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Inside

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NY BUSINESS LAW JOURNAL

HeadNotes

With the immediacy of the financial crisis behind us, New York business practitioners can take a more reflective look at the impact of changes in the law as they affect our clients. In that spirit, the first three articles in this issue explore issues that come to the fore in a business downturn.

Our leadoff article focuses on accounting and regulatory changes on the lending side and how they may affect both the practices of lenders and the availability of credit. In "Principles of Commercial Debt Restructuring and the Politics of 'Mark to Market' Asset Valuation," attorney Charles Wallshein, a partner of Asset Quality Solutions who acts as counsel to community banks and thrift institutions on regulatory issues affecting loan valuation, explains how banks value commercial real estate loans in their portfolios, and how those valuations affect their posture with their regulators. Along the way he provides a wealth of useful information on the background of the commercial debt securitization markets and the history of the recent crisis. He explains how the over-availability of credit undermined the soundness of lending practices, and how internal bank practices and regulatory policy mitigate against an abrupt write-down of loan values. Although the trend in loan valuation is to fair value accounting, Mr. Wallshein notes that regulators should recognize the risks in the current environment and work with lenders to ameliorate them.

Another area of heightened concern affects trade creditors, specifically the risk that companies they deal with may file for bankruptcy. In particular, suppliers of goods on credit face the risk that they might not be paid for years, if at all, if their customer should file a bankruptcy petition. In turn, this might induce them to withhold credit if their customer has a liquidity crisis, thereby causing the customer's position to deteriorate further. In "Claims for Goods Delivered on the Eve of a Bankruptcy Filing: What Every Business Lawyer Needs to Know," Scott H. Bernstein and Robert A. Rich of Hunton & Williams explain how Congress has provided some comfort, in the form of Section 503(b)(9) of the Bankruptcy Code, which was enacted with exactly this situation in mind. In essence, this Section provides that a claim for the value of goods delivered within 20 days of the petition will be treated as an administrative claim against the bankruptcy estate. As such, it may be paid in full even before confirmation of the plan. The authors note that there is a downside for the debtor, however: the need to pay trade creditors in full makes it harder to conserve cash to emerge from bankruptcy.

One of the (perhaps predictable) consequences of the financial crisis is the largest number of failing or problem banks in a generation. Since one person's crisis is another's opportunity, the possibility of acquiring banks at fire-sale prices has attracted numerous investors, such as hedge funds and private equity funds, that have not historically invested in banks. The fundamental problem is that the mindset of such investors toward weak or failing businesses—buy them, fix them, and sell them at a profit, preferably in three to five years—is at odds with the regulatory structure of bank ownership. In "So You Think You Want to Buy a Bank?" the editor outlines the realities of bank ownership, in terms of the draconian restrictions imposed by American law and regulatory policy, and the tentative steps taken to date by the Federal Deposit Insurance Corporation (FDIC) and the Federal Reserve to make bank ownership more feasible and attractive for private investors.

In "Thus Spake Zarathustra (and Other Cautionary Tales for Lawyers)" Evan Stewart, our legal ethics guru, deals with some recent case law developments in a number of areas: 1) the so-called "corporate Miranda warning," whereby a corporation's lawyer notifies a corporate officer that he or she is not representing the officer personally, and thus that anything he says may be used against him; 2) the hazards for attorneys who do not act promptly and thoroughly to retain documents in anticipation of litigation; and 3) the developing law of inadvertent waiver of the attorney-client privilege. As always, Mr. Stewart combines comprehensive knowledge of the law with a clear and entertaining style—complete with a cartoon.

On the litigation front, Skadden Arps attorneys Matthew Matule, Edward Micheletti and Peter Morrison have once again provided their comprehensive "Inside the Courts" feature, recapping and explaining significant case law developments in securities and related litigation. And White & Case's Jack Pace and John Rue, joined by Jason Bartlett, have contributed their second article on "E-discovery 'Worst Practices.'" A year ago they detailed "Ten Sure-Fire Ways to Mismanage a Litigation Hold"; this time it's "Ten Sure-Fire Ways to Mismanage Document Review and Production." Noting that there is extensive literature on "best practices" in e-discovery, with tongue in cheek they explain how one can master the ten "worst practices" in this area. In the process, they entertainingly elucidate the pitfalls, as shown by recent cases, for attorneys who take these worst practices to heart.

On the securities regulation front, Steven Glusband, Guy Lander and Sharon Rosen of Carter Ledyard & Millburn discuss another example of how the electronic age is changing the practice of law. In "XBRL Interactive Data for Financial Reporting," they explain that all reporting companies are now required to use XBRL (eXtensible Business Reporting Language), a computer language that enables data delivered to the SEC over the internet to be processed by certain software applications. The substantive reporting requirements have not changed.

Another regular feature of the *Journal* is the Employment Law Update contributed by James Grasso, a partner of Phillips Lytle in Buffalo. In this issue Mr. Grasso features changes in New York employment law extending employment rights to domestic workers and bereavement leave rights to same-sex partners, and treating all construction workers as statutory employees; a tightening by the New York Department of Labor of permissible deductions from employee paychecks; Department of Labor rules requiring federal contractors to post notices of workers' union rights; and a DoL interpretation under the Family and Medical Leave Act clarifying that same-sex parents are eligible for child-related leave.

Lastly, I want to mention the very successful Fall Meeting of the Business Law Section, which took place in mid-October at the historic Gideon Putnam resort in Saratoga Springs. Section Secretary Jay Hack has contributed a very informative write-up of the program, along with photos covering some of the highlights of the meeting.

David L. Glass
Editor-in-Chief

Business Law Section Fall Meeting

By Jay L. Hack

The annual Fall Meeting of the Business Law Section, under the leadership of Bruce Baker as Chair, was held at the Gideon Putnam Hotel in Saratoga Springs, New York. With so many diverse interests in the Section, which has 10 separate committees, it has been difficult in the past to provide programs of interest to the entire Section. This year, Paul Silverman, Program Chair and Senior Vice Chair of the Section, took charge and solved this problem with a diversified approach to the CLE sessions by asking each committee to present a program during morning breakout sessions. Seven committees took up the challenge. (Committee Reports, which appear on pp. 74-75 in this issue, go into more detail on some of these programs).

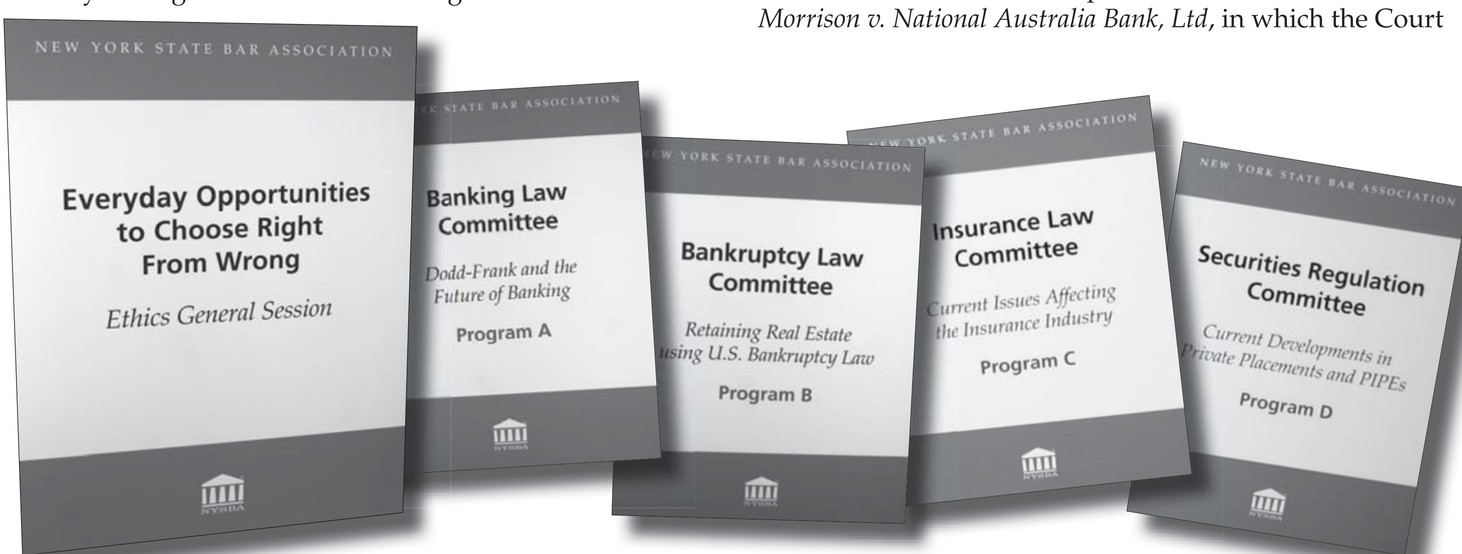
At the session "*Business and Personal Identity Theft Risks for Lawyers,*" by the Consumer Financial Services Committee (Randy Henrick, Chair), participants learned that you can't completely eliminate identity theft but described steps to reduce the chance that you will become a victim.
Presenter: Randy Henrick

"Solutions to Corporate Law Credit and Finance Issues," by the Corporations Law Committee (Jeffrey Bagner, Chair) focused on resolving legal issues in M&A negotiations by having a better understanding of the economic consequences of the contract terms in dispute.
Presenter: Richard De Rose

"Current Issues Affecting the Insurance Industry," by the Insurance Law Committee (Matthew Kaplan, Chair) included a discussion of impending new regulations under Dodd-Frank and the need for attorneys to be proactive as soon as the regulations are promulgated.
Presenters: Robert Goodman, Joseph Jean, Thomas Kelly, Martha Lees

"Current Developments in Private Placements and PIPEs," by the Securities Regulation Committee (Howard Dicker, Chair) discussed the rise of Registered Direct offerings in lieu of PIPEs because of increased post-closing investor flexibility.
Presenters: William Hicks, Robert Schroeder

"Extraterritorial Reach of the Federal Securities Regulation," also by the Securities Regulation Committee, discussed the recent U.S. Supreme Court decision in *Morrison v. National Australia Bank, Ltd*, in which the Court



limited the application of Securities Exchange Act Section 10(b) and Rule 10b-5 to transactions in U.S.–listed securities or other domestic purchases or sales.
Presenters: Daniel Cahill, James Redwood

"Retaining Real Estate Using U.S. Bankruptcy Law" by the Bankruptcy Law Committee (Norma Ortiz, Chair) explained strategies that can be used by the bankruptcy practitioner to avoid foreclosure and reach a result acceptable to both lenders and borrowers.
Presenter: Scott Bernstein

"Dodd-Frank and the Future of Banking" by the Banking Law Committee (David Glass, Chair) taught us that although it may not yet have a catchy acronym, the Bureau of Consumer Financial Protection established under Dodd-Frank will have the authority to outlaw unfair, deceptive or abusive acts or practices.
Presenters: Michael Campbell, David Glass, Jonathan Rushdoony

"The Effect of Regulatory Reform on OTC Derivatives," by the Derivatives and Structured Products Committee (Daniel Budofsky, Chair), cautioned lawyers that they need to be proactive in the process of formulating new regulations required under Dodd-Frank so that they respect the intent of the new law without depriving the financing and investing industry of an important product.
Presenters: Daniel Budofsky, Gabriel Rosenberg

Not wanting to give ethical obligations of attorneys short shrift, Mr. Silverman also organized a magnificent Ethics program designed for the entire Section, *"Everyday Opportunities to Choose Right From Wrong."* The participants included Thomas Baxter, Executive Vice President and General Counsel of the Federal Reserve Bank of New York; C. Evan Stewart, partner in the firm of Zuckerman Spaeder LLP and an adjunct professor at both

Fordham and Brooklyn Law Schools; and Michael Stone, formerly general counsel to Morgan Stanley and an adjunct Professor at Cardozo Law School. The riveting and sometimes contentious program had speakers and attendees continuing the debate of the decade—who's at fault for the mortgage crisis—with ethics questions raised about attorneys participating in the residential mortgage collapse from origination through securitization. That was followed by a discussion of the extent to which the First Circuit's decision in *U.S. v. Textron*, 577 F.3d 21 (1st Cir. 2009) (*en banc*) eviscerates a good part of the work product privilege by limiting it to material prepared solely, or principally, for litigation.

In addition to the top quality educational programs, there was a lot of time for socializing and networking among the approximately 70 Section members and guests in attendance. The Thursday evening welcome dinner included a blind wine tasting of six wines in a room filled with over 300 pre-poured and numbered glasses of wine. The winners were the deliciously fruity 2009 Paumanok (Long Island, North Fork) Sauvignon Blanc in the white wine category and the complex structured 2004 Chateau Compassant (Bordeaux, Entre Deux Mers) in the red wine category.

At the Friday lunch session, President of the Association Stephen Younger spoke about the importance of bringing younger lawyers into the association. The closing dinner was held at the National Museum of Racing, with everyone having the opportunity to tour the museum and its incredible collection of gold and silver victory trophies. Section members also had the opportunity to participate in a golf tournament at the Saratoga Spa Golf Course—regularly given four stars in *Golf Digest*'s "Best Places to Play."

Principles of Commercial Debt Restructuring and the Politics of "Mark to Market" Asset Valuation

By Charles Wallshein

There is little argument that the landscape of the CRE and CMBS[1] markets has changed since 2007. The most dramatic changes are to the values of loan portfolios and the regulation of the institutions that hold them. The valuation issues are systemic and involve not only a decrease of the value of the collateral but also the relative strength of the borrowers and guarantors. Regulation has likewise been transformed with a major focus on the valuation and classification of loans that are "troubled." The valuation and classification of assets speak directly to the institution's capital strength. The supervisory agencies that regulate institutions base their regulatory decisions upon those computations.

There are three timelines that indicate recovery performance for the commercial real estate sector. The first is the timeline for economic recovery as a whole. As the economy improves, borrowers' cash flows are expected to improve. The second is the timeline of loan extensions and restructurings. Extension, restructuring and modification of loans allow institutions to write down losses in an orderly manner, thereby preserving the financial system's infrastructure. The third is the timeline along which commercial real estate credit markets reopen for creditworthy projects. The longer it takes for these three timelines to cross, more commercial real estate loans will produce unavoidable losses that in the end will be borne by the borrower, the lender, or the taxpayer.

Banks must evaluate the strength of commercial real estate loans in their portfolios against the path of the three timelines. This means projecting, among other things, the income that can be produced by the property, the borrower's record in servicing the debt, and the present ratio of the property's value to the amount of the loan. On the basis of those projections, the lender must decide whether the loan can be repaid and whether changing the terms of the loan increases that possibility or just delays its inevitable failure.

The timelines are inextricably interrelated. The plan for recovery for the banking industry, for businesses and property owners and for the economy as a whole requires unified policies to be adopted that incubate recovery on all three timelines. Weaknesses or conflicts in rehabilitative policies in one timeline will have negative effects on the other two. The crisis caused by the real estate bubble is complex and has wound its way into every sector of the economy. There is no way to wipe the slate clean in a short period. The potential losses, if recognized at once, would be overwhelming and would certainly cause a collapse of not only the smaller institutions but of the large ones as well. TARP[2] was created as a stopgap measure to infuse temporary capital into the financial system, but it is not a long-term solution. Policy makers believe that sound policies, sound management and time will allow the markets to correct. The main components of such policies are the measurement, mitigation and regulation of risk among financial institutions.

The matter of "buying time" concerns regulatory elements that will allocate financial resources to institutions and assets that are most likely to be rehabilitated. Regulators are exerting more pressure than ever to force institutions to present a hyper-accurate picture of their financial condition and take the appropriate steps to mitigate risks and ameliorate losses. Many institutions have had to revise internal management policy to meet these requirements. It is relatively easy for an institution to change internal policy. It is rather more difficult to implement. In the past, banks simply wrote down bad debt and booked the loss. Their balance sheets were healthy as a whole and could easily absorb the loss. Many institutions can now no longer do that, as doing so would render them insolvent. Institutions must carefully write down, restructure or liquidate debt as a strategy to remain solvent.

For many institutions the task involves implementing new procedures that determine the definition, identification, assessment, measurement and management of risk. Once the risk from "troubled" assets is analyzed the institution must employ a "prudent" methodology for the mitigation of same. Loss mitigation may involve sale of the asset, foreclosure or a restructuring of the debt. Very often a restructuring of the debt is warranted. However, debt restructure strategies must be "prudent" as defined by the *Policy Statement on Prudent Commercial Loan Workouts*.[3]

Industry opinion on the *Policy Statement*, since its publication in late 2009, is generally mixed. One purpose of the *Statement* is for institutions that hold CRE and CMBS paper to know that as matter of policy regulators will not or should not automatically assign a negative stigma to loan workouts.[4] The *Statement* also attempts to define methodologies that institutions must employ so that their debt restructurings are consistent with *safe and sound lending practices and relevant regulatory reporting requirements.* The news that regulators would view loan workouts in a more positive light was encouraging. However, the language used to describe adequate methods and practices remains sufficiently vague.

The supervisory mandate is clear and there is recognition that troubled assets must be reclassified and in many cases restructured. There is no question that troubled loans have a significant negative effect on the capital of the banks that hold them. Regulators state that restructuring debt will not be automatically viewed in a negative light. The new policy is encouraging, yet many of the same old rules apply. New terms of art are being used and to this date are not clearly defined. The question then is what is the definition of a "troubled" asset, a "prudent" workout, "experiencing financial difficulties," etc.? During this crisis in lending and risk management we are therefore faced with a new set of financial circumstances that must be managed under new and as yet not clearly defined standards using largely the same accounting rules that pre-dated the crisis.

The aspects of risk assessment that have not changed dramatically include the valuation concepts used for income producing property, the classification definitions used by internal and regulatory auditors and the accounting rules that govern ALLL and Accruals.

Some of the risks of commercial real estate loans can produce a direct impact on bank capital, some trigger related financial market consequences, and still others can be eased or resolved by private negotiations short of any immediate impact. The following is a general discussion of the bank capital rules that set the terms on which loan failures can affect bank strength and a general summary of the accounting policies involved.

Institutions are being forced to clean up their balance sheets. Although bank capital computations are often very technical and complicated, the core of the rules can be stated simply. A bank's capital strength is generally measured as the ratio of specified capital elements on the firm's consolidated balance sheet (e.g., the amount of paid-in capital and retained earnings) to its total assets.[5]

Decreases in the value of assets on a bank's balance sheet change the ratio by requiring that amounts be withdrawn from capital to make up for the losses. Losses in asset value that are carried directly to an institution's capital accounts without being treated as items of income or loss have the same effect. During the financial crisis the deterioration of these ratios accelerated dramatically. A decrease in the value of a bank's loan portfolio has a negative impact on the value of the bank's assets. This decrease will cause the bank's supervisor to require the institution to raise additional capital. In the event the institution cannot raise the necessary capital the institution will be deemed insolvent.

The data indicate that the decade preceding the crisis experienced a financial and real estate market where increased cash flows, lower cost of funds and lower capitalization rates were the norm. It is now apparent that the sector that financed smaller balance commercial loans, including those on commercial real estate, was ill-prepared to meet the capital requirements of a crisis of this magnitude. Without making excuses for the community and commercial banking industry, it is fair to say that while they may not have been the root of the crisis, they may be bearing the brunt of the regulatory burden. The next decade will witness a vastly altered community and commercial lending industry. Those lenders that consistently loaned money most prudently in the strongest markets and on the strongest projects are still considered "sound." There are then those institutions whose portfolios are weakened but are still largely based on performing assets that may be "troubled" due to a decrease in asset classification and or value. Then there are the institutions whose portfolios are weak across their entire spectrum and that will probably fail.

The regulatory objective is to keep as much capital flowing in the most prudent manner possible. Within that objective it is apparent that regulators want to eliminate the weakest players. It is also apparent that official regulatory policy has shifted to allow banks to manage their risks by restructuring debt, while not taking unnecessary actions that force those who can reasonably manage portfolio restructuring into lower categories.

Most if not all regulated institutions must implement standardized procedures for risk management, but many do not have the necessary Management Information Systems to do so. The reasons for the lack of internal auditing and risk management procedures are numerous. However, the most obvious is that prior to the instant financial crisis, institutions could generally manage risk by looking at the historical performance of the loans in their portfolios. In other words, if a loan were performing it would likely receive a "pass" classification and be accorded "accrual" status. This is no longer the case. Regulators are forcing institutions to re-underwrite and re-grade all the loans in their portfolios. The current "re-underwriting" and grading standards are often more stringent than they were when the loan was committed.

The following is a discussion of the history of CRE and CMBS, an overview of the current CRE and CMBS markets and the relevant aspects of regulatory law. Incorporated throughout the discussion is how the elements of regulatory law, transactional law and principles of accounting should, in theory, work together so institutions and their internal review processes can perform their managerial and auditing functions more efficiently to manage risk and restructure their "troubled" debt.

Also following are the very real discussions concerning the positions of the Financial Accounting Standards Board (FASB), the regulatory agencies and bank management. There is a heated debate as to the valuation methodologies that banking institutions must use in their accounting process. Both sides of the argument have merit;

however, regulatory policy concerning "mark to market" accounting is inconsistent and is applied with varying results.

History

The present crisis is the third major crisis in the last century. The first was the Great Depression, The second occurred in the late 1980s and early 1990s. The mid-1980s represented a time of boom for the commercial real estate industry. A combination of increased money supply, lower interest rates and changes to the tax code fueled the boom. During that period the amount of domestic commercial real estate debt held by banks increased from 6.9 percent to 12.0 percent. Combined with the expansion of the industry as a whole the increase represented a tripling of the amount of commercial real estate debt. In 1987 there was a precipitous drop in the stock market that affected the balance sheets of nearly everyone who held securities. There was an ensuing break in the upward trending economic cycle, and by 1989 the economy went into a recession. Commercial property values dropped precipitously as did the value of the commercial loan portfolios held by commercial banks and thrifts.

Unable to recoup their losses, roughly 2,300 lending institutions failed, and the government was forced to expend $157.5 billion protecting depositors' funds and facilitating the closure or restructuring of these organizations. The government responded by passing *FIRREA* (the Financial Institutions Reform, Recovery and Enforcement Act) in 1989. Among other aspects of the Act, the Resolution Trust Corporation (RTC) was created to liquidate the assets of the insolvent thrift institutions and use the revenue to recover the government's outlays. The number of banks and thrifts contracted from 14,222 banks in 1980 to 10,313 in 1994. Thrifts declined from 3,234 in 1986 to 1,645 in 1995. The concentration of insured deposits among the 25 largest banks grew from 29 percent in 1980 to 42 percent in 1994.

By the early 1990s the commercial real estate market started its recovery. The banks were better regulated, and therefore the reasons for the collapse were resolved. The economy recovered, interest rates declined and there was an increased money supply. Demand for commercial real estate therefore improved under the favorable economic conditions.

Due to these improved conditions and some very creative thinking on Wall Street, there was a restructuring of the way investments could be made in commercial real estate. Some created *Real Estate Investment Trusts* (REITS) and turned the ownership and cash flow of commercial real estate into securities as a way of restructuring and recapitalizing their holdings. Simultaneously, the Wall Street banks took the debt on those properties as well as other performing debt and turned pools of commercial real estate debt into CMBS securities.

Scope of Industry Risk

In the early part of the 2000s the larger institutions came to dominate consumer and home lending with a corresponding decrease in the market share of those products previously provided by the smaller banks. Another trend was that the larger and most secure commercial real estate mortgage transactions gravitated toward the CMBS market.

On the other hand, community banks and the smaller commercial banks increased their focus on smaller balance commercial real estate lending. That market niche was ideally suited for those smaller institutions. The lending was taking place on a regional level and banks in those communities were very familiar with the borrowers and the real estate they were lending on.

Irrespective of the diverging trends, the net result was that smaller institutions came to hold a larger percentage of small balance commercial and commercial real estate loans than they ever had. These assets, while not then considered "unsound," were less likely to retain their value in the event of a correction in the commercial real estate market. The smaller banks that made these loans were doubly at risk because in the event of a market correction their loan portfolio was less diversified and their ability to raise the necessary capital to shore up loan loss reserves was likewise limited.[6]

Many smaller banks held RMBS, CDO and CMBS securities on their books. Regulators put pressure on community banks to diversify their portfolios and spread their *concentration* risk exposure out of commercial real estate loans. Without the ability to compete in the consumer and residential mortgage market and originate their own loans in sufficient numbers to diversify, they were forced to purchase RMBS, CDO and CMBS as an alternative.

Concerns: Overleveraging and Recognition of the Crisis

By 2006, regulators had cause to be concerned about the state of the real estate sector as a whole. Underwriting standards for residential loans had deteriorated to the point where anyone who could sign his name could obtain a mortgage. The availability of inexpensive credit and abnormally high loan to value loans helped cause a bubble in the residential real estate market. While the underwriting standards for commercial real estate loans had not reached that point, commercial real estate itself experienced a bubble as the CRE market witnessed increases in market value that were previously unheard of.[7]

Underwriting standards in the CMBS market also deteriorated. More loans were made with no amortization of principal, markets for lower and lower tranche recoveries such as mezzanine financing, policy exceptions, lengthening maturities and a lack of quality control and independence in the due diligence and appraisal process.[8]

In addition to the underlying issues concerning real estate fundamentals, credit default swaps became a popular derivative investment. A CDS is really an insurance policy against a credit default by a borrower. This is perhaps in principle a great hedging instrument, except when the insurer does not have the liquidity to honor the policy.

Market share and competition among the smaller banks contributed to the higher concentration of commercial loans on their balance sheets. The smaller banks were being edged out of markets in which they used to participate as they were no longer competitive.[9] In addition, CMBS securitizations began to include small balance commercial loans with lending limits as low as $100,000. As the market sectors narrowed for commercial and community banks, portfolios became concentrated with those loans that the smaller banks were best suited to write. These included commercial real estate loans, commercial loans partially secured by real estate,[10] commercial lines of credit, and construction loans.

The inexpensive cost of credit also fueled the concentration of small balance commercial loans with community banks. Even if the strictest underwriting standards were followed and Net Operating Incomes (NOI) were assumed to remain static, in terms of limitations on Loan-to-Value (LTV), Debt Service Coverage Ratio (DSCR), no notice was taken that both of these functions are highly rate-sensitive. First, lower interest rates on the mortgage note allow a higher DSCR. Property valuation is a function of the NOI and Capitalization Rate. Capitalization rates for all investments had fallen to historic lows as Cap Rates tend to follow the same trends as bond yields. While the Loan to Value on loans banks made never really exceeded 75 or 80 percent and did not exceed regulatory guidelines,[11] in retrospect the calculations for LTV were artificially high due to the NOI being multiplied by a lower Cap Rate.

Similar phenomena occurred with the DSCR calculation. As mortgage note interest rates rise the corresponding NOI must increase to generate the same DSCR ratio. If a bank's governing standard for DSCR limits on commercial loans was to be 1.25 on office properties, the NOI could support a loan of *X* dollars at interest rate *Y*. A drop in NOI or an increase of the interest rate would cause the DSCR to drop below the 1.25 threshold established by the bank's internal control policies.

Many of the small balance commercial mortgages were written with note rates set to adjust at some anniversary date of the loan and usually at corresponding intervals thereafter. The interest rate adjustment is based on a *margin* and an *index*. For example, the interest rate adjustment would be set at the 60-month anniversary of the loan with an adjustment of 275 basis points over the 5-year treasury note[12] with a set *floor rate*. The *floor rate* is the interest rate below which the loan cannot adjust even if the index and margin adjustment would so warrant. Any increase reflected in the *index*, and corresponding increase in note payment, would push the Debt Service Coverage Ratio down.

Balloon notes also pose a significant risk to banks. When a loan matures and balloons a significant portion of the note's principal balance remains unpaid. Lenders generally assumed that Net Operating Incomes would continue to increase and that interest rates would remain low, ensuring that at maturity the balloon amount would be refinanceable. Present market conditions indicate that rental values across the board have declined in almost all sectors, and operating expenses have increased, thereby depressing NOIs for many properties from the years 2003-2007.[13]

Revelations about deteriorating loan performance in subprime residential mortgages and resulting declines in the value of residential mortgage backed securities (RMBS), collateralized debt obligations (CDOs), and other instruments began in the spring of 2007. The crisis continued to worsen in the RMBS market and had a waterfall effect on the capital markets as a whole. The secondary markets were contracting, which caused a liquidity crisis that made the sale of assets, including commercial loans, nearly impossible. The underlying collateral that formed the basis for the CMBS, CDO and RMBS markets was overvalued and overleveraged.

While nobody can say exactly where the epicenter of the disaster originated, a "perfect storm" scenario ensued in 2007. The market for overleveraged CMBS, CDO and RMBS loans dried up. Even insured *agency paper*[14] could not be bought or sold because the bid and ask prices were so far apart. In essence the capital markets collapsed.

The Present Condition

At this point it is fair to conclude that the present crisis was at least, in large part, caused by the over-availability of credit. Too much capital on the street fueled the tremendous economic expansion of the past decade. The economy is contracting to levels that would have been expected had the economy not been flooded with available capital. Likewise, the values of homes, businesses and commercial real estate are also contracting. The issue of overvalued commercial real estate, with the corresponding amount of "troubled assets," is now and will continue to be the focus of concern for smaller balance lending institutions for years to come.

Troubled assets present two types of risk for lenders, *Credit Risk* and *Term Risk*. *Credit Risk* can be defined as the likelihood that a loan will go into payment default prior to maturity. *Term Risk* is defined as loans that are unlikely to qualify for refinancing at the end of their term.

Credit risk is the more serious of the two because it affects the fundamental ability of the bank to be made whole on its loan according to the terms of the promissory note. Credit defaults are more difficult for banks to manage. The main factors that cause payment default are a deterioration of the property's income potential and a deterioration of the income potential of the tenant(s). A credit default means that a property cannot support the loan payments in the current market. Under normal circumstances a landlord with a defaulting tenant would evict the tenant and replace the tenant with a new tenant who would resume paying rent at market levels. The other risk is that there are no tenants in the marketplace who will take the vacant space at rents sufficient to service the debt. This concern is referred to as a drop in *absorption* levels.

The precipitous drop in commercial property values since 2007 ultimately means that banks may have to take losses in the range of $200 billion-$300 billion.[15] In many cases, loans that were made prior to the crisis may still be and may remain sound and produce no loss. Likewise, there are many loans that threaten bank portfolios because they will not be able to be refinanced at the end of their term or are now or will be "upside down," with the amount owed exceeding the value of the property.

Commercial real estate's value is a function of the amount of capital it can generate compared to other economic factors such as supply and demand, development costs, cost of funds, etc. The overriding factor in predicting future losses within a given portfolio is the overall difference between the income generated by the underlying collateral in the portfolio when the loan was made and the projected income relative to economic conditions at some future date. The current regulatory environment is one where banks are being forced to re-underwrite their entire portfolios, determine the changes in the value of the underlying collateral, determine the changes in the relative strength of the borrowers and guarantors, and ultimately, write down, liquidate and/or restructure loans based upon projected weaknesses concerning those analyses.

An existing loan that is "impaired" is to some degree a liability to a lender. Unless there has been no change in the value of the collateral, or to the relative strength of the borrower/guarantor, most existing loans have been or should probably be downgraded. Therefore, in many cases, lenders are motivated to restructure debt and mitigate the amount of capital they must reserve against potential losses.

It is becoming apparent that writing down losses on loans prophylactically may in the end be less expensive for banks than the cost of writing down larger portions of loans in the future. Therefore, the overriding concern for banks should be to reestablish realistic value for their loans, assess their collectability and modify the terms accordingly.

The problem with this concept is that in order for banks to recognize and quantify the levels to which their loans and portfolios are overleveraged they must obtain updated information and re-analyze every loan in their portfolio. Unfortunately, most banks do not have the analytical tools or enough adequately trained human resources to accomplish the task.

For most institutions, portfolio management in today's environment is more about risk management and asset rehabilitation than portfolio expansion. Likewise, institutions and the industry as a whole are at a disadvantage because of the lack of management information systems and qualified personnel to qualify those borrowers whose loans are candidates for rehabilitation. As in so many other industries, in banking employee skill sets are highly specialized. This problem is being identified because an effective commercial loan workout officer must have underwriting, regulatory, legal and communication skills. A senior manager may possess all of these skills, due to enhanced training and years of industry experience, but generally junior management does not.

The deficiency in a bank's junior management's skill sets is mirrored in most institutions' management information systems (MIS). This is not meant to be an indictment of the banking industry prior to the crisis. The industry, prior to 2007, was focused on growth and not on management of troubled assets. Growth requires an emphasis and focus on one type of skill set, and MIS dealing with troubled debt requires another.[16]

ALLL: Nature and Purpose

The *ALLL* is the Allowance for Loan and Lease Losses and is one of the most significant estimates in an institution's financial statements and regulatory reports.[17] The ALLL covers estimated credit losses on individually evaluated loans that are determined to be impaired and on estimated credit losses inherent in the remainder of the portfolio. The ALLL is determined by measuring impairment according to GAAP.

> An estimated credit loss is defined as "… *an estimate of the current amount of loans that it is probable the institution will be unable to collect given facts and circumstances as of the evaluation date. Thus, estimated credit losses represent net charge-offs that are likely to be realized for a loan or group of loans. These estimated credit losses should meet the criteria for accrual of a loss contingency (i.e., through a provision to the ALLL) set forth in GAAP. When available information confirms that specific loans, or portions thereof, are uncollectible, these amounts should be promptly charged off against the ALLL.*[18]

In estimating a group of loans having similar characteristics within a loan portfolio FASB 5 applies. In estimating credit losses on loans that are individually evaluated, FASB 114 applies. In both cases the impairments are measured as of the date of evaluation. In both cases, the Allowance for Loan and Lease Losses and the Provision for Loan and Lease Losses (*PLLL*) are based upon management's current judgments about the credit quality of the loan portfolio. In making these judgments management should consider "*…all known relevant internal and external factors that affect loan collectability as of the evaluation date…. An institution's failure to analyze the collectability of the loan portfolio and maintain and support an appropriate ALLL in accordance with GAAP and supervisory guidance is generally an unsafe and unsound practice.*"[19]

Regulatory Guidance

The risks associated with overvalued real estate and the credit quality of the borrower impact directly upon an institution's balance sheet. The institution's balance sheet reflects the valuation of its assets. Assets are comprised of capital, its loan portfolio and other assets such as REO. The loan portfolio is valued by using accounting standards, on the accrual side of the balance sheet for a performing loan and on the non-accrual side if the loan is severely impaired or non-performing.

In the current environment performing loans, even loans with perfect payment histories, are being downgraded due to other deficiencies inherent in the loan or the institution's internal loan supervision.[20] Loans that are protected by adequate collateral value, stable debt service coverage, good relative strength of the borrower and guarantors and have accurate reporting are considered "sound." Departure from any of the above will probably cause internal and supervisory auditors to downgrade the loan's risk rating with a corresponding call to increase the institution's ALLLs.

The greater systemic problem for institutions is the grading of the loans in their portfolios. Every loan in a portfolio is assigned a risk grade based on internal policies and procedures that describe the methodologies for determining impairment. Changes in risk grades have corresponding changes to the amount of reserves the bank must hold against that particular loan. The value of the asset is risk-weighted: the higher the risk, the lower the relative value of the asset.

Grading systems and methodologies vary from institution to institution. While these methodologies vary, regulators are primarily concerned that each institution have a uniform system of controls for evaluating loan risk. One would think that the relationship between credit grade and the appropriate reserve in dollars would be governed by a uniform formula. In reality, determining ALLL reserves has become a rather "dark art."[21]

The corresponding regulatory issue to the institution's system is the supporting documentation for making grading decisions.[22] The problem, however, is that to a large degree, ALLLs are based on historical data derived from past portfolio performance. Current information concerning the property's value and the financial condition of the borrower is required as part of the documentation in accurately grading loans and calculating ALLLs. Most banks include in their mortgage note covenants a requirement that the borrower provide annual reports on the property and the borrower/guarantor's financial condition. While in the past regulators found deficiencies in many banks' enforcement of this covenant and made mention of same in their audits, little corrective action was taken. Regulators are now downgrading assets due to lack of enforcement of this covenant.

We are considered to be at the beginning of the crisis and, therefore, historical data that indicate valuation and migration trends within a portfolio may not truly be an accurate measure of the magnitude of future impairment. Nevertheless, internal data that indicate migration trends from grade to grade were considered an adequate method for estimating credit losses. However, as discussed later in this article, historical migration data and ratio analysis are now deemed inadequate.

The Agency's determination of the inadequacy and useful limits of historical migration data and ratio analysis is evidenced in a comparison of the 2001 *Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions*, and the 2009 *Interagency Policy Statement on the Allowance for Loan and Lease Losses.* The 2009 policy statement mandates the enhancement of the documentation and methodologies banks must use to determine their estimates of credit losses.

Internal loan data are based upon loan performance and borrower data contained within a particular institution's portfolio. The internal information used in calculating ALLLs may be stale or otherwise non-representative of the overall potential loss exposure in the institution's market relative to its concentration levels of certain types of loans. Real estate market data that report quarterly information relating to comparable cash flows and property sales prices would have a significant impact on improving the predictability of expected ALLLs.

Imagine if, *today,* every institution accurately assessed the potential losses in its portfolios and generated roll-up reports of their findings. Also imagine if, *tomorrow,* the supervisory agencies received those reports, conducted their own audits and took immediate corrective action. I dare say that not a single institution would be unscathed, though some would be much worse off than others. This is, of course, impossible due to the number of institutions and the limited capabilities of the regulatory agencies.

However, it is no secret that come every Friday afternoon institutions all over the country are seized, only to reopen the following Monday under new management.

Besides the fact that witnessing such a scenario is highly unlikely due to logistical constraints, it is also unlikely because such a scenario would wreak havoc to an already weakened commercial real estate market. As a matter of regulatory policy and practicality for most institutions, the resolution of their balance sheet crisis is more one of timing, strategy and loss mitigation rather than immediate recognition and write down of losses. There are three reasons why the agencies should not force all potential losses to be recognized immediately.

First, recognition of all losses and the forced corrective action would further depress an already depressed market. If all below-par assets were to come on the market at the same time, it would cause a downward spike below the assets' "fair value" based on reasonable long-term cash flow potential.

Second, commercial real estate values have already witnessed a major correction and are more in line with their inherent market values based on historical trends. Write-downs do not automatically cause sales, but liquidation is one of the strategies banks use to raise needed capital. A drop in values caused by a flood of undervalued assets in the market would inure to the benefit of new investors by allowing them to buy at unrealistically low prices. Likewise, banks would be robbed of real equity in the assets by not being given the time to rehabilitate those assets through restructuring and mitigation of potential losses.

Third, from a policy perspective, forcing immediate recognition of losses and liquidation of assets would cause many institutions to become insolvent. The result would be an unfair transfer of profit potential from banks to non-bank investors. Such a transfer would create economic inefficiency by taking lending institutions out of the marketplace, making economic recovery more difficult, especially in sectors not served by the "big banks."

It is therefore reasonable to conclude that the agencies will try to moderate the crisis by giving the system time to classify the components of debt ranging from most serious to least. It is also reasonable to conclude, based on policy statements and congressional reports, that "prudent" debt restructuring will become the most favored alternative wherever possible. This does not mean that agencies will allow bad debt and severely troubled assets to be swept under the rug. The most poorly run banks will ultimately be put out of business and their lowest class assets will be liquidated. Yet, many banks that have weakened portfolios will be given the opportunity to rehabilitate their assets and mitigate their losses.

Identification and Classification of Risk

Classification of risk, classification of loans and credit loss estimates, though closely related, involve different analyses. Loans may be placed in a particular grade class because they share similar characteristics that affect the likelihood of repayment. Loans should also be segregated into risk categories that are less concerned with loan performance history, collateral value, borrowers and guarantors, but rather with particular sensitivities to external factors.

Credit Risk is concerned with the borrower's ability to repay the loan due to cash flow and its other global debt profile. *Term Risk* is associated with the note maturing and the loan not being able to be refinanced. *Concentration Risk* affects the institution by its having too many loans of a particular type in its portfolio. *Interest Rate Risk* concerns increases in the cost of funds and profitability. There are also general economic and political factors that can affect both loan performance and institutional performance. It is probably impossible to quantify all risk exposure scenarios. However, the policies, procedures and methodologies adopted by institutions must at least be prepared to identify those risks and quantify same wherever possible.

Loans are segregated into five main credit classes: Pass, Special Mention, Substandard, Doubtful and Loss. Loans that receive a *Pass* grade contain excellent payment histories and have quality credit and collateral strength. A *Special Mention* asset has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution's credit position at some future date. *Special Mention* assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification. *Substandard* loans are inadequately protected by the current sound worth and paying capacity of the obligor or the collateral pledged, if any. Loans so classified have well-defined weaknesses or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected. Loans classified *Doubtful* have all the weaknesses inherent in those classified *Substandard* with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently known facts, conditions and values, highly questionable or improbable. Loans classified *Loss* are considered uncollectible and of such little value that maintaining them as bankable assets is not warranted. This classification does not mean that the loan has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be affected in the future.

Classification headings used by banks may vary from the five basic headings above. Most banks use expanded classifications as per the internal policies and procedures the bank has adopted for its loan management methodology. For example, a bank may decide as part of its policy and procedures to break up the *Special Mention* and *Substandard* categories into several subcategories that more accurately describe the types of weaknesses or sensitivities in a particular loan.[23]

Irrespective of the categories used to describe particular or peculiar risks in individual loans within a portfolio, the institution must have a uniform system for loan credit grading. The system must evaluate the *fair value* of the collateral, the creditworthiness of the borrower and the sufficiency of the guarantees as of the time of the review.

Loan grades may migrate downward for a variety of reasons other than deterioration of cash flows and sufficiency of guarantees. A common reason for downgrades is the lack of information regarding property performance and financials on the borrowers and guarantors. A performing loan's classification with reporting deficiencies may migrate downward to a certain point and stop there if the institution can support its contention that other fundamentals regarding the property are sound. Another area of risk identified by regulators is disproportionate concentrations of certain types of loans on their balance sheets. The trend was identified and the Agencies issued a statement that they intended to create a policy statement on the matter.

In January, 2006 the Agencies issued a proposed *Interagency Guidance of Concentrations in Commercial Real Estate Lending, Sound Lending Practices* and invited comment from the industry. In December, 2006, after reviewing the comments, the Agencies issued a joint policy statement, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices (Final Guidance).* The *Guidance* was developed to reinforce sound risk management practices for institutions with high and increasing concentrations of commercial real estate loans. The *Guidance* addresses the issue of risks that a lack of diversity of loan types can have on balance sheets. Prior to issuing the *Final Guidance,* the Agencies requested comments from regulated institutions and their trade groups. The following is a summary of the *Final Guidance* and the comments the Agencies received prior to issuing same.

Initially, the Agencies were concerned with the fact that the smaller institutions were developing very high concentrations of CRE loans on their balance sheets. The policy was to treat all CRE loans as having the same levels of risk without assessing the different risks associated with particular types. Comments on the Agencies' generalization of CRE risk prompted the *Final Guidance* to recognize that different loan types have different risk sensitivities. The fact that different types of CRE loans bear different risks was never lost on most institutions' management. It is somewhat disturbing that the Agencies would go forward advancing that notion in their initial proposal. Perhaps it is indicative of an internal disconnect within the Agencies, between Agency management and its examiners, or of a more systemic disconnect between the Agencies and the economic and business realities of institutions they regulate.

After comment, the *Final Guidance* acknowledged that there are different types and levels of risk associated with different types of CRE loans. Therefore, risk characteristics should be segmented by property type, market and credit risk sensitivities. For example, some loans will be more dependent upon collateral value than on the credit quality of the borrower and should be classified as such. The agencies mandate that loans with common risk characteristics be identified and grouped together to ensure that the institution can maintain a balanced portfolio.[24] Even if none of the loans in a particular group is troubled, concentrations of those loan types pose a risk to the institution as a whole.[25]

Many institutions have concentrations in a particular type of real estate such as the mixed use/multifamily sector. The concentration may have developed over a long period of time due to a variety of factors.[26] Of all loan types, construction loans and land loans continue to account for the largest drain on banks' Tier 1 capital. *De novo* banks came to the market without well-established ties to their communities. To become profitable many *de novos* engaged in lending on riskier types of projects than did their well-established competitors. It is fair to say that during the commercial real estate boom of the last decade the riskier loans did not appear risky at the time they were underwritten. However, the measurement of actual risk and the measurement of risk exposure are two different calculations. Actual risk may have been calculated based on historical data. Risk exposure, if at the time it was calculated at all, should have been established by stressing the factors that formed management's assumptions concerning future loan performance.

Market absorption is the most obvious factor relating to construction loans. It is also not overly indicative of the overall economy. Local markets can become flooded with a particular type of newly finished, vacant space without national economic data being affected. However, an increase of supply without a corresponding increase in demand not only poses measureable risk to the expected future cash flow of the construction project; it also exerts downward pressure on the existing market's projected cash flows.

In the course of a bank's business, a bank, like any business, develops a niche in the community and becomes known for doing a particular type of loan very well. In this capacity the bank will likely streamline its underwriting department to suit a particular type of loan and therefore be able to offer the community lower rates and shorter underwriting periods. Mortgage brokers will also steer their business to lenders who favor a particular type of loan. Another important factor is the type of real estate in a particular community. For example, if a particular community is comprised of mostly small multifamily and mixed use properties, it is logical that the bank in that community would see a higher concentration of loans of those types. This leads to the bank holding a disproportionate percentage of loans of a particular type in its portfolio.

There are practical considerations to the new guidelines' call for CRE concentration assessment. Concentration tests may not be dispositive of the overall risk on an institution's balance sheet. Portfolio risk is a function of many factors, including the institution's relative strength, risk tolerance, portfolio diversification, prevalence and quality of guarantees, secondary collateral and the condition of the local and regional economy. First, the elements that define segments must be identified and qualified. Second, the institution must have a database that can analyze the portfolio in terms of those definitions.[27]

The increase of *Liquidity Risk* has perhaps been the most troubling aspect for institutions to deal with since the beginning of the crisis. Prior to the crisis banks held loans on their balance sheets in three classes. First, loans intended to be held for investment to maturity. Second, loans intended for sale at some point, and third, loans originated specifically for sale. One of the strategies used by banks to generate profit and raise capital when needed was to sell assets.[28] This was, of course, when there *was* a market for whole loans with other banks and in the securitization market.

The secondary market[29] has all but disappeared for the types of loans that are held by community banks and thrifts. The whole loan market for sales to other banks has been greatly curtailed. In many cases, loans originated prior to the crisis have experienced some impairment in value. The sale of these loans, even at discounted values, presupposes the existence of accurate methods of determining value for the seller and the buyer of the paper. Very often the perception of values for discounted assets for sale is represented by a spread in the hundreds or even thousands of basis points in the bid and asking positions of the parties.

Concentration risk is not something regulators can just regulate out of existence. Concentration risk has become an inherent part of the thrift and community banking business. It must be intelligently managed both at regulatory and institutional levels.

Borrower's Repayment Capacity, Sufficiency of Guarantees, Evaluating Collateral Value: Fair Value Reporting

The initial underwriting process, loan grading, ALLL estimation and evaluation of a troubled asset for restructuring can be broken down into three areas of focus: first the capacity of the borrower to repay the loan; second, the presence of a financially capable and responsible guarantor; and third, the *fair value* of the underlying collateral. Recent data indicate a deterioration of strength in all three areas.[30] Recent surveys conducted by the agencies also report that the quality of loan underwriting in all three areas deteriorated as well.[31]

The requirements for participating banks' loan underwriting, loan and portfolio management are codified in the Federal Deposit Insurance Act.[32] In addition to the Act, the FDIC and other regulatory agencies issue guidelines and policy statements that attempt to clarify the Act's language. The problem is that the policy statements are sufficiently vague and, therefore, somewhat open to interpretation. The policy statements offer hypothetical examples to clarify their intended meanings. The examples are helpful, though their guidance is limited in that no two loan scenarios are the same. The following is a summary of the practical considerations management must document as part of their policies and practices.

Repayment Capacity

The underwriting of the borrower's creditworthiness takes into account the following: the character, overall financial condition, resources, and payment record of the borrower; the nature and degree of protection provided by the business' operational cash flow or the collateral on a global basis that considers the borrower's total debt obligations; market conditions that may influence repayment prospects and the cash flow potential of the business operations or underlying collateral; and the prospects for repayment support from any financially responsible guarantors.[33]

The documentation required for borrower credit underwriting includes at least two years' business tax returns for the borrowing entity;[34] income and expense reports for the property; copies of the executed leases; estoppel certificates from the tenants; and bank statements verifying the stated property cash flow.

Sufficiency of Guarantees

A loan guarantee consists of an individual's or an entity's entering into an agreement with the lender whereby in the event of a default by the borrowing entity the lender may seek *recourse* against the guarantee individual or entity. An example of a lender seeking recourse against the guarantor is where there may be insufficient equity in the property and the lien amount is not recovered at sale. Another example is where there are intervening superseding liens to the mortgage[35] and the lender, in the event the property were liquidated (at foreclosure for instance), would not be made whole on the value of its lien. There are many more instances where properties are foreclosed and the property is sold at a price that is less than the value of the lien. In such a case the foreclosing party may seek a *deficiency judgment* against the guarantor for the difference in respective values. *Recourse* loans, therefore, provide additional security to the lender, especially if a property cannot service its debt.[36]

The underwriting of the guarantor's strength involves verifying that the individual or entity has both the financial capacity and willingness to provide support for the credit through ongoing payment curtailments or re-margining; the guarantee is adequate to provide support for repayment of the indebtedness, in whole or in part, during the remaining loan term; and the guarantee is written and legally enforceable.[37]

The documentation required for due diligence on the guarantor consists of a current financial statement with assets and liabilities, personal tax returns, tax returns from other entities with which the guarantor is affiliated, credit bureau reports, bank statements, statements concerning partnership interests and property held jointly with others and similar documentation from the guarantor's spouse concerning marital property.[38]

Collateral Values

The *market value* in a collateral valuation and the *fair value* in an impairment analysis are based on similar valuation concepts. Both measure the value of the underlying collateral as that value relates to the sale price the collateral would bring on the open market making similar assumptions about the market participant's behavior, date of transfer, etc. Market value is usually determined by qualified appraisers or qualified bank personnel who evaluate sales of similar properties in a particular market at a given time. *Fair value* is defined as follows:

> *A fair value measurement assumes that the asset or liability is exchanged in an orderly transaction between market participants to sell the asset or transfer the liability at the measurement date*.[39]

However, the market valuation may differ from the collateral's *fair value* for regulatory reporting purposes.[40] For example, differences may result if the market value and the fair value estimates are determined as of different dates or the fair value estimate reflects different assumptions than those in the market valuation. Such situations may occur as a result of changes in market conditions and property use since the "as of" date of the appraisal.

Market value conclusions may vary from *fair value* conclusions depending on the purpose of estimating value. For example, a market value in a workout plan where a property is intended to be valued at stabilization would differ from a value that would be realized from a foreclosure sale. In either case, institutions and examiners must make certain assumptions that are based on current conditions pertaining to the property's ability to generate cash flow. It is the examiner's responsibility to review and evaluate the reasonableness of the institution's conclusions in its impairment analysis and internal review procedures.

A determination of the reasonableness of the institution's conclusions includes an analysis of current and projected vacancy and absorption rates; lease renewal trends and anticipated rents; effective rental rates or sale prices, considering sales and financing concessions; the time frame for achieving stabilized occupancy or sell-out; volume and trends in past due leases; net operating income of the property as compared with budget projections, reflecting reasonable operating and maintenance costs; and discount rates and direct capitalization rates.[41]

The most preferred method for institutions to present the most reasonable, if not the most accurate, information concerning *market value* is to obtain a new appraisal of the property. In doing so, the institution establishes a *"base line"* for the underlying assumptions concerning value and bolsters its documentation for same. However, *market value* is different from *fair value*. The term *fair value* is used to describe the accounting methodology defined in FAS[42] 157. It is commonly known as "mark to market."

Recognition and Measurement of Impairment

FAS 5 and FAS 114 govern the accounting rules for how creditors recognize and measure impaired loans. FAS 5 describes how a group of loans with similar characteristics are evaluated for impairment. FAS 114 describes how individual loans should be evaluated for impairment. FAS 5 and 114 have more of a nexus to the ALLL than to loan credit grade. FAS 114 states that a creditor should use its normal loan review procedures in evaluating collectability.[43] FAS 157 governs the calculation of impairment.

FAS 114 and FAS 5 come into play when a loan is restructured such that it is improbable that the bank will collect the full amount of the loan with interest and principal according to the contractual terms of the agreement (the promissory note, installment contract, etc.). A good example would be where a bank restructures a note in such a way that at the loan's maturity under the restructuring agreement, the present value of the loan's cash flow is less than the expected cash flow under the terms of the original contract. There are ways of restructuring loans that do not impair the loan under the definition of FAS 5 and 114; however, the circumstances that would give rise to such a scenario are uncommon in the current environment.

FAS 114 contains two main definitional elements. First, it defines the *recognition* of *impairment*. Second, it defines the *measurement* of impairment. Recognition of impairment is defined as follows:

> *A loan is impaired when, based on current information and events, it is* ***probable***[44] *that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. As used in this Statement and in Statement 5, as amended, all amounts due according to the contractual terms means that both the contractual interest payments and the contractual principal payments of a loan will be collected as scheduled in the loan agreement. This Statement does not specify how a creditor should determine that it is probable that it will be unable to collect all amounts due according to the contractual terms of a loan.… Thus, a demand loan or other loan with no stated maturity is not impaired if the creditor expects to collect all amounts due including interest accrued at the contractual interest rate during the period the loan is outstanding*.[45]

The measurement of impairment is calculated using one of three methods that deal with the valuation of future cash flows from the loan. The three methods below are calculated by the amount of information the creditor has concerning the projection of future cash flow. Once a bank recognizes the impairment, it usually is booked as a loss on the bank's balance sheet. FAS 5 and 114 describe the methods for calculating those losses.[46]

The first is a present value *calculation of expected future cash flows discounted at the loan's effective interest rate,* except that as a practical expedient, a creditor may measure impairment based on a loan's observable market price, or the *fair value* of the collateral if the loan is collateral dependent. Regardless of the measurement method, a creditor shall measure impairment based on the *fair value* of the collateral when the creditor determines that foreclosure is probable. A loan is collateral dependent if repayment of the loan is expected to be provided solely by the underlying collateral.

The second is present value *amount*. The creditor shall calculate that present value amount based on an estimate of the expected future cash flows of the impaired loan, discounted at the loan's effective interest rate. This method is more heavily dependent upon the creditor being able to calculate present values of cash flows, to wit, the cash flow is dependent upon a longer fixed interest rate (adjusting at terms of longer periods).

The third is present value *calculation*. The estimates of expected future cash flows shall be the creditor's best estimate based on reasonable and supportable assumptions and projections. In the case of interest rates that adjust more frequently as per the restructured contract, interest rate volatility will have a significant effect on measuring impairment. All available evidence, including estimated costs to sell if those costs are expected to reduce the cash flows available to repay or otherwise satisfy the loan, should be considered in developing the estimate of expected future cash flows. The weight given to the evidence should be commensurate with the extent to which the evidence can be verified objectively. This methodology is called *Level 3 fair value accounting.* It is used when there is no observable market and there is no observable likeness to a market, as in *Levels 1* and *2*.

In performing a *Level 3* analysis, the bank would consider, among other data, its historical loss experience in collecting loans in similar situations, such as the typical recovery rate, including amount and timing. However, the use of historical statistics alone would be inappropriate if the nature of the loans or current conditions differ from those on which the statistics were based. Any allowance that is recorded under Statement 5 must be reasonably estimable and supported by an analysis of all available and relevant information about circumstances that exist at the balance sheet date.

Historical loss experience is no longer as valuable or reliable as it once was. Trends affect loss migrations. When interest rates are declining and property values are increasing, it is logical to assume that loss migration levels remained static. However, economic trends have reversed direction. Every indicator, except interest rates, forecasts that asset values will continue to deteriorate, with corresponding impact on institutions' Tier 1 capital.

There has been substantial debate over FAS 157 *fair value* accounting. The debate is really about to what extent banks must reflect the value of assets on their books. The appropriate method of measuring and reserving against impairment depends on management's judgments of loan collectability. Collectability depends on a combination of borrower and guarantor credit and collateral value. There is no dispute that real estate fundamentals affecting property cash flow have deteriorated. These metrics are relatively easy to obtain, though more difficult to organize in such a manner that management can make them relevant to their institution's portfolio. Just because a property has lost some of its ability to service debt in the current environment does not necessarily mean that the loan is less collectible. The regulatory environment has reverted to analyzing borrower and guarantor credit as the benchmark of the collectability question.

However, credit qualities have also deteriorated. The real problem is that institutions do not have adequate internal data on borrower and guarantor credit quality. In other words, loan collectability based on actual current credit quality data has become a big question mark. While it is easier to obtain metrics for cash flows within a loan portfolio, it is rather more difficult to obtain credit data unless the borrower delivers those data to the bank in a report as agreed (which borrowers almost never do).

The fact is that we are in an illiquid market where there are far fewer "observable" transactions that would enable institutions to base determinations of asset (note) values. The use of discounted future cash flows is likewise inaccurate as this could possibly cause assets to be undervalued and immediately lead to accounting insolvency by over-impairing Tier 1 capital. It is not unreasonable to conclude that FAS 157 *fair value* accounting in an illiquid market threatens every institution whose asset valuation methodologies and collectability predictions are not transparent and based on accurate data. There is little argument that *fair value* accounting of assets will create havoc on bank balance sheets. However, to deny the existence of real impairments on bank balance sheets due to deteriorations of collateral and of the borrowers' and guarantors' credit quality is to deny the existence of the "bubble."

FAS 157 is not based on wishful thinking. FAS 157 requires the use of *relevant observable inputs*,[47] not smoothed-out assumptions. Likewise, the CAMELS rating system is based on calculations of capital adequacy, asset values and liquidity inputs. Asset quality bears directly on capital adequacy. That ratio ultimately determines solvency. The accuracy of a valuation methodology that reflects current economic conditions and considers the probability of repayment ultimately lies in determining at what levels loans in a portfolio are likely to debt-service. There is no question that the probability of full recovery of the investment for some loans will be better than others. Yet it is impossible to determine *fair value* without understanding the risks to the borrower's cash flow and its ability to service its debt, not only at the time of review but also in the future.

During this crisis the real question to be asked when approaching the loan collectability issue is where and under what circumstances will loans become more secure? The apparent answer to that question would lead management to overstate the value of performing loans based upon historical performance data rather than current credit and collateral considerations. Ultimately, performing loans perform until there is an event that impairs the cash flow of the underlying collateral (for example, the failure to obtain lease renewals) that causes them to stop performing. Who really has the ability to forecast loan collectability in this market under these conditions without a management information system that incorporates predictive modeling?

There are certain facts that every sector of the banking industry as a whole has to consider. These facts apply to regulators, accountants, attorneys, institutional management, investors and rating agencies. The current regulatory structure and the structure of the investment community are based on the transparency of the balance sheet. The argument used by FASB in expanding 157 accounting is that the use of its *Level 3* value model is supported by the fact that there are not enough "observable" transactions sufficient to justify the use of *Level 1* or *Level 2* methodologies. This may overstate the real problem. However, the model was drafted by accountants, and by nature accountants want to get to a measurable bottom line.

On the other side of the argument we find bankers who realize that *fair value* accounting could in many cases cause irreparable harm to their institutions. However, they offer very little credibility to their argument by relying on historical data to support their contentions of asset values and likelihood of loan collectability. Even more important is the lack of a factual basis for the projected likelihoods of recovery. The fact is that both positions are unreasonable in that real estate metrics and borrower data are both "observable" and readily available. Valuation based on a property's ability to generate cash flow and the borrower's desire to maintain ownership is measurable. However, under what terms? The fact is that many loans will have to be restructured so that the inherent risks associated with their debt service capabilities are lessened to the point they are deemed "sound." Regulators have the option as a matter of agency policy to consider a restructured loan's viability in terms of probability of repayment irrespective of the bottom line impairments generated by *fair value* accounting. The bankers are not wrong when they state their objection to the notion that impairment automatically equates to a directly proportional capital risk. There have been no data forthcoming that would support the FASB's position on the need for expanding *fair value* accounting.

The major flaw inherent in *fair value* accounting for impairments is that the methodology fails to take into account that it is measuring asset values as if they were sold today. This methodology leads to assets being unrealistically undervalued. Bank management judgment, which is a component of valuation/impairment methodology, has been based on historical performance data. The placement of too much emphasis on historical loan loss migration data under these economic conditions is probably an unwise and unsound practice.[48] At the core of the arguments for or against the expansion of *fair value* accounting for calculating impairments and ALLLs is the recognition of the inherent inaccuracies in the two methodologies. FASB's model relies on data that undervalues assets because of the lack of an observable market. Management's model could be criticized as relying on data that are no longer relevant.

Restructuring Loans

Loss Mitigation Objectives and Recovery Methods

The reason institutions restructure loans is to maximize their recovery potential. Defaulted, delinquent loans with diminished collateral values and other credit risks threaten capital adequacy. Once these loans are identified, the institution has a choice of several recovery strategies. Foreclosure and asset liquidation are the methods used when the institution chooses to recapture its investment through a sale of the asset/collateral.

Forbearance delays the foreclosure process once it has started and gives the borrower an opportunity to cure the default. Asset sales generate immediate capital, however, often at the expense of selling assets below market value. Debt restructuring is used to keep the asset out of default by modifying the terms of the loan agreement in a way that is beneficial to the institution and the borrower. Each strategy has its own risks.

Foreclosure is used after the bank analyzes the collateral value and the borrower's credit and decides that there is no other way to recapture its investment. Foreclosure usually results in a sale to the highest bidder at a judicial sale when the judgment amount is low enough that the expected winning bid will cover the outstanding principal, default interest and costs or when there are no bidders above the upset price set by the lien holder, resulting in the property becoming an asset of the bank as an REO.[49]

Institutions may sell assets for a variety of reasons. Two common scenarios are where a performing loan[50] is sold to raise capital or where a troubled asset is sold to remove it from the institution's balance sheet. The issue of the disposition of troubled assets involves the need for the highest degree of judgment by bank management. Since the beginning of the crisis institutions have seen increasing numbers of performing loans with negative migrations in classification, causing increases in their provisions for loan and lease losses which drain Tier 1 capital. Institutions must carefully balance their capital adequacy requirements against their need for loans that generate profit. In many cases, institutions are taking unnecessary losses by disposing of assets at below market prices because they do not have the tools to accurately value the asset or the human resources to effectively restructure debt, or both.

Types of Institutional Risk

The restructuring strategy, therefore, must address the risk or risks that threaten the loan's present and future performance. It is not uncommon for a loan to have several weaknesses that affect its current risk rating and future performance. When designing a restructuring strategy, the institution must prioritize those risks and implement a plan that addresses short-term and long-term goals for mitigation of those risks. The plan must also function so that it is internally consistent; in ameliorating one type of risk it should not exacerbate another. This consistency should ensure that the elements of the plan do not cause conflicts between risk mitigation goals within the *loan* restructure and also ensure the plan does not cause conflicts with *institutional* policies. It is inevitable that there will be conflicts of this nature, and it is management's responsibility to make sound, informed decisions on strategy.

Institutions have two main areas of concern in managing portfolio risk. The first concerns risks that are recognized by deficiencies in internal portfolio management procedures. The second concerns actual credit risk that affects loan collectability and impairment. Internal management methodologies, practices and policies are more easily addressed than credit risk because the institution has substantial control over the former and very little control over the latter. An institution's ALLL is affected by both risk types because credit risk and management risk affect loan grade.

Whenever possible, institutions should attempt to restructure loans without the use of concessions.[51] Concessions involve an institution entering into an agreement with the debtor that it would not otherwise consider but for the alleviation of the debtor's financial difficulties. The agreement may be imposed upon the creditor by a court, in bankruptcy for example, or result from voluntary agreement between the parties. A creditor may restructure the terms of a debt to alleviate the burden of the debtor's near-term cash requirements to help the debtor attempt to improve its financial condition.[52]

The term *Troubled Debt Restructuring* (TDR) is a term of art associated with FAS 15.[53] A debt restructuring is not necessarily a TDR. For accounting purposes, TDRs are treated differently than debt restructurings. In either case, a restructuring will not result in the debtor increasing its liability to the creditor in terms of the amounts owed, the interest payments or the term (time).[54] In most circumstances, debt restructuring results in an automatic impairment of a loan for regulatory and accounting purposes. The restructuring strategy should consider minimizing the impairment in relation to minimizing the negative impact on the institution's ALLL. Therefore, restructuring strategy is not only about the "*how much*?" but also about "*how much over how long a period?*" The calculation of a debt restructuring's impact on the ALLL is an accounting function.

Avoiding concessions may not always be possible, however: "in an attempt to protect as much of its investment as possible, the creditor in a troubled debt restructuring [sometimes] grants a concession to the debtor that it would not otherwise consider."[55]

Credit risk should be divided into three main categories: term risk, the probability and amount of repayment and external factors. Each of the above three is further categorized by the projected impact on the institution's ALLL in a restructuring. When loans are identified that contain credit risk, a primary goal for the restructuring plan should reflect an attempt to stabilize the loan in terms of debt service capacity while also considering the strength of the guarantors. These two considerations are basic underwriting functions.

The recovery strategy must also consider whether the loan is *collateral dependent*. Loans that are collateral dependent involve assets that must be sold for the institution to recover its investment of principal and interest. In restructuring collateral dependent loans, institutions must obtain information on the *market value* and *fair value* of the collateral and then apply an impairment analysis under FAS 114. This involves both underwriting and accounting functions.

Term risk is the risk associated with a loan maturing and being judged ineligible for refinancing leaving the unamortized balance due under the note. The loan may be deemed ineligible because the debtor is no longer creditworthy under today's underwriting standards or because current information on the value of the collateral[56] exceeds the loan to value parameters set by the institution, or both. In this scenario, management would consider the expected monetary recovery by comparing the value of this asset at sale through foreclosure to the loan's *fair value* in a loan restructuring. In this case a consideration of *market value* and *fair value* comes into play.[57] This analysis also involves underwriting and accounting functions, together with a high degree of judgment by management considering factors such as the value of the lender-borrower relationship.

Loss Mitigation Strategies

The second paragraph of the *Policy Statement on Prudent Commercial Real Estate Loan Workouts* states the following:

> Financial institutions that implement prudent CRE loan workout arrangements after performing a comprehensive review of a borrower's financial condition will not be subject to criticism for engaging in these efforts even if the restructured loans have weaknesses that result in adverse credit classification. In addition, renewed or restructured loans to borrowers who have the ability to repay their debts according to reasonable modified terms will not be subject to adverse classification solely because the value of the underlying collateral has declined to an amount that is less than the loan balance.

The *Statement's* following 33 pages of text explain the regulatory and accounting considerations that affect prudent commercial loan restructuring. While it is encouraging that regulatory policy no longer casts a negative stigma on restructuring, the *Policy Statement* offers very little practical guidance.

"Attachment 1" of the statement gives examples of restructurings in a variety of scenarios. These scenarios provide some guidance on the forms of prudent restructurings and are separated by the type of loan being restructured. However, like many other regulatory guides and policy statements, this one is very vague and offers the practitioner little assistance.

In formulating a restructuring plan, strategy is everything. Irrespective of whether the practitioner represents the creditor or debtor, the plan must accommodate both sides. The plan must meet regulatory requirements and enhance the likelihood and amount of recovery for the creditor and must also be economically realistic for the debtor.

Regulators will often *red flag* restructured loans. It is incumbent upon the creditor to demonstrate that restructuring the loan increases the likelihood of recovery and increases the amount the institution will recover as compared to the other recovery strategies available to the bank. If a loan that is not collateral dependent goes into default, and the lender feels it will recover all of its investment through foreclosure, then foreclosure would probably be a better choice than a loan modification. Conversely, if a loan is *upside down*, then a restructuring which results in a modification of terms that allows the borrower to stabilize cash flow until the property meets appropriate debt service requirements is probably the better choice.

A recovery analysis must be performed and should be based on current, documented loan and borrower data pursuant to GAAP methodologies. The variable in observable and measurable risk in determining the appropriate recovery strategy lies in the analysis of data used by the regulating agency as opposed to that used by the bank. This is particularly important for determining the *fair value* of collateral.

Conclusion

There is little doubt that the trend in loan valuation methodology is pointing towards *Level 3 fair value accounting*. However, fair value accounting methodology does not have to result in drastic impairments to an institution's balance sheet. Regulators want to see that institutions are taking affirmative measures to handle the deterioration of asset values. Bankers or regulators cannot, regardless of what they do, improve the fundamental economics that affect collateral values or the creditworthiness of borrowers. What is expected, however, is that regulators will work with lenders that recognize the risks associated with the current environment and take steps to ameliorate same.

The regulatory definitions of *safe and sound* practices speak to management methodology, policies and practices. Other than requiring the maintenance of certain ratios concerning capital adequacy and liquidity, the regulations place considerable emphasis on management's judgment. Judgment is graded on the basis of the methodology and process supporting management decisions.

The real challenge for bankers during the crisis is not the possible ramifications of the *fair value* methodology but rather adapting their internal processes. In the absence of an observable market, *Level 3* actually provides considerable room for discussion on the processes of asset valuation, asset management and risk mitigation. The Agencies do not demand one hundred percent accuracy from an institution's credit classification system. What they do demand is a coherent and uniform methodology supported by accurate data incorporated into a modern management information system and process.

Endnotes

1. CRE is the acronym for *Commercial Real Estate* loans defined as any real estate loan whose collateral is not 1-4 family residential. CMBS is *Collateralized Mortgage Backed Security*. CMBS are asset-backed bonds based on a group, or pool, of commercial real estate permanent mortgages.
2. TARP is an acronym for *Troubled Asset Relief Program.*
3. *Policy Statement on Prudent Commercial Loan Workouts* (Nov. 2009). The regulators have found that prudent CRE loan workouts are often in the best interest of the financial institution and the borrower. Examiners are expected to take a balanced approach in assessing the adequacy of an institution's risk management practices for loan workout activity.
4. *Id.* TDRs (troubled debt restructurings) will not be automatically downgraded once loans are restructured. However, the net effects of the restructured terms will most likely have an effect on the institution's ALLL pursuant to the realized impairment.
5. Capital adequacy is measured by two risk-based ratios, Tier 1 and Total Capital (Tier 1 Capital plus Tier 2 Capital (Supplementary Capital)). Tier 2 Capital may not exceed Tier 1 Capital. Tier 1 Capital is considered core capital while Total Capital also includes other items such as subordinated debt and loan loss reserves. Both measures of capital are stated as a percentage of risk-weighted assets. A financial institution is also subject to the Leverage Ratio requirement, a non-risk-based asset ratio, which is defined as Tier 1 Capital as a percentage of adjusted average assets. *See* Federal Deposit Insurance Corporation, Risk Management Manual of Examination Policies, Section 2.1 Capital (Apr. 2005) (Office of the Comptroller of the Currency, Comptroller's Handbook (Section 303), Capital Accounts and Dividends, (May 2004)). In addition, the risk-based capital standards identify "concentration of credit risk, risks of nontraditional activities, and interest rate risk as qualitative factors to be considered in the [supervisory] assessments of an institution's overall capital adequacy." *See* Accounting Research Manager, Chapter 1: Industry Overview—Banks and Savings Institutions, at 1.31.
6. *See* Agencies Proposed Guidance, Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of Thrift Supervision, *Concentrations in Commercial Real Estate, Sound Risk Management Practices* (Jan. 9, 2006). In response to comments received on their proposed guidance on commercial real estate lending in 2006, the supervisors noted the concerns that smaller institutions expressed about the fact that real estate lending had become their "bread and butter" business in part because other lending opportunities for these smaller banks had dwindled over time. Many observers have noted that small and medium-sized banks have lost market share in credit card lending and mortgage financing, for example, leaving them less diversified and with portfolios concentrated on riskier loans such as commercial real estate. This, in turn, reflects the larger trends in financial intermediation, particularly the growth in securitization of mortgages and consumer and credit card loans as well as the economies of scale that allow the largest banks to originate such loans in large volumes either for their own portfolios or for inclusion in asset-backed or mortgage-backed securities. *See, e.g.*, Timothy Clark et al., *The Role of Retail Banking in the U.S. Banking Industry: Risk, Return, and Industry Structure*, FRBNY Economic Policy Review, at 39, 45-46 (Dec. 2007).
7. Federal Deposit Insurance Corporation, *Financial Institution Letters: Managing Commercial Real Estate Concentrations in a Challenging Environment* (March 17, 2008).
8. Office of the Comptroller of the Currency, *Remarks by John C. Dugan, Comptroller of the Currency, Before the New York Bankers Association, New York, N.Y.* (Apr. 6, 2006).
9. Consumer finance, residential 1-4 family properties, auto loans, credit cards.
10. This sector includes loans on owner-occupied buildings containing the borrower's business.
11. 12 C.F.R. §365.2 (1993). (Appendix A).
12. Other common indices used are LIBOR and the Prime Rate. *Floor Rates* are set and agreed to at commitment and usually inure to the lender's benefit by ensuring that their yields are not exposed to downward interest rate pressure.
13. *Survey of Credit Underwriting Standards,* Office of the Comptroller of the Currency (2009). Regulators have noted that bank managers are concerned that there is a continued weakening in the economy; more specifically, a downturn in real estate markets, declines in market values and prices as a result of oversupply or slow-moving inventory, changes in risk appetite based on internal and external factors and performance and quality of loans in the portfolio and accompanying risk associated with those loans.
14. *Agency Paper* is a term used to describe Fannie Mae, Ginnie Mae, Freddie Mac, etc. These are quasi-governmental agencies that insure residential mortgage loans.
15. *See* Parkus and Trifon, *Searching for a Bottom*, at 65 (Dec. 1, 2009). This estimate appears to be generally consistent with another recent estimate by Moody's Investors Service. Moody's projects \$77 billion in commercial real estate losses between Q4 2009 and the end of 2011 at the banks it rates. This number would be higher were it not for the fact that the banks Moody's rates hold only about 50 percent of the total bank exposure to commercial real estate. The Moody's report also does not include losses incurred in 2012 and beyond. Joseph Pucella et al., Moody's Investors Service, U.S. Bank Ratings Incorporate Continued High Commercial Real Estate Losses (Feb. 6, 2010).
16. Institutions should ensure they have sufficient staff and appropriate skill sets to properly manage an increase in problem loans and workouts. Management should develop a ready network of legal, appraisal, real estate brokerage, and property management professionals to handle additional prospective workouts. FDIC, Financial Institution Letter, *Managing Commercial Real Estate Concentrations in a Challenging Environment* (March, 2008).

17. *Interagency Policy Statement on the Allowance for Loan and Lease Losses,* (Dec. 2009).

18. *Id*.

19. *Id.*

20. *See* Federal Deposit Insurance Corporation, *Schedule RC-N – Past Due and Nonaccrual Loans, Leases, and Other Assets: Definitions* (Feb. 9, 2010). A loan is to be reported to the FDIC as being in nonaccrual status if "(1) it is maintained on a cash basis because of deterioration in the financial condition of the borrower, (2) payment in full of principal or interest is not expected, or (3) principal or interest has been in default for a period of 90 days or more unless the asset is both well secured and in the process of collection." *See* Barron's Real Estate Handbook, Sixth Edition, at 388 (2005). A loan is non-performing when it is not earning income, cannot be expected to be repaid in full, has payments of interest or principal over 90 days late, or was not repaid after its maturity date.

21. Arriving at an appropriate allowance involves a high degree of management judgment and results in a range of estimated losses. Prudent, conservative, but not excessive, loan loss allowances that fall within an acceptable range of estimated losses are appropriate. In accordance with GAAP, an institution should record its best estimate within the range of credit losses, including when management's best estimate is at the high end of the range. Determining the allowance for loan losses is inevitably imprecise, and an appropriate allowance falls within a range of estimated losses; An "unallocated" loan loss allowance is appropriate when it reflects an estimate of probable losses, determined in accordance with GAAP, and is properly supported. Allowance estimates should be based on a comprehensive, well-documented, and consistently applied analysis of the loan portfolio; and the loan loss allowance should take into consideration all available information existing as of the financial statement date, including environmental factors such as industry, geographical, economic, and political factors. *Selected Loan Loss Allowance Methodology and Documentation Issues* (SAB 102).

22. The documentation guidance within this Policy Statement is predominantly based upon the GAAP guidance from Financial Accounting Standards Board (FASB) Statement Numbers 5 and 114 (FAS 5 and FAS 114, respectively); Emerging Issues Task Force Topic No. D--80 (EITF Topic D--80 and attachments), Application of FASB Statements No. 5 and No. 114 to a Loan Portfolio (which includes the Viewpoints Article--an article issued in 1999 by FASB staff providing guidance on certain issues regarding the ALLL, particularly on the application of FAS 5 and FAS 114 and how these statements interrelate), Chapter 7--Credit Losses, the American Institute of Certified Public Accountants' (AICPA) Audit and Accounting Guide, Banks and Savings Institutions--2000 edition (AICPA Audit Guide); and the Securities and Exchange Commission's (SEC) Financial Reporting Release No. 28 (FRR 28).

23. The Agencies note that because the Guidance does not impose lending limits, its scope is purposely broad so that it includes those CRE loans, including multifamily loans, with risk profiles sensitive to the condition of the general CRE markets, such as market demand, changes in capitalization rates, vacancy rates, and rents. However, the Agencies believe that institutions are in the best position to segment their CRE portfolios and group credit exposures by common risk characteristics or sensitivities to economic, financial, or business developments. As explained in the final Guidance, institutions should be able to identify potential concentrations in their CRE portfolios by common risk characteristics, which will differ by property type.

24. The Agencies recognize that risk characteristics vary by different property types of CRE loans and that institutions are in the best position to identify potential concentrations by stratifying their CRE portfolios into segments with common risk characteristics.

25. A commenter noted that a concentration test cannot reflect the distinct risk profile within an institution's loan portfolio and that the risk profile is a function of many factors, including the institution's risk tolerance, portfolio diversification, the prevalence of guarantees and secondary collateral, and the condition of the regional economy.

26. While smaller institutions acknowledged that many community banks do concentrate in commercial real estate loans, they contended that there are few other lending opportunities in which community-based institutions can successfully compete with larger financial institutions. Community-based institutions commented that secured real estate lending has been their "bread and butter" business and, if they were required to reduce their commercial real estate lending activity, they would have to look to other types of lending, which have been historically more risky. Moreover, these commenters noted that community-based institutions are actively involved in their local communities and markets, which affords them a significant advantage when competing for CRE loan business. Community-based institutions also noted that their lending opportunities have dwindled as a result of competition from other types of financial institutions, such as finance companies, Farm Credit banks, and credit unions.

27. Many comments acknowledged that the risk management principles described in the proposal should be viewed as prudent industry standards for an institution engaged in CRE lending. However, some commenters alleged that the proposed guidance would create additional regulatory burdens at a time when institutions are already faced with other compliance responsibilities. Further comments noted that the Agencies needed to consider an institution's size and complexity in assessing the adequacy of risk management practices. This particular concern was raised with regard to the expectations for management information systems and portfolio stress testing that commenters found to be burdensome for smaller institutions.

28. Loan participations, whole loan sales, and securitizations are a few examples of strategies for actively managing concentration levels without curtailing new originations. If the contingency plan includes selling or securitizing CRE loans, management should assess periodically the marketability of the portfolio. This should include an evaluation of the institution's ability to access the secondary market and a comparison of its underwriting standards with those that exist in the secondary market. *Concentrations on Commercial Real Estate Lending, Sound Risk Management Practices, Final Guidance,* by OCC, FRB, FDIC (Dec. 2006).

29. The *secondary market* includes sales to other banks and to securitizers.

30. *Survey of Credit Underwriting Standards,* Office of the Comptroller of the Currency (2009). The majority of the banks surveyed tightened underwriting standards for both commercial and retail loans. This tightening offsets widespread easing that was reported in the surveys for 2004 through 2007 and is a measured response to a slowing economy and pockets of deteriorating product performance. As expected, the economy was a major factor in the 2009 survey findings. Examiners reported that the economy was the most important credit issue confronting banks, in addition to being the primary reason changes were made to underwriting standards. Examiners identified the following additional factors that affected loan production and underwriting standards: Depressed real estate market, changes in risk appetite, refinancing concerns, and the impact that relaxed underwriting standards from prior years had on payment performance.

31. The term "underwriting standards" refers to the terms and conditions under which banks extend or renew credit, such as financial and collateral requirements, repayment programs, maturities, pricing, and covenants.

32. Institutions should refer to the guidelines adopted by their primary federal regulator as follows: For national banks, Appendix A to Part 30; for state member banks, Appendix D to Part 208; for state nonmember banks, Appendix A to Part 364; for savings associations, Appendix A to Part 570.

33. *See supra* note 2.

34. If the transaction is a purchase and the entity is newly formed, the underwriting will concentrate on the documented cash flow from the property in the form of leases. If the transaction is a refinance, the borrowing entity's tax returns should indicate the appropriate cash flow in terms of gross income.

35. Examples of intervening superseding liens are property tax liens or environmental agency assessments, municipal fines, etc. In most jurisdictions these liens take a priority lien position to the mortgage even if they are perfected after the date of the mortgage.

36. Lenders may not seek to proceed in *equity* to enforce a mortgage lien. Lenders may elect to proceed *at law* and simply bring suit under the note. The advantages and disadvantages are discussed later in this article.

37. It is important to note that underwriting the guarantee for its enforceability is different than underwriting for collectability. A creditor may be barred under state statute from executing against certain assets of the guarantor depending on the location of the asset and the domicile of the guarantor. A creditor could obtain a legally enforceable judgment in one jurisdiction that may be partially or wholly uncollectible in another jurisdiction.

38. "Marital property" is defined by state statute.

39. The transaction to sell the asset or transfer the liability is a hypothetical transaction at the measurement date, considered from the perspective of a market participant that holds the asset or owes the liability (ASC topic 820, Subtopic 10, Section 35). The exit price objective applies for all assets and liabilities measured at fair value.

40. Financial Accounting Standard 157, adopted in 2006, was meant to provide a clear definition of fair value based on the types of metrics utilized to measure fair value (market prices and internal valuation models based on either observable inputs from markets, such as current economic conditions, or unobservable inputs, such as internal default rate calculations).

41. Capitalization rates, or the Discount Rate/NPV approach, works best for stabilized income-producing properties. It would not work for raw land or for real estate whose value is dependent upon sale for repayment of the loan.

42. FASB stands for Financial Standards Accounting Board. The FASB writes the rules for accountants (FAS) which are incorporated into Generally Accepted Accounting Principles (GAAP).

43. A creditor should apply its normal loan review procedures in making that judgment. This Statement does not address when a creditor should record a direct write-down of an impaired loan, nor does it address how a creditor should assess the overall adequacy of the allowance for credit losses. In addition to the allowance calculated in accordance with this Statement, a creditor should continue to recognize an allowance for credit losses necessary to comply with Statement 5.

44. The term *probable* is used in this Statement consistent with its use in Statement 5, which defines probable as an area within a range of likelihood that a future event or events will occur confirming the fact of the loss. That range is from probable to remote, as follows: *Probable:* The future event or events are likely to occur. *Reasonably possible:* The chance of the future event or events occurring is more than remote but less than likely. *Remote:* The chance of the future event or events occurring is slight.

45. *FAS 114,* paragraph 8, *Recognition of Impairment.*

46. *FAS 114,* paragraphs 12-16, *Measurement of Impairment.*

47. *FAS 157*, FASB Staff Position Paper 157-3, (October, 2008).

48. The ALLL Policy Statement notes that determining the appropriate level for the ALLL is inevitably imprecise and requires a high degree of management judgment. An institution's process for determining the ALLL should be based on a comprehensive, well-documented, and consistently applied analysis of its loan portfolio that considers all significant factors that affect collectability. That analysis should include an assessment of changes in economic conditions and collateral values and their direct impact on credit quality. If declining credit quality trends relevant to the types of loans in an institution's portfolio are evident, the ALLL level as a percentage of the portfolio should generally increase, barring unusual charge-off activity. *See Managing Commercial Real Estate Concentrations in a Challenging Environment*, FIL 22-2008 (Mar. 2008).

49. REO (OREO) is an acronym for Real Estate Owned or Other Real Estate Owned.

50. A performing loan is a loan in "accrual" status.

51. FAS 15, ASC 310-40, *Receivables – Troubled Debt Restructurings by Creditors* and FAS 15, ASC 470-60*, Debt – Troubled Debt Restructurings by Debtors* for the characteristics of "experiencing financial difficulties" and "concession."

52. Whatever the form of concession granted by the creditor to the debtor in a troubled debt restructuring, the creditor's objective is to make the best of a difficult situation. That is, the creditor expects to obtain more cash or other value from the debtor, or to increase the probability of receipt, by granting the concession than by not granting it. *Id* at paragraph 3.

53. FAS 15 is now referred to as ASC 470-60.

54. While many workouts and restructurings contain provisions that lower the principal balance and/or rate of interest paid during the plan, other aspects of the restructure agreement may increase the borrower's and guarantor's overall liabilities. The borrower's/guarantor's increased exposure in some circumstances may give rise to lender liability claims. Lender liability is addressed later in this article.

55. *Supra,* note 47, (paragraph 7). What this means (in English) is that a restructuring is NOT a TDR when the creditor recovers the debt in full satisfaction of the amount owed, albeit in another form not contemplated in the security agreement. The term concession when used in this paragraph (sub p. *d*) is used to refer to a concession that does not affect the creditor's lien position, such as allowing subordinate financing or waiving, partially or in whole, pre-payment penalties.

56. Pursuant to an updated appraisal, for example.

57. The most common restructure scenario used by banks in dealing with term risk is an extension of the term with an "in house" refinance. Sometimes the debtor is asked to pay down the balance by some amount and/or add collateral or additional guarantors to the note.

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Claims for Goods Delivered on the Eve of a Bankruptcy Filing: What Every Business Lawyer Needs to Know

By Scott H. Bernstein and Robert A. Rich

Blissfully unaware that its customer, a merchant, is on the brink of filing a bankruptcy petition, your client has delivered goods on credit. The likely unhappy result: when the customer files, your client is left holding a general unsecured claim, with little chance to be paid until the conclusion of the proceeding. That may be years down the road, and when it finally takes place may amount to no more than pennies on the dollar. But all may not be lost.

This article focuses on section 503(b)(9) of the Bankruptcy Code, a specific bankruptcy provision that was enacted with the intent of addressing this situation, and provides a primer for business lawyers that are called upon to counsel clients who have delivered goods to a bankrupt company during the twenty-day period prior to the date of the bankruptcy filing.

The Enactment of Section 503(b)(9)

The enactment of the 2005 Bankruptcy Prevention and Consumer Protection Act amended Title 11 of the United States Code, §§ 101-1532 (as amended, the "Bankruptcy Code") in many ways to enhance the rights of trade creditors in commercial bankruptcies, including section 503(b)(9) of the Bankruptcy Code. Section 503(b)(9) provides that a creditor has an administrative expense claim for the "value of any goods received by the debtor within 20 days before the date of commencement of a case under [the Bankruptcy Code] in which the goods have been sold to the debtor in the ordinary course of such debtor's business."[1] A creditor's right to assert a section 503(b)(9) claim is not linked or conditioned upon the creditor's separate, potential right to assert a reclamation claim against the debtor pursuant to section 546(c) of the Bankruptcy Code.[2]

Prior to section 503(b)(9), prepetition obligations of a debtor to a trade creditor were classified as general unsecured claims for all purpose—often resulting in distributions of pennies on the dollar, or nothing. Now such claims, if they satisfy section 503(b)(9), are transformed into administrative expense claims which are given priority of treatment over general unsecured claims, and which must be paid in full in order for a chapter 11 debtor to emerge from bankruptcy.[3] A second benefit of the statute to trade creditors is the possibility of more prompt payment of the section 503(b)(9) claim.[4] Since the liability is an administrative expense and not a prepetition claim, a chapter 11 debtor with adequate resources can pay the allowed administrative expense prior to confirmation of a plan. In sum, trade creditors that successfully assert a section 503(b)(9) claim for goods delivered within twenty days of the petition date have an increased likelihood of a full and quicker recovery of this claim. A downside from the debtor's perspective is that the cash needed to successfully reorganize and emerge from chapter 11 will be significantly increased by the amount necessary to pay the section 503(b)(9) claims in full, and the payment of the section 503(b)(9) claims may deprive the debtor of much needed liquidity.[5] However, debtors—even after allowance and payment of the section 503(b)(9) claims for the value of the goods—may continue to realize the mark-up profit on the re-sale of the goods or use of the goods incorporated into a finished product for sale.

In enacting this provision, it is believed that Congress intended to address the situation in which a supplier would withhold credit and goods during a customer's liquidity crisis out of a concern that it would be paid little or nothing for goods delivered to a debtor on the eve of its bankruptcy.[6] (And as prior cases and experience have made clear to trade creditors, traditional reclamation rights under section 546(c) of the Bankruptcy Code could easily be defeated in a bankruptcy.) This would often turn liquidity problems into full-blown liquidity crises, as debtors would increasingly be unable to buy goods on credit that were vital for continued operations. Anecdotes also abounded of less ethical companies placing unusually large orders for goods to be delivered just days before a planned bankruptcy filing from vendors who were unaware of the severity of the debtor's liquidity problems. By filing for bankruptcy right after receiving the goods, a retailer (for instance) would have products on its shelves to allay customer concerns and generate cash for post-filing expenses—coupled with a debt to be paid, if at all, under a confirmed chapter 11 plan months or years down the road.

With little legislative history behind section 503(b)(9), practitioners and courts recognize there are many questions about the interpretation and application of this statute. Just two years after its enactment, Judge Burton R. Lifland of the United States Bankruptcy Court for the Southern District of New York was already writing that "[t]his new provision presents other issues concerning, *inter alia*, the valuing of the subject goods; what constitutes the actual receipt of the goods; how is the claim asserted; when is it to be paid; is it subject to the claims processing and omnibus bar date orders, etc."[7] Now that the statute has operated for more than five years and there has been an increased number of retail bankruptcies during the recent economic downtown, case law is beginning to address the issues raised by section 503(b)(9).

Developments in the Case Law and Practice

1. What Is the Meaning of "Goods"?

Based upon the distinction between "goods" and "services" throughout the Bankruptcy Code, there is universal agreement that section 503(b)(9) does not cover a claim for services provided.[8] However, the term goods is not defined by the Bankruptcy Code. Uniform Commercial Code ("UCC") § 2-105(1) defines goods as "all things (including specially manufactured goods) which are moveable at the time of identification to the contract for sale other than the money in which the price is to be paid, investment securities (Article 8) and things in action."[9] Many bankruptcy courts have concluded that the term goods as used in section 503(b)(9) must conform to the meaning given in UCC § 2-105(1). *See, e.g., In re Circuit City Stores, Inc.*,[10] *In re Goody's Family Clothing, Inc.*,[11] *In re Plastech Engineered Prods.*[12] Three reasons are often given for adopting the definition of goods from the UCC. First, using the UCC definition gives a consistent, uniform approach, since forty-nine states have already adopted some version of the UCC.[13] Second, the UCC definition is consistent with the definition in Black's Law Dictionary and with the term's ordinary and common usage.[14] In other words, the UCC definition is the "well-known meaning" of goods and fits the commercial expectations of the parties. Third, courts find support for using the UCC definition from the fact that section 503(b)(9) is itself part of a section titled "Reclamation" in the 2005 amendments to the Bankruptcy Code. Given that reclamation has its origins in the UCC, which defines "goods," and that Congress did not choose to provide a different definition in the Bankruptcy Code, courts have reasoned that the UCC definition was likely intended to apply to the Bankruptcy Code as well.[15] Courts have similarly found that the terms "received," "sold," and "ordinary course of business" as used in section 503(b)(9) must conform to the meanings given in the UCC.[16]

2. What if a Contract Involves the Sale of Goods and Services?

Courts have considered whether the "predominant purpose test," developed by courts to determine whether the UCC applies to hybrid contracts calling for the delivery of both goods and services, should be used for claims under section 503(b)(9).[17] Under this test, the court must determine whether "the sale of goods predominates."[18] Despite the administrative ease of applying the predominant purpose test and the likelihood that its application will reduce the number of allowed section 503(b)(9) claims, many trade creditors have raised a fairness concern: that a court's holding that the predominant purpose was not to provide goods results in an "all or nothing result," denying a section 503(b)(9) claim even if a significant purpose was to provide goods to the debtor.

An alternative approach is to separate the goods aspect of the trade creditor's claim from the services components, and grant administrative claims for the value of the tangible items. In rejecting the predominant purposes test, one court reasoned that while a "winner takes all" approach might be logical and necessary in particular nonbankruptcy contexts, there is nothing in section 503(b)(9) that requires such an approach.[19] Rather, because the statute refers to the "value of any goods received," where there was a mixed goods/services contract section 503(b)(9) would apply to the value of the goods sold but would not apply to the value of the services provided.[20] Another court, when rejecting the predominant purposes test, has held that "Congress, in section 503(b)(9), did not provide any basis for excluding from the section's scope goods delivered pursuant to a contract the primary thrust of which is provision of services."[21]

However, generally courts agree that to establish a section 503(b)(9) claim, the claimant must prove by a preponderance of the evidence that (1) the vendor sold goods to the debtor; (2) the goods were received by the debtor within twenty days prior to filing; and (3) the goods were sold to the debtor in the ordinary course of business.[22] Received means taking physical possession of the goods during the twenty days prior to the bankruptcy filing.[23] Additionally, the claimants must show that the debtor has not already paid for the goods.[24]

3. What Is the Meaning of "Value"?

In an October 2009 decision from the S*emCrud*e bankruptcy proceeding in the United States Bankruptcy Court for the District of Delaware, Judge Brendan Linehan Shannon addressed the meaning of "value" under section 503(b)(9).[25] In *SemCrude*, a secured creditor opposed certain section 503(b)(9) claims, asserting that the term "value" for purposes of a section 503(b)(9) claim should be "the resale price of goods, or if the goods were not resold, the current market value of the goods on the effective date of the Plan."[26] Not surprisingly, many of the vendors argued that the "value" of the goods was established by the invoice or contract price. Judge Shannon, while recognizing that the term "value" is not defined in the Bankruptcy Code, found that "there is ample and convincing authority to support the proposition that the invoice or purchase price is presumptively the best determinant of value."[27] The court noted, however, that such price could be rebutted under the particular facts and circumstances of a given transaction.[28]

4. When Are Section 503(b)(9) Claims Paid?

In *In re Global Home Products, LLC*, the court addressed the issue of the timing of payment on section 503(b)(9) claims. There, the court noted that section 503(b)(9) does not specify a time for payment, yet section 1129(a)(9) requires that all administrative expense claims be paid in full on the effective date of the plan.[29] The court also considered three factors in determining how to exercise its discretion on the timing of payment of an administrative expense claim: (1) the prejudice to the debtor, (2) hardship to the claimant, and (3) potential detriment to other creditors. The debtor argued against immediate payment for a variety of reasons, including the lack of sufficient funds, the fact that the debtor-in-possession financing agreement prohibited the debtor from paying any debts not included in the post-petition budget, and the concern that immediate payment of one section 503(b)(9) claim would trigger an avalanche of similar demands. The creditor, on the other hand, presented no evidence of hardship.[30] The court, finding that the prejudice to the debtor clearly outweighed the hardship to the claimant, denied the creditor's motion for immediate payment and ordered that section 503(b)(9) claims were payable only on the effective date of a plan.[31]

Soon after *Global Home Products*, the court in *In re Bookbinders' Restaurant, Inc*. considered a similar motion for immediate payment of a section 503(b)(9) claim. The creditor argued that section 503(b)(9) requires a chapter 11 debtor to treat section 503(b)(9) administrative expenses in the same manner as administrative expenses arising from the post-petition delivery of goods and services; since the debtor in that case had been paying its post-petition trade debt in the ordinary course, it was likewise required to pay the section 503(b)(9) administrative expenses in the ordinary course. The court squarely rejected this argument and found that the pre-confirmation allowance of a section 503(b)(9) claim does not create an "unqualified right to immediate payment."[32] Instead, the court adopted the same three-factor test used in *In re Global Home Products*, and found that an evidentiary hearing would be required to determine whether to compel immediate payment of the allowed section 503(b)(9) claim or defer payment to a later stage in the case.[33]

Both decisions suggest that a section 503(b)(9) claimant may be able to obtain immediate payment of its administrative expense claim if the claimant demonstrates, at an evidentiary hearing, that it will suffer unusual hardship in the absence of immediate payment. However, practitioners should note that it is almost unheard of for a section 503(b)(9) claimant to have satisfied this burden.

5. May Secured Creditors Enjoy the Benefit of Section 503(b)(9)?

In *In re Brown & Cole Stores, LLC*,[34] a creditor, Associated Grocers, Incorporated ("AGI"), sought allowance of a section 503(b)(9) claim while asserting that it held a security interest in property of the debtor to secure its claim. The debtor, Brown & Cole Stores, LLC ("B&C"), opposed the allowance of the administrative expense claim, contending that section 503(b)(9) applied only to unsecured claims for goods received within the twenty-day statutory period.[35] B&C argued that, unlike the language of section 503(b)(1)(B)(i) which provides administrative priority for any tax "incurred by the estate, whether secured or unsecured…," section 503(b)(9) was silent as to the secured status of the claim. B&C also asserted that since all other section 503(b) claims were unsecured claims, the silence implied that only unsecured claims were included.[36] AGI wanted both an administrative claim and a secured claim in order to increase its ability to oppose confirmation of B&C's chapter 11 plan. In a chapter 11 reorganization, a secured creditor has its own ability to oppose confirmation of a chapter 11 plan, while creditors holding administrative expense claims must be paid in full in order for a chapter 11 plan to be confirmed and become effective. Accordingly, a secured creditor with an administrative claim may more effectively oppose confirmation of a chapter 11 plan by arguing that the chapter 11 plan will not result in full payment of administrative expense claims on the effective date of the chapter 11 plan.

The Ninth Circuit Bankruptcy Appellate Panel rejected B&C's position on the grounds that the statute was unambiguous. The Bankruptcy Appellate Panel explained:

> By the plain terms of the statute, a vendor's right to assert an administrative claim is limited in only three ways: (1) the vendor must have provided goods (not services); (2) the debtor must have received the goods within twenty-days of the commencement of the case; and (3) the goods must have been sold "in the ordinary course" of the debtor's business. This right to an administrative claim does not depend on whether the seller has a right to reclaim under state law.… It applies even if the goods are no longer in the possession of the debtor or are not identifiable. It applies even if the goods are encumbered by a senior security interest.[37]

The Ninth Circuit Bankruptcy Appellate Panel also found no merit to B&C's argument that the strict application of section 503(b)(9) to a secured claim would be inequitable to other creditors since funds paid to an administrative claimant would be available to other creditors if not paid to the secured creditor.[38] While the Bankruptcy Appellate Panel deferred to Congress as to the equities and related statutory priorities, it also noted that payment of an administrative claim would free up collateral that could be available for unsecured creditors. The Bankruptcy Appellate Panel further explained that if such a creditor turns out to be unsecured or under-secured, denying it priority as an administrative expense would effectively ignore the statute.[39]

Additionally, while the bankruptcy court below held the debtor could not set off its prepetition unsecured debts against the trade creditor's administrative expense, the Bankruptcy Appellate Panel reversed.[40] Section 503(b)(9) claims are the only section 503(b) claims based on debts incurred by the debtor prepetition. For that reason, the Bankruptcy Appellate Panel held that section 553(a) of the Bankruptcy Code (which authorizes the setoff of mutual prepetition debts), applies to section 503(b)(9) claims.[41] Accordingly, a debtor may be able to avoid paying a section 503(b)(9) claim to the extent it can establish a right of prepetition setoff against its obligation to the creditor holding the section 503(b)(9) claim.

6. Is Section 502(d) a Bar to Section 503(b)(9) Claims?

There is a split in authority over whether section 502(d) of the Bankruptcy Code may be used to temporarily disallow a claim under section 503(b)(9) of the Bankruptcy Code up to the amount potentially recoverable on account of preferential transfers allegedly avoidable under section 547 of the Bankruptcy Code. Section 502(d) requires disallowance of a claim of a transferee of a voidable transfer under chapter 5 of the Bankruptcy Code *in toto* if the transferee has not paid the amount or turned over the property received as required under the sections of the Bankruptcy Code under which the transferee's liability arises.[42] The bankruptcy court in *Circuit City* recently held that section 502(d) may be used to disallow a section 503(b)(9) claim, which it considered nothing more than a claim as defined in section 101(5)(A)[43] of the Bankruptcy Code and therefore subject to sections 501(a) and 502(d) of the Bankruptcy Code.[44] The *Circuit City* court agreed with the debtors' argument that section 503(b)(9) claims are different from other administrative claims in two important respects: first, they are governed by section 501(a), meaning that the claimant must file a proof of claim, and second, they arise pre-petition, unlike all other administrative claims.[45]

Moreover, the *Circuit City* court emphasized that sections 501, 502 and 503 are not mutually exclusive provisions of the Bankruptcy Code because a creditor "may be required to seek allowance of its claim under both §§ 502 and 503."[46] The court was concerned that declining to temporarily disallow the claims might prejudice the debtors' bankruptcy estates and defeat the goal of equitable distribution to similarly situated creditors in bankruptcy by allowing section 503(b)(9) claimants both to receive payment on their asserted administrative claims for the delivery of goods and to use the provision of the same goods as the basis of the new value defense under section 547(c)(4) of the Bankruptcy Code in the preference defense litigation. Accordingly, the *Circuit City* court concluded that section 503(b)(9) claims, which if not temporarily disallowed would have to be paid in full at confirmation of the debtors' chapter 11 plan, should be temporarily disallowed pending a decision during the related preference litigation under section 547 of the Bankruptcy Code as to whether creditors are able to use the delivery of the goods during the twenty-day period as a "new value" credit to offset their preference exposure while being paid in full on the section 503(b)(9) claims.[47]

7. How Are Section 503(b)(9) Claims Asserted?

The Bankruptcy Code and the Federal Rules of Bankruptcy Procedure do not provide clear instruction on how a party should assert a section 503(b)(9) claim. Ordinarily, a creditor holding a prepetition claim against a debtor files a proof of claim against the debtor's bankruptcy estate.[48] A properly filed proof of claim is deemed allowed unless a party in interest objects.[49] Unlike proofs of claim that are deemed allowed by being properly filed, administrative expense claims, arguably including section 503(b)(9) claims, are only allowed "after notice and a hearing."[50] A request for the allowance of such an expense requires the filing of a motion[51] and, unless the court orders otherwise, all parties in interest are entitled to notice of the request and the opportunity to object thereto.[52] As of the date hereof, there is no consensus on whether section 503(b)(9) claims, which despite their administrative expense status are prepetition claims, are filed as proofs of claim or motions requesting allowance of the claims, or whether both a proof of claim and a motion have to be filed by claimants.[53]

Accordingly, debtors often ask courts to approve certain procedures for asserting section 503(b)(9) claims in a case. For example, in *In re SemCrude, L.P.*, the Delaware bankruptcy court entered an *Order Establishing Procedures for the Resolution of Administrative Claims Asserted Pursuant to Section 503(b)(9) of the Bankruptcy Code and Regarding Payments for Post-Petition Purchases* (the "Procedures Order").[54] The Procedures Order was entered after substantial negotiation and input by the debtors and interested parties. Its primary purpose was to provide a streamlined mechanism for determination and allowance of section 503(b)(9) claims, as the debtors expected thousands of creditors to assert hundreds of millions of dollars of such claims.[55] Under the Procedures Order, the debtors were required to include in Schedule E to their *Schedules of Assets and Liabilities* a listing of the estimated amounts, based on their records, owed to vendors who delivered goods within the twenty days prior to the petition date.[56] The debtors filed that listing and thereafter the Court set a bar date establishing March 3, 2009 as the deadline to file proofs of claim that applied to section 503(b)(9) claims as well as other prepetition claims.[57] Thus, in *SemCrude L.P.*, section 503(b)(9) claimants, despite their elevated treatment since 2005 in terms of priority and potential for getting paid during the bankruptcy proceeding, followed the same procedure for filing proofs of claim as the other types of creditors holding prepetition claims.

Conclusion

While section 503(b)(9) appears simple on its face, the number of issues that already have been litigated prove the complexity of its application. There can be substantial cost to exercising the rights provided under section 503(b)(9). Since the Federal Rules of Bankruptcy Procedure and the Bankruptcy Code do not specify how a section 503(b)(9) claim is to be asserted, a creditor may end up retaining a lawyer to file a motion requesting the allowance and payment of a section 503(b)(9) claim as well as to file a proof of claim before the applicable bar date asserting the section 503(b)(9) claim. If challenged, discovery may be needed to determine the value of the goods received by the debtor within the twenty-day period prior to the bankruptcy filing and an evidentiary hearing may be conducted to fix the value of the claim.

Once the claimant succeeds in having its section 503(b)(9) claim fixed in amount and allowed by court order, there is always the potential that the chapter 11 estate might be administratively insolvent, in which case the claim may not be paid in full or at all. Debtors may also manipulate the timing of payment of the section 503(b)(9) claim to meet their own liquidity needs. Debtors may attempt to discount the payment of section 503(b)(9) claims by obtaining orders that grant them the discretion to pay such claims on terms favorable to their bankruptcy estates. Debtors then use the promise of quick, consensual payment as an inducement for the claimant to agree to reduce the amount of its allowed claim or to provide favorable credit terms going forward. Of course, a section 503(b)(9) claimant can refuse a debtor's offer to accept a lesser amount in exchange for a quicker payment and instead sit on its claim and demand cash on delivery. Thus, while the section enhances the protection of trade creditors, in the short term section 503(b)(9) remains a source of dispute and other issues are likely to arise as parties (and courts) become more experienced with section 503(b)(9).

Endnotes

1. 11 U.S.C. § 503(b)(9).
2. *See ASM Capital, LP v. Ames Dep't Stores, Inc. (In re Ames Dep't Stores, Inc.)*, 582 F.3d 422, 424 n.2 (2d Cir. 2009) (Congress "amended section 546(c)(2) to provide that '[i]f a seller of goods fails to provide notice in the manner described in paragraph (1), the seller still may assert the rights contained in section 503(b)(9)'") (citation omitted); *see also In re Plastech Engineered Prods.*, 397 B.R. 828, 838 (Bankr. E.D. Mich. 2008) ("However, there is nothing in § 503(b)(9) that requires a claimant to also be entitled to a reclamation right under § 546. Section 546 does not limit or control in any way the rights that a claimant has under § 503(b)(9)"). The 2005 Bankruptcy Prevention and Consumer Protection Act also expanded Section 546(c) to provide a longer look-back period, allowing sellers of goods the right to seek reclamation of goods sold to a debtor in the ordinary course of the seller's business and received by the insolvent debtor within the forty-five day period prior to the bankruptcy filing.
3. Section 1129(a)(9)(A) of the Bankruptcy Code requires full payment of allowed administrative expenses on the effective date of the plan as a condition of confirmation, unless the holder has agreed to different treatment. So, under section 503(b)(9), a debtor may no longer confirm a plan that provides for payment over time or partial payment for the value of goods received within 20 days before the petition date, unless the particular claimant agrees. Section 503(b)(9) is one of the few instances where a claim arising prepetition is treated as an administrative, or post-petition, claim. Other instances include the actual and necessary expenses incurred by a petitioning creditor that files an involuntary bankruptcy petition against a debtor, and the reasonable compensation for professional services rendered by the petitioning creditor's attorney or accountant. *See* 11 U.S.C. §§ 503(b)(3)(A), (b)(4).
4. Section 503(b)(9) may provide the statutory basis for a bankruptcy court approving a critical vendor program that allows for immediate payment of all or a portion of a vendor's section 503(b)(9) claims in exchange for a commitment from the vendor to ship goods on a postpetition basis. *See In re Mark IV Industries, Inc.*, No. 09-12795 (SMB) (Bankr. S.D.N.Y. May 27, 2009) (Docket No. 164) (*Order Authorizing (I) the Debtors to Pay Certain Prepetition Claims of Critical Vendors and Certain Administrative Claimholders, and (II) Financial Institutions to Honor and Process Related Checks and Transfers*).
5. Michael L. Atkinson, a Managing Director of Protiviti, Inc., through an unpublished article in the co-authors' possession, presents a strong case that the enactment of section 503(b)(9) has created a nearly impossible hurdle to clear in chapter 11 reorganizations of retailers because the retailers would not only need sufficient financing to fund working capital and future expected losses, but would also need additional financing to pay section 503(b)(9) claims in full. Mr. Atkinson believes that this hurdle has proved impossible to clear either through direct lending or a combination of lending and capital infusions from buyers looking to obtain an equity interest in the reorganized company.
6. *See In re Arts Dairy, LLC*, 414 B.R. 219, 220 (Bankr. N.D. Ohio 2009) (describing policy goals of section 503(b)(9)).
7. *In re Dana*, 367 B.R. 409, 411 (Bankr. S.D.N.Y. 2007).
8. *See In re Goody's Family Clothing, Inc.*, 401 B.R. 131, 136 (Bankr. D. Del. 2009) (denying administrative expense status under section 503(b)(9) for services provided to the debtor within 20 days preceding the bankruptcy filing); *see also Brown & Cole Stores, LLC v. Associated Grocers, Inc. (In re Brown & Cole Stores, LLC)*, 375 B.R. 873, 878 (B.A.P. 9th Cir. 2007) ("By the plain terms of the statute, a vendor's right to assert an administrative claim is limited [in that] the vendor must have provided goods (not services)").
9. U.C.C. § 2-105(1).
10. *In re Circuit City Stores, Inc.*, 416 B.R. 531, 536 (Bankr. E.D. Va. 2009).
11. *Goody's*, 401 B.R. at 134.
12. *In re Plastech Engineered Prods.*, 397 B.R. 828, 836 (Bankr. E.D. Mich. 2008).
13. *See Circuit City*, 416 B.R. at 535; *see also Goody's*, 401 B.R. at 134.
14. *See Circuit City*, 416 B.R. at 535.
15. *See id*. at 536.
16. *See In re SemCrude, L.P.*, 416 B.R. 399, 405 (Bankr. D. Del. 2009); *see also In re Pridgen*, No. 07-04531-8 (RDD), 2008 Bankr. LEXIS 1274, at *11 (Bankr. E.D.N.C. Apr. 22, 2008).
17. *See Circuit City*, 416 B.R. at 537.
18. *Id*. In so ruling, the court looked with favor upon the formulation of the predominant purpose test set forth in *Princess Cruises, Inc. v. Gen. Elec. Co.*, 143 F.3d 828, 833 (4th Cir. 1998) (quoting *Bonebreak v. Cox*, 499 F.2d 951 (8th Cir. 1974)), which held that "[t]he test for inclusion or exclusion is not whether they are mixed but, granting that they are mixed, whether their predominant factor, their thrust, their purpose, reasonably stated, is the rendition of service, with goods incidentally involved (e.g., contract with artist for painting) or is a transaction of sale, with labor incidentally involved."
19. *See In re Plastech Engineered Prods.*, 397 B.R. 828, 838 (Bankr. E.D. Mich. 2008) (holding that claimants with mixed goods and services claims would only hold allowed priority claims for the goods portion of the claims).
20. *See id*. at 837-38.
21. *In re Pilgrim's Pride Corp.*, 421 B.R. 231, 237 (Bankr. N.D. Tex. 2009).
22. *See In re Goody's Family Clothing, Inc.*, 401 B.R. 131, 133 (Bankr. D. Del. 2009).
23. *See Circuit City*, 432 B.R. at 228-230. In *In re Circuit City Stores, Inc.*, the court applied the UCC's definition of goods to determine when goods were received for the purpose of section 503(b)(9). Under the UCC, "receipt" of goods means "taking physical possession of them." UCC § 2-103(c). The court held that the debtors did not take receipt of the goods during the twenty-day period when the goods were physically received by the debtors prior to the

statutory period, the goods were sold on consignment, and the creditor retained title to the consigned goods until the time of sale when title to the particular consigned goods passed to the debtors and then to the customer as part of a simultaneous transaction. Accordingly, the court disallowed the claims as administrative expense claims and allowed them as non-priority, general unsecured claims. *See id*. at 227-231.

24. *See In re Renew Energy, LLC*, No. 09-10491 (RDM), 2009 Bankr. LEXIS 3352, at **8, 12 (Bankr. W.D. Wis. Sept. 30, 2009) (holding that the delivery of prepaid goods within twenty days prior to filing did not give rise to a claim under section 503(b)(9)); *see also In re Wetco Rest. Group, LLC*, No. 07-51169 (RS), 2008 Bankr. LEXIS 1272, at *8 (Bankr. W.D. La. Apr. 23, 2008) (same).

25. *See In re SemCrude, L.P.*, 416 B.R. 399, 405 (Bankr. D. Del. 2009).

26. *Id*.

27. *Id*.

28. *See id*.; *see also In re Pilgrim's Pride Corp.*, 421 B.R. 231, 243 n.13 (Bankr. N.D. Tex. 2009) ("If the contract provided a breakdown between goods delivered and services rendered,…the contract price for the goods delivered would provide a good starting place, as is the case with determination of value of post-petition performance of a rejected contract").

29. *In re Global Home Prods., LLC*, No. 06-10340 (KG), 2006 Bankr. LEXIS 3608, at **9-10 (Bankr. D. Del. Dec. 21, 2006).

30. *Id*. at *15.

31. *Id*. at **15-16.

32. *In re Bookbinders' Rest., Inc.*, No. 06-12302 (ELF), 2006 Bankr. LEXIS 3749, at *16 (Bankr. E.D. Pa. Dec. 28, 2006).

33. *See id*. at ** 2, 14.

34. *Brown & Cole Stores, LLC v. Associated Grocers, Inc. (In re Brown & Cole Stores, LLC)*, 375 B.R. 873, 876 (B.A.P. 9th Cir. 2007).

35. *See id*.

36. *See id*. at 877-78.

37. *Id*. at 878 n.7.

38. *See id*. at 876.

39. *See id*. at 878.

40. *See id*. at 879.

41. *See id*.; *see also In re Circuit City Stores, Inc.*, No. 08-35653 (KRH), 2009 Bank. LEXIS 4011, at **22-23 (Bankr. E.D. Va. Dec. 3, 2009) (holding that the debtors were allowed to set off section 503(b)(9) administrative claims against any receivables or other items owed to the debtors by such claimants and these rights may be exercised by the debtors under section 558 of the Bankruptcy Code against section 503(b)(9) claims without first having to offset against non-priority claims).

42. *See* 11 U.S.C. § 502(d) ("[T]he court shall disallow any claim of any entity from which property is recoverable under section 542, 543, 550 or 553 of this title…unless such entity…has paid the amount, or turned over any such property, for which such entity…is liable under section 522(i), 542, 543, 550, or 553 of this title").

43. 11 U.S.C. § 101(5)(A) ("The term 'claim' means—(A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured").

44. *In re Circuit City Stores, Inc.*, 426 B.R. 560, 571 (Bankr. E.D. Va. Jan. 6, 2010), *reh'g denied*, No. 08-35653 (KRH), 2010 Bankr. LEXIS 571 (Bankr. E.D. Va. Feb. 23, 2010); *but see ASM Capital LP v. Ames Dep't Stores, Inc. (In re Ames Dep't Stores, Inc.)*, 582 F.3d 422, 430 (2d Cir. 2009) (holding that section 503(b)(9) claims are not subject to disallowance under section 502(d) of the Bankruptcy Code because administrative expense claims are not claims within the meaning of section 101(5)(A) of the Bankruptcy Code); *In re Plastech Engineered Products, Inc.*, 394 B.R. at 163-64 (same).

45. *In re Circuit City Stores, Inc.*, No. 08-35653 (KRH), 2010 Bankr. LEXIS 571 at *9.

46. *See id.* at **16-17.

47. *See id*. at **6, 20-25. Courts have yet to reach a consensus on whether fully funded section 503(b)(9) claims count as additional new value to reduce preference liability. *See TI Acquisition, LLC v. Southern Polymer, Inc. (In re TI Acquisition, LLC)*, 429 B.R. 377, 385 (Bankr. N.D. Ga. 2010) (holding that a creditor that delivered goods to the debtor prepetition is not entitled to the new value defense under section 547(c)(4) when that creditor has been paid in full on a section 503(b)(9) claim); *but see Commissary Operations, Inc. v. Dot Foods, Inc. (In re Commissary Operations, Inc.)*, 421 B.R. 873, 879 (Bankr. M.D. Tenn. 2010) (holding that held claims entitled to section 503(b)(9) status may constitute new value for purposes of section 547(c)(4)).

48. *See* 11 U.S.C. § 501(a) ("A creditor or an indenture trustee may file a proof of claim. An equity security holder may file a proof of interest").

49. *See* 11 U.S.C. § 502(a) ("A claim or interest, proof of which is filed under section 501 of this title, is deemed allowed, unless a party in interest, including a creditor of a general partner in a partnership that is a debtor in a case under chapter 7 of this title, objects").

50. *See* 11 U.S.C. § 503(b) ("After notice and a hearing, there shall be allowed, administrative expenses….").

51. *See* Fed. R. Bankr. P. 9013 ("a request for an order, except when an application is authorized by these rules, shall be by written motion…").

52. *See* Fed. R. Bankr. P. 2002(a)(6), (i).

53. *See In re Circuit City Stores, Inc.*, No. 08-35653 (KRH), 2010 Bankr. LEXIS 571 at **16-17 (Bankr. E.D. Va. Jan. 6 2010) (reaffirming an earlier decision that section 503(b)(9) claimants must file proofs of claim under section 501(a) and request administrative expense status by filing a motion under section 503(a) in order to be allowed their section 503(b)(9) claims).

54. *In re SemCrude, L.P.*, No. 08-11525 (BLS) (Bankr. D. Del. Sept. 16, 2008) (Docket No. 1376).

55. *See In re SemCrude, L.P.*, No. 08-11525 (BLS) (Bankr. D. Del. Aug. 11, 2008) (Docket No. 600) (*Motion of Debtors for Authorization to Establish Procedures for the Resolution of Reclamation Claims, Administrative Claims Asserted Pursuant to Section 503(b)(9) of the Bankruptcy Code, and Liens Asserted Pursuant to First Purchaser Lien or Similar Statutes*).

56. *See* Procedures Order at page 2, paragraph (a).

57. *See In re SemCrude, L.P.*, Case No. 08-11525 (BLS) (Bankr. D. Del. Jan. 8, 2009) (Docket No. 2746 at page 3, paragraph (c)) (*Order Pursuant to Bankruptcy Rule 3003(c)(3) and Section 503(b)(9) of the Bankruptcy Code Establishing Deadlines for Filing Proofs of Claim and Approving the Form and Manner of Notice Thereof*).

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So You Think You Want to Buy a Bank?

By David L. Glass

I. Introduction

Among the fallout of the recent financial crisis has been something of a fire sale on weak or failing banks. During 2009, the number of problem banks on the "watch list" maintained by the Federal Deposit Insurance Corporation ("FDIC") reached 552 by September 2009—up from 416 only three months earlier—with some $346 billion in assets, the largest numbers since 1993.[1] With its insurance fund already seriously depleted by resolutions of failing banks,[2] it is no secret that the FDIC is eager to have private investors take some of the remaining ones off its—and, potentially, the taxpayers'—hands. Given the magnitude of the problem, the agency has sought to encourage entities that traditionally have not invested in banks—private equity funds, real estate developers, sovereign wealth funds, and others—to step up to the plate. And in turn, these entities have perceived an opportunity to enter the banking business—which offers, through its base of FDIC-insured deposits, the cheapest and most reliable source of funding available—at bargain basement prices.

While the FDIC is self-funding through assessments made against insured deposits, the losses sustained on failing bank resolutions since the crisis began have plunged its insurance fund $8.2 billion into the red (including a provision of $21.7 billion for expected losses)[3]—the first time it has been underwater since 1991. Furthermore, the temporary increase from $100,000 to $250,000 per insured account (other than retirement accounts, which are fully insured) adopted by the FDIC as an emergency measure in 2008 was extended through 2013 by the Helping Families Save Their Homes Act, signed into law by President Obama last May,[4] significantly increasing the agency's potential exposure. Beginning September 30, 2009, the FDIC has been permitted by law to base its insurance assessments on the $250,000 figure, and has taken other measures, such as requiring banks to prepay their premiums, in an attempt to ameliorate a funding crisis.[5]

All of this would suggest that the agency is paving the way for prospective investors to beat a path to its door. To date, however, the path remains relatively untrodden. The reason lies in the thicket of regulation that surrounds any entity that would presume to own or invest in a bank, not to mention the uncertainty surrounding the current legislative climate. Specifically, the objectives of private investors on the one hand, and bank regulators and the laws they administer on the other, are fundamentally at odds. Private equity firms typically seek to obtain a controlling position in struggling or undervalued companies, then "fix them, grow them, and sell them," usually in a period of three to five years.[6] The conundrum is that bank regulatory laws place severe restrictions on entities that control banks—restrictions that are anathema, unless the entity's fundamental business purpose is to operate banks rather than to invest in undervalued companies. Still, for certain classes of investors, the current crisis may represent a historic opportunity that should not be overlooked.

This article reviews the legal impediments to investing in a bank or thrift institution[7] by a non-banking investor, and the efforts to date by the Federal Reserve ("Fed"), which has authority over all acquisitions of a bank by any company, as well as the FDIC to facilitate such investments. The article concludes by outlining some of the issues such an investor should consider in determining whether to pursue such an investment at this time.

II. Background: The Bank Holding Company Act

The starting point in the analysis is the Bank Holding Company Act of 1956, as amended ("BHCA").[8] The BHCA was enacted with the primary objective of separating banking from "commerce"—defined broadly to include basically, any and all non-financial activities.[9] Under the BHCA, any company that controls one or more banks is deemed to be a bank holding company ("BHC") and, as such, cannot engage in any activity other than banking, or a list of activities determined by the Fed to be "so closely related to banking as to be a proper incident thereto."[10] The Gramm-Leach-Bliley Financial Modernization Act of 1999 ("GLBA")[11]—infamously, if erroneously, referred to as the "repeal of the Glass-Steagall Act"[12]—liberalized the activities permissible for BHCs, if they could meet certain criteria relating to capital adequacy, management, and service to their local communities. A BHC that meets these criteria can elect to be treated as a "financial holding company," and as such can engage in financial activities, including selling insurance and securities, without limitation through subsidiary companies subject to regulation based upon their function (i.e., securities subsidiaries are regulated by the SEC and insurance subsidiaries by the insurance department of the state in which they are located).[13]

In enacting the GLBA, the Congress rejected a provision which would have allowed FHCs to engage more broadly in non-financial activities—with a narrow exception for activities determined by the Fed to be "complementary" to an existing financial activity, provided the proposed complementary activity does not pose a significant risk to the "financial system generally."[14] The concept of "complementary" means that the FHC already is engaged in a financial activity, to which the proposed non-financial activity is merely complementary.[15] To date, the primary use that has been made of the "complementary" exception is in the area of physical commodities trading. While banks and BHCs are generally prohibited from trading physical commodities, an FHC can do so if it is already engaged in a related financial activity, such as trading derivatives based on that commodity, as long as the FHC receives prior approval from the Fed. As noted in the Fed's Orders approving this activity for certain FHCs, the exception is narrow and is discretionary with the Fed; among other things, the FHC applying for the exception must make the case that it has the infrastructure to manage the activity.[16] Also, the word "complementary" implies that the volume of the commercial activity is not large in relation to the underlying financial activity.

It should be noted that, apart from the BHC Act, changes in control of an insured bank are subject to the Change in Bank Control Act ("CBC Act").[17] The CBC Act essentially requires prior notice to the bank's regulator if 10% or more of the bank changes hands.[18] Unlike the BHC Act, however, the CBC Act does not impose any activity restrictions or ongoing regulatory requirements, once the initial notice is given. The CBC Act specifically exempts transactions that are subject to other laws, such as the BHC Act or the Bank Merger Act.[19] Thus, it would pick up an acquisition not covered by these laws—for example, the purchase of a bank by an individual or group of individuals, since the BHC Act applies only to control of a bank by a "company." Care must be taken, however; if a group of individuals are acting in concert, there is ample precedent for the Fed to determine that they have formed an association which is a de facto "company." Thus, the essential dilemma for investors such as private equity or sovereign wealth funds[20] is that if they become BHCs, they will be precluded from investing in assets and industries that stray from the financial field. Furthermore, they will be required to register with and be regulated by the Fed. It follows that investing in a bank generally is only feasible if the fund can avoid becoming a BHC in the process. To do so, it must avoid taking "control" of the bank, directly or indirectly.[21]

The BHC Act defines "control" in three ways. A company "controls" a bank or a BHC if it: (i) owns 25% or more of any class of voting equity; (ii) has the power to appoint a majority of the board of directors; or (iii) if the Fed determines, under all the facts and circumstances, that it exercises a "controlling influence" over the management and policies of the bank or company.[22] The first two definitions in effect are irrebuttable presumptions—no state of facts can be adduced to rebut the presumption of control if either of these two things is shown. The third definition comes into play only if neither of the first two conditions is met. It can be seen immediately that a company can be deemed to "control" a bank even if, as a practical matter, its ability to control the bank's day-to-day activities is minimal. For example, imagine that the investor owns 25% of the voting equity, while a giant BHC such as Citigroup or BankAmerica owns the remainder. In the real world, control of the bank will be dominated by the 75% owner. Nonetheless, under the law both will be deemed to be BHCs (because they are deemed to be in control as a matter of law) and thus subject to all the restrictions and regulatory requirements of the BHC Act.

Under the "controlling influence" prong, by contrast, the presumption is one of non-control. In principle, at least, the burden is on the Fed to rebut the presumption that the investor does not control the bank, if the Fed believes this to be the case. In that event, the Fed must provide the investor with notice and an opportunity for a hearing.[23] But the shifting of the burden may be more theoretical than actual; as long as the Fed's interpretation of the statute is reasonable, as a matter of administrative law it will be upheld by the courts. Applying its *Chevron* doctrine,[24] the Supreme Court repeatedly has made clear that an interpretation of a regulatory statute by the bank regulatory agency charged with its enforcement will not be overturned by a court unless it is found to be arbitrary and capricious, with no rational basis in the underlying statute.[25] And as a practical matter, an enforcement proceeding is not a happy way to start life as a BHC.

III. What Constitutes a "Controlling Influence"?

Thus, the threshold inquiry for an investor contemplating an investment in a bank or BHC is whether, and how, the investment can be structured to avoid a determination of "control." At the outset, for the reasons noted, we assume that the investment stops short of 25% of any class of voting equity and that the investor cannot control a majority of the board of the target bank or BHC—otherwise, game over. At the other end of the spectrum, the Fed generally has treated equity interests of less than 5% as de minimis and presumptively non-controlling. So the area between 5% and 25% is where the inquiry lies.

In 1982, in an attempt to clarify and provide some certainty regarding the basis for a "controlling influence" determination, the Fed issued a "Statement of policy on non-voting equity investments by Bank Holding Companies" ("1982 Policy").[26] The 1982 Policy responded to a wave of "stakeout" investments, in which BHCs would purchase a substantial interest in an out-of-state bank or BHC with the manifest intent, usually stated as such in the deal documents, of acquiring the remaining shares if and when interstate acquisitions were permitted.[27] These interests would be structured to fall just below the irrebuttable presumptions noted above. Nonetheless, they typically had numerous features aimed at effectively controlling the investment, such as "covenants or options that, among other things…limit the discretion of the bank's management over major policies and decisions," allow the investor to block acquisitions by other parties, and the like.[28]

The 1982 Policy was, therefore, aimed at reining in the unfettered use of these devices to evade the BHC Act. Although the Fed recognizes that "the complexity of legitimate business arrangements precludes rigid rules," and that the "circumstances of each case" are unique and must be taken into account, the Fed also laid out guidance regarding provisions that could be included to negate a finding of controlling influence.[29] Examples were giving the bank a right of first refusal, if the investor wished to sell its interest, leaving management free to carry out all permissible activities without interference, and limiting the aggregate ownership of voting and non-voting stock.

Over the years, investors falling into the gray area between 5% and 25% developed a mechanism to rebut a Fed finding of controlling influence by entering into a passivity agreement with the regulator. These agreements were focused on provisions prohibiting investors from seeking or exercising a controlling influence over the management, and from seeking or accepting representation on the bank's board. In this manner the Fed would be assured that unregulated investors were not, in fact, controlling the bank. These agreements evolved into two distinct forms, based on the percentage of voting shares held by the investor. The first, referred to as the "Lincoln" commitment, would be used if the investor acquired between 10% and 14.9% of a class of voting stock, and was not thereby the largest shareholder.[30] The second, referred to as the "Crown X" commitment, was used when the percentage of voting stock was 15 to 24.9% (or 10 to 14.9% if the investor was the largest shareholder).[31]

Under the Lincoln commitment, the investor was limited to appointing one member of the bank's board of directors, and even that seat would have to be relinquished if the investor subsequently passed the 15% barrier or became the largest shareholder.[32] It precluded appointing management of the bank or its subsidiaries; proposing a director in opposition to one proposed by management; attempting to influence the operating policies of the bank; soliciting proxies; disposing or threatening to dispose of stock because of some action taken by management; and engaging in transactions with the bank, other than placing a deposit of not more than $500,000.[33] The Crown X commitment included all of the above, and further precluded even a single director to represent the investor.[34]

It is apparent that both sets of commitments are inimical to the way private equity firms normally operate. As a consequence, investments in banks simply were not attractive to private equity funds and similar investors, whose focus was on taking control, turning around the bank, and ultimately selling it at a profit. By 2008, however, with the crisis in the banking industry spreading rapidly, it had become evident that additional sources of capital were necessary, and a group of private equity funds and hedge funds petitioned the Fed to reconsider its criteria for controlling influence.[35]

Accordingly, the Fed issued a new "Policy statement on equity investments in banks and bank holding companies" ("2008 Policy").[36] Whether coincidentally or not, the 2008 Policy was issued as the financial panic of 2008 hit full stride, a week after the failure of Lehman Brothers and just one day after the Fed Board approved the shotgun conversion of Morgan Stanley and Goldman Sachs to BHCs (on a Sunday, no less), in an attempt to stave off panic that they, too, were on the verge of imminent failure.[37]

Still, the changes made are significant, and fell into three broad areas: (1) appointment of board members; (2) communication with management; and (3) total permissible equity holding.

First, the 2008 Policy addressed the concern about not being able to appoint even a single board member—which for many private equity firms is a non-starter.[38] Recognizing that banking organizations typically have nine or ten member boards, the Fed concluded that a single board member was unlikely to give the investor a controlling influence. Furthermore, the 2008 Policy allows a second board member, if the bank is otherwise controlled by a registered BHC and the investor's two appointees do not exceed 25% of the total board members.[39] These board members may serve on board committees, subject to the 25% test, if they "do not have the authority or practical ability unilaterally to make (or block the making of) policy or other decisions that bind the board or management of the bank[]. . . ."[40] The investor's board representatives may not, however, serve as chair of the board or of a committee.

A second notable change is in the ability of the investor to communicate with management.[41] Previously there was little guidance in this regard, but the 2008 Policy makes clear that the investor may voice its opinion about the bank's dividend policy, capital raising plans, mergers and acquisitions, entering or leaving particular lines of business, and the general role of management.[42] In effect, the Fed is recognizing that, absent other indicia of control, the BHC Act is not seeking to prevent discussions with management. The investor's formal role is still, after all, limited to a minority investment and minority board representation. Nonetheless, the investor or its representative still may not threaten to disinvest as a means of expressing dissatisfaction with management policy.

Third, and perhaps most significantly, the Fed has relaxed its view of the total investment that may be made, combining voting and non-voting securities.[43] Under the 2008 Policy, the investor may acquire up to a 33% combined equity position in the bank, as long as it has no more than 15% of any class of voting security.[44] Previously, the Fed had taken the view that the mere fact of owning an equity position as large as 25%, even if entirely non-voting, would per se enable the investor to influence the management.[45]

While the 2008 Policy was a step forward, it disappointed the funds that had requested it because it does not get these investors all the way to the desired state of control. But the story may not be over; the Fed tends to move cautiously in making major supervisory policy changes. For example, when the Fed first allowed bank-affiliated broker dealer firms to underwrite securities, it initially restricted the underwriting activity to no more than 5% of the affiliate's revenues.[46] Over a matter of years the Fed then raised the limit incrementally to 25%, as it gained comfort that these affiliates did not pose a significant threat to the safety and soundness of the financial system.[47]

IV. The FDIC: Seeking Buyers for Failed Banks

At the same time that the Fed was rethinking the rules for "controlling influence," the FDIC was seeking a means to expand the list of potential buyers for failed banks. Generally, the FDIC is required to pursue the lowest-cost solution to resolving a failing bank.[48] Selling the bank to a prospective buyer often will result in lower costs than liquidating the bank, because liquidation destroys any enterprise or goodwill value associated with the institution's franchise. But the problem is that there are too few potential buyers that are already BHCs, or that are otherwise experienced in managing banks. Thus, the agency has attempted to reach out to a broader range of investors.

In July 2009 the FDIC published for comment a proposed Statement of Policy on qualifications for failed bank acquisitions ("Proposed SOP").[49] The preamble makes clear that the FDIC continues to prefer that banks be sold to existing BHCs, since they have a "well developed prudential framework" that included minimum capital requirements; support for banks that experience difficulties (i.e., the "source of strength" doctrine that the Fed historically has applied to BHCs);[50] and protection against insider transactions.[51] Accordingly, in allowing new classes of investors to purchase banks, the agency took the initial approach of imposing similar requirements. The requirements in the Proposed SOP, however, were draconian, and regarded as unworkable by the majority of commenters.[52]

In September 2009 the FDIC released its final Statement of Policy on qualifications for failed bank acquisitions ("SOP").[53] The SOP attempted to accommodate some of the principal concerns expressed about the Proposed SOP.[54] Nonetheless, it still left private investors facing more onerous requirements than those that would apply to an existing bank or BHC.[55] The agency thus continues to leave no doubt that its preferred buyers are institutions already subject to the bank regulatory regime, and with a track record for compliance with those regulations.

By its terms, the SOP applies to two broad classes of persons, referred to as "investors" in the regulation: (i) private investors in a company, including any company acquired to facilitate bidding on a failed bank or thrift, that is proposing—directly or indirectly, including through a shelf charter—to assume deposit liabilities, or both deposit liabilities and assets, from the resolution of a failed bank; and (ii) applicants for deposit insurance to establish a de novo charter in connection with the resolution of a failed bank.[56] The FDIC declined to define "investors" more precisely; since the SOP is, after all, a policy and not a statute, the agency wanted to retain the flexibility of defining this term in relation to actual agreements it is able to reach with investors. Also, a more precise definition would be difficult to craft, given the variety of capital structures that could be formed by consortia of private investors, each of whom would hold less than a 25% interest (which, as discussed above, is the level at which the irrebuttable presumption of control would kick in under the BHC Act).

The following reviews the principal aspects of the final SOP.

Applicability

The SOP creates a de minimis exemption for Investors with less than 5% of the bank's equity, provided such investors are not acting in concert. It also would not apply to minority investors in a bank controlled by a BHC with a strong majority interest and a track record for successful operation of banks. Finally, if the bank maintains a composite CAMELS rating[57] of 1 or 2 for at least seven years, the investor can apply for exemption.[58]

Minimum Capital

Since capital represents the bank owner's "skin in the game" and acts as a cushion against losses, regulators are obsessive about the importance of maintaining a strong ratio of capital to assets. In the Proposed SOP an unworkably high 15% capital ratio was proposed. The commenters noted that placing the requirement so much higher than required for traditional owners such as BHCs—three times the minimum requirement for "well capitalized" and twice the industry average—would place private investors at a competitive disadvantage, make it difficult to earn a reasonable rate of return, and encourage risky post-acquisition strategies (i.e., in an effort to generate a better return on investment).[59] The SOP reduces the requirement to 10%, but mandates that it be comprised of Tier One capital—the preferred form, since it consists of common equity that has no claim against the assets of the bank until all other claims are satisfied.[60]

Affiliate Transactions

BHCs are subject to Section 23A of the Federal Reserve Act[61] and its implementing regulation, Federal Reserve Regulation W.[62] Section 23A restricts transactions between a bank and its affiliates—for example, a loan to an affiliate is limited to 10% of the bank's capital, and must be fully secured. The SOP is even more restrictive; it essentially prohibits all such loans.[63]

Cross-Support

In the Proposed SOP, the FDIC proposed a cross-guarantee provision, whereby investors with interests in more than one bank would have to commit each such bank to support another if it got in trouble. The commenters stressed that this would deter private investment, since it would place legally separate investments at risk. The SOP scaled back the circumstances in which such cross-guarantees, now euphemistically softened as "cross-support," would be required. It would now apply only if at least 80% of each bank was owned by common investors. Further, the FDIC could waive the cross-support obligation if enforcing it would not reduce the cost to the FDIC of resolving the bank failure.[64]

It might be noted that cross-guarantee is an idea with which the FDIC has been enamored for some time, going back to the rash of bank and thrift failures in the 1980s—and, in particular, the failure of individual banks that were part of holding company structures in which there were other banks that remained healthy, but could not be compelled to support their weaker sisters.[65] This was the case in several states—most notably, Texas—that historically had prohibited branch banking. As a consequence, the state had a large number of small community banks—more than two thousand at one time—which were overly vulnerable to economic conditions in their local communities. The agency felt, not unreasonably, that where a number of such banks were affiliated through a holding company structure, they should be required to cross-guarantee each others' deposits, in effect making them de facto branches. It attempted to achieve this in the 1989 FIRREA legislation[66] but the practical problems with its implementation resulted in only a watered down version.[67]

Continuity of Ownership

The Proposed SOP would require investors to maintain their investments for a minimum of three years. The SOP adopted this without change.[68]

Prohibited Structures

Noting its concern with "complex and functionally opaque" arrangements such as silo structures, the FDIC retained a general prohibition on investments by funds that are part of a group—in particular, structures whereby a private equity firm (or its sponsor) that controls multiple investment vehicles that would be used for bank acquisitions. The underlying concern is that the objective of these arrangements is to evade the prohibitions of the BHC Act on non-financial investments by artificially isolating the bank investment from the rest of the group.[69]

Source of Strength

The Fed historically has indicated that it expects BHCs to be a "source of strength" to their subsidiary banks. This requirement is inimical to private equity investors, who would view their investments as legally separate. The FDIC had proposed source of strength in the Proposed SOP but dropped it from the SOP.[70]

Secrecy Jurisdictions

Investors organized in designated secrecy jurisdictions would be prohibited from bidding on failed banks, unless they were subsidiaries of companies determined by the Fed to be subject to "comprehensive consolidated supervision" ("CCS").[71] In essence, this would preclude all entities from such jurisdictions, except for foreign banks approved by the Fed, to engage in banking in the U.S.[72]

Bid Limitation

The Proposed SOP would not allow an owner of 10% or more of a failed bank to bid on it in receivership. This was unchanged in the SOP.[73]

Disclosure

The SOP mandates disclosure of extensive information about entities in the chain of ownership, analogous to the BHC Act. While this is of great concern to private investors, the FDIC noted that confidential information would be protected in accordance with applicable law.[74] In this regard, one area of concern would be the intention of Attorney General Holder, stated on behalf of the Obama Administration, that the current Administration would take a much narrower view of exemptions from disclosure under the Freedom of Information Act.[75]

V. The State of Play

So where does all this leave the prospective investor? While it is obviously too early to draw any definitive conclusions, some preliminary observations are in order.

First, for investors who are satisfied with passive interests of less than 10%, it is still possible to avoid regulation and regulatory scrutiny. This is apparently the preferred approach of sovereign wealth funds, no doubt for this reason.[76]

Second, investors have greater latitude than in the past with respect to the use of non-voting securities, such as preferred stock, as long as such stock does not allow them to vote for or influence the board of directors; is a passive investment that does not enable the investor to influence the management or policies of the bank; and limits voting rights to those given shareholders whose interests have been adversely affected.[77] It must be recognized, however, that under long-standing Fed policy, securities convertible into voting stock at the instance of the investor will be counted as if they are already voting.

Third, investors can avoid a control determination by acting individually as part of a consortium. The problem is that, if the investors consciously act in parallel, they may be deemed to be acting "in concert" and, as such, becoming a de facto BHC. The risks and uncertainty of this approach will generally preclude it from being used to evade the restrictions on control.

Fourth, a private equity fund can use the "silo" approach—i.e., creating a bank-focused fund that is separate from its other non-banking funds. A number of funds have in fact been created with the objective of acquiring banks. Such funds will, of course, be BHCs if they purchase controlling interests, but presumptively will be BHC Act-compliant by remaining separate from other investment funds. The problem is that common control of the funds will defeat this objective; the BHC Act requires the Fed to look to the "ultimate parent" in making a BHC determination.

Fifth, in the failed bank world, the FDIC's SOP does not provide adequate comfort to private investors to assure their participation. Still, there are indications that they are ready to buy if the price is right.[78]

VI. Conclusion

The unprecedented situation in the financial markets over the past few years has created a unique challenge for the bank regulators. In attempting to find new sources of capital for the banking industry, they have been able to re-think, to some extent, their traditional aversion to the control of banks by investors lacking a proven track record of banking. But the fundamental underlying tension is still there; the American obsession with separating banking and "commerce," which finds its expression in the BHC Act, makes the regulators wary of erring on the side of being too inclusive in the quest for new investors.

On the investor side, these considerations create a conundrum as well. For private equity investors, the preferred business model is to take control of a weak or failing company, straighten it around, and sell it at a profit in a comparatively short time frame. These objectives are inherently at odds with banking law and regulatory policy, which are aimed at precluding engagement in non-banking activities and maintaining continuity of management. Such investors also are unused to a culture of full disclosure and the "source of strength" concept—which implicitly commits them to "throw good money after bad" if the bank continues to struggle.

Seen in this light, the policy changes by the Fed and the FDIC are no more than hesitant first steps. In turn, the private equity market thus far has tiptoed gingerly around the idea of bank investment, as they weigh the potential for superior returns—with many banks available at bargain basement prices—against the many pitfalls in the Fed and FDIC policies. The next few years will tell whether the agencies are willing to liberalize further as they gain experience with private equity investors.

Endnotes

1. David Ellis, *Bank 'Problem' List Climbs to 552*, CNNMoney.com, Nov. 24, 2009, http://money.cnn.com/2009/11/24/news/companies/fdic_list/index.htm. The FDIC does not disclose the names of the troubled banks in order to prevent a run on their deposits.
2. Fifty insured institutions (banks and savings and loans associations) with total assets of $69 billion failed in the third quarter of 2009 alone, the largest number in any quarter since 1990. Kevin Brown, *Insurance Fund Indicators*, *in* FDIC Quarterly Banking Profile: Third Quarter 2009 28 (2009), http://www2.fdic/gov/qbp/2009sep/qbp.pdf.
3. *Id.*
4. Helping Families Save Their Homes Act of 2009, Pub. L. No. 111-22, 123 Stat. 1633 (2009) (codified in scattered sections of 12, 15, 31, 38, and 42 U.S.C.); Brown, *supra* note 2, at 14.
5. Brown, *supra* note 2, at 14–15.
6. Ravi R. Desai, Comment, *Private Equity Investment in Financial Institutions and How to Avoid Becoming a Bank Holding Company*, 13 N.C. Banking Inst. 385, 386 (2009) (citation omitted).
7. Thrift institutions include savings and loan associations, savings banks, and similar institutions. Although thrift institutions are under a different regulatory regime (the Office of Thrift Supervision, or OTS) than commercial banks, for purposes of the issues discussed in this article their treatment is similar. For clarity, the article will use the word "banks" with the understanding that, except as otherwise stated, similar considerations apply to thrift institutions.
8. 12 U.S.C. §§ 1841–50 (2006).
9. *Turmoil in the U.S. Credit Markets: Examining the U.S. Regulatory Framework for Assessing Sovereign Investments: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs*, 110th Cong. (Apr. 24, 2008), *available at* www.federalreserve.gov/newsevents/testimony/alvarez20080424a.htm (statement of Scott G. Alvarez, General Counsel, Board of Governors of the Federal Reserve System).
10. 12 U.S.C. § 1843(c)(8) (2006). The list of activities determined to meet this test, known as the "laundry list," is found in the Fed's List of Permissible Non-Banking Activities, 12 C.F.R. § 225.28(b) (2010). Under the Gramm-Leach-Bliley Act of 1999, this list was essentially frozen in place as of November 12, 1999, the date of its enactment; henceforth the Fed may not approve any non-banking activities not on the list for a BHC unless it qualifies as a financial holding company ("FHC") thereunder.
11. Pub. L. No. 106-102, 113 Stat. 1338 (1999) (codified in scattered sections of 12 and 15 U.S.C.).
12. The Depression-era Glass-Steagall Act was aimed at separating commercial banking and the securities business. But the regulators and the courts long ago established that agency-only brokerage of securities was permitted. The key prohibitions in the Act, which forbid banks (as distinguished from their securities affiliates) from trading and underwriting securities remain in place. *See* 12 U.S.C. § 24 para. Seventh (2006) (providing that the business of trading in securities and stock by a national bank is limited to agency-only activities); 12 U.S.C. § 378(a)(1) (2006) (providing that companies that underwrite securities are prohibited from taking

deposits). These key provisions were left undisturbed by the GLBA. The repealed portions of the Act were section 32 (12 U.S.C. § 78 (repealed 1999)), an archaic and ineffective provision that prohibited a person sitting on the board of directors of a bank from also sitting on the board of a securities company, and section 20 (12 U.S.C. § 377 (repealed 1999)), which prohibited affiliations between a bank and a company "engaged principally" in underwriting securities. *See* 113 Stat. at 1341. Prior to the GLBA the Fed had allowed limited underwriting, up to 25% of the affiliate's revenues, as not violating the "engaged principally" standard. As a practical matter, since the GLBA froze the "laundry list" of permitted non-banking activities, unless the BHC qualifies as an FHC it will still be bound by this standard, notwithstanding the repeal of section 20. *See* 12 C.F.R. § 225.28(b).

13. 12 U.S.C. § 1843(k)(1) (2006).

14. § 1843(k)(1)(B).

15. § 1843(k)(1)(A), (B).

16. *See, e.g.*, JP Morgan Chase, 92 Fed. Res. Bull. C57 (2006), *available at* http://www.federalreserve.gov/pubs/bulletin/2006/legal06-508.pdf; Barclays Bank PLC, 90 Fed. Res. Bull. 511 (2004), *available at* http://www.federalreserve.gov/pubs/bulletin/2004/autumn04_legal.pdf.

17. 12 U.S.C. § 1817(j) (2006 & Supp. 2010).

18. 12 C.F.R. § 225.41 (2010).

19. 12 U.S.C. § 1817(j)(17).

20. The Fed has made clear that, while foreign governments are not themselves "companies" and thus cannot become BHCs, a sovereign wealth fund is a "company" for this purpose. Alvarez, *supra* note 9.

21. "Indirectly" in this context refers to controlling a bank by controlling a company that in turn controls a bank—i.e., a BHC. 12 C.F.R. § 225.2(c)(1) (2010). It should be noted that "control" is tested separately at each level. Thus, if A owns 25% of B, which in turn owns 25% of the bank, A cannot argue that it does not control the bank because its interest is actually only 6.25% (.25 times .25). Control is conclusively presumed at each level.

22. 12 U.S.C. § 1841(a)(2) (2006); *see generally* Pauline B. Heller & Melanie L. Fein, Federal Bank Holding Company Law § 2.05 (2006).

23. Alvarez, *supra* note 9.

24. Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 842–44 (1984).

25. In the 1990s the Supreme Court unanimously applied this principle in three separate cases. Though all three involved interpretations of the National Bank Act by the Office of the Comptroller of the Currency, the same principle applies to the Fed or any other agency interpreting a statute which it is charged to interpret and enforce. *See* NationsBank of N.C. v. Variable Annuity Life Ins. Co., 513 U.S. 251, 264 (1995) (upholding as reasonable the Comptroller's ruling that annuities are a banking product rather than a form of insurance); Smiley v. Citibank, 517 U.S. 735, 744–46 (1996) (holding that the Comptroller reasonably determined what charges were and were not "interest" for purposes of applying state usury laws to national banks); Barnett Bank of Marion County v. Nelson, 517 U.S. 25, 27–28 (1996) (holding that state infringement on national bank insurance agency activities is permitted under federal law).

26. Bank Holding Companies and Change in Bank Control, 47 Fed. Reg. 30,965, 30,965 (July 16, 1982) (codified at 12 C.F.R. § 225.143 (2010)).

27. 12 C.F.R. § 225.143(a)(1). At that time, the so-called Douglas Amendment to the BHC Act prohibited acquisitions of a bank in one state by a BHC in another state unless the statute law of the first state explicitly allowed such acquisitions, "by language to that effect and not merely by implication." 12 U.S.C. § 1842(d) (2006). In the early 1980s certain states began to enact laws that were reciprocal with those of selected neighboring states, creating "regional compacts" in which interstate bank ownership would be permitted. Such compacts were upheld by the Supreme Court in Northeast Bancorp v. Board of Governors of the Federal Reserve System, 472 U.S. 159, 162 (1985). The Douglas Amendment was repealed by the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. Pub. L. No. 103-328, 108 Stat. 2338, 2339 (current version at 12 U.S.C. § 1842(d) (2006)). Today there are no restrictions on such interstate acquisitions, but Fed Board approval is required as is the case for all BHC acquisitions.

28. Desai, *supra* note 6, at 393.

29. 12 C.F.R. § 225.143(a)(2).

30. Desai, *supra* note 6, at 394.

31. *Id.* at 395.

32. *Id.* at 394.

33. *Id.* at 394–95.

34. *Id.* at 395.

35. *See* Gibson Dunn, Financial Markets Crisis: Issues For Hedge Funds and Private Equity Funds (2008), http://www.gibsondunn.com/Publications/Pages/FinancialMarketsCrisis-HedgeFunds-PrivateFunds.aspx.

36. Bd. of Governors of the Fed. Reserve Sys., Policy Statement on Equity Investments in Banks and Bank Holding Companies 1 (Sept. 22, 2008), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20080922b1.pdf. Although the Board of Governors refers to this source as a provision in the C.F.R., it was never published as a proposed or adopted regulation in the Federal Register, and therefore has never been formally adopted as a regulation in the C.F.R.

37. *Id.*

38. *Id.* at 6.

39. *Id.* at 7.

40. *Id.* at 8.

41. *Id.* at 11.

42. *Id.* at 11–12.

43. *Id.* at 8.

44. *Id.* at 7.

45. *See supra* note 12. Indeed, when Sumitomo Trust & Banking Corp., a foreign bank that is a BHC under the law, sought to acquire a 25% interest in Goldman Sachs, the Fed was concerned about a controlling influence even though the proposed investment was to be in the form of subordinated debt, with no voting equity at all (a control position would have violated the Glass-Steagall Act at that time). *See* David L. Glass, *The Sumitomo-Goldman Sachs Partnership*, 3 Rev. Fin. Servs. Regulation 11 (1987).

46. *See* Sec. Indus. Ass'n v. Bd. of Governors of the Fed. Reserve Sys., 807 F.2d 1052 (D.C. Cir. 1986).

47. *See* Revenue Limit on Bank-Ineligible Activities of Subsidiaries of Bank Holding Companies Engaged in Underwriting and Dealing in Securities, 61 Fed. Reg 68,750 (Dec. 20, 1996), *available at* http://www.federalreserve.gov/boarddocs/press/boardacts/1996/19961220/R-0841.pdf.

48. 12 U.S.C. § 1823(c)(4) (2006).

49. Proposed Statement of Policy on Qualifications for Failed Bank Acquisitions, 74 Fed. Reg. 32,931, 32,931 (July 9, 2009) [hereinafter Proposed Statement].

50. Although it is not articulated therein, the Fed has interpreted the BHCA as mandating that BHCs serve as a "source of strength" to their subsidiary banks. Policy Statement on the Responsibility of Bank Holding Companies to Act as Sources of Strength to Their

Subsidiary Bank, 52 Fed. Reg. 15,707, 15,707 (Apr. 24, 1987). The Fed explicitly incorporated the doctrine in its Regulation Y, which governs BHCs generally. 12 C.F.R. § 225.4(a)(1) (2010). The doctrine has been controversial, in that its application could be deemed to violate the general principle that a corporation's liability is limited. *See* Heller & Fein, *supra* note 22, at § 3.02–.03.

51. Proposed Statement, 74 Fed. Reg. at 32,932–33.
52. *See* Final Statement of Policy on Qualifications for Failed Bank Acquisitions, 74 Fed. Reg. 45,440, 45,440–42 (Sept. 2, 2009) [hereinafter Final Statement].
53. *Id.*
54. *Id.*
55. *Id.*
56. *Id.* at 45,441.
57. CAMELS is the basic system for examination of banks (Capital, Asset quality, Management, Earnings, Liquidity, and Sensitivity to market risk). The bank receives a rating from 1 (highest) to 5 (lowest) in each category, and a composite rating. A composite rating of 3 or lower generally indicates significant weaknesses in one or more areas. *See* Uniform Financial Institutions Rating System, 61 Fed. Reg. 67,021, 67,022, 67,025 (Dec. 19, 1996).
58. *See* Final Statement, 74 Fed. Reg. at 45,446.
59. *Id.* at 45,442.
60. *Id.* at 45,446.
61. 12 U.S.C. §§ 226, 371c (2006).
62. 12 C.F.R. § 223.1–.71 (2010).
63. Final Statement, 74 Fed. Reg. at 45,441, 45,444.
64. *Id.* at 45441, 45443–44, 45446–47.
65. One prominent example was MCorp, a BHC that filed for bankruptcy that owned a number of Texas banks. *See* Bd. of Governors of the Fed. Reserve Sys. v. MCorp Fin., Inc., 502 U.S. 32 (1991).
66. Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989, Pub. L. 101-73, 103 Stat. 183 (codified as amended in scattered sections of 12 U.S.C.); *see* Jeffery M. Cooper, Note, *Out on a Limb: FIRREA's Cross-Guarantee Provision "Takes" Root in* Branch v. United States, 33 Hous. L. Rev. 299, 313–15 (1996).
67. David L. Glass, *"Cross-Guarantee": A Threat to Bank Creditors?*, Bank Analyst, May/June, 1990, at 5.
68. Proposed Statement, 74 Fed. Reg. 32,932, 32,934 (July 9, 2009); Final Statement, 74 Fed. Reg. at 45,449.
69. Final Statement, 74 Fed. Reg. at 45,442, 45,447, 45,449.
70. Proposed Statement, 74 Fed. Reg. at 32,933; Final Statement, 74 Fed. Reg. at 45,443.
71. The CCS standard was adopted into the law in the Foreign Bank Supervision Enhancement Act of 1991, in response to scandals involving certain foreign banks. In essence, it mandates the Fed to determine that any foreign bank seeking to enter the U.S. is subject to comprehensive supervision on a consolidated worldwide basis by its home country regulator. 12 U.S.C. § 3105(d)(2)(A) (2006).
72. Final Statement, 74 Fed. Reg. at 45,449.
73. *Id.* at 45,449.
74. *Id.*
75. 5 U.S.C. § 552(b)(4) (2006). The Freedom of Information Act contains an exemption for trade secrets and confidential information. Under the Bush Administration, requests for confidential treatment generally were granted almost pro forma; under the new policy there is a "clear presumption of disclosure," so that the case for non-disclosure must be pleaded with greater particularity. *See* Office of Info. Policy, U.S. Dep't of Justice, President Obama's FOIA Memorandum and Attorney General Holder's FOIA Guidelines (2009), *available at* http://www.justice.gov/oip/obama_holder_foia_memo_march2009.pdf.
76. Alvarez, *supra* note 9.
77. Desai, *supra* note 6, at 399–400.
78. *See* Paul Davis, *Field of Failed-Bank Suitors Getting Crowded*, Am. Banker, Mar. 1, 2010, at 1.

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Thus Spake Zarathustra (and Other Cautionary Tales for Lawyers)

By C. Evan Stewart

Friedrich Nietzsche believed that "What does not destroy me, makes me stronger."[1] That maxim should certainly be adopted by lawyers who deal with sticky, pre-trial tactical issues. In the very recent past, some prominent lawyers have gotten important body parts singed by their miscues on such matters. Perhaps a review of some of these episodes will help the rest of us avoid such problems in the future.

The Dangers of the Corporate Miranda Warning

The Corporate Miranda Warning has always struck me as a tad counterintuitive and structurally counterproductive. Consistent with our professional obligations (*see, e.g.*, ABA Model Rule 1.13), we lawyers, when we are about to engage in substantive discussions with corporate individuals (as opposed to the fictitious legal entity which is our client, i.e., the corporation), are supposed to advise said individuals (i) that they are not our clients, (ii) that anything they say to us is covered by the attorney-client privilege of the corporation, which the corporation may or may not decide to breach to third parties, and (iii) that they should divulge to us significant information that could ruin their livelihoods and/or jeopardize their freedoms.[2] The cartoon above depicts this odd state of affairs.[3]

Although the responsibility to give the Corporate Miranda Warning is not new, two cases highlight that it is far from perfectly understood or uniformly practiced. In 2006, for example, Irell & Manella was hired by the Audit Committee of Broadcom Corp. to do an investigation of the Company's history of granting stock options. The company's Board of Directors, which included its CFO, William Ruehle, also met and agreed that (i) the fruits of Irell's investigation would be disclosed to the company's outside auditors, and (ii) the company would fully cooperate with government regulators. Shortly thereafter, Irell lawyers interviewed all of the key executives at Broadcom, including Mr. Ruehle, regarding the hows, whens, wheres, and whats of Broadcom's stock option practices.

Later, with private lawsuits being filed and the SEC commencing an investigation, four things happened:

- An Irell partner met with Ruehle and advised him to get separate counsel.
- Broadcom turned over Irell's investigation report to its outside auditors, and thereafter restated earnings.
- The U.S. Attorney met with Irell lawyers and debriefed them regarding their interview and meetings with Ruehle.
- Ruehle was indicted.

At his criminal trial, Ruehle moved to bar the use of any and all evidence gleaned from the U.S. Attorney's meetings with the Irell lawyers. On April 1, 2009, the federal judge overseeing the case granted the motion, precluding the government from using the Irell information at trial; he also referred the Irell firm to the State Bar of California for disciplinary action.[4]

In granting Ruehle's motion, the judge found that the CFO had reasonably believed that when he met with the Irell lawyers they were representing him and that any information he provided to them would remain confidential. The Irell lawyers testified that they had given Ruehle a Corporate Miranda Warning, but the judge did not credit that testimony because (i) Ruehle had testified that he remembered no such warning, and (ii) no warning was referenced in the Irell interview notes of their session with Ruehle.[5] And, even if there was an oral warning, the judge found it not sufficiently helpful in telling Ruehle that the Irell lawyers were not **his** lawyers and, in any event, the judge ruled that "[a]n oral warning, as opposed to a written waiver of the clear conflict presented by Irell's representation of both Broadcom and Mr. Ruehle, is simply not sufficient to suspend or dissolve an existing attorney-client relationship and to waive the privilege."[6]

The judge also found at least three ethical breaches by the Irell lawyers:

- failure to get Ruehle's informed written consent of the firm's joint representation.
- failure of its duty of loyalty to Ruehle "by interrogating him for the benefit of another client, Broadcom."
- disclosure of Ruehle's "privileged communications to third parties without his consent."[7]

On interlocutory appeal, the Ninth Circuit reversed the district court with respect to blocking the government from utilizing Ruehle's statements to the Irell lawyers. Not addressing the ethical violations determined below, the court of appeals focused only on whether Ruehle had a reasonable basis for believing his meetings with the Irell lawyers were in fact subject to the broad protections of the attorney-client privilege. Because Ruehle (as a Board member and in his capacity as CFO) indisputably knew that Irell's investigation report would be disclosed to Broadcom's outside auditors, the Ninth Circuit ruled that Ruehle had no credible expectation of confidentiality—a critical cornerstone to any assertion of the privilege.[8] That the Ninth Circuit was clearly correct in its privilege ruling was probably of little solace to the Irell lawyers.[9]

And if that were not enough of a wake-up call, consider the financial scandal involving the Stanford Financial Group. A partner at the Proskauer Rose firm (who previously had served for an extended term of duty in the SEC's enforcement division) was hired to represent that company in connection with allegations of widespread fraud, allegations which triggered (among other things) an SEC investigation. On February 10, 2009, Stanford's Chief Investment Officer, Laura Pendergest-Holt, gave testimony at the SEC. With her was the Proskauer partner, who stated that he was there on behalf of Stanford and was also representing Pendergest-Holt "insofar as she is an officer or director of one of the Stanford affiliated companies."[10] Four days later, the Proskauer partner made a "noisy withdrawal," resigning from his representation of Stanford and "disaffirm[ing] all prior oral and written representations made by me and my associates to the SEC staff."[11]

Later that same month, Pendergest-Holt was arrested and charged with giving false testimony at her SEC deposition; she was subsequently indicted for that alleged conduct.[12] Pendergest-Holt thereafter sued both Proskauer and the partner individually for malpractice and breach of fiduciary duty.[13] And that was not the last shoe to drop—Proskauer and the partner were later named as defendants in a class action by victims of Stanford's alleged fraud, and the partner subsequently stepped down from his partnership at Proskauer.[14]

The Downsides of Document "Retention"

In a previous issue of the *NY Business Law Journal,* I highlighted a number of very unhappy situations where lawyers had fallen down in their duties to ensure the preservation and/or production of relevant materials.[15] More recently, Judge Scheindlin's decision in *Pension Comm. of the Univ. of Montreal Pension Plan v. Banc of America Secs.*[16] gives us the latest set of standards for the "when" of document retention, as well as the consequences of failure. Addressing the *plaintiffs'* various screw-ups, the judge made the following determinations:

- "Possibly after October, 2003, when *Zublake IV* was issued, and definitely after July, 2004, when the final relevant *Zublake* opinion was issued, the failure to issue a **written** litigation hold constitutes gross negligence because that failure is likely to result in the destruction of relevant information."[17]
- The obligation to retain back-up tapes exists only when said tapes are the "sole source of relevant information."[18]
- "While litigants are not required to execute document productions with absolute precision, at a minimum they must act diligently and search thoroughly at the time they reasonably anticipate litigation."[19]

And after reviewing the litany of attorney screw-ups (e.g., issuing a written litigation hold four years too late, failure to request documents from critical employees, etc.), the judge did not go lightly on sanctions (e.g., adverse inference jury instruction, monetary sanctions, etc.).[20]

The Developing Law of Inadvertent Waiver

A few years back the legal powers that be (with the help of Congress) made some changes to protect those lawyers who are not perfect in the chaotic world of document (and email) production.[21] First, the Federal Rules Advisory Committee adopted Fed. R. Civ. P. 26(b)(5) (and analogs to it in Rules 16, 33, 34, and 37); and later Congress adopted Rule 502(b) of the Federal Rules of Evidence, codifying that an "inadvertent disclosure" of privileged material does not operate as a waiver so long as (i) the privilege holder took "reasonable steps to prevent disclosure"; and (ii) the privilege holder took "reasonable steps to rectify the error." The first of those two prongs is where the rubber meets the road,[22] and so the question is: how have courts been interpreting what constitutes "reasonable steps to prevent disclosure"?

Perhaps not surprisingly, "reasonableness" appears to be in the eye of the beholder. In *Rhoads Industries Inc. v. Building Materials Corp. of America*,[23] for example, the plaintiff produced in discovery 78,000 e-mail messages; it was subsequently determined that 812 of the e-mails were privileged. Needless to say, the defendant wanted to make use of the 812 e-mails, while the plaintiff wanted to pull back the "inadvertently" produced materials.

On the defendant's motion to find that there had been a waiver, the district court ruled in plaintiff's favor, notwithstanding that the plaintiff's efforts had been (in the court's words) "to some extent, not reasonable," and despite the fact that out of the five factors courts consider in determining the inadvertent nature of the waiver, four favored the defendant. Those five factors are:

- The reasonableness of the precaution(s) taken to prevent inadvertent disclosure.
- The number of inadvertent disclosures.
- The extent of the disclosures.
- Any delay and measures taken to rectify the disclosure.
- Whether the "interests of justice" would be served by pardoning one party of its mistake(s).[24]

The *Rhoads* court determined that the first four factors all favored the defendant.[25] The fifth factor, however, tipped the balance because in the court's eyes the "[l]oss of the attorney-client privilege in a high-stakes, hard-fought litigation is a severe sanction and can lead to serious prejudice."[26]

In *Sitterson v. Evergreen School District No. 114*,[27] a court applying the same five factors reached a different result. There, the defendant produced 439 pages of documents to the plaintiff; included in that production were four privileged documents. At trial, when the plaintiff sought to use the documents, the defendant opposed their use on privilege grounds. After hearing from defense counsel that he had produced the letters under the mistaken belief that he was obligated to do so, and later hearing him lament that he "wasn't thorough enough," the trial judge allowed the documents into evidence. And one of them was particularly explosive—defense counsel had opined that his client's position "would not pass the smell test."

After the plaintiff won at trial, the ensuing appeal focused on whether there had been in fact a waiver of the privileged materials. The appellate court, weighing the five factors, found that the first four factors favored waiver, and as to the "interests of justice" factor, the court found it favored neither side. The verdict was thus affirmed.

Subsequent decisions confirm the crapshoot nature of leaving your fate to a judge who, with 20-20 hindsight (and perhaps a desire to impact the outcome of the litigation), has essentially unfettered discretion to make a determination of "reasonableness."[28] To be absolutely sure (and not be forced to explain the disastrous consequences to an impacted client), it still is best to do everything possible to prevent leaks of privilege in the first place, rather than hoping a judge (and Fed. R. Evid. 502) will pull your chestnuts out of the fire.

Conclusion

The foregoing is merely a first course (or perhaps an aperitif) of the many daunting challenges that face lawyers in the increasingly complex world of representing clients in litigated disputes.[29] As the sergeant in "Hill Street Blues" used to say every week: "Let's be careful out there!"

Endnotes

1. Friedrich Nietzsche, Twilight of the Idols 8 (1889). ("Was mich nicht umbringt, macht mich stärker"). For an excellent biography of Nietzsche, see Julian Young, Friedrich Nietzsche: A Philosophical Biography (Cambridge Univ. Press 2010). On the other hand, Socrates said "To do is to be"; Plato said "To be is to do"; and Sinatra said "Dooby, Dooby, Doo" (*see* Strangers in the Night (Reprise Records 1966)). And it is important to note that Sinatra's philosophical crooning served as the inspiration for the cartoon canine Scooby Doo.
2. This warning is sometimes also called an *Upjohn* warning, as derived from the Supreme Court's ruling in *U.S. v. Upjohn Co.*, 449 U.S. 383 (1981). In my view, this is a mischaracterization of *Upjohn*, which (i) has nothing to do with lawyers' ethical duties, and (ii) stands for the proposition that **all** corporate employees are covered by the attorney-client privilege for purposes of discovery under the Federal Rules of Civil Procedure.
3. *See* C. Evan Stewart, Federal Bar Council News (June 1997). Famously, or infamously, when Kidder, Peabody & Co. Inc.'s general counsel gave this warning to Joseph Jett (whose fraudulent bond trading ultimately brought down that firm), Jett politely excused himself to go to the bathroom (ala Michael Corleone in "The Godfather") and then left the building—for good. *See* Roger Parloff, *Case Closed*, The American Lawyer, Nov. 1997.
4. *See U.S. v. Nicholas*, 606 F. Supp. 2d 1109 (C.D. Cal.), *rev'd sub nom. U.S. v. Ruehle*, 583 F.3d 600 (9th Cir. 2009).
5. *See* 606 F. Supp. 2d at 1116.
6. *See Id.* at 1117.
7. *See Id.* at 1117-20.
8. *See* 583 F.3d at 610-11. The court also rejected the argument that any ethical breaches by the Irell lawyers constituted a basis for suppressing the evidence, especially given that there was no allegation of any wrongdoing by the U.S. Attorney. *Id.* at 613.
9. That this case also sounds like a law school exercise question is true—I used it for my 2010 spring semester exam at the Fordham Law School.
10. *See* Zach Lowe, *Lessons from the Stanford Scandal: Bring Your Own Lawyer*, AmLaw Daily, Mar. 3, 2009, http://www.amlawdaily.com.
11. *See* Ashby Jones, *Sizing Up Thomas Sjoblom's 'Noisy Withdrawal,'* Wall St. J. Law Blog, Feb. 19, 2009, http://www.blogs.wsj.com/law/.
12. *See* Amir Efrati, *Indictment Cranks Up Heat on Proskauer's Sjoblom*, Wall St. J. Law Blog, May 14, 2009, http://www.blogs.wsj.com/law/.
13. *See* Ashby Jones, *The Stanford Situation Heats Up: Pendergest-Holt Sues Sjoblom*, Wall St. J. Law Blog, Mar. 31, 2009, http://www.blogs.wsj.com/law/.
14. *See Proskauer, Sjoblom Hit in Class Action* AmLaw Daily, Aug. 28, 2009, http://www.amlawdaily.com (noting that Stanford's former CFO, as part of his plea agreement, appeared to implicate the Proskauer partner as part of the fraudulent conspiracy); Lawshucks.com, *Sjoblom Resigned from Proskauer*, http://lawshucks.com, Oct. 14, 2009.

15. *See* C. Evan Stewart, *Ethical Issues for Business Lawyers—Documents and Lawyers: Oil and Water?* N.Y. Bus. Law J., Fall 2008. *See also Qualcomm Inc. v. Broadcom Corp.*, 539 F. Supp. 2d 1214 (S.D. Cal. 2007), *aff'd in part, vacated in part*, 548 F.3d 1004 (Fed. Cir. 2008); ultimately, the Qualcomm lawyers who were originally sanctioned for the discovery debacles in that hotly contested litigation were held not accountable in sanctions, the magistrate judge finding that "although a number of poor decisions were made, the involved attorneys did not act in bad faith…." *See Attorneys' Discovery Lapses in Patent Case Didn't Show Bad Faith; Sanctions Not Needed*, Law. Man. on Prof. Conduct (ABA/BNA) 220, (Apr. 14, 2010); *Qualcomm Inc. v. Broadcom Corp.*, No. 05cv1958-B (BLM), 2010 WL 1336937, at *2 (S.D. Cal. Apr. 2, 2010)). *Accord Lawson v. Sun Microsystems, Inc.*, No. 1:07-cv-196-RLY-TAB, 2010 WL 503054, at *3 (S.D. Ind. Feb. 8, 2010) (overturning sanctions because attorneys' conduct was not "wanton").

16. *Pension Comm. of Univ. of Montreal Pension Plan v. Banc of Am. Sec.*, No. 05 Civ. 9016(SAS), 2010 WL 184312 (S.D.N.Y. Jan. 15, 2010).

17. *Id*. at *3.

18. *Id*. at *12 n.99.

19. *Id*. at *24.

20. *Id*. at *23-24. For other recent cases in which counsel has been sanctioned, *see Cherrington Asia Ltd. v. A&L Underground Inc.*, 263 F.R.D. 653 (D. Kan. 2010); *Bray & Gillespie Mgmt. LLC v. Lexington Ins. Co.*, No. 6:07-cv-0222-Orl-35KRS, 2010 WL 55595, at *6-7 (M.D. Fla. Jan. 5, 2010); *In re A&M Florida Properties*, Bankruptcy No. 09-15173 (AJG), 2010 WL 1418861, at *6-7 (S.D.N.Y. Apr. 7, 2010). For other recent cases in which an adverse inference has been imposed, *see Diocese of Harrisburg v. Summix Dev. Co.*, Civ. Action No. 1:07-CV-2283, 2010 WL 2034699, at *1-2 (M.D. Pa. May 18,2010); *Kwon v. Costco Wholesale Corp.*, Civ. No. 08-00360JMSBMK, 2010 WL 571941, at *3 (D. Haw. Feb. 17, 2010); *Wilson v. Thorn Energy, LLC*, No. 08 Civ. 9009(FM), 2010 WL 1712236 (S.D.N.Y. Mar. 15, 2010.)

21. *See* C. Evan Stewart, *Will Waiving the Privilege Save It?*, N.Y. Bus. Law J., Spring 2007.

22. Traditionally, courts had faced the waiver issue by utilizing one of three standards: (i) the "strict" approach—inadvertent waiver equals waiver; (ii) the "forgiveness" approach—inadvertent waiver which is unintentional does not equal waiver; and (iii) the "balancing test" approach—a case by case analysis to determine whether the conduct was reasonable and thus exercisable. *See* Stewart, *supra* n.21. Federal Rule of Evidence 502 was designed to adopt the "balancing test" approach. *Id.*

23. *Rhoads Indus., Inc. v. Bldg. Materials Corp. of Am.*, 254 F.R.D. 216 (E.D. Pa. 2008) (*reported in* Law. Man. on Prof. Conduct (ABA/BNA) 605 (Nov. 26, 2008)).

24. These five factors are also identified in the Advisory Committee Notes to Rule 502 of the Federal Rules of Evidence.

25. For example, the judge found that Rhoads did not use additional search terms to weed out privileged materials. Also, Rhoads' law firm had designated an associate to handle the document production who had no prior experience doing a privilege review (and the firm had no senior lawyer overseeing the inexperienced associate).

26. *Rhoads Indus., Inc.,* 254 F.R.D. at 606. The district court then mitigated the impact of its ruling, noting that the defendant would be receiving a large number of privileged communications anyway because Rhoads' attorneys had mishandled the privilege log.

27. *Sitterson v. Evergreen Sch. Dist. No. 114*, 196 P.3d 735 (Wash. Ct. App. 2008) (*reported in* Law. Man. on Prof. Conduct (ABA/BNA) 635 (Dec. 10, 2008)).

28. *Compare Mt. Hawley Ins. Co. v. Felman Prod. Inc.*, No. 3:09-CV-00481, 2010 WL 1990555 (S.D. W. Va. May 18, 2010) (attorney/client precautions *not reasonable*) *with Edelen v. Campbell Soup Co.*, 265 F.R.D. 676 (N.D. Ga. 2010) (attorney/client precautions *reasonable*).

29. *See, e.g.*, C. Evan Stewart, *How One Bad Ruling Can Spoil a Whole Bunch of Cases*, N.Y. Law J., Jan. 8, 2009.

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Inside the Courts: An Update on Securities Litigation

By Matthew J. Matule, Edward B. Micheletti and Peter B. Morrison

U.S. SUPREME COURT

Foreign Corporations

Supreme Court Rules Against "Foreign-Cubed" Claims in U.S. Jurisdictions

***Morrison v. Nat'l Australia Bank Ltd.*, No. 08-1191 (U.S. June 24, 2010)**

In a five-justice majority opinion authored by Justice Antonin Scalia, the Supreme Court held that Section 10(b) of the Securities Exchange Act does not provide a cause of action for so-called "foreign-cubed" claims—those brought by foreign plaintiffs, against foreign corporations, over securities purchased on a foreign exchange. Instead, Section 10(b) only applies to "transactions in securities listed on domestic exchanges, and domestic transactions in other securities." That new bright-line rule overturns the "conduct" and "effects" tests originated by the Second Circuit Court of Appeals and applied by other courts throughout the country to determine whether Section 10(b) applied extraterritorially.

The plaintiffs, all Australian citizens, claimed that National Australia Bank, its American subsidiary HomeSide, and certain individual directors and officers violated Section 10(b) because HomeSide allegedly manipulated its financial models to inflate the apparent value of the mortgage servicing rights it owned. The Supreme Court held that because Section 10(b) applies only to "transactions in securities listed on domestic exchanges, and domestic transactions in other securities," it cannot apply to "foreign-cubed" claims. Based on the "long and often cited" presumption that federal laws do not apply extraterritorially, the Supreme Court rejected the "conduct test" (*i.e.*, whether the alleged misconduct occurred in the U.S.) and "effects test" (*i.e.*, whether the alleged misconduct had a substantial effect in the U.S. or on American citizens). The Supreme Court found those two tests unsupported by statute because the focus of the Securities Exchange Act is upon securities purchased and sold in the United States—and not upon the place where the deception originated. The Court also noted that extraterritorial application of the Securities Exchange Act risked turning the U.S. into "the Shangri-La of class-action litigation for lawyers representing those allegedly cheated in foreign securities markets" and further noted that limiting extraterritorial application would not render the U.S. a "Barbary Coast" for those alleged to have perpetrated fraud on a foreign security market.

Public Company Accounting Oversight Board

Justices Hold PCAOB Removal Provisions Unconstitutional

***Free Enter. Fund v. Pub. Co. Accounting Oversight Bd.*, No. 08-861 (U.S. June 28, 2010)**

In a 5-4 opinion authored by Chief Justice John Roberts, the Supreme Court addressed for the first time the constitutionality of the Public Company Accounting Oversight Board (PCAOB)—a creation of the Sarbanes-Oxley Act of 2002—under separation of powers doctrine and the Appointments Clause. The Supreme Court left in place the PCAOB's substantive powers under the Sarbanes-Oxley Act to promulgate auditing and ethics standards, issue punitive and monetary sanctions in disciplinary proceedings, and revoke the registration of public accounting firms that audit public companies. However, the Supreme Court held unconstitutional the portions of the Sarbanes-Oxley Act that make PCAOB members removable only for cause by the Securities and Exchange Commission, the commissioners of which can only be removed for cause by the president. The PCAOB removal provisions contravene separation of powers principles by impermissibly insulating inferior executive officers from the president's control, but those removal provisions could be severed from the remainder of the Sarbanes-Oxley Act (by making the PCAOB members serve at the pleasure of the SEC). The court recognized that the president might find it useful to cede the PCAOB's direct accountability for policy reasons, but that policy choice was not determinative because separation of powers does not depend "on whether the encroached-upon branch approves the encroachment." Finally, the Supreme Court also concluded that the manner in which PCAOB members are appointed—by the SEC—does not violate the Appointments Clause, because the members are inferior officers whose appointment Congress may constitutionally vest in the "Head of a Department," rather than in the President with the Senate's advice and consent, and the SEC commissioners, taken together, constitute a "Head."

Statute of Limitations

Supreme Court Clarifies Section 1658(b)'s Two-Year Limitations Period

***Merck & Co., Inc. v. Reynolds*, No. 08-905 (U.S. Apr. 27, 2010)**

In a six-justice majority opinion authored by Justice Stephen Breyer, the Supreme Court construed 28 U.S.C.

Section 1658(b), the statute of limitations and repose governing private rights of action under Section 10(b) of the Securities Exchange Act of 1934—claims of "fraud, deceit, manipulation, or contrivance in contravention of a regulatory requirement concerning the securities laws." The Court rejected what was commonly known as the "inquiry notice" standard and held that Section 1658(b)'s two-year limitations period begins to run when a plaintiff discovers, or a reasonably diligent hypothetical plaintiff would have discovered, facts constituting the underlying violation, including scienter—whichever occurs earlier. The applicable two-year statute of limitations begins to accrue not just upon actual discovery but also when a reasonably diligent plaintiff would have discovered facts constituting the underlying alleged violations, regardless of whether any investigation was actually conducted. For purposes of the statute of limitations analysis, the use by Congress of the word "discovery" in Section 1658(b) means that the limitations period begins upon the earlier discovery "not only [of] those facts the plaintiff actually knew, but also those facts a reasonably diligent plaintiff would have known." (In his concurring opinion, Justice Antonin Scalia argued against implying a constructive-discovery rule for a Section 10(b) claim, pointing to the explicit language in Section 13 of the Securities Act (applicable to claims alleging violations of Sections 11 and 12) creating a constructive-discovery rule. In addition, he recognized that a constructive-discovery standard may be easier to apply to Section 11 and 12 claims.) Further, in light of the heightened pleading requirements for scienter in Section 10(b) claims, "facts showing scienter" are among those that must be discovered before the limitations period begins to run because "unless a [Section] 10(b) plaintiff can set forth facts in the complaint showing that it is at least as likely as not that the defendant acted with the relevant knowledge or intent, the claim will fail." The plaintiffs otherwise would be required to sue before they had facts necessary to plead scienter with specificity to avoid a limitations-period bar. However, the Supreme Court did not address whether a plaintiff must also have discovered facts relating to other elements of a private right of action such as reliance, losses and loss causation, leaving these issues for further percolation through the courts. Finally, "inquiry notice"—*i.e.*, the point "where the facts would lead a reasonably diligent plaintiff to investigate further"—may occur before discovery of the facts constituting the Section 10(b) claim, and accordingly such notice is no longer determinative of when a claim accrues and the limitations period commences. However, "inquiry notice" does bear upon the question of whether a reasonably diligent plaintiff would have been prompted to investigate a potential violation.

AUDITOR LIABILITY

S.D.N.Y. Dismisses Claims Related to Feeder Fund Investments with Madoff

***In re Tremont Sec. Law, State Law & Ins. Litig.*, No. 09 md 2052 (S.D.N.Y. Mar. 30, 2010)**

Judge Thomas P. Griesa of the U.S. District Court for the Southern District of New York dismissed claims that KPMG and Ernst & Young, the auditors of feeder funds that invested part of their assets with Bernard Madoff, violated Section 10(b) of the Securities Exchange Act by failing to detect Madoff's fraud and failing to notify investors of the risks associated with investing in the funds. The court determined that the complaint failed to plead that the auditors acted with scienter because the auditors only audited the financial statements of the feeder funds investing with Madoff, and were not engaged to audit Madoff's business or to issue an opinion on the financial statements of Madoff's investment firm. Further, although the complaint attempted to plead scienter based on the auditors' alleged ignorance of purported red flags, the more compelling inference was that the auditors did not uncover Madoff's fraud because of his proficiency in covering up his scheme.

CLASS ACTION FAIRNESS ACT

Second Circuit Dismisses Appeal of CAFA Remand Order for Lack of Jurisdiction

***Greenwich Fin. Servs. Distressed Mortgage Fund 3 LLC v. Countrywide Fin. Corp.*, No. 09-3660-cv (2d Cir. Apr. 20, 2010)**

The U.S. Court of Appeals for the Second Circuit determined it lacked jurisdiction to hear Countrywide's appeal of the district court's remand order under the Class Action Fairness Act of 2005. The plaintiffs—owners of certificates in trusts created by Countrywide that owned Countrywide-originated mortgages—sued Countrywide over the modification of certain mortgages owned by those trusts pursuant to a settlement with state attorneys general. Countrywide had removed the case to federal court, based on CAFA diversity jurisdiction and federal question jurisdiction, but the federal district court remanded because it lacked jurisdiction. Although an order remanding a case to state court may not ordinarily be appealed, federal appeals courts may hear appeals of orders remanding class actions to state court. However, federal appeals courts lack jurisdiction to hear appeals of remand orders if the remanded class action "solely involves" "a claim that relates to the rights, duties (including fiduciary duties), and obligations relating to or created by or pursuant to any security (as defined under section 2(a)(1) of the Securities Act of 1933 (15 U.S.C. 77b(a)(1)) and the regulations issued thereunder)." The court explained that because the district court remanded under the equivalent exception to federal jurisdiction, it would construe the two provisions together and determine either that (1) the district court incorrectly applied the exception and so the court had jurisdiction to reverse the remand order or (2) the district court lacked jurisdiction under this exception and so the appeals court similarly lacks jurisdiction to review the remand order. The court further explained that this exception applies to claims over "instruments that create and define securities," *e.g.*, certificates of incorporation or bond indentures. The plaintiffs claimed that the agreements creating the trusts required Countrywide to buy back from the trusts the mortgages it wished to modify before they could be modified. Because the plaintiffs' only claim was to enforce an instrument creating their securities and sought no other relief, the court determined that the class action "solely involve[d]" a claim "that relates to the rights, duties…and obligations relating to [a] security." As such, the appeal was dismissed for lack of jurisdiction.

CLASS CERTIFICATION

Washington Federal Court Finds "In-and-Out" Traders Typical

***McGuire v. Dendreon Corp.*, No. C07-800 (W.D. Wash. May 27, 2010)**

Judge Marsha J. Pechman of the U.S. District Court for the Western District of Washington certified a class action brought against Dendreon, a biotechnology company developing a cancer treatment product, and certain of its officers and directors. The complaint alleged that the defendants misrepresented the results of an FDA inspection of Dendreon's manufacturing facilities, and that one of its directors engaged in insider trading when he sold Dendreon stock with full knowledge of the results of the inspection and before the results were publicly disclosed. Dendreon allegedly told investors that "we hosted a good inspection," despite the FDA's finding that there were "significant objectionable conditions" in its inspection. The plaintiffs sought to certify a class of all investors and a subclass consisting of people who purchased Dendreon stock on the date one of its directors sold his shares.

Applying the standard recently enunciated by the Ninth Circuit in *Dukes v. Wal-Mart Stores, Inc.*, 603 F.3d 571 (9th Cir. 2010) (en banc), the district court certified a class and subclass. The district court rejected Dendreon's argument that so-called "in-and-out traders," who purchased or sold before the issuance of Dendreon's corrective disclosure, should be excluded from the class. Judge Pechman noted that after the Supreme Court's decision in *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005), courts have struggled with "whether *Dura*'s discussion of inflated purchase price as it relates to loss causation overturns the Ninth Circuit's rule," enunciated in *Wool v. Tandem Computers Inc.*, 818 F.2d 1433 (9th Cir. 1987), that in-and-out traders may be included in a class. The court noted that the Second Circuit, the only circuit to address the issue, "declined to include in-and-out traders in a class action on a motion for class certification" and that "[d]istrict courts in the Ninth Circuit have been in conflict with each other over whether in-and-out traders are appropriately included." The court ultimately approved a class that includes in-and-out investors, finding that "*Dura* only relates to how loss causation needs to be pled in the complaint," not "the class definition at the class certification stage."

The district court also rejected the defendants' argument that the lead class member of the subclass was not typical because he did not rely on the market price when purchasing his shares. As a threshold matter, the court explained that "the Ninth Circuit has emphasized that 'the defense of non-reliance is not a basis for denial of class certification.'" In addition, the court found that the lead plaintiff's purportedly atypical beliefs about short sellers suppressing the stock price and rigging the market "simply indicates that he (a 'long seller') believed the stock was undervalued, not that he did not rely on Dendreon's misrepresentations." The district court also rejected the defendants' argument that this plaintiff was inadequate because he lacked sufficient familiarity with the case, explaining that "while [the lead plaintiff] may not know the judge's last name or the legal terms of art, he does know that Dendreon made misrepresentations, members of the class bought shares in reliance on that misrepresentation, and members of the class lost money when the misrepresentation was revealed."

DIRECTORS AND DIRECTORS' DUTIES

Books and Records

Court of Chancery Dismisses Two Section 220 Actions

***King v. VeriFone Holdings, Inc.*, C.A. No. 5047-VCS, 2010 WL 1904972 (Del. Ch. May 12, 2010)**

***Baca v. Insight Enters., Inc.*, C.A. No. 5105-VCL (Del. Ch. June 3, 2010)**

In *King v. VeriFone Holdings, Inc.*, Vice Chancellor Leo E. Strine Jr. of the Delaware Court of Chancery dismissed a Section 220 books and records action for failing to state a proper purpose as required under the DGCL. In 2007, VeriFone Holdings Inc. announced that it would restate its financial statements for the first three quarters of 2007. A number of securities suits were filed promptly. One putative shareholder filed a derivative action in federal district court a mere 11 days after the announcement, asserting failure of oversight (so-called "*Caremark*") claims and seeking, among other things, to hold certain directors and officers liable to indemnify VeriFone for damages or costs incurred in the securities suits. King's derivative suit was first filed, and King's counsel was appointed lead counsel in the consolidated derivative actions. King's derivative complaint was eventually dismissed without prejudice and, thereafter, King made a books and records demand upon VeriFone. Unable to reach agreement over requested documents with VeriFone, King filed this Section 220 action. His stated purpose for this action was to "help him plead a viable claim for demand excusal" in the derivative action.

Vice Chancellor Strine dismissed King's Section 220 action because King had not stated a proper purpose. First, the court characterized King's Section 220 proceeding as "a costly, inefficient end-run around the discovery rules applicable in the derivative action that he, and no one else, chose to initiate against VeriFone." In particular, the court acknowledged "the case law interpreting Federal Rule of Civil Procedure 23.1 generally precludes a derivative plaintiff from suing first, and then begging for discovery to aid him in pleading a viable demand excusal complaint." Second, the court remarked that "[y]oking this Court as an adjunct to another Court thousands of miles away wastes scarce judicial resources through repetitive litigation, and exposes the corporation and its shareholders to unnecessary additional defense costs." The court further noted that King had not identified any reason to make an exception to the policy that generally prevents the inefficiencies of litigating in multiple forums. Third, "and perhaps most importantly, to allow King to use § 220 in an after-the-fact manner to bolster his derivative complaint exacerbates the perverse incentives motivating too many representative plaintiffs' unseemly and inefficient race to the courthouse." Ultimately, in dismissing King's action the court noted that "[f]or years our [Delaware] Supreme Court has made clear that derivative plaintiffs should seek books and records and otherwise conduct an adequate investigation into demand excusal *before* rushing off to file a derivative complaint."

Less than one month later, in *Baca v. Insight Enterprises, Inc.*, Vice Chancellor J. Travis Laster of the Delaware Court of Chancery adopted Vice Chancellor Strine's reasoning in *King* to dismiss a books and records action similarly commenced after the plaintiff filed a derivative action in federal district court. Vice Chancellor Laster held that "[f]or reasons explained thoroughly in *King*, a stockholder does not act with a proper purpose when the stockholder attempts to use Section 220 to investigate matters that the same stockholder already put at issue in a plenary derivative action. Analyzed at the level of the individual plaintiff, the stockholder who serves a post-plenary-action Section 220 demand contradicts his own certification that he already possessed sufficient information to file a complaint. Analyzed doctrinally, permitting a post-plenary-action Section 220 demand circumvents the substantive legal principles embodied in Rule 23.1. Analyzed systemically, permitting a post-plenary-action Section 220 demand rewards entrepreneurial plaintiffs' lawyers who file quickly to gain control of a derivative case without conducting a meaningful pre-suit investigation."

Demand Futility

S.D.N.Y. Dismisses Class Claims Related to Mutual Fund's Investments in Offshore Gambling Company

***Seidl v. Am. Century Cos., Inc.*, No. 08 Civ. 8857 (DLC) (S.D.N.Y. May 7, 2010)**

Judge Denise Cote of the U.S. District Court for the Southern District of New York dismissed purported class claims that a mutual fund breached its fiduciary duties to its shareholders, because the plaintiff failed to adequately plead demand futility. The plaintiff claimed the mutual fund, the directors of the corporation managing that fund and that fund's investment advisor invested in an offshore gambling company despite knowing (or recklessly not knowing) that the company took bets from American gamblers in violation of United States law. Applying Maryland law (the fund manager's state of incorporation), the court determined that the purported claims were derivative claims on behalf of the corporation because suits to enforce fiduciary duties only may be brought by a corporation, directly or derivatively. Further, the court determined that the plaintiff failed to adequately plead demand futility in accordance with controlling Maryland law because the plaintiff did not specifically plead that irreparable harm would occur to the corporation by waiting for a response to the demand or that the directors would be so conflicted that they could not exercise business judgment. As to the directors' inability to exercise business judgment, the directors' failure to take legal action in the two years after the value of the investment declined did not demonstrate that they could not exercise good faith business judgment, and the plaintiff did not specifically allege that the directors were involved in the decision to invest in the offshore gambling company or that the directors could be exposed to criminal liability for approving investing in the offshore gambling company.

Mergers & Acquisitions

Delaware Supreme Court Affirms Dismissal of Case Related to Redemption of Shares Before Merger

***Nemec v. Shrader*, 991 A.2d 1120 (Del. 2010)**

The Delaware Supreme Court affirmed the Court of Chancery's dismissal of the plaintiffs' claims against the Booz Allen board of directors for breach of the implied covenant of good faith and fair dealing, breach of fiduciary duty and unjust enrichment. Two retired employees of Booz Allen, who held shares pursuant to an officers' stock rights plan, brought suit alleging that the company's directors breached the implied covenant of good faith and fair dealing inherent in the stock rights plan and breached their fiduciary duty of loyalty by redeeming their shares shortly before a merger. This redemption added nearly $60 million to the proceeds received by the balance of the Booz Allen stockholders (which included the Booz Allen directors exercising the redemption rights on behalf of the company). In addition, the redemption deprived the plaintiffs of the opportunity to participate in the merger consideration. The Court of Chancery dismissed the plaintiffs' claims in their entirety.

In a split decision, a majority of the Delaware Supreme Court affirmed the Court of Chancery's decision. As to the implied covenant of good faith and fair dealing claim, the court stated that "[o]ne generally cannot base a claim for breach of the implied covenant on conduct authorized by the agreement." The court explained that it would only employ the covenant to imply contractual terms where one party proves that the other party had acted "arbitrarily or unreasonably, thereby frustrating the fruits of the bargain that the asserting party reasonably expected." Examining the parties' reasonable expectations at the time of contracting, the court found that the plaintiffs "lacked a reasonable expectation of participating in the benefits of the [merger] transaction." The majority reiterated that "Delaware's implied duty of good faith and fair dealing is not an equitable remedy for rebalancing economic interests after events that could have been anticipated, but were not, that later adversely affected one party to a contract."

The majority also held that the plaintiffs' breach of fiduciary duty claims "seek [] to enforce obligations that are expressly addressed by contract (the Stock Plan) and that, therefore, must be adjudicated within the analytical framework of a breach of contract claim." The plaintiffs argued that their fiduciary duty claim was grounded on the additional fact that the directors were the persons responsible for the company's redemption decision and "stood to gain personally from that decision." The court found the plaintiffs' position lacked merit, explaining that "[e]ven though the Directors caused the Company to redeem the plaintiffs' shares when it did, the fiduciary duty claim still arises from a dispute relating to the exercise of a *contractual* right.… As a consequence, the nature and scope of the Directors' duties when causing the Company to exercise its right to redeem shares covered by the Stock Plan were intended to be defined solely by reference to that contract."

Court of Chancery Denies Request to Enjoin "Squeeze-Out Tender Offer"

***In re CNX Gas Corp. S'holders Litig.*, C.A. No. 5377-VCL (Del. Ch. May 25, 2010)**

Vice Chancellor J. Travis Laster of the Delaware Court of Chancery denied a request by minority stockholder plaintiffs to enjoin a so-called "squeeze-out tender offer" by a controlling shareholder, but held that the entire fairness standard of review would apply in connection with any claims brought post-merger for damages. Defendant Consol Energy, Inc., the majority owner of defendant CNX Gas, agreed to commence a tender offer to acquire the outstanding public shares of CNX Gas. The tender offer was to be followed by a short-form merger, and was subject to a non-waivable condition that a majority of the minority shares be tendered, including the shares of T. Rowe Price, CNX Gas' largest minority shareholder (with 6.3 percent ownership), and CONSOL's third-largest shareholder (with 6.5 percent ownership). CNX Gas formed a special committee (comprised of its sole independent director) to evaluate the transaction; it was authorized only to review and evaluate the tender offer and engage advisors—not to negotiate or approve the terms of the tender offer or consider alternatives. The special committee determined to remain neutral with respect to the tender offer. CNX Gas' minority shareholders moved to enjoin the tender offer, and argued that it should be reviewed under the entire fairness standard.

In this opinion, the Court of Chancery applied what is described as the "unified standard for reviewing controlling stockholder freeze-outs described in *In re Cox Communications, Inc. Shareholders Litigation*.…" As the court explained, under this standard the business judgment rule presumptively applies to a two-step freeze-out tender offer if the transaction is (1) negotiated and affirmatively recommended by a special committee of independent directors and (2) conditioned on the affirmative vote (or tender) of a majority of the minority shares. Applying the unified standard to the facts before it, the court concluded that the tender offer was not subject to the business judgment rule because the special committee did not recommend in favor of the transaction. The court held that "[t]hat fact alone is sufficient to end the analysis and impose an obligation on CONSOL to pay a fair price." The court went on to note that the special committee was not provided with authority comparable to what a board would possess in a third-party transaction, including the ability to adopt a rights plan, or "to provide the subsidiary with time to respond, negotiate, and develop alternatives."

The court also noted that the plaintiffs had "raised sufficient questions about the role of T. Rowe Price to undercut the effectiveness of the majority-of-the-minority tender condition." Specifically, because T. Rowe Price owned 6.5 percent of CONSOL's outstanding stock and 6.3 percent of CNX Gas' outstanding stock, it had "materially different incentives" with respect to the tender offer than a holder of CNX Gas stock, "thereby calling into question the effectiveness of the majority-of-the-minority condition."

Although the court concluded that the plaintiffs had established a reasonable likelihood of success on the merits of their substantive claims, it refused to enjoin the tender offer because the plaintiffs' disclosure claims were meritless, and an injunction might deprive minority stockholders of the opportunity to accept a premium offer.

Court of Chancery Enjoins Proposed Acquisition Based Upon Misleading Disclosures

***Maric Capital Master Fund, Ltd. v. PLATO Learning, Inc.*, No. 5402-VCS (Del. Ch. May 13, 2010)**

Vice Chancellor Leo E. Strine Jr. of the Delaware Court of Chancery enjoined a proposed acquisition of PLATO Learning, Inc. by Thoma Bravo, LLC for $5.60 per share. The plaintiff had argued that the defendants failed to comply with their so-called "*Revlon*" duties, and that this failure supported the issuance of an injunction against the closing of the merger. In an earlier bench ruling, the Court of Chancery held that the plaintiff had not established a reasonable probability of success on the *Revlon* claim and that it did not constitute grounds for an injunction. In this subsequent written opinion, the court addressed the plaintiff's claim that the proxy statement was materially misleading, and concluded that the shareholder vote scheduled to occur in six days should be enjoined until satisfactory disclosures are made.

The Court of Chancery granted the injunction for three reasons. First, the court held that the disclosures relating to the discounted cash flow (DCF) analysis used by PLATO's investment banker were misleading. The proxy disclosed that the banker derived the discount rate used for the DCF analysis "based upon an analysis of [PLATO's] weighted average cost of capital." The proxy also disclosed, without further explanation, that the discount rate range was 23-27 percent. However, the banker provided PLATO's special committee with a discount rate range that was lower than the range disclosed in the proxy. The banker's explanation for why it used a higher discount rate range than the one it generated and provided to the special committee was not disclosed in the proxy. For these reasons, the court believed corrective disclosure on these points was necessary. Second, the court held that additional disclosure relating to projections and PLATO's future performance was needed. Specifically, the court found that the proxy "for some inexplicable reason excised the free cash flow estimates that had been made by PLATO's management" and were provided to PLATO's banker. The court further noted that "[a]lthough I recognize that there is a legitimate concern about the prolixity of proxy statements and that reasonable minds might differ on this issue, in my view, management's best estimate of the future cash flow of a corporation that is proposed to be sold in a cash merger is clearly material information." Third, the proxy statement also misleadingly stated that "'in reaching their decision to approve the merger and the merger agreement,' PLATO's special committee and board considered 'the fact that Thoma Bravo did not negotiate terms of employment, including any compensation arrangements or equity participation in the surviving corporation, with PLATO's management for the period after the merger closes.'" However, PLATO's CEO had discussions with Thoma Bravo about typical equity incentive packages that Thoma Bravo provided to management of acquired companies. During those discussions, PLATO's CEO specifically asked whether Thoma Bravo liked to retain management, and was assured that Thoma Bravo typically liked to keep existing management after an acquisition. Thus, the proxy statement "creates the materially misleading impression that management was given no expectations regarding the treatment they could receive from Thoma Bravo."

The court enjoined the transaction until "timely and satisfactory disclosures are made in a way that gives the PLATO stockholders adequate opportunity to digest them before a final merger vote."

ERISA

Illinois Federal Court Grants Baxter Summary Judgment in ERISA Class Action

***Rogers v. Baxter Int'l Inc.*, No. 1:04-cv-06476 (N.D. Ill. May 3, 2010)**

Judge Joan B. Gottschall of the U.S. District Court for the Northern District of Illinois granted the defendants' motion for summary judgment disposing of a class action brought against Baxter, two committees of Baxter's 401(k) plan and two Baxter officers. The plaintiff alleged that the defendants breached their fiduciary duties to participants in the 401(k) plan by, among other things, allowing plan assets to be invested in Baxter's purportedly "artificially inflated" stock. The court held that ERISA's Section 404(c) safe harbor provision relieved the defendants of any liability for most of the alleged breaches of fiduciary duty. The defendants qualified for protection under Section 404(c)'s safe harbor because, among other things, the plan gave participants "sufficient information to make informed investment decisions." Critical to its finding, the court noted that the defendants provided more than the statutorily required "general description" of the Baxter Common Stock Fund and that the plaintiff had not "shown that Plan fiduciaries affirmatively concealed facts from Plan participants." The court rejected the plaintiff's argument that its breach of fiduciary duty claim based on "mismanagement of plan assets" was outside the purview of Section 404(c)'s safe harbor, concluding that the harm alleged "was the result of individual participants' acquisitions of Baxter common stock, not of defendants' conduct." In addition, the court held that the plaintiff's claim that the defendants breached their fiduciary duties by making misstatements and omissions, even if not barred by the safe harbor, failed as a matter of law. The court explained that "[w]ithout a specific reference to or evidence of a misstatement or omission, the court cannot conclude that a triable issue of fact supports [plaintiff's] claim that defendants are liable for omissions or misstatements."

FTCA

California Federal Court Tosses Madoff Investors' Suit Against the SEC

***Dichter-Mad Family Partners LLP v. United States*, No. 09-CV-9061 (C.D. Cal. Apr. 20, 2010)**

Judge Stephen V. Wilson of the U.S. District Court for the Central District of California dismissed for lack of subject matter jurisdiction an action asserting claims under the Federal Tort Claims Act (FTCA) brought against the SEC by plaintiffs seeking to recover their losses from their investments with Bernard Madoff. Specifically, the court held that the action was barred by the FTCA "discretionary function exception," which precludes liability for "'[a]ny claim based upon an act or omission of an employee of the Government…based upon the exercise or performance or the failure to exercise or perform a discretionary function or duty on the part of a federal agency or an employee of the Government, whether or not the discretion involved be abused.' 28 U.S.C. Section 2680(a)."

The court explained that whether FTCA's "discretionary function exception" applies and provides a shield of immunity depends on a two-step inquiry to determine if the challenged action "involves an element of judgment" and, if so, "whether that judgment is of the kind that the discretionary function exception was designed to shield." The court relied on case law, statutory analysis and legislative history to reach its finding that the SEC investigators' decisions of when and how to conduct investigations were discretionary and grounded in policy, and so fell squarely within the "discretionary function exception." Key to its analysis was the use of permissive language in Section 21 of the Securities Exchange Act, which establishes the SEC's investigatory powers and explicitly grants the SEC discretion in undertaking its investigations. The analysis in *United States v. Gaubert*, 499 U.S. 315 (1991) supported the court's finding that day-to-day regulatory decisions like the challenged SEC investigatory measures may be shielded from liability by the discretionary function exception where "the routine or frequent nature of a decision [is not] sufficient to remove an otherwise discretionary act from the scope of the exception, [since otherwise] countless policy-based decisions by regulators…would be actionable." The government met its threshold burden of showing that the contested investigative and enforcement decisions were "discretionary and/or susceptible to policy judgments," creating a strong presumption under *Gaubert* that the discretionary function exception was satisfied. The plaintiffs' attempt to rebut the presumption failed as they were unable to identify particular acts that were either "(1) mandatorily prescribed by statute, regulation, or policy, or (2) were not 'susceptible to policy analysis.'" The court deemed the plaintiffs' allegations "conclusory" and lacking "any plausible allegation revealing that the SEC violated its clear, non-discretionary duties, or otherwise undertook a course of action that is not potentially susceptible to policy analysis." Without that showing, the discretionary function exception barred the plaintiffs' claims.

The court, nevertheless, granted the plaintiffs leave to amend the complaint to incorporate "plausible factual allegations showing that the SEC failed to conform to its mandatory duties," but cautioned the plaintiffs to avoid "submitting additional conclusory allegations." However, as the plaintiffs did not meet the pleading standards under *Twombly*, the court denied their request for discovery, noting that "Plaintiffs have failed to consult the voluminous public record that might bolster their conclusory assertions or potentially contradict them."

INVESTMENT COMPANY ACT

Maryland Federal Court Dismisses Anti-Pyramiding Claims Brought by Investment Company

***Gabelli Global Multimedia Trust Inc. v. W. Inv. LLC*, No. RDB 10-0557 (D. Md. Apr. 1, 2010)**

Judge Richard D. Bennett of the U.S. District Court for the District of Maryland dismissed claims that Western Investment and three investment companies it controls violated Section 12(d)(1)(A)(i) of the Investment Company Act, because there is no private right of action under that section. The plaintiff, another investment company, alleged that the defendants violated Section 12(d)(1)(A)(i)'s anti-pyramiding provision (which prohibits any investment company from owning more than 3 percent of another investment company) by effectively acquiring more than 3 percent of the plaintiff. The court applied the analysis in the Supreme Court's decision in *Alexander v. Sandoval*, 532 U.S. 275 (2001), to determine that Congress did not create a private right of action under Section 12(d)(1)(A)(i). First, the Investment Company Act protects individuals who invest in investment companies, and not investment companies themselves, and as such the anti-pyramiding provision must be interpreted in that light. Moreover, because the anti-pyramiding provision prohibits all interfund investments over 3 percent, the plaintiff—an investment company—lacked standing to assert a violation of Section 12(d)(1)(A)(i). Second, Section 12(d)(1)(A)(i) does not indicate an intent to create a private right of action, because it is not phrased in terms of the persons protected; instead, the statute is directed solely at imposing regulations on investment companies. Further, Section 12(d)(1)(A)(i) does not include a remedy for its violation, especially in comparison to other remedial mechanisms in the Investment Company Act (including the later-added Section 36(b), with an explicit private right of action). Finally, the court also recognized that the plaintiffs could not assert a Section 48(a) claim (for control person liability against the sole individual who controlled Western Investment) because there is also no private right of action under Section 48(a).

LOSS CAUSATION

Georgia Federal Court Tosses Shareholder Suit Against HomeBanc Executives

***In re HomeBanc Corp. Sec. Litig*., No. 1:08-cv-1461-TCB (N.D. Ga. Apr. 13, 2010)**

Judge Timothy C. Batten Sr. of the U.S. District Court for the Northern District of Georgia dismissed putative class claims that HomeBanc's CEO and COO/CFO violated Section 10(b) of the Securities Exchange Act by making allegedly false or misleading statements in SEC filings and conference calls about HomeBanc's underwriting standards, loan loss reserve model, purchase of mortgage-backed securities, pace and quality of loan originations, focus on purchase money mortgages, risk management practices, internal controls and other mortgage-origination/purchasing practices. The court determined that the complaint failed to plead loss causation because it did not allege facts establishing the elements of loss causation, how the purported fraud was revealed (as the alleged corrective disclosure did not state that the earlier statements were "in any way tainted by misconduct"), or why the decline in HomeBanc's stock price was caused by alleged misconduct and not by the general collapse of the mortgage industry. Further, although the gravamen of the complaint was that HomeBanc's forward-looking statements expressed an "overly optimistic view of the future" (*e.g.*, HomeBanc's stated belief that its "reputation" and "focus on high-quality" loans, among other things, would ultimately "provide [it] with significant advantages"), the court recognized that the forward-looking statements were accompanied by extensive meaningful cautionary language, warning about "a challenging credit market" and "uncertaint[ies] and risks endemic to its industry," which effectively "erode[d]" the complaint's essential allegations. The court also recognized that the complaint did not plead a material misrepresentation (as none of HomeBanc's alleged misrepresentations caused a spike in HomeBanc's stock price or trading volume) or scienter (as there was a "complete absence" of allegations about a financial restatement, auditor concerns, insider stock sales or the defendants' motive to defraud).

PSLRA SAFE HARBOR PROVISION

Second Circuit Affirms Dismissal of Case Against American Express

***Slayton v. Am. Express Co.*, No. 08-5442-cv (2d Cir. May 18, 2010)**

The U.S. Court of Appeals for the Second Circuit affirmed the dismissal of purported class claims that American Express and certain executives violated Section 10(b) of the Securities Exchange Act. In a Form 10-Q, American Express had disclosed a $182 million first-quarter write-down on its high-yield debt portfolio and represented that total losses in the rest of the year "are expected to be substantially lower than in the first quarter." Basing its allegations upon a *Wall Street Journal Asia* article, the complaint alleged that American Express' CEO knew when the 10-Q was filed that this statement was false. The sole issue on appeal was whether the statement was subject to the PSLRA safe harbor, which provides complete protection from liability for (1) identified forward-looking statements that are accompanied by meaningful cautionary statements or (2) statements that are made without actual knowledge of their falsity. The court explained as a threshold matter that although the statement was included in a Form 10-Q, it was included in the management discussion and analysis section, and not the financial results section, and consequently could be subject to PSLRA forward-looking statement safe-harbor protection. The court determined that the first prong of the PSLRA safe harbor did not apply because the statement was not accompanied by meaningful cautionary statements; the accompanying cautionary statements were boilerplate and not tailored to specific future projections. However, the statement was still subject to the second prong of the PSLRA safe harbor, and therefore inactionable, because the complaint failed to adequately plead that the challenged statement was made with actual knowledge that it was false or that there was no reasonable basis for the statement. The *Wall Street Journal Asia* article—the sole basis for the complaint's allegations—did not support a contention that the defendants had reason to believe that its future write-downs on the high-yield debt would be as high as its first-quarter write-down, and, in fact, the article recognized that American Express' CEO was "stunned" to learn what the losses would be following American Express' own internal conservative evaluation of potential losses two months after the challenged statement was made. Although "a close case," the court concluded that the more compelling inference was not suggestive of scienter but rather that American Express was engaging in a good-faith effort to inform itself and the public of the risks associated with its high-yield debt portfolio.

SANCTIONS

Georgia Federal Court Denies Motion for Sanctions in Case Regarding ARS Collapse

***Zisholtz v. SunTrust Banks, Inc.*, No. 1:08-CV-1287-TWT (N.D. Ga. May 14, 2010)**

Following dismissal of purported class claims alleging violations of Rule 10b-5, Judge Thomas W. Thrash denied the defendants' motion for sanctions under the PSLRA. The plaintiffs, on behalf of a purported class, claimed that SunTrust Banks and one of its subsidiaries had made false or misleading statements about the nature of auction rate securities (ARS). In moving for sanctions, the defendants claimed that two of the plaintiffs' allegations lacked evidentiary support: (1) that they purchased ARS from SunTrust Robinson Humphrey and (2) that they (and putative class members) were harmed by the collapse of the ARS market. The court, however, determined that the plaintiffs had some evidentiary support for both allegations. First, in naming SunTrust Robinson Humphrey (instead of SunTrust Investment Services, which defendants stated actually sold ARS to the plaintiffs), the plaintiffs relied upon two regulatory investigations that each concluded that SunTrust Robinson Humphrey, of all SunTrust subsidiaries, had used unfair marketing materials to sell ARS. The fact that the plaintiffs' statements were issued by SunTrust Investment Services was not conclusive because they provided information about all of the plaintiffs' finances. Second, the plaintiffs had sufficient evidence to allege that they had been harmed by the ARS collapse even though their ARS had been redeemed for par value before filing suit, because after the collapse of the ARS market, they were required to either sell an investment they believed had short-term liquidity for a discount to par value or to wait with an illiquid asset until they could exchange it for par value.

S.D.N.Y. Imposes PSLRA Sanctions in Case Against Bank

***In re Austl. & N.Z. Banking Group Ltd. Sec. Litig.*, No. 08 Civ. 11278 (DLC) (S.D.N.Y. May 11, 2010)**

Following the dismissal of the amended complaint, Judge Denise Cote of the U.S. District Court for the Southern District of New York entered an order imposing PSLRA sanctions on the plaintiffs' counsel. The original complaint claimed that the defendants (Australia & New Zealand Banking Group Limited and four of its officers and directors) made allegedly false and misleading statements about the bank's financial results by failing to disclose financial difficulties at an Australian margin lender/brokerage, Opes Prime. According to the complaint, the bank was aware of Opes' financial difficulties before it entered receivership in March 2008 based upon internal e-mails purportedly dated more than a year before. Because the e-mail assertion was the only allegation concerning the bank's purported pre-receivership knowledge of Opes' financial difficulties, the court determined it was the "cornerstone" of the complaint, "infect[ing] the entire pleading." One of the attorneys who authored that complaint conceded that the allegation was false, and the court rejected his attempt to explain it as the result of misreading an article referring to e-mails as placing those e-mails in March 2007 rather than 2008. Instead, it was "objectively unreasonable" for the allegation to be made because the existence of those e-mails was material to the entire pleading. In addition, because "any reasonable inquiry" would have caught the fact that the article was referencing e-mails in March 2008, not March 2007, the misreading, coupled with "subsequent lack of diligence or further inquiry" was sanctionable as "an act of gross negligence bordering on recklessness." The court, however, gave the parties an opportunity to submit evidence on whether the sanction—awarding the defendants their reasonable attorneys fees and costs for defending the entire action—would be unreasonable or unjust.

SCIENTER

Pennsylvania Federal Court Dismisses Case Relating to Subprime Mortgage-Servicer

***In re Radian Sec. Litig.*, No. 07-3375 (E.D. Pa. Apr. 30, 2010)**

After initially dismissing with leave to amend purported class claims alleging that Radian Group and three of its officers violated Section 10(b) of the Securities Exchange Act (because scienter was not adequately pled), Judge Mary A. McLaughlin of the U.S. District Court for the Eastern District of Pennsylvania again dismissed—this time with prejudice—those amended claims. The complaint claimed that Radian allegedly misrepresented the financial condition of C-BASS (a subprime mortgage-servicer in which Radian held a 46 percent equity stake) to allow Radian to consummate a merger with another company that also held a 46 percent equity stake in C-BASS. In addition, Radian was accused of making those misrepresentations to allow its insiders to sell their Radian holdings at inflated prices. The court determined that the amended complaint did not adequately plead scienter because the market was aware of the downward trend in the subprime industry, as shown by allegations in the complaint about that trend, and which Radian had repeatedly acknowledged during the purported class period. Further, the complaint could not demonstrate scienter through statements by former C-BASS employees because those statements lacked "the required particularity" to demonstrate that the defendants knew their statements were false or misleading as they related to C-BASS's financial state and did not contradict any of the defendants' public statements. In addition, the court rejected the complaint's attempt to demonstrate scienter by focusing on the four-day period between when Radian disclosed it had provided C-BASS with an additional line of credit and when it announced that its investment in C-BASS was materially impaired. First, the court recognized that two-thirds of the lender margin calls that C-BASS received in the first half of the year were received during that period, "such that it is unsurprising that Radian announced its impairment days after." Second, whether Radian made misleading statements or omissions in a four-day period at the end of the purported six-month class period did nothing to establish a strong inference of scienter by the defendants at the beginning of that purported class period, especially as C-BASS had returned to profitability during the six months at issue. Finally, the court recognized that, under the Third Circuit's decision in *Institutional Investors Group v. Avaya*, scienter cannot be established solely through a showing of motive and opportunity, and rather there must be facts that, if true, give rise to a strong inference of reckless or conscious misbehavior.

Massachusetts Federal Court Grants Summary Judgment in Favor of Boston Scientific

***In re Boston Scientific Corp. Sec. Litig.*, No. 05-11934-DPW (D. Mass. Apr. 27, 2010)**

Judge Douglas P. Woodlock of the U.S. District Court for the District of Massachusetts granted summary judgment in favor of Boston Scientific and nine of its officers, dismissing class claims that they violated Section 10(b) of the Securities Exchange Act. The complaint alleged that the defendants failed to disclose Boston Scientific's discovery of a manufacturing "fix" to product defects for six months so that they could disclose the "good news" of problem-free batches rather than disclosing the "bad news" that current product batches were susceptible to serious problems. However, the court granted summary judgment in favor of the defendants as to the required elements of scienter, materiality and loss causation. First, although the defendants were aware of a causal relationship between a manufacturing fix and product flaw, the evidence demonstrated that Boston Scientific was not aware of a "significant risk" in waiting to submit that change to the FDA for approval. In fact, the evidence established that the defendants believed at the time that their previous corrective and preventative measures were "very effective." Moreover, the plaintiffs could not rely upon the individual defendants' trading to establish scienter because all of the transactions (including certain purchases) were made during "open windows" or under Rule 10b5-1 trading plans. Finally, there was no evidence of corporate scienter because the evidence demonstrated that Boston Scientific was cautiously and prudently attempting to understand the cause of the product defect and how to correct it. The court also determined that the evidence did not demonstrate a genuine issue of material fact as to materiality because the market was aware (1) of the manufacturing defects and (2) that Boston Scientific had identified a fix it was waiting to implement and because Boston Scientific had disclosed all of the product defects to the FDA, which were publicly available. Similarly, the plaintiffs could not establish loss causation because the mere fact that the stock price was inflated prior to the product recall was insufficient, in and of itself, to prove that the alleged misrepresentations caused the plaintiffs' economic loss.

SEC ENFORCEMENT

Sixth Circuit Agrees That Officer/Director Bar Is Remedial and Not Time-Barred

***Sec. & Exch. Comm'n v. Quinlan*, No. 08-2619 (6th Cir. Apr. 21, 2010)**

The U.S. Court of Appeals for the Sixth Circuit, in an unpublished decision, affirmed the district court's judgment permanently enjoining Patrick D. Quinlan from future violations of securities laws and barring him from serving as an officer or director of certain issuers. In the underlying action, the SEC alleged that Quinlan participated in a "large scale securities offering and accounting fraud perpetrated by senior officers and personnel of MCA Financial Corporation to buttress a failing, high-risk mortgage banking business." Quinlan challenged the district court's injunction order, arguing that the SEC's claims were filed outside of 28 U.S.C. Section 2462's five-year statute of limitations. Noting the split of authority on whether "some or all of [the SEC's] equitable remedies are exempt from § 2462's limitations period as a matter of law," the panel chose not to resolve the debate. Instead, the court found that the SEC's action against Quinlan was timely under even those authorities that have applied Section 2462's limitations period to certain equitable claims brought by the SEC. The Sixth Circuit, quoting *SEC v. Jones*, 476 F. Supp. 2d 374, 381 (S.D.N.Y. 2007), explained that those courts that have applied Section 2462 to SEC equitable claims have only done so for "'relief that seeks to punish,'" not for relief that seeks to "'remedy a past wrong or protect the public from future harm.'" In the case at bar, the district court found that the injunction and the officer/director bar would remedy a past wrong and protect the public. Accordingly, Section 2462 did not bar the SEC's equitable claims.

Tenth Circuit Affirms Permanent Injunction Against Stock Promoter

***Sec. & Exch. Comm'n v. Curshen*, No. 09-1196 (10th Cir. Apr. 13, 2010)**

In an unpublished decision, the U.S. Court of Appeals for the Tenth Circuit affirmed the district court's judgment in favor of the SEC, which found Jonathan Curshen civilly liable for violating Sections 10(b), 17(a)(1)-(3) and 17(b) of the Securities Exchange Act and SEC Rule 10b-5.

The SEC alleged that Curshen violated the securities laws by posting 35 anonymous messages on the Internet about Freedom Golf that failed to disclose that Curshen was a paid promoter of the company and sold his shares while simultaneously encouraging the public to invest. After a bench trial, the court found in favor of the SEC, enjoined Curshen from participating in penny stock offerings and violating the securities laws, and ordered Curshen to disgorge monies earned from the sale of his securities.

In affirming the district court's judgment, the Tenth Circuit rejected Curshen's argument that his messages were non-actionable "puffery." To the contrary, the messages "suggest[ed] that Mr. Curshen ha[d] personal knowledge about the company and its plans." Moreover, the Tenth Circuit suggested, without deciding, that the "puffery exception" may be limited to statements "by the corporation or someone investors would know is associated with the corporation." The Tenth Circuit further agreed that Curshen's "failure to disclose that he was being compensated for making material statements" was a material omission. Next, the court rejected Curshen's argument that the SEC failed to prove with admissible evidence that he received compensation for promoting Freedom's stock. The panel also agreed with the district court that a former co-defendant's prior deposition testimony on the subject was admissible under Federal Rule of Evidence 807, even though the deponent was unavailable to testify at trial and his deposition occurred prior to Curshen's being named a defendant in the action. Finally, the Tenth Circuit affirmed the district court's permanent injunction order in light of its specific findings that Curshen's misconduct was "egregious," he was "not a fully credible witness" and he failed to "recognize [his] wrongdoing."

SECONDARY ACTORS

Second Circuit Affirms Motion to Dismiss Claims Against Law Firm

***Pac. Inv. Mgmt. Co. LLC v. Mayer Brown LLP*, No. 09-1619-cv (2d Cir. Apr. 27, 2010)**

The U.S. Court of Appeals for the Second Circuit affirmed the dismissal, on a motion to dismiss, of claims that the law firm of Mayer Brown and a partner at that firm violated Section 10(b) of the Securities Exchange Act where no statements were publicly attributed to them. (The court "emphasize[d] that nothing in this opinion limits the scope of liability with respect to government enforcement actions, whether civil or criminal.") The complaint alleged that Refco (which Mayer Brown represented) had violated Section 10(b) by structuring fraudulent loan transactions to conceal its uncollectible debt and by making false statements in SEC filings. The complaint further alleged that Mayer Brown had violated Section 10(b) by facilitating those fraudulent loan transactions and by drafting the alleged false statements. However, secondary actors (*i.e.*, lawyers, accountants or other parties not employed by the firms whose securities are the subject of alleged fraud) could only be subject to primary liability in a private Section 10(b) suit if the allegedly misleading statements were attributed to them. The court rejected the SEC's proposed "creator standard" (*i.e.*, where a defendant can be liable for creating a false statement relied upon by investors even if that statement is not attributed to the defendant) because plaintiffs must have relied on a secondary actor's "*own* deceptive statements" to state a claim under Section 10(b) and because an attribution standard—unlike a creator standard—establishes a clear boundary between primary violators and aiders and abettors. Accordingly, because the allegedly misleading statements were not attributed to Mayer Brown or the partner, the claims against them were properly dismissed. Further, the court determined that the allegations concerning Mayer Brown's alleged facilitation of Refco's fraudulent loan transactions were not distinguishable from *Stoneridge* and could not form a basis for "scheme liability," because the plaintiffs admitted that they were unaware of any allegedly deceptive conduct by Mayer Brown when they purchased Refco securities and consequently could not have relied upon it.

SECURITIES ACT

S.D.N.Y. Dismisses Claims in Connection With Sale of Mortgage Pass-Through Certificates

***Pub. Employees' Ret. Sys. of Miss. v. Merrill Lynch & Co. Inc.*, No. 08 Civ. 10841 (JSR) (S.D.N.Y. June 1, 2010)**

In an order explaining his March 31, 2010, "bottom line" order, Judge Jed S. Rakoff of the U.S. District Court for the Southern District of New York dismissed claims against Merrill Lynch, ratings agencies, J.P. Morgan, C-BASS and ABN AMRO for violations of Sections 11 and 12(a)(2) of the Securities Act in connection with the sale of mortgage pass-through certificates issued by a Merrill Lynch subsidiary in 84 different offerings. Even though the named plaintiffs sought to represent a class of purchasers in all 84 offerings, they had only purchased certificates in 19 of those offerings and consequently lacked standing to assert Section 11 and 12(a)(2) claims with respect to 65 of the 84 offerings at issue. The court also recognized that the one-year limitations period applicable to Securities Act claims had already run, and therefore those claims were dismissed with prejudice because the plaintiffs could not propose additional named plaintiffs who purchased certificates in the other 65 offerings. As to the Section 11 claims related to the 19 offerings in which the plaintiffs purchased certificates, those claims may only be brought against, *inter alios*, underwriters, and the court determined that the ratings agencies were not statutory underwriters. SEC Rule 436(g)(1) expressly excluded ratings made by national ratings agencies from the registration statements, which the SEC had explained as intending to exclude ratings agencies from Section 11 liability. Further, to qualify as an underwriter as defined in Section 2 of the Securities Act, a party must participate in purchasing securities from the issuer with an eye to their resale, which the ratings agencies did not do. For that reason, the court also dismissed the Section 11 claims against three companies who were alleged only to have acquired the underlying loans from the loan originators. The court also dismissed the Section 12(a)(2) claims—which were brought only against the actual underwriters—because a plaintiff bringing a Section 12(a)(2) claim must have actually purchased the security directly from the underwriter in the public offering, and the plaintiffs did not allege that they had done so. The court also dismissed the claims premised upon the offerings in which the plaintiffs had not purchased certificates on standing grounds, and allowed the plaintiffs an opportunity to replead their claims against Merrill Lynch, J.P. Morgan and ABN AMRO. However, the court did not dismiss the claims based on the one-year limitations period because there was a plausible inference that the plaintiffs were not on inquiry notice more than one year before bringing suit.

S.D.N.Y. Tosses Claims Against Bank Related to Goodwill Write-Down

***Fait v. Regions Fin. Corp.*, No. 09 Civ. 3161 (LAK) (S.D.N.Y. May 10, 2010)**

Judge Lewis A. Kaplan of the U.S. District Court for the Southern District of New York dismissed purported class claims that Regions Financial Corp., its directors and its auditors violated Sections 11 and 12(a)(2) of the Securities Act by allegedly overstating goodwill and underestimating loan loss reserves in SEC filings incorporated in offering documents. The plaintiff claimed that Regions failed to write down goodwill associated with its acquisition of another bank, because there was purported "growing evidence" of "serious problems" with the acquired bank's loan portfolio, and as a consequence, Regions did not carry adequate loss reserves. The plaintiff had specifically disclaimed any allegation that Regions knowingly or recklessly misstated its goodwill, to avoid triggering the PSLRA's heightened pleading requirements. Insofar as goodwill is the difference between what Regions paid for the other bank and the fair market value of that bank's assets, which is a matter of judgment (as these assets are not traded on an efficient market), the plaintiff failed to state a claim because there were no particularized allegations that Regions believed the goodwill figure on its SEC filings was materially overstated. Further, Regions' loss reserves were opinions as to what percentage of the loans were uncollectible, and the complaint did not allege that Regions did not truly hold those opinions at the time they were made public.

California Federal Court Trims Claims in *Wells Fargo MBS* Case

***In re Wells Fargo Mortgage-Backed Certificates Litig.*, No. C 09-01376 SI (N.D. Cal. Apr. 22, 2010)**

Judge Susan Illston of the U.S. District Court for the Northern District of California greatly reduced the scope of a putative class action brought by purchasers of mortgage pass-through certificates issued by Wells Fargo Bank. The plaintiffs alleged that the offering documents filed with the SEC contained numerous false and misleading statements and omissions in violation of Sections 11, 12(a)(2) and 15 of the Securities Act. The plaintiffs brought suit against Wells Fargo Bank and related entities and individuals (Wells Fargo); McGraw-Hill Companies, Moody's Investors Service, Inc. and Fitch, Inc. (the Rating Agencies); and Goldman Sachs & Co., Morgan Stanley & Co., JP Morgan Securities, Inc. and others (the Underwriters). As an initial matter, the court dismissed the plaintiffs' claims based on 37 of the 54 offerings because they did not purchase securities from those offerings. In so doing, the court rejected the plaintiffs' argument that they had standing to sue on behalf of all 54 of the challenged offerings because all of the offerings stemmed from a common registration statement. The district court explained that "each offering was associated with a separate Prospectus and Prospectus Supplement" and, according to applicable regulations, must be treated as a separate registration statement. The court also dismissed the plaintiffs' Section 12(a)(2) claims, which required a definitive allegation that the plaintiffs purchased the security directly from the issuer as part of an initial market, because the plaintiffs only alleged that they "'purchased *or otherwise acquired* Certificates pursuant *and/or traceable* to the defective Prospectuses.'" Finally, the court dismissed with prejudice the plaintiffs' claim against the Rating Agencies for violation of Section 11. The Rating Agencies could not be held liable under Section 11 as "underwriters" because, even assuming the plaintiffs adequately alleged that the Rating Agencies were necessary to the formulation and structuring of the securities, Section 11 only imposes liability for "'participation'…*related to the underwriting* of the securities at issue."

The court did, however, deny Wells Fargo's and the Underwriters' motions to dismiss the plaintiffs' remaining Section 11 and 15 claims. In denying their motions to dismiss the remaining claims, the court rejected Wells Fargo's argument that the plaintiffs' Section 11 claims were untimely, in part, because the question of whether press coverage of the mortgage crisis put the plaintiffs on notice "is a factual question not appropriate for resolution on a motion to dismiss." The court also rejected the argument that the plaintiffs failed to tie any inconsistent underwriting conduct to the specific certificates at issue in the case. In this regard, the court found it sufficient "that plaintiffs have alleged that the challenged conduct infected the entire underwriting process, including with respect to prime loans."

S.D.N.Y. Dismisses Claims Related to Disclosure of Known Trends in IPO Filing

***In re Noah Educ. Holdings, Ltd. Sec. Litig.*, No. 08 Civ. 9203 (RJS) (S.D.N.Y. Mar. 31, 2010)**

Judge Richard J. Sullivan of the U.S. District Court for the Southern District of New York dismissed claims that Noah Educational Holdings (a foreign issuer) and its underwriters violated Sections 11 and 12(a)(2) of the Securities Act by filing an IPO registration statement and prospectus containing allegedly false or misleading information. The complaint alleged that the prospectus failed to disclose that, at the time of the IPO, Noah was experiencing a significant rise in raw material costs and that it failed to disclose a violation of a Chinese environmental-labeling regulation. Noah was not required to disclose the rise in raw material costs under Item 303 (disclosure of known trends), because that rise was only alleged to be an isolated event (experienced only in the first two months of the quarter), and Item 303 does not require companies to disclose isolated occurrences that affect their financial performance. Moreover, the cautionary language in the IPO registration statement (which included the risk that Noah's raw materials cost could increase) did not imply that Noah's cost of raw materials had not increased, to some extent, in the current quarter.

SECURITIES FRAUD PLEADING STANDARDS

Second Circuit Affirms Dismissal of Case Related to Disclosure of Merger Negotiations

***Vladimir v. Bioenvision, Inc.*, No. 09-3487-cv (2d Cir. Apr. 7, 2010)**

In a summary order signed by the clerk, the U.S. Court of Appeals for the Second Circuit affirmed the dismissal of claims that Bioenvision and six of its officers and directors violated Section 10(b) of the Securities Exchange Act by failing to disclose that Bioenvision was engaged in merger negotiations with another company. The court affirmed the dismissal because there is no duty which requires the defendants to disclose merger negotiations—as opposed to a definitive merger agreement—and disclosure is not required simply because "a reasonable investor would very much like to know that fact."

S.D.N.Y. Dismisses Auction Rate Securities Suit Against UBS

***In re UBS Auction Rate Sec. Litig.*, No. 08 Civ. 2967 (LMM) (S.D.N.Y. June 10, 2010)**

Judge Lawrence M. McKenna of the U.S. District Court for the Southern District of New York dismissed purported class claims that UBS, two of its subsidiaries and three of its executives violated Section 10(b) of the Securities Exchange Act. The plaintiffs alleged that UBS manipulated the market for ARS it had underwritten by intervening in auctions for those ARS to prevent auction failures, encouraging its financial representatives (through conference calls and offering larger commissions) and getting rate-cap waivers from the ARS issuers (which allowed the clearing rates on ARS to exceed the ARS rate caps without resetting the rates to below-market levels). Because of the significant amount of publicly available information about ARS auction intervention by underwriters, the court determined that UBS's intervening in ARS auctions did not constitute manipulation, as UBS's purported actions did not cause the plaintiffs to believe something that was not true, and the plaintiffs could not have relied on the assumption that UBS was not intervening in ARS auctions. Further, the complaint did not tie UBS's allegedly manipulative conduct to the ARS that the named plaintiffs actually purchased, and, in addition, UBS was not obligated to disclose the incentive structure it provided to its employees.

Illinois Federal Court Dismisses Securities Class Action Against Boeing

***City of Livonia Employees' Ret. Sys. v. Boeing Co.*, No. 09-C-7143 (N.D. Ill. May 26, 2010)**

Judge Suzanne B. Conlon of the U.S. District Court for the Northern District of Illinois dismissed a putative class action brought by an institutional investor against the Boeing Company and several of its corporate officers, which sought to hold the defendants liable under Section 10(b) of the Securities Exchange Act and SEC Rule 10b-5 and to impose joint and several liability against them under Section 20(a) of the act. The complaint alleged that the defendants intentionally deceived investors about the results of a wing stress test and the delivery schedule for Boeing's 787 Dreamliner, a cutting-edge commercial passenger airplane with the fastest rate of customer orders in Boeing's history. In dismissing the complaint, the court found that the plaintiff could neither rely on statements made before the class period commenced nor after it purchased Boeing stock. Separately, the court found the complaint's allegations insufficient to support an inference of scienter. In so finding, the court discounted the complaint's reliance on confidential, internal e-mails because the complaint neither identified their authors nor provided sufficient information about the confidential sources. The court also found the complaint's scienter allegations deficient because they referred to "defendants" generally, without providing "individualized factual allegations regarding each defendant's state of mind." In sum, the court found that "[t]he more cogent inference from the amended complaint is that Boeing detected problems during the wing stress testing and spent time investigating and analyzing the problem and trying to find a solution that would allow adherence to the first flight and delivery schedule." The court also denied the plaintiff's request for leave to expand the class period, noting that the plaintiff "had ample opportunity" to do so, and "is not entitled to 'leisurely repeated bites at the apple.'"

Delaware Federal Court Dismisses Complaint Related to Rate-Fixing Scheme for Failure to Plead Scienter

***City of Roseville Employees' Ret. Sys. v. Horizon Lines, Inc.*, No. 08-969 (D. Del. May 18, 2010)**

Chief Judge Harvey Bartle III of the U.S. District Court for the District of Delaware dismissed with prejudice an amended complaint asserting claims that Horizon Lines, one of its subsidiaries and five of its executives violated Section 10(b) of the Securities Exchange Act. Three of Horizon's former executives had been indicted and pled guilty to engaging in an illegal rate-fixing scheme within the Puerto Rico market. The complaint alleged that the defendants' failure to disclose that scheme while attributing Horizon's increase in revenue to legitimate business practices constituted a material misrepresentation or omission. (Two of those former executives were also named as defendants, but they did not seek dismissal of the amended complaint.) The plaintiffs were not entitled to a fraud-on-the-market presumption or the *Affiliated Ute* presumption for its executive's alleged pre-IPO misrepresentations, because no market existed for Horizon's stock at the time it was made, and the *Affiliated Ute* presumption only applied to omissions, not misrepresentations. Even though the complaint alleged with particularity that the defendants made allegedly materially false and misleading statements, the court determined that it did not sufficiently plead scienter. The court rejected the plaintiffs' attempt to show scienter through stock sales or compensation, as they are "ubiquitous in corporate America," and rejected the plaintiffs' attempt to use group pleading—by naming all of the indicted former executives' superiors as defendants—to show scienter, as they failed to allege particular facts, including each defendant's role. Similarly, the plaintiffs could not rely upon statements made by a former employee at another company about documents created at that company, as they constituted "at best" "nonspecific allegations" and required an "inferential leap" to assuming the same type of documents were made at Horizon and available to the non-indicted executives. The court also rejected the plaintiffs' "collective scienter" theory (*i.e.*, allowing scienter to be established against a corporate defendant even if it cannot be established with respect to an individual defendant). On June 15, 2010, the plaintiffs appealed the dismissal of their claims to the U.S. Court of Appeals for the Third Circuit.

S.D.N.Y. Declines to Dismiss Claims Relating to Lehman-Guaranteed Note

***Ellenburg v. JA Solar Holdings Co. Ltd.*, No. 08 Civ. 10475 (JGK) (S.D.N.Y. May 17, 2010)**

Judge John G. Koeltl of the U.S. District Court for the Southern District of New York upheld purported class claims that JA Solar and three senior officers and directors violated Section 10(b) of the Securities Exchange Act by making allegedly materially false statements or omissions about JA Solar's July 2008 investment in a three-month $100 million note guaranteed by Lehman Brothers and issued by Lehman's Dutch subsidiary. In August 2008, one month after buying the note, JA Solar indicated that its "cash and cash equivalents" had increased and that it had engaged Lehman Brothers, among others, to help it invest that cash. Lehman Brothers then declared bankruptcy in September 2008, and JA Solar issued a press release disclosing its ownership of that $100 million note. In the conference call following JA Solar's press release, one of the individual defendants (the CFO) was questioned as to the guarantee and Lehman's bankruptcy. Two months later, when the note had not been repaid, JA Solar announced that it was taking an impairment charge for the note, significantly driving down the price of JA Solar's American depository shares. The court determined that the complaint alleged a material omission in August 2008 by JA Solar concerning how JA Solar's cash was invested and its relationship with Lehman. Similarly, the September 2008 statements were alleged to be misleading because JA Solar had assured investors that the note was "fully protected" despite the bankruptcy of its sole guarantor—Lehman.

S.D.N.Y. Declines to Dismiss Claims Against E*Trade Concerning Mortgage Origination and Servicing

***Freudenberg v. E*Trade Fin. Corp.*, No. 07 Civ. 8538 (S.D.N.Y. May 10, 2010)**

Judge Robert W. Sweet of the U.S. District Court for the Southern District of New York upheld purported class claims that E*Trade and three of its senior executives violated Section 10(b) of the Securities Exchange Act by making allegedly false and misleading statements or omissions concerning E*Trade's mortgage origination and servicing. The complaint alleged that E*Trade misrepresented that it was originating most of the mortgages it was servicing, that the mortgages it was servicing were "superprime" based on certain objective criteria (*e.g.*, loan-to-value ratios), and that E*Trade used "discipline and conservativism" in monitoring its risk profile. E*Trade had made three class-period disclosures about loan losses, substantially driving down its stock price, but the first two times E*Trade continued to reassert its "conservative approach" (the third disclosure marked the end of the purported class period). The court determined that the complaint adequately pled material misrepresentations because the complaint alleged that E*Trade's senior executives knew those representations were false (*e.g.*, the plaintiffs specifically alleged that a senior executive told a confidential witness to stop reviewing loan pools when the confidential witness informed the president of E*Trade's mortgage division at a meeting about the low quality of loans). The court also determined that the complaint sufficiently pled scienter because it identified the confidential witnesses who had first-hand knowledge of the events alleged and showed that E*Trade's senior management was involved and knew about the poor and high-risk nature of E*Trade's loans. Finally, the complaint adequately pled loss causation because the allegedly false and misleading statements caused E*Trade's stock price to be inflated, and the three disclosures about loan losses caused the stock price to decline. Moreover, E*Trade's disclosure of an SEC investigation into these issues was sufficiently connected to the stock price drop so as to demonstrate loss causation because it "was linked to the purported fraudulent misconduct" and thus akin to corrective disclosure.

Washington Federal Court Dismisses Class Action Complaint Against WaMu and Deloitte

***In re Wash. Mut., Inc. Sec. Litig.*, No. 2:08-md-1919 MJP (W.D. Wash. Apr. 28, 2010)**

Judge Marsha J. Pechman of the U.S. District Court for the Western District of Washington dismissed California state law claims for fraud, negligent misrepresentation and violations of the California Corporations Code brought against various directors of Washington Mutual (WaMu) and its auditor Deloitte & Touche LLP relating to WaMu's purported abandonment of "recognized underwriting standards used to evaluate both 'prime' mortgages and 'subprime' loans." The plaintiffs sought to hold the director defendants responsible based on their signing of WaMu's financial statements and their allegedly integral role to the function of WaMu. The plaintiffs attempted to hold Deloitte responsible based on its purported issuance of "clean" audit opinions that allegedly violated generally accepted accounting standards and misrepresented, among other things, WaMu's financial condition. The court dismissed the plaintiffs' claims for fraud and negligent misrepresentation because the plaintiffs' generic allegations of reliance failed to satisfy Rule 9(b). Critically, the court noted that "Plaintiffs only suggest that they read the Forms 10-K and Deloitte's certifications, without expressly alleging which documents they read, when they read them or how they impacted their decision to purchase or retain WaMu debt securities." The court also rejected the plaintiffs' negligent misrepresentation claim against Deloitte because the plaintiffs were not alleged to be among a class of "intended beneficiaries of the auditor's opinion"—a general prerequisite under California law to hold an auditor liable for negligent misrepresentation. Separately, the court rejected the plaintiffs' claims predicated on a violation of Section 25401 of the California Corporations Code, which only creates liability if defendants actually sold the plaintiffs' securities, and under Section 25403(b) of that code, which does not provide a private right of action.

Kentucky Federal Court Nixes Fraud Action Against Bear Stearns Relating to MBSs

***Republic Bank & Trust Co. v. Bear, Stearns & Co.*, No. 3:09-CV-287-S (W.D. Ky. Apr. 13, 2010)**

Judge Charles R. Simpson III of the U.S. District Court for the Western District of Kentucky dismissed an action brought by Republic Bank & Trust Company against Bear Stearns & Co., Inc. and one of its employees (collectively, Bear) relating to Bear's sale to Republic of over $50 million of residential mortgage-backed securities (MBSs) in 2003 and 2006. The plaintiff asserted claims for fraud, negligent misrepresentation and violations of Kentucky's Blue Sky laws based on allegations that it was forced to "write-down" its assets by over $14 million because Bear made material misrepresentations and omissions about the MBSs that were sold to Republic. The court held that Bear's alleged misstatements that the MBSs were "reasonably safe investment products" was non-actionable because it was only "an opinion, from which no fraud action can originate." Nor could Republic base a claim on Bear's alleged misstatements that it "intended" to create a secondary security market for the MBSs because "an alleged 'intent' to do something is not an actionable statement." Finally, it could not ground a claim on Bear's purported misstatements that the certificates would receive credit enhancements because "[t]he offering documents informed Republic of precisely the risk" that no such credit enhancements would be obtained.

The court also rejected Republic's claims founded on allegations of fraud by omission. Republic could not base a claim on Bear's purported failure to disclose, among other things, that "prudent underwriting standards" were not followed because "'[p]rudence'…is an inherently subjective characteristic involving foresight and sound judgment." Republic's allegation that Bear failed to disclose that "a substantial number of the underlying loans were issued to borrowers whose creditworthiness was either insufficiently examined or did not support the amounts of loans" likewise failed because "Republic could have and should have inspected [the underlying offering documents] carefully to learn exactly what it was buying." In addition, as to Bear's 2003 offering, the court found that Republic's claims were time-barred because Republic was "charged with discovering [the prospectus supplements'] contents (either actually or constructively) once the documents were available to it."

SETTLEMENTS

Sixth Circuit Says Consent Decree Is Not a Bar to Ex-CFO's Suit Against Dollar General

***Sec. & Exch. Comm'n v. Dollar Gen. Corp.*, No. 09-5907 (6th Cir. May 19, 2010)**

The U.S. Court of Appeals for the Sixth Circuit, in an unpublished decision, reversed and vacated the district court's order enjoining Brian M. Burr, former CFO of Dollar General, from bringing suit in a Tennessee state court against Dollar. Burr alleged that Dollar misled him into believing that he could cash in his stock options in compliance with all applicable regulations. Burr had entered into a consent decree with the SEC that, among other things, prohibited him from seeking to recover in a subsequent lawsuit against Dollar or any of the other co-defendants to the SEC action. Burr argued to the Sixth Circuit that the consent decree did not bar his Tennessee action because Dollar lacked standing to enforce its terms. The Sixth Circuit agreed with Burr, finding that the district court's standing analysis was in "direct conflict with controlling Supreme Court and Sixth Circuit case law." As the Supreme Court articulated in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 750 (1975), "a consent decree is not enforceable directly or in collateral proceedings by those who are not parties to it even though they were intended to be benefited by it." The Sixth Circuit further held that, while the district court may have had the inherent authority under the Anti-Injunction Act to "protect" or "effectuate" its prior judgment against Burr, its injunction swept too broadly. The court held that "the injunctive order *may* have been justified in part but, in enjoining prosecution of the state court action as a whole, is broader than authorized by the terms of the Consent Judgment."

Delaware Supreme Court Affirms Settlement of Stockholder Suit Regarding BOA/Countrywide Merger

***Ark. Teacher Ret. Sys., Fire & Police Pension Ass'n of Colo. v. Caiafa*, No. 530, 2009 (Del. May 21, 2010)**

The Delaware Supreme Court affirmed the settlement of stockholder litigation arising from the Bank of America/Countrywide merger. A Countrywide stockholder, TRS, objected to the settlement on the basis that the Court of Chancery failed to properly value TRS's derivative claim (pending in a companion federal district court action) when deciding whether to approve the settlement. TRS additionally argued that the Court of Chancery should place part of the merger consideration into a constructive trust in order to protect the value of the derivative claim. The Court of Chancery denied TRS's objection—in part because it valued the derivative claim as worthless—and approved the settlement, allowing the merger to close and, thus, extinguishing TRS's standing to pursue its derivative claim. On appeal, the Delaware Supreme Court affirmed the Court of Chancery's decision to approve the settlement, noting that "[t]he Vice Chancellor appropriately denied [TRS's] objection, because Delaware corporate fiduciary law does not require directors to value or preserve piecemeal assets [such as a potential derivative claim] in a merger setting, and TRS failed to show a likelihood of prevailing on the merits of its claims."

However, the Delaware Supreme Court did not end its opinion there. The court noted that TRS had "alleged facts that reflect conduct wholly inappropriate for Delaware corporate directors." In particular, the court highlighted that before the merger, "Countrywide's board settled insider trading, improper stock repurchase, and predatory lending claims, while the company exposed itself to bad loans causing plummeting stock value that allegedly cost Countrywide $848 million to $25 billion." These allegations suggested "a potential relationship between the directors' alleged premerger fraudulent conduct and the rapidly and severely depressed stock price on which the merger consideration was based."

The Delaware Supreme Court continued by identifying the general rule that "other than in instances of fraud or reorganization, a plaintiff loses standing to maintain a derivative suit where the corporation, in which the plaintiff holds stock, merges with another company." However, the Delaware Supreme Court also explained that "Delaware law recognizes a single, inseparable fraud when directors cover massive wrongdoing with an otherwise permissible merger." After acknowledging the Court of Chancery's conclusion that avoiding liability was not the only or principal reason for approving the merger with BOA, the Delaware Supreme Court remarked that "an otherwise pristine merger cannot absolve fiduciaries from accountability for fraudulent conduct that necessitated that merger.… [A]fter allegedly intentionally engaging in fraudulent conduct that caused the stock price to plummet near bankruptcy, Countrywide directors would understandably seek an acquiror to effect a merger that would extinguish potential derivative claims during such a period of upheaval that they would have few alternatives. Whether this plausible scenario reflects this board's single, cohesive plan or merely ties together, like patchwork, a snowballing pattern of fraudulent conduct and conscious neglect, the result is the same and would not fairly constitute a proper discharge of the fiduciary duties of directors of a Delaware corporation." However, because this "fraud" theory was never properly presented to either court, the Delaware Supreme Court held that "the Vice Chancellor did not abuse his discretion in approving the settlement, despite facts in the complaint suggesting that the Countrywide directors' premerger agreement fraud severely depressed the company's value at the time of BOA's acquisition, and arguably necessitated a fire sale merger."

Court of Chancery Approves Settlement of Breach of Fiduciary Duty Claims in Suit Related to Tender Offer

In re Cox Radio, Inc. S'holders Litig., C.A. No. 4461-VCP (Del. Ch. May 6, 2010)

Vice Chancellor Donald F. Parsons Jr. of the Delaware Court of Chancery certified a class action and approved a proposed settlement of breach of fiduciary duty claims in connection with a transaction consisting of a tender offer by a controlling shareholder and a second-step, short-form merger over the objection of two sets of shareholders.

In March 2009, Cox Enterprises, Inc. (CEI), the controlling shareholder of Cox Radio, Inc., commenced a tender offer through its wholly owned subsidiary, Cox Media Group, Inc. (CMG), for all of the Cox Radio stock that it did not already own. Certain shareholder plaintiffs challenged the transaction, alleging that various defendants breached their fiduciary duties to Cox Radio by offering inadequate consideration and making misleading and incomplete disclosures in connection with the transaction. The tender offer was subject to several conditions, including a non-waivable majority of the minority tender condition and a waivable condition that at least 90 percent of all Cox Radio shares be tendered. CEI and CMG also promised to consummate a short-form merger promptly at the same price as the tender offer if the tender offer succeeded in obtaining 90 percent of the outstanding shares. Cox Radio promptly formed a special committee constituted of its two independent directors. After meeting with its legal and financial advisors, the special committee unanimously determined that the tender offer price was fair and recommended that the shareholders tender their shares. After resolving some uncertainties concerning its powers, the special committee withdrew its initial recommendation and engaged in negotiations with CEI. As a result, CEI agreed to increase the tender offer price, and the special committee publicly recommended in favor of the tender offer.

Contemporaneously, the plaintiffs agreed to settle the pending litigation based on the increase in the tender offer price and an agreement from CEI and Cox Radio to make certain supplemental disclosures. Thereafter, the tender offer closed, satisfying the majority of the minority condition.

Certain shareholders objected to the settlement because it released "meritorious" federal securities law claims for only therapeutic disclosures. The court disagreed with the objectors and explained that stockholders received two benefits from the settlement: (1) a per share increase in the tender offer price and (2) supplemental disclosures. The court explained that although the evidence indicated "Cox Radio needed to increase the tender offer price in order for the tender offer to close successfully," there was also evidence that "the work of plaintiffs and their counsel contributed to the price increase." The court also found that the federal securities law claims were not in fact meritorious, and were unlikely to succeed. As a result, the court found their release under the terms of the settlement to be fair. Another group of objectors urged the court not to approve the settlement because "the Transaction must be reviewed for entire fairness," and their claim could be "potentially worth hundreds of millions of dollars."

The court rejected the argument that entire fairness would be the proper standard of review, explaining that *In re Pure Resources* "held that a court should not apply the entire fairness standard to a tender offer by a controlling shareholder when that offer is 'non-coercive' and 'the independent directors of the target are permitted to make an informed recommendation and provide fair disclosure.'" Applying the *Pure Resources* standard, the court stated that the transaction was subject to a non-waivable majority of the minority condition, and CEI promised to consummate a prompt short-form merger at the same price offered in the tender offer; thus, the court concluded that any claim of coercion would not be successful. In addition, the special committee hired its own advisors and had the power to negotiate, and did in fact negotiate, with CEI, and as a result of the supplemental disclosures, there was "no reason to doubt that the minority received adequate information to allow them to make an informed judgment." The court therefore approved the settlement.

SLUSA PREEMPTION

Florida Federal Court Dismisses Claims Against Law Firm Related to Ponzi Scheme

Sullivan v. Holland & Knight LLP, No. 8:09-CV-531-T-17AEP (M.D. Fla. Mar. 31, 2010)

Judge Elizabeth A. Kovachevich of the U.S. District Court for the Middle District of Florida dismissed state statutory and common law claims against Holland & Knight in connection with its alleged failure to perform adequate due diligence when preparing private placement memoranda for funds operated by a Ponzi scheme operator (*e.g.*, failing to disclose that the fund operator had been disbarred for misappropriating client trust funds). The court determined that the claims—asserted on behalf of a purported class—were preempted by SLUSA because the case was a covered class action asserting state law claims in connection with the purchase of a covered security. The court explained that the purported class claims were "in connection with" the purchase of covered securities because the funds accepted the purported class's money to allegedly purchase covered securities and because the funds were marketed as investing in covered securities.

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E-discovery "Worst Practices": Ten Sure-Fire Ways to Mismanage Document Review and Production

By Jack E. Pace III, John D. Rue, and Jason A. Bartlett

A year ago, the authors published an article in this journal on "Worst Practices" for electronic document preservation through litigation holds.[1] At that time, approximately two years after the incorporation of the "new" e-discovery rules into the Federal Rules of Civil Procedure, we were surprised to feel like pioneers in a field as crowded as e-discovery practice is. That is, even as thousands of "e-discovery experts"[2] came forward, a multitude of "e-discovery luminaries" were identified and interviewed,[3] and accolades were given to at least one "e-discovery scholar,"[4] it seemed that nobody else had stepped forward to lay claim to expertise in the area of e-discovery "Worst Practices."

A year later, and much to our surprise, the e-discovery "Worst Practices" bandwagon seems yet to have left the station. Although, as we noted in 2009, an internet search for the phrase "e-discovery best practices" yielded 27,400,000 hits at that time and 49,500,000 hits today, a recent search for the phrase "e-discovery worst practices" yielded only 8 results, ***each and every one of them referring to our previous article in this journal.*** With that revelation, we reluctantly concluded that we have no choice but to soldier on with the next installment in our treatment of the subject. For if not us, then who?[5]

The following are ten Worst Practices in the area of document review and production.

1. Stick It to 'Em!

First and foremost, discovery is the opportunity to stick it to your adversary. For example, why would you produce electronically stored information ("ESI") in the manner by which that information is usually kept?[6] Why would you produce in a format that allows your adversary easily to search through the data, or that provides your adversary with metadata that could just as easily remain hidden? The "Worst Practices" attorney produces in the most burdensome format possible.

For example, in *Goodbys Creek, LLC v. Arch Ins. Co.*, the defendant chose to produce TIFF images rather than files in native format, which made searching through the ESI "much more difficult."[7] The federal district court in Florida rejected the defendant's production choice and ruled that since defendant ordinarily maintained its ESI in a searchable storage format, it could not produce that information in a form that "removes or significantly degrades" that searchability.[8] The court compelled the defendant to "reproduce the data in question in their native format, provide the documents in another comparably searchable format, or supply [plaintiff] with software for searching the TIFF images."[9] While the court declined to sanction the defendant (in part because the plaintiff never specified its desired format for ESI production), the court nevertheless did not seem to appreciate the common "rule" of practice and required the defendant to reproduce what it had already provided to plaintiff—forcing defendant to incur duplicate costs and work.

Another federal judge in Florida also refused to respect this Worst Practice rule in *Bray & Gillespie Management, LLC v. Lexington Insurance Co.* There, the defendant's requests for production specified that ESI was to be produced in native format, without altering any associated metadata, and the plaintiff did not object.[10] Scrupulously observing this Worst Practice, plaintiff "manipulated" 800,000-plus pages of emails and other ESI "to convert the searchable text with metadata to a TIFF image stripped of metadata."[11] Even though the defendant could have conducted searches of the ESI by converting the files into searchable text (in other words, converting over 800,000 pages through optical character recognition ("OCR") technology),[12] the court held that the ESI produced was "not in a reasonably usable form" as required by Rule of Civil Procedure 34.[13] For this and for ignoring the format specified in the defendant's requests for production, the court issued sanctions (1) reopening the discovery period, and (2) requiring plaintiff, at its own expense, to provide defendant with plaintiff's ESI database.[14]

2. Details, Details—Who Cares?

Why go through the trouble of explicitly specifying the format in which you would like to receive an ESI production? Isn't it easier simply to assume that the producing party will supply its ESI in a convenient, ready-to-use format that is easily searchable?

In *MGP Ingredients, Inc. v. Mars, Inc.*, MGP asserted patent infringement and related claims against Mars over a type of dog chew. In response to MGP's requests for production of documents, Mars provided a CD containing documents that Mars indicated were produced "as kept in the ordinary course of business."[15] Since the ESI produced was arranged by custodian, rather than by topic or by any specific request for production, MGP objected to the production and asserted that it was "faced with a 48,000 page haystack and no guidance where to look for a few needles."[16] The court recognized that the production presented MGP with the "formidable task of having to determine which documents are responsive to each particular request,"[17] but nonetheless denied MGP's motion to require Mars to relate the produced documents to each of the document requests.

The court held that Mars had satisfied its production obligations as provided in Rule 34(b). That rule provides that "the producing party must either produce the documents as they are kept in the usual course of business *or* organize and label them to correspond with the categories in the request."[18] Because the rule is phrased in the disjunctive, Mars was justified in producing the ESI arranged by custodian—as it was kept in the usual course of business.[19] MGP may have been able to avoid the task before it by relying on a different part of Rule 34(b), which allows a requesting party either to (1) agree with the producing party on the manner of production, or (2) seek an order from the court mandating the manner of production.[20] As MGP had not availed itself of either option prior to serving its requests, the court refused to spare MGP the burden of "determining which documents relate to each set of its twenty-some requests."[21]

Courts' failure to appreciate this Worst Practice rule is prevalent. In *Ford Motor Company v. Edgewood Properties*, the defendant actually did demand that the plaintiff produce ESI in its native format or in files containing metadata.[22] Plaintiff, however, objected and replied that it would produce ESI in TIFF format.[23] The parties were unable to agree upon a format, and plaintiff produced in TIFF format on three dates spanning eight months. Only after the third and final production did defendant formally object to the format, and after that it waited another two months to first bring its objection to the court.[24] The court found that the defendant acted unreasonably when it waited eight months (after which production was nearly complete) to object to the form of production.[25] Showing no respect for this common Worst Practice rule, the court stated that "it is without question unduly burdensome to a party months after production to require that party to reconstitute their *entire* production to appease a late objection."[26]

3. Deadlines Are for Kids!

Being a Worst Practices attorney can be a hectic job. One sure-fire way to avoid stress is to treat production deadlines as suggestions instead of imperatives. Why rush to meet the court-imposed schedule when you can work at your own schedule?

For example, in *In re Seroquel Products Liability Litigation*, defendant approached production with an admirable pattern of "purposeful sluggishness" that allowed defendant not only to miss discovery deadlines and to produce ESI late, but also to produce incomplete and sometimes unusable ESI.[27] While any Worst Practices attorney can tell you that an attorney's conduct during discovery should aspire to be "stress-free," the court mistakenly referred to it here as "sanctionable."[28]

One must remember that when following this Worst Practice rule, an attorney need not provide explanations for missing deadlines; the attorney need only produce when he or she deems fit. For example, in *Thompson v. U.S. Dept. of Housing and Urban Development*, the defendants produced 80,000 e-mails responsive to plaintiff's document requests long after discovery had closed, without any meaningful explanation for the delay.[29] Once again, the court ignored the Worst Practice rule and sanctioned the defendants. Improbably, defendants were not allowed to introduce any of the 80,000 e-mails into evidence or to use any of the e-mails to refresh a witness's recollection, while the plaintiffs were allowed to use the e-mails in whatever fashion plaintiffs chose.[30]

Further, these Worst Practice rules are not mutually exclusive; for best results, one should employ the tactics suggested by multiple rules. For example, in *Bray & Gillespie Management, LLC*, the plaintiff not only received sanctions for producing ESI in a burdensome format,[31] but also later managed to receive more severe sanctions just months later for failing to timely and diligently search for and produce responsive documents. The court found that the plaintiff had followed the Worst Practice rules even in the face of the defendant's "clear, unambiguous, and frequent" demands for such information and despite "three equally clear and unambiguous orders compelling Plaintiff to produce" the information at issue.[32] The court sanctioned the plaintiff for its inaction by dismissing with prejudice the plaintiff's claim for damages and ordering the plaintiff to pay $75,000 to reimburse the defendant for its discovery expenses and subsequent sanctions motions.[33]

4. Candor (Part I): If You Say It's True, It Must Be!

Sometimes simply ignoring production deadlines is impossible. Courts are notorious for asking questions about whether the parties are complying with case management orders. What is a Worst Practices attorney to do in this situation? This Worst Practice rule contains the answer to this tricky question.

The best answer to this question is simple: tell the court you have satisfied your production obligations, regardless of the actual state of affairs, as that should get you out of the immediately uncomfortable situation of admitting the truth. In *Coleman (Parent) Holdings, Inc. v. Morgan Stanley & Co., Inc.*, plaintiffs alleged fraud in connection with the sale of stock.[34] During discovery, defendant violated the court's production order in a variety of ways, but certified full compliance despite the existence of more than 1,000 backup tapes that had not been processed, searched, or produced at the time of certification.[35] Defendant let this and other data languish for more than six months past the deadline for production.[36] Eventually, defendant produced 8,000 pages of e-mails and asserted that the e-mails were from "newly discovered" tapes, but later admitted the tapes' existence was known even before the initial certification of compliance.[37] Later, as evidentiary hearings were scheduled, the defendant periodically "located" new tapes and claimed others had been "misplaced" by a vendor.[38] The court imposed several sanctions against the defendant: (1) an adverse inference instruction, (2) the shifting of the burden of proof from the plaintiff to the defendant, (3) plaintiff's costs and fees, and (4) a statement to be read to the jury detailing defendant's behavior during discovery.[39]

5. Who Cares About Search Terms?

Developing the proper search terms to sort through backup tapes and other electronic storage media can be a tedious and time-consuming process for a producing party. A Worst Practices secret: much time and effort can be saved by simply leaving the requesting party in charge of formulating the list of search terms.

In re Fannie Mae Securities Litigation is a story of how a federal agency completely avoided the dreadful task of formulating a list of search terms, all for a bargain price equal to about 9% of the agency's annual budget. In this multidistrict litigation against Fannie Mae, the parties subpoenaed records collected by the Office of Federal Housing Enterprise Oversight ("OFHEO"). OFHEO, not a party to the litigation, had conducted a then-closed special review of Fannie Mae's accounting and financial practices.[40] As a part of its response to the subpoenas, OFHEO agreed to a stipulation that the "Defendants will specify the search terms to be used" in searching OFHEO's disaster-recovery backup tapes for responsive ESI.[41] The defendants "submitted over 400 search terms, which covered approximately 660,000 documents."[42] The D.C. Circuit found the unambiguous terms of the stipulation to be controlling and upheld the district court's finding that the stipulated order gave the defendants "sole discretion to specify search terms and imposed no limits on permissible terms."[43] The $6 million OFHEO would need to spend to comply with the stipulated order[44] must have been a pittance compared to the blood, sweat, and tears the agency saved by relinquishing discretion to select search terms to the defendants.

6. Backup Data Is Irrelevant by Definition!

A major problem with producing ESI is the large amount of irrelevant information through which one must search to find relevant information. To avoid this arduous task, the savvy Worst Practices attorney knows that it is best to make every effort to minimize the importance of additional discovery in the court's eyes. First and foremost: Ignore all backup data.

In *Kipperman v. Onex*, the trustee for a debtor's litigation trust sued a private equity firm that had acquired the debtor's subsidiaries for constructive transfer and fraud. During discovery, the defendants' counsel appears to have misrepresented the value of information that would be gleaned from defendants' backup tapes.[45] Indeed, in opposing plaintiff's motion to compel, the defendants successfully induced the court to rely on these statements in ordering a compromise solution to plaintiff's motion.[46] Unfortunately, the court found that "defense counsel's statements were either purposefully misleading or made with a reckless disregard for the truth"[47] and that defense counsel's conduct (including several other unrelated discovery missteps) constituted "a textbook case of discovery abuse."[48] The court ordered defendants to pay over $1 million for plaintiff's attorney's fees and other costs associated with the discovery difficulties created by defendants' behavior.[49]

An excellent way to minimize the value of further production is to certify to the court that production is complete when it may not be; we have already seen the success attorneys have had with this tactic.[50] Thus, the key to this Worst Practice rule is to remember that you can effectively eliminate the need to search for the few relevant needles in the haystack of irrelevant ESI by simply misrepresenting the value of discovery to the court.

7. Electronic Data (and Responsibility for It) Rolls Downhill!

E-discovery vendors can be an extraordinarily useful tool in the production of ESI. Worst Practices adherents know well that delivery of ESI to vendors for preparation and production ends the producing party's role in the discovery process. After all, how can it be your fault if you didn't make the mistake?

PSEG Power New York, Inc. v. Alberici Constructors, Inc. arose from a construction contract between PSEG and Alberici under which Alberici was the principal contractor for a project at a PSEG energy center. PSEG originally produced over 3,000 e-mails, which consisted of over 200,000 individual pages. Alberici soon realized that much of the data provided through a vendor was incomplete—many emails were "divorced" from their corresponding attachments.[51] The cause of this problem? PSEG's vendor used software that couldn't handle the plaintiff's document format and, as a result, the metadata linking attachments to e-mails was destroyed.[52] While the court found that PSEG had not acted maliciously and even lauded its efforts to resolve the problem through cooperation with Alberici,[53] the court refused to require Alberici to accept a "flawed discovery process."[54] The court ordered PSEG to reproduce the data damaged by its vendor's errors at PSEG's own expense.[55] PSEG estimated the cost of reproduction at approximately $206,000.[56]

Courts ignore this Worst Practice rule at an alarming rate. The *In re Seroquel* court cited the Sedona Principles in rejecting defense counsel's splendid attempt to pass on responsibility for shortcomings with ESI produced to plaintiffs, holding that "[u]ltimate responsibility for ensuring the preservation, collection, processing, and production of electronically stored information rests with the party and its counsel, not with the nonparty consultant or vendor."[57]

8. Candor (Part II): If You Can't Dazzle Them with Brilliance…

Production of electronic documents can be complicated. Fortunately, this Worst Practice rule absolves an attorney from ever having to understand fully the technical nuances of the production process.

In *Bank of Mongolia v. M & P Global Financial Services*, the plaintiff alleged that the defendants had conspired to defraud plaintiff of $23 million. At the hearing on the plaintiff's motion to compel following the defendants' failure to respond to document requests, defense counsel had no answers for the court's inquiry into the defendants' search and production methodology.[58] Defense counsel conceded that there was no substantial justification for the defendants' failure to comply with the plaintiff's document requests.[59] The court ordered the defendants to cover the plaintiff's costs associated with the motion to compel.[60]

Worst Practices adherents also may employ creative explanations of the production process. In the *Coleman (Parent) Holdings* and *Bray & Gillespie Management* cases, counsel for the producing party adopted this approach. The stories offered by counsel in these cases differed: one attributed the source of a production to "newly discovered" documents,[61] while the other "concocted" a tale about the process it used to collect ESI for production.[62] In each case, counsel's explanation sadly came undone when the court recognized conflicts between the explanation and other facts before the court.[63]

9. Don't Worry, Be Happy (Part I—Privilege Review): Clawback Agreements and Other Bedtime Stories

Worst Practices adherents know that privileged material will stay privileged no matter what, i.e., even if inadvertently produced, so long as the parties have entered into a clawback agreement. If you already have addressed waiver and inadvertent production issues prior to entering discovery, you're covered, right? Alas, many courts disagree.

In *United States v. Sensient Colors, Inc.*, the plaintiff produced approximately 135,000 pages to defendants over six different dates spanning nine months. Having been notified that its initial document production inadvertently had included privileged material, plaintiff did nothing to change its production methods to prevent further disclosure of privileged material, and each of the plaintiff's following productions also contained privileged materials.[64] The plaintiff relied upon the Discovery Plan it had negotiated with the defendant, which explicitly stated that "the inadvertent production of privileged documents or information (including ESI) shall not, in and of itself, waive any privilege that would otherwise attach to the document or information produced."[65]

The court, oblivious to the prevailing Worst Practice rule, read the Plan to mean only that a mere inadvertent production would not result in a waiver and that the parties intended to incorporate a "flexible" standard to determine if a waiver had occurred.[66] This standard, drawn from Federal Rule of Evidence 502(b), requires that the privilege holder take reasonable steps to prevent inadvertent disclosure and, if necessary, promptly take reasonable steps to rectify any errors in production.[67] The court found that the plaintiff acted unreasonably in refusing to alter its production methods after having been notified that it had produced privileged material; accordingly, the court found that plaintiff had waived privilege as to those documents it produced after being notified of the inadvertent production.[68]

Other courts weighing in on the strength of clawback agreements and similar arrangements also have disregarded the Worst Practice rule. For example, a poor choice of search terms for a privilege review of ESI has been found to waive privilege.[69] Even where a clawback agreement is reached, "reasonable precautions" to protect against inadvertent disclosure remain a necessity for a party wishing to maintain privilege.[70]

10. Don't Worry, Be Happy (Part II—Redaction): If You Cover Your Eyes, They Can't See You!

Electronic documents can be redacted easily by using word processing software to add dark rectangles over text or to shade the background to match the font color. Once you do that, those electronically redacted words are forever protected from the public eye, right? Well, perhaps not perfectly—and some authorities (and technical realities) have proven insufferable nitpickers in this regard.

During the Federal Trade Commission's investigation into Whole Foods Market's purchase of Wild Oats Markets, FTC lawyers electronically filed documents that contained dozens of redacted Whole Foods trade secrets.[71] As the news media discovered, the electronically shaded text could be "searched, copied, pasted and read."[72] Before the FTC realized its mistake and replaced the originally filed documents with scanned images of the redacted documents, the world learned that Whole Foods planned to close at least 30 Wild Oats stores and that Whole Foods negotiated with its suppliers to drive up costs for Wal-Mart.[73]

Electronic redaction problems are not exclusive to attorneys: the United States military revealed classified materials regarding the death of an Italian citizen at a traffic checkpoint in Iraq after it was discovered the black rectangles used to redact information in a PDF document did not prevent a reader from copying and pasting the text beneath the rectangles into a separate document.[74] However, given the rising prevalence of electronic filings, all but the most devoted Worst Practices adherents must remain wary of electronic redaction methods.

Best Practices

As in our earlier Worst Practices article, we close with a few affirmative recommendations for the readers inclined to avoid adventure, and sanctions. We again strongly recommend those interested in the "Best Practices" to become familiar with the Sedona Principles, bane of the Worst

Practices adherent.[75] Our list below highlights three recurring issues: formatting, scope, and ownership:

1. **Formatting:** As requesting party, specify your desired format. As producing party, produce in "reasonably usable" form, no matter the format requested. Be wary of electronic redaction tools.

2. **Scope:** Consider all available data for production, including, in certain cases, back-up data, and locate documents for review using carefully selected (and appropriately negotiated) search terms.

3. **Ownership:** "Own" the production by choosing proper search terms, working with vendors, fully understanding your production process, and taking all reasonable precautions to protect privileges. Meet deadlines, but manage your time well to avoid incomplete productions. Candidly admit your errors and technical problems, both to your adversary and the court, as soon as practical.

Endnotes

1. Jack E. Pace III & John D. Rue, *E-discovery "Worst Practices": Ten Sure-Fire Ways to Mismanage a Litigation Hold*, 13 N.Y. Bus. L.J. 2, 48 (Fall 2009).
2. An internet search for the phrase "e-discovery expert" in quotes yields about 226,000 hits.
3. *See, e.g.*, *e-discovery 2.0*, *available at* http://www.clearwellsystems.com/e-discovery-blog/2008/08/12/five-e-discovery-questions-with-craig-ball/ (announcing the commencement of "a long-running series of interviews with e-discovery luminaries").
4. *See, e.g.*, Hon. Judge John Carol, *Digital Discovery and Electronic Discovery Law*, *available at* http://www.lawcourse.net/ediscovery6/ (describing Judge Shira Sheindlin, author of the *Zubulake* opinions, as "[t]he foremost judicial E-discovery scholar").
5. *See* David Doepp, *Spiderman* (Sony Films 2002) ("With great power comes great responsibility."); *cf.* Nothing to Fear 464, Ben D. Zevin, ed. (World Publishing Company 1946) ("Today we have learned in the agony of war that great power involves great responsibility," quoting an undelivered speech by Franklin D. Roosevelt).
6. *See* Fed. R. Civ. P 34(b)(2)(E)(ii) ("If a request does not specify a form for producing electronically stored information, a party must produce it in a form or forms in which it is ordinarily maintained or in a reasonably usable form or forms.").
7. *Goodbys Creek, LLC v. Arch Ins. Co.*, No. 3 07-cv-947-J-34HTS, 2008 WL 4279693, at *3 (M.D. Fla. Sept. 15, 2008).
8. *Id.* ("[T]he option to produce in a reasonably usable form does not mean that a responding party is free to convert electronically stored information from the form in which it is ordinarily maintained to a different form that makes it more difficult or burdensome for the requesting party to use the information efficiently in the litigation. If the responding party ordinarily maintains the information it is producing in a way that makes it searchable by electronic means, *the information should not be produced in a form that removes or significantly degrades this feature*.") (emphasis in original) (citing to Rule 34 advisory committee's note (2006 Amends.)); *see also Covad Commc'ns Co. v. Revonet, Inc.*, 260 F.R.D. 5, 9 (D.D.C. 2009) ("Understandably, taking an electronic document such as a spreadsheet, printing it, cutting it up, and telling one's opponent to paste it back together again, when the electronic document can be produced with a keystroke is madness in the world in which we live.") (discussing defendant's failure to produce ESI in the form in which it was ordinarily maintained).
9. *Goodbys Creek, LLC*, at *3.
10. *Bray & Gillespie Mgmt., LLC v. Lexington Ins. Co.* (*B & G I*), 259 F.R.D. 568, 572-73 (M.D. Fla. 2009).
11. *Id.* at 585.
12. *Id.* at 575.
13. *Id.* at 575-76.
14. *Id.* at 588. The court noted that the costs related to this production might include "purchasing software or paying license fees for [defendant's] use of the database software, and hiring professionals to copy the database, if necessary." *Id.* Plaintiff also was required to provide a computer expert to inspect the ESI database to ensure plaintiff's compliance with the court's sanctions. *Id.*
15. *MGP Ingredients, Inc. v. Mars, Inc.*, Civil Action No. 06-2318-JWL-DJW, 2007 WL 3010343, at *1 (D. Kan. Oct. 15, 2007).
16. *Id.* at *3.
17. *Id.* at *4.
18. Fed. R. Civ. P. 34(b)(i).
19. *MGP Ingredients*, at *3-4 ("Plaintiff is bound by Rule 34(b)(i). Consequently, Defendants had the right to choose the option of producing their documents and ESI as kept in the usual course of business. Defendants made that choice, and, thus, have satisfied their duty under Rule 34(b).").
20. *See id.* at *4 (citing Fed. R. Civ. P. 34(b)).
21. *Id*.
22. *Ford Motor Co. v. Edgewood Props.*, 257 F.R.D. 418, 424 (D.N.J. 2009).
23. *Id.*
24. *Id.* at 425-26.
25. *Id.* at 426. The court did not specify any precise time limit in which an objection would be timely and explicitly eschewed any "rigid formulation as to when a party must object to a document production." *Id.* The court instead noted that "[r]easonableness is the touchstone principle, as it is with most discovery obligations." *Id.*
26. *Id.* (emphasis in original); *see also In re Payment Card Interchange Fee and Merch. Disc. Antitrust Litig.*, No. MD 05-1720(JG)(JO), 2007 WL 121426, at *4 (E.D.N.Y. 2007) (denying defendants' motion to require plaintiffs to reproduce documents plaintiffs had previously produced and to which defendants had waited nearly 12 months to object, thus finding that as between defendants and plaintiffs, "it would be less fair to impose the costs of a second form of production on the latter").
27. *In re Seroquel Prod. Liab. Litig.*, 244 F.R.D. 650, 661 (M.D. Fla. 2007) ("Plaintiffs contend [defendant] waited until mid-May 2007 to begin production of the overwhelming majority of the documents from these 'custodians' and the documents produced have significant errors of omission and are not readable or searchable. Plaintiffs contend that the custodial production has a great deal of missing data, *e.g.*, although [defendant] has a system to deliver voicemail, faxes, and video into Outlook inboxes, none has been produced; there are few emails from some custodians, and email boxes are missing from alternate email boxes.… [Defendant] missed deadlines and produced the electronic documents late; a significant portion of the production had blank pages; new load files were not searchable, in part because the date formats in the metadata were inconsistently loaded and email attachments not consistently associated or identified; authors were not identified as custodians for files; transposed metadata recipients/authors; and no page breaks were inserted in 3.75 million pages.").
28. *Id.* at 652 ("However, [defendant's]…failure to timely and systematically produce electronic discovery associated with eighty [defendant] 'custodians' in any manageable, searchable form [is] sanctionable conduct.").
29. *Thompson v. U.S. Dept. of Hous. and Urban Dev.*, 219 F.R.D. 93, 96 (D. Md. 2003).
30. *Id.* at 104-05.

31. *See supra* notes 10-14 (re: *B & G I*) and accompanying text.

32. *Bray & Gillespie Mgmt., LLC v. Lexington Ins. Co.* (*B & G II*), No. 6:07-cv-222-Orl-35KRS, 2010 WL 55595, at *5 (M.D. Fla. Jan. 5, 2010).

33. *Id.* at *5-7.

34. *Coleman (Parent) Holdings, Inc. v. Morgan Stanley & Co., Inc.*, No. 502003CA005045XXOCAL, 2005 WL 679071 (Fla. Cir. Ct. Mar. 1, 2005).

35. *Id.* at *1-2.

36. *Id.* at *2-5.

37. *Id.* at *3-4.

38. *Id.* at *4.

39. *Id.* at *7-8.

40. *In re Fannie Mae Sec. Litig.*, 552 F.3d 814, 816 (D.C. Cir. Jan. 6, 2009).

41. *Id.* at 817.

42. *Id.*

43. *Id.* at 817-21.

44. *Id.* at 817 ("OFHEO undertook extensive efforts to comply with the stipulated order, hiring 50 contract attorneys solely for that purpose. The total amount OFHEO spent on the individual defendants' discovery requests eventually reached over $6 million, more than 9 percent of the agency's entire annual budget.").

45. *Kipperman v. Onex*, 260 F.R.D. 682, 692 (N.D. Ga. 2009) ("The court does condemn Defendants, however, for making blatant misrepresentations about the value of e-mail discovery in this case in an effort to influence the court's ruling, for refusing to follow the court's ruling once made, and for behaving as if they, and not the court, got to decide what electronic material was relevant and discoverable under Rule 26 and what material was not.").

46. *Id.* at *690-93.

47. *Id.* at *692.

48. *Id.* at *700.

49. *Id.*

50. *See supra* notes 34-39 and accompanying text (discussing *Coleman (Parent) Holdings, Inc. v. Morgan Stanley & Co., Inc.*).

51. *PSEG Power N.Y., Inc. v. Alberici Constructors, Inc.*, No. 1:05-CV-657 (DNH/RFT), 2007 WL 2687670, at *2, 6 (N.D.N.Y. Sept. 7, 2007).

52. *Id.* at *2, 5.

53. *Id.* at *9.

54. *Id.* at *12.

55. *Id.* ("But for PSEG's vendor creating this email attachment fiasco, we would not be having this discussion. Without question, attachments should have been produced with their corresponding emails as such are kept in the usual course of business.… Whether created by a software incompatibility or malfunction, such deficiency does not provide a sufficient excuse from presenting an important aspect of discovery in a convoluted fashion.").

56. *Id.* at *3.

57. *In re Seroquel*, 244 F.R.D. at 664 (citing Sedona Principle 6.d). The *In re Seroquel* court based its finding that sanctions were warranted not only on the "purposeful sluggishness" of the defendant described above, but also on defendant's "continued failure to produce single-page TIFF documents that would be 'usable' or 'reasonably accessible.'" *In re Seroquel*, 244 F.R.D. at 664. Defense counsel attributed these problems to vendor errors concerning load files and metadata. *Id.*

58. *Bank of Mongolia v. M & P Global Fin. Servs.*, 258 F.R.D. 514, 517 (S.D. Fla. 2009). For example, defense counsel could not explain why it had not searched deleted and unsaved ESI for responsive documents. *Id.*

59. *Id.* at 522.

60. *Id.*

61. *Coleman*, at *3.

62. *B & G I*, at *7-8 ("The false explanation [counsel] gave regarding how ESI had been collected…unreasonably prolonged and multiplied the proceedings regarding the ESI discovery dispute.").

63. *See Coleman*, at *3 ("[Defendant] has failed to offer any explanation to reconcile the obvious conflict between its assertions at the time of production…and the testimony of its own witness[.]"); *B & G I*, at *8 ("In creating this false tale, [counsel] ignored numerous facts known or readily available to him about the actual process that was used to collect ESI and produce it to [opposing counsel].").

64. *United States v. Sensient Colors, Inc.*, Civil No. 07-1275 (JHR-JS), 2009 WL 2905474, at *4 (D.N.J. Sept. 9, 2009).

65. *Sensient Colors*, at *2 n.4.

66. *Id.* at *3.

67. *Id.* at *3; *see* Fed. R Evid. 502(b).

68. *Sensient Colors*, at *4-7.

69. *Victor Stanley, Inc. v. Creative Pipe, Inc.*, 250 F.R.D. 251 (D. Md. 2008). The defendants were found to have waived privilege over ESI inadvertently produced following a privilege review consisting of searching electronic documents for certain terms. The court held that the defendants had not taken reasonable precautions to safeguard the privileged material, and thus were "not insulated from waiver." *Id.* at 263. The court described the defendants' privilege review shortcomings as follows:

> Defendants have failed to demonstrate that the keyword search they performed on the text-searchable ESI was reasonable. Defendants neither identified the keywords selected nor the qualifications of the persons who selected them to design a proper search; they failed to demonstrate that there was quality-assurance testing; and when their production was challenged by Plaintiff, they failed to carry their burden of explaining what they had done and why it was sufficient.

Id. at 262.

70. *Spieker v. Quest Cherokee, LLC*, No. 07-1225-EFM, 2009 WL 2168892 (D. Kan. July 21, 2009). The court rejected the requesting party's suggestion that the producing party could avoid the costs of a privilege review by turning over all its ESI with a clawback agreement. *Id.* at *3. "Simply turning over all ESI materials does not show that a party has taken 'the reasonable steps' to prevent disclosure of its privileged materials." *Id.*; *see also id.* at *3 n.4 ("[S]imply turning over ***all*** ESI information without some effort to protect privileged material does not rise to the level of 'reasonable steps' set forth in Rule 502(b)." (emphasis in original)).

71. Christopher S. Rugaber, *Error by FTC Reveals Whole Foods' Trade Secrets*, Wash. Post, August 15, 2007, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2007/08/14/AR2007081401784.html.

72. *Id.*

73. *See id.*; *see also Documents Describe Whole Foods' Strategy*, N.Y. Times, August 15, 2007, *available at* http://www.nytimes.com/2007/08/15/business/15food.html?_r=2&scp=19&sq=whole+foods&st=nyt.

74. Munir Kotadia, *Military secrets escape through PDF file*, ZDNet UK, May 5, 2007, *available at* http://www.zdnet.co.uk/misc/print/0,1000000169,39197313-39001093c,00.htm.

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

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XBRL Interactive Data for Financial Reporting

By Steven J. Glusband, Guy P. Lander and Sharon Rosen

The Securities and Exchange Commission (the "SEC") has adopted rules that require companies to provide their financial statements in interactive (i.e., computer-readable) data format using eXtensible Business Reporting Language ("XBRL"). The interactive data requirements do not change disclosure requirements under the federal securities laws and regulations, but rather add a requirement to include financial statements in a new interactive data format as an exhibit. The disclosure in interactive data format is in addition to, rather than instead of, disclosure in the traditional electronic format of ASCII or HTML. Financial statements will continue to be required to be submitted in traditional format under existing requirements.

The primary purpose of the XBRL rules is to make financial information easier for investors and analysts to compare and analyze, and to assist companies in automating regulatory filings and business information processing.

Companies reporting under generally accepted accounting principles in the United States ("U.S. GAAP") that are large accelerated filers are already subject to the requirement to file XBRL data. All remaining U.S. and non-U.S. filers using U.S. GAAP and foreign private issuers that prepare their financial statements in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB") must file XBRL data along with their first quarterly report (or annual report, for foreign private issuers) for a fiscal period ending on or after June 15, 2011.

What Is XBRL?

XBRL is a computer language that enables financial and other data contained in reports filed with the SEC and delivered over the Internet to be processed by certain software applications. XBRL consists of a standard set of identifiers, or "tags," which are embedded within the financial statements and can be read by specialized software. XBRL includes numerous sets (or "taxonomies") of standard tags for different industry groups, each designed for use in connection with a particular accounting regime. XBRL enables analysts and investors to pull information out of SEC filings and compare and analyze information from numerous companies.

Filers using U.S. GAAP are required to tag their financial statements using the most recent list of tags of U.S. financial statement reporting, as released by XBRL U.S. Inc. and required by the EDGAR Filer Manual. Similarly, filers using IFRS as issued by the IASB are required to tag their financial statements using the most recent list of tags for international reporting standards, as released by the International Accounting Standards Committee Foundation and required by the EDGAR Filer Manual.

In its first year of interactive data reporting, a company is required to tag the face of its financial statements. A company is also required to tag its financial statement footnotes and schedules in its first year, but only as blocks of text. After the first year of such tagging, a company is also required to tag, as a separate block of text, each significant accounting policy and table within a footnote, and to separately tag each amount (monetary value, percentage and number) within the footnotes and schedules, and will be permitted, but not required, to the extent it chooses, to tag each narrative disclosure.

A filer required to provide XBRL data must "map" each element of its financial statements to the appropriate XBRL standard tags using a commercially available XBRL software package. Companies must generally use the standard XBRL tag having a definition that matches the financial concept represented by the relevant line item. If a standard XBRL tag is not available for a particular financial statement element, a company can create a customized tag, called an "extension." When the standard tag's definition is appropriate for a financial statement element but the company's label for that line item is different from the standard tag, the company must change the label of the tag instead of creating a new tag. For example, a company might use the term "operating revenues" in its financial statements for an element that has "net revenues" for the standard tag; when preparing its XBRL exhibit, the company will need to change, or extend, the standard label to become "operating revenues."

Phase-In Dates

The obligation to provide XBRL data is being phased in over several years, as follows:

- The first affected filers were U.S. and non-U.S. companies reporting under U.S. GAAP that are large accelerated filers with a public float over $5 billion, which were required to file XBRL data along with their first quarterly report (or annual report, for foreign private issuers) for a fiscal period ending on or after June 15, 2009.
- Other U.S. and non-US. large accelerated filers using U.S. GAAP are required to file XBRL data along with their first quarterly report (or annual report, for foreign private issuers) for a fiscal period ending on or after June 15, 2010.

- All remaining U.S. and non-U.S. filers using U.S. GAAP are required to file XBRL data along with their first quarterly report (or annual report, for foreign private issuers) for a fiscal period ending on or after June 15, 2011.
- Foreign private issuers that prepare their financial statements in accordance with IFRS as issued by the IASB are required to file XBRL data along with their first annual report for a fiscal period ending on or after June 15, 2011.

Financial Statements for Which XBRL Data Is Required

Subject to the applicable phase-in period, public companies will be required to include an exhibit that includes XBRL-tagged financial statements in the following filings:

- annual reports on Form 10-K, Form 20-F and Form 40-F;
- quarterly reports on Form 10-Q;
- current reports on Form 8-K and Form 6-K that include updated or revised financial statements;
- transition reports on Form 10-Q, Form 10-K and Form 20-F; and
- registration statements filed under the Securities Act of 1933 (the "Securities Act") that include financial statements (other than financial statements incorporated by reference), but only after a price or price range has been determined and any later time when the financial statements are changed.

A registrant's first filing to be subject to the interactive data requirement would be a quarterly report, or, for a foreign private issuer not required to file quarterly reports, an annual report. A registrant is required to submit its first XBRL-format exhibit for a registration statement only after it has filed its first quarterly or annual report that is required to include interactive data. Accordingly, interactive data exhibits will not be required for initial public offerings.

A foreign private issuer that files interim financial statements in accordance with the nine-month updating requirement of Item 8.A.5. of Form 20-F would be required to submit an interactive data file with that filing.

Interactive data requirements do *not* apply to:

- Management's Discussion and Analysis (MD&A), executive compensation, or other statistical or narrative disclosure;
- financial statements for (i) acquired companies or businesses to be acquired (Rule 3-05 of Regulation S-X), (ii) unconsolidated subsidiaries and 50% or less owned persons (Rule 3-09 of Regulation S-X), (iii) certain real estate operations to be acquired (Rule 3-14 of Regulation S-X), and (iv) affiliates whose securities constitute a substantial portion of the collateral for a class of securities being registered (Rule 3-16 of Regulation S-X);
- pro forma financial statements prepared under Article 11 of Regulation S-X;
- financial statements in Form 10, Form 20-F and Form 40-F registration statements under the Securities Exchange Act of 1934 (the "Exchange Act");
- foreign private issuers that prepare their financial statements using accounting standards other than U.S. GAAP or IFRS as issued by IASB; and
- investment companies registered under the Investment Company Act and business development companies as defined in Section 2(a)(48) of that Act.

Initial Filing Grace Period

Interactive data is required to be to be submitted to the SEC at the same time as the rest of the filing to which it relates, except that:

- A company's initial interactive data submission will have a 30-day grace period and may be filed as an amendment to the report or registration statement within 30 days after the earlier of the respective due date or filing date.
- In year two, a filer will have a similar 30-day grace period for its first interactive data exhibit that is required to include detailed tagging of its footnotes and schedules.

Website Posting of Interactive Data

A company required to provide financial statements in interactive data format to the SEC is also required to post the financial statements in interactive data on its corporate website not later than the calendar day it filed or was required to file the related report or registration statement, whichever is earlier. The interactive data must be posted for at least 12 months. Companies are not allowed to comply with the web posting requirement by including a hyperlink to the SEC's website.

Consequences of Non-Compliance

Filers that do not provide or post the required interactive data by the required due date will be deemed not current with their Exchange Act filings and, as a result, will not be eligible to use short form registration statements on Form S-3, Form F-3 and Form S-8, nor may they elect under Form S-4 or Form F-4 to provide information at a level prescribed by Form F-3 or Form S-3. Such filers will also be deemed not to have available adequate current public information for purposes of the resale exemption safe harbor provided by Rule 144. This disqualification will last until the interactive data is provided. Once a filer complies with the interactive submission and posting requirements—provided it previously filed its financial statement information in traditional format on a timely basis—it will be deemed to be timely and current in its periodic reports.

Hardship Exemptions

The SEC has also adopted hardship exemptions for the inability to submit interactive data. Rule 201 of Regulation S-T provides a temporary hardship exemption from submitting or posting interactive data, without Staff or SEC action, when a filer "experiences unanticipated technical difficulties preventing the timely preparation and submission of an electronic filing." The temporary hardship exemption will cause the filer to be deemed current for purposes of incorporation by reference, short form registration and Rule 144, for a period of up to six business days from the date the interactive data was required to be submitted and posted.

Rule 202 of Regulation S-T permits a filer to apply in writing for a continuing hardship exemption from submitting or posting interactive data if information otherwise required to be submitted or posted in electronic format cannot be so filed without undue burden or expense. If the exemption is granted, the filer will be deemed current until the end of the period for which the exemption is granted.

Limited Securities Law Liability for First Two Years

An interactive data file generally will be subject to federal securities laws in a modified manner if the filer submits the interactive data within 24 months of the time the filer is required to submit interactive data files but no later than October 31, 2014. During the time a filer's interactive data files are treated in this modified manner, they will be:

- subject to the anti-fraud provisions, except in connection with a failure to comply with the tagging requirements that occurs despite a good faith attempt to comply and that is corrected promptly after the filer becomes aware of the failure;
- deemed not "filed," or part of a registration statement or prospectus for purposes of Section 11 or 12 of the Securities Act and not otherwise subject to liability under these sections;
- deemed not "filed" for purposes of Section 18 of the Exchange Act or Section 34(b) of the Investment Company Act and not otherwise subject to liability under these sections; and
- deemed "filed" for purposes of Rule 103 under Regulation S-T (and, as a result, will not be subject to liability for electronic transmission errors beyond its control if the registrant corrects the problem through an amendment as soon as reasonably practicable after becoming aware of the problem).

Auditor Liability

Auditor assurance on interactive data submissions is not required. Filers are not required to involve third parties, such as auditors or consultants, in creating their interactive data filings.

Officer Certifications

Interactive data is excluded from the officer certification requirements of Rules 13a-14 and 15d-14 under the Exchange Act. However, interactive data is not excluded from the definition of "disclosure controls and procedures" and as a result, a registrant is required to evaluate its interactive data procedures for purposes of disclosure controls and procedures compliance, but the outcome of the evaluation does not require management to assess or an auditor to attest to the registrant's XBRL format exhibit.

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Employment Law Update

By James R. Grasso

New York State Construction Industry Fair Play Act Presumes All Construction Workers to Be Employees

Due to "dangerous levels of employee misclassification fraud," the New York State Legislature recently amended the New York Labor Law by adding a new article 25-B, known as the New York State Construction Industry Fair Play Act, effective October 26, 2010. This new law provides that any person performing services for a construction contractor or subcontractor is deemed an employee, unless (a) the individual is free from control and direction in performing the job, both under his or her contract and in fact; (b) the service is performed outside the usual course of business for which the service is performed; and (c) the individual is customarily engaged in an independently established trade, occupation, profession or business that is similar to the service at issue. A business entity will be considered a separate entity from the contractor or subcontractor where all of the following criteria are met:

(1) the business entity is performing the service free from the direction or control over the means and manner of providing the service, subject only to the right of the contractor for whom the service is provided to specify the desired result;

(2) the business entity is not subject to cancellation or destruction upon severance of the relationship with the contractor;

(3) the business entity has a substantial investment of capital in the business entity beyond ordinary tools and equipment and a personal vehicle;

(4) the business entity owns the capital goods and gains the profits and bears the losses of the business entity;

(5) the business entity makes its services available to the general public or the business community on a continuing basis;

(6) the business entity includes services rendered on a Federal Income Tax Schedule as an independent business or profession;

(7) the business entity performs services for the contractor under the business entity's name;

(8) when the services being provided require a license or permit, the business entity obtains and pays for the license or permit in the business entity's name;

(9) the business entity furnishes the tools and equipment necessary to provide the service;

(10) if necessary, the business entity hires its own employees without contractor approval, pays the employees without reimbursement from the contractor and reports the employees' income to the Internal Revenue Service;

(11) the contractor does not represent the business entity as an employee of the contractor to its customers; and

(12) the business entity has the right to perform similar services for others on whatever basis and whenever it chooses.

The new law requires construction contractors and subcontractors to post a notice at the work site listing the responsibility of independent contractors to pay taxes as well as the various rights of employees, including their right to worker's compensation, unemployment benefits, minimum wages, overtime, and other federal and state protections. Employers who fail to post the required notice or who improperly classify an employee are subject to civil ***and*** criminal penalties. The civil penalties provide for a fine of $2,500 for the first misclassification violation and $5,000 for each subsequent violation within five years. Criminal penalties include 30 days' imprisonment or a fine of up to $25,000 for the first violation, and 60 days in prison and $50,000 for each subsequent violation of this law. Further, any officer of the corporation or shareholder holding ten percent or more of the offending corporation is also subject to civil and criminal liability, and any such person or contractor or subcontractor convicted of a misdemeanor is automatically barred from submitting bids on public works contracts for up to one year from the first violation and up to five years from any subsequent violation.

New York Extends Bereavement Leave Rights to Same-Sex Partners

As the result of the enactment of § 79-n of the New York Civil Rights Law, effective October 29, 2010, New York employers who provide bereavement leave for the death of an employee's spouse or the child, parent or other relative of the spouse must provide the same leave to an employee for the death of the employee's same-sex committed partner or the child, parent or other relative of the same-sex committed partner. The new law does not require employers to provide bereavement leave to any employees. However, if an employer provides bereavement leave to its employees for the death of a spouse or the child, parent or other relative of the spouse, then an employee's committed same-sex partner must be considered as the employee's spouse for purposes of such leave. The statute defines same-sex committed partners to be "those who are financially and emotionally interdependent in a manner commonly presumed of spouses."

Department of Labor Issues Regulations and Required Union Rights Notice for Federal Contractors

President Obama signed Executive Order 13496 ("Order") on January 30, 2009, requiring most federal contractors and subcontractors who are covered by the National Labor Relations Act (NLRA) to post an "Employee Rights" notice ("Notice") informing their employees of their rights under the NLRA, including the right to join and support unions. (The Order does not apply to prime contracts below the simplified acquisition threshold of $100,000 or subcontracts of $10,000 or less.) On May 20, 2010, the U.S. Department of Labor ("DOL") issued its final regulations implementing the Order, along with the required Notice for posting. The regulations became effective June 21, 2010. Covered employers must post the DOL-issued Notice upon signing a new contract or subcontract that mandates compliance with the Order. The Notice must be posted at each location where other required employee notices are posted and at each part of the facility where any employee covered by the NLRA performs work related to the covered contract or subcontract. The Notice can be obtained from the DOL's website at http://www.dol.gov/olms/regs/compliance/EO13496.htm. If a covered contractor or subcontractor customarily posts notices to employees electronically, it must also post the required Notice electronically. The electronic posting requirement can be satisfied by prominently displaying a link to the Notice on any external or internal website maintained and customarily used for notices to employees about terms and conditions of employment. The text for the link must read, "Important Notice about Employee Rights to Organize and Bargain Collectively with Their Employers," and it must link to the specific web page identified in the regulations.

New York Department of Labor Limits Deductions from Wages

Under Section 193 of the New York Labor Law, an employer may only make deductions from an employee's wages that are required by law or authorized by the employee in writing and are for insurance premiums, pension or health and welfare benefits, contributions to charitable organizations, payments for U.S. bonds, payments for union dues or assessments and "similar payments for the benefit of the employee." For many years, the New York Department of Labor (NYDOL) took the position that deductions from an employee's wages for money owed to the employer, such as for a loan, salary advance or overpayment of wages, were permissible under § 193. In addition, many employers interpreted the phrase "similar payments for the benefit of the employee" broadly to include deductions for a wide variety of other items, such as for damage to the employer's property, meals in employer-run cafeterias, tuition and the purchase of goods and services from the employer, so long as the employee authorized the deduction in writing. The NYDOL did not take a definitive position on such deductions in the past and they were for the most part tolerated.

However, the NYDOL has now explicitly determined that deductions for overpayments, salary advances and items other than those specifically listed in § 193 are not permitted, even if the employee consents to the deduction in writing. In adopting this position, the NYDOL relied on two New York Court of Appeals decisions in which the Court narrowly interpreted what is a permissible deduction from wages under § 193. Regarding what constitutes a "similar payment," the NYDOL now states that such payments are limited to deductions that are either an investment of money for the later benefit of the employee or used by someone other than the employee or employer to support some purpose of the employee. Thus, employers may no longer make deductions from wages for other items not explicitly identified in § 193, unless those other items are either an investment of money for the later benefit of the employee or used by someone other than the employee or employer to support some purpose of the employee.

To recover a wage overpayment or advance, the NYDOL states that an employer is limited to requesting that the employee repay the money or suing the employee in court. If an employer requests that the employee repay the money, the NYDOL states that the employer cannot threaten the employee with discipline or termination for failure to pay back the money and must clearly communicate that the employee's refusal to do so will not result in discipline or retaliatory action. According to the NYDOL, requiring or coercing an employee to repay an overpayment or advance would violate § 193(2) of the New York Labor Law, which prohibits requiring an employee to make a payment by separate transaction unless such payment is a permitted deduction from wages.

New York Extends Employment Rights to Domestic Workers

As the result of amendments to the New York Labor Law, Executive Law and Workers' Compensation Law, New York has significantly expanded the rights of certain domestic workers, effective November 29, 2010. Under the amendments (contained in Assembly Bill A. 1470), a covered "domestic worker" is any "person employed in a home or residence for the purposes of caring for a child, serving as a companion for a sick, convalescing or elderly person, housekeeping, or for any other domestic service purpose." However, "domestic worker" does not include any person working on a casual basis, any person employed by an employer or agency other than the family or household using his or her services or relatives through blood, marriage or adoption.

The amendments to the Executive Law make it unlawful to sexually harass a covered domestic worker or otherwise harass him or her because of gender, race, religion or national origin. The amendments to the Labor Law require that covered domestic workers receive overtime for hours worked over 40 in a work week, 24 hours of rest in each calendar week (the worker may agree to work on the day of rest but must receive overtime for doing so), and three days of paid leave per year after one year of employment. The law also extends unemployment benefits to covered domestic workers. Likewise, the amendments to the Workers' Compensation Law extends workers' compensation benefits to covered domestic workers.

FMLA Child-Related Leave Provisions Extended to Same-Sex Parents and Nontraditional Families

On June 22, 2010, the U.S. Department of Labor (DOL) issued an interpretation of the Family and Medical Leave Act (FMLA) that clarifies that same-sex parents and members of nontraditional families are eligible for child-related leave. The interpretation concerns the definition of "son or daughter" under the FMLA. A "son or daughter" under the FMLA includes not only biological or adopted children, but also foster children and stepchildren, and a legal ward or a child of a person standing *in loco parentis*. The DOL's interpretation addresses the circumstances in which a person stands *in loco parentis* to a child. Although the FMLA regulations define *in loco parentis* to include those with day-to-day responsibilities to care for and financially support a child, the DOL states that the regulations do not require an employee who intends to assume the responsibilities of a parent to provide both day-to-day care and financial support. Rather, it is the DOL's interpretation that "either day-to-day care or financial support may establish an *in loco parentis* relationship where the employee intends to assume the responsibilities of a parent with regard to a child." The result of this interpretation is that an employee who has no biological or legal relationship with a child, but who provides either day-to-day care or financial support for the child, is now eligible for child-related FMLA leave.

The DOL interpretation provides two examples of how this expanded definition of *in loco parentis* will affect same-sex parents and members of nontraditional families. In the first example, the DOL states that an employee who has no biological relationship with an unborn child, but who will share in the child's raising with a biological parent, would be entitled to FMLA leave for the birth of a child. In the second example, the DOL states that an employee who will share in the raising of an adopted child with a same-sex partner, but who does not have a legal relationship with the child, would be entitled to leave to bond with the child or to care for the child if the child had a serious health condition. The DOL interpretation also states that there is no restriction on the number of parents a child may have under the FMLA, and that the fact that a child has both a mother and a father does not prevent a finding that the child is the "son or daughter" of an employee who lacks a biological or legal relationship with the child. Where an employer has questions whether an employee's relationship to a child is covered under the FMLA, the employer may require the employee to provide reasonable documentation or a statement of the family relationship. However, the DOL states that in situations where there is no legal or biological relationship, such as *in loco parentis*, a simple statement from the employee asserting that the requisite family relationship exists is all that is needed for the employee to establish the required relationship.

James R. Grasso is a partner with Phillips Lytle LLP, Buffalo. He focuses his practice in the area of labor and employment on behalf of management in the private and public sectors and counsels clients on the full range of human resources issues. His labor law practice encompasses labor arbitrations, negotiating collective bargaining agreements, contract administration and defending management before NLRB, PERB and other federal and state agencies.

Committee Reports

Banking Law Committee

The Banking Law Committee held a well-attended and very productive meeting as part of the Section's Fall Meeting in Saratoga in mid-October. The focus was (what else?) the new Dodd-Frank reform law and the future of banking. We were fortunate to have as our guest speakers Michael Campbell, Esq., a senior attorney at the Federal Reserve Bank of New York, and Jonathan Rushdoony, Esq., District Counsel for the Office of the Comptroller of the Currency (OCC). Mr. Campbell, who also currently serves as Chair of the Banking Law Committee of the Association of the Bar of the City of New York, is on secondment from the Federal Reserve to the Treasury Department at present, where he is assisting in establishing the new Consumer Financial Protection Bureau established by Dodd-Frank. At this stage the Bureau is recruiting personnel, with a focus on staff of the existing regulatory agencies who have responsibility for consumer financial protection. While the Bureau's mandate is to write rules for a broad range of consumer financial products, the regulatory agencies will have primary responsibility for assuring compliance and enforcement for the institutions under their charge and thus will be able to balance consumer protection against their traditional mandate to assure safety and soundness. Mr. Campbell said that the Bureau's interim head, Professor Elizabeth Warren of Harvard Law School, whose appointment by President Obama has been controversial, has a primary focus of enhancing transparency, rather than restricting or prohibiting particular products. Mr. Rushdoony spoke about the challenges to the OCC of implementing provisions of the law. For example, historically the OCC has relied upon ratings by nationally recognized statistical rating organizations to determine which securities are permissible investments for national banks; the legislation forbids the use of these ratings going forward, so the OCC is currently reviewing and revising its rules. Finally, Section Chair Bruce Baker contributed some very useful observations regarding how Dodd-Frank is perceived by smaller community banks, especially the concerns about increased compliance costs and a chilling effect on bank lending.

—David L. Glass, Chair

Franchise Distribution and Licensing Law Committee

The Franchise, Distribution and Licensing Law Committee had a very busy summer. In June, the Committee co-sponsored the Fundamentals of Franchising Program, a full-day CLE program held at the Affinia Manhattan. I was the Chair for the program, and it included presentations by Committee members Julie Lusthaus, Craig Tractenberg and me. The last Committee Meeting was held on July 14, and it was attended by approximately 20 members. The meeting featured a presentation from Nonie Manion (Director of Tax Audits) and Brian Haas (Director of Desk Audit Operations) from the New York Department of Taxation and Finance. Our presenters led a discussion about the new franchisor reporting law which requires franchisors to file semi-annual Information Reports concerning purchases and sales for each franchisor's New York-based franchisees. Our presenters discussed which franchisors are required to file, the information that must be included in each filing, key filing deadlines, how the Department of Taxation and Finance reviews and acts on the information that it receives from franchisors and the penalties for non-compliance.

—David W. Oppenheim, Chair

Insurance Law Committee

The Insurance Law Committee of the Business Law Section had a robust discussion on several topics at its October meeting, which was held during the Business Law Section's Fall Meeting in Saratoga, New York. Kicking off the discussion was Martha Lees, Deputy Superintendent and General Counsel of the New York State Insurance Department, who updated the committee on numerous current and pending matters of focus at the department. The committee then enjoyed a spirited discussion regarding current insurance policy coverage issues between Robert Goodman, a litigation partner at Debevoise & Plimpton LLP, and Joseph Jean, a litigation counsel at Kasowitz, Benson, Torres & Friedman LLP. Finally, Thomas Kelly, a partner at Debevoise & Plimpton LLP, walked the committee through the finer points of the Dodd-Frank Act as they affect U.S. insurance companies. For copies of the materials from the committee meeting, contact the Committee Chair at mekaplan@debevoise.com.

—Matthew E. Kaplan, Chair

Securities Regulation Committee

Since our last update, the Securities Regulation Committee has continued its monthly meeting programs addressing a wide range of matters of importance to securities law practitioners. Our dinner meetings tend to foster lively discussions, and afford Committee members an opportunity to discuss "hot topics" with persons closely associated with them. Among the topics presented at our recent meetings were:

1. Corporate Governance and Risk
2. Fairness Opinions—Recent Cases and Other Developments
3. Financial Reform Legislation—an Insider's View
4. Current Issues in Executing Capital Markets Transactions
5. FINRA Regulatory Notice 10-22: Obligation of Broker-Dealers to Conduct Reasonable Investigations in Regulation D Offerings, plus other developments
6. Reverse Mergers
7. Dodd Frank Act: (A) Investment Adviser registration and other provisions affecting Hedge Funds and Private Equity, plus (B) the Corporate Governance & Executive Compensation provisions
8. Dodd-Frank Act: Derivatives provisions (that even non-derivatives lawyers need to know)
9. After the Subprime Crisis: A New Era of Financial Reporting
10. "Proxy Access"
11. Recent 2nd Circuit decision involving SOXA 304 (clawback) and indemnification rights of the CEO and CFO
12. "Proxy Plumbing" & the SEC Concept Release

In addition, at the Business Law Section Fall Meeting, the Committee sponsored two outstanding programs. The first was "Trends in Private Placements, PIPEs, Registered Directs, Confidentially Marketed Public Offerings and Bought Deals." We heard from an experienced banker and a seasoned lawyer on the current techniques used by companies to raise capital and how to navigate the issues. Then, in the "Extraterritorial Reach of the Federal Securities Regulation" program, we heard from a securities litigator and a law professor/former SEC enforcement attorney on how the recent *Morrison* Supreme Court decision overruled nearly 50 years of accepted case law, and what that means to us. A lively discussion ensued.

—Howard Dicker, Chair

Publication Policy and Manuscript Guidelines for Authors

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

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

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

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

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

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

Deadlines

Manuscripts are to be submitted to:

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New York State Bar Association

Business Law Section

ANNUAL STUDENT WRITING COMPETITION

The Business Law Section sponsors an annual Student Writing Competition, open to all students who are candidates for the J.D. or LL.M. degree at an accredited law school during the year in which the article is submitted. The student articles submitted in a given year that are judged first and second best, provided they are of publishable quality and otherwise meet the criteria of the Competition, will receive cash prizes of $1,500 and $1,000, respectively. At the discretion of the editors, they also will be published in the NYSBA *NY Business Law Journal*, which is sponsored by the Section in cooperation with New York Law School. Additional cash prizes may be awarded in the discretion of the Section. Entries that do not qualify for cash prizes may also be considered for publication in the *Journal*.

Articles submitted will be judged on the following criteria:

- Relevance to the *Journal*'s audience (New York business lawyers)
- Timeliness of the topic
- Originality
- Quality of research and writing
- Clarity and conciseness

The manuscript should follow Bluebook cite format (using endnotes rather than footnotes) and be a minimum of 3,000 words (there is no maximum). All submissions become the property of the NYSBA and the *NY Business Law Journal*. By submitting an article, the student is deemed to consent to its publication, whether or not a cash prize is awarded.

To enter, the student should submit an original, unpublished manuscript in Word format to David L. Glass, Editor-in-Chief, NYSBA *NY Business Law Journal* (david.glass@macquarie.com). The student should include a brief biography, including law school attended, degree for which the student is a candidate, and expected year of graduation.

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