NY BUSINESS LAW JOURNAL

SPRING 2004

Vol. 8, No. 1

THE BUSINESS LAW SECTION
NEW YORK STATE BAR ASSOCIATION

in cooperation with

ALBANY LAW SCHOOL

ISSN 1521-7183

BUSINESS LAW SECTION—OFFICERS—2003-2004

Chair	Grace Sterrett Hudson Cook, LLP 636 Plank Road, Suite 107 Clifton Park, NY 12065
First Vice-Chair	Gregory J. Blasi Nixon Peabody LLP 437 Madison Avenue New York, NY 10022
Second Vice-Chair and Fiscal Officer	Samuel F. Abernethy Menaker & Herrmann LLP 10 East 40th Street New York, NY 10016
Secretary	David L. Glass Clifford Chance US LLP 31 West 52nd Street New York, NY 10019

John Grisham and You

Scratch the surface of most lawyers and you are likely to find a frustrated author struggling for free expression. Lawyers love to talk, but they also like to express themselves on paper. Witness the lawyer-novelists: Grisham, Turow, Martini, Fairstein, Baldacci.

True, a full-blown novel may be a bit much to squeeze in at this stage of your career, but if you are feeling the need for self-expression, there is a way to get relief: **SUBMIT AN ARTICLE TO THE *NY BUSINESS LAW JOURNAL*!** Really. This is something you can do. No prior experience necessary. An article for the *Journal* can be on any business law topic of general interest to practitioners, offering practical advice or insight on any topical issue of law. Preparing an article for publication could be as simple as minor editing of a recent client memorandum already in your files. There are no formal requirements for articles as to length or style. See page 47 of this issue for further information regarding the *Journal*'s publication policy and guidelines for manuscript submission. The *Journal* is published twice each year and, generally, publication occurs within several months after a manuscript is accepted.

So be an author. Impress your partners. Share your expertise and experience with other members of the Business Law Section. Submit an article now. And that novel? Maybe next year.

NY BUSINESS LAW JOURNAL

Advisory Board

Members

Editorial Board

Business Law Section Committees

	Chair:
Banking Law	James W. Orband Hinman Howard & Kattell 80 Exchange Street Binghamton, NY 13901 (607) 231-6727
Bankruptcy Law	Margaret M. Cangilos-Ruiz Whiteman Osterman & Hanna LLP 1 Commerce Plaza Albany, NY 12260 (518) 487-7665
Consumer Financial Services	Vincent N. Amato Law Offices of Vincent N. Amato 1 Blue Hill Plaza PO Box 1537 Pearl River, NY 10965 (845) 735-5980
Corporations and Other Business Entities	Frederick G. Attea Phillips, Lytle, Hitchcock, Blaine & Huber LLP 3400 HSBC Center Buffalo, NY 14203 (716) 847-7010
Franchise, Distribution and Licensing Law	Harold L. Kestenbaum Farrell Fritz EAB Plaza West Tower, 14th Floor Uniondale, NY 11556 (516) 745-0099
Futures and Derivatives Law	Sherri Venokur Stroock Stroock & Lavan LLP 180 Maiden Lane New York, NY 10038 (212) 806-5855
Insurance Law	Jeffrey R. Gaylord Lewis, Brisbois, Bisgaard & Smith 100 Wall Street, 9th Floor New York, NY 10005 (212) 232-1302
Internet and Technology Law	Micalyn S. Harris 625 North Monroe Street Ridgewood, NJ 07450 (201) 447-0561
Securities Regulation	Michael J. Holliday 327 Jefferson Avenue Westfield, NJ 07090 (908) 654-9038

Minutes of the Meeting of the Consumer Financial Services Committee Held on January 28, 2004 in New York City in Conjunction with the Annual Meeting of the New York State Bar Association

The Chair called the meeting to order and a discussion quickly ensued on the topic of predatory lending and the Office of the Comptroller of the Currency's position on preemption. The discussion focused on the issues raised in the morning's presentation which examined the role of regulators in the predatory lending arena and the implications of the OCC's preemption initiative. There was a consensus among the Committee members that real lending abuses existed and would continue to exist irrespective of the regulatory framework so that there would always be a need for consumer advocates.

Grace Sterrett raised the issue of bounce protection and its treatment under New York's regulatory scheme. Specific discussion was held on the treatment of bounce protection in connection with ATM withdrawals. After recognizing the issues presented, it was noted that most players were waiting for the Federal Reserve Board's action as to whether bounce protection fees constituted finance charges.

At this juncture, Al Narin presented an update from the New York State Banking Department in the area of consumer finance. Mr. Narin highlighted some trends in examinations of mortgage brokers which uncovered failures to disclose yield spread premiums on good-faith estimates. Mr. Narin also indicated a situation where some lenders commence operations from new offices by taking applications even though final approval for the new office has not been received from the Banking Department. This activity is viewed as impermissible and will result in disciplinary action. Also highlighted was the issue of lenders requiring borrowers to obtain hazard insurance in excess of the replacement value of the property when obtaining mortgage financing. Mr. Narin also clarified the Department's position on felony criminal records for employees of mortgage bankers and brokers. Mr. Narin stressed the Department's view that there is no flat-out prohibition; however, common sense should prevail given the employment context and notification and approvals should be obtained from the Banking Department when necessary. It was also noted that the Department has received a significant number of applications for budget planners which the Department is looking at.

At this point in the meeting, Randy Henrick provided an overview of proposed legislation in New York governing identity theft and the impact it would have if passed on financial service companies. Comparisons were made to the California law on the issue and the impact it has had on lenders generally. It was noted how the proposed New York legislation would go beyond the requirements of the California law covering consumer databases as well as providing notice to everyone that could have been affected by that database being accessed by unauthorized third parties.

The Chair then announced to the group that the Section had elected Geoffrey Rogers of Hudson Cook to serve as the new Chair of the Committee starting June 1, 2004. In addition, Philip Veltre of Municipal Credit Union and Laurie Bigman of the Greenpoint Bank were elected to serve on the Executive Committee of the Business Law Section.

At this point, the meeting was adjourned with the announcement of the next meeting to be held in April at the Association of the Bar of the City of New York.

Securities and Exchange Commission Issues Proposed Rules Regarding Inclusion of Security Holder Nominees in Company Proxy Materials

By Warren de Wied

Introduction

Early last year, following a review of the current proxy rules, the Division of Corporation Finance published a report recommending that the Securities and Exchange Commission propose rules mandating that public companies provide enhanced disclosure concerning their nomination process and shareholder communications with boards of directors. More controversially, the Division also recommended that the SEC propose rules mandating enhanced security holder access to the proxy process related to the nomination of directors. On August 8, 2003, the SEC published rules in response to the Division's recommendations for enhanced disclosure.[1] On October 14, 2003, the SEC published rules that, if adopted, would require public companies, under certain circumstances, to include security holder nominees in the company's proxy statement for elections of directors.[2]

While these so-called "shareholder access" rules are broadly supported by shareholder governance groups, many public companies have expressed substantial concerns regarding their impact. These include concerns that such rules may:

- Diminish, rather than enhance, overall board effectiveness;
- Deter individuals from serving as directors of public companies, at a time when the pool of candidates is already limited;
- Impose significant additional costs on public companies, without corresponding benefits to shareholders;
- Be exploited by special interest groups seeking to further social or political agendas; and/or
- Be used as a means to effect a change of control of the company.

Moreover, the Sarbanes-Oxley Act, the rule changes proposed by the self-regulatory organizations, and other SEC rulemaking activities have resulted or will result in significant changes in the composition, operation and responsibilities of boards of directors and committees of public companies. Many companies believe that these sweeping corporate governance change reforms should be given a chance to work in practice before further significant governance changes are introduced.

The proposed rules represent a significant departure from the process for the nomination and election of directors that has been applicable to public companies for more than 60 years. At the same time, the proposed rules reflect that the SEC has taken heed of a number of the concerns expressed by public companies. The principal features of the proposed rules are discussed below.

Applicability of Proposed New Rule 14a-11

Proposed new Rule 14a-11 under the Securities Exchange Act of 1934 would apply to all companies that are subject to the Exchange Act proxy rules, including investment companies registered under Section 8 of the Investment Company Act.[3] However, a company would become subject to the security holder nomination procedure only where the company's security holders have an existing right under state law to nominate candidates for election as a director. In addition, if state law permits companies incorporated in that state to prohibit security holder nominations by charter or bylaw provision and companies have adopted such a provision, the procedure would not be available.

Although the rule as proposed would apply to all companies subject to the proxy rules, the staff of the SEC is considering limiting the applicability of Rule 14a-11 to companies that fall within the SEC's definition of "accelerated filer"[4] under Exchange Act Rule 12b-2, and invites comments on whether such a limitation would be appropriate in view of the potential for the proposed rule to impose a disproportionate burden on smaller issuers.

Nomination Procedure Triggering Events

The proposed security holder nomination procedure would become operative only after the occurrence of one or both of the following events:

- At least one of the company's nominees for the board of directors for whom the company solicited proxies received "withhold" votes from more than 35% of the votes cast at an annual meeting of security holders held **after January 1, 2004** (excluding contested elections of directors to which Rule 14a-12(c) applies or an election to which the security holder nomination procedure of proposed Rule 14a-11 applies)[5]; or

- A security holder proposal submitted pursuant to Rule 14a-8 providing that the company become subject to the procedure in proposed Rule 14a-11 (a) was submitted for a vote of security holders at an annual meeting held **after January 1, 2004** by a security holder or group of security holders that held more than 1% of the company's voting securities for more than one year as of the date the proposal was submitted and provided evidence of such security holding to the company; and (b) received more than 50% of the votes cast at the meeting. For purposes of this calculation, only votes cast for and against a proposal are included, and abstentions and broker non-votes are not included. The company would not be permitted to exclude the shareholder proposal from the proxy statement on the ground that it relates to an election for board members (which, absent Rule 14a-11, would be grounds for exclusion).

Once triggered, the security holder access procedure would apply to any annual or special meetings held during the remainder of the calendar year in which the triggering event occurs, the following calendar year, and the portion of the second following calendar year up to and including the annual meeting or special meeting in lieu of an annual meeting.

Under the SEC's triggering event proposals, the shareholder nomination procedure could apply to companies as soon as 2005, a year earlier than some observers had anticipated. Some companies are likely to find themselves the target of a Rule 14a-8 shareholder nomination proposal in 2004, in order to activate the shareholder nomination procedure for the company's 2005 annual meeting.[6] In order to meet the deadline for submission of a Rule 14a-8 proposal, a stockholder must submit his proposal to the company not less than 120 days prior to the anniversary date of the company's proxy statement for its previous annual meeting. For a Rule 14a-8 proposal approved by a majority of the votes to activate the shareholder nomination procedure, however, it must have been submitted by a holder or group of holders who have held more than 1% of the company's voting stock for a year (this is considerably more stringent than the general eligibility standard for submission of a Rule 14a-8 proposal, which is satisfied if the proponent has held stock with a market value of at least $2,000 for one year).[7]

In proposing its triggering events, the SEC considered other possible triggering events, including events relating to economic performance, delisting, indictment on criminal charges, and restatement of earnings. According to the proposing release, the SEC believes that nomination procedure triggering events should be tied closely to evidence of ineffectiveness of, or security holder dissatisfaction with, the proxy process. However, the SEC states that it is considering, and solicits comments on whether to include, as an additional element of the procedure, a third possible triggering event. Under this third possible trigger, a company would be subject to the procedure if

- A Rule 14a-8 proposal, other than a direct access security holder proposal, was submitted for a vote of security holders at an annual meeting by a security holder or group of security holders that held more than 1% of the company's voting securities for more than one year as of the date the proposal was submitted and provided evidence of such security holding to the company;
- The proposal received more than 50% of the votes cast on the proposal; and
- The board of directors of the company failed to implement the proposal by the 120th day prior to the date the company mailed its proxy materials for the next year's annual meeting.

Prior to the issuance of the proposed rules, many of those who commented expressed concern that the SEC might propose access triggering events tied to the failure of companies to comply with Rule 14a-8 proposals that receive majority approval. The most common of these Rule 14a-8 proposals, those seeking the elimination of any non-shareholder approved poison pill or the elimination of staggered board provisions, tend to receive very high levels of shareholder support. Since boards of directors rarely implement these resolutions, an organized campaign by holders meeting the proposed eligibility requirements could potentially result in large numbers of companies rapidly becoming subject to the shareholder access procedure. Although the SEC has, at least for the time being, not proposed the inclusion of this triggering event, companies should ensure that their views regarding this potential third triggering event are communicated to the SEC.

Disclosure of Occurrence of a Triggering Event

Companies would be required (i) to disclose the occurrence of either of the nomination procedure triggering events in their Form 10-Q for the period in which the matter was submitted to a vote or in their Form 10-K, if the event occurred in the fourth quarter of the fiscal year; (ii) to disclose that, as a result, the registrant will be subject to the shareholder nomination procedure for the remainder of the calendar year, and the portion of the second following calendar year up to and including the annual meeting or special meeting in lieu thereof; and (iii) to state the date by which security holders must submit their nominations in accordance with the shareholder nomination procedure.

Eligibility Standards for the Submission of Nominees

To be eligible to submit a nomination in accordance with proposed Rule 14a-11, a security holder or group must

- Beneficially own, individually or in the aggregate, more than 5% of the company's securities eligible to vote in the election of directors at the next annual meeting, with each of the securities used to calculate that ownership having been held continuously for at least two years as of the date of nomination;
- Intend to own the securities through the date of the annual meeting;
- Be eligible, as to the holder or each member of the group, to report beneficial ownership on Schedule 13G in reliance on Rule 13d-1(b) or (c) (which permit certain institutional investors, and passive investors who own less than 20% of the company's common stock, to file Schedule 13G); and
- Have filed a Schedule 13G or amendment reporting such beneficial ownership before or on the date of submission of the nomination to the company and containing a certification that the holder or group has held more than 5% of the subject securities for at least two years.

These Schedule 13G requirements mean that a shareholder is eligible to nominate directors only if it does not have an intent to control the company.

Nominee Requirements

A company would not be required to include a security holder nominee in its proxy materials if the nominee's candidacy or board membership would violate controlling state law, federal law, or rules of the national securities exchange or association applicable to the company (other than rules that set forth requirements regarding independence of directors). In addition, the nominee would have to meet the following independence standards:

- If the nominating security holder is a natural person, the nominee is not the nominating security holder, a member of the nominating security holder group, or a member of the immediate family of the nominating holder or of a member of the nominating group;
- If the nominating security holder or any member of the nominating group is an entity, neither the nominee nor any immediate family member of the nominee has been an employee of the nominating holder or any member of the nominating group in the current calendar year or the preceding calendar year;
- Neither the nominee nor any immediate family member of the nominee has, during the year of the nomination or the immediately preceding calendar year, accepted, directly or indirectly, any consulting, advisory or other compensatory fee from the nominating holder or any member of the nominating group or any of their respective affiliates (other than fixed amounts of compensation under a retirement plan for prior service that is not contingent on continued service);
- The nominee is not an executive officer, director (or person fulfilling similar functions) of the nominating holder or any member of the nominating group or any of their respective affiliates; and
- The nominee does not control the nominating holder or any member of the nominating group (or, in the case of any holder or group member that is a fund, an interested person of the holder or group member as defined in Section 2(a)(19) of the Investment Company Act).

In addition, the nominee must satisfy the independence standards of the national securities exchange or association applicable to the company, except where those standards require a subjective determination of independence by the board or a committee of the board. Furthermore, neither the nominee nor the nominating holder or any member of the nominating group can have any agreement regarding the nomination of the nominee.

Limitation on Number of Nominees the Company Must Include in Its Proxy Materials

One of the significant concerns of public companies regarding potential shareholder access rules is that such rules could provide a mechanism for effecting a change in control of the company. Proposed Rule 14a-11 would not be available to any security holder or group that is seeking control of the company. A company would be required to include in its proxy materials one security holder nominee if the number of directors is eight or fewer; two security holder nominees if the number of directors of the company is greater than eight and less than 20; and three security holder nominees if the number of directors is 20 or more. In the case of any company with a staggered board, if the company already has a director who was elected as a security holder nominee, and the term of that director extends beyond the annual meeting for which proxies are being solicited, the company would be required to include in its proxy materials security holder nominees only to the extent that, if elected the number of such nominees would not exceed the limits described in the preceding sentence.

Moreover, if more than one holder or group proposes a nominee or nominees, the company would be required to include in its proxy materials the nominee or nominees of the holder or group with the largest beneficial ownership at the time of delivery of the nominating holder's notice of intent to nominate a director.

Requirements for Notice of Nominations

To have a nominee included in the company's proxy statement and form of proxy, the SEC proposes that the nominating holder or group be required to provide notice to the company no later than 80 days prior to the date of mailing of the company's proxy materials for the meeting. The notice would be required to include:

- A representation that the holder is eligible to submit a nominee under the security holder nomination procedure;
- A statement that, to the knowledge of the nominating holder or group, the candidate's nomination would not violate controlling state law, federal law or listing standards (other than those relating to independence);
- A representation that the nominee meets the objective criteria for independence set forth in the rules of the applicable national securities exchange or association;
- Representations regarding the absence of any prohibited relationship between the nominee and any nominating holder or group member;
- A representation that neither the nominee nor the nominating holder or group has any agreement with the company regarding the nomination of the nominee;
- A copy of the Schedule 13G of the nominating holder or group;
- A representation that the nominating holder or group was eligible to report its ownership on Schedule 13G pursuant to Rule 13d-1(b) or (c);
- A representation that the nominating holder or group has held more than 5% of the appropriate class of securities continuously for at least two years and intends to continue to own those securities through the date of the election of directors;
- A consent of the nominee to be named in the proxy statement and to serve if elected;
- Disclosure about the nominee which complies with Item 7(a), (b) and (c) and, for investment companies, Item 22(b), of Schedule 14A;
- Certain additional information regarding each nominating security holder or group member if not included in the Schedule 13G; and
- The methods by which the nominating holder or group may solicit security holders, including any website address on which the holder or group may publish soliciting materials.

This notice (other than the previously filed Schedule 13G) would be required to be filed with the SEC as soliciting material no later than two business days after being furnished to the company and would be subject to the anti-fraud provisions of Rule 14a-9.

Response by the Issuer

A company that receives a nomination from a nominating holder or group would be required to determine whether the holder or group complied with Rule 14a-11 and satisfied each of the requirements of the proposed procedure. Unless the company determines it is not required to include a nominee in its proxy materials, it would be required to include information regarding the security holder nominee in its proxy statement, including the website address on which the nominating holder or group intends to solicit support for its nominee, and to include the name of the nominee on the proxy card included in its proxy materials.

If the company chooses to make a statement supporting the company's nominees and/or opposing the security holder nominee, other than a recommendation to vote in favor of or withhold votes from specified candidates, the nominating holder must be given the opportunity to include in the company's proxy statement a statement of support for the security holder nominee or nominees, not to exceed 500 words. If the company chooses not to make a statement in support of or in opposition to nominees in its proxy statement, it would not be obligated to include a supporting statement of the nominating holder or group. In either case, both the company and the nominating holder or group would be able to solicit in favor of their nominees outside the proxy statement, such as on designated websites.

On its proxy card, the company could identify security holder nominees as such and recommend that security holders vote against, or withhold votes from, those nominees, and vote in favor of management nominees. The company would not be permitted to provide authority in the proxy card to vote for or withhold votes for nominees as a group, but would instead have to permit separate voting on each candidate.[8]

A company may determine that it is not required to include a nominee in its proxy materials if:

- The security holder nomination procedure is not applicable to the company;
- The nominating holder or group has not complied with the procedure;
- The nominee does not meet the requirements of the procedure;
- Any representation in the notice to the company is false or misleading in any material respect; or
- The company has received more nominees than it is required to include and the nominating holder or group is not entitled to have its nominees included.

The company would be required to notify the nominating holder or group of its determination in writing not less than 30 days before the date of the company's proxy statement for the previous year's annual meeting, or if the meeting date is changed by more than 30 days from the prior year, a reasonable time before the mailing of the current year's proxy statement. If the company determines that it is entitled to exclude a nominee, it must provide to the nominating holder or group a description of its determination, including an affirmative statement of its determination not to include the specific nominee, a discussion of the requirements of proposed Rule 14a-11 that permit it to exclude the nominee, and a discussion of the specific basis for the belief it is permitted not to include the nominee. Information relating to the company's determination would also have to be disclosed in the company's proxy statement. If the company determines it must include the nominee, it must advise the nominating holder or group whether the company intends to include disclosure in opposition to the nominee and, if it intends to include such a statement, advise the nominating holder or group of its right to include a supporting statement of not more than 500 words. Any such supporting statement must be filed by the nominating holder or group as soliciting material in accordance with proposed Rule 14a-11(f)(2).

Exchange Act Liability for Statements

The nominating holder or group would be liable for any false or misleading statements included in the notice to the company. Proposed Rule 14a-11(e) expressly provides that the company would not be liable for such disclosure. In addition, information supplied by the nominating holder or group would not be incorporated by reference in any filing by the company unless the company determined specifically to do so. If the company did elect to incorporate such disclosure by reference, it would assume liability for that disclosure.

Application of Other Proxy Rules to Solicitations by a Nominating Holder or Group

To facilitate communication by security holders wishing to form groups in order to meet the minimum ownership threshold of 5% to nominate a director, the SEC is proposing a limited exemption from certain of the proxy rules. The security holder would have two alternatives: either to limit any solicitation to not more than 30 persons; or to include in any written communication no more than (a) a statement that the holder intends to form a nominating group, (b) the percentage of securities beneficially owned by the holder or any nominating group to which he belongs, and (c) the means by which security holders may contact the soliciting party. Any soliciting material published, sent or given to security holders must be filed with the SEC on the date it is first published, sent or given to security holders.

In addition, the SEC proposes to exempt solicitations by or on behalf of a nominating holder or group from Rules 14a-3 to 14a-6(o), 14a-8 and 14a-10 to 14a-15, provided that the soliciting party does not, at any time during such solicitation, seek the power to act as proxy or furnish or request, or act on behalf of any person who furnishes or requests, a form of revocation, abstention, consent or authorization; and each written communication includes the identity of the nominating holder or group and a description of their interests, by security holdings or otherwise, and includes a prominent legend advising security holders that a security holder nominee is or will be included in the company's proxy statement and that the security holders should read the proxy statement when it becomes available because it includes important information and advises them where they can find the proxy statement, other soliciting material and other documents, at no charge, on the SEC's website. Any soliciting material published, sent or given to security holders in accordance with these provisions must be filed with the SEC on the date it is first published, sent or given to security holders.

Application of the Proposed Rule to Investment Funds

The proposed rule would also apply to investment funds in the same manner that it would apply to operating companies, with certain modifications. Disclosure of triggering events would be included in the fund's semi-annual Form N-CSR. Form 8-K would apply to funds for the limited purpose of ensuring that security holders are made aware on a timely basis of the date by which they must submit a nomination notice. Any nominating holder or group would be required to represent that its nominee is not an "interested person" of the fund as defined in Section 2(a)(19) of the Investment

Company Act. This test would also apply to nominees for election to the board of a business development company. Because security holders of mutual funds are not required to file Schedule 13G, the notice to the fund of the security holder's intent to require inclusion of its nominee in the fund's proxy statement would be required to contain information concerning the holder's beneficial ownership of the fund's securities and a certification that the person filing the notice has held the securities continuously for at least two years.

Related Rule Clarifications

An instruction would be added to Schedule 13G to clarify that nomination of a director, solicitation activities in connection with the nominee, or having the nominee elected as a director, should not be viewed as having the purpose or effect of changing or influencing control of the company and, accordingly, would not preclude eligibility to file statements of beneficial ownership on Schedule 13G. In addition, the SEC states that it does not believe that a group formed solely for purposes of nominating a director, solicitation activities in connection with the nominee, or having the nominee elected as a director, should cause members of the group to be aggregated for purposes of forming a greater-than-10% security holder subject to Section 16 of the Exchange Act. The SEC also states its belief, in view of the nominee independence requirements contained in the proposed rules, that for Section 16 purposes, the "deputization" theory (under which beneficial ownership of a stockholder may be imputed to a director, and director status may be imputed to a stockholder, on the theory that a director is the deputy or agent of the stockholder) should not be considered to apply as between a security holder nominee director and the nominating holder or group.

The SEC also states that a nominating shareholder would not be deemed an "affiliate" of the company (1) solely as a result of nominating a director or soliciting the election of the nominee or (2) upon election of the nominee as a director, where the nominating shareholder or group does not have an agreement or relationship with the director other than in connection with the nomination.

Conclusion

The SEC's proposals will not allay the concerns of public companies that shareholder access rules may adversely affect board composition, dynamics and effectiveness. At the same time, numerous aspects of the proposals, including the proposed triggering events, the security holder eligibility requirements, the nominee independence standards, and the limitations on the number of security holder nominees, demonstrate an effort by the SEC to strike a balance between the concerns of corporate governance advocates and those of public companies. In consequence, there may be as many critics who find fault with the proposed rules for not going far enough as there are critics who complain that the proposals go too far.

Endnotes

1. Release No. 34-48301, August 8, 2003.
2. Release No. 34-48626, October 14, 2003.
3. The shareholder access rule would not be applicable to foreign private issuers, who are generally exempt from the proxy rules.
4. An accelerated filer is an issuer that (i) has a public float of at least $75 million, (ii) has been subject to periodic reporting requirements for at least 12 months, (iii) has filed at least one annual report and (iv) is not a small business issuer.
5. The SEC's proposing release states that, based on a sample of 2,227 director elections, approximately 1.1% of companies had total withhold votes in excess of 35% of votes cast.
6. The SEC has indicated that, in light of the proposed rule, it will not permit companies to exempt shareholder nomination proposals under Rule 14a-8 on the basis that they relate to an election of directors, despite the fact that the proposed rule is not yet effective and could undergo significant modification. A number of commentators have objected strongly to this aspect of the SEC's proposals.
7. The SEC considered a variety of possible ownership thresholds, including the eligibility threshold set forth in current Rule 14a-8, as well as higher thresholds. The individuals who perennially submit the bulk of Rule 14a-8 proposals generally own small amounts of stock and therefore would not meet this proposed threshold. Those individuals would need to organize a group in order to avail themselves of the procedure. The activist pension funds typically hold larger positions and would likely find it relatively easy to organize a group to meet this threshold, if they do not satisfy the threshold individually.
8. Under the current proxy rules, in a contested election, the company's proxy card does not provide a mechanism to split the stockholder's vote between company nominees and insurgent nominees. The proposed rule provides a mechanism whereby shareholders will have the ability to split their vote among management nominees and one or more security holder nominees on the Company's proxy card. Thus, the nominating group would have the ability to target individual company nominees in an effort to cause the election of one or more security holder nominees.

Warren S. de Wied, Esq., is a corporate partner resident in Fried Frank's New York office. His practice focuses on mergers and acquisitions (including negotiated transactions; hostile takeovers and takeover defense; proxy contests; and financial adviser representations); leveraged buyouts and private equity transactions; restructurings, spin-offs and recapitalizations; joint ventures; corporate governance; and general corporate counseling.

Delaware Boards Beware: Defensive Action that Interferes with Shareholder Voting Rights Invokes Both *Unocal* and *Blasius* Standards of Review

By David L. Finkelman and Gregg Freedman

Overview

In January 2003, the Supreme Court of Delaware decided *MM Companies, Inc. v. Liquid Audio, Inc.*, 813 A.2d 1118 (Del. 2003) ("*Liquid Audio*"), the latest in a line of cases in which Delaware courts have addressed the limits of board action taken in response to real or perceived threats to the corporation. Among these cases are *Unocal Corporation v. Mesa Petroleum Corporation*[1] ("*Unocal*"), a 1985 decision of the Delaware Supreme Court, and *Blasius Industries v. Atlas Corporation*[2] ("*Blasius*"), a 1988 decision of the Delaware Court of Chancery. *Unocal* focused on defensive board action in the form of a self tender offer taken in response to a hostile tender offer regarded as an immediate "threat to control," and how the inherent conflict of interest in such a situation shifts the presumptions usually afforded management under the business judgment rule so as to require the board to show its action was "proportionate," i.e., "reasonable in relation the threat posed." In *Blasius*, the Court of Chancery focused on defensive board action in the form of increasing the size of the board and filling the resulting vacancies, where the purpose was to prevent the effectiveness of a shareholder vote in the context of a contested election seeking to change actual control of the board. *Blasius* required the board to demonstrate a "compelling justification" for its action.

In *Liquid Audio*, the Delaware Supreme Court reversed a final judgment by the Court of Chancery that permitted the incumbent board of directors of Liquid Audio to take defensive action by increasing the size of the board. The Supreme Court found that the defensive measures were taken for the primary purpose of impeding the full effectuation of the shareholder vote in an impending election for two successor directors on Liquid Audio's staggered board and applied the enhanced standards of judicial review of both *Blasius* and *Unocal*. The Court found that the Chancery Court had applied the *Unocal* standard of review properly, but should have first applied the higher standard of the *Blasius* "compelling justification" doctrine.

The decision represents a significant extension of the *Blasius* doctrine. In *Blasius*, the defensive action would have made it impossible for shareholders to achieve their objective of changing actual control of the board. The *Liquid Audio* opinion makes it clear that the defensive action need not actually prevent the shareholders from successfully seating one or more members and that the election contest need not involve a challenge for outright control of the board. The Court held that to invoke the *Blasius* doctrine compelling justification standard of review within application of the *Unocal* standard of review, the defensive action need only be taken for the primary purpose of interfering with, or impeding the effectiveness of, the stockholder vote in a contested election.

This article looks at the application of the business judgment rule and enhanced judicial review under *Unocal*, *Blasius* and *Liquid Audio*, and discusses the implications of *Liquid Audio* for defensive actions taken by boards of directors of Delaware corporations.

Unocal and the Business Judgment Rule

In *Unocal*, the Supreme Court of Delaware upheld the board's initiation of a self-tender by the corporation for a portion of its outstanding shares other than the substantial block of shares already owned by the hostile bidder.[3] The board had taken this action in response to a hostile tender offer it deemed to be "harmful to the corporate enterprise." The Supreme Court noted that normally it applies the business judgment rule to board actions and does not substitute its views for those of the board if the board's decision can be attributed to "any rational business purpose."[4] The business judgment rule is a "presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the Company."[5]

However, the Supreme Court observed that when, as in *Unocal*, a board acts in response to an immediate "threat to control,"[6] the directors are "of necessity confronted with a conflict of interest, and an objective decision is difficult."[7] According to the Supreme Court, when such a conflict of interest exists, courts must shift the presumptions usually afforded to management under the business judgment rule, and require the board to justify its action under a two-step test.

Step one requires the board to establish that after a reasonable investigation it determined in good faith that there were reasonable grounds for believing a danger to corporate policy and effectiveness existed,[8] and that the threat "warranted a defensive response."[9] The threat must be real or at least not so remote that its occurrence is highly unlikely.[10]

In step two, the board must demonstrate that its action was "proportional"—i.e., "reasonable in relation to the threat posed."[11] The key inquiry is whether the defensive measures were "draconian," in the sense of being "preclusive or coercive."[12] An action is preclusive when it prevents a hostile entity from acquiring the company and coercive when it forces the shareholders to accept management's preferred alternative. Board action that is neither preclusive nor coercive, and that falls within the range of reasonableness (for example, that merely impedes or hinders the threat)[13] is likely to be upheld. Board action that completely eliminates shareholder options with respect to the threat likely will be found disproportionate and will not be upheld.

Applying this two-part analysis in *Unocal*, the Supreme Court ruled that:

1. The board had "both the power and duty to oppose a bid it perceived to be harmful to the corporate enterprise";
2. The action was "reasonable in relation to the threat posed"; and
3. The board acted "in proper exercise of sound business judgment." [14]

Blasius and the Compelling Justification Standard of Review

In *Blasius*, the Court of Chancery invalidated board action to increase the size of the board from seven to nine members. The board was responding to a shareholder's recapitalization proposal and a related proposal to increase the board from seven to 15 members that, if successful, would have given the shareholders' nominees a majority position on the board and the power to approve the recapitalization plan.

The Court ruled that even though the board acted "in a good faith effort to protect its incumbency, not selfishly, but in order to thwart implementation of the recapitalization that it feared, reasonably, would cause great injury to the Company,"[15] it could not, consistent with its fiduciary duty, act "for the primary purpose of preventing or impeding an unaffiliated majority of shareholders from expanding the board and electing a new majority."[16]

According to the Court, such board action "inevitably involves a conflict between the board and shareholder majority,"[17] raises the "question of who, as between the principal and the agent, has authority with respect to a matter of internal corporate governance,"[18] and places a heavy burden on the board to "demonstrate a compelling justification for such action."[19]

Under *Blasius*, whether a court must apply the heightened scrutiny is determined by the motivation behind the board's actions. Where board action has effectively frustrated and denied shareholders the right to vote for the election of successor directors, and the board was motivated primarily by a desire to entrench itself and purposefully interfere with shareholder voting rights, the court must apply enhanced scrutiny. Where no conflict of interest exists, and the board justifies its actions, courts will presume that such actions are in the best interests of the shareholders and will not substitute their judgment for that of the board.[20]

For example, the board is charged with formulation of corporate policy and may take action to advance that policy, including expending corporate funds to inform shareholders about a perceived threat to the corporation and to convince them of the wisdom of the board's planned response. However, board action that deprives shareholders of their right to choose who they want on the board violates the basic principles of corporate democracy.[21]

Liquid Audio

The Battle for Control of Liquid Audio

On October 26, 2001, MM Companies, Inc. ("MM"), which owned approximately 7% of Liquid Audio's common stock, notified Liquid Audio's board that it was willing to acquire Liquid Audio for approximately $3.00 per share. The board rejected the offer. In June 2002, MM began to solicit proxies for the annual shareholder meeting scheduled for July 1, 2002. In addition to proposing two nominees for the two directorships on Liquid Audio's staggered board that were up for election at the meeting, MM proposed to increase the size of the board by four (from five to nine) and to fill those positions with its nominees, thereby resulting in MM's nominees constituting a majority of the board. The board expansion proposal required a super-majority vote of two-thirds of Liquid Audio's outstanding shares. However, before the meeting, Liquid Audio announced a stock-for-stock merger with Alliance Entertainment Corp. and postponed the annual meeting. In response to a suit by MM, the Chancery Court ordered Liquid Audio to hold its annual meeting in late September 2002.

In August 2002, it became apparent that MM's two nominees would be elected. On August 23, 2002, Liquid Audio announced that its board of directors had amended its by-laws to increase the size of the board to seven members and that the board had appointed two persons to fill the newly created seats on the board. At the annual meeting, MM's two nominees were elected, but its proposal to expand the board failed to obtain the requisite two-thirds vote. Thus, MM then held two positions on Liquid Audio's seven-person board.

MM then amended an earlier suit to allege that the August expansion of the board from five to seven members and the appointment of two new members by the incumbent board violated the principles of both *Blasius* and *Unocal*, as the action frustrated MM's attempt to obtain a "substantial" presence on the board for at least another year.

The Court of Chancery Decision

The Court of Chancery rejected both of MM's arguments. The Court held that the board expansion was not coercive or preclusive under *Unocal*, because Liquid Audio's shareholders had the same choices after the board action was taken as they had before, and that there was no showing that the board's action fell outside a range of reasonable responses. The Court rejected the *Blasius* claim by finding that the board expansion "did not impact the shareholder vote or the shareholder choices in any significant way."[22]

The Supreme Court Decision

In an expedited appeal, the Supreme Court of Delaware reversed the Court of Chancery's decision. The Supreme Court first discussed the Chancery Court's principal factual finding that the Liquid Audio board acted "for the *primary purpose* of diminishing the influence of MM's nominees, if they were elected at the annual meeting."[23] The Supreme Court then discussed in detail how the enhanced standards of judicial review of both *Blasius* and *Unocal* are not mutually exclusive:

> [B]oth standards recognize the inherent conflicts of interest that arise when a board of directors acts to prevent shareholders from effectively exercising their right to vote either contrary to the will of the incumbent board members generally or to replace the incumbent board members in a contested election.[24]

The Supreme Court went on to note that the *Unocal* standard of review must be applied whenever a board adopts any defensive measure "in response to some threat to corporate policy and effectiveness which touches upon issues of control."[25] Thus, where board action interferes with the exercise of the shareholder franchise during a hostile contest for control, such as when an acquirer launches both a proxy fight and a tender offer, such action necessarily will invoke both *Unocal* and *Blasius*. The Court went on to find that:

> This case presents a paragon of when the compelling justification standard of *Blasius* must be applied within *Unocal's* requirement that any defensive measure be proportionate and reasonable in relation to the threat posed. The *Unocal* standard of review applies because the Liquid Audio board's action was a "defensive measure taken in response to some threat to corporate policy and effectiveness which touches upon issues of control." The compelling justification standard of *Blasius* also had to be applied *within* an application of the *Unocal* standard to that specific defensive measure because the primary purpose of the Board's action was to interfere with or impede the effective exercise of the shareholder franchise in a contested election for directors.[26]

The Supreme Court stated that the "compelling justification" standard of *Blasius* is applied independently or within the *Unocal* standard only where the primary purpose of the board's action is to interfere with or impede exercise of the shareholder franchise and the shareholders are not given a full and fair opportunity to vote effectively. Thus, in *Unitrin*, where the primary purpose of a defensive stock repurchase program was not to interfere with or impede the shareholders' right to vote, the *Unocal* standard of review was applied, but the board was not required to demonstrate a compelling justification for that action.

In *Liquid Audio*, however, because the Supreme Court found that the Liquid Audio board had acted with the primary purpose of thwarting the effective exercise of the shareholder franchise, the board had the burden of first demonstrating a compelling justification for that action in order to withstand enhanced judicial scrutiny within the *Unocal* standard of reasonableness and proportionality. Since the board did not demonstrate a compelling justification for its action, the Supreme Court held that the expansion of the board and the appointment of two new members on the eve of a contested election should have been invalidated by the Chancery Court.

The *Liquid Audio* opinion represents an expansion of the *Blasius* compelling justification doctrine beyond actions that directly impact the results of a shareholder vote. Unlike the board action taken in *Blasius*, the action of the Liquid Audio board did not prevent MM from succeeding in its goal of electing two directors to fill the two seats that were up for election and would not have prevented MM from achieving actual board control had its board expansion proposal garnered the required two-thirds super-majority vote. But because the board's action was taken for the primary purpose of reducing the MM directors' ability to influence board decisions, the Supreme Court found *Blasius* applicable.

Future Implications

The *Liquid Audio* decision could lead to further expansion of the *Blasius* doctrine to various other actions taken by an incumbent board in the context of a proxy contest involving corporate governance issues other than the actual election of directors. For instance, by-law amendments that prescribe the qualifications of nominees for election as directors or the formation of an executive or other committee that excludes insurgent directors could invoke the *Blasius* standard of compelling justification. If *Blasius* is found applicable, it is hard to imagine a factual situation that would meet the standard and not result in an invalidation of the board action in question.

Although the Delaware Supreme Court has left open the theoretical possibility that there could be a "compelling justification" for board action that "purposefully disenfranchises" shareholders, to date no defensive board action that impedes the shareholders' ability to exercise their vote effectively has been sustained on such grounds. Rather, such actions have been viewed as "contrary to established principles of corporate democracy"[27] and have been overturned. Certainly, a board of directors of a corporation subject to Delaware law would be well advised to exercise extraordinary care when contemplating such defensive action.

Endnotes

1. 493 A.2d 946 (Del. 1985).
2. 564 A.2d 651 (Del. Ch. 1988).
3. In response to the Court's upholding Unocal's discriminatory tender offer, the Securities and Exchange Commission subsequently adopted its so-called "all holders" rule which requires a tender offer to be open to all security holders of the class of securities subject to a tender offer. Rule 14d-10 under the Securities Exchange Act of 1934.
4. *See Unocal*, 493 A.2d at 949.
5. *Unitrin, Inc. v. American General Corp.* (*In re Unitrin, Inc.*), 651 A.2d 1361, 1373 (Del. 1994) (quoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)).
6. *Id.*
7. *Id.*
8. *See Unitrin, Inc*. 651 A.2d at 1373.
9. *See Chesapeake Corp. v. Shore*, 771 A.2d 293, 330 (Del. Ch. 2000).
10. The Supreme Court of Delaware's decision in *Omnicare, Inc. v. NCS Healthcare, Inc*., 818 A.2d 914 (Del. 2003) extended the *Unocal* enhanced judicial scrutiny doctrine to a Delaware court's evaluation of deal protection provisions designed to protect a merger agreement. In *Omnicare*, the Court applied a *Unocal* analysis to defensive measures embedded in a merger agreement agreed to by the board, which included voting agreements with two shareholders holding a majority of the corporation's shares. More particularly, the Court found the voting agreements, along with the "force the vote" provision, "committed them irrevocably to vote their majority power in favor of the merger." *Id*. at 933. These deal protection devices essentially made it impossible for any competing offer to succeed and were thus found to be "preclusive" and "coercive." *Id*. at 935.
11. *See Unitrin*, 651 A.2d at 1373; *see also Unocal*, 493 A.2d at 955.
12. *In re Gaylord Container Corp. S'holders Litig.*, 753 A.2d 462, 480 (Del. Ch. 2000).
13. *Id*. at 480.
14. *See Unocal*, 493 A.2d at 958.
15. *See Blasius*, 564 A.2d at 658.
16. *Id*. at 652.
17. *Id*. at 660.
18. *Id*.
19. *Id*. at 661.
20. *See id*.
21. In *Liquid Audio* the Court stated that the vote was "effectively" denied. By this the Court meant that even though the shareholders could still use their vote to elect board members, the action of the board in expanding its size and appointing new directors negated any change that may have resulted from election of directors by the shareholders. Hence, the Court stressed that the actions were to be judged according to their effect on control, and not merely on whether the vote was simply removed. *See Liquid Audio*, 813 A.2d at 1132. *See also Giurich v. Emtrol Corp*., 449 A.2d 232, 239 (Del. 1982).
22. *Liquid Audio*, 813 A.2d at 1122.
23. *Id*. at 1126 (emphasis in original).
24. *Id*. at 1129.
25. *Id*. at 1131 (quoting *Gilber v. El Paso Co*. 575 A.2d 1131, 1144 (Del. 1990)).
26. *Id*. at 1131.
27. *Schnell v. Chris-Craft, Indus., Inc*., 285 A.2d 437, 439 (Del. 1971). In *Schnell*, the Supreme Court rejected an attempt by the board of directors to advance the date of the annual meeting to impede the efforts of dissident shareholders to elect new directors. While such action was legally permissible, the Court found that because such action obstructed the right to undertake a proxy contest against management, it was inequitable and therefore could not stand.

David L. Finkelman is a retired partner of Stroock & Stroock & Lavan LLP and now of counsel concentrating in mergers and acquisitions. Gregg Freedman is an associate in Stroock's Securities Practice Group.

Funding Options for Start-Ups in Today's Tough Economy

By Steven Masur and Bruce Strzelczyk

With the economic downturn and slow growth of domestic markets, start-ups and early-stage companies are increasingly seeking financing. However, today's difficult economic environment has made the task of obtaining financing that much more difficult, as investors are more averse to risk. In tackling this latest challenge, entrepreneurs should not jump at the first opportunity that appears promising. Determining which source of financing to consider requires a careful assessment of the dynamics of each. A company's needs, the industry it operates in and its growth and exit strategy are contributing factors to the decision-making process.

The upside is that there are several options to pursue. But being effective at this process requires substantial research, patience, and, yes, even a bit of good ol' fashioned intuition. First, let's clear up some common miscommunications and set forth some "best practices" to adopt, hopefully saving the early-stage company valuable time and energy when seeking financing in this difficult economic environment.

So, Who Should You Call?

Well, there are many questions leading up to the answer. Consider these:

- What sorts of investors should you approach, given the business you operate in?
- Can you bootstrap?
- How can friends and family help, and how will this play out in the long run?
- Is your business appropriate for funding from angel investors? Venture capital firms? Investment banks?
- What about obtaining a regular bank loan or line of credit?
- Can the government help, or are there any special grants, loans or funding available from any not-for-profit sources?
- What about an IPO?

The options available to you in financing your small business depend on the opportunity you are pursuing. Before entering into an agreement for funding, know and understand your options inside and out. They vary from traditional "dig into your pockets and sees what comes out" methods to venture capital funding. No matter what path you pursue, each brings to the table a different set of dynamics. So consider what you are willing to compromise, on a personal and business standpoint, to obtain funding.

Keep in mind that a comfort and trust level with the person and the process is pertinent to any business relationship. After all, this is your idea and company, one that you have lost many sleepless nights over trying to get off the ground.

So, when determining potential funding sources, think of each potential investor as someone you might ultimately want to sit on the board of directors—someone who you are confident can contribute to the process and whom you would trust with the internal operations of the business. (Remember that you will be regularly reporting your financials to them.) Also, consider the industry and business experience, as well as resources that the potential investor brings to the table, the entities they have invested in before, and personal affinities, contacts or previous experience.

Bootstrapping

Bootstrapping is often the first and best means of financing. The idea here is to use your hard-earned savings—unless you were a lucky lottery winner—to get the company off the ground. This option can be quite appealing to the entrepreneur: it allows you to concentrate on cash flow rather than stroking investors. After all, ultimately cash flow is more important—it is what you need to stay afloat. You do not have to answer to any investors or loan officers as to how you choose to spend your money or grow your business. You are free to explore different paths and change direction as necessary without seeking the approval of your investors. And whatever money you generate from operations is yours to keep or reinvest in the business—without distributing it among every Tom, Dick and Harry. Furthermore, you are less likely to build any debt payments or equity structures (involving investors) into your financials, or worry about what their exit strategy is.

Kaliel Tuzman, of Recognition Group, a turnaround and specialty financing consultancy who previously founded GovWorks, which was featured in the feature film *Startup.com*, has this to say:

> For GovWorks we raised in excess of $59 MM in 3 institutional rounds with investors like KKR, Mayfield Fund, Hearst, American Management Systems

> and First Data, whereas Recognition Group was entirely bootstrapped. I have found this to be a much more manageable experience, because it is easier reporting only to yourself and your partners than to an entire constituency of investors.

Remember, however, that when you bootstrap, the growth of your company is limited to how deep your pockets are or how long you can financially carry the company single-handedly before it begins to generate a profit. Rather than blowing cash on a fancy office, and desks and chairs, you'll probably agree to set up shop in your parents' garage or basement. As a result, large advertising budgets, hiring and retaining a sales force, or capital improvements are typically out of the question. Thus, it will probably take longer to build your business. So, if the business you are planning is smaller in scale and requires few employees, low capital investment, and limited advertising, bootstrapping is for you. Otherwise, you need to put on your walking shoes, get out there and raise some money.

Friends and Family

Once you have exhausted the bootstrapping option, the next recourse is usually approaching your family and friends. If you are one of the lucky ones, you have a rich uncle hiding somewhere. The perception is that family and friends will not require the same degree of due diligence or formality as investors further up the chain. However, it is a good idea to encourage family and friends to familiarize themselves as much as possible with the business and to hire an attorney to review the investment documents, not only to protect themselves, but to protect your business interests as well. Either way, you should approach any funding agreement as a business relationship. When friends and family investors do not fully understand the risks of investing and those risks are realized, it can lead to a great deal of acrimony, which can end in legal battles.

This can be avoided up front by clearly stating in writing the risks inherent to the investment process, documenting how much money is invested, what equity or debt structure is received, and when and how the investor might expect to receive a return on his investment. In addition, it is helpful to frequently update investors, monthly if possible, on what is happening with the business. This will not only give them an opportunity to voice their concerns, but will help you in any legal battle that could ensue. Also, friends-and-family investment is often best accompanied by other investments to supplement the investment and spread the risk.

Bank and Other Loans

Some entities will require greater up-front investment than is practical for us to bootstrap. Traditional bank loan financing has often been ignored because of the popularity in recent years of venture capital and other equity investment opportunities. However, for many businesses, bank loans are an ideal solution.

In deciding whether to grant a loan, a bank will look for proven cash flow from existing businesses, assets (including inventory) to serve as collateral for the loan, and a reputable management team with a proven track record in the business.

Typically, the bank will want to see cash flow from existing operations or businesses that can support at least two times the debt service needed to repay the loan. In addition, the liquidated value of the collateral should be sufficient to repay the loan in the event that cash flow cannot. Finally, banks look for a management team with a proven history of honest and ethical business practices—one with a credit history (for example, the repayment of previous loans in a timely manner).

There is some truth to the old industry adage that "banks are available to lend money to people who don't need it." Lawrence Glenn Sr. spent 32 years as a banker at Citibank and currently runs a consulting business, assisting people in workouts for their venture capital investment portfolios. As Mr. Glenn succinctly states, "In the current market, people are very risk-averse and unlikely to invest in anything that does not have a proven cash flow. Just as in the 1970s, it may take years now for lenders to once again become comfortable with the risks in the market."

Angel Investors

Although the tremendous financial returns to entrepreneurs of the 1990s have created some affluent business owners—who have since turned angel investors—the economy has created a greater hesitancy in taking financial risks. Angel investors are individuals who have succeeded in some business of their own, have an affinity for start-ups, and invest money for profit, but also wish to pass along some of what they learned when building previous businesses. And unlike the venture capitalist (VC), angel investors are not always looking for the next IPO or exit strategy. They tend to invest in companies for the longer term. "Second to my competitive urge to succeed, which is generally measured by economic success, I invest because I want to be actively involved in exciting ventures with smart people. It keeps me on my toes," says Michael Tannen of Tannen Media Ventures.

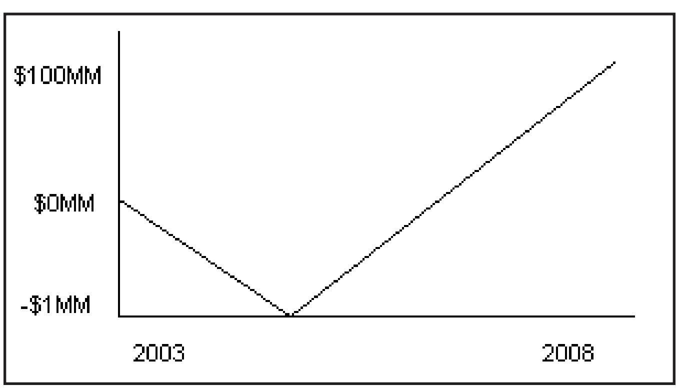
When seeking angel investment, you should look for high net-worth individuals who have a particular affinity for, or knowledge about the business you are starting. But just as they are likely to conduct due diligence of your business model, be sure you do due diligence on your angel investors. It is important to determine that they can realistically afford to make investments in your business and that they understand the risks. The more informed they are about your industry, the more likely they will be to invest and the more help they will be along the way.

Some angel investors can contribute significantly, lending tremendous business insight and experience. Angel investors can be extremely helpful with relevant industry contacts, know-how and advice regarding how to proceed through the many challenges your business will face. However, they often want to exert a higher degree of direct control than other financing sources require. (Agree ahead of time as to what role they will play in your company. There is a strong likelihood that you may need to relinquish partial ownership of your business in exchange for angel financing.) However, if they understand your business well, they can often be more committed to it and be around for a much longer haul than other types of investors.

According to angel investor John Ason, "Company valuations have been greatly compressed, primarily because of the requirements of venture capitalists. Angels will not invest in valuations that guarantee almost with certainty a down venture capital round." Also, "Instead of new startups, most angel money is currently going to existing companies—cash flow generating companies or distressed asset plays."

Venture Capital Funds

Venture capital investment grew out of the capital-intensive needs of technology companies during the 1970s and '80s. Venture capital funds tend to invest in businesses likely to yield an exponential return on investment within five years. Very few VCs or angel investors will invest without equity upswing potential. Such businesses are called "hockey stick" businesses, because a graph of their revenue over time should resemble just that (see below).



Most venture capital funds perform intensive due diligence, and their investments tend to remain highly focused on industries that the principals thoroughly understand. In evaluating an investment, a venture capitalist will look for a compelling product or service that addresses a specific need in a large market; a proven and dedicated management team with relevant industry contacts and experience; traction or success at selling the product in the market; a good financial model; and reasonable valuation at which to invest.

Anne Maffei, Managing Director of Cedar Street Group, defines traction as having proven your business concept by having revenue generating contracts in place. "We want to see that you deliver value to your customers and that buying from you is a high priority for them."

While in previous years it may have been possible to obtain venture funding pre-revenue, such first-round venture financings have all but disappeared. Part of the reason may be that venture capitalists must answer to the limited partners who invest in their funds, who are more averse to risk during difficult economic times. According to Ms. Maffei, if you are unable to show revenue then you are unlikely to raise money from a venture capital fund in the current economy. If you do, the valuation at which a venture capital fund invests will be very low.

Public Monies and Grants from Private Foundations

It may be possible to obtain money from local, state and federal sources. There may be grants available for minority-owned businesses or for businesses founded in industries or locations that local, state or federal governments have an interest in promoting. According to Mr. Tuzman, "In the matrix of government assistance, you can always find somewhere you fit in."

It may also be possible to organize your business as a not-for-profit entity for tax purposes and obtain funding from private foundations. They are more often interested in the business outcome on a fundamental level than they are looking for immediate ROI.

Not-for-profit entities must stick to a mission statement that adheres to specific guidelines of state and federal tax laws. For example, such criteria are entities that promote education, research or the arts. According to Maria Gotsch, President of the Civil Capital Corporation and Senior Vice President of the New York City Investment Fund, the decision to form a not-for-profit entity depends on whether your business activities create substantial UBIT, or unrealized business income.

Ms. Gotsch also claims that "the universe of people who provide grants to not-for-profit businesses is small and well-networked, so the first place to start is with your traditional funder" or the foundation that has funded your business in the past. If you are researching funding sources for the first time, keep your research geographically concentrated and work your networking contacts.

Public Markets

Preparing for an initial public offering of securities—or "going public"—can be an option for revenue-generating entities with marketable business models that desire to raise in excess of $20MM for their operations. Such offerings are typically underwritten by a reputable investment bank and require teams of lawyers and accountants to complete and facilitate the filing of documentation with the Securities and Exchange Commission. The documentation must strike a balance between effectively promoting the stock offering for sale to the public and fairly representing the prospects of the business without making any material misstatements of fact.

Conclusion

As you can see, the most common theme running through all levels of the investment community is that investors are more risk-averse than they had previously been. And they are likely to invest only in businesses with proven track records that generate revenue.

In evaluating whether to seek investment and from whom, you should think through in great detail what your business is, how it fits into the economy and how outside sources of financing will affect it. Especially after "the bubble," the road to a self-sustaining successful business is littered with the carcasses of businesses in which entrepreneurs did not take into account the motivations of their investors, sought financing too quickly, tried to grow too quickly, or distorted otherwise workable business models to fit the desires of investors. Says Mr. Tuzman,

> When speaking to entrepreneurs, I always ask two critical questions. First, is your personality such that you can tolerate explaining to investors your every business decision? Second, will it be easier to raise from investors the amount you are seeking, or could you just as easily earn that amount by selling your product or service?

We have all heard the stories of what did not work. Be realistic and decide what will work in the long term for your company in an economy that might get worse or better, depending upon circumstances beyond your control. Ultimately you have to give investors back their money with a substantial return on investment. Think through very clearly how you plan to do that.

Steven Masur is an attorney at Masur & Associates, LLC practicing corporate and intellectual property law. He has led a wide variety of companies through successive financings and serves on the boards of directors of some of his most successful clients. <http://www.masurlaw.com>

Bruce Strzelczyk, CPA, is a partner at Eisner LLP, a leading Northeast accounting and business advisory services firm. Bruce has extensive experience in representing start-up companies, particularly in strategic development, SEC matters, the purchase and sale of companies, strategic planning, structuring joint ventures and strategic alliances, and due diligence. Bruce's specialized skills include representing companies in obtaining and maintaining financing through private placements, venture capital raises, public offerings, mergers or acquisitions. <http://www.eisnerllp.com>

Retaining and Maintaining Closed Files: Professional Responsibilities, Ethical Considerations and Practice Suggestions

By Stuart B. Newman

The Collyer Brothers must have been members of our noble profession at some point in their lives: they shared the same packrat trait of holding on to every scrap of paper that came into their possession. Probably through a combination of lack of time and confusion about a lawyer's professional responsibility regarding closed files, the one expense line on a law firm's operating statement that is guaranteed to grow geometrically is its monthly storage fees for warehousing closed files.

This article will offer practical suggestions for reducing file storage fees by better management of closed files and will explore the ethical considerations and legal responsibilities of law firms regarding client documents and closed files.

File Management

Although this may seem so obvious as to hardly need mentioning, it is astonishing how common a practice it is to end a corporate matter or conclude a litigation without any thought given to organizing the firm's file on the matter after closing or settlement. Typically, a lawyer's interest in a matter which has reached closing or settlement quickly wanes, and usually doesn't survive beyond the final accounting and settling up with the client for fees and expenses.

Under most circumstances, corporate lawyers and their paralegals usually take the time to put together a closing binder of key documents. But what about those somewhat less than "key" documents, interim drafts (even multiple copies of interim drafts), handwritten notes, memoranda, client documents and exhibits. In a litigation, the firm is likely to have in its possession at the end of the case an extensive collection of client documents produced during pre-trial discovery. The same is true in a merger and acquisition transaction when extensive client documents and records are collected during due diligence for purposes of analyzing and complying with disclosure requirements pursuant to the agreement.

In both litigated and corporate matters, it is not uncommon for a firm to accumulate confidential documents and original records from both sides—produced by, or delivered to, the firm in fulfillment of disclosure requirements. These documents and records are usually governed by separate confidentiality agreements or even by orders of the court.

The need to take some time "the morning after" to review the state of the office's file after closing or settlement should be obvious. The matter is fresh in mind and the attorneys who worked on it are as knowledgeable as anyone in the firm will ever be again to decide what needs to be preserved, what should be returned to the appropriate party, and what can quite obviously be discarded before it becomes fossilized in the warehouse.

Return of client documents and records should be the first step. It is an unnecessary burden for a firm to perpetuate responsibility for a client's original documents and records.[1] By parallel example, it is increasingly more common for accountants and tax preparers to return to their clients the documents and records collected from the client during tax preparation or audits.

Copies of the client's original documents delivered to the firm by the client are probably unnecessary surplussage and usually can be destroyed, rather than shipped back, with the consent and agreement of the client.

Confidential documents may be under mandated order of destruction. Even if no court order exists, in this environment of computer-assisted fraud and identity theft, it is prudent for attorneys to consider destroying rather than simply discarding certain client and client-related information. Record and document destruction services are readily available. Most file storage companies will offer this service and provide the firm with a certificate of destruction.

Implementing the suggestions above, a closed file should now be reduced to its presumably minimum contents, ready for transfer to storage within a reasonable time after the closing of the matter. But how long must the contents remain in storage?

Professional Responsibilities and Ethical Considerations

What is a lawyer's professional responsibility with respect to retaining documents in the lawyer's possession relating to the representation of a client or former client? Is there an objective standard or prescribed time frame for maintenance of files and records? Do lawyers have a duty to give prior notice to clients or former clients of their intention to discard or destroy files and records?

With only a few exceptions, there are no specific, objective time requirements imposing legal obligations on lawyers or their law firms for maintaining and preserving files and records. In fact, lawyers do not have a general duty to preserve all files permanently.[2] The American Bar Association's Committee on Ethics and Professional

Responsibility has acknowledged that "mounting and substantial storage costs can affect the cost of legal services, and the public interest is not served by unnecessary and avoidable additions to the cost of legal services."[3]

This sentiment has been echoed for New York practitioners by the Committee on Professional Ethics of the New York State Bar Association: "The ethics of our profession do not cast upon lawyers the unreasonable burden of maintaining all files and records relating to their clients."[4]

General Rule

Instead of any hard-and-fast retention rule, except for certain specific categories of documents and records, the length of time for retention or disposition of a file is generally within the reasonable discretion of the lawyer and his firm.

> Those files and records that do not contain material for which the client . . . foreseeably will have a need [and which are not required by law to be further maintained], may be destroyed where they have been retained for a reasonable period of time after the lawyer has requested instructions for their disposition from his client, or his client's legal representative, and such instructions have not been received.[5]

In an effort to guide attorneys in exercising discretion regarding how long to retain files and when they may be disposed of, the ABA's Committee on Ethics observes:

> The nature and contents of some files may indicate a need for longer retention than do the nature and contents of other files, based upon their obvious relevance and materiality to matters that can be expected to arise.[6]

These general principles are endorsed by the American Law Institute's Restatement of the Law, which requires retention of documents "while there is a reasonable likelihood that the client will need the documents" but suggests destruction of documents that are "outdated or no longer of consequence."[7]

Examples of documents clearly imposing a higher duty of retention and preservation include releases, instruments of transfer of property or other assets (especially if not recorded) and agreements containing post-closing covenants or warranties.

Exceptions

For New York State practitioners, a notable exception to the broad discretion afforded generally regarding file retention is a firm's bookkeeping records. The Disciplinary Rules of the New York Supreme Court[8] require lawyers practicing in New York to maintain for *seven years* the following categories of bookkeeping records:

(1) records of all deposits in, and withdrawals from, *all* bank accounts through which the operations of the lawyer's practice are conducted, including check books, check stubs, bank statements, cancelled checks and deposit slips;

(2) copies of all retainer agreements with clients;

(3) copies of all bills rendered to clients and of all statements showing disbursement of funds to them or on their behalf;

(4) records of all payments to other lawyers, investigators or other persons, not in the lawyer's regular employ, for services rendered;

(5) copies of all retainer and closing statements filed with the Office of Court Administration.

Note that the requirement of preservation of banking records applies to all accounts, not just to attorney escrow accounts.[9]

Duty of Notice

The law does not provide that lawyers must give notice to their clients or former clients with respect to the disposition of client files. There is no general duty by lawyers to provide notice to clients or former clients with regard to such matters.

However, the American Bar Association's Committee on Ethics and Professional Responsibility, in the same informal opinion cited above, proposed that a lawyer should not destroy or dispose of a file without first screening it in order to determine that consideration has been given to significant documents or information, such as information the lawyer knows or should know may still be necessary or useful in the assertion or defense of the client's position in a matter for which the applicable statutory limitations period has not expired; or information that the client may need, that has not previously been given to the client, that is not otherwise readily available to the client, and that the client may reasonably expect will be preserved by the lawyer. Not inconceivably, in considering the duty of a lawyer to screen a file before disposing of it, a court could find that the giving of notice to the client of the lawyer's intention to dispose of the documents or information was a reasonable step in safeguarding the client's interests in the documents.

In New York, a distinction is made between file documents belonging to the lawyer, and documents that belong to the client:

> Where a file has been closed, except to the extent that the law may require otherwise, all documents belonging to the lawyer may be destroyed without consultation or notice to the client in the

absence of extraordinary circumstances manifesting a client's clear and present need for such documents.[10]

With respect to documents belonging to the client, however, lawyers in New York should offer to make such documents available to the client. It is recommended that the offer be in writing, announcing the intention to dispose of the file. The lawyer may dispose of the documents if the client fails to respond after a reasonable period of time or cannot be contacted after reasonable efforts to do so.[11]

In *Opinion 623*, New York's Committee on Professional Ethics cautioned, however, that determining whether certain documents "belong to the lawyer" may not always be easy and may involve some complex issues of both law and fact.

Dissolution of a Firm

Not surprisingly, to the extent that a lawyer or his firm has responsibility for preserving files, the responsibility does not end on his retirement, or upon dissolution of the firm. The Disciplinary Rules in New York make this obligation abundantly clear. Upon the dissolution of a firm the members of the firm are obligated to make appropriate arrangements for preservation of its files, especially its bookkeeping, banking and billing records.[12]

Endnotes

1. Lawyers have been disciplined for failure to fulfill a duty to safeguard documents. *Florida Bar v. Penrose*, 413 So. 2d 15 (Fla. 1982) (abandoning practice leaving files unattended); *Florida v. Ward*, 366 So. 2d 405 (Fla. 1978) (losing client's insurance policy); *Attorney Grievance Committee v. Pollack*, 425 A.2d 1352 (Md. 1981) (temporarily misplacing a deed); *In re Laubenheimer*, 335 N.W.2d 624 (Wis. 1983) (transferring files to another lawyer without client notice or consent). Moreover, there is ample authority for a lawyer's duty to return client documents and papers at the conclusion of the representation. *E.g.*, *Nolan v. Foreman*, 665 F.2d 738 (5th Cir. 1982).
2. *Informal Opinion 1384*, "Disposition of a Lawyer's Closed or Dormant Files Relating to Representation or Services to Clients." American Bar Association, Committee on Ethics and Professional Responsibility (March 14, 1977).
3. *Id*.
4. *Opinion 623*, "Closed files; disposition procedures; dissolution of law firm." New York State Bar Association, Committee on Professional Ethics (November 7, 1991).
5. *Id*.
6. *Opinion 1384*, ABA.
7. Restatement of the Law (Third)—The Law Governing Lawyers § 46, American Law Institute (2000).
8. N.Y. Rules of Court § 1200.46 [DR 9-102](d)(5).
9. Rule 1.15 of the ABA Model Rules, regarding safekeeping of property, suggests a *five*-year period for keeping records of client trust funds and preserving "other (client) property."
10. *Opinion 623*, NYSBA.
11. *Id*.
12. N.Y. Rules of Court § 1200.46.

Stuart B. Newman is a Member of Salon Marrow Dyckman & Newman LLP. He is also the Chair of the Advisory Board of the *NY Business Law Journal*. **The author wishes to acknowledge the invaluable assistance of Charis Uyecio, a third-year student at Columbia Law School, in researching and developing this article.**

A Primer on Waiting Time and On-Call Time Under The Fair Labor Standards Act

By Roberta Pike

The Fair Labor Standards Act of 1938 ("FLSA" or the "Act") represents one of the most important pieces of social and economic legislation of the 20th century. Enacted during an era where sweatshops and child labor were the norm and where the workplace was characterized by substandard wages, long hours and poor working conditions, the FLSA was drafted by Congress with the goal of protecting employees from exploitation by employers. Among its most important accomplishments are the establishment of minimum wages, the institution of protections against excessive workdays by requiring the payment of overtime compensation, and the limiting of the hours, times and occupations for which minors may be employed.

Obviously, much has changed since President Franklin D. Roosevelt signed the Act into law. Whereas the typical American worker of the 1930s was engaged in manufacturing and was not highly educated, today's workplace is distinguished by a more highly educated workforce, one which supports an economy which is based on technology, information and services rather than factory work. The drafters of the FLSA, however, could not possibly have foreseen the technological changes which have shaped the 21st century workplace. As a consequence, the FLSA is ill-suited to address many modern-day employment situations.

One such area where the FLSA falls short is in dealing with issues concerning waiting time and on-call time. Determining exactly which types of situations are compensable for purposes of calculating wages and overtime compensation and which are not tends to be a difficult analysis. These cases are oftentimes highly fact-specific, and while existing case law provides valuable guidance as to how to analyze the facts at issue, it does not provide bright-line tests which enable courts to arrive at consistent conclusions. The result has, unfortunately, been wide inconsistencies, even within the same courts and even where similar fact patterns have been presented.

The on-call case tends to present itself as the more difficult of the two to resolve. Whereas waiting time cases tend to involve an employer's request that an employee physically remain at or close to the employer's place of business, on-call cases permit the employee to leave but require him or her to be available on short notice to return to the workplace or attend to work-related business. Recent advances in telecommunications such as cell phones, pagers and similar equipment have made on-call arrangements an integral part of today's workplace.

As a general matter, an employee is on-call and hence working and entitled to compensation, when he or she is required to remain available to work on short notice such that the employee cannot reasonably use the time for his own purposes. Examples include fuel company service personnel who must stay at home to await service calls and cannot attend to their own personal business, or medical residents who must leave their pagers on while at home in the event they must be summoned to the hospital.[1] Simply requiring an employee to leave details where he or she may be reached does not constitute a compensable on-call situation. An example of this might be asking your associate for the telephone number of her hotel before she leaves for vacation, just in case you have a pressing question on a case you are handling in her absence.[2]

Most court decisions addressing on-call and waiting time cases are grounded in the principles enunciated by the United States Supreme Court in the seminal waiting time case of *Skidmore v. Swift & Co.*[3] The Court stated that the proper analysis of a waiting time situation "involves scrutiny and construction of the agreements between the particular parties, appraisal of their practical construction of the working agreement by conduct, consideration of the nature of the service, and its relation to waiting time, and all of the surrounding circumstances."[4]

Both the FLSA and the New York State Labor Law contain broad definitions of the term "employ." Under the FLSA, "employed" is defined as "to suffer or permit to work."[5] Under the Labor Law, one is "employed" when "permitted or suffered to work."[6] Even if an employer does not ask that an employee perform work and even if it does not actually assign work to an employee while the employee is on the premises, it can be held liable for compensating the employee for waiting time if it permits the employee to remain "on the clock" while idle for its own benefit.[7]

In this Circuit, time spent by an employee awaiting work must be compensated if the waiting is "primarily for the benefit of the employer and his business."[8] Thus a vital element of any waiting time or on-call analysis includes (but is certainly not limited to) an examination of what the parties agreed to and whether they followed that agreement, and a determination as to who is deriving the greater benefit, the employee or the employer. Whether time spent by an employee waiting for work is compensable "depends upon particular circumstances."[9] "Facts may show that the employee was engaged to wait or they may show that he waited to be engaged."[10]

Any analysis as to whether an employee has been "engaged to wait" (and thus must be compensated) or is "wait[ing] to be engaged" (and thus need not be compensated so long as the employer is not requiring the employee to wait), must be made with the most extreme care. Mistakes can be quite costly. Aside from the obvious expense and business disruption which go hand-in-hand with litigation, failure to pay proper wages can, absent a showing of good faith, subject the employer to liquidated damages under both the FLSA and the Labor Law.[11] Additionally, individuals determined to be statutory employers may be held personally liable under the FLSA for unpaid wages and overtime compensation.[12] Thus, for example, supervisory personnel or even owners or investors who do not have day-to-day control over the operations of a company can still be held personally liable for failure to properly pay wages or overtime compensation even if they were not involved in determining employees' wages and even if they were totally unaware wages were being paid improperly.[13]

Many of my firm's clients are ground transportation companies, including "black car," limousine, and taxi companies. I am frequently asked about two narrow overtime exceptions which are worth brief mention. The first is the FLSA's Motor Carrier exemption, which applies to employers engaged in interstate transportation.[14] This exemption applies only to employers over whom the DOT has jurisdiction where the employer is a private carrier hauling property, or a common carrier which hauls property or passengers where the employee's duties affect the safety of operation of the vehicle and the employee's travel is in interstate commerce or the employee handles intrastate trips which connect to interstate commerce.

The second exemption is commonly known as the "taxi exemption."[15] Under this exemption, a company does not have to pay overtime to "any driver employed by an employer engaged in the business of operating taxicabs." Unless your client is a true taxi company, it should not rely upon this exemption, as the courts have construed it quite narrowly. I am aware of several reported cases where it has been found inapplicable to limousine companies, airport shuttle services, and other ground transportation operators.[16] Unfortunately, the statute does not define the term "taxicab," and the courts generally find against the company based upon the conclusion that, for example, the vehicle doesn't have a taxi meter, is not licensed within the municipality as a taxi, operates on a schedule, or doesn't pick up street hails.[17]

A last point concerns the utility of waiting time policies and agreements. In a case decided by the United States District Court for the District of Columbia entitled *Caryk v. Coupe*,[18] a group of chauffeurs brought a lawsuit against a limousine company which formerly employed them, seeking to recover wages and overtime compensation. Part of the chauffeurs' claim concerned waiting time they claimed was owed to them. In this case, there was a waiting time agreement between the chauffeurs and the company. The agreement was essentially that chauffeurs would be paid for waiting at the office for calls, provided they got to the office by 8:30 a.m. If they arrived late, they would not be paid for time spent waiting. The chauffeurs were under no obligation to wait at the office; it was optional. When they commenced their lawsuit, one type of damage the chauffeurs sought to recover concerned unpaid time spent waiting. Thus, for example, if the chauffeur arrived late, he wanted to be paid anyway despite his agreement with the company.

The court found the chauffeurs were not entitled to any waiting time which did not fall within the parties' agreement. They weren't required to remain on the company's premises waiting for work. The deal was that if they came at a given time they could wait and be paid while waiting. If they came late, they wouldn't be paid for waiting. The court also noted that the waiting time agreement appeared to have been offered solely as an incentive to having a ready pool of chauffeurs available in the morning for unexpected calls for service. If the company did not receive the benefit upon which payment was offered, such as when an employee arrived and waited in the afternoon, it should not have to pay for that unwanted waiting time.

The *Caryk* case demonstrates the value of having a written policy as to how waiting time is handled. A policy which delineates the times and circumstances under which waiting time is compensable, and which provides the employee the choice of opting out can operate to limit when waiting time must be paid. Whether or not the individual has discretion is evidently key. If an employer requires an employee to wait, such time is typically compensable. If the employer gives the employee the option of being paid for waiting in exchange for the employee's willingness to do something, such as to come to the employer's office by a specified time to wait for calls for service, the employee's failure to comply with the terms of the employer's offer may discharge the employer of the obligation to pay waiting time.

Rather than having a policy, some employers list criteria governing the payment of waiting time in the employment agreements between the employee and employer. There have been relatively few cited cases concerning such agreements. In such cases, the courts have evidently concluded that the parties to an employment relationship are in a better position to assess the approach to waiting time than the court.[19] The only definitive statement which can be made concerning such agreements is that employers should not, of course, attempt to enter into employment agreements stating that waiting time is not compensable. A statutory employee cannot contract away his right to be paid the minimum wage or overtime compensation.

In closing, the law regarding on-call and waiting time continues to evolve. Much of the inconsistency which plagues this area of law flows from the FLSA's exceptionally broad definition of "work," from the fact that the FLSA was enacted to regulate an employment landscape which was much different than the modern workplace, and from the fact that these cases are highly fact-intensive, thus precluding the formulation of definitive step-by-step tests by the courts. The issue of who is benefiting more, the employer or the employee; the extent of the employee's discretion, if any, to decline to participate; and the burden placed upon the employee constitute the most useful guidelines available to the practitioner confronted with a waiting time or on-call situation.

Endnotes

1. Requiring these employees to remain on the employer's premises awaiting work generally gives rise to a waiting time situation.
2. *See* 29 C.F.R. § 785.17.
3. *Skidmore v. Swift & Co.*, 323 U.S. 134, 65 S. Ct. 161, 89 L. Ed. 124 (1944).
4. *Id.* at 137.
5. 29 U.S.C. § 203(g).
6. N.Y. Lab. L. § 2(7).
7. *See* 29 C.F.R. § 785.13 (noting that "it is the duty of management to exercise its control and see to it that the work is not performed . . . It cannot sit back and accept the benefits without compensating for them").
8. *Owens v. Local No. 169, Ass'n of W. Pulp & Paper Workers*, 971 F.2d 347, 350 (2d Cir. 1992) (*quoting Armour & Co. v. Wantock*, 323 U.S. 126, 132, 65 S. Ct. 165, 89 L. Ed. 118 (1944)).
9. 29 C.F.R. § 785.14.
10. *Skidmore*, 323 U.S. at 137, 65 S. Ct. at 161.
11. *See* 29 U.S.C. § 216(b) (prevailing employee entitled to liquidated damages representing 100 percent of total wages owed) and N.Y. Lab. L. § 198(1-a) (prevailing employee entitled to liquidated damages of 25 percent of total wages owed). Demonstration of good faith under the FLSA is quite difficult, with "double damages . . . the norm, single damages the exception." *Southern New England Telecom.*, 121 F.3d 58, 71 (2d Cir. 1997) (internal citations and quotations omitted).
12. 29 U.S.C. § 203(d). The FLSA has a two-year statute of limitations for non-willful violations, and a three-year limitation period for violations deemed to be willful (intentional). 29 U.S.C. § 255(a). New York State's Labor Law, § 1983(3), makes no distinction between willful and non-willful violations and has a six-year statute of limitations.
13. *See, e.g., Herman v. RSR Security Services, Ltd.,* 172 F.3d 132 (2d Cir. 1999).
14. 29 U.S.C. § 213(b)(1).
15. 29 U.S.C. § 213(b)(17).
16. *See, e.g., Herman v. Bewah Cab, Inc.*, 992 F. Supp 1054 (E.D. Wis. 1998) (distinguishing characteristics of defendant limousine company from those of taxi companies entitled to exemption); *Wirtz v. Cincinnati, Newport & Covington Transp. Co.*, 375 F.2d 513 (6th Cir. 1967) (airport shuttle service not a taxi co.).
17. There are, of course, numerous other exemptions under the FLSA, the most familiar of which are those set forth under section 13(a)(1) of the Act and defined by the Secretary of Labor at 29 C.F.R. §§ 541 et seq. In brief, these "white collar" exemptions apply to salaried employees who receive their full salary for any work week or portion thereof worked, and who devote no more than 20% of their time to work outside the exemption (40% for employers engaged in retail or service businesses). The exemptions include the Executive exemption (for employees with management as their principal responsibility; who direct the work of at least two other full-time employees; who have authority to hire/fire or recommend such personnel decisions; and who exercise independent judgment); the Administrative Exemption (for employees who perform office or non-manual work directly related to the management policies or general business operations of their employer; who exercise discretion and judgment; and who assist management or perform specialized or technical work); the Professional Exemption (for employees who perform work requiring advanced knowledge and education, such as doctors, lawyers, teachers, engineers, scientists, computer programmers, etc.); and the Outside Sales Exemption (for salesmen who make sales primarily away from the employer's place of business).
18. *Caryk v. Coupe*, 663 F. Supp. 1243 (D.C. 1987).
19. *See, e.g., Brock v. El Paso Natural Gas*, 826 F.2d 369 (5th Cir. 1987); *Brown v. Luk, Inc.*, 3 Wage & Hours Case 2d 560 (N.D.N.Y. 1996); *Cleary v. ADM Milling Co.*, 827 F. Supp. 472 (N.D. Ill. 1993).

Roberta C. Pike, Esq. is a partner with Pike & Pike, P.C., with offices located at 1921 Bellmore Avenue, Bellmore, New York 11710. The firm concentrates in commercial litigation, including workers' compensation and unemployment insurance matters, employment practices, franchising and business practice matters.

Convergence of Cross-Border Insolvency Laws: "It's a Good Thing"

By TaeRa K. Franklin

Introduction

As the globalization of the world economy continues unflinchingly, national borders have become less meaningful to businesses and trade. Inexorably, corporations continue to expand their operations, assets, and liabilities across the borders of political states.[1] When these international conglomerates go bankrupt, the impact of their business failures is felt across borders: employees around the world lose their posts, the interests of domestic or foreign creditors and investors are placed at risk, and communities lose important organizational structures and leaders.[2] These cross-border insolvencies frequently require insolvency proceedings in various jurisdictions, although non-domestic assets may be controlled without commencing an insolvency proceeding at the locus of the assets.[3] Hence, in cross-border insolvencies courts face the choice of whether to resolve the disputes before them under their own bankruptcy laws or under those of another nation.[4] The efficient and fair operation of cross-border insolvency by a local bankruptcy system has become a general concern.[5] Currently, not many countries possess bankruptcy systems that can manage cross-border insolvencies effectively.[6]

Needless to say, the interest for reforming international insolvency laws has gained global attention.[7] This interest has led to international cooperation to cope with the increasing number of failures of multinational corporations.[8] Three legal texts have been developed and become precursors to expansion of international cooperation in cross-border insolvencies: the European Union Insolvency Regulation ("the Regulation"); the UNCITRAL Model Law on Cross-Border Insolvency ("the Model Law"); and the American Law Institute's Principles of Cooperation in Transactional Insolvency Cases Among the Members of the North American Free Trade Agreement ("the Principles").[9] Several countries have modified their insolvency laws.[10] The United Kingdom's Insolvency Act 2000 renders adoption of the Model Law likely in the near future.[11] And the United States is awaiting the adoption of Proposed Chapter 15, which incorporates the Model Law.[12]

This article examines the theories and approaches to dealing with transnational insolvencies. It takes the view that there should be a unified system governing transnational bankruptcies, providing certainty and predictability in these insolvency proceedings. Part I will consider the theories, weighing the pros and cons of each theory. Part II will analyze the three legal texts and recent development with respect to cross-border insolvency outside the United States. Part III will review the current U.S. Bankruptcy Code provisions applicable to cross-border insolvencies and Proposed Chapter 15.

Part I. Three Theories: Universalism, Territorialism and Contractualism

Coping with cross-border insolvency is clearly a choice-of-law issue.[13] To date, Universalism and Territorialism have dominated the discourse on cross-border insolvency choice-of-law questions.[14] Recently, a third theory, namely Contractualism, has surfaced in academia.[15]

A. Universalism

Universalism advocates a "centralized administration of each insolvency under one country's laws."[16] It seeks to return any property owned by the foreign debtor to its home country for distribution to the creditors pursuant to the laws of the home country.[17] A primary bankruptcy proceeding is commenced in the debtor's domiciliary country. Secondary courts in other jurisdictions defer to the main proceeding and foster the "centralized liquidation of the debtor's estate according to the rules of the debtor's home country."[18] Hence, courts sitting at the locus of the debtor's assets turn over the assets to the foreign representative, be it trustee or liquidator, of the primary proceeding.[19] Creditors, both local and non-local, file their claims in the primary proceeding.[20]

Universalism focuses on the concept of "market symmetry," which dictates that the legal systems must be in symmetry with the market: the rights and obligations within the legal systems must encompass all or most transactions and parties in interest in that market.[21] Hence, the insolvency law must reach the whole market in which the debtor operates, and thus, bind all stakeholders involved.[22] In order to achieve this symmetry, a single proceeding that administers all of the debtor's assets and liabilities under a single set of rules is necessary.[23] In liquidation, the single arrangement maximizes the value of the debtor's assets and distributes the assets pursuant to priorities by providing a universal stay prohibiting arbitrary seizures and a unified method of collecting and disseminating the assets of the debtor.[24] Since such a single scheme will bind all stakeholders, it provides a reorganization plan with sufficient predictability of outcomes.[25]

A good example of this theory is *In re Culmer*,[26] which involved assets owned by a Bahamian bank in the U.S. The Bahamian liquidators, appointed by the Bahamian Supreme Court, filed an ancillary proceeding and sought the turnover of the debtor's assets to the Bahamas for distribution pursuant to Bahamian law. The U.S. Bankruptcy Court granted the request, preferring the "uniform administration" of the insolvency proceeding in the Bahamas.[27]

Universalism is not without problems. First, it presupposes the similarity of laws among nations because it can work only if there are uniform laws regarding insolvency and priority throughout the world.[28] Second, the premise of Universalism is that the debtor's "home country" is recognizable in advance, yet the "home country" has not been defined with specificity and no reliable method of defining it has been offered.[29] Hence, it would provide international conglomerates a choice as to where they could file for bankruptcy.[30] This would result in forum shopping, which countries would be bound to honor.[31] Third, since countries would be obligated under their local laws or international conventions to honor the rulings of the home country court, Universalism creates "not a single-court system, but merely a dominant-court system."[32]

Yet proponents of this theory insist that economic globalization is engineering a convergence of the bankruptcy laws, and this convergence will lead to a "workable" international insolvency system sooner rather than later.[33] This argument does not seem farfetched. Even an arch-proponent of Territorialism has conceded that Universalism will prevail eventually because of the convergence of the insolvency laws precipitated by economic globalization.[34] She even suggested a modified version of Territorialism that provides possible solutions to cross-border insolvency disputes until the day that Universalism becomes the global law of international insolvencies.[35] The biggest endorsement of Universalism can be found in the adoption of the Model Law, which implements Universalist ideals, by several countries.[36] In the U.S., Proposed Chapter 15 incorporates the Model Law almost verbatim.[37] In short, Universalism has been gaining global support.

B. Territorialism

Territorialism is based on the idea that each nation has the "exclusive right to govern" matters within its territory.[38] Under this doctrine, the court sitting in a jurisdiction in which the debtor's assets are located proceeds pursuant to its local laws in distributing the assets.[39] Hence, Territorialism allows countries to maintain their sovereignty over the matters within their jurisdiction.[40] A court may administer assets of the debtor within its territory but not those located elsewhere.[41] This theory is also known as the "grab rule" since local courts seize the assets within their boundaries and distribute them to creditors appearing before them.[42]

In re Toga Manufacturing, Ltd.[43] exemplifies this theory. In *In re Toga*, a Canadian debtor's trustee commenced an ancillary proceeding in the U.S., seeking to enjoin all creditors from commencing or continuing actions against the debtor's assets in the U.S. and requesting the U.S. bankruptcy court to turn over certain assets held by a U.S. county as a result of an arbitration award in favor of a U.S. creditor.[44] The U.S. Bankruptcy Court noted that the U.S. judgment creditor would become unsecured under the Canadian priority laws.[45] Further, it found that Canada would not honor the U.S. Court's orders directing turnover of the U.S. debtor's assets to the U.S. trustee.[46] The Bankruptcy Court denied the Canadian trustee's request, stating that "[t] his Court must protect United States citizens' claims against foreign judgments inconsistent with this country's well-defined and accepted policies."[47]

Territorialism faces much criticism. It appears to give "little or no regard for foreign proceedings."[48] Since the assets are distributed by the laws of the situs, that law may only "benefit local creditors."[49] Generally, local law applies to most issues, not just the distribution.[50] This forces international conglomerates to create local subsidiaries that the local country can administer in a local insolvency proceeding.[51] In cases where international cooperation is necessary, parallel insolvency proceedings are available.[52] However, some countries refuse to cooperate in parallel proceedings.[53] Yet proponents argue that those countries declining to render even limited cooperation under parallel proceedings would surely refuse to cooperate under concepts of Universalism.[54]

At present, Territorialism seems to be the prevailing international insolvency law.[55] Several countries still maintain their territorial views.[56] Even countries adopting the Model Law persist in the requirement of reciprocity, which frustrates the purpose of the Model Law.[57] Others have provisions the result of which would favor local interests over foreign ones.[58] In the U.S., this is evident in a ruling by the Second Circuit in *Bank of New York v. Treco (In re Treco)*,[59] and in certain elements to be considered in granting relief pursuant to 11 U.S.C. § 304.[60] Even Proposed Chapter 15 maintains these elements of Section 304.[61]

C. Contractualism

Contractualism advocates the specification in corporate charters of the choice of forum for bankruptcies.[62] The chosen forum would apply its own law because of the complexity of any bankruptcy law.[63] Hence, the choice of forum would act as the choice of law as well.[64]

Contractualism seeks to give effect to a party's choice, thereby satisfying the party's expectation and allowing some degree of certainty as to its rights in bankruptcy.[65] Unlike two-party contracts, the choice of insolvency law and forum would bind almost all parties that transact with the debtor.[66] Parties who come into business contact with the debtor will be given notice because the chosen law and forum will be included in the debtor's corporate charter.[67] The choice does not cover involuntary creditors, who may face situations that are unfair or unreasonable.[68] This can be remedied by enacting a law following the principles laid out in *Bremen v. Zappata Off-Shore*.[69] In *Bremen*, the Supreme Court declared that forum selection clauses in international contracts are *prima facie* valid unless they are unenforceable.[70] They would be unenforceable if: (1) the contract was affected by "fraud, undue influence, or overweening bargaining power"; (2) the chosen forum was "seriously inconvenient" so as to be "unreasonable"; or (3) enforcement would "contravene strong public policy of the forum in which the suit is brought, whether declared by statute or by judicial decision."[71] Hence, by enacting a law requiring that U.S. courts honor the choice of forum so long as important U.S. policies and laws would not be violated in the chosen forum, an effective means to resolve the claim will have been established.[72]

The U.S. Supreme Court has repeatedly enforced the choice of law and forum provisions in international contracts so long as the aforementioned requirements are met.[73] Contractualism relies on these decisions and seeks to extend the application of the Supreme Court's principles to international insolvencies.[74] A contractualist would assert that this extension may increase the efficiency of bankruptcy laws because countries may vie for the selection of their own law and forum in cross-border bankruptcies.[75]

This approach is yet to be tested in real situations and remains confined to academia.[76] However, it must be noted that Contractualism can be seen as a subset of Universalism. Whereas Contractualism seeks to give the choice solely to the prospective debtor, Universalism gives the choice to the creditors or other entities in involuntary cases and the debtor in voluntary cases. While the choice occurs at corporate formation under Contractualism, it takes place immediately before the filing for bankruptcy under Universalism.[77] Contractualism makes this choice explicit, whereas Universalism allows it indirectly. Both Contractualism and Universalism will have one main proceeding under one applicable insolvency law subject to public policy and the relevant laws of the secondary jurisdiction. Hence, it seems difficult to assert that Contractualism is an independent theory, wholly distinguishable from the other two.

Part II. Current Approaches to Cross-Border Insolvencies

There are now three legal texts that seek to provide efficient and fair resolution of cross-border insolvencies. Many countries have adopted new bankruptcy laws, accepting these legal texts. This section will examine the three legal texts and recent developments in other countries with respect to international insolvency.

A. The European Union Insolvency Regulation ("the Regulation")

On May 29, 2000, the European Council and the European Commission adopted the European Union Council Regulation on Insolvency Proceedings ("the Regulation").[78] The Regulation went into effect on May 31, 2002, with the exception of Denmark.[79] The Regulation is a device to collaborate cross-border insolvency proceedings in the European Union (EU) member states.[80] It does not reconcile individual substantive laws but seeks to provide "efficient[] and effective[]" cross-border insolvency proceedings in the EU.[81] It attempts to discourage forum shopping within the member states by incorporating three devices: jurisdiction, recognition, and applicable law.[82]

The Regulation applies to personal and corporate collective bankruptcy proceedings, with the exception of investment enterprises, insurance entities and credit companies.[83] It applies to an entity with a branch office or assets in two or more member states, but not to those that have only subsidiaries in fellow member states.[84] It does not include administrative receiverships.[85]

Any order or judgment commencing bankruptcy proceedings will be recognized so long as the issuing court has jurisdiction and the order or judgment is already in effect in that jurisdiction.[86] The jurisdiction is questioned only through appeal of the judgment itself.[87] An allegation that the commencing court lacked jurisdiction cannot be a basis for a denial of recognition.[88] Upon recognition, the commencing state's law will apply to all member states, subject to the public policy of the member states.[89] The jurisdiction for main proceedings lies in the debtor's "center of main interests."[90] For companies, the location of their registered office is presumed to be the "center of main interests."[91]

A secondary proceeding is intended to be a "winding-up" process resulting in "realization" of the debtor's assets, and its impact is limited to the assets located in that member state.[92] It can be commenced only in a state where the debtor has an "establishment."[93] An "establishment" is defined as "any place of operations where the debtor carries out a non-transitory economic activity with human means and goods."[94] This can mean anything from a "mail drop" to a "branch."[95] A liquidator as well as parties with right to petition under the local law may commence a secondary proceeding.[96] The law of the state that commences a secondary proceeding applies to that secondary proceeding.[97] The mechanism of secondary proceedings not only helps to protect the local creditors' interests but also eases complications involving a debtor whose estate is "too complex to administer."[98]

Although the Regulation furnishes workable solutions with respect to cross-border insolvency, there are issues yet to be resolved.[99] First, the concept of "center of main interests" is not readily discernible.[100] This may lead to multiple judgments in main proceedings involving the same debtor.[101] Forum shopping remains prevalent. In a case involving a Spanish Enron subsidiary, an English court granted an administrative order as a main proceeding pursuant to Article 3(1).[102] Although the debtor was incorporated in Spain and had its primary business in Spain, England was determined to be the "center of main interests" because the debtor's headquarters were situated in London.[103] Another case involved a U.S. company.[104] The debtor was incorporated in the U.S. Its registered office was located in Delaware.[105] The English court easily rebutted the presumption that the "center of main interests" is where the debtor's registered office is located.[106] It reasoned that the debtor traded mostly from the United Kingdom, not the U.S.[107] It held that according to Article 3 and the purpose of the Regulation, the only test was whether the debtor's "center of main interests" was in a relevant member state, and not where the debtor was incorporated.[108] This case demonstrates not only how the obscurity of the term "center of main interests" can lead to forum shopping, but also how the Regulation can be used to reach decisions that indicate the territorial posture of a court toward non-member countries.

Aside from the "center of main interests" issue, the Regulation faces other problems. Since it does not apply to financial undertakings, the important players of the global economy are not protected under it.[109] Further, although the outcomes under the Regulation are dramatically unitary when there is only one bankruptcy proceeding for a debtor,[110] much confusion as to choice of law emerges when secondary proceedings are commenced.[111] Moreover, because the application of the commencing state's law is subject to the public policy of other member states, the Regulation does not guarantee uniform administration of cross-border insolvencies.[112] Finally, the Regulation does not provide for cooperation among courts, thereby lowering the optimal level of international cooperation and coordination.[113] Therefore, under the Regulation the administration of cross-border insolvencies becomes mainly territorial, expensive and complicated.[114]

B. The American Law Institute's Principles of Cooperation in Transnational Insolvency Cases Among the Members of the North American Free Trade Agreement ("the Principles")

Developed by the Transnational Insolvency Project, the Principles are intended to apply under the current laws of the three member countries of the North American Free Trade Association.[115] The Principles do not authorize automatic recognition but require a separate recognition process.[116] They nonetheless require a minimal demonstration of a need for the stay.[117] They recommend distribution under the Universalist theory insofar as local laws permit it.[118] For instance, the Principles suggest the dismissal of non-main proceedings in order to achieve reorganization in the main proceeding without that proceeding becoming subject to varying priority rules.[119] The claims allowed in one NAFTA country are considered allowed in the other two without relitigating the issue of allowability, subject to special local insolvency or priority rules.[120] An approved reorganization plan is binding upon all creditors.[121] Those creditors who received payments under the plan or took part in the reorganization in one of the NAFTA countries are prohibited from bringing any litigation at odds with the approved plan.[122] If a creditor filed a claim under a country with jurisdiction over it and then files the same in another country, the latter country should dismiss the claim before it.[123]

Unlike the Regulation, the Principles provide a list of guidelines to assist courts and administrators to communicate either directly or indirectly.[124] The *Guidelines Applicable to Court-to-Court Communications in Cross-Border Cases* ("*Guidelines*")[125] view court-to-court communications as a desirable tool for connecting concurrent proceedings.[126] The *Guidelines* have proved useful in facilitating international cooperation among courts in the NAFTA countries.[127] Its success promotes its further application to other countries with major economies, such as Germany, Italy, Portugal, Spain, France, Japan and Korea.[128]

Under the Principles cross-border sales are conducted to achieve the best possible value to creditors. Maximizing that value sometimes means the loss of a partial sale that would yield a better value to creditors in the local proceeding.[129] The Principles allow subsidiaries of corporations to file in the home country of the parent company to achieve collective reorganization, even if this is not possible generally.[130] They provide that in order to maximize cross-border cooperation and coordination, conglomerates should be reorganized as a single unit subject to certain value allocation issues.[131] This is different from the Regulation because the Regulation grants no special rules for conglomerates and leaves the issue to individual substantive laws.[132] Finally, the Principles support the adoption of the Model Law by each NAFTA country.[133]

C. The UNCITRAL Model Law on Cross-Border Insolvency ("the Model Law")

In April 1994, the United Nations Committee on International Trade Law convened to institute uniform principles in cross-border insolvencies.[134] In 1997, this committee adopted the Model Law.[135] The Model Law follows many of the Regulation concepts. Like the Regulation, the Model Law does not reconcile local substantive laws, but aims to supply "a modern, harmonized and fair framework" dealing with transnational insolvencies.[136] Similarly, it aims to furnish in cross-border insolvencies: (1) cooperation among the countries involved; (2) greater legal assurance for international commerce and trade; (3) "efficient" and "fair" facilitation of insolvency proceedings; (4) protection of the interests of all stakeholders and maximization of the value of the debtor's assets; and (5) assistance in the relief of financially troubled entities.[137]

The Model Law has thirty-two articles, which can be divided into four categories: (1) scope; (2) access; (3) recognition; and (4) cooperation and communication among proceedings in several countries.[138] It covers all proceedings pertaining to collective bankruptcy so long as the relevant court supervises and manages the debtor's assets and activities.[139] These include circumstances in which: (1) a foreign representative or court in a foreign proceeding requests relief in another country; (2) a nation is asked to aid a proceeding pending before another nation under particular insolvency laws of the latter; (3) concurrent proceedings are pending; and (4) creditors or parties in interest seek to commence or participate in a foreign proceeding under foreign insolvency laws.[140]

Article 4 specifies the court or authority that will carry out the Model Law. Article 5 confers general authority for the bankruptcy administrators to act in foreign jurisdictions within the bounds of the foreign law.[141] The Model Law gives a foreign representative the right to appear in local courts subject to scrutiny under diplomatic requirements.[142] A foreign representative has standing to commence a local bankruptcy proceeding or to partake as a matter of right in a pending local proceeding.[143] The local courts have authority to confer additional relief on the foreign representative.[144]

The Model Law makes easy the recognition of a foreign representative: the representative need only demonstrate his appointment by submitting certificates of the foreign court commencing the foreign proceeding and appointing him; certificates affirming such commencement and appointment; or any other acceptable proof of the foreign proceeding and appointment.[145] There is a presumption of authentication as to these documents.[146] Recognition of a foreign proceeding is made pursuant to the "procedural law of the enacting State other than the provisions implementing the Model Law," subject to appeal on the issue of whether Articles 15 and 16 were followed.[147] Both "main" and "non-main" proceedings must be recognized.[148] As in the Regulation, a main proceeding is a proceeding in a country in which the debtor has the "center of its main interests."[149] Recognition of a main proceeding is accompanied by a mandatory stay of all actions against the debtor's assets.[150] Non-main proceedings need to be recognized only if the debtor has an "establishment" in that country.[151] Recognition becomes evidence of the debtor's insolvency, absent proof indicating otherwise.[152]

Foreign creditors receive the same treatment as local creditors.[153] Foreign creditors are entitled to the same notice that local creditors receive, but they receive individual service unless the court finds proper other types of service.[154] They receive instructions as to the place and time to file their claims within a reasonable time.[155] Secured creditors are notified whether they must file their secured claim.[156] Creditors who have obtained distributions in a foreign proceeding must abstain from a local distribution until other creditors of the same class have received the equivalent amount from the local proceeding.[157]

Unlike the Regulation, the Model Law allows direct and indirect communication among courts and representatives with their foreign counterparts to the "maximum extent possible."[158] Courts may request assistance and information from foreign courts or representatives.[159] These courts operate under local rules governing due process and fairness.[160] The Model Law provides a list of "forms of cooperation."[161] Recognition of a main proceeding does not proscribe commencing a non-main proceeding so long as the debtor has assets in the secondary state.[162] Courts are required to seek cooperation and coordination pursuant to the Model Law when there are concurrent proceedings in the local and foreign states.[163] When two or more foreign proceedings apply for recognition, the foreign main proceeding must be granted primacy.[164]

Although the Model Law seeks to provide uniform guidance for the fair and efficient administration of cross-border insolvencies, it also includes provisions that could lead to territorial decisions. This is notable in its treatment of foreign creditors. Although they are entitled to the same treatment that local creditors receive, the foreign creditors lose this protection with respect to priorities.[165] They are afforded the priorities that general unsecured creditors receive under local law.[166] Nevertheless, they may lose even this minimal protection if a class of local claimants receives a lower priority than the general unsecured creditors.[167] This becomes problematic. For example, U.S. courts have refused to defer to foreign laws where the U.S. creditors would lose their secured status under the competing foreign laws.[168] Hence, the Model Law leaves unresolved much contention in cross-border insolvencies.

Moreover, the Model Law faces problems similar to those faced by the Regulation because of its adoption of certain Regulation principles. For example, confusion as to the meaning of the "center of main interests" also takes places under the Model Law. Forum shopping attributable to this confusion will continue. When multiple proceedings are filed, the unitary effect of the Model Law may vanish as in the Regulation. Additionally, enacting countries can easily strip themselves of the Model Law's uniform principles by requiring reciprocity.

D. Developments Around the World

Japan has abandoned its long-held Territorialist approach[169] and enacted the Law on Recognition of and Assistance in Foreign Insolvency Proceedings which adopts the Model Law.[170] However, its version deviates from the Model Law in several ways. First, it prohibits concurrent proceedings: Japanese courts are required to dismiss either the recognition application of a foreign proceeding or the local proceeding if they take place concurrently.[171] In order for a foreign proceeding to survive this dismissal, Japanese courts must find that: (1) the foreign proceeding is a main proceeding; (2) dismissing the local proceeding serves generally all creditors' interests; and (3) there is no likelihood of harm to local creditors.[172] Hence, a recognition petition could easily get dismissed if the local case is more advantageous to local creditors. Such an outcome would clearly eliminate international cooperation and coordination as designed by the Model Law.[173]

Japanese law does not provide for automatic relief upon recognition of foreign proceedings while it does give interim relief that may act as a stay.[174] Further, Japanese law eliminates the requirement of immediate action on a recognition petition under the Model Law.[175] It stays execution by secured creditors only if the law of the main proceeding prohibits the execution.[176] Moreover, Japanese tax claims are not stayed because Japanese law deems such claims nonjudicial.[177] Courts are not allowed to communicate directly with other courts or administrators.[178] The law only permits direct communication and cooperation among administrators.[179]

As part of the reformation of its bankruptcy law, Mexico adopted the Model Law and became the first Latin American nation to adopt it.[180] *La Ley de Concursos Mercantiles (LCM)* has replaced the old insolvency law.[181] It consists of both a reorganization and a liquidation process.[182] *LCM* adopts the Model Law nearly verbatim except for some provisions.[183] Under *LCM*, the filing of a bankruptcy petition does not trigger an automatic stay.[184] Hence, recognition of a foreign proceeding does not result in a moratorium unlike Article 20 of the Model Law.[185] *LCM* continues to treat separately the bankruptcy of the debtor's Mexican branch from the rest of the debtor's bankruptcy, thereby allowing the liquidation of that branch as a local subsidiary of the debtor, which affects only local assets and creditors who transacted with that branch.[186] *LCM* applies only to merchants, not consumers, and the term *comerciante* means any entity in a bankruptcy proceeding.[187] Its requirement of the appointment of a disinterested expert to make a visit to verify the fact that the *comerciante* is indeed insolvent extends to a foreign debtor whose representative requests recognition in Mexico.[188] Finally, *LCM* requires reciprocity although adoption of the Model Law by the relevant foreign country may well suffice as a proof of reciprocity.[189]

Germany follows the Universalist approach.[190] On October 18, 1994, Germany promulgated the Insolvency Act and an Introductory Act to the Insolvency Act (the German *Insolvenzordnung*), which became effective on January 1, 1999.[191] The German *Insolvenzordnung* provides for recognition of foreign bankruptcy proceedings.[192] It does not require a separate proceeding for recognition.[193] It allows local bankruptcy proceedings to affect local assets only.[194] It supplies a conflict rule for actions which sets aside particular transactions which occurred prior to the commencement of bankruptcy proceedings.[195]

The German *Insolvenzordnung* mirrors much of the "most sophisticated pre-existing bankruptcy regime, namely, the Bankruptcy Code of the United States," yet it introduces it in a "continental legislative style" that appeals to Central and Eastern Europe and Latin America.[196] It is attractive to "transition economies"[197]: Mexico has heavily espoused the German concept of unitary proceedings which allows for determination of the proper solution after a period of initial analysis of the debtor's business condition,[198] and the Bulgarian Parliament has enacted an insolvency law which consists of many elements of the new German insolvency law that are vital to market conformity.[199]

South Africa has adopted the Model Law; however, the South African version requires reciprocity.[200] The Republic of Montenegro, Romania, Eritrea, and Poland have adopted the Model Law.[201] Spain has passed legislation similar to, if not more comprehensive than, the Model Law.[202] In the United Kingdom, The Insolvency Act 2000 allows certain ministries to adopt the Model Law through a procedure requiring final approval by Parliament.[203] A bill adopting the Model Law has been submitted in Argentina.[204] A recommendation to adopt the Model Law has been made in Australia and New Zealand.[205] It is anticipated that the Canadian Parliament will submit a report recommending adoption of the Model Law.[206]

Part III. The United States Bankruptcy Law

The U.S. Bankruptcy Code falls between Universalism and Territorialism.[207] Currently, there are three provisions in the Bankruptcy Code that deal with international insolvency issues. Section 303 allows commencement of an involuntary proceeding by a foreign representative.[208] Section 305 allows foreign representatives to move for dismissal or suspension of a local proceeding.[209] Section 304 provides the option of commencing an ancillary proceeding in the U.S. by a foreign representative.[210]

Section 304 was enacted to "deal with the complex and increasingly important problems involving the legal effect the United States courts will give to foreign bankruptcy proceedings."[211] It is designed to furnish a "statutory mechanism through which U.S. courts may defer to and facilitate foreign insolvency proceedings."[212] However, the application of Section 304 by courts has varied. Demand for reformation or clarification of Section 304 has been made by courts and scholars.[213] Such demand and the worldwide reform of international insolvency laws prompted the consideration of new legislation dealing with transnational insolvency.[214] The Congress has passed Proposed Chapter 15 that heavily incorporates the Model Law.

A. Current U.S. Approach

Under Section 303, the foreign representative may file a plenary involuntary proceeding against a person if the property of the debtor in the U.S. is sufficiently sizable or complex to necessitate a full proceeding.[215] A person is defined as an "individual, partnership, and corporation" or "governmental unit" obtaining interest in the property of the "person."[216] Section 305 allows the court to dismiss or suspend any local insolvency proceedings so long as there is a "pending foreign proceeding" and Section 304(c) "warrant[s] such dismissal or suspension."[217] It further allows the foreign representative of a pending foreign proceeding to move to dismiss or suspend the local insolvency proceeding if Section 304(c) is satisfied.[218] Such dismissal or suspension is not appealable.[219]

Section 304 allows commencement of a local proceeding ancillary to a foreign proceeding by a foreign representative.[220] A foreign representative is a "duly selected trustee, administrator, or other representative of an estate in a foreign proceeding."[221] A foreign proceeding is a

> proceeding, whether judicial or administrative and whether or not under bankruptcy law, in a foreign country in which the debtor's domicile, residence, principal place of business, or principal assets were located at the commencement of such proceeding, for the purpose of liquidating an estate, adjusting debtors by composition, extension or discharge, or effecting a reorganization.[222]

If the foreign representative seeks injunctive relief, it must file a petition in the district in which the action in question is pending.[223] If the relief sought is a stay of enforcement of a lien against, or the turnover of, the debtor's property, the proceeding must be brought in the district where the property is located.[224] For any other relief, the proceeding must be brought in the district where the debtor's principal place of business or principal assets in the U.S. are located.[225]

After the petition for an ancillary proceeding has been filed by the foreign representative, if no interested parties contest the petition or after trial, courts have the authority to proscribe the "commencement or continuation of any action against" the debtor or its property or the "enforcement of any judgment against the debtor."[226] In addition, courts may "order turnover of the property . . . or the proceeds" of the property to the foreign representative.[227] Moreover, they may grant "other appropriate relief."[228] The grant of such relief is made pursuant to the infamous subsection (c) of Section 304 (Subsection (c)), which enumerates six factors to be examined.[229] These factors are provided to facilitate the "economical and expeditious" administration of the foreign proceeding.[230]

In short, Section 304 proceedings are not plenary bankruptcy proceedings.[231] They do not create an estate.[232] They do not trigger an automatic stay or allow discharges of debts.[233] They are commenced to "prevent piecemeal distribution of a debtor's estate."[234] Hence, Section 304 offers a "broad and flexible" approach to dealing with international insolvency[235] out of "comity and respect" for foreign laws and decisions.[236]

The interpretation of Section 304 has varied, especially because Subsection (c) invokes a "case-specific exercise of discretion in light of all the circumstances."[237] Some courts follow the Universalist approach to interpreting Section 304.[238] These courts generally place more importance on the comity factor of Subsection (c), while those endorsing the Territorialist view place equal weight on all factors.[239] This pro-Universalist approach is best illustrated by *In re Culmer.*

In *In re Culmer,* the Bahamian debtor maintained deposit accounts in the U.S. The Bahamian liquidators sought an injunction against creditors to prohibit them from bringing any action against the debtor's assets in the U.S., as well as the turnover of those assets to the Bahamian insolvency proceeding. The Bankruptcy Court first reviewed the legislative history and discerned that Subsection 304(c) is meant to give courts "maximum flexibility" in dealing with cross-border insolvencies.[240] Then it held that comity is the underlying principle in determining whether to grant the relief sought and applied the five factors in accordance with that underlying principle.[241] Further, the Court stated that such a comity determination is proper so long as enforcement of the foreign judgments would not amount to "the approval of a transaction which is inherently vicious, wicked or immoral, and shocking to the prevailing moral sense."[242]

The Second Circuit's decision in *In re Treco* demonstrates an approach closer to Territorialism.[243] In *In re Treco*, the liquidators of a Bahamian debtor filed a petition seeking turnover of the debtor's assets deposited in an American bank which held a security interest in these assets.[244] Under the Bahamian law, secured claims become junior to administrative expenses whereas under U.S. law they do not.[245] The American creditor argued that the turnover was prohibited under Subsection (c) because of the differences between the U.S. and the Bahamian laws. The liquidators argued that the U.S. courts should grant the turnover request out of comity, insisting that comity trumps the other five factors of Subsection (c). The Second Circuit acknowledged that "comity is the ultimate consideration in determining whether to provide relief under § 304."[246] However, it stated that "comity does not . . . automatically override the other specified factors."[247] Then it held that a conclusion that comity "categorically" trumps the other factors would mean "effective[] eliminat[ion]" of the other factors from the statute, which would clearly violate the judicial obligation to "give effect, if possible, to every clause and word of a statute."[248]

As the above case law indicates, the confusion over the question whether comity trumps the other factors comes from the differences between the legislative history and the statutory language of Section 304(c). Undoubtedly, a clarification of this question is necessary.[249] In response to this confusion and the global acknowledgment of a need for cooperation and coordination among nations, Congress has passed Proposed Chapter 15, which, once adopted, will repeal and replace Section 304 of the Bankruptcy Code.[250]

B. Proposed Chapter 15

The title of the Proposed Chapter 15 is "Ancillary and Other Cross-Border Cases."[251] It is designed to facilitate cooperation between the U.S. and other countries on cross-border insolvency matters.[252] Proposed Chapter 15 implements much of the Model Law with some exceptions, including steps which ensure preservation of U.S. interests.[253]

Proposed Chapter 15 applies in circumstances that the Model Law covers.[254] Yet it excludes from its scope: (1) railroads, regulated financial undertakings, and U.S. insurance entities; (2) U.S. citizens, permanent residents and legal aliens residing in the U.S. who satisfy the Chapter 13 requirements under 11 U.S.C. § 109(e); (3) entities subject to the Securities Investor Protection Act; and (4) stock and commodity brokers subject to Chapter 7 of the Bankruptcy Code.[255] A debtor for the purpose of Proposed Chapter 15 means "an entity that is the subject of a foreign proceeding."[256] This definition has extinguished confusion as to whether a debtor in an ancillary proceeding should qualify as the debtor under 11 U.S.C. § 101(13) or under applicable foreign laws.[257] Under Proposed Chapter 15 the debtor is defined simply by referring to the applicable foreign laws.

"Recognition" is defined as the "entry of an order" recognizing foreign main or non-main proceedings.[258] Unlike the Model Law, Proposed Chapter 15 does not give foreign representatives automatic recognition. A foreign representative must submit a recognition application in a bankruptcy court.[259] The foreign representative gains access to other U.S. courts only after he receives recognition from the bankruptcy court.[260] All actions regarding comity must go through the bankruptcy courts, thereby putting an end to inconsistent decisions on comity among U.S. courts.[261] Voluntary petitions are filed by representatives of foreign main proceedings, whereas involuntary ones may be commenced by any foreign representative.[262] This is different from the Model Law, which allows any foreign representative to commence insolvency proceedings regardless of whether the proceedings are involuntary or not.

Where the Model Law grants automatic stay upon recognition against commencement or continuation of any action against, execution of lien against, and transfer of the debtor's assets upon recognition, Proposed Chapter 15 also incorporates other U.S. bankruptcy provisions, such as adequate protection, post-petition use, sale or lease of the debtor's property and post-petition impact on a security interest.[263] Furthermore, it authorizes U.S. courts to grant any additional relief they see fit.[264]

U.S. courts may appoint a "trustee or another entity" to represent the debtor's estate abroad.[265] Such representative may act in "any way permitted by the applicable foreign law."[266] This demonstrates a congressional effort to accommodate unitary resolutions of cross-border insolvencies by deferring to foreign laws and jurisdiction. However, such an attempt is curtailed by Section 1507, which gives U.S. courts the power to refuse any proceeding "manifestly contrary to the public policy of the United States."[267]

The requirements for a recognition process are the same as those under the Model Law: certified copies of the judgment beginning the foreign proceeding and appointing the foreign representative; and a certificate of appointment of the representative and of the existence of the proceeding issued by a foreign court.[268] Similarly, there is a presumption that the recognition requirements have been satisfied.[269] Likewise, recognition must be made of foreign main or non-main proceedings.[270] Once recognition is made, after notice and a hearing, the recognition order shall be entered.[271]

Sections 1525 through 1527 provide rules governing international cooperation and coordination. Upon recognition, courts and trustees "shall cooperate to the maximum extent possible with foreign courts or foreign representatives."[272] Courts may allow the implementation of agreements pertaining to coordination of the local and foreign proceedings.[273] Both courts and trustees may directly communicate with other courts and foreign representatives.[274] However, such international coordination and cooperation are allowed only if the formal recognition is made, whereas the Model Law does not require the formal recognition.[275]

Now we turn to Section 1507(b), which is designed to resolve the confusion as to whether comity is determined by incorporating the other five factors of Subsection (c). Proposed Chapter 15 resolves the confusion surrounding comity thorough Section 1507(b). Section 1507(b) provides:[276]

> In determining whether to provide additional assistance under this title or under other laws of the United States, the court shall consider whether such additional assistance, consistent with the principles of comity, will reasonably assure—
>
> (1) just treatment of all holders of claims against or interest in the debtor's property;
>
> (2) protection of claim holders in the United States against prejudice and inconvenience in the processing of claims in such foreign proceeding;
>
> (3) prevention of preferential or fraudulent dispositions of property of the debtor;
>
> (4) distribution of proceeds of the debtor's property substantially in accordance with the order prescribed by this title; and
>
> (5) if appropriate, the provision of an opportunity for a fresh start for the individual that such foreign proceeding concerns.

If adopted, this will mean that comity is the underlying principle of the ancillary proceedings and may be determined by examining these five factors.[277] Hence, it can be said that comity trumps any of the other factors in considering whether to grant relief sought by foreign representatives in ancillary proceedings. Nonetheless it is doubtful whether courts that were concerned about protecting local interests would be dissuaded from refusing to give deference where such interests would be harmed by the deference.

At this juncture, a brief look at comity is apposite. Comity is not an "obligation" or "mere courtesy"[278]: it is a voluntary recognition by one nation of foreign laws or acts.[279] Comity is not "categorical deference" to foreign laws or proceedings.[280] The extension of comity is not proper where foreign laws or proceedings are "repugnant to our laws and policies."[281] Even courts which defer to foreign laws and fora under comity acknowledge certain limitations on deference.[282] *In re Culmer*, the most illustrative case for the pro-Universalist approach, stated that deference is proper so long as the enforcement of foreign judgments would not amount to "the approval of a transaction which is inherently vicious, wicked or immoral, and shocking to the prevailing moral sense."[283] Also, in *In re Brierley*, the Bankruptcy Court stated that "one cannot simply 'feel' that comity is warranted."[284] That Court proceeded to compare British and American insolvency law to determine whether comity should be granted.[285]

Further, Section 1507(b) itself clearly provides that the relief requested must be in "substantial accordance" with U.S. court orders under the Bankruptcy Code and that U.S. creditors should not be prejudiced or inconvenienced by the foreign forum. These are sections that have been used by courts to deny deference or relief sought by foreign representatives.[286] Hence, without more, the fact that comity is the underlying principle when considering relief requested by foreign representatives in ancillary proceedings will continue to split U.S. courts.[287]

The Universalist ideals are curtailed further by other provisions in Proposed Chapter 15. As in the Model Law, Proposed Chapter 15 does not define the "center of main interests." It only provides a rebuttable presumption that the "debtor's registered office" or "habitual residence" is the "center of main interests."[288] Foreign non-main proceedings are commenced where the debtor has an "establishment."[289] As noted earlier, these concepts are not easily ascertainable hence they lead to the recognition process becoming more complicated and territorial in nature, at the same time that it fails to dissuade forum shopping.[290]

The public policy exception to applying the law of foreign proceedings may result in territorial decisions. Although this exception is limited to situations in which U.S. public policy would be "manifestly" contradicted by the applicable foreign laws, the proposed statute does not explain when there is such contradiction.[291] Hence, courts are left to determine such circumstances with no guidance from the statute. This could lead to inconsistent decisions, dividing courts yet again into pro-Universalist and pro-Territorialist.

Proposed Chapter 15 confers on U.S. courts the authority to allow distribution of the local assets by the foreign representatives. However, such an allowance is made only if courts are "satisfied" that the interests of U.S. creditors are "sufficiently protected."[292] Moreover, although Section 1528 confines the effect of the local plenary bankruptcy to local assets, such effect will extend to non-local assets if they are not protected by the courts in recognized foreign proceedings.[293]

In sum, Proposed Chapter 15 equips U.S. courts with principles that follow Universalism more closely than Section 304. Nevertheless, it embodies certain protective measures for local interests. This raises the specter of potential chaos and jeopardizes administration of transnational insolvency in a single proceeding under a single set of rules.

Conclusion

Universalism has gained more support in the last decade. However, the day on which pure Universalism will become the international insolvency law is yet to come. Territorialism is still strong around the world. Denmark and Sweden adhere to the territorial approach and insist that insolvency is effective only in the state in which it was commenced and that foreign representatives have no powers extraterritorially.[294] Even the three texts that seek to provide the universal approach to cross-border insolvencies contain elements of Territorialism within them, as discussed earlier.

American courts have recognized that encouraging "a friendly intercourse between sovereignties" advances U.S. self-interest, particularly where transnational commerce and trade are involved.[295] However, they have refused to defer to foreign laws that are contrary or "repugnant" to the U.S. laws and policies.[296] The current U.S. approach to cross-border insolvencies can be seen as "a modified form of universalism accepting the central premise of universalism, that is, that assets should be collected and distributed on a worldwide basis, but reserving to local courts discretion to evaluate the fairness of home country procedures and to protect the interests of local creditors."[297] Although it incorporates much of the Universalist approached espoused by the Model Law, the new legislation continues this modified Universalism: it is clear in its message that deference to foreign proceedings will be extended only if the interests of U.S. parties are sufficiently protected.

As the world moves toward convergence of international insolvency laws, many questions must be addressed to achieve a definite unitary solution to cross-border insolvencies. With all of its deficiencies, the Model Law seems to offer the best solution available to cross-border insolvencies at present.[298] Many countries have adopted it. Many other countries are in the process of adopting it. The Model Law has support from the American Law Institute. Its adoption has been recommended by the Asian Development Bank, the International Monetary Fund, and the World Bank.[299]

Considering that enactment of Section 304 has constituted "a step toward the universality approach,"[300] the adoption of Proposed Chapter 15, which is armed with many of the provisions of the Model Law, will move the U.S. closer to the Universalist approach than is the case under current U.S. bankruptcy laws. This is a positive movement toward effectuating a major purpose of the U.S. bankruptcy system: to provide a unified, federalized system for administering the insolvent estate and balancing the rights and obligations of all interested parties.

Endnotes

1. Rasmussen, Robert K., *Resolving Transnational Insolvencies Through Private Ordering*, 98 Mich. L. Rev 2252 (June 2000).

2. Rasmussen, Robert K., *A New Approach to Transnational Insolvencies*, 19 Mich. J. Int'l L. 1 (Fall 1997).

3. Gerber, Elizabeth J., *Not All Politics Is Local: The New Chapter 15 to Govern Cross-Border Insolvencies*, 71 Fordham L. Rev. 2051, 2052 (April 2003).

4. Rasmussen, *supra* note 1, at 2252.

5. Gerber, *supra* note 3, at 2052.

6. *Id*.

7. Westbrook, Jay Lawrence, *Multinational Enterprises in General Default: Chapter 15, The ALI Principles, and The EU Insolvency Regulation*, 76 Am, Bankr. L. J. 1 (Winter 2002).

8. *Id*.

9. *Id*. at 2; *see also* Gerber, *supra* note 3; Lee, Paul L., *Ancillary Proceedings Under Section 304 and Proposed Chapter 15 of the Bankruptcy Code*, 76 Am Bankr. L. J. 115 (Spring 2002).

10. Countries including Germany, Japan, and Mexico, have rewritten their insolvency laws. Westbrook, *supra* note 7, at 24–29.

11. Westbrook, *supra* note 7, at 29.

12. *Id*. at 18–19; Gerber, *supra* note 3; Lee, *supra* note 9.

13. Buxbaum, Hannah L., *Rethinking International Insolvency: The Neglected Role of Choice-of-Law Rules and Theory*, 36 Stan. J. Int'l L. 23, 25 (Winter 2000).

14. *Id*.

15. Gerber, *supra* note 3, at 2056.

16. *In re Maxwell Communication Corporation PLC.*, 93 F.3d 1036 (2d Cir. 1996).

17. Gerber, *supra* note 3, at 2055.

18. *Bank of New York v. Treco (In re Treco)*, 240 F.3d 148, 153 (2d Cir. 2001).

19. Gerber, *supra* note 3, at 2056.

20. *Id*.

21. Westbrook, Jay Lawrence, *A Global Solution to Multinational Default*, 98 Mich. L. Rev. 2276, 2283 (June 2000).

22. *Id*. at 2284.

23. *Id*.

24. *Id*. at 2285.

25. *Id*.

26. 25 B.R. 621 (Bankr. S.D.N.Y. 1982).

27. *Id*. at 629.

28. Westbrook, Jay Lawrence, *Theory and Pragmatism in Global Insolvencies: Choice of Law and Choice of Forum*, 65 Am. Bankr. L. J. 457, 485 (1991); LoPucki, Lynn M., *The Case for Cooperative Territoriality in International Bankruptcy,* 2216 (June 2000).

29. LoPucki, *supra* note 28, at 2216–17.

30. *Id*. at 2217.

31. *Id*. at 2216.

32. *Id*. at 2221.

33. Westbrook, *supra* note 21, at 2291.

34. LoPucki, *supra* note 28, at 2217; Westbrook, *supra* note 7, at 8.

35. LoPucki, *supra* note 28.

36. Westbrook, *supra* note 7.

37. H.R. 333, 107th Cong. (2001); Westbrook, *supra* note 7; Gerber, *supra* note 3; Delving, Brian M., *The Continuing Vitality of the Territorial Approach to Cross-Border Insolvency*, 70 UMKC L. Rev. 435, 448 (Winter 2001).

38. LoPucki, *supra* note 28, at 2218.

39. *In re Treco*, 240 F.3d at 153.

40. Gerber, *supra* note 3, at 2058–59.

41. *Id*. at 2058.

42. *In re Treco*, 240 F.3d at 153; Gerber, *supra* note 3, at 2058.

43. 28 B.R. 165 (Bankr. E.D. Mich. 1983).

44. *Id*.

45. *Id*. at 170.

46. *Id*.

47. *Id*.

48. Westbrook, *supra* note 7, at 5.

49. *Id*.

50. *Id*. at 5–6.

51. LoPucki, *supra* note 28, at 2218.

52. *Id*.

53. *Id*.

54. *Id*. at 2219.

55. *Id*.

56. *E.g.*, Denmark & Sweden. Balz, Manfred, *International Law Symposium: The European Union Convention on Insolvency Proceedings*, 70 Am. Bankr. L. J. 485 (Fall 1996).

57. *E.g.*, Mexico and South Africa.

58. *E.g.*, Japan.

59. The Second Circuit refused to turn over the assets in the U.S. to the Bahamian liquidator since the Bahamian priority rules are not "substantially in accordance" with those of the U.S. *In re Treco*, 240 F.3d at 158.

60. Section 304 of the Bankruptcy Code provides in pertinent part:

> In determining whether to grant relief under subsection (b) of this section, the court shall be guided by what will best assure an economical and expeditious administration of such estate, consistent with–
>
> (2) protection of claim holders in the United States against prejudice and inconvenience in the processing of claims in such foreign proceeding;
>
> ……..
>
> (4) distribution of proceeds of such estate substantially in accordance with the order prescribed by this title;

11 U.S.C. § 304.

61. H.R. 333 § 1507(b).

62. *In re Treco*, 240 F.3d at 153 n.2.

63. Rasmussen, *supra* note 2, at 33–34.

64. *Id*.

65. *Id*. at 33.

66. *Id*. at 34.

67. *Id*.

68. *Id*. at 35.

69. 407 U.S. 1 (1972).

70. *Id.*

71. *Id.* at 15. For more detail, *see* Franklin, TaeRa K., *The Formation, Evolution, and Application of the Bremen Standard: The New Federal Common Law Approach to Choice of Forum and Law Clauses In International Contracts*, 7 NYSBA NY Bus. L. J. 22 (Summer 2003).

72. Rasmussen, *supra* note 2, at 35.

73. *See Bremen v. Zapata Co.*, 407 U.S. 1; *Scherk v. Alberto-Culver Co.*, 417 U.S. 506 (1974); *Mitsubishi Motors Corp v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614 (1985).

74. Rasmussen, *supra* note 2, at 35.

75. *Id.* at 35.

76. *In re Treco*, 240 F.3d at 153 n.2.

77. As discussed previously, Universalism breeds forum shopping because it gives choice to the parties with respect to where they could commence their bankruptcy due to the amorphous definition of "home country" or the location of the debtor. *See supra* text accompanying notes 28-32.

78. Council Regulation (EC) 1346/2000 of 29 May 2000 on Insolvency Proceedings, *available at* <http://www.iiiglobal.org/country/european_union/regulation.pdf > (hereinafter "the Regulation").

79. *Id*. at preamble para. (33) & Art. 42.

80. Leonard, E. Bruce, *International Scene, The International Year in Review*, 2003 ABI JNL LEXIS 223, at *1 (December 2003).

81. The Regulation, *supra* note 78, at preamble para. (2) & (11); *see also* O'Neil, Barry, *European Union Cross-Border Insolvency Regulation*, *available at* <http://www.efc.ie/publications/legal_updates/articles/corp_recov/eu_cross_border_regulations.html.>.

82. The Regulation, *supra* note 78, at preamble para. (4) & (8).

83. *Id.* at preamble, para. 9. There are distinct systems dealing with the excluded financial institutions. *See also* Lueke, Wolfgang, *The New European Law on International Insolvencies: A German Perspective*, 17 Bank. Dev. J. 369, 376 (Spring 2001).

84. O'Neil, *supra* note 81, at para. 3.1.

85. The Regulation, *supra* note 78, Annex A.

86. *Id*. at Arts. 16(1) & 17(1).

87. Lueke, *supra* note 83, at 378.

88. *Id.*

89. The Regulation, *supra* note 78, at Art. 26.

90. *Id.* at Art. 3(1).

91. *Id.*

92. Lueke, *supra* note 83, at 398.

93. The Regulation, *supra* note 78, at Art. 3(2).

94. *Id.* at Art. 2(h).

95. Gerber, *supra* note 3, at 2068.

96. The Regulation, *supra* note 78 at Art. 29.

97. *Id.* at Art. 28.

98. *Id.* at preamble para. 19.

99. Lueke, *supra* note 83, at 404.

100. *Id.* at 380.

101. *Id.*

102. Moss, Gabriel, *Summary of Decision of Lightman, J., In re Enron Directo Sociedad Limitada* (July 2002), available at <http://iiiglobal.org/country/european_union/Enron%Directo%20decision%20of%20Lightman%20J.pdf>; *see also* Leonard, *supra* note 80, at *1–2.

103. *Id.*

104. *In re Brac Rent-A-Car International Inc.* [2003] EWHC (Ch) 128 (J. Lloyd), *available at* <http://www.bghcam.de/volltext-2003/zhc4.htm.>.

105. *Id.*

106. *Id.*

107. *Id.*

108. *Id.*

109. Lueke, *supra* note 83, at 376.

110. Westbrook, *supra* note 7, 34.

111. *Id.* at 35; Lueke, *supra* note 83, at 405.

112. The Regulation, *supra* note 78, at Art. 26.

113. *Id.* at Art. 31.

114. Westbrook, *supra* note 7, at 35; Lueke, *supra* note 83, at 405.

115. Westbrook, *supra* note 7, at 30–32.

116. *Id.* at 33.

117. *Id.*

118. *Id.* at 35.

119. *Id.*

120. *Id.*

121. *Id.* at 36.

122. *Id.* at 38.

123. *Id.* at 36–37.

124. *Id.* at 37.

125. *Guidelines Applicable to Court-to-Court Communications in Cross-Border Cases*, American Law Institute (May 16, 2000), available at <http://www.iii.globar.org/international/projects/ali.pdf>.

126. Leonard, *supra* note 80, at *8.

127. *Id.* at *10. *In re Systech Retail Systems (USA) Inc.* (Bankr. E.D.N.C. 2003); *In re Matlack Systems Inc.* (Bankr. D. Del. 2001); *In re PSINet Inc.* (Bankr. S.D.N.Y. 2001).

128. These countries either have obtained or are about to obtain the translated version of the *Guidelines* to cope with cross-border insolvency issues. Leonard, *supra* note 80, at *11–12.

129. Westbrook, *supra* note 7, at 37–38.

130. *Id.* at 38.

131. *Id.*

132. *Id.*

133. *Id.*

134. Leonard, *supra* note 80, at *14–15.

135. United Nations Model Law on Cross-Border Insolvency, U.N. Commission on International Trade Law, G.A. Res. 52/158, U.N. GARO, 30th Sess., Supp. No. 17, U.N. Doc. A/52/17 (1997) (hereinafter "Model Law"). The Official Text of the Model Law has been distributed and can be found at <http://www.uncitral.org/en-index.htm>.

136. Guide to Enactment of the UNCITRAL Model Law on Cross-Border Insolvency, 30th Sess., U.N. Doc. A/CN9/442, at part I para. 1 & 3 (1997) (hereinafter "Guide to the Model Law").

137. The Model Law, *supra* note 135.

138. *Id.*

139. *Id.*

140. *Id.* at Art 1(1).

141. *Id.* at Arts. 4 & 5.

142. *Id.* at Arts. 3 & 9.

143. *Id.* at Arts. 11 & 12.

144. *Id.* at Art. 21(1).

145. *Id.* at Art. 15(2).

146. *Id.* at Art. 16.

147. Guide to The Model Law, *supra* note 136, part V, paras. 129 & 131.

148. The Model Law, *supra* note 135, at Art. 17(2).

149. *Id.* at Art. 17(2)(a).

150. *Id.* at Art. 20(a).

151. *Id.* at Art. 17(2)(b).

152. *Id.* at Art. 31.

153. *Id.* at Art. 13(1).

154. *Id.* at Arts. 14(1) & (2).

155. *Id.* at Art. 14(3)(a).

156. *Id.* at Art. 14(3)(b).

157. *Id.* at Art. 32.

158. *Id.* at Art. 25(1).

159. *Id.* at Art. 25(2).

160. Gerber, *supra* note 3, at 2069; Report of the National Bankruptcy Review Commission, *available at* <http://govinfo.library.unt.edu/nbrc/report/10transn.html> (Oct. 20, 1997).

161. The Model Law, *supra* note 135, at Art. 27.

162. Guide to The Model Law, *supra* note 136, at part V, para. 184.

163. The Model Law, *supra* note 135, at Arts. 29 & 30.

164. *Id.* at Art. 30.

165. *Id.* at Art. 13(2).

166. *Id.*

167. *Id.*

168. *In re Treco*, 240 F.2d 148; *In re Toga,* 28 B.R. 165.

169. Before this adoption, Japan neither recognized foreign bankruptcy proceedings nor extended the effect of its domestic proceedings to a Japanese debtor's property located elsewhere. *See* Leonard, *supra* note 80, at *16.

170. *Id.* at *24.

171. Westbrook, *supra* note 7, at 24.

172. *Id.* at 24–25.

173. *Id.* at 25.

174. *Id.* at 25–26.

175. *Id.* at 26.

176. *Id.*

177. *Id.*

178. *Id.*

179. *Id.*

180. *Id.* at 27; International Statement of Mexican Insolvency Law 20 (Transnational Insolvency Project, Council Draft No. 1, Dec. 1, 1997).

181. Westbrook, *supra* note 7, at 27.

182. *Id.*

183. *Id.*

184. *Id.* at 28.

185. *Id.* at 29.

186. *Id.* at 27.

187. *Id.* at 28.

188. *Id.*

189. *Id.*

190. Balz, *supra* note 56.

191. *Id.* at 487 n.6.

192. *Id.*

193. Lueke, *supra* note 83, at 377.

194. *Id.*

195. *Id.*

196. The German law provides for unitary proceedings in which all means of distributing the debtor's estate are worked out under a "unitary set of rules." Since the purpose of unitary proceedings is maximization of the value of the bankruptcy estate for the creditors' benefit pursuant to the absolute priority rule, these proceedings are driven completely by claimants, and the debtor cannot "impose its will upon the creditor's interest" or toy with the creditors' money. Creditors decide whether the debtor should stay in possession and appoint a trustee. When a debtor files for voluntary reorganization, it cannot act as the debtor in possession. There is no preference for reorganization or a sale of the entire asset rather than piecemeal liquidation, and mainly creditors determine what is in their best interests and may impose the chosen method upon the debtor and the equity holders. The automatic stay is triggered by the commencement of the bankruptcy proceeding; however, the secured creditors continue to receive payments under the contractual interest on their claims. Voting rights are accorded pursuant to the "real (i.e., insolvency) value of entitlements," thus giving secured creditors more influence in determining the course of proceedings. Creditors can renegotiate for a better solution at any point of the proceeding, which results in flexible classification of the interests of creditors. A plan is confirmed only if all individual dissenting creditors receive the cash equivalent of their claim, namely what they would receive in "a best-case liquidation." The treatment of classes is fair and adequate if "(1) no other claimant or class receives more than the full value of its claims; (2) neither the debtor nor any junior claimant or class receives any value; and (3) no claimant or class with equal liquidation rank receives better treatment than the dissenting class." A discharge is granted if the debtor surrenders her assets to the trustee for seven years and assigns any "garnishable" prospective income to the trustee, who in turn distributes it to creditors pro rata. *See* Balz, Manfred, *Symposium: Bankruptcy in the Global Village: Symposium Commentary: Market Conformity of Insolvency Proceedings: Policy Issues of the German Insolvency Law*, 23 Brook. J. Int'l L. 167, 170–71 (1997).

197. *Id.* at 179.

198. Westbrook, *supra* note 7, at 27.

199. Balz, *supra* note 196, at 179.

200. Westbrook, *supra* note 7, at 29; Cl. 2(2)(a)–(b) of Cross-Border Insolvency Act of 2000, *reprinted in* 426 S. African Gazette No. 21899 (Dec. 15, 2000).

201. Leonard, *supra* note 80, at *16.

202. *Id.* at *16–17.

203. Westbrook, supra note 7, at 29; Fletcher, Ian F., *International Insolvency in Transformation: United Kingdom Perspectives on Implementation of the European Union Regulation on Insolvency Proceedings*. A series of changes was adopted in September 2003. The U.K. no longer provides for private receivership. The government claims no longer enjoy priority status. They will be treated as general unsecured claims. The new legislation recommends reorganization of companies over their liquidation, a shift from traditional practice. *See* Leonard, *supra* note 80, at *3–4.

204. Leonard, *supra* note 80, at *17.

205. Westbrook, *supra* note 7, at 30; *New Zealand Law Commission, Cross-Border Insolvency: Should New Zealand Adopt the UNCITRAL Model Law on Cross-Border Insolvency?* (1999); New Zealand Law Commission, Insolvency Law Reform: Promoting Trust And Confidence (2001); Leonard, *supra* note 80, at *17.

206. Leonard, *supra* note 80, at *17.

207. Balz, *supra* note 56, 488–89.

208. 11 U.S.C. § 303.

209. 11 U.S.C. § 305.

210. 11 U.S.C. § 304.

211. *Cunard Steamship Co., Ltd. v. Salen Reefer Servs. AB*, 773 F.2d 452, 454 (2d Cir. 1985).

212. *In re Treco*, 240 F.3d at 156.

213. *See id.*; Stuart A. Krause, et al., *Relief Under Section 304 of the Bankruptcy Code: Clarifying the Principal Rule of Comity in Transnational Insolvencies,* 64 Fordham L. Rev. 2591, 2609 (1996); Lifland, Burton R.J., *Suggested Modification to Ancillary Proceeding Statutes,* 4 Am. Bankr. Inst. L. Rev. 530 (1996).

214. *See* H.R. 333 at § 1501(a).

215. 11 U.S.C. § 303(b)(4). *See also In re Cunard*, 775 F.2d at 456.

216. 11 U.S.C. § 101(41).

217. 11 U.S.C. § 305(a)(2).

218. 11 U.S.C. § 305(b).

219. 11 U.S.C. § 305(c).

220. 11 U.S.C. § 304(a).

221. 11 U.S.C. § 101(24).

222. 11 U.S.C. § 101(23).

223. 28 U.S.C. § 1410(a).

224. 28 U.S.C. § 1410(b).

225. 28 U.S.C. § 1410(c).

226. 11 U.S.C. § 304(b)(1).

227. 11 U.S.C. § 304(b)(2).

228. 11 U.S.C. § 304(b)(3).

229. 11 U.S.C. § 304(c) provides:

> In determining whether to grant relief under subsection (b) of this section, the court shall be guided by what will best assure an economical and expeditious administration of such estate, consistent with–
>
> (1) just treatment of all holders of claims against or interests in such estate;
>
> (2) protection of claim holders in the United States against prejudice and inconvenience in the processing of claims in such foreign proceeding;
>
> (3) prevention of preferential or fraudulent disposition of property of such estate;
>
> (4) a distribution of proceeds of such estate substantially in accordance with the order prescribed by this title;
>
> (5) comity; and
>
> (6) if appropriate, the provision of an opportunity for a fresh start for the individual that such foreign proceeding concerns.

230. *Id.*

231. H.R. Rep. No. 95-595, 95th Cong., 2d Sess. 324, *reprinted in* 1978 U.S. Code. Cong & Admin. News 5963, 6281; S. Rep. No. 989, 95th Cong., 2d Sess. 35, *reprinted in* 1978 U.S. Code. Cong. & Admin. News 5787, 5821.

232. 11 U.S.C. § 541(a).

233. *In re George*, 844 F.2d 1562, 1568 (11th Cir. 1988).

234. *Koreag v. Refco F/X Assocs., Inc. (In re Koreag)*, 961 F.2d 341, 358 (2d Cir. 1991).

235. *Cunard*, 773 F.2d at 455.

236. H.R. Rep., *supra* note 231, at 324–25; *Cunard*, 773 F.2d at 455. The emphasis on comity in the legislative history to Section 304 has led many courts to believe that Section 304 was intended to give courts the "maximum flexibility possible" in dealing with cross-border insolvency. *E.g., In re Brierly*, 145 B.R. 151 (Bankr. S.D.N.Y. 1992).

237. *In re Treco*, 240 F.3d at 156.

238. *In re Culmer*, 25 B.R. 621; *In re Koreag, Controle et Revision S.A.*, 130 B.R. 705, 712 (Bankr. S.D.N.Y. 1991) (holding that "comity is inevitably the more significant factor since the other factors . . . are inherently taken into account when considering comity"), *vacated on other grounds, Koreag v. Refco F/X/ Assocs.*, 961 F.2d 358; *In re Brierly,* 145 B.R. 151, 166 (Bankr. S.D.N.Y. 1992) (applying a standard similar to *Culmer* and affording comity to a British insolvency proceeding, stating that the foreign law need not be identical to U.S. law so long as it is "not . . . repugnant to American laws and policies").

239. Delving, *supra* note 37, at 439–40; Gerber, *supra* note 3, at 2076.

240. *In re Culmer*, 25 B.R. at 628 (citing H.R. Rep., *supra* note 231).

241. *Id*. at 629.

242. *Id.*

243. *See also In re Lineas Areas de Nicaragua*, (without discussing any other factors, the Court held that requiring the local creditors to submit to Nicaraguan law for distribution was "an alternative to be avoided if possible under 304(c)(2)"); *In re Toga*, 28 B.R. 165; *In re Papelas Reunidas, S.A.,* 92 B.R. 584 (Bankr. E.D.N.Y. 1988) (rejecting the approach that comity is the overriding factor in determining whether to grant the relief requested under Section 304 and holding that comity "requires . . . an analysis of the effect that the recognition of a foreign proceeding has upon the

laws, public policies and the rights of citizens of the United States").

244. *In re Treco*, 240 F.3d 148.

245. *Id.* at 155–56.

246. *Id.* at 156.

247. *Id.*

248. *Id.* at 157.

249. *Id.* at 157 n.7; Krause, *supra* note 213, at 2609; Lifland, J, *supra* note 213.

250. Westbrook, *supra* note 7, at 20; Gerber, *supra* note 3, at 2094. Proposed Chapter 15 has yet to be adopted, and is awaiting the President's signature. *See* http://thomas.loc.gov.

251. H.R. 333 § 1501(a) (2001).

252. Gerber, *supra* note 3, at 2070.

253. H.R. 333.

254. *Id.* at § 1501(b).

255. *Id.* at § 1501(c).

256. *Id.* at § 1502(1).

257. *See In re Goerg,* 844 F.2d at 1566–67; *Saleh v. Triton Container International, Ltd. (In re Saleh)*, 175 B.R. 422 (Bankr. S.D. Fla. 1994).

258. H.R. 333 § 1502(6).

259. *Id.* at § 1509(a).

260. *Id.* at § 1509(d).

261. *Id.* at § 1509(c); Westbrook, *supra* note 7, at 23. Since Proposed Chapter 15 is not applicable to individual debtors with indebtedness within the Chapter 13 limitation, the U.S. courts, other than bankruptcy courts, may freely assist a foreign creditor or representative under the principle of comity in cases involving these small individual debtors.

262. H.R. 333 § 1511(a).

263. *Id.* at § 1520.

264. *Id.* at § 1521.

265. *Id.* at § 1505.

266. *Id.*

267. *Id.* at § 1506.

268. *Id.* at § 1515.

269. *Id.* at § 1516(a).

270. Lee, *supra* note 9, at 185.

271. H.R. 333 § 1517(a).

272. *Id.* at §§ 1525(a), 1526(a).

273. *Id.* at § 1527.

274. *Id.* at §§ 1525(b), 1526(b).

275. *Id.* at §§ 1525, 1526, 1527.

276. *Id.* at § 1507(b).

277. Delving, *supra* note 37, at 450.

278. *Hilton v. Guyot*, 159 U.S. 113, 164 (1895).

279. Franklin, *supra* note 71, at 23.

280. *In re Treco*, 240 F.3d at 157.

281. *In re Schimmelpenninck*, 183 F.3d 347, 365 (5th Cir. 1999); *Travin Banker Assoc. v. Banco Popular del Peru*, 109 F.3d 850, 854 (2d Cir. 1997) (deference under comity is not proper "when doing so would be contrary to the policies or prejudicial to the interest of the United States"); *Victrix S.S. Co. v. Salen Dry Cargo A.B.*, 825 F.2d 709, 713 (2d Cir. 1987) (noting that "Federal courts generally extend comity whenever the foreign court had proper jurisdiction and enforcement does not prejudice the rights of United States citizens or violate domestic public policy").

282. *E.g., In re Culmer,* 25 B.R. 621; *In re Brierly*, 145 B.R. 151; *Cunard*, 773 F.2d 452.

283. *In re Culmer*, 25 B.R. at 629. *See also In re Brierly*, 145 B.R. at 163 (stating that "[c]omity will be granted to the decision or judgment of a foreign court if it is shown that the foreign court is a court of competent jurisdiction, and that the laws and public policy of the forum state and the rights of its residents will not be violated").

284. *In re Brierly,* 145 B.R. at 164 (holding that "one cannot simply 'feel' that comity is warranted. So we turn to a comparison of British and American insolvency law as [a] useful device in helping to arrive at the decision whether or not to grant it").

285. *Id.*

286. *E.g., In re Treco*, 240 F.3d 148.

287. *In re Brierly,* 145 B.R. at 164 (holding that "one cannot simply 'feel' that comity is warranted. So we turn to a comparison of British and American insolvency law as [a] useful device in helping to arrive at the decision whether or not to grant it").

288. H.R. 333 § 1516(c).

289. *Id.* at § 1502(5).

290. Lee, *supra* note 9, at 183–84.

291. H.R. 333 § 1506.

292. *Id.* at § 1521(b).

293. *Id.* at § 1528.

294. Balz, *supra* note 56, at 488 n.8.

295. *In re Maxwell Communication Corporation PLC.*, 93 F.3d at 1053 (quoting *Hilton v. Guyot*, 159 U.S. at 165 and citing *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614 and *Wildenhus's Case*, 120 U.S. 1 (1887)).

296. *See In re Treco*, 240 F.3d 148; *In re Hourani*, 180 B.R. 58 (Bankr. S.D.N.Y. 1995) (refusing a turnover because Jordanian law did not distinguish secured and unsecured claims); *In re Papeleras Reunidas, S.A.*, 92 B.R. 584, 593 (Bankr. E.D.N.Y. 1988) (same because under Spanish law the creditor would be treated as unsecured even though in the U.S. it would be a secured creditor); *In re Toga*, 28 B.R. at 168–70.

297. *In re Maxwell Communication Corporation*, 170 B.R. 800, 816 (Bankr. S.D.N.Y. 1994).

298. Bob Wessles, *The European Union Insolvency Regulation: An Overview With Transatlantic Elaborations*, 2003 Norton Annual Survey of Bankruptcy Law 506 (2003), *available at* <http://www.iiiglobal.org/country/netherlands.html>.

299. *Id.*

300. *In re Treco*, 240 F.3d at 154.

TaeRa K. Franklin, Esq., currently serves as a Judicial Term Clerk for the Honorable Adlai S. Hardin, Jr., United States Bankruptcy Judge for the Southern District of New York, White Plains Division. She received a J.D. from Benjamin N. Cardozo School of Law. **I thank my husband Aaron for all his smiles, company, and love.**

Book Review

U.S. Securities Regulation: All you need to know about going public, listing, reporting and private placements, by Guy P. Lander (Institutional Investor Books, 2003).

Reviewed by James D. Redwood

The treatise which I have used in my basic Securities Regulation course, the first of its kind, now in its ninth edition, is some 1,600 pages long and counting. I suspect that most of its competitors carry the same heft. The effort to find a succinct and learned treatise in this very difficult area bears comparison to the search for the proverbial needle in the equally proverbial haystack. On rare occasions the effort is crowned with success, as in the case of Guy Lander's excellent, and mercifully short, treatment of the field in the little volume which is the subject of this review. Mr. Lander covers the field thoroughly, no small tour de force in a book numbering only 123 pages, and he does it with customary authority and aplomb. Kudos are in order.

Mr. Lander knows of what he speaks. A partner in the firm of Davies Ward Phillips & Vineberg LLP, he concentrates in corporate and securities law for both domestic and international companies. His practice is comprehensive and extensive, and he is the author of several treatises in the field, among others, notably, the respected two-volume work, *U.S. Securities Law for International Financial Transactions and Capital Markets*,[1] reviewed by this author in an earlier volume of this *Journal*. He has also chaired the Committee on Securities Regulation of the New York State Bar Association and the State Bar's Business Law Section. He presides over numerous continuing legal education programs in this area, and actively participates in conferences and seminars devoted to what is perhaps the most intractable area of statutory law today. I repeat, he knows of what he speaks.

For a novice in the field, spooked by the wealth of often turgid material which purports to introduce the subject of securities regulation, Mr. Lander's book comes as a godsend. For the more experienced it is no less valuable. The book is organized soberly and logically, with a brief introduction to state and federal securities law and a description of the SEC and the workings of its integrated disclosure system, followed by short, focused chapters which give the salient features of all major aspects of securities law without shoving the reader into the quicksand of detail. This is an unmixed blessing for one seeking to master the field, and a valuable refresher for those already conversant with it. After a discussion of what constitutes a "security," a sometimes frustratingly elusive concept, Mr. Lander proceeds to describe the registration process, followed by a guide to the registration forms, applying the forensic lens of a skilled practitioner in the subject. His approach is of invaluable assistance to anyone whose constituents are clients rather than students of the academy, although its potential value to the latter should not be underestimated. Next, Lander discusses the trading markets, and then he devotes chapters to the all-important issuer and resale exemptions. Chapters follow on Exchange Act reporting and registration, accounting issues, tender offers, and finally, to civil enforcement matters. As icing to this extremely rich cake one need only turn to the appendices, which include a practical guide to going public, New York Stock Exchange and NASDAQ listing standards, and critical treatment of the most important issues under the Sarbanes-Oxley Act. An extremely rich confection indeed, one which leaves the reader sated but not uncomfortably so. Could the same be said of all such treatments of the subject, even ones shorter than this, the field would be a happier one.

Mr. Lander is a doyen on foreign securities law matters, and his expertise shows through even in this little volume, as it did so markedly in his authoritative two-volume treatise on the subject. Everywhere he sprinkles in details valuable to the foreign issuer, or to practitioners who serve such issuers, and adds insight in an area which is normally beyond the ken of most U.S.-based securities lawyers. His experience in this area is helpful indeed, and given the realities of securities globalization and cross-border stock offerings, it is also quite timely. He writes with a deft and lucid hand, and has, in the opinion of this reviewer, achieved the virtually impossible, and that with resounding success: compendious but authoritative treatment of a daunting subject within the confines of a volume which one can balance comfortably on a single finger of one hand. The work deserves the respect normally reserved for those intimidating pieces known as "tomes." Many of the latter, I suspect, are doomed, as has been said of the later novels of Henry James, to remain largely unread on the shelf. Mr. Lander's excellent little work, never.

Endnote

1. 4 NY Business Law Journal 41 (2000).

James D. Redwood is the Editor of the *NY Business Law Journal* and a Professor of Law at Albany Law School.

CASE NOTE

By Arthur Chen

Bansbach v. Zinn, 1 N.Y.3d 1, 769 N.Y.S.2d 175 (2003)

Under current law, shareholders must make demand upon a corporation's board of directors to initiate an action before bringing a shareholder derivative action on behalf of the corporation.[1] An exception to the demand requirement exists when demand upon the board is considered futile, in which case demand is excused and the action is allowed to proceed.[2]

Ever since *Marx v. Akers*, demand has been excused in three situations: when the complaint alleges that 1) the majority of the directors are interested in the transaction; 2) the directors failed to inform themselves of the transaction to a degree reasonably necessary; or 3) the challenged transaction was so egregious on its face that it could not have been the product of sound business judgment.[3] Directors are interested in two situations: when they are self-interested or when their independence is lost because the disinterested directors are controlled by the interested directors.[4]

Recently, in *Bansbach v. Zinn*, the Court of Appeals addressed the following issues: 1) whether a prior litigation collaterally estopped a plaintiff from raising demand futility; 2) whether demand was in fact futile; and 3) whether the plaintiff was entitled to summary judgment. This case note seeks to show both the consistency in the application of the demand doctrine and some of the ambiguities that have arisen when dealing with these issues.

In 1992, the defendant Zinn, the Board Chairman, CEO, and President of Besicorp Group Inc. ("Besicorp"), was subpoenaed by the Government in an investigation of allegedly illegal congressional campaign contributions made with corporate funds, a violation of the Federal Election Campaign Act. It was found that Zinn had induced Besicorp employees to make political contributions, and in return, he reimbursed them using corporate funds, via cash bonuses or salary raises. On May 22, 1996, the defendant Board of Directors of Besicorp met in a special board meeting and approved the advancement to Zinn of funds to cover legal fees and expenses relating to of the Government investigation. Zinn was indicted, and on June 17, 1997, he pleaded guilty. In the course of his plea Zinn admitted to knowingly and willfully violating the law through his funding conspiracy.

On August 13, 1997, the plaintiff commenced a shareholder's derivative action alleging that the defendants breached their fiduciary duties and wasted corporate assets by authorizing the use of Besicorp funds to pay Zinn's legal fees without seeking reimbursement. On October 22, 1997, Besicorp stopped the payments for Zinn's legal fees, and on January 23, 1998, the Board (excluding Zinn) convened to seek reimbursement of Zinn's cash advancements, but ultimately decided to defer the repayments.

In the Supreme Court, the defendants made a motion to dismiss based on the plaintiff's failure to make a pre-filing demand on the board, which was required pursuant to Business Corporation Law § 626(c).[5] The trial court agreed with the defendants' reasoning and granted the motion. After the dismissal, the Board (including Zinn) reconvened in 1999 and fully indemnified Zinn for all of the legal fees he owed, finding that at the time he broke the law he reasonably believed his actions were in the best interests of the company and that he had no reasonable cause to believe his actions were unlawful. The minutes did not indicate the basis for the Board's conclusions.

The plaintiff appealed the Supreme Court's dismissal, and argued that the complaint sufficiently alleged that demand was futile because of the defendants' personal friendships and past business relationships with Zinn. The Appellate Division, Third Department held that although mere allegations of personal friendships between interested and disinterested directors were insufficient to establish an interested director's domination and control of the disinterested directors, the allegations of prior business dealings in the complaint were sufficiently detailed to allow the complaint to survive a motion to dismiss based on the interested director exception.[6] Therefore, the Appellate Division reversed the Supreme Court's dismissal, the complaint was reinstated, and the case was remanded to the Supreme Court.

Upon remand, the defendants filed a motion for summary judgment, but the Supreme Court granted the plaintiff's cross-motion and ruled that the defendant Zinn had breached his fiduciary duty. The defendants appealed on the basis of collateral estoppel, and the Appellate Division reversed the Supreme Court's decision and granted summary judgment in favor of the defendants. Under the principles of collateral estoppel, "where a pending issue was raised, necessarily decided and material in a prior action, and where the party to be estopped had a full and fair opportunity to litigate the issue in the earlier action, fairness and efficiency dictate that the party should not be permitted to try the issue again."[7] In *Lichtenberg v. Zinn,* the plaintiff had brought a derivative action against the defendants, alleging breach of fiduciary duty and corporate waste, the same issues litigated in *Bansbach*. The Supreme Court in *Lichtenberg* granted the defendants' motion for summary judgment because "the directors' personal relationships and prior business dealings with Zinn were insufficient to create a question of fact regarding the directors' independence," and the directors were not Zinn's "cronies."[8] Therefore, having already afforded the plaintiff in *Lichtenberg* a full and fair opportunity to litigate the issue of Zinn's control and dominance of the other directors, the plaintiff in *Bansbach* was collaterally estopped from relitigating the same issue.[9]

When *Bansbach* went up on appeal, the Court of Appeals first addressed and reaffirmed the necessity, requirements, and exceptions with respect to the demand requirement as stated in *Marx v. Akers*. Second, the Court of Appeals rejected the defendants' collateral estoppel defense, stating that the issues in the *Lichtenberg* case and in the present suit were too different to estop the plaintiff from litigating the futility of demand. In *Lichtenberg*, the defendants were charged with breach of fiduciary duty and waste of corporate assets by granting board members substantial stock options and warrants for little or no consideration, whereas the present case dealt with the directors' granting of indemnification to Zinn. The Court stated that even though the defendants received a favorable judgment on a similar issue, that judgment would not protect the defendants from similar claims brought against them (i.e., just because the defendants received a favorable judgment on the issue of granting stock options and warrants, that judgment did not support the proposition that the defendants were independent with respect to the separate issue of director indemnification).[10] In addition, there was no evidence in the present case of the defendants' independence from Zinn, whereas in *Lichtenberg,* there was sufficient evidence of independence. Another important distinction was the fact that the Board was composed of different members at the two times. Therefore, as a result of these differences, collateral estoppel was inapplicable.

Third, the Court concluded that demand was futile and that the board was dominated and controlled by Zinn through his position and association with the directors, which caused them to place his interest above that of the corporation. "That interest is exemplified by the board's immediate action covering Zinn's fees upon issuance of the subpoenas, yet delaying reimbursement . . ., continuing to advance defense costs . . . after Zinn in open court admitted" to his illegal conduct made in bad faith.[11] The Court cited two cases where interest was found and demand was excused: one where the board approved an offer which was less favorable to the company but more beneficial to the board members personally,[12] and another where self-interest was shown by allegations that the outside directors comprised a majority of the board and received a personal benefit through self-dealing.[13] The facts of the *Bansbach* case fit both of these situations. The Court supplemented its reasoning with additional evidence revealed by post-litigation events (the 1998 deferment of payment, and the 1999 indemnification of legal fees), which supported the plaintiff's assertions that demand on the directors would have been futile.

Lastly, the Court of Appeals stated that pursuant to Business Corporation Law § 722(b), the termination of a legal proceeding by judgment or conviction would not create a presumption that a director acted in good faith for an action which he reasonably believed to be in the best interests of the corporation.[14] In other words, just because the trial regarding Zinn's wrongful campaign contribution had terminated, that did not automatically establish that Zinn's actions were made in good faith. Business Corporation Law § 722(a) makes it illegal for a corporation to indemnify a director if the director acted in bad faith, or if his action resulted from active and deliberate dishonesty. Because Zinn had admitted to knowing and willful misconduct during his trial, his actions were taken in bad faith.[15] Therefore, based on the above facts, Zinn could not be indemnified by the corporation for his legal fees, and summary judgment was granted to the plaintiff.

With regard to both the collateral estoppel issue and the statutory indemnification issue addressed in this case, the Court of Appeals did not deviate in its judgment from the current state of the law, and the case further illustrates the circumstances in which collateral estoppel applies and corporate indemnification is permissible. However, the case does leave some questions open to interpretation.

Courts have previously ruled that futility of demand is measured up to the time of filing of the complaint.[16] Further, demand cannot be based on post-litigation evidence.[17] In *Bansbach*, the Court of Appeals used evidence of the defendants' post-litigation actions (mainly the 1999 indemnification of Zinn's legal fees) to support its decision that demand on the defendants was futile. It is uncertain, however, whether the Court used this evidence as a basis for its decision, or merely as an extra justification for its conclusions. If the Court did use this evidence in making its decision, a future argument could be made that post-litigation evidence is admissible to support judges when they make a decision on demand futility, which would potentially result in the expansion of the scope of evidence to be used in determining that futility. This possibility raises the following questions: At what point in time do we look to determine the futility of demand? And how much weight is to be accorded to post-litigation actions by directors?

The Court of Appeals neglected to consider or address the third prong of demand futility as discussed in *Marx v. Akers*, namely that the plaintiff's allegation that the defendants' 1999 action indemnifying Zinn was so egregious on its face that it could not have been the product of sound business judgment. The Appellate Division touched briefly on this argument, but rejected it based on the fact that Zinn's 1999 indemnification was an action which occurred after commencement of the plaintiff's lawsuit and was therefore inadmissible for determining futility.[18] In addition, the plaintiff merely stated that Zinn's actions were so egregious on their face that they could not have been the product of sound business judgment, which was a conclusory statement and therefore insufficient to excuse demand.[19] However, had the Court of Appeals found that the 1996 payment of Zinn's legal fees was sufficient evidence of director interest, perhaps that payment would have been sufficient to meet the third prong of the *Marx* futility test.

It should be noted that the Court did not consider affidavits submitted by the defendants, which leaves open the question of how much weight is to be accorded those documents, and also the question of whether such documents should be considered at all in analyzing the defendants' innocence. In the *Lichtenberg* case, the Appellate Division used affidavits submitted by the defendant directors as one of the factors in determining director independence. After *Bansbach*, however, are we to assume that affidavits by the defendants are irrelevant?

From a policy standpoint, the Court of Appeals ruling was correct because post-litigation evidence indeed confirmed that the defendant directors put their interests above those of the corporation, and therefore demand was rightfully excused. In general, "Derivative actions are not favored in the law because they ask courts to second-guess the business judgment of the individuals charged with managing the company," but in certain circumstances (like this case) they are valuable in "protecting corporations and minority shareholders against officers and directors who, in discharging their official responsibilities, place other interests ahead of those of the corporation."[20] Therefore, on the whole, the Court of Appeal's decision in the *Bansbach* case is consistent with prior decisions. Expansion of the use of post-litigation evidence to determine or confirm futility would be a reasonable tool in helping to correct corporate abuses, especially during a time where courts and the public are holding corporate directors more accountable for their actions.

Endnotes

1. Business Corporation Law § 626(c).
2. *Marx v. Akers,* 88 N.Y.2d 189, 200 (1996).
3. *Id.*
4. *Id.*
5. *Bansbach v. Zinn,* 1 N.Y.3d 1, 7 (2003).
6. *Bansbach v. Zinn*, 258 A.D.2d 710, 712 (3d Dep't 1999).
7. *Bansbach*, 1 N.Y.3d at 10.
8. *Bansbach v. Zinn,* 294 A.D.2d 762, 763 (3d Dep't 2002).
9. *Bansbach*, 1 N.Y.3d at 10 (citing *Pinnacle Consultants v. Leucadia Nat'l Corp.*, 94 N.Y.2d 426, 431–32 (2000)).
10. *Bansbach,* at 11 (citing *Lichtenberg, v. Zinn*, 260 A.D.2d 741, 742–43 (3d Dep't 1999)).
11. *Bansbach,* 1 N.Y.3d at 12.
12. *Barr v. Wackman*, 36 N.Y.2d 371, 380 (1975).
13. *Marx*, 88 N.Y.2d at 202.
14. *Bansbach,* 1 N.Y.3d at 12–13.
15. *Id.*
16. *Bryan v. West 81 St. Owners Corp.*, 186 A.D.2d 514, 515 (1st Dep't 1959).
17. *Id.*
18. *Bansbach*, 285 A.D.2d at 763.
19. *Id.*
20. *Bansbach*, 1 N.Y.3d at 8.

Arthur Chen is a second-year student at Albany Law School, and is the student editor of the *NY Business Law Journal*. He has a B.S. in Business Management from SUNY Stony Brook.

Publication Policy and Manuscript Guidelines for Authors

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

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

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

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

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

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

Deadlines

Manuscripts intended for publication in the fall and spring issues must be received by the preceding June 15 and December 15, respectively. Manuscripts are to be submitted to: *NY Business Law Journal*, c/o Stuart B. Newman, Advisory Board Chair, Salon Marrow Dyckman & Newman, LLP, 292 Madison Avenue, New York, NY 10017, telephone (212) 661-7100, ext. 903, fax (212) 661-3339.

Subscriptions

Subscriptions to the *Journal* are available to non-attorneys, universities and other interested organizations. The 2004 subscription rate is $75.00. Please contact the Newsletter Department, New York State Bar Association, One Elk Street, Albany, NY 12207 or call (518/487-5671/5672) for more information.

NEW YORK STATE BAR ASSOCIATION
Business Law Section Committees

Great Opportunities for Involvement!

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

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

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

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

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

Committees

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

Name ____

Office Address ____

Home Address ____

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

E-mail Address ____________________________

Please return this application to:

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

Join online: www.nysba.org