informed basis.[42]

Where the board is taking action to protect stockholders from potentially detrimental activities of a raider, particularly in circumstances where no bona fide bid has been made for the company, courts have generally been supportive of reasonable defensive actions taken by the board after adequate investigation and due deliberation. For example, a California appeals court affirmed the grant of summary judgment on behalf of Chevron's directors, upholding various defensive actions they had taken in response to Pennzoil's 8.8 percent, $2.1 billion secret acquisition of Chevron stock.[43]

In *Unitrin*, where the board was taking defensive actions in response to a bona fide bid, the Delaware Supreme Court re-emphasized the need for judicial restraint in reviewing defensive responses under a "range of reasonableness" standard:

> The *ratio decidendi* for the "range of reasonableness" standard is a need of the board of directors for latitude in discharging its fiduciary duties to the corporation and its shareholders when defending against perceived threats. The concomitant requirement is for judicial restraint. Consequently, if the board of directors' defensive response is not draconian (preclusive or coercive) and is within a "range of reasonableness," a court must not substitute its judgment for the board's.[44]

Revlon Principles for a Sale of Control

On the other hand, if a sale of control is in question, *Revlon* principles will apply[45] and the courts are likely to more closely scrutinize the board's process and actions in order to ensure that stockholder interests are fully protected. In those circumstances, the courts may not defer as readily to the board's business decisions as might be suggested by the *El Paso* and *Time-Warner* rulings. Accordingly, determining what constitutes a "sale of control" is a significant part of a court's analysis. In *Paramount Communications Inc. v. QVC Network, Inc.*,[46] for example, the Delaware Supreme Court held first that, because the merger transaction approved by the board resulted in a transfer of voting control from the Paramount public shareholders to the individual controlling shareholder of the bidder, the transaction was a sale of control, triggering the duty under *Revlon* to obtain the best value reasonably available.[47] The court found that the Paramount directors had failed to satisfy that duty in favoring Viacom over QVC.

Significantly, the court specified the obligation which the directors had under the circumstances of a sale of control as follows:

> Under the facts of this case, the Paramount directors had the obligation: (a) to be diligent and vigilant in examining critically the Paramount-Viacom transaction and the QVC tender offers; (b) to act in good faith; (c) to obtain, and act with due care on, all material information necessary to compare the two offers to determine which of these transactions, or an alternative course of action, would provide the best value reasonably available to the stockholders; and (d) to negotiate actively and in good faith with both Viacom and QVC to that end.[48]

The Delaware Supreme Court observed that:

> a court applying enhanced judicial scrutiny should be deciding whether the directors made a reasonable decision, not a perfect decision. If a board selected one of several reasonable alternatives, a court should not second-guess that choice even though it might have decided otherwise or subsequent events may have cast doubt on the board's determination. Thus, courts will not substitute their business judgment for that of the directors, but will determine if the directors' decision was, on balance, within a range of reasonableness.[49]

The Delaware Supreme Court reviewed the record and concluded that "the Paramount directors' process was not reasonable, and the result achieved for the stockholders was not reasonable under the circumstances."[50] Similarly, in *Cede & Co. v. Technicolor, Inc.*,[51] the Delaware Supreme Court held that the Technicolor board's decision to sell the company was not entitled to the presumptions of the business judgment rule because it found that the decision was uninformed, even though it also found that the board had obtained a fair price. On remand, the Chancery Court held that the sale transaction was entirely fair to the Technicolor stockholders and dismissed the claim against Technicolor's board, a ruling which was affirmed by the Delaware Supreme Court.[52]

Entire Fairness Defense if Duty Is Breached

In general, the Delaware cases subject defensive decisions to a preliminary judicial examination to determine if the standards discussed above have been met.[53] If, indeed, the directors' defensive actions satisfy these basic standards and if the directors' decisions are based upon their evaluation of business considerations, they will be protected by the business judgment rule and will not be second-guessed by the courts. If the board breaches one of the triads of its fiduciary duties (good faith, loyalty, or due care) or fails to meet the *Unocal/Unitrin* or *Revlon* standards, business judgment rule protection is lost. However, the board's actions are not, therefore, *ipso facto* invalid. Rather, the directors then have the burden of proving the "entire fairness" of the challenged actions, which will be upheld if they are found to be fair to stockholders.[54]

In a case involving the usurpation of a corporate opportunity by a controlling stockholder, the Delaware Supreme Court held that the breach of the duty of loyalty rendered the defendants liable to disgorge any benefits received and to compensate the corporation for any damages attributable to the breach, reversing the Chancery Court's application of the entire fairness test and refusal to award damages under that test.[55]

Considerations of Stockholder Voting Rights

When directors take actions that affect stockholders' exercise of their right to vote, the courts will examine the purpose and effect of those actions. In *Schnell v. Chris-Craft Industries, Inc.*,[56] the Delaware Supreme Court in 1971 held a board's rescheduling of an annual meeting to be unlawful, because:

> management ha[d] attempted to utilize the corporate machinery and the Delaware Law for the purpose of perpetuating itself in office; and, to that end, for the purpose of obstructing the legitimate efforts of dissident stockholders in the exercise of their rights to undertake a proxy contest against management. These are inequitable purposes, contrary to established principles of corporate democracy.[57]

Later cases placed the burden on directors to justify a manipulation of the corporate machinery,[58] and, in the *Blasius* case, to demonstrate a "compelling justification" if the board's actions had "the primary purpose of impeding the exercise of stockholder voting power."[59]

The *Blasius* principle stems from the corporate governance policy rationale that regards stockholder enfranchisement "as the 'ideological underpinning' upon which the legitimacy of the directors' managerial powers rest."[60] According to Chancellor Allen in *Blasius*, because of the fundamental nature of this agency governance principle, the deferential business judgment rule and *Unocal* standard are not satisfactory when examining board actions that affect shareholder voting rights.[61]

In its 2003 opinion in *MM Companies v. Liquid Audio, Inc.*,[62] the Delaware Supreme Court endorsed the use of the *Blasius* standard in both takeover and non-takeover situations. In *Liquid Audio*, the court reversed a Chancery Court ruling that had upheld defensive board actions under *Unocal* and *Blasius*. MM Companies had sought to acquire Liquid Audio, but the board entered into a merger agreement with a third party.[63] MM then sought to elect two directors at the next annual meeting, which could have led, as a practical matter, to MM's gaining control of the board because of the concern that two of the other three incumbent directors would resign if MM's nominees were elected.[64] In response, the Liquid Audio board expanded the size of the board from five to seven directors and appointed directors to fill the two new board positions.[65] The Delaware Supreme Court noted that the Chancery Court concluded after an expedited trial that the director defendants timed their actions "for the *primary purpose* of diminishing the influence of MM's nominees, if they were elected at the annual meeting."[66]

Based on that finding, the Delaware Supreme Court applied *Blasius* "*within* an application of the *Unocal* standard of review,"[67] stating:

> When the *primary purpose* of a board of directors' defensive measure is to interfere with or impede the effective exercise of the shareholder franchise in a contested election for directors, the board must first demonstrate a compelling justification for such action as a condition precedent to any judicial consideration of reasonableness and proportionality.[68]

Since the director defendants did not demonstrate a compelling justification for their action in expanding the board, the court ruled that the board expansion should have been invalidated by the Court of Chancery.[69]

In two earlier cases, *Stroud* and *Unitrin*, the Delaware Supreme Court had held the *Blasius* analysis inapplicable. In *Stroud*, it upheld a director nomination bylaw, because it could not be said "that the 'primary purpose' of the board's action was to interfere with or impede exercise of the shareholder franchise" and because the shareholders had a "full and fair opportunity to vote."[70] In *Unitrin* and *Stroud*, that court specifically noted that "boards of directors often interfere with the exercise of shareholder voting when an acquirer launches both a proxy fight and a tender offer."[71]

In reviewing board defensive action in such a case, the *Unitrin* court said it was "mindful of the special import of protecting the shareholder's franchise within *Unocal's* requirement that a defensive response be reasonable and proportionate."[72] The court found that the shareholders' franchise was not impeded by the Unitrin board's repurchase program, because "a proxy contest remained a viable (if more problematic) alternative for American General even if the Repurchase Program were to be completed in its entirety."[73] Nevertheless, the court instructed the Chancery Court on remand to "determine whether Unitrin's Repurchase Program would only inhibit American General's ability to wage a proxy fight and institute a merger or whether it was, in fact, preclusive because American General's success would either be mathematically impossible or realistically unattainable."[74]

In the *MONY Group Shareholders Litigation*,[75] shareholder plaintiffs unsuccessfully raised a *Blasius* claim in challenging the MONY Board's actions in connection with seeking shareholder approval of a proposed merger with AXA. After the Delaware Chancery Court had required additional disclosures in MONY's merger proxy,[76] MONY's Board postponed the shareholder meeting for the vote on the proposed merger. The Board also determined to set a new record date in part in order to improve the likelihood of obtaining the required 50% vote of outstanding MONY shares in favor of the merger.[77]

The court rejected plaintiffs' claim that the Board had violated *Blasius* principles. The court observed that *Blasius* applied differently to a merger vote than it did to an election of directors:

> [W]hen the matter to be voted on does not touch on issues of directorial control, courts will apply the exacting *Blasius* standard sparingly, and only in circumstances in which self-interested or faithless fiduciaries act to deprive stockholders of a full and fair opportunity to participate in the matter and to thwart what appears to be the will of a majority of the stockholders, as in *State of Wisconsin Investment Board v. Peerless Systems Corporation*, [2000 Del. Ch. LEXIS 170 (Sept. 27, 2000)]. Where such circumstances are not present, the business judgment rule will ordinarily apply in recognition of the fact that directors must continue to manage the business and affairs of the corporation, even with respect to matters that they have placed before the stockholders for a vote.[78]

The court further noted that:

> Where the plaintiff fails to rebut the presumption that a majority of the board of directors was disinterested and acted in good faith and with due care, the court will ordinarily defer to the board's decisions involving the administration of the stockholder vote . . . This is consistent with the recognition that once a board of directors deems a merger agreement favorable, it may employ various legal powers to achieve a favorable outcome on a shareholder vote required to approve that agreement.[79]

The court denied the preliminary injunction, finding that the MONY Board fulfilled its fiduciary duties[80] and that its setting the new meeting and record dates appeared "reasonable in the circumstances."[81] The court concluded that "there was ample room for the Board to make a good faith and honest determination that approval of the merger, and a change in the record date in order to achieve that result, was in the best interests of the corporation."[82]

In *Aquila, Inc. v. Quanta Servs.*,[83] the Quanta board faced a proxy contest by Aquila, an insurgent shareholder. The board created a stock employee trust ("SECT"), to which it sold 10% of its shares, under terms which provided that certain non-director employees of Quanta would vote those shares.[84] Aquila claimed that the board's motivation in creating the SECT was to dilute Aquila's voting power.[85] Defending its action, the board argued that the main purpose of the SECT was to benefit company employees and that its voting provisions were normal and incidental to its business purpose.[86]

In an opinion issued before *Liquid Audio*, the court declined to apply *Blasius*'s "compelling justification" standard,[87] but held that the stock issuance was likely to fail the *Unocal* test. The court noted that, in applying *Unocal*, it was "obliged to show special vigilance for protecting the shareholder franchise. That special vigilance requires that the voting feature of the SECT be analyzed and justified on its own terms, as a distinct defensive measure."[88]

The court observed that the board's "decision to have those shares voted by persons who do not own them necessarily raises substantial questions about the propriety of the Special Committee's purpose in doing so" and concluded that "the defendants will not be able to meet their initial burden under *Unocal* of showing that their actions were reasonable in relation to the threat posed by Aquila's activities."[89] Nevertheless, the court denied the requested preliminary injunction for lack of irreparable harm, finding that, given Aquila's 34% voting power, it was unlikely the SECT shares would be decisive in the proxy contest, and, if necessary, following the election, the court could provide relief after a prompt final hearing on the merits.[90]

In The Learning Company's (TLC's) defense of its merger plan with Broderbund against a hostile bid by SoftKey, the Delaware Chancery Court permitted a defensive move to give the target board and its stockholders time to vote on the proposed stock-for-stock merger and consider other alternatives to SoftKey's bid.[91] The court interpreted *Unitrin* to establish that board action to allow stockholders to vote on a proposed transaction and to give the board "a reasonable time to explore and develop other options" as a defensive measure against a hostile tender offer coupled with a proxy contest "does not implicate the *Blasius* standard of review."[92] The *TLC* court found that the *Blasius* compelling justification standard had been limited to cases where inequitable conduct relating to a shareholder vote had the effect of either "(i) precluding effective shareholder action . . . or, of (ii) 'snatch[ing] victory from an insurgent slate on the eve of the noticed meeting' . . ."[93]

In *Hilton Hotels Corp. v. ITT Corp.*,[94] as a defense to Hilton's hostile bid, the ITT board had approved a reorganization that placed most of ITT's operations in a new corporation with a staggered board, thereby preventing ITT shareholders from voting on Hilton's effort to oust the ITT board at ITT's upcoming annual meeting to facilitate its takeover bid. The federal court enjoined the classified board provision and other elements of the board's plan as a violation both of *Unocal* and *Blasius* principles.[95] With respect to the *Blasius* claim, the court specifically found that the primary purpose of the reorganization plan was to interfere with the shareholder franchise and that no compelling justification existed for that interference.[96]

Certainly, *Liquid Audio* sends a clear signal that the Delaware courts will rigorously review board action that could affect an election contest. The directors, in this context, should evaluate the reasons for the proposed action and its probable impact on the shareholder franchise.

Effect of Stockholder Approval

One way to significantly reduce the risk of potential breach of fiduciary duty claims is for the board to obtain shareholder approval of a proposed transaction, when this is a feasible course to follow. While a board may have no legal duty to subject proposed transactions to a shareholder vote absent an express requirement pursuant to a statute or a corporation's certificate of incorporation or bylaws,[97] shareholder approval of a proposed merger or other transaction may shield the board from most breach of fiduciary duty claims.[98]

However, it is unclear whether a "duty of loyalty claim" against directors may be eliminated by stockholder ratification on less than a unanimous vote.[99] In *Solomon v. Armstrong*, *supra*, Chancellor Chandler observed that the legal principles on this question "may be one of the most tortured areas of Delaware law."[100] In that case, the court held that, in addressing duty of loyalty claims, "where there is no controlling shareholder, control group or dominating force that can compel a particular result," shareholder approval of a merger or other challenged transaction "provides an independent reason to maintain business judgment protection for the board's acts."[101]

In *Lewis v. Austen*,[102] the stockholder plaintiff challenged the treatment of stock options in a spinoff transaction. The court ruled that the stockholder approval of the option modifications did not extinguish a duty of loyalty claim; however, the court ruled, ratification put the burden on plaintiff to plead either insufficient proxy disclosures or a claim of corporate waste in order to overcome the business judgment rule presumption. Since the plaintiff's pleadings were inadequate, the claim was dismissed.[103]

Moreover, when defensive measures are employed after a hostile bid has been made or *Revlon* duties are at issue, shareholder ratification of a transaction will not shield the board's decision to erect the defenses or the board's fulfillment of *Revlon* requirements from enhanced judicial review, unless the shareholders specifically ratified the defensive measures or the auction process, and not just the transaction.[104] Furthermore, the burden rests on the party relying on shareholder approval to establish that the shareholders were fully informed and disinterested.[105] Nonetheless, as to any transaction specifically voted upon, the general rule remains that, "in most circumstances, 'where a majority of fully informed stockholders ratify action even of interested directors, an attack on the ratified transaction normally must fail.'"[106]

Duties of Directors of an Acquiring Corporation

In the mergers and acquisitions arena, the law of directors' fiduciary duties has generally evolved in relation to the actions of the target company's board. Delaware and other courts have had fewer opportunities to review the actions of an acquiring company's directors. However, in *Ash v. McCall*,[107] the Delaware Court of Chancery recently applied traditional business judgment principles in evaluating the approval of a merger by an acquirer's board.[108] Rejecting a breach of duty-of-care claim, the court held that the board was "entitled to the presumption that it exercised proper business judgment."[109] Additionally, *Ash* sets forth legal standards for determining the circumstances when the directors of an acquiring company would not be entitled to the classic business judgment presumption. These standards are consistent with the business judgment rule as applied by Delaware and other courts in other contexts.

The plaintiffs' claim in *Ash* stemmed from the stock merger of McKesson Corporation and HBOC & Co. in January 1999. After the completion of that merger, in April 1999, management of the combined company, McKesson HBOC, discovered various irregularities in HBOC's accounting of sales, revenues, and earnings from 1996 to April 1999. This discovery resulted in McKesson HBOC disallowing $327.4 million of revenue and $191.5 million of operating income and an approximate 50% reduction in the company's market capitalization. Plaintiffs claimed that the McKesson directors breached their duty of due care by failing to discover these accounting irregularities during the course of their pre-merger due diligence investigation of HBOC. Additionally, plaintiffs alleged that the McKesson board's disregard of several "clear warnings" of these irregularities, including some well-publicized reports of HBOC's accounting practices, was further evidence of this breach of the duty of care.

Although the court disposed of most of the plaintiffs' claims on procedural grounds for failure to demonstrate demand futility,[110] Chancellor Chandler also addressed several of the substantive claims in ways that provide helpful guidance to directors of a company planning an acquisition. In dismissing the plaintiffs' duty of care claims, the court held that, in challenging a transaction approved by a board composed of a majority of independent, disinterested directors, plaintiffs bear a heavy burden to create reasonable doubt that the directors fulfilled their duty of care.[111] To determine whether reasonable doubt exists courts examine the decision-making process rather than the business result of a decision and whether the directors (i) informed themselves of available critical information before approving the transaction; (ii) considered expert opinion; (iii) provided all Board members with adequate and timely notice of the [transaction] before the full Board meeting and of its purpose; or (iv) inquired adequately into the reasons for or the terms of [the transaction].[112]

Since the McKesson board satisfied these process requirements, in particular the consideration of expert advice, the plaintiffs failed to meet this burden and the court dismissed their claims.

As McKesson engaged expert accounting and financial advisors to perform due diligence and those advisors gave HBOC a "clean bill of health," the court focused the duty of care inquiry as a question of whether the acquirer's directors may properly rely on qualified experts. In answering this question, the court applied long-standing principles of Delaware law and wrote "[d]irectors of Delaware corporations quite properly delegate responsibility to qualified experts in a host of circumstances. One circumstance is surely due diligence review of a target company's books and records."[113] Furthermore, to overcome the presumption that a board may rely on experts, the court held that plaintiffs must allege particularized facts that, if proved, would show that (1) the directors in fact did not rely on the expert, or (2) that their reliance was not in good faith, or (3) that they did not reasonably believe that the experts' advice was within the experts' professional competence, or (4) that the directors were at fault for not selecting experts with reasonable care, or (5) that the issue . . . was so obvious that the board's failure to detect it was grossly negligent regardless of the experts' advice, or (6) that the board's decision was so unconscionable as to constitute waste or fraud.[114]

Endnotes

1. In cases against directors arising out of completed actions involving operational issues, "the business judgment rule shields directors from personal liability if, upon review, the court concludes the directors' decision can be attributed to any rational business purpose."
2. *Beam v. Stewart*, 845 A.2d 1040, 1049, n.16 (Del. 2004) (emphasis added), quoting *Aronson v. Lewis*, 473 A.2d 805, 812.
3. *Cinerama, Inc. v. Technicolor, Inc*., 663 A.2d 1156, 1162 (Del. 1995).
4. *See* William T. Allen et al., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 Bus. Law. 1287 (Aug. 2001) (hereinafter Function Over Form). The authors are former Delaware Chancellor Allen, then Vice Chancellor and later Delaware Supreme Court Justice Jacobs, and Vice Chancellor Strine.
5. *Id*. at 1298 (footnotes omitted). In that article, the authors also question whether good faith should be treated as a separate one of a triad of directors' fiduciary duties, suggesting that "it is a subset or 'subsidiary requirement' that is subsumed within the duty of loyalty, as distinguished from being a compartmentally distinct fiduciary duty of equal dignity with the two bedrock fiduciary duties of loyalty and due care." *Id*. at 1305 n.69 (quoting *Emerald Partners v. Berlin*, C.A. No. 9700 Del. Ch. LEXIS 20, at *87 n.63 (Del. Ch. Feb. 7 2001) (citations omitted).
6. *Id*. at 1296.
7. In *re Caremark Int'l Inc. Derivative Litig*., 698 A.2d 959, 967–968 (Del. Ch. 1996) (footnotes omitted).
8. *See* Fleischer & Sussman § 4.07.
9. *See Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985).
10. *Id. Accord Citron v. Fairchild Camera & Instrument Corp.*, 569 A.2d 53, 66–67 (Del. 1989); *Grobow v. Perot*, 539 A.2d 180, 190–91 (Del. 1988) (dismissing stockholder derivative claim of gross negligence for failure to make pre-suit demand).
11. *Malpiede v. Townson*, 780 A.2d 1075, 1097 n. 76 (Del. 2001) (quoting *McMullin*, 765 A.2d at 921 (quoting *Aronson*, 473 A.2d at 812)).
12. 768 A.2d 492 (Del. Ch. 2000).
13. *Id.* at 505 n.56 (citing *Kahn v. Roberts*, Del. Ch., C.A. No. 12324, 1995 Del. Ch. LEXIS 151, *11. Steele, V.C. (Dec. 6, 1995) ("gross negligence means 'reckless indifference to or a deliberate disregard of the whole body of stockholders' or actions which are 'without the bounds of reason'") (quoting *Tomczak v. Morton Thiokol, Inc.*, Del. Ch., C.A. No 7861, 1990 Del. Ch. LEXIS 47, *35, Hartnett, V.C. (Apr. 5, 1990)), *aff'd*, 679 A.2d 460 (Del. 1996)). *See also Function Over Form*, *supra*, note 3, defining "gross negligence" as involving "a devil-may-care attitude or indifference to duty amounting to recklessness." 56 Bus. Law at 1300.
14. *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 362, 365 (Del. 1993), after remand sub nom. *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156 (Del. 1995). For further discussion of "disinterested" and "independent" directors and additional cases, see Independence of the Board, *infra* § 111-C1c.
15. *Cede*, 634 A.2d at 363–64.
16. *Technicolor*, 663 A.2d at 1167.
17. *Id.* at 1168–70.
18. No. 15192, 2001 Del. Ch. LEXIS 34 (Del. Ch. Feb. 23, 2001).
19. *Id.* at *30 (quoting *Rales v. Blasband*, 634 A.2d 927, 936 (Del. 1993)).
20. *Id.* at *33.
21. 825 A.2d 275 (Del. Ch. 2003).
22. 325 F.3d 79 (7th Cir. Mar. 28, 2003).
23. *See Disney*, 825 A.2d at 286; *Abbott*, 325 F.3d at 809–11.
24. *Disney*, 825 A.2d at 289 (emphasis in the original); *accord Abbott*, 325 F.3d at 809.
25. *See*, e.g., *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361, 1383 (Del. 1995) (recognizing "prerogative of a board of directors to resist a third party's unsolicited acquisition proposal or offer.") (quoting *Paramount v. QVC Network, Inc.*, 637 A.2d 34, 43 n.13 (Del 1994)); *Paramount Communications, Inc. v. Time Inc.* (Time Warner) 571 A.2d 1140, 1152,[1989-1990] [Transfer Binder] Fed. Sec. L. Rep (CCH) ¶ 94,938 (Del. 1990) ("We have repeatedly stated that the refusal [of directors] to entertain an offer may comport with the valid exercise of a board's business judgment."); *Gagliardi v. Trifoods Int'l, Inc.*, 683 A.2d 1049, 1055 (Del. Ch. 1996) (holding directors may "refuse" to negotiate or entertain sale of company to potential acquirer absent bad faith); *Shamrock Holdings, Inc. v. Polaroid Corp.*, 559 A.2d 278 (Del. Ch. 1989).
26. *Kahn v. MSB Bancorp, Inc.*, No. 14712-NC, 1998 WL 409355 (Del. Ch. July 16, 1998), *aff'd without publ'd op.*, 1999 WL 507085 (Del. June 14, 1999).
27. *Id.* at *2.
28. The bidder modified its offer price subsequently, and the target's board once again rejected it. The target's board then received yet another bidder's unsolicited offer to merge with the target. The target's board rejected that offer as well. *Id.* at *2.
29. *Id.* at 3. *MSB* therefore held explicitly that the stricter standard of review of a board's actions embodied in *Unocal v. Mesa Petroleum*, 493 A.2d 946 (1985), was "irrelevant where, as here, no defensive action was taken." *MSB* at 3.
30. *Id.* The court refused expressly to accept the shareholder plaintiffs' invitation to create "a new rule that a board should be required to persuade the court that it has acted in good faith with due care when it rejects a merger offer." Such a rule, MSB held, "would depart from precedent." *Id*.
31. *Minzer v. Keegan*, No. CV-97-4077 (CPS), 1997 U.S. Dist. LEXIS 16445 (E.D.N.Y. Sept. 22, 1997), second amended complaint dismissed, No. 97-CV-4077 (E.D.N.Y. Jan. 25, 1999), *aff'd*, 218 F.3d 144 (2d Cir. July 10, 2000), *cert. denied*, 531 U.S. 1192 (2001).
32. *Id.* at 34.
33. *Id.* at 32 (citing N.Y. Bus. Corp. Law § 717; *Auerbach v. Bennett*, 47 N.Y.2d 619, 629–31 (1979)).
34. *Id.* at 32 (citing *Alpert v. 28 Williams St. Corp.*, 457 N.Y.S.2d 4, 6 (App. Div. 1982)).
35. *Minzer*, 218 F.2d 144. The dismissal was granted by the district court and affirmed on appeal for failure to plead a federal claim and, accordingly, the courts did not reach the state law fiduciary duty issues.
36. *Id.* at 150.
37. *See*, *e.g*., *Pogostin v. Rice*, 480 A.2d 619, 627 (Del. 1984) (failure of board to negotiate with third party that made premium offer is not *prima facie* breach of fiduciary duty, derivative suit dismissed for failure to make demand); *Lewis v. Straetz*, No 7859 (Del. Ch. Feb. 12, 1986) (motion to dismiss derivative suit granted because: "The fact that a hostile tender offer was rejected, standing alone, does not state a breach of fiduciary duty.").
38. *See Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156 (Del. 1995). Bad faith is "not simply bad judgment or negligence, but . . . the conscious doing of a wrong because of dishonest purpose or

moral obliquity . . . [I]t contemplates a state of mind affirmatively operating with furtive design or ill will."

39. *Gilbert v. El Paso Co.*, 575 A.2d 1131 [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,303 (Del. 1990).
40. *Id*. at 96,414 (citing *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334 (Del. 1987); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985); and other cases. *See Unitrin v. American Gen. Corp.* 651 A.2d 1361 (Del. 1995).
41. *Unocal*, 493 A.2d 946.
42. *El Paso*, 575 A.2d at 1145.[1990 Transfer Binder] Fed Sec. L. rep. (CCH) ¶ 95,303, at 96,414, n.29.
43. *Katz v. Chevron Corp*., 27 Cal. Rptr. 2d 681 (1st Dist. 1994).
44. *Unitrin*, 651 A.2d at 1388 (citing *Paramount*, 637 A.2d at 45–46).
45. *See Selling the Company*, *infra* § XII.
46. *Paramount Communications Inc. v. QVC Network, Inc.*, 637 A.2d 34 (Del. 1994).
47. *Id*. at 43–48.
48. *Id*. at 48.
49. *Id*. at 45. *Accord, In re Rennaco Energy, Inc. Sh. Litig*., 787 A.2d 691 (Del. Ch. 2001) (quoting above passage from QVC) (denying motion for preliminary injunction against sale of company to third party).
50. *Id*. at 49.
51. *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345. [1993 Transfer Binder] Fed. Sec. L. Rep (CCH) ¶ 97,811 (Del. 1993), after remand sub nom. *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156 (Del. 1995) (Technicolor).
52. *Technicolor*, 663 A.2d at 1172–80.
53. The Delaware Supreme Court has directly ruled that target directors generally must justify defensive measures that favor one suitor over others before they can obtain dismissal of a suit challenging their conduct. *See In re Santa Fe Pac. Corp. S'holder Litig.*, 669 A.2d 59, 72 (Del. 1995).
54. *See Williams v. Geier*, 671 A.2d 1368, 1378 & n.20, 1384 (Del. 1996); *Technicolor*, 663 A.2d at 1162–64; *Unitrin*, 651 A.2d at 1377 n.18 (Del. 1995) (citing authorities). Cases analyzing the damage remedies for directors' breaches of fiduciary duty in approving a sale of merger transaction are discussed in Fleischer & Sussman § 15.04 (G).
55. *See Thorpe v. CERBO, Inc.*, 676 A.2d 436, 437, 442–45 (Del. 1996).
56. *Schnell v. Chris-Craft Indus.*, 285 A.2d 437 (Del. 1971).
57. *Id*. at 439, quoted with approval in *Unitrin*, 651 A.2d at 1378. Other cases have precluded similar board actions that affected corporate governance and were taken for the primary purpose of entrenchment. See, for example, *Leman v. Diagnostic Data, Inc*., 421 A.2d 906, 914 (Del. Ch. 1980) and discussion of that case and others in Fleischer & Sussman § 6.06 (C).
58. *See*, *e.g*., *Aprahamian v. HBO & Co.*, 531 A.2d 1204 (Del. Ch. 1987).
59. *Blasius Indus., Inc. v. Atlas Corp*., 564 A.2d 651, 661 (Del. Ch. 1988). The Delaware Supreme Court recently noted that "we accept the basic legal tenets" set forth in *Blasius*. *Unitrin*, 651 A.2d at 1378–79 (Del. 1995) (quoting *Stroud v. Grace*, 606 A.2d 75, 91 (Del. 1992).
60. *Blasius*, 564 A.2d at 659.
61. *Id*. at 660.
62. 813 A.2d 1118 (Del. 2003).
63. *Id*. at 1124.
64. *Id*. at 1125–26.
65. *Id*. at 1124.
66. *Id*. at 1126 (emphasis in the original).
67. *Id*. at 1132 (emphasis in the original).
68. *Id*. (emphasis in the original).
69. *Id*.
70. *Stroud*, 606 A.2d at 92, as quoted in *Unitrin*, 651 A.2d at 1379.
71. *Unitrin*, 651 A.2d at 1379 (citing *Stroud*, 606 A.2d at 92 n.3).
72. *Unitrin*, 651 A.2d at 1379.
73. *Id*. at 1388.
74. *Id*. at 1388–89.
75. *In re The MONY Group, Inc. S'holder Litig*., No 20554, 2004 WL 769817 (Del. Ch. April 12, 2004) (as revised April 14, 2004).
76. *In re The MONY Group, Inc. S'holder Litig*., No. 20554, 2004 WL 303894 (Del. Ch. Feb. 17, 2004) (denying preliminary injunction against proposed merger, but granting injunction to require additional disclosures concerning change-in-control agreements).
77. 2004 WL 769817 at 6.
78. *Id*. at 7 (footnotes omitted, distinguishing Peerless and noting that, "[o]f course, there are other positive limitations placed on board conduct" relating to a stockholder vote).
79. *Id*. at 8.
80. *Id*. at 9.
81. *Id*. at 9.
82. *Id*.
83. 805 A.2d 196 (Del. Ch. 2002).
84. *Id*. at 198.
85. *Id*. at 205.
86. *Id*. at 201, 205–06.
87. *Id*. at 205.
88. *Id*. at 207 (citing *Unitrin*, 651 A.2d at 1386–87).
89. *Id*. at 207–08 & n.32 (noting that this result was consistent with prior precedents "enjoining the voting of shares issued for entrenchment purposes").
90. *Id*. at 208–09.
91. *See Kidsco, Inc. v. Dinsmore* (TLC), 674 A.2d 483 (Del. Ch.), *aff'd*, 670 A.2d 1338 (Del. Nov. 29, 1995) (order affirming on opinion below).
92. *TLC*, 674 A.2d at 496 (denying preliminary injunction against bylaw amendment giving board 25 additional days to call a special meeting and noting the *Stahl* case was "functionally indistinguishable").
93. *TLC*, 674 A.2d at 495–96 (quoting *Stahl*, 579 A.2d at 1123, and citing other precedents).
94. *Hilton Hotels Corp. v. ITT Corp*., 978 F. Supp. 1342 (D. Nev. 1997).
95. *Id*. at 1347–50.
96. *Id*. at 1348–50.
97. *See Lennane v. ASK Computer Sys., Inc.*, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,674, 1990 WL 154150 (Del. Ch. Oct. 11, 1990), *appeal refused*, 588 A.2d 660 (Del. Oct. 19, 1990) (decision without published opinion), *aff'd on reconsideration*, 1990 WL 161094 (Del. Ch. Oct. 19, 1990).

98. *See generally Solomon v. Armstrong*, 747 A.2d 1098, 1113–17 (Del. Ch. 1999), *aff'd on opinion below*, 746 A.2d 277 (Del. 2000) (granting motion to dismiss claims challenging the General Motors board decision to split off its Electronic Data Systems subsidiary); *In re Wheelabrator Technologies Inc. S'holder Litig*,., 663 A.2d 1198, 1201–05 (Del. Ch. 1995) ("Wheelabrator II"). *See also Weiss v. Rockwell Int'l Corp*., C.A. No. 8811, 1989 Del. Ch. LEXIS 94, at 8–10 (Del. Ch. July 19, 1989) (citing *Smith v. Van Gorkom*, 488 A.2d at 890, for well-settled rule that shareholder approval with full disclosure precludes breach of fiduciary duty claims, except where approved transaction involves "gift or waste of assets, fraud, or ultra vires"), *aff'd mem*., 574 A.2d 264 (Del. 1990).

99. In *Williams v. Geier*, 671 A.2d 1368, 1378 (Del. 1996), the Delaware Supreme Court, after noting circumstances under which "interested transactions" may be ratified and citing cases, stated: "We express no opinion on the question whether a 'duty of loyalty claim' may or may not be ratified." *Id*. at 1379 (citing *Wheelabrator* II, 663 A.2d at 1202) for "noting some such circumstances [under which interested transactions may be ratified] and concluding that stockholder ratification may not extinguish a 'duty of loyalty claim.'" *See Solomon v. Armstrong*, 747 A.2d 1098, 1114–18 (Del. Ch. 1999) (Chancellor Chandler's detailed review of the law on this subject, "one of the most tortured areas of Delaware law." *Id*. at 1114), *aff'd on opinion below*, 746 A.2d 277 (Del. 2000).

100. 747 A.2d at 1114; *see id*. at 1117 n.59 ("The Delaware Supreme Court has not squarely addressed the issue of whether fully-informed shareholder ratification may legally bar approving shareholders from subsequently asserting duty of loyalty claims," citing *Williams v. Geier*, 671 A.2d at 1379 n.23, but noting that in *Bershad v. Curtiss-Wright Corp*., 535 A.2d 840, 848 (Del. 1987), the Delaware Supreme Court stated that "[w]hen an informed minority shareholder either votes in favor [of a transaction or] . . . accepts the benefits of the transaction, he or she cannot thereafter attack its fairness").

101. *Id*. at 1117; *see id*. at 1127 (holding fully informed, non-coerced shareholder vote required rejection of duty of loyalty challenge to General Motors' split-off of its EDS subsidiary). See also *Wittman v. Crooke*, 120 Md. App. 369, 377–378, 707 A.2d 422 (Md. Ct. Sp. App. 1998) (holding that shareholder ratification extinguishes duty of loyalty claim under Maryland law).

102. *Lewis v. Austen*, C.A. No. 12937, 1999 WL 378125 (Del. Ch. June 2, 1999).

103. *See id*., slip op. at 6 n.24 (citing cases). See generally *Fleischer & Sussman* § 3.01[A][b].

104. See *In re Santa Fe Pac. Corp. S'holder Litig*., 669 A.2d 59, 67–68 (Del. 1995) ("Since the stockholders . . . merely voted in favor of the merger and not the defensive measures, we decline to find ratification"). The application of this non-ratification principle to *Revlon* claims is less clear as the court in Santa Fe held that plaintiffs had failed to plead a valid *Revlon* claim. *Id*. at 71.

105. *See Geier*, 671 A.2d at 1378. *See generally Fleischer & Sussman* § 15.03[F].

106. *Santa Fe*, 669 A.2d at 68 (quoting *Cinerama v. Technicolor*, 663 A.2d 1156, 1176 (Del. 1995) (quoting *Smith v. Van Gorkom*, 488 A.2d 858, 890 (Del. 1985))). In *Technicolor*, where the Technicolor directors had the burden of proving the entire fairness of the sale of the company in a two-stage tender offer/merger transaction, the Delaware Supreme Court noted that "the Court of Chancery properly found the tender by an overwhelming majority of Technicolor's stockholders [i.e., over 75 percent of the outstanding stock was tendered] to be tacit approval and, therefore, constituted substantial evidence of fairness." 663 A.2d at 1176 (citations omitted).

107. 2000 Del. Ch. LEXIS 144 (Sept. 15, 2000).

108. See Directors' fiduciary duties in takeovers and mergers, *supra* § 111-A1 for a general discussion of the business judgment rule in Delaware.

109. *Ash* 2000 Del. Ch. LEXIS 144 at 31.

110. *See Fleischer & Sussman* § 3.01[C] for a discussion of derivative claims.

111. *Ash* 2000 Del. Ch. LEXIS 144 at 33.

112. *Id*. at 34.

113. *Id*. at 30 (citing 8 Del. C. § 141 (e)).

114. *Id*. at 32 (citing *Brehm v. Eisner*, Del. Supr., 746 A.2d 244, 262 (2000)).

Arthur Fleischer, Jr. is Fried Frank's Senior Partner in the New York office. Mr. Fleischer has led the firm's mergers and acquisitions practice and regularly represents corporate clients, both as acquirers and targets, and many of the leading investment banking firms in M&A transactions.

Mr. Sussman concentrates his practice in complex securities, corporate and commercial trials and appeals, as well as merger and acquisition counseling and litigation. He also represents clients in class actions and derivative suits, financing and accounting disputes, Securities and Exchange Commission proceedings, other major litigation and alternative dispute resolution, arbitration and mediation.

This article is an excerpt from Arthur Fleischer, Jr and Alexander R. Sussman, Responses to Takeover Bids: Corporate, SEC, Tactical and Fiduciary Considerations (BNA Corporate Practice Series, Portfolio No. 6-3rd, 2004 Supp., July 2004) (800-372-1033). (<http://www.bna.com>)

NYSBA v. FTC: The Dolphins Escape! (Or Do They?)

By David L. Glass

> It is the policy of the Congress that each financial institution has an affirmative and continuing obligation to respect the privacy of its customers and to protect the security and confidentiality of those customers' nonpublic personal information.[1]

> [Lawyers are like] happy dolphins swimming along in the ocean and getting caught in a tuna net.[2]

On April 30 of this year, Judge Walton of the District Court for the D.C. Circuit issued an Order granting the motion of the New York State Bar Association ("NYSBA") for summary judgment and denying the cross-motion of the Federal Trade Commission ("FTC") for summary judgment in a case brought by the NYSBA in 2002.[3] (In an article published in the Fall 2002 issue of the *New York Business Law Journal*, reprinted hereafter, the author discussed the background of the NYSBA's suit and analyzed the prospects for its success.)

The NYSBA's action, subsequently joined by the American Bar Association ("ABA"), sought to overturn the FTC's interpretation that attorneys are covered by the privacy requirements under the financial reform legislation enacted in 1999. Known as the Gramm-Leach-Bliley Act ("GLB Act"), the 1999 law requires, among other things, that all "financial institutions" provide their customers with written notices, at the outset of the relationship and annually thereafter, detailing their policy regarding disclosure of the customer's non-public information to third parties, and giving the customer an opportunity to "opt out" of such disclosure.[4] In a breathtakingly wrong-headed example of administrative decision-making by the wooden application of a rule, rather than the dictates of common sense,[5] the agency had interpreted its own rule implementing the GLB Act to mean that an attorney engaged in the practice of law is a "financial institution"—at least to the extent that he provides services, such as real estate settlement, tax advice or tax planning, considered to be financial in nature—and, as such, is required to comply with the Act's notice requirements.

Thus, the FTC's interpretation, had it been allowed to stand, could have required many or most of NYSBA's 72,000 members—along with their nearly one million colleagues nationwide—to provide their clients with annual privacy notices, in the form prescribed by the GLB Act and the FTC's rules thereunder, and potentially left them exposed to the risk of substantial penalties if they failed to do so. Having thus cast its tuna net far and wide, the FTC found itself reeling in some not-so-happy dolphins. The resulting cost and paperwork burden stood to fall most heavily on solo practitioners, small firms, and public interest attorneys with limited resources and large numbers of individual clients.

But even more than the potential cost and burden of complying with a disclosure requirement designed primarily for large banks and other financial institutions, the NYSBA and its members were concerned about the potential adverse effect upon client relations. Under long-standing practice, not to mention ethical rules and standards in effect in every state, clients take for granted that personal information they give their attorneys in the course of the attorney-client relationship will not be disclosed by the attorney without their consent. What are clients to think, therefore, when—as would have been required by the FTC's interpretation—they receive a communication from their attorney, outlining her "policy" for sharing their information with third parties?

Judge Walton's Order ("*FTC II*") implemented his thorough and well-reasoned memorandum opinion issued in August 2003, in which he initially denied the FTC's motion to dismiss the complaint ("*FTC I*"). In *FTC I*, the court determined that it did not appear that Congress ever intended that attorneys be subject to the GLB Act's privacy provisions; that the agency's failure to provide sufficient reasoning to support its contrary interpretation could, therefore, be considered arbitrary and capricious and beyond its statutory authority within the meaning of the Federal Administrative Procedure Act ("APA")[6]; and that the agency's failure to consider whether a *de minimis* exception was applicable, even if the rule otherwise arguably applied to attorneys, was similarly arbitrary and capricious.[7]

However, because the court did not have the entire administrative record before it, the fashioning of a remedy was left for another day. Then in *FTC II* the Judge issued a final Order granting NYSBA's motion for summary judgment, and declaring the FTC's interpretation to be arbitrary and capricious and beyond its statutory authority. In the interim, the FTC had stipulated that it would not seek to enforce the rule against attorneys, pending final resolution of the case.[8]

So for now, at least, the dolphins have successfully dodged the tuna net. On July 9, however, the FTC filed a notice of appeal, apparently to preserve its right to appeal by giving notice within the required 60 days (the Judge signed his Order on May 12). As this article goes to press, it remains unclear whether the FTC actually intends to go forward with the appeal. In the author's view, the District Court's decision is soundly reasoned and solidly grounded in basic principles of administrative law, and should, therefore, withstand any appeal that ultimately may be brought.

The remainder of this article briefly reviews the background of the litigation and the key aspects of the D.C. District Court's decision.

The GLB Act Privacy Provisions

The GLB Act was the product of more than 20 years of discussion and negotiation, aimed at enabling U.S. banking organizations to compete more effectively with their global brethren by breaking down the existing barriers to their participation in other financial services—particularly insurance and securities.[9] For nineteen of those 20 years, privacy was not part of the discussion; H.R. 10, the precursor to the GLB Act, which passed the House (but not the Senate) in 1998, contained no mention at all of financial privacy. In the spring of 1999, however, just as the final language of the bill was being crafted in the House of Representatives, the attorney general of Minnesota brought an action against a large bank that sold its customer list to a third-party marketing firm.[10] The publicity surrounding that action apparently galvanized consumer advocates, who expressed concern regarding the privacy of customer information in the hands of large financial companies.

Within days, the House Commerce Committee inserted a privacy provision into the pending legislation. As enacted, the GLB Act's privacy provision has two principal elements. First, it requires financial institutions to adopt a policy as to whether they will share customer information with third parties, and to disclose that policy to their customers at the outset of the relationship and annually thereafter. Second, it implements an "opt out" approach—i.e., if the customer does not want his information shared, he must affirmatively notify the institution to that effect. The ability of financial institutions to share such information among their subsidiaries and affiliates, earlier made explicit through an amendment to the Fair Credit Reporting Act ("FCRA"), remained undisturbed.

As is typically the case with complex financial legislation, Congress entrusted the regulatory authorities with the responsibility to implement the Act's requirements through rule-making. Thus, the federal bank regulatory agencies have promulgated rules setting forth the privacy notice requirements for the banking institutions under their respective jurisdictions. The Securities & Exchange Commission ("SEC") did likewise for securities firms it regulates, as did the state insurance regulators for insurance companies. The FTC was given residual authority for all financial businesses that were not under the jurisdiction of any of these agencies.

Given this history, it was and is clear that Congress was concerned with giving consumers the option of preventing their financial information from being sold or otherwise disseminated to third parties by financial institutions with whom they deal. It is equally clear that Congress never contemplated the possibility that attorneys engaged in practicing law might be deemed to be "financial institutions." There is no mention of lawyers in the legislative history, and the legislation was never referred to the House or Senate Judiciary Committees, which would have jurisdiction over legislation that impacts on the practice of law. Indeed, an FTC staff attorney, while insisting that lawyers were "technically covered by the [FTC rule] and need to comply," acknowledged that applying the GLB Act to lawyers "doesn't make sense."[11]

Nonetheless, in a letter dated April 8, 2002 to the ABA (the "Beales Letter"), the FTC stood by its decision that attorneys were covered by its rule.[12] The NYSBA responded by filing its Complaint.[13] (The ABA initially brought a separate action in North Carolina, which was subsequently discontinued when it joined the NYSBA action.) The crux of the NYSBA's Complaint lies in the area of administrative law—namely, whether the agency's action—or, in this case, inaction—was arbitrary, capricious or not in accordance with law. The complaint also alleged that applying the GLB Act to attorneys would violate the Tenth Amendment of the Constitution, in that the regulation of the confidential nature of the relationship between clients and practicing lawyers historically has been committed to the states.

NYSBA v. FTC: Round One

In their pleadings, the ABA and NYSBA sought a declaratory judgment to the effect that 1) the FTC exceeded its statutory authority by holding attorneys to the privacy requirements of the GLB Act; 2) the FTC's decision that attorneys are subject to the GLB Act's privacy provision was arbitrary and capricious agency action, within the meaning of the APA; and 3) even if attorneys otherwise were covered, the FTC's refusal to grant at least a *de minimis* exemption was arbitrary and capricious.[14] For its part, the FTC moved to dismiss the complaints for failure to state a claim upon which relief could be granted. In its memorandum opinion, the court denied the FTC's motion and held for the plaintiffs on each of the three grounds asserted.

FTC I dealt at length with each of the issues presented by the case and, in the author's view, should be upheld if the appeal goes forward. Assuming it is upheld, the decision's thorough analysis is very helpful to practitioners—not only by removing the cloud hanging over the practice of law and the attorney-client relationship, but also by defining the scope of the GLB Act's privacy provisions and providing some further contours to the ongoing question regarding the degree to which informal agency actions are entitled to deference from the courts.

The following discussion briefly summarizes the key aspects of the court's reasoning with respect to each of the points raised.

1. Was the FTC Determination a Final Agency Action?

At the outset, the court acknowledged that a predicate for its review of an agency's action under the APA is that the action taken must be a "final agency action." To meet this test, an agency's action must have a direct and immediate effect on the parties; immediate compliance must be expected; the action should have the status of law; and the question presented should be a legal one, susceptible of judicial resolution.[15] Here, the FTC never issued a rule-making or formal interpretation regarding its view on the applicability of the GLB Act to attorneys.

Nonetheless, the court had no trouble concluding that the FTC's ruling met this test. In addition to the Beales Letter, the court noted that, in its response to the ABA, the FTC had stated that attorneys, along with other "financial institutions," had to comply beginning May 13, 2003. It was clear, therefore, that the FTC regarded the interpretation as final and was prepared to take enforcement action based thereon (although it later agreed not to enforce the rule against attorneys, pending resolution of the litigation). As such, it was a final action subject to review under the APA.

2. Does the Plain Language of the GLB Act Cover Attorneys?

Under the Supreme Court's *Chevron* standard, a court reviewing the action of an administrative agency in implementing a statute is instructed to first determine whether "the intent of Congress is clear [as to] the precise question at issue."[16] If so, "that is the end of the matter . . . [but] if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute." Furthermore, if the agency's choice represents a reasonable accommodation of conflicting policies committed to its discretion by Congress, that interpretation should not be overturned by the court unless it appears from the statute or legislative history that it is not a reading that Congress would have sanctioned.[17]

Thus, the first step in the *Chevron* analysis is to determine whether Congress has spoken to the precise issue in question. If the court determines that the statute is silent or ambiguous regarding that question, the next step is to determine whether the agency's construction is a permissible on.

The GLB Act applies its privacy provisions to all "financial institutions." That term is defined by reference to the Bank Holding Company Act ("BHCA"), as amended by the GLB Act,[18] and cross-references the list of activities deemed to be "closely related" to banking (referred to by banking lawyers as the "laundry list"), as set forth in regulation Y of the Federal Reserve (the "Fed").[19] Because the laundry list includes certain real estate settlement services, tax preparation, and tax planning, the FTC essentially took the position that attorneys engaged in performing these services must be deemed to be financial institutions.

To the court, however, this interpretation "seems to ignore the plain language of the statute's regulatory scheme."[20] The starting point of the analysis is whether an attorney should be deemed to be an "institution" in the first place. The second question is whether the practice of law is properly considered a financial activity under the GLB Act, simply because it may include one or more of these activities.

a. Are You an "Institution"?

Since the term "institution" is not defined in the statute, the court looked to its common dictionary meaning—namely, an "established organization or corporation." In this context, the court noted that more than half of all attorneys are solo practitioners or in firms of five or fewer lawyers.[21] The court concluded that, even applying the broadest possible construction of the term "institution," it would be a "distortion" to conclude that such individual practitioners were intended to be covered—even though many of them no doubt perform services such as a real estate settlement, tax preparation and tax planning. Thus, whether or not they engage in these or other financial activities, the court made clear that at least these attorneys cannot be considered "institutions" whom Congress intended to be covered under the GLB Act definition.

b. Is the Practice of Law a "Financial" Activity?

As part of its statutory responsibility under the BHCA, the Fed over the years has determined various activities to be "closely related to banking." The significance of this determination is that a bank holding company—defined as any company that owns or controls one or more banks—may engage in such activities. As noted, among the activities that have been determined by the Fed to be "closely related," and added to the laundry list by formal rule-making, are "providing real estate settlement services" and "providing tax-planning and tax-preparation services to any person."[22] Nonetheless, the court held that, viewed in context, the practice of law as such could not be considered a financial activity, even if it in part entailed these services.

Thus, with respect to real estate settlement services, the *context* in which they came to be included in the Fed's laundry list was in conjunction with the broader authority of bank holding companies to make real estate loans, and to perform services incidental to such lending, such as real estate settlement, escrow, and document preparation.

Likewise, tax planning and preparation were found by the Fed to be "closely related" to banking because these services are performed by banks and bank trust departments in connection with activities such as financial counseling and estate management.

Furthermore, the court pointed out that the practice of law by banks or bank holding companies is specifically prohibited. In this context, the court noted that, in its original rulemaking adding tax planning to the laundry list, the Fed had explicitly considered the concern that tax planning could stray into the unauthorized practice of law.[23] The Fed accordingly stipulated that the activity must be carried out in accordance with local law, and would be prohibited in any jurisdiction which treated that activity as the practice of law.[24]

The Fed's explicit distinction between the practice of law on the one hand, and the conduct of certain quasi-legal activities by a bank holding company on the other, strengthens the inference that Congress' reference to the Fed's laundry list in defining financial activities was never intended to catch attorneys in the tuna net. Rather, that reference was intended to pick up, under the definition of "financial institution," any "institution" providing those or similar services, in order to achieve the congressional objective of protecting the privacy of customers and the confidentiality of their nonpublic personal information in dealings with financial institutions—particularly the behemoths envisioned in the GLB Act's authorization of affiliations among different types of financial service providers.

That this concern is not present with respect to attorneys is evident in the purpose and structure of the GLB Act, which was intended to provide a "prudential framework" for the future affiliation of banks, securities dealers, insurance companies and other financial businesses. As the court aptly noted, existing ethical rules in every state already preserve the confidentiality of client information. For example, as noted by the NYSBA, and acknowledged by the court, New York court rules require attorneys to prominently display a client's "bill of rights" in their offices which, among other things, explicitly notifies clients of their right to privacy, and to have their secrets and confidences preserved, in their dealings with their attorney.[25]

Furthermore, as discussed above, the GLB Act was enacted to further affiliations among financial institutions. By contrast, state ethics and disciplinary rules likely would prohibit attorneys from affiliating with financial institutions, due to prohibitions on entering into partnerships with non-lawyers or sharing fees with them.[26] In sum, as noted by the ABA in its memorandum to the court, "there are no circumstances in which the GLB Act affords greater protection than the rules to which lawyers are already subject."[27]

3. Did Congress Intend to Interfere with State Regulation of Attorneys Through "Subtle" Language?

Since the GLB Act does not explicitly overturn the existing structure of state regulation of the practice of law—indeed, as noted it does not refer to the practice of law at all—the court next considered whether Congress plausibly would have attempted to interfere with the states' historic role in regulating attorneys through the use of "subtle language" (i.e., by including attorneys implicitly, rather than explicitly, in the definition of "financial institution"). Based upon its analysis of a line of Supreme Court cases dealing with agencies' attempts to regulate a significant matter based upon "subtle" statutory authority, the court concluded that it would not.

Thus, in one case statutory language permitting the Federal Communications Commission to "modify" certain tariff filing requirements did not justify its action in making such filings optional for certain carriers. The Court held that it was "highly unlikely" that Congress would have left the determination of whether an industry would be rate-regulated in the hands of an agency, through such a subtle device as permission to modify certain filing requirements.[28] Similarly, the Court overturned an attempt by the Food and Drug Administration to regulate tobacco products, since it had historically not done so and had no express congressional authorization to do so.[29]

The court concluded that these precedents stand for the proposition that Congress "does not alter the fundamental details of a regulatory scheme in vague terms or ancillary provisions—it does not, one might say, hide elephants in mouseholes."[30] Thus, in the absence of a clear indication to that effect, it is "unlikely" that Congress intended the GLB Act to apply to attorneys, since it has never sought to regulate the ethical conduct of attorneys, which historically has been committed to the states. With this holding the court effectively finessed the Tenth Amendment argument initially advanced by NYSBA—i.e., whether Congress would be infringing upon the historic function of states in regulating the practice of law—by noting that the issue is not whether Congress can, in any circumstances, regulate the practice of law, but only whether it attempted to do so here. In the absence of a clear indication of Congressional intent to infringe on state authority, therefore, there is no need to reach the Tenth Amendment issue.[31]

The court also rejected the FTC's argument that Congress has subjected the conduct of attorneys to regulation in other areas. For example, attorneys are subject to the Fair Debt Collection Practices Act, the civil rights acts, and the anti-racketeering RICO statute, among others. In each of these cases, however, as the court pointed out, the statute in question uses the term "persons" to describe the scope of its coverage. Their scope is manifestly intended to be broader than the GLB Act, which by its terms applies only to "financial institutions." And, the court noted, none of those statutes purports to regulate generally the ethical conduct of attorneys.[32]

On the other side of the coin, the court pointed to the Citizens Protection Act ("CPA") as an indication of congressional intent to defer to the states with respect to the regulation of attorney ethics. The CPA stemmed from an attempt by the Justice Department to exempt its attorneys from the "no contact" rule applicable in every state—i.e., the disciplinary rule prohibiting an attorney from contacting directly a person known to be represented by counsel. In a memorandum to Department staff, former Attorney General Thornburgh had taken the position that state ethical rules did not apply to federal attorneys, if they conflicted with attorneys' federal responsibilities. In response, Congress enacted the CPA, also known as the McDade amendment, which expressly applies state attorney conduct rules to all federal attorneys.[33] In the court's view, this legislation "reflects the respect Congress has for the right of the states to regulate the ethical conduct of lawyers who practice law in their jurisdiction."[34]

4. Is the FTC's Interpretation Entitled to Deference Under *Chevron*?

The court's analysis under the APA assumed, *arguendo*, that the FTC's interpretation was entitled to deference under *Chevron*. In general, of course, the interpretation of a regulatory statute by the agency charged with its enforcement is normally entitled to considerable deference. However, in *United States v. Mead Corporation*, the Supreme Court recently clarified that the appropriate degree of deference depends upon the circumstances.[35] In particular, the *Mead* case distinguished an informal agency action, such as an opinion letter, from a formal agency action, such as a rule-making or adjudication. In determining the appropriate degree of deference for an informal action, the Court held that a reviewing court should look to

> the degree of the agency's care, its consistency, formality, and relative expertness, and . . . the persuasiveness of the agency's position . . . the weight [to be accorded to the agency's judgment] will depend upon the thoroughness evident in [the agency's] consideration, the validity of its reasoning . . . and all those factors which give it power to persuade . . .[36]

Thus, interpretations contained in an opinion letter, such as the Beales Letter, are entitled to some respect, but only to the extent that they have the power to persuade.

Applying this analysis, the court found the FTC's position to fall well short of the standard for *Chevron* deference. First, it was made "without any degree of deliberation, thoughtful consideration or comments from the public." Second, the Beales Letter, while acknowledging the concern expressed by attorneys about the possible application of the rule to them, "fails to provide any logic" to support its interpretation. It thus lacks the "power to persuade" called for under *Mead*. The court noted that the FTC did not get around to explaining the rationale behind the interpretation until its motion to dismiss. "Such *post hoc* rationalizations are inadequate under *Chevron* and cannot serve as a substitute for an agency's reasoned decision-making."[37]

5. Was the FTC's Interpretation Arbitrary and Capricious Under *Chevron*?

In an "arbitrary and capricious" review, the court's analysis focuses on whether the agency (i) has relied on factors that Congress did not intend it to consider; (ii) entirely failed to consider an important aspect of the problem; (iii) offered an explanation that is contrary to the evidence before it; or (iv) offered an explanation that is so implausible that it could not be ascribed to differing views or the product of agency expertise.[38]

Given the circumstances of the FTC's decision making, the court had no trouble concluding that the interpretation was arbitrary and capricious agency action under *Chevron*. Having nothing before it to shed light on the interpretation, other than the Beales Letter, the court said that it "could not even speculate" as to the basis for the decision: "The FTC has failed to articulate *any* explanation, let alone a satisfactory one, for its interpretation (emphasis in original). Missing, therefore, was any indication of a rational connection between the facts and the choice made, or that the agency took the requisite hard look at the issues presented."[39]

6. Should the FTC Have Granted a *De Minimis* Exemption?

Finally, the court considered whether, assuming *arguendo* that the agency's interpretation was not arbitrary and capricious, it should at least have granted a *de minimis* exemption to attorneys engaged in the practice of law. In addition to any other exemptions they are empowered to grant, agencies have inherent authority to provide exemptions "when the burdens of regulation yield a gain of trivial or no value . . . this principle derives from the commonplace notion that 'law does not concern itself with trifling matters.'"[40] The FTC did not contest that it had this authority; nor could it, given that it had previously granted an exemption to institutions of higher learning.

The court held that the request for an exemption for attorneys fairly could be characterized as a request for a *de minimis* exemption, given the rationale that attorneys are already subject to state ethics rules. Given that subjecting attorneys to the rule demonstrably results in a "gain of trivial or no value," the FTC should have taken the resulting burdens into account. Its failure to do so was the more compelling, in that it had made exactly this type of analysis in exempting institutions of higher learning, which are already subject to stringent privacy requirements under law.

Conclusion

The GLB Act was the product of many years of negotiation among financial institutions, the agencies that regulate them, Congress and the Executive branch, all aimed at streamlining the financial system and enabling American financial companies to compete with their foreign competitors. The Act's purpose is "to enhance competition in the financial services industry by providing a prudential framework for the affiliation of banks, securities firms, insurance companies and other financial services providers."[41] Lawyers manifestly do not "compete" with financial conglomerates; nor are financial firms permitted to practice law.

In this context, the FTC's interpretation that attorneys are "financial institutions" under the GLB Act privacy rules is a classic example of the mischief that can result when an administrative body interprets its mandate as the mechanistic application of a rule, rather than the exercise of judgment and common sense to achieve a legislative objective. Although the presumption under *Chevron* strongly favors agency interpretations, *FTC I* makes clear that agency discretion is not unbridled; the exercise of that discretion must have a rational basis, in order to comport with basic notions of due process and fundamental fairness. In the author's view, the decision is well-reasoned and likely to be upheld, if the FTC goes forward with its appeal.

So at least for now, it is safe for all of us happy dolphins to go back in the water. But keep your eye peeled for those lurking tuna nets.

Endnotes

1. Gramm-Leach Bliley Financial Modernization Act of 1999 ("GLB Act"), P.L. 106-102 Title V, Section 501(a).
2. Loomis, *With July Deadline, State Bar Challenges FTC's Position*, New York L.J., Vol. 227, No. 99 (May 23, 2002) at 5 (quoting NYSBA's then-President Steven C. Krane).
3. *New York State Bar Ass'n v. Federal Trade Commission*, slip op., 2004 WL 964173 (D.D.C. Apr. 30, 2004 ("*FTC II*").
4. GLB Act, *supra* n. 1, Title V, codified at 15 U.S.C. §§ 6801 *et seq.*
5. *See generally* Philip K. Howard, The Death of Common Sense (Random House, New York 1994).
6. 5 U.S.C. § 706(2)(A), (C).
7. *New York State Bar Ass'n v. Federal Trade Commission*, 276 F. Supp. 2d 110 (D.D.C. Aug. 11, 2003) ("*FTC I*").
8. *See FTC I* at 112 n.1.
9. *See generally* David L. Glass, *The Gramm-Leach-Bliley Act: Overview of the Key Provisions*, 17 N.Y.L. Sch. J. Hum. Rts. 1 (2000).
10. Remarks of David L. Glass, 17 N.Y.L. Sch. J. Hum. Rts. 53, 65–7 (2000).
11. *Lawyers Try to Make Sense of Rule Requiring Privacy Notice to Clients,* New Jersey Law Journal, Vol. 165, No. 1 (July 2, 2001), at 7.
12. Letter dated April 8, 2002 to Robert E. Hirshon, President, and Robert D. Evans, Director, Governmental Affairs, from J. Howard Beales, Director, Bureau of Consumer Protection (the "Beales Letter").
13. *New York State Bar Ass'n v. Federal Trade Commission*, No. 1:02CV00810, complaint filed (D.D.C. April 29, 2002) (discussed in the author's prior article, reprinted in this issue).
14. 276 F. Supp. 2d at 113.
15. *Id.* (citing *Carter/Mondale Presidential Committee v. Federal Election Commission*, 711 F.2d 279, 285–6 (D.C. Cir. 1983)).
16. *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842 (1984).
17. *Id*. (citing an *amicus* brief submitted by state and local bar associations).
18. 12 U.S.C. § 1843(k).
19. 12 C.F.R. § 225.28.
20. 276 F. Supp. 2d 118.
21. *Id*. (citing an *amicus* brief submitted by state and local bar associations).
22. 12 C.F.R. § 225.28(b)(2)(vii), (6)(vi).
23. 276 F. Supp. 2d at 121 (citing the ABA's Memorandum).
24. *See* 51 F.R. 39994, 39998 (Nov. 4, 1986).
25. 22 N.Y.C.R.R. part 1210, as cited in 276 F. Supp. 2d at 131 n.15.
26. 276 F. Supp. 2d at 123–4 and n.10.
27. 276 F. Supp. 2d at 130.
28. *MCI Telecommunications Corp. v. American Telephone & Telegraph Co.*, 512 U.S. 218 (1994).
29. *FDA v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120 (1996).
30. 276 F. Supp. 2d at 131.
31. *Id*. at 128 n.12.
32. *Id*. at 133.
33. *See* 28 U.S.C. § 530 gl.
34. 276 F. Supp . 2d at 131.
35. *United States v. Mead Corporation*, 533 U.S. 218, 228 (2001).
36. *Id*.
37. 276 F. Supp. 2d at 139.
38. *Id*. at 140.
39. *Id*. at 140–1.
40. *Id*. at 143 (citing *Environmental Defense Fund v. EPA*, 82 F.3d 451 (D.C. Cir. 1996)).
41. H.R. Rep. No. 106-434, at 1.

David L. Glass is Counsel with Clifford Chance US LLP, New York City, past Chairman of the Banking Law Committee of the New York State Bar Association, and a member of the Executive Committee of NYSBA's Business Law Section. He is an adjunct professor of Banking Law at New York Law School and Pace University School of Law, and has advised the New York State Banking Department regarding the Gramm-Leach-Bliley Act. The views expressed are entirely the author's own.

Are You a Dolphin? Or a Financial Institution?

By David L. Glass

> It is the policy of the Congress that each financial institution has an affirmative and continuing obligation to respect the privacy of its customers and to protect the security and confidentiality of those customers' nonpublic personal information.[1]

> [Lawyers are like] happy dolphins swimming along in the ocean and getting caught in a tuna net.[2]

For only the second time in its 125-year history, the New York State Bar Association (NYSBA) has filed a lawsuit on behalf of its members.[3] In late September 2002, the Government filed a motion to dismiss NYSBA's Complaint. And the American Bar Association (ABA), which has been working behind the scenes on a legislative fix, has now taken up the litigation cudgel as well.[4]

At issue in both actions is the refusal of the Federal Trade Commission (FTC) to acknowledge the seemingly obvious: that an attorney engaged in the practice of law is not a "financial institution" under the financial reform legislation enacted in 1999, known as the Gramm-Leach-Bliley Act ("GLB Act").[5] Among other things, the GLB Act requires all "financial institutions" to take certain measures to protect the privacy of consumers with whom they deal. No one—not the Congress, not the consumer advocates, not the lawyers who assisted in drafting the legislation, and apparently not the FTC itself[6]—ever intended or contemplated that lawyers would be caught in this particular tuna net. But the FTC has elected to cast its net wide and far, and many of the one million practitioners in the United States are going to be not-so-happy dolphins.

At a minimum, the FTC's interpretation imposes a substantial paperwork burden on the profession. The GLB Act mandates that all financial institutions dealing with consumers provide a notice to their customers, upon establishing the relationship and annually thereafter. It is doubtful that most individual practitioners or smaller firms have the systems capability to readily identify all of the clients to which the requirement applies.[7] This burden falls especially heavily on legal aid lawyers and others representing poor clients, who typically have large caseloads and limited resources.[8] And it is unclear how the law applies to someone who is a client for a one-time transaction, such as a real estate closing.

But the potential consequences are far more troublesome than additional paperwork. As noted in NYSBA's Complaint, applying the GLB Act to lawyers raises the specter that the privacy requirements imposed by the Act could be deemed to preempt the more stringent confidentiality and privilege rules to which the profession is subject under state law.[9] And the notices are sure to alarm clients, who may well perceive them as a *reduction* in the confidentiality they take for granted in their relationships with their attorneys.[10]

This assumes that a client bothers to read the notice in the first instance. Shortly after the enactment of the GLB Act, the author participated in a panel discussion on the privacy provisions with a representative of the American Civil Liberties Union (ACLU). While arguing for still more stringent privacy legislation, the ACLU representative complained that the required notices were already so lengthy and confusing that consumers "couldn't be bothered" to read them.[11] Of course, a notice identifying one's attorney as a "financial institution" is just what is needed to clear up the confusion (and help fill up the recycling bin).

As stated by NYSBA in its Complaint, the FTC's interpretation ". . . is the paradigm of a regulatory pronouncement that is arbitrary, capricious, contrary to law, and an offense to common sense."[12] Viewed in a broader context, it is the *reductio ad absurdum* of the "one size fits all" model of regulation, as so persuasively described by attorney Philip Howard in his best-seller "The Death of Common Sense,"[13] whereby those charged with administering the law see themselves as constrained from the exercise of judgment and common sense, and are reduced to the wooden application of the literal language of a rule. Indeed, it seems clear that the FTC itself—or at least its staff—sees its role in exactly this way.

Thus, an FTC staff attorney has been quoted as acknowledging that "[n]o one realized at the time that [the GLB Act] might apply to lawyers. . . . We agree that it doesn't make sense."[14] But the same staff attorney—even while conceding that lawyers are covered by state disciplinary rules that are far more protective of clients' confidential information than is the GLB Act—also said that "all folks who are technically covered by the [FTC] rules need to comply."[15] Thus, having determined that attorneys are "technically covered," the FTC relieves itself of the need to exercise judgment, discretion or common sense.

The remainder of this article discusses the background of the FTC's action, reviews NYSBA's complaint and its prospects for success, and considers the prospects for reconsideration by the FTC or new legislation as a way out of the morass.

The FTC Rule

The FTC promulgated its rule pursuant to the mandate of the GLB Act, which assigned the responsibility to write privacy rules to seven federal agencies and, with respect to insurance companies that are historically regulated by the states, some 50 state agencies. The FTC's authority is residual; it essentially covers all entities that meet the definition of "financial institution," but are not under the jurisdiction of the SEC or one of the federal banking or state insurance regulators. As required by the GLB Act, the FTC published its proposed privacy regulations for comment in 2000.[16] The proposed rule made no reference to lawyers as such, but stated that it applied to entities engaged in "any activity that the [Federal Reserve] Board has determined to be a financial activity." The FTC received some 640 comments on the proposed rule from members of the public, not one of them regarding its possible applicability to lawyers.[17]

In accordance with the mandate of Congress, as promulgated the FTC's regulations require every "financial institution" to provide its customers, at the outset of the relationship and on an annual basis thereafter, with a notice setting forth the institution's policy regarding whether and under what circumstances it will share the customer's nonpublic information in its possession with others, and giving the customer an opportunity to "opt out" of such sharing.[18] For this purpose, the FTC rule states that "financial institutions . . . include, but are not limited to . . . credit counselors and other financial advisors, tax preparation firms . . . and investment advisors that are not required to register with the Securities and Exchange Commission."[19]

Among the examples given of financial activities to which the law would apply were "real estate settlement services; providing financial or investment advisory activities including tax planning, tax preparation, and instruction on individual financial management."[20] These are all activities that lawyers may engage in from time to time. Arguably, therefore, the FTC definition is broad enough to include lawyers, at least to the extent that they provide financial advice to individual clients—for example, in connection with tax or estate planning, real estate transactions, or trust fund management.[21] Nonetheless, the bar did not recognize the danger until the spring of 2001, with the rule due to take effect on July 2 of that year.

The Bar's Response

On June 22, 2001, NYSBA filed a letter with the FTC, calling upon the agency to declare for the record that attorneys were exempt from the GLB Act privacy provisions.[22] The following week the ABA also filed a letter with the FTC, requesting an extension of time to comply. On July 10, 2001, the ABA sent a letter to the chairman of the FTC, formally requesting an exemption.[23] While noting that "common sense" dictated otherwise, the ABA letter conceded that a lawyer or law firm "significantly engaged" in one or more of the covered financial activities "potentially would be subject to the [GLB] Act's privacy requirements."[24] Thereafter representatives of the bar associations met with FTC staff.[25] The FTC participants initially appeared to be receptive to the concept of exempting attorneys, but indicated that they did not yet "fully understand" the scope of the agency's authority to issue exemptions.[26] On August 22, 2001, the ABA again wrote to the FTC, enclosing a memorandum discussing state regulation of the legal profession, in response to questions raised by FTC staff.[27]

Nonetheless, in a letter dated April 8, 2002 (the "Beales Letter"), the FTC declined to grant relief. While stating that the FTC "recognized" the concerns raised by applying the privacy rules to attorneys, it noted "significant questions as to the legal authority of the [FTC] to grant the exemption you request." The letter went on to assert that the FTC's authority to grant exemptions was limited to section 502 of the GLB Act, which prohibits disclosure by a financial institution of a consumer's nonpublic personal information to third parties unless the consumer has been given a chance to "opt out" of such disclosure. Therefore, in the FTC's view, the GLB Act did not confer authority to grant exemptions from the Act's other provisions, such as the annual notice requirement.[28]

The NYSBA Complaint

Just three weeks after the Beales Letter, NYSBA responded by filing its Complaint. The Complaint sought relief on essentially two grounds: first, that the FTC's failure to grant an exemption was arbitrary, capricious and contrary to the law and the Congress' intent; and second, to the extent that the law was read to apply to attorneys, it would violate the Tenth Amendment of the Constitution, since it "infringes on an area of lawmaking and regulation historically committed and reserved solely to the States—the regulation of the confidential nature of the relationship between clients and practicing lawyers subject to State licensure."[29]

The Tenth Amendment issue received comparatively short shrift in the Complaint, although it was developed in much greater depth in NYSBA's Memorandum opposing the Government's motion to dismiss, filed on September 16, 2002 (discussed below). The crux of the Complaint lies in the area of administrative law—namely, whether the agency's action—or, in this case, inaction—was arbitrary, capricious or not in accordance with law.[30] Under the Supreme Court's *Chevron* standard, the court is instructed to first determine whether "the intent of Congress is clear [as to] "the precise question at issue."[31] If so, "that is the end of the matter . . . [but] if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute . . . if the administrator's reading . . . defines a term in a way that is reasonable in light of the legislature's revealed design, we give the administrator's judgment controlling weight."[32]

Thus, the *Chevron* standard requires the court to give "controlling weight" to the FTC's judgment only if 1) the intent of Congress is not clear, 2) the construction of the statute adopted by the FTC is a permissible one, and 3) "a term [i.e., "financial institution"] is defined in a way that is reasonable in light of the legislature's revealed design." In the NYSBA case, there appear to be grounds for optimism on all three points.

Is the Intent of Congress Clear?

While the statute is silent on its face as to whether lawyers are included, the legislative intent of Congress seems quite clear that they were *not* intended to be included. The GLB Act was crafted over a period of years, by the House Financial Services Committee (formerly the Banking Committee), the House Energy & Commerce Committee, and their Senate counterparts. Numerous trade groups, representing banks, securities dealers, insurance underwriters and agents, and other financial services providers, participated actively in its drafting, along with a variety of consumer advocates. The stated objective of the GLB Act was to repeal or overhaul those provisions of the Glass-Steagall Act and the Bank Holding Company Act that prohibited the affiliation of banks with securities firms and insurance companies, and more generally to modernize the structure for the delivery of financial services.[33] The privacy issue played no part in the early deliberations. Indeed, a precursor to the GLB Act passed the House in 1998 without any privacy provision at all.

The privacy title first appeared in early 1999, during the final deliberations that led to the bill that ultimately was enacted.[34] It was included primarily to secure the support of consumer advocates for the legislation, which was perceived in some quarters as not being in the interests of consumers. Under these circumstances, there is no indication whatever that Congress ever intended to cover lawyers under the GLB Act's privacy title. To the contrary, there is every indication that such coverage was not intended.[35] As the Complaint notes, had Congress intended the GLB Act to cover lawyers, as a matter of normal practice—not to mention procedural fairness—it would have been referred to the House and Senate Judiciary Committees, which have jurisdiction over legislation that impacts on the practice of law. In fact, however, it was never referred to either of these committees.[36]

Is the FTC's Construction a Permissible One?

The second inquiry under *Chevron* is whether the agency's construction of the enabling statute is a permissible one. Given the unique structure of the GLB Act privacy provisions, it appears that the FTC's interpretation fails this test.

A key aspect of the GLB privacy provisions is that they explicitly preserve the authority of the states to adopt privacy laws that afford greater protection to consumers. Indeed, several states have actively considered legislation along these lines. Consistent with this objective, the GLB Act preserves state law that is "not inconsistent," and expressly provides that a state law affording *greater* protection to consumers than the GLB Act is "not inconsistent" and, therefore, is not preempted.[37] As the Complaint argues, the federal law, if construed to apply to lawyers, could effectively preempt the far greater protections afforded under state regulation of the practice of law. For example, the GLB Act specifically allows financial institutions to share nonpublic personal information with third parties, unless the consumer expressly "opts out" of such sharing. But attorneys clearly would be violating well-settled principles of privilege and confidentiality if they were to share client information without the client's consent.[38]

Thus, the FTC's construction is directly contrary to the structure and intent of the GLB Act. Clearly, state disciplinary rules would prohibit an attorney from selling her client list, containing personal information, to third-party marketers. But in principle, at least, an attorney could argue that the FTC regulations authorize her to do exactly that, as long as she has given the client an opportunity to "opt out."

Is the FTC's Definition Reasonable?

The FTC has adopted a definition of "financial institution" that it construes to include attorneys. As such, the definition is unreasonable, because it flies in the face of the "legislature's revealed design." As argued by NYSBA in its Complaint,[39] and again in its brief opposing the government's motion to dismiss,[40] there is nothing in the language or the legislative history of the GLB Act to suggest that Congress intended to include lawyers in the definition of "financial institution." To the contrary, there is every indication to the contrary.

As discussed above, the GLB Act was the product of many years of negotiation among financial institutions, the agencies that regulate them, the Congress and the executive branch, all aimed at streamlining the financial system and enabling American financial companies to compete with their foreign competitors. Thus, the legislative history states the Act's purpose to be "to enhance competition in the financial services industry by providing a prudential framework for the affiliation of banks, securities firms, insurance companies and other financial services providers."[41] Lawyers manifestly do not "compete" with financial conglomerates; nor are financial firms permitted to practice law.

As noted, the privacy title was the caboose that was added to the train as it was about to leave the station—primarily to address the concern of consumer groups and elected officials that customer privacy be preserved in the brave new world of financial conglomerates. To adopt a definition that does not distinguish the practice of law from the services offered by these conglomerates manifestly does violence to the intent of Congress. Indeed, as NYSBA notes in its brief, the regulators of financial conglomerates supervise their activities to make certain that, in offering services such as tax planning, they do not inadvertently lap over into the unauthorized practice of law.[42]

The Tenth Amendment Argument

It is axiomatic that courts will avoid reaching a constitutional issue if the case presents narrower grounds for decision. Nonetheless, NYSBA sets forth a persuasive case to overturn the FTC's reading of the GLB Act on Tenth Amendment grounds.

The Tenth Amendment reserves to the states all powers not expressly granted to the federal government. When a federal statute appears to intrude into an area traditionally reserved to state regulation, therefore, Congress is presumed not to have intended "to precipitate a constitutional confrontation" unless its intent to do so is clear.[43] In *Gregory v. Ashcroft*, a group of Missouri state judges argued that the federal Age Discrimination in Employment Act (ADEA), which protects "employees" from age discrimination, preempted the Missouri state constitution, which mandated retirement for judges at age 70. ADEA specifically exempts "appointees on the policymaking level" from its protections.[44] The respondents in *Gregory* argued that appointed state judges fall within this exemption because, inter alia, state courts have supervisory power over the state bar.

In upholding Missouri's right to establish mandatory retirement age for appointed judges, the Supreme Court said that Congress' power to impose its will on the states is one that " . . . we must assume Congress does not exercise lightly." Accordingly, there must be a clear and unmistakable intent by Congress, in a "plain statement," to override state sovereignty before it will be inferred that that is the result. Applying this "plain statement" rule, the Court held that because the ADEA did not have clear, unambiguous language that appointed state judges were intended to be covered, it is presumed that they are not covered.[45]

Thus, it is not sufficient to infer, as the FTC did, that lawyers were intended to be included in the GLB Act privacy protections simply because they were not expressly excluded (applying, or misapplying, the hoary maxim of statutory construction that *expressio unius est exclusio alterius*). Given that regulation of lawyers, as officers of the court, is a long-standing state prerogative, the inclusion of lawyers is not to be inferred unless it is clearly stated.

FTC Administrative Precedent

The FTC is on record as asserting that it lacks the jurisdiction to reverse its interpretation, absent a formal rule-making or a legislative fix. Not the least ironic aspect of the situation is that an agency that sometimes has been aggressive, if not high-handed, in upsetting settled expectations in the past is suddenly so deferential regarding its own jurisdiction. Just two years ago, for example, in an informal staff opinion, the FTC abruptly reversed what the lending industry had long thought was its settled interpretation under the Fair Credit Reporting Act (FCRA). FCRA generally requires certain protections in connection with a "consumer report." The agency's long-standing interpretation was that a consumer report obtained in connection with a business, rather than personal, transaction—for example, a report on a sole proprietor in connection with a transaction for his business—was not covered by the protections of FCRA.

This interpretation, which appears in the agency's own FCRA regulations,[46] was abruptly overturned by an "informal" staff interpretation—which did not even bother to reference the apparently contrary language in the regulation, even as it baldly asserted that it was consistent with that regulation. The opinion stated that it was an informal staff opinion, and as such was "not binding" on the FTC.[47] While technically correct as a matter of administrative law, this statement is more than a bit disingenuous; it cannot be reasonably supposed that such an opinion would be issued by a staff attorney without at least implicit approval from the agency, or that the agency would disregard it once it has been issued. Certainly the lending and leasing industry took it quite seriously; the letter generated a firestorm of protest, leading to the intercession of the general counsel of all four federal banking agencies in asking the FTC staff to reconsider. In response, a subsequent staff letter beat a hasty retreat from the worst aspects of the initial, ill-considered, position.[48]

The FTC's Commentary on FCRA, included as an appendix to its regulation, states that "Staff will continue to respond to requests for *informal* staff interpretations" [emphasis supplied], but goes on to provide a separate procedure for seeking "*formal* Commission interpretations of the FCRA . . ."[49] The FTC does not appear to make a similar distinction in the case of the GLB Act regulations, and it is not clear whether the agency regards the Beales Letter, which was signed by the Director of its Bureau of Consumer Protection, as a formal or informal interpretation. The NYSBA Complaint asserts that it is a final agency action, which as a matter of administrative law would be a prerequisite to suing the agency.

In any event, if it were so inclined, the FTC could reverse its interpretation and end the controversy without the need for legislation or a court determination. There is no need for a new rule-making, because it is not the FTC's rule that is at issue. The rule itself, as noted, makes no mention of attorneys; it is the FTC's interpretation of the rule that has created the problem. And the agency has the clear authority under the GLB Act to create exemptions; it has already exempted colleges and universities that comply with the Federal Educational Rights and Privacy Act.[50]

Corrective Legislation

Finally, the problem could be corrected by legislation amending the GLB Act to expressly exempt lawyers from the definition of "financial institution." As this article went to press, Reps. Judy Biggert (R-Illinois) and Carolyn Maloney (D-New York) were introducing legislation to this effect.[51] The American Bar Association's legislative office previously had indicated that it has the support of members from both parties for "narrowly crafted legislation to exempt lawyers" from the GLB Act privacy provisions,[52] and has established a working group to seek a legislative fix.[53]

Whether the legislation makes any headway is something else again, however. Congressman John LaFalce (D-New York), ranking member of the House Financial Services Committee, told the author in June that he regarded the FTC's interpretation as clearly violating the intent of the Congress, and intended to support a legislative fix. But Rep. LaFalce since has decided not to seek reelection. And with the public mood not favorable to professions such as law and accounting in the wake of Enron and other scandals, there is no great incentive for Congress to move this issue at this time. As one attorney active in the legislative effort noted, the response she got from members of Congress was, "Why would we tell the world we were trying to exempt lawyers from a privacy statute?"[54]

In the end, the attempt at a legislative fix may prove counterproductive. In the absence of a favorable court decision on the NYSBA (or ABA) action, the FTC can continue to take the position that it need not act to reconsider its position on the application of the GLB Act to lawyers, since legislation is pending. Indeed, that is precisely the position the agency has taken in commenting on the Biggert-Maloney initiative.[55]

Conclusion

The FTC's refusal to exempt attorneys from the GLB Act privacy rules is a classic example of the law of unanticipated consequences—as well as the mischief that can result when an administrative body interprets its mandate as the mechanistic application of a rule, rather than the exercise of judgment and common sense to achieve a legislative objective. If it is not reversed, its consequences will range from added cost and administrative burden, to potential disruption of the ethical governance of legal practice at the state level.

In *New York State Bar Ass'n v. Reno*, NYSBA's only prior venture into court, it succeeded in enjoining enforcement of a provision in the "Granny's Lawyer Goes to Jail" Act, which sought to impose criminal penalties on lawyers and others who counsel individuals to dispose of assets in order to qualify for Medicaid benefits.[56] The court agreed with NYSBA that the provision was patently unconstitutional; and besides, the Justice Department had made clear that it had no intention of enforcing it anyway.

In this case, by comparison, NYSBA is seeking not to enjoin, but to compel, a federal agency to issue a ruling in an area where it has declared it has no jurisdiction to act. The NYSBA's and ABA's efforts to judicially compel the agency to reverse its course present novel questions of administrative law. Under normal circumstances, an interpretation by an agency of a statute entrusted to its jurisdiction carries every presumption of validity, and will not be overturned unless arbitrary and capricious, which is a heavy burden for the complainant to meet. In this case, however, the particular structure of the underlying legislation—which specifically empowers the agency to make exemptions in accordance with the legislative intent, and in effect not to preempt state laws that afford greater protection to consumers—offers some hope of a favorable decision.

While courts normally are loath to reach constitutional issues if they can be avoided, the Tenth Amendment issue here may be the ace in the hole. The FTC determined that lawyers were included in the rule simply because they were not expressly excluded and, arguably, some of their activities appear to fit the definition of financial institution. But as the NYSBA memo persuasively argues, under *Gregory v. Ashcroft* that is not sufficient—rather, given the historical and long-settled state regulation of the practice of law, the intent of Congress to cover attorneys would have to be explicit before it can be assumed that they are covered.

Absent a sudden reversal by the FTC—which, as noted, the FTC could do if it were so inclined—attorneys whose practice falls into one of the covered areas are best advised, as a matter of prudence, to comply with the FTC rule's notice requirements, at least pending the outcome of the NYSBA suit or a legislative fix. The good news is that it appears that attorneys who attempt to comply in good faith, by furnishing at least a minimal notice to their covered clients, will not be subject to enforcement action. And at the least, we attorneys can take some comfort from thinking of ourselves as happy dolphins for a change, rather than those other "dorsal finned denizens of the deep"[57] with which we are more often compared.

Endnotes

1. Gramm-Leach-Bliley Financial Modernization Act of 1999, P.L. 106–102 tit. V, § 501(a) (hereinafter "GLB Act").
2. Loomis, *With July 1 Deadline, State Bar Challenges FTC's Position*, 227 N.Y.L.J. No. 99 at 5 (May 23, 2002) (quoting outgoing NYSBA President Steven C. Krane) (hereinafter "Loomis").
3. *New York State Bar Ass'n v. Federal Trade Commission*, No. 1:02CV00810, complaint filed (D.D.C., Apr. 29, 2002); *see NYSBA sues FTC over privacy notice requirement for lawyers*, 44 State Bar News No. 3 (May/June 2002). *See also N.Y. Bar Association Seeks Exemption From Privacy Requirements*, 8 Andrews Sec. Litig. & Reg. Rep. No. 1 at 15 (June 19, 2002). NYSBA is the largest voluntary state bar association in the United States, with some 70,000 members.
4. *ABA Sues Over Privacy Statute*, A.B.A.J. eReport (Sept. 27, 2002), available online at http://www.abanet.org/journal/ereport/s27glb.html.
5. GLB Act tit. V, codified at 15 U.S.C. §§ 6801 *et seq.*
6. *See* Loomis, *supra* note 2 (quoting a consumer advocate to the effect that application of the GLB Act privacy provisions to lawyers is "silly").
7. *See Firms Face Deadline for Mailing Privacy Notices*, 225 N.Y.L.J. No. 124 at 5 (June 28, 2001).
8. Loomis, *supra* note 2 (quoting former NYSBA president Steven Krane).
9. *New York State Bar Ass'n v. The Federal Trade Commission*, Case No. 1:02CV00810, Complaint for Declaratory Relief filed April 29, 2002 (hereinafter "Complaint").
10. Loomis, *supra*.
11. *See* David L. Glass, remarks at Symposium of N.Y.L. Sch. J. Hum. Rts., Apr. 28, 2000, reprinted in 17 N.Y.L. Sch. J. Hum. Rts. 53, 61.
12. Complaint ¶ 52.
13. Philip K. Howard, The Death of Common Sense (Random House, New York 1994).
14. *Lawyers Try to Make Sense of Rule Requiring Privacy Notice to Clients*, 165 New Jersey L.J. No. 1 at 7 (July 2, 2001).
15. *Law Firms Scramble to Meet FTC Rule*, 24 Legal Times No. 27, July 2, 2001, at 20.
16. 65 Fed. Reg. 11,174 (Mar. 1, 2000).
17. *Law Firms Scramble to Meet FTC Rule*, *supra*.
18. 16 C.F.R. § 313.1(a).
19. 16 C.F.R. § 313.1(b).
20. *Id.*
21. *N.Y. Bar Seeks Exemption from Privacy Regulations*, 3 Andrews E-Business L. Bull. No. 10 (July 2002).
22. Complaint ¶ 39.
23. Letter from Martha Barnett, president of the ABA, to Hon. Timothy J. Muris, Chairman, FTC (July 10, 2001) (the "ABA Letter").
24. *Id.* at 4.
25. *See* Complaint ¶¶ 37–63.
26. *Law Firms Scramble to Meet FTC Rule*, *supra*.
27. Letter from Robert D. Evans, Director, Governmental Affairs Office, to J. Howard Beales, Director, Bureau of Consumer Protection (Aug. 22, 2001).
28. Letter from J. Howard Beales, Director, Bureau of Consumer Protection, to Robert E. Hirshon, President, and Robert D. Evans, Director, Governmental Affairs (Apr. 8, 2002) (the "Beales Letter").
29. Complaint ¶ 6.
30. The Complaint itself gives comparatively short shrift to the Tenth Amendment argument, which is developed at much greater length in the NYSBA's brief opposing summary judgment.
31. *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842 (1984).
32. *NationsBank v. VALIC*, 513 U.S. 251 (1995) (paraphrasing *Chevron*).
33. *See generally* Glass, *The Gramm-Leach-Bliley Act: Overview of the Key Provisions*, 17 Part One N.Y. Law Sch. J. of Hum. Rts. 1 (2000).
34. *Id.* at 26 *et seq.*
35. *See* Complaint ¶¶ 76-79.
36. Complaint ¶ 81.
37. 15 U.S.C. § 6807(a) and (b).

38. *See* Complaint ¶¶ 64-67.

39. Complaint ¶¶ 80-82.

40. *New York State Bar Ass'n v. The Federal Trade Commission*, Case No. 1:02CV00810, Memorandum of the New York State Bar Association in Opposition to the FTC's Motion to Dismiss the Complaint, Sept. 16, 2002 ("NYSBA Memo").

41. H.R. Rep. No. 106-434 at 1.

42. Federal Reserve Bank Holding Co. Supervision Manual § 3130.6 (1998).

43. NYSBA Memo at 23.

44. 29 U.S.C. § 630(f).

45. NYSBA Memo at 24.

46. Statement of General Policy or Interpretation, 55 Fed. Reg. 18804 (codified at 16 C.F.R. pt. 600) app. "Commentary on the Fair Credit Reporting Act" at 18811 ("[a] report on a consumer for credit or insurance in connection with a business operated by the consumer is not a 'consumer report,' and [FCRA] does not apply to it.").

47. *In re* Applicability of FCRA to Commercial Credit Reports, [Bank-Issue 98–99 FBLR Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 92–419 (Charles Tatelbaum, FTC Advisory Op. July 26, 2000); *available at* http://www.ftc.gov/os/statutes/fcra/tatelbaum.htm.

48. *See* Glass, *The Business Use Purpose under FCRA Is Alive and Well (Or Is It?)*, 20 Banking & Financial Services Policy Report No. 10 (Oct. 2001) at 1.

49. Commentary ¶ 4 (emphasis supplied).

50. *N.Y. Bar Association Seeks Exemption from Privacy Requirements*, 8 Andrews Sec. Litig. & Reg. Rep. No. 1 at 15.

51. A.B.A.J. eReport, Sept. 27, 2002 (http://www.abanet.org/journal/ereport/s27glb.html).

52. *ABA Talks with Congress About Gramm-Leach-Bliley Exemption*, 29 Florida Bar News No. 16, Aug. 15, 2002, at 5.

53. *Taking it to Congress*, 88-JUN A.B.A.J. 70 (June 2002).

54. *Lawyers Still Lax About Reach of Gramm-Leach*, 169 New Jersey L.J. No. 93 at 1 (July 8, 2002).

55. *See* A.B.A.J. eReport, Sept. 27, 2002, *supra.*

56. *New York State Bar Ass'n v. Reno*, 999 F. Supp. 710 (N.D.N.Y. 1998).

57. Loomis, *supra*.

David L. Glass is Counsel with Clifford Chance US LLP, New York City, past Chairman of the Banking Law Committee of the New York State Bar Association, and a member of the Executive Committee of NYSBA's Business Law Section. He is an adjunct professor of Banking Law at New York Law School and Pace University School of Law, and has advised the New York State Banking Department regarding the Gramm-Leach-Bliley Act. The views expressed are entirely the author's own.

Reprinted from the *NY Business Law Journal*, Fall 2002, Vol. 6, No. 2, published by the New York State Bar Association, One Elk Street, Albany, New York 12207.

SEC Expands and Reorganizes Form 8-K, Providing for Significant Additional Disclosures and Shorter Filing Deadlines

By Erica H. Steinberger and R. Scott Shean

Introduction

On March 16, 2004, the SEC adopted "landmark" rules that expand the number and types of events that public companies will be required to disclose in current reports on Form 8-K and require them to do so faster.[1] The 10 additional disclosure items, only two of which were previously reportable in periodic filings, and two expanded disclosure items, carry out the disclosure goals of Section 409 of the Sarbanes-Oxley Act of 2002 for "rapid and current" disclosure by public companies of material information to investors regarding changes in companies' financial condition or operations.

> *"[T]he SEC adopted 'landmark' rules that expand the number and types of events that public companies will be required to disclose in current reports on Form 8-K and require them to do so faster."*

Filings on Form 8-K, which has been reorganized into topical categories utilizing a new numbering system, will generally be required to be made within four business days after the occurrence of a reportable event. This replaces the previous five business day and 15 calendar day deadlines. However, companies furnishing reports under new Item 7.01 (Regulation FD disclosure) or filing reports under Item 8.01 (Other Events) solely to satisfy Regulation FD obligations must do so in accordance with Regulation FD deadlines. Companies are provided a limited safe harbor from liability under Exchange Act Section 10(b) and Rule 10b-5 for failure to timely file certain Form 8-K reports. Compliance with the new rules is required as of August 23, 2004.

Expanded Disclosure

The new rules add eight new disclosure items to Form 8-K:

- entry into or amendment of a material definitive agreement not made in the ordinary course of business;
- termination of a material definitive agreement not made in the ordinary course of business;
- creation of a material, direct financial obligation or an obligation under an off-balance sheet arrangement, whether or not the company is a party to the agreement;
- occurrence of any event that accelerates or increases a material direct financial obligation or a material obligation under an off-balance sheet arrangement, whether or not a company is a party to the transaction under which the triggering event occurs;
- exit or disposal activities to which the company is committed under which material charges will be incurred under GAAP;
- determination that the company is required to record a material impairment charge under GAAP;
- receipt of notice of delisting or failure to satisfy a continued listing rule or standard or transfer of listing from a national securities exchange or inter-dealer quotation system; and
- determination that investors should no longer rely on previously issued financial statements or a related audit report or completed interim review.

Part of two items previously reportable in periodic reports are transferred to Form 8-K:

- unregistered sales of equity securities by the company aggregating at least 1 percent of the outstanding class (5 percent for small business issuers); and
- material modifications to the rights of holders of the company's registered securities.

In addition, two existing Form 8-K disclosure items are expanded to require disclosure of:

- any departure of directors or principal officers, election of directors other than by shareholder vote and appointment of principal officers; and

- any amendment to its articles or bylaws if the company did not propose the amendment in a previously filed proxy statement, and any change in fiscal year other than by shareholder vote or article or bylaw amendment.

Forms 10-Q and 10-K have been amended as necessary to conform to changes in Form 8-K and to provide that disclosure is required on such forms of any event during the period covered by the form that was required to be, but was not, disclosed on Form 8-K.

Annex A sets out the revised Form 8-K items and discusses the additional and amended disclosure items in greater detail in the new order and under the new item numbers established by the rules.

Filing and Furnishing of Exhibits

Copies of agreements, amendments or other required documents must be filed or furnished as exhibits to the Form 8-K only if an item specifically so requires, and certain agreements and other documents may be filed at a later date or with the company's next periodic report. This will not, however, affect any other requirement to file such documents, including as exhibits to registration statements or pursuant to Item 601 of Regulation S-K.

Limited Safe Harbor

The rules create a limited safe harbor from public and private claims under Exchange Act Section 10(b) and Rule 10b-5 for failure to timely file a report on Form 8-K with respect to seven new disclosure items that the SEC understands may require company management to quickly assess the materiality of the event in order to determine whether a disclosure obligation has been triggered: entry into a material definitive agreement (Item 1.01), termination of a material definitive agreement (Item 1.02), creation of a direct financial obligation or an obligation under an off-balance sheet arrangement (Item 2.03), triggering events that accelerate or increase a direct financial obligation under an off-balance sheet arrangement (Item 2.04), costs associated with exit or disposal activities (Item 2.05), material impairments (Item 2.06), and company determinations of non-reliance on previously issued financial statements (Item 4.02(a)).

The safe harbor applies only to a failure to timely file a report on Form 8-K, and not to any material misstatements or omissions in a Form 8-K. It states that no failure to file a Form 8-K report that is required solely pursuant to the provisions of Form 8-K shall be deemed to be a violation of Section 10(b) or Rule 10b-5. The safe harbor will not apply to, or impact, any other disclosure obligation a company may have and extends only until the due date of the company's next periodic report, so that failure to make disclosure in such periodic report will subject the company to potential liability under Section 10(b) and Rule 10b-5, as well as under Section 13(a) or 15(d).

Relief Under Form S-2, Form S-3 and Rule 144 Eligibility Requirements

Failure to timely file a Form 8-K will continue to result in a loss of Form S-2 or S-3 eligibility for the 12 months following the required filing date, except for failures to report any of the seven items for which the safe harbor is provided. Nevertheless, a company must be current in its Form 8-K filings with respect to those items at the actual time it files a Form S-2 or S-3 registration statement.

Rule 144 has been amended to clarify that a company need not file all required Form 8-K reports during the 12 months preceding a sale of securities to satisfy the "current public information" requirement of the rule, although this does not affect the requirement that the selling security holder represent that it does not have inside information.

Impact of the New Form 8-K Requirements

The SEC intends for these new rules to assist investors in making accurate investment decisions by granting them more information on a more timely basis. However, the rules, including the new timing requirements, will require both inside and outside counsel to be vigilant in their examination of whether transactions and events trigger a filing requirement and to carefully coordinate, on a regular basis, with management and inside and external accountants.

In addition, the expanded and accelerated reporting requirements will require companies to assess and in many cases modify their disclosure controls and procedures. For example, companies should evaluate whether their existing procedures, which may include review by a disclosure committee, are sufficiently flexible to permit the materiality determinations required by the new rules on a timely basis. A company's ability to comply with the new Form 8-K reporting requirements will also impact the attestation report on management's assessment of internal control over financial reporting by the company's independent auditors under Regulation S-K, Item 308, and the CEO and CFO certifications required as exhibits to Forms 10-K and 10-Q.

The New, Expanded and Reorganized Form 8-K

As noted above, the amendments reorganize Form 8-K into eight topical categories—Business and Operations, Financial Information, Securities and Trading Markets, Matters Related to Accountants and Financial Statements, Corporate Governance and Management, Regulation FD, Other Events and Financial Statements and Exhibits—each of which is discussed below, with emphasis on new or expanded requirements.

Section 1—Registrant's Business and Operations

Item 1.01—Entry into a Material Definitive Agreement

This new disclosure item requires disclosure of the entry into, or material amendment of, a material definitive agreement not made in the ordinary course of business, utilizing the same standard with respect to the types of agreements requiring disclosure as Item 601(b)(10) of Regulation S-K. Disclosure of non-binding agreements, including letters of intent, is not required.[2]

The date on which the agreement was entered into or amended, the identity of the parties, a brief description of any material relationship between the company or its affiliates and any of the parties and a brief description of the material terms and conditions of the agreement or amendment are required to be disclosed. The agreement or amendment is not required to be filed as an exhibit to the Form 8-K, although the Commission urges companies to do so if feasible, in particular when confidential treatment is not being requested. Instead, a company may continue to file the material agreement with its next periodic report.

Note that if the filing of the Form 8-K for a business combination agreement constitutes the first "public announcement" for purposes of Rule 165 under the Securities Act and Rule 13e-4(c), Rule 14d-2(b) or 14a-12 under the Exchange Act, the filer will be able to satisfy its obligations under those rules by checking a box on the new Form 8-K cover page to so indicate (so long as all the information required by those rules is included).

Item 1.02—Termination of a Material Definitive Agreement

This new disclosure item requires disclosure of the termination of a material definitive agreement (using the same definition as Item 1.01) not made in the ordinary course of business that terminates for any reason other than as a result of expiration of the agreement or completion of obligations. The disclosure must include the date of termination, the identity of the parties, a brief description of any material relationship between the company or its affiliates and any of the parties, a brief description of the material terms and conditions of the agreement, a brief description of the material circumstances surrounding the termination and any material early termination penalties incurred by the company. Instructions to the item now state that no disclosure is required during negotiations or discussions regarding termination, but only upon termination, and that no disclosure is required, unless a notice of termination has been received in accordance with the agreement, if the company in good faith believes the agreement has not been terminated.

Item 1.03—Bankruptcy or Receivership

This item retains the basic substance of previous Item 3.

Section 2—Financial Information

Item 2.01—Completion of Acquisition or Disposition of Assets

This item retains most of the substantive requirements of previous Item 2, including its threshold significant asset test. The item has been amended, however, to eliminate disclosure regarding the nature of the business in which acquired assets were used and whether the company intends to continue such use, as well as disclosure of the source of funds for the acquisition, except where a material relationship exists between the company and the funding source.

Item 2.02—Results of Operations and Financial Condition

This item retains all the substantive requirements of previous Item 12 regarding companies' public announcements or releases of material non-public information with respect to their results of operations or financial condition for any completed fiscal quarter or year.

Item 2.03—Creation of a Direct Financial Obligation or an Obligation Under an Off-Balance Sheet Arrangement of a Registrant

If a company becomes obligated under a material, direct financial obligation,[3] this new item requires disclosure of the following information:

- the date on which the company becomes obligated;
- a brief description of the transaction or agreement;
- the amount of the obligation, including the terms of payment; and
- a brief description of other material terms.

If the company becomes directly or contingently liable for a material obligation arising out of an off-balance sheet arrangement (regardless of whether the company is also a party to the transaction or agreement creating the contingent obligation), the company must provide the following information:

- the date on which the company becomes liable;
- a brief description of the transaction or agreement creating the arrangement and obligation;
- a brief description of the nature and amount of the obligation, including the terms under which it may become a direct obligation or be accelerated or increased and the nature of any recourse provision enabling recovery from third parties;
- the maximum potential future payments (undiscounted and without reduction for any amount that may be recoverable under recourse or collateralization provisions in any guarantee agreement or arrangement); and
- a brief description of other material terms.

Item 2.04—Triggering Events That Accelerate or Increase a Direct Financial Obligation or an Obligation Under an Off-Balance Sheet Arrangement

This new item requires disclosure of the occurrence of any event that accelerates or increases a material direct financial obligation or a material obligation under an off-balance sheet arrangement, or causes a contingent obligation of a company under an off-balance sheet arrangement to become a material direct financial obligation, of the company, whether or not the company is a party to the transaction under which the triggering event occurs. A company will be required to disclose the following information:

- the date of the triggering event, a description of the agreement or arrangement under which the obligation was created and is increased or accelerated (or a brief description of the off-balance sheet arrangement);
- a brief description of the triggering event;
- the amount of the obligation; and
- any other material obligations of the company that may arise, increase, be accelerated or become a direct financial obligation as a result thereof.[4]

No disclosure is required until a triggering event has occurred in accordance with the terms of the relevant agreement or arrangement, including notice if required and the satisfaction of all conditions except the passing of time. As with Item 1.02, unless the company has received notice, no disclosure is required if the company has a good faith belief that no triggering event has occurred.

Item 2.05—Costs Associated With Exit or Disposal Activities

Disclosure is necessary under this new item if the board of directors or a board committee (or an authorized officer(s) if board action is not required) commits the company to an exit or disposal plan or disposes of a long-lived asset or terminates employees under a plan described in paragraph 8 of FASB Statement of Financial Accounting Standards No. 146, Accounting for Costs Associated with Exit or Disposal Activities (SFAS No. 146), under which the company will incur material charges under GAAP. The company must provide the date of the commitment to the action, a description of the plan, an estimate (total or range) of each major type of cost, and the total amount to be incurred in connection with the action as well as an estimate of charges that will result in future cash expenditures. If a good faith estimate of the amount of the charges cannot be made at the time of filing the Form 8-K, an amendment must be filed within four business days after the company formulates an estimate.

Item 2.06—Material Impairments

When a company's board of directors or a board committee (or an authorized officer(s) if board action is not required) concludes that a material charge for impairment to one or more of its assets, including an impairment of securities or goodwill, is required under GAAP, this new item mandates disclosure of the date of such conclusion, a description of the impaired asset and the facts and circumstances leading to such conclusion, and the company's estimate of the amount (or range of amounts) of the impairment charge that will result in future cash expenditures. As with Item 2.05, an amendment to the Form 8-K must be filed within four business days after the company formulates such estimate if a good faith estimate cannot be made at the time of the original Form 8-K filing. No Form 8-K disclosure is required, however, if such conclusion is made in connection with the preparation, review or audit of financial statements to be included in the company's next periodic report and such report is timely filed and discloses such conclusion.

Section 3—Securities and Trading Markets

Item 3.01—Notice of Delisting or Failure to Satisfy a Continued Listing Rule or Standard; Transfer of Listing

Paragraph (a) of this new item requires disclosure of any notice from a national securities exchange or association maintaining the principal listing for any class of the company's common equity that the company or such class of security does not satisfy a rule or standard for continued listing, the exchange has submitted an application to the SEC under Rule 12d-2 to delist such class, or the association has taken all necessary steps under its rules to delist the security from its automated inter-dealer quotation system. The date of such notice, the rule or standard implicated and any action or response that the company has determined to take, as of the date of filing, must be disclosed, but the notice need not be filed as an exhibit. Paragraph (b) of Item 3.01 requires the same disclosure with respect to any notice by the company to such exchange or association that the company is aware of any material noncompliance with a rule or standard for continued listing.

Disclosure is also required if such exchange or association issues a public reprimand letter or similar communication in lieu of suspension or delisting, or if the company takes definitive action to cause delisting of a class of common equity on such exchange or association, including to transfer such listing to another exchange or association. Delistings by reason of certain events, including redemption or call for redemption of the entire classes in accordance with the terms of the security, the conversion by merger of the class into cash or another security and the payment at maturity or retirement of the entire class, are exempt.

Item 3.02—Unregistered Sales of Equity Securities

Disclosure of information regarding an issuer's unregistered issuances (through sale or upon conversions or similar transactions) of equity securities, previously required in Item 2(c) of Form 10-Q and Item 5(a) of Form 10-K, will now be required in new Item 3.02 if the number of securities sold since the most recent of the company's last Form 8-K filed under Item 3.02 or last periodic report aggregate at least 1 percent of the outstanding securities of that class (5 percent for a small business issuer). The disclosure obligation arises when the company enters into an enforceable agreement (whether or not subject to conditions) under which the securities are to be sold or, if no such agreement, within four business days after the closing or settlement of the transaction. Any issuances not reported on Form 8-K will continue to be required to be reported in periodic reports.

Item 3.03—Material Modifications to Rights of Security Holders

This item will require the same substantive disclosure with respect to material modifications to the rights of holders of any class of a company's registered securities as previously required by Items 2(a) and (b) of Form 10-Q. No duplicative disclosure of such modification is required in any periodic reports filed subsequent to the Item 3.03 Form 8-K.

Section 4—Matters Related to Accountants and Financial Statements

Item 4.01—Changes in Registrant's Certifying Accountant

This item is essentially the same as previous Item 4 requiring disclosure of the resignation, dismissal or engagement of an independent accountant.

Item 4.02—Non-Reliance on Previously Issued Financial Statements or a Related Audit Report or Completed Interim Review

If the company concludes that any previously issued annual or interim financial statements no longer should be relied upon because of an error in such statements as addressed in Accounting Principles Board Opinion No. 20 (APB Opinion No. 20), paragraph (a) of this new item requires disclosure of the date of such conclusion, the financial statements and year(s) covered that should no longer be relied upon, a brief description of the facts underlying the conclusion, to the extent known to the company at the time of filing (the adopting release notes that the Form 8-K may be amended voluntarily to reflect any changes to the facts underlying the conclusion after such filing), and a statement as to whether the subject matter giving rise to such conclusion had been discussed with the company's independent accountant.

Likewise, similar disclosure is required under Item 4.02(b) if the company is advised by its independent accountant that disclosure should be made or other action taken to prevent future reliance on a previously issued audit report or completed interim review related to previously issued financial statements. In this situation, the company must provide the independent accountant with a copy of the disclosures being made under Item 4.02(b) no later than the day the Form 8-K is filed with the SEC and request that the independent accountant furnish the company with a letter, addressed to the SEC, stating whether the accountant agrees with the company's disclosures and indicating where it does not agree. The Form 8-K must then be amended to include the letter as an exhibit within two business days of receipt.

Section 5—Corporate Governance and Management

Item 5.01—Changes in Control of Registrant

Previous Item 1 of Form 8-K has been streamlined but remains substantially the same.

Item 5.02—Departure of Directors or Principal Officers; Election of Directors, Appointment of Principal Officers

Existing disclosure requirements under previous Item 6 have been significantly expanded. In the case of the departure of a director due to a disagreement with the company, known to an executive officer of the company, on any matter relating to the company's operations, policies or practices, or removal for cause, Item 5.02(a) requires disclosure describing the date of resignation, refusal to stand for re-election or removal, any committee positions held by the director at such time, and a brief description of the circumstances of the disagreement surrounding the departure, including copies of all written correspondence from the director concerning the circumstances surrounding his or her resignation, refusal or removal. Item 6 previously required disclosure only if a director departed as a result of a disagreement and provided a letter describing the disagreement and requested that the company make public disclosure of the matter. The company must provide the director with a copy of the disclosure being made in response to Item 5.02(a) no later than the day the Form 8-K is filed with the Commission and provide the director with the opportunity to furnish a letter to the company stating whether he or she agrees with the company's disclosures and describing the respects in which he or she does not agree. If the company receives a letter from the director, the Form 8-K must be amended to include the letter as an exhibit within two business days of its receipt.

Item 5.02(b) requires disclosure of the retirement, resignation or termination of the company's principal executive officer, president, principal financial officer, principal accounting officer, principal operating officer or any person performing similar functions, and any director's resignation, refusal to stand for re-election, or removal other than in circumstances requiring disclosure under paragraph (a).

Item 5.02(c) requires disclosure of appointments of newly appointed officers (those listed in (b)), including the material terms of any employment agreement and certain information regarding the background of the officer and his or her relationship with the company as required by Items 401(b), (d), (e) and Item 404(a) of Regulation S-K.

Item 5.02(d) requires disclosure of the election of any new director other than by vote of security holders at a meeting called for such purpose, including a description of any arrangement or understanding between the director and any other persons, naming them, pursuant to which he or she was selected, any committee to which the new director has been or is expected to be appointed, and information concerning certain related transactions between the new director and the company as required by Item 404 of Regulation S-K.

Filings with respect to the election of an officer may be delayed until the day on which the company first makes public announcement of such election other than by means of a Form 8-K filing to enable the company to make a smooth transition of authority. To the extent information is not known about employment contracts of officers or board committees or related party transactions with respect to new directors, an amendment to the Item 5.02 Form 8-K containing the required information must be made within four business days after it is determined or becomes available.

Item 5.03—Amendments to Articles of Incorporation or Bylaws; Change in Fiscal Year

Companies with a class of equity securities registered under Exchange Act Section 12 must disclose under this new item any amendment to their articles of incorporation or bylaws, if not proposed in a previously filed proxy or information statement, and any change in fiscal year other than by a vote of security holders or an amendment to the articles or bylaws. If an amendment to the articles or bylaws is reported on Form 8-K, only the text of the amendment need be filed as an exhibit, but the company's restated articles or bylaws must be filed as an exhibit to its next periodic report.

Item 5.04—Temporary Suspension of Trading Under Registrant's Employee Benefit Plans

The new rules revise previous Item 11 to clarify that a Form 8-K must be filed with respect to this item no later than the fourth business day after the company receives the required notice of a suspension of trading under a company's employee benefit plan under ERISA or, if no notice is received, on the same date that the company transmits a timely notice to an affected officer or director under Regulation BTR.

Item 5.05—Amendments to the Registrant's Code of Ethics, or Waiver of a Provision of the Code of Ethics

This item was previous Item 10, effective March 30, 2003.

Section 6 of the Form has been reserved for future use, and *Section 7—Regulation FD, Item 7.01 Regulation FD Disclosure, Section 8—Other Events, Item 8.01 Other Events,* and *Section 9—Financial Statements and Exhibits, Item 9.01 Financial Statements and Exhibits,* are previous Items 9, 5 and 7, respectively.

Endnotes

1. Final Rule: Additional Form 8-K Disclosure Requirements and Acceleration of Filing Deadline; Release Nos. 33-8400; 34-49424; File No. S7-22-02 (March 16, 2004), as amended by: Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date; Correction; Release Nos. 33-8400A; 34-49424A; File No. S7-22-02 (August 4, 2004).
2. Footnote 39 of the adopting release notes that a non-binding letter of intent that also contains binding but nonmaterial provisions, such as a confidentiality or no-shop agreement, need not be filed because the binding provisions are not material.
3. "Direct financial obligation" means a long-term debt obligation, a capital lease obligation, an operating lease obligation (as defined in Item 303(a)(5)(ii)(A)(B) and (C), respectively, of Regulation S-K) or a short-term debt obligation arising other than in the ordinary course of business, provided that obligations that are securities (or terms of securities) sold or to be sold pursuant to an effective registration statement need not be reported on Form 8-K if the sale prospectus contains the information required by Item 2.03 and is filed within the required period under Securities Act Rule 424. "Off-balance sheet arrangement" is as defined in Item 303(a)(4)(ii) of Regulation S-K.
4. For purposes of Item 2.04, the meaning of "direct financial obligation" in Item 2.03 is expanded to include any obligation arising out of an off-balance sheet arrangement accrued as a probable loss contingency under FASB Statement of Financial Accounting Standards No. 5, Accounting for Contingencies (SFAS No. 5).

Erica H. Steinberger, a partner in the New York office of Latham & Watkins, has considerable experience in hostile tender offers, tender offer defense, proxy fights and negotiated mergers, acquisitions and divestitures, as well as in public and private offerings of debt and equity securities and exchange offers, and also advises public and private clients on corporate, securities and governance issues, including compliance with the Sarbanes-Oxley Act of 2002 and related regulations.

R. Scott Shean is a partner in the Orange County office of Latham & Watkins, and his practice focuses on mergers and acquisitions, corporate finance and general corporate and securities matters.

Fried, Frank, Harris, Shriver & Jacobson LLP

Internal Revenue Service Clarifies Treatment of Golden Parachute Rules in Bankruptcy

On July 19, 2004, the Internal Revenue Service issued Revenue Ruling 2004-87, providing guidance on the application of the golden parachute rules of Section 280G of the Internal Revenue Code to companies that have filed voluntary petitions for relief under the Bankruptcy Code.

Background

Section 280G of the Code denies a corporation a deduction for "excess parachute payments," and Section 4999 of the Code imposes a nondeductible 20% excise tax on these payments. "Excess parachute payments" consist, in summary, of payments to specified individuals[1] that are contingent upon a change in ownership or control of a corporation, or a change in a substantial portion of the corporation's assets, and that exceed a statutorily determined base amount (essentially, the average of five years of W-2 compensation). Sections 280G and 4999 were enacted to discourage substantial golden parachute payments to these individuals in connection with changes in corporate control. It was believed that, in some situations, the existence of golden parachute arrangements could encourage executives and other key personnel to favor a proposed takeover that was not in the best interests of the corporation's shareholders. The IRS promulgated final regulations interpreting Section 280G in August, 2003.

Revenue Ruling 2004-87

In Revenue Ruling 2004-87, the IRS applied Section 280G to four hypothetical situations arising under the Bankruptcy Code.

- **Situation 1:** After negotiation with a court-appointed creditors' committee,[2] shares of a public company are distributed pursuant to a Chapter 11 plan approved by the Bankruptcy Court, with 75% of the shares being distributed to the creditors. No single creditor receives 20% or more of the company's common stock, and the pre-organization board of directors endorses the company's new board of directors.

Under the final regulations promulgated under Section 280G, a change in control of a corporation occurs when any person, or more than one person acting as a group, possesses more than 50% of the total fair market value or voting power of the stock of the corporation. In addition, a change in control of a corporation is presumed to occur when one person, or more than one person acting as a group, acquires stock with 20% or more of the voting power of the corporation.

In Revenue Ruling 2004-87, the IRS holds that, in the bankruptcy context, a change in control under Section 280G will not be deemed to have occurred under the facts given in Situation 1 and therefore any excess parachute payments that are triggered as a result of these facts would not be denied a deduction and would not be subject to the nondeductible 20% excise tax. The rule treating persons as acting as a group would not apply to creditors' committees in the bankruptcy context because (1) creditors would typically prefer to be paid in cash rather than in stock and therefore the distribution of stock is often involuntary, and (2) the formation of the committee and the distribution of stock typically results from the financial resources of the corporation rather than an intention on the part of the creditors to take control of the corporation.

- **Situation 2:** This situation contains all of the facts as Situation 1, except that a single creditor receives 25% of the reorganized company's common stock.

In Revenue Ruling 2004-87, the IRS held that a change in control is presumed to occur, thereby making any excess parachute payments triggered as a result of the facts given in Situation 2 ineligible for a deduction and subject to the nondeductible 20% excise tax, because a single creditor received 20% or more of the corporation's voting stock. However, this presumption could be rebutted by showing that the creditor will not act to control the management and policies of the corporation.

- **Situation 3:** An insolvent public company in Chapter 11 proposes to sell more than one-third of its assets to an acquirer pursuant to a motion filed with, and an order to be entered by, the Bankruptcy Court. The company has been delisted, and its shares do not trade on an exchange or any other market (including the pink sheets, the over-the-counter market, the over-the-counter bulletin board or the automated confirmation transaction service). A motion is also filed by an executive of the debtor that specifies and describes certain payments that will be paid to the executive as a result of the asset sale and asks the Bankruptcy Court to approve the payments as actual, necessary costs and expenses of preserving the bankruptcy estate.

Under the final regulations promulgated under Section 280G, a change in the ownership of a substantial portion of a corporation's assets is deemed to occur when one person, or more than one person acting as a group, acquires assets having a total gross fair market value of one-third or more of the fair market value of the assets of the corporation (determined without regard to liabilities associated with the assets). However, companies, the stock of which is not readily tradable on an established securities market or otherwise, can exempt payments from the effects of Section 280G and 4999 by obtaining shareholder approval of the payments. The final regulations promulgated under Section 280G describe these private company shareholder approval requirements in detail (which include, among other things, preparation of a detailed disclosure statement and dissemination of the disclosure statement to all shareholders).

Revenue Ruling 2004-87 drew two conclusions with respect to the facts given in Situation 3. First, the IRS held that, because its shares were not traded on any exchange or any other market, the corporation is eligible to use the private company shareholder approval exemption under Section 280G. Second, the IRS held that the private company shareholder requirements were met because the payments were approved by the Bankruptcy Court upon a motion that specified and described those payments. The rationale for the second conclusion is that the pre-organization shareholders (whose continuing interests in the corporation may be difficult to determine or predict) may lack a material interest in the corporation and therefore a motivation to evaluate the payments appropriately. In this context, the approval of the Bankruptcy Court serves as a factual finding that the payments are actual, necessary costs and expenses of preserving the bankruptcy estate, thereby accomplishing the goal of Section 280G to protect the estate and the ultimate owners from unnecessary or excessive payments. Therefore, any excess parachute payments that are triggered as a result of the facts given in Situation 3 would not be denied a deduction and would not be subject to the nondeductible 20% excise tax.

- **Situation 4:** This situation contains all of the facts as Situation 3, except that the public company's stock is traded on an over-the-counter market after being delisted.

Revenue Ruling 2004-87 held that the trading of the stock of a corporation that is a debtor in bankruptcy on an over-the-counter market (including, for example, pink sheets, the over-the-counter bulletin board or automated confirmation transaction service) is impaired and, therefore, that the stock is not "readily tradable" under Section 280G. Accordingly, the private company shareholder approval exemption would be available for such a corporation such that any excess parachute payments that are triggered as a result of the facts given in Situation 4 would not be denied a deduction and would not be subject to the nondeductible 20% excise tax.

Effective Date

Revenue Ruling 2004-87 applies to any payment that is contingent on a change in ownership or control that occurred on or after July 19, 2004. An exception to this effective date is provided for a bankruptcy debtor with securities traded on an over-the-counter market. Such a debtor's securities are not considered "readily tradable" for purposes of the private-company shareholder approval exemption discussed above even if the change in ownership or control occurred prior to July 19, 2004.

The IRS has asked interested parties to submit comments as to whether and to what extent stock traded on an over-the-counter market should be treated as other than "readily tradable" under Section 280G outside of the bankruptcy context. The IRS requested that comments be submitted by October 18, 2004.

Authors:

Bankruptcy and Restructuring (New York)

Brad Eric Scheler
Vivek Melwani
Alan N. Resnick
Bonnie Steingart
Kalman Ochs

Executive Compensation and Employee Benefits (New York)

Donald P. Carleen
Howard B. Adler
Jonathan F. Lewis

Endnotes

1. These specified individuals consist of employees and independent contractors of a corporation who are officers, more-than-1% shareholders or highly compensated individuals at any time during the 12-month period prior to and ending on the date of the change in control.
2. It does not appear that the status of a committee as court-appointed is central to the analysis of the Revenue Ruling.

New Overtime Regulations Became Effective on August 20, 2004

By Laura B. Hoguet and Randi B. May

The United States Department of Labor recently announced new regulations governing exemptions from overtime pay requirements under the Fair Labor Standards Act (FLSA). Not paying overtime required by the FLSA can have dire financial consequences, so employers will want to make sure that employees the DOL considers entitled to overtime are correctly classified as "nonexempts"—that is, as employees who are subject to, and not exempt from, the FLSA's minimum pay, overtime and recordkeeping requirements.

The Department of Labor forecasts that some 8 million employees who are not now receiving overtime will have to be reclassified under the new regulations. At first glance, this is puzzling because the regulations are not very different in substance from the old regulations that have been in place for over 50 years. The major change that survived the rulemaking process (DOL received over 80,000 comments on the regulations in their draft form) is that the new regulations provide updated examples of jobs to illustrate DOL's position on what is required to qualify for the "executive," "administrative" and "professional" exemptions under the Act. If it is true that employers have classified more new-economy jobs as "exempt" in recent years than DOL thinks appropriate, then enforcement of the new regulations could, indeed, lead to significant increases in overtime pay.

Some Fair Labor Standards Act Basics

The FLSA, enacted in 1938 as one of the centerpieces of New Deal labor legislation, guaranteed workers a minimum hourly wage plus time and half as overtime for hours worked over 40 hours in any given work week. The Act also requires employers to keep records of the time worked by employees covered by the Act.

Reflecting a deep-seated but hard-to-articulate difference between the workers who were intended to be protected under the Act and other employees who were not, DOL's regulations implementing the FLSA from the outset divided all employees into two groups: "nonexempts," that is workers who are guaranteed overtime and the minimum wage and for whom time records must be kept, and "exempts," who are exempt from the Act's coverage. Traditionally, manual or "blue collar" workers are nonexempt. Employees paid by the hour, including "white collar" workers, are also nonexempt, while employees who are paid on a "salary basis" or "fee basis" and whose work is "executive, administrative or professional" are exempt. Also included as exempt under the statute are outside sales employees and certain computer employees.

In the more than fifty years that have elapsed since the FLSA was passed, the content of jobs in the workplace has changed dramatically. In the old days bosses dictated and typists typed, but in today's workplace boss and admin both use the computer. Is the admin exempt? What about a paralegal, or someone who sits at a computer help desk? How about the analyst numbers cruncher? For answers to these and other overtime questions, it is prudent to consult the regulations rather than a summary of them such as that provided in this article, which is not intended to provide advice about any particular situation.

Overview of the New Regulation

Under the new regulations, as under the old, manual workers, and people paid on an hourly basis in general, are nonexempt. The new regulations specifically provide that police officers, firefighters, paramedics, emergency room technicians, licensed practical nurses and other so-called "first responders" are nonexempt.

Most FLSA classification problems concern office employees who are paid on a salary basis. The new regulations set an annual salary threshold for "automatic" exemption from the overtime requirements at $100,000 (which may include commissions and discretionary bonuses). Employees who earn more than this amount are ineligible for overtime no matter what their job duties are. At the other end of the scale, employees who earn less than $23,600 per year are, broadly speaking, guaranteed overtime without regard to what their jobs are.

Of course, the large majority of salaried, non-hourly employees earn somewhere between $23,600 and $100,000 per year. Except for a few categories of employees who are automatically exempt regardless of their duties (outside sales employees, teachers, practicing lawyers and doctors, some computer employees), the way to determine whether these employees in the middle salary range are exempt or nonexempt is to measure their job duties against the regulations' description of the requirements for the executive, administrative and professional exemptions. Actual job duties, not job titles, are key to this inquiry.

Employees who qualify for the executive exemption are those whose "primary duty is management of the enterprise . . . or a customarily recognized department or subdivision thereof" *and* who "customarily and regularly" direct the work of two or more other employees *and* who have authority to hire, fire and promote, or whose recommendations concerning hiring, firing and promotion of other employees "are given particular weight." The regulations recognize that an employee may have concurrent job functions and still qualify for exemption as an "executive," as, for example, an assistant manager of a retail store who may help stock shelves or clean, but whose primary duty is management. On the other hand, an electrician is nonexempt even if he directs the work of other employees at a job site.

Employees who qualify for the administrative exemption are those whose "primary duty is the performance of office or non-manual work directly related to the management or the general business operations of the employer or the employer's customers" *and* whose "primary duty includes the exercise of discretion and independent judgment with respect to matters of significance." This rubric encompasses tax, finance, accounting, auditing, insurance, advertising and marketing (but not selling) and a host of similar functions which, in many companies, are thought of as staff rather than line jobs. The "exercise of independent judgment" means more than the use of skill, and does not include secretarial or clerical work or data tabulation "or performing other mechanical, repetitive, recurrent or routine work." As examples, the new regulations say that insurance claims adjusters are probably exempt, as are financial services employees who collect and analyze information regarding customer income, assets and investments, and who advise customers about financial products. A project team leader will likely also qualify for the administrative exemption. An administrative assistant "to a business owner or senior executive of a large business" may qualify if "such employee, without specific instructions or prescribed procedures, has been delegated authority regarding matters of significance." HR managers are usually exempt—but HR clerks who screen resumes are not.

Employees qualify for the professional exemption if their primary duty is the performance of work "requiring knowledge of an advanced type in a field of science or learning customarily acquired by a prolonged course of specialized intellectual instruction" or "requiring invention, imagination, originality or talent in a recognized field of artistic or creative endeavor." The regulations in this category explain that registered nurses are exempt, practical nurses are not; dental hygienists are exempt, as are physicians' assistants; accountants are exempt, but bookkeepers "who normally perform a great deal of routine work" are not; chefs with an academic degree in culinary arts are exempt, but cooks who perform routine work are not; paralegals are not exempt even if they have been to paralegal school. In the "creative" category we find that actors, musicians, painters, and writers are usually exempt, as are journalists (except those who merely rewrite press releases, who are nonexempt).

The Consequences of FLSA Violations

The overtime regulations are a minefield for employers because overtime claims are doubled as a penalty and, under the case law, can't be settled or compromised—all the employer can do is pay the full amount when assessed plus interest and the employee's attorney fees. Some of the biggest overtime claim problems come from record-keeping violations—if an employer has classified employees as exempt and therefore has not kept time records for them, subsequent reclassifications triggered by a DOL audit can lead to very high payments to employees because the employer has no way to prove that the employees worked little or no actual overtime.

Enforcement of the overtime rules depends, in large part, on the budget and effectiveness of the Department of Labor. Audits sometimes occur as a result of complaints by employees who think they should be getting overtime but are not. The lower end of the salaried workforce, when business conditions have required employees to work overtime, is a likely source of such complaints.

Laura B. Hoguet is a founder of Hoguet Newman & Regal, LLP and a trial lawyer with wide experience in business, financial and employment matters.

Randi B. May is an associate at Hoguet Newman & Regal, LLP.

The Value of Important Papers

By Robert D. Bring

This short article, in the opinion of the author, has applicability both to the client and to the attorney, who, so often, is guilty of the "shoemaker's children without shoes" syndrome.

Are you able to prove that you are an American (whether born in this country or otherwise)? Or that your son or daughter was born on American soil? Or that he or she was vaccinated against smallpox in 1938?

Or, for that matter, are you able to prove that you paid for liability or life insurance premiums this year or were graduated from college in 1941 or served in the armed forces during World War II?

"With time," you say, "probably, of course I can."

Then, if you said that, you are among the millions of Americans who fail to keep track of vital records concerning their affairs and daily lives.

For example, the time required to locate armed service records may mean costly delay if you unexpectedly need hospitalization at a VA hospital.

Another example is the location of a cemetery deed, to be readily available when needed. The time to obtain a copy of your birth certificate may mean an unnecessary delay in issuing your passport. The time to trace insurance records—liability or otherwise—may mean a long delay in the settlement of claims. Time is money in the business of your own affairs as well as in the affairs of your business. It is vital that you be certain *now* that your family records and valuable papers will be available when you need them.

According to estate planners, family records can be divided into those relating to personal affairs, banking, insurance, real estate, personal property and bonds and investments.

Your "personal affairs" files should include: your marriage certificate, birth certificate, naturalization papers, armed service records, a "family tree," income tax returns (and evidence of payments), receipts for paid bills (and expense records), diplomas, licenses and family health records (vaccinations, etc., with dates).

Your banking records are of the utmost importance. Can you remember, without the help of records, the name of every bank in which you have ever had an account, and in whose names those accounts were opened? Few of us can, after heading a family for so many years, yet you or your spouse may need this information some day . . . for income tax or credit investigations or for a dozen other reasons.

Other important items under the heading of banking records are: canceled checks, bank statements, bank books, 1099 forms and vouchers. These should be kept at least six (6) years, in case you are called upon to prove that you did, in fact, pay $10,000 for that missing diamond bracelet . . . or that you did, in fact, pay that old electric bill.

As far as insurance policies are concerned, merely knowing where they are is not good enough. For instance, do your records indicate the last time your life insurance policies were reviewed? Was it before your second child was born? If before, you may want to contact your life insurance agent. You should also make sure that his or her name and address are easy to find.

"It is vital that you be certain now *that your family records and valuable papers will be available when you need them."*

"Real estate" files should contain: your deed (or lease), condominium (or cooperative) prospectus, copy of mortgage, title insurance policy, certificate(s) of occupancy and bills (with attached canceled checks) for improvements made by you to your home. These documents are also needed for any secondary (vacation) home.

"Personal property" files should contain: data on your automobile(s) and, ideally, an inventory of household goods, jewelry, and other valuables, together with dated photographs (or tapes) of each item. Distasteful as it is to talk of disaster ("if anything should happen . . ."), it is necessary that your spouse have enough knowledge at his or her disposal to take over the "business of the family." If you are unconscious, your spouse will have to provide the hospital admission clerk with information about your hospitalization policy, "living will," health care proxy and power of attorney. If you are out of town and discover that you have forgotten your checkbook or credit cards, your spouse had better know what they look like so that they may be sent to you.

No matter what happens to your savings bonds, investment bonds and securities, you are safe it you have recorded their serial numbers. You are even safer if those numbers are recorded in a few different places. The location of all your bonds and securities, and the name, address and telephone number of your stockbroker should also be recorded.

> *"Apply the same common-sense ideas to the 'business of your family' that you do in your business or profession."*

You should not only make a will, but also discuss its provisions with your spouse, as well as any trust agreements which you may have executed. Finally, does your will name guardians for your minor children if they should lose both you and your spouse at the same time? This is a harsh prospect for a parent to contemplate, but who is better qualified to determine who will raise your children if you and your spouse are not fortunate enough to do so yourselves? Above all, do not depend on word-of-mouth agreements. If the insurance money comes with the children, even the most selfish relatives may become "loving" overnight and make attempts through the courts to be awarded custody.

Apply the same common-sense ideas to the "business of your family" that you do in your business or profession. Inventory the valuable papers that are your "assets." Know where they are. Be certain that someone—preferably more than one person—besides yourself also knows their location, and has a key for any locked cabinet or drawer. Finally, it is urged that you plan for the future of your family—considering all the possibilities, even the disagreeable ones.

Robert D. Bring is a sole practitioner in private practice, as well as the past Co-Chair of the Real Property Committee of the Rockland County Bar Association, and he is a Director of the Trust and Estate Planning Council of Rockland County.

Circular 230: Changes for Tax Opinions and Best Practices for Tax Advisors

By Alice Joseffer

The Treasury Department has recently proposed changes in Circular 230 regarding regulations that govern practice before the Internal Revenue Service. These proposed changes (1) prescribe best practices for all tax advisors; (2) combine and modify standards applicable to marketed and more likely than not tax shelter opinions; (3) revise procedures for ensuring compliance with standards of practice; and (4) provide for advisory committees to the Office of Professional Responsibility.

One key proposed change modifies the definition of "tax shelter" and, as a result, the standards applicable to tax shelter opinions now apply to tax opinions not previously subject to the regulations. A tax shelter could be, for example, a municipal bond offering or a family limited partnership. The new definition of tax shelter would affect tax shelter opinions rendered after the date the final regulations are published in the Federal Register. However, in April 2004, the IRS announced that, in final regulations, the definition of tax shelter opinion for these purposes will not apply, if at all, to written advice concerning municipal bonds rendered less than 120 days after the publication of final regulations. Also, the "best practices" and procedures for ensuring compliance with standards of practice apply to tax advisors generally, and are not limited to the tax shelter context.

A summary of the proposed changes follows.

1. Best Practices to Be Observed by All Tax Advisors

1. Communicate clearly with the client regarding the terms of the engagement and the form and scope of the advice or assistance to be rendered;
2. Establish the relevant facts, including evaluating the reasonableness of any assumptions or representations;
3. Relate applicable law, including potentially applicable judicial doctrines, to the relevant facts;
4. Arrive at a conclusion supported by the law and facts;
5. Advise the client regarding the significance of the conclusions reached;
6. Act fairly and with integrity in practice before the Internal Revenue Service.

The best practices apply to oral as well as written advice. Some of them seem to go beyond other professional ethical requirements. For example, the requirement to evaluate the reasonableness of any assumptions or representations appears to impose additional obligations.

A marketed tax shelter opinion is a tax shelter opinion that a practitioner knows or has reason to know will be used by other(s) in promoting or recommending the tax shelter to one or more taxpayers.

2. Requirements for Marketed Tax Shelter Opinions and More Likely Than Not Tax Shelter Opinions

Requirements for these tax shelter opinions include: (1) identifying and considering all relevant facts and not relying on unreasonable factual assumptions or representations; (2) relating the applicable law to the relevant facts and not relying on unreasonable legal assumptions, representations, or conclusions; (3) reaching a conclusion, supported by the facts and the law, with respect to each and all material federal tax issues; and (4) providing an overall conclusion as to the federal tax treatment of the tax shelter item or items and the reasons for that conclusion. If a practitioner cannot reach a conclusion with respect to one or more material federal tax issues or cannot reach an overall conclusion, the opinion must state the issues and reasons for failing to reach a conclusion. "Limited scope" opinions are allowed only if the opinion is not marketed and certain disclosures are made.

3. Required Disclosures

A practitioner must disclose any compensation arrangement or any referral agreement with any person (other than the client) with respect to promoting, marketing, or recommending tax shelters. A marketed opinion must disclose (1) that it may not be sufficient for a taxpayer to use for the purpose of avoiding penalties; and (2) that the taxpayers should seek advice from their own tax advisors. A limited scope opinion must state that additional issues may exist that could affect the federal tax treatment of the tax shelter under discussion. If an opinion fails to reach the confidence level of at least more likely than not with respect to one or more material federal tax issues, it must disclose that fact and that it was not written, and cannot be used by the recipient for the purpose of avoiding penalties with respect to such issues.

An objective of the proposed regulations is to ensure a client is informed explicitly about what protection an opinion provides to the client.

Conclusion

Under the proposed rules, tax practitioners must establish procedures for compliance with the best practices. Practitioners will need to determine whether or not tax advice is a tax shelter opinion and, if it is, ensure compliance with additional requirements. Devising adequate procedures will require creativity to meet clients' needs for timely responses while complying with the regulations.

Alice Joseffer is a partner at Hodgson Russ LLP, in Buffalo, concentrating in the area of tax law. Her areas of expertise include tax planning and dispute resolution issues.

Great Opportunities for Involvement!

The New York State Bar Association Business Law Section Committees offer both the experienced and novice practitioners excellent ways to enhance their knowledge and expertise. Through Section activities members examine vital legal developments in business law. The Section sponsors continuing legal education programs and publishes a journal to keep members informed on the latest updates in the area of business law.

Business Law Section Committees are a valuable way for you to network with other attorneys from across the state and research issues and influence the laws that can affect your practice. Committees are also an outstanding way to achieve professional development and recognition. Your involvement is very much welcomed.

☐ Please consider me for appointment to the Committees as indicated below.

☐ As a member of the New York State Bar Association, I enclose my payment of $25 for Business Law Section dues.

☐ I wish to become a member of the New York State Bar Association and the Business Law Section. Please send me an Association and Section application. No payment is enclosed.

Committees

__ Banking Law Committee (BUS1100)
__ Bankruptcy Law (BUS1200)
__ Futures and Derivatives Law (BUS1300)
__ Insurance Law (BUS1900)
__ Internet and Technology Law (BUS1400)
__ Consumer Financial Services (BUS1500)
__ Corporations and Other Business Entities (BUS1600)
__ Securities Regulation (BUS1700)
__ Franchise, Distribution and Licensing Law (BUS1800)

Name ______________________________

Office Address ______________________________

Home Address ______________________________

Office Phone No. ____________ Office Fax ____________ Home Phone No. ____________

E-mail Address ______________________________

Please return this application to:

Membership Department
New York State Bar Association
One Elk Street
Albany, NY 12207
Telephone: 518 487-5577
E-mail: membership@nysba.org

Join online: www.nysba.org

Publication Policy and Manuscript Guidelines for Authors

All proposed articles should be submitted to the *Journal*'s Editor-in-Chief at Albany Law School. Each author must submit a 3½" disk, double density or high density, plus two printed copies of the manuscript. The disk should be labeled indicating the type of computer software used in the creation of the material. Preferred document formats are: Microsoft Word for Macintosh, Microsoft Word for Windows and Microsoft Word for DOS. WordPerfect is also acceptable if formatted using v.5.1 or 6.0. Most laser-printed copy is acceptable. Dot matrix copy is not. There should be no pencil or pen markings made on either of the printed copies submitted. Authors are responsible for the correctness of all citations and quotations; footnotes should be double spaced and segregated at the end of the article. A short author's biography should also be included.

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

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

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

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

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

Deadlines

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

NY Business Law Journal
c/o Professor James D. Redwood
Editor-in-Chief
Albany Law School
80 New Scotland Avenue
Albany, N.Y. 12208
telephone: (518) 472-5870
e-mail: jredw@mail.als.edu.

Subscriptions

Subscriptions to the *Journal* are available to non-attorneys, universities and other interested organizations. The 2005 subscription rate is $75.00. Please contact the Newsletter Department, New York State Bar Association, One Elk Street, Albany, NY 12207 or call (518/487-5671/5672) for more information.