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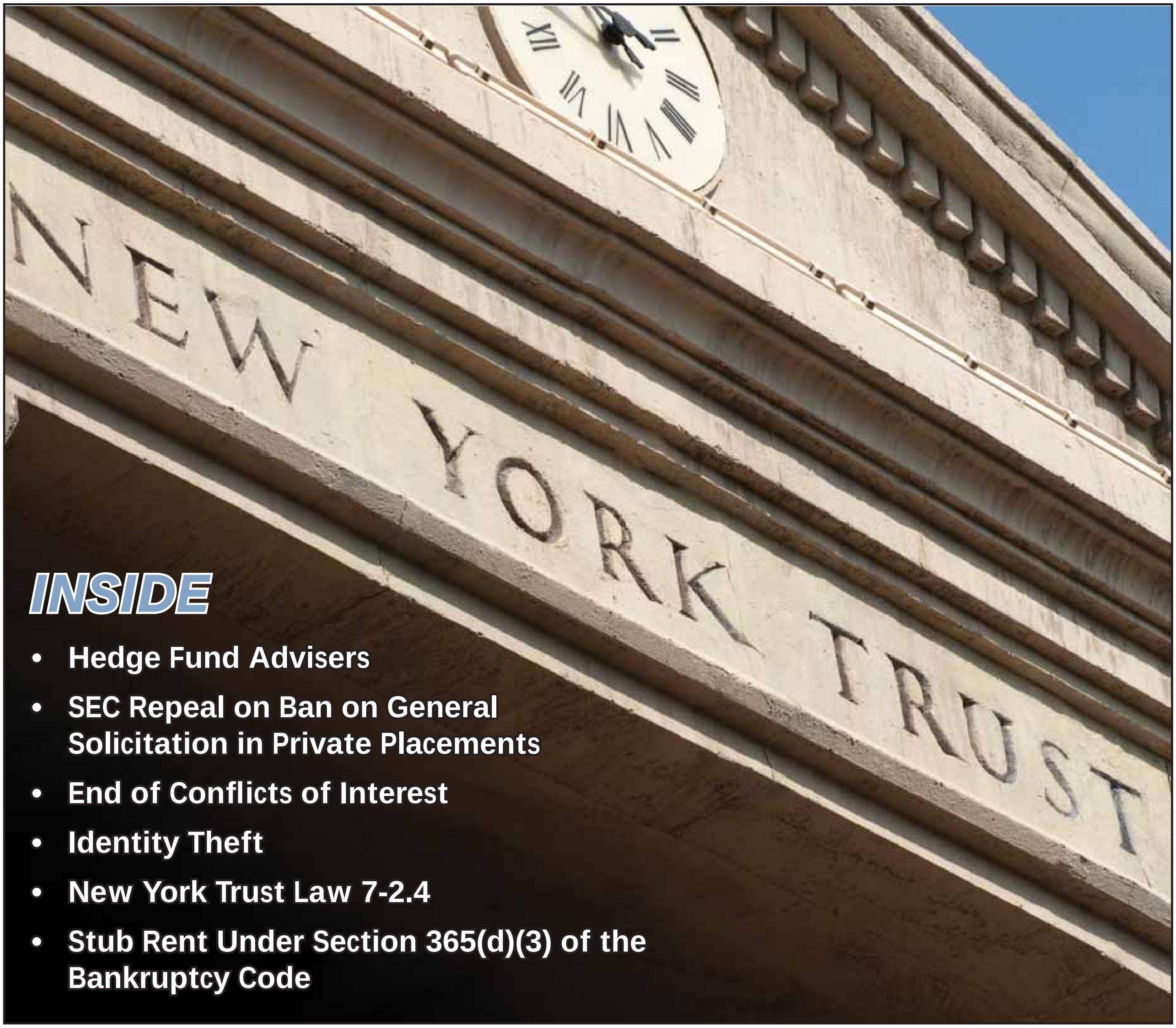

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HeadNotes

As this issue was going to press, the Congress had just brokered a temporary deal to raise the debt ceiling and reopen the government. But the battle over Obamacare continues, and the well-publicized problems with the health care website may presage issues down the road for businesses and their lawyers. As H.L. Mencken observed, "Under democracy one party always devotes its chief energies to trying to prove that the other party is unfit to rule—and both commonly succeed, and are right." Stay tuned.

One of the most gratifying developments during my tenure as Editor-in-Chief of the *NY Business Law Journal* has been the increasing awareness of our *Journal* outside New York, and our concomitant ability to attract quality contributions from non-New York practitioners, academics and law students, as well as from the unparalleled legal community in our State. Case in point: Our lead article, contributed by Bryan Morben, a law student at the University of Minnesota. Mr. Morben addresses an issue that has become as timely as today's headlines, given the volatility in the markets and the ability of the media to make "rock stars" out of successful investment managers.

In December 2012, a hedge fund manager known for his success in short selling (i.e., selling borrowed stock in the hope that it will decline in value and can be repurchased at a lower price) went public with an attack on Herbalife Inc., the multi-level marketing company, alleging that it was a fraudulent Ponzi scheme. The stock declined precipitously over the next few days, creating substantial profits for the hedge fund. Then came a counter-attack from another well-known investor who was "long" (owned) the stock. The stock rose in response. These events create troubling questions under the securities laws regarding the ability of hedge fund managers to influence stock prices to their own advantage. In "The Ability of Hedge Fund Advisers to Manipulate the Market and Make Millions Doing It: The Battle Over Herbalife and the Need to Extend the Investment Advisers Act," Mr. Morben tells the compelling story of how this controversy has played out over the past year. He also cogently summarizes the applicable antifraud provisions of the securities laws, highlighting why they may not be adequate to address this type of market manipulation, and proposes enhancements to the Investment Advisers Act aimed at giving the Securities & Exchange Commission (SEC) the tools to address it.

In other securities law developments, the SEC has now amended its rules to liberalize the use of private placements in securities offerings. In "SEC Repeals Ban on General Solicitation in Private Placements, Adds a Disqualification for Bad Actors and Proposes New Reg. D Requirements," former Business Law Section Chair Guy P. Lander and his colleagues at Carter Ledyard & Milburn discuss changes to SEC rules aimed at implementing requirements imposed by both the Dodd-Frank Wall Street Reform Act of 2010 and the Jumpstart Our Business Startups (JOBS) Act of 2012. The former requires the SEC to prohibit certain "bad actors" from participating in private placements of securities under SEC Rule 506. Mr. Lander et al. summarize and explain the criteria for who is a "bad actor," and the predicate acts giving rise to this determination. The JOBS Act was passed to encourage new business formations by, among other things, making it easier for business startups to raise capital. Toward this end, the SEC has now eliminated the ban on general solicitation in connection with private placements. Previously, only limited solicitation could take place. The article explains that the new rule preserves the existing safe harbors, while adding the additional solicitation approach sanctioned by the JOBS Act.

Given the increasing complexity of business law, and the size and diverse practices of law firms that represent businesses, lawyers are loathe to commit to engagements that may preclude them from taking more lucrative engagements down the road due to conflicts of interest. Over the years lawyers have attempted to deal with this by using "waiver" clauses in their engagement agreements, in effect asking the client to waive in advance potential but unknown conflicts that may develop down the road. These were sometimes thought to be unenforceable, but several recent cases may suggest otherwise. In "The End of Conflicts of Interest? Courts Warm Up to Advance Waivers," our legal ethics guru, Evan Stewart of Cohen & Gresser LLP, discusses two recent, and eye-opening, cases that may presage broad changes in the approach of the courts to these waivers. In his usual clear and engaging style, Mr. Stewart explains the significance of these cases and offers practical guidance for lawyers, while casting a jaundiced eye on the reasoning behind these decisions. And he also debunks your Editor's long-held belief that Gracie Allen, when told by George Burns to "Say goodnight, Gracie," replied, "Goodnight, Gracie."

A popular ongoing feature of the *Journal* is "Inside the Courts," a compendium of current securities litigation prepared by the attorneys of Skadden Arps in New York City. As concise as it is comprehensive, "Inside the Courts" is an invaluable way for business practitioners to stay on top of key litigation developments that could affect their clients and practice. This issue's entry spans the gamut from Auditor Liability to Statutes of Repose. Of particular interest, at least to your Editor, is a recent case decided by Judge Sheindlin in the Southern District of New York, in which she dismissed claims that a bank violated Section 10(b) of the Securities Exchange Act by allegedly participating in the well-publicized LIBOR rate manipulation scheme. Among other things, the Judge held that statements about the bank's business practices were not false and misleading because its business ethics representations constituted non-actionable puffery (no comment).

Perhaps not surprisingly, the Federal Trade Commission (FTC) reports that identity theft led the list of consumer complaints filed with the agency for the thirteenth consecutive year. A major reason is, of course, the proliferation of new electronic media and the resulting challenge to financial institutions, as well as consumers, to keep up with the new technologies and the way they can be manipulated by thieves. In "Identity Theft—Know the Law," Clifford Weber of Hinman, Howard & Ketell provides a graphic example of a recent case in which a bank was not up to the challenge. A thief was able to "hijack" a consumer's bank account by obtaining the customer's telephone access code and using it to transfer funds overseas. Mr. Weber, a past chair of the NYSBA Banking Law Committee, clearly lays out how the Electronic Funds Transfer Act (EFTA) and the Federal Reserve's Regulation E, which implements EFTA, applied to hold the bank liable for the consumer's loss. Moreover, with the transfer of authority to enforce these roles to the new Consumer Financial Protection Bureau (CFPB) created under the Dodd-Frank Act, he notes that the interpretation of these provisions will be even more strongly pro-consumer going forward—raising the stakes for banks and their counsel.

Attorney Charles Wallshein, who has contributed to the *Journal* in the past on matters related to secured lending and securitization, returns with an article explaining how real estate mortgage investment companies (REMICs) can fall into the trap of double taxation under a provision of New York Trust Law. A REMIC—essentially a pool of mortgages—is not taxed at the entity level, since it distributes its income to the trust certificate holders. To make sure that their tax status is not compromised, New York law makes a transfer of an asset into the pool void ab initio if it would threaten the trust's tax exempt status or bankruptcy remoteness. But in turn, the securitization failure destroys marketable title in the underlying real estate. In "New York Trust Law 7-2.4: Securitization Failure, Why Late Loan Transfers to REMICs are Void, Part One," Mr. Wallshein explains the historical context of this seemingly draconian outcome and discusses how it impacts on the duties of the trustees.

Congress amended the Bankruptcy Code in 1984 to, among other things, make sure that landlords can collect rent after the petitioner files for bankruptcy. One aspect of this is referred to as "stub rent"—i.e., rent that accrues from the date of filing through the end of the first month in bankruptcy. But courts have followed two different methods of determining stub rent, known as "billing rate" and "proration." In "Stub Rent Under Section 365(d)(3) of the Bankruptcy Code: Proration Should Be Uniformly Applied," Benjamin Chapple, a student at Widener University School of Law and Articles Editor of the *Delaware Journal of Business Law*, argues for uniform application of the latter, pointing out the potentially significant consequences resulting from whether stub rent is considered to arise pre- or post-petition. Attorneys who represent landlords in particular will find Mr. Chapple's article enlightening and timely.

For attorneys engaged in business litigation, Haig's *Business and Commercial Litigation in Federal Courts* has long been an indispensable reference. Concluding this issue, Samuel F. Abernethy of Menaker & Herrmann LLP in New York City provides a thoughtful and in-depth review of the third edition. Mr. Abernethy, a past Chair of the Business Law Section and currently a Section representative in the Bar's House of Delegates, notes that Haig's treatise is essential not only for litigators, but also for in-house business counsel charged with overseeing and supervising a firm's litigators.

David L. Glass

The Ability of Hedge Fund Advisers to Manipulate the Market and Make Millions Doing It: The Battle Over Herbalife and the Need to Extend the Investment Advisers Act

By Bryan Morben

I. Introduction

Pershing Square Capital Management, a large investment hedge fund adviser run by billionaire William Ackman, gave a presentation on December 20, 2012 at the Sohn Conference Foundation Special Event where it presented a 334-slide powerpoint about why it believes Herbalife[1] is a pyramid scheme.[2] Ackman also disclosed that he had taken a $20 million share short position in the company worth one billion dollars.[3] In a four-day period around this presentation, Herbalife stock dropped a substantial 38.68%.[4]

Not long after, other hedge fund managers jumped on the Herbalife bandwagon. This time, however, they took the long position. Daniel Loeb of Third Point, LLC announced on January 9, 2013 that he had acquired 8.9 million Herbalife shares in response to the "panicked selling" that followed Ackman's presentation.[5] Loeb rejected Ackman's claims and made comments about how the stock was much more valuable than its current price.[6] Over the next few days, the Herbalife stock rose ten percent.[7]

What is to be done about the ability of hedge fund managers and other influential investors to manipulate the market by publicly articulating the reasons why they are taking a particular position in a company and move the stock price in their favor? This article will examine some of the ways the market is manipulated by these types of investors, how the securities laws currently play a role in regulating market manipulation, and what other regulations may be warranted. Part II will explore a couple of common methods of illegally moving a stock's price and take a closer look at the hedge fund battle in Herbalife as an example. It will also discuss the current regulation of hedge fund market manipulation under the Securities Exchange and Investment Adviser Acts. Part III will analyze whether the hedge funds in the Herbalife example may be violating the current law, how the current laws may fall short in addressing the problem of hedge fund manipulation, and what can be done to better prevent it. This article concludes that the SEC needs to adopt a new rule to extend the negligence standard of Rule 206(4)-8 under the Advisers Act to fraudulent or deceptive conduct by investment advisers affecting investors outside the pooled investment vehicles.

II. Background

A. Market Manipulation Through False and Misleading Statements[8]

Manipulation is not defined in the regulatory statutes and incorporates a wide range of fraudulent behavior. One general definition is conduct that interferes with the free play of supply and demand, induces people to trade, or forces a security's price to an artificial level.[9] There are two main methods of manipulating stock prices: by disseminating false and misleading information about the issuer—the "pump and dump" method—and the "short and distort" method.

1. "Pump and Dump"

The classic "pump and dump" scheme involves a person who purchases a substantial position in a security, aggressively promotes the particular security by making baseless projections about its future share price or earnings, and then sells the position at a profit after the price has increased because of the false information.[10] As the market digests the false and misleading information, the share price of the targeted company usually moves dramatically in the direction intended by the perpetrator. The schemer then "dumps" his or her overvalued shares for a profit, the price falls back down, and other investors lose money.[11]

The "pump and dump" scheme typically targets micro- and small-cap stocks, or "penny" stocks, because of their ease to manipulate.[12] Due to the small float of these types of stocks it does not take a lot of new buyers to push the stock higher.[13] But when influential investors and big-time hedge funds are the violators, even large companies traded in efficient markets can be manipulated.

2. "Short and Distort"

The "short and distort" scam is basically the opposite of the "pump and dump." Traders short sell a stock and then spread negative information or rumors about the company in an attempt to drive down the stock price.[14] This tactic is less known than the "pump and dump," but is rapidly becoming more popular.[15] Generally, it is easier to manipulate stocks to go down in a bear market and up in a bull market.[16] Ever since the accounting scandals in the early 2000s[17] and, more recently in 2008,[18] investors are much less inclined to believe anything good about a public company.[19]

Both schemes generally require some sort of credibility in the scammer in order to work effectively.[20] But large hedge fund advisers are very influential to others in the market and usually have more than enough credibility to make people follow their lead in securities trading. Back in 2008, the Securities and Exchange Commission (SEC) conducted a massive investigation into the possibility of hedge funds spreading false rumors to manipulate the shares of two major firms at the time, Bear Stearns and Lehman Brothers.[21] The tug-of-war game over Herbalife is just the latest example of potential hedge-fund foul play in the market.

B. The Herbalife Debacle

Herbalife International was founded in 1980 and is a multi-level marketing company that sells weight management, nutritional supplement, energy, sports and fitness products, and personal care products.[22] The company distributes its products across the world through a network of approximately 2.7 million independent distributors.[23] The company's mission is to "'chang[e] people's lives' by providing a financially rewarding business opportunity to distributors and quality products to distributors and customers who seek a healthy lifestyle."[24] Herbalife suddenly became the fulcrum of a heated hedge fund battle over its stock starting around the middle of 2012.

1. Ackman's Presentation and Short Bet Plummets Stock

William Ackman of Pershing Square Capital Management revealed to his investors in a letter in June 2012 that he had invested in a new short position.[25] Finally, on December 19, 2012, it was reported that Herbalife was the company the bet was against and that Ackman was calling it a pyramid scheme.[26] Herbalife's CEO, Michael Johnson, responded the same day by saying that Ackman's proposition was a "bogus accusation" and "blatant market manipulation."[27] The next day, on December 20, 2012, Ackman gave a lengthy, in-depth presentation in Manhattan explaining why he thinks Herbalife is a pyramid scheme, which included, among other things, his claim that "distributors earn more than ten times as much from recruitment as they do by selling the company's overpriced products to bona fide retail customers."[28] Ackman's target price for the stock was $0, and he pledged to donate any personal profits to charity.[29] Ackman also refuted Herbalife's claim of market manipulation by saying that Pershing Square doesn't own any options.[30] After the presentation, Ackman unveiled the FactsAboutHerbalife.com website, where the fund has compiled documents, promotional material from the company, videos, and depositions.[31] The site also includes the complete presentation given on December 20 and an executive summary of it.[32]

Herbalife responded by saying that the presentation was:

> a malicious attack on Herbalife's business model based largely on outdated, distorted[,] and inaccurate information. Herbalife operates with the highest ethical and quality standards, and our management and our board are constantly reviewing our business practices and products. Herbalife also hires independent, outside experts to ensure our operations are in full compliance with laws and regulations. Herbalife is not an illegal pyramid scheme.[33]

Despite the company's pleas, the stock continued to topple down to a 52-week low of $24.24 per share. The significant decrease in the shares' price stimulated other fund managers to invest in the company, but on the long side, and signaled the beginning of the Herbalife hedge fund battle.

2. Loeb Buys in Long, Touts Stock

On January 9, 2013, Daniel Loeb of Third Point, LLC filed a Schedule 13D with the SEC disclosing that his hedge fund had taken an 8.24% stake in Herbalife.[34] Mr. Loeb explained in a letter to his investors, and essentially others, why he found Herbalife to be such a compelling long investment.[35] First, Loeb argued that Ackman's thesis was premised on the notion that the federal regulators have missed a massive fraud for over three decades and will suddenly catch it because of the nudging of a hedge fund short seller, an assertion he thought "preposterous."[36] Second, Loeb said that there are very few complaints about Herbalife each year and that Ackman's presentation "presented no evidence" that would prompt regulators to shut Herbalife down.[37] Finally, Loeb contended that Herbalife shares should, at a minimum, be worth $55 to $68 per share and could trade well above that range.[38] Over the next few days, the stock rose over ten percent.

3. The Fight Continues

On January 10 Herbalife hosted an analyst / investor day in Manhattan in response to Ackman's presentation.[39] The company gave a 102-slide counter-presentation that attempted to debunk the points Ackman made about the company and its business.[40] CEO Michael Johnson accused Ackman of "gross mischaracterizations" and claimed that he was "misleading" and used "misinformation."[41]

Ackman wasted no time in responding. Pershing Square released a statement from Ackman saying that "the company distorted, mischaracterized, and outright ignored large portions of our presentation."[42] The fund promised to release a series of questions for Herbalife and its executives, which are posted on the Facts About Herbalife website.[43] But by the end of the day on January 14, 2013, shares of Herbalife had rallied back to above where they were when Ackman confirmed his short bet, up more than 3.7% since December 18, 2012.[44]

4. Icahn Joins in Defending Herbalife; Loeb Bails

On February 14, 2013, another large hedge fund adviser got in on the mix. Carl Icahn of Icahn Enterprises announced in a Schedule 13D filing that he had accumulated 14 million shares, or a 12.98% stake, in Herbalife.[45] Icahn's announcement sent shares soaring up more than 20% in after-hours trading.[46] It appeared as though Icahn was attempting to short squeeze Ackman. Icahn included in the filing that he "intend[s] to have discussions with management of the issuer regarding the business and strategic alternatives to enhance shareholder value, such as a recapitalization or a going-private transaction."[47]

Just two days later, sources revealed that Daniel Loeb, who had heralded the company the month before when he purchased his large stake, had significantly trimmed his position in Herbalife.[48] Loeb considered the stock's rally to be overextended in the short term and felt that the company was a "different proposition" once it was trading in the mid to high 40s.[49] Others have questioned the move by Loeb.[50] One journalist pondered whether, after making such a big public commotion about Herbalife as a "compelling long investment," it was ethical to sell a large chunk of that stock at a price far below what Loeb told investors it was worth.[51] This question will be reexamined in Part III.

C. Current Regulation of Hedge Fund Market Manipulation

This section gives a very limited overview of how current regulation may inhibit hedge fund market manipulation through the dissemination of information about the manipulators' positions, with a focus on the antifraud provisions of the federal securities laws. Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 (Exchange Act) are probably the most effective enforcement provisions for the conduct discussed above at this time. Since the passage of the Dodd-Frank Act in 2010, certain hedge funds are also regulated under the Investment Advisers Act of 1940 (Advisers Act).[52] These two Acts are discussed below only in regard to their abilities to regulate the type of hedge fund market manipulation at issue.[53]

1. Section 10(b) and Rule 10b-5 of the Exchange Act

Generally, whether hedge fund trading is deemed to be manipulative or deceptive depends on an analysis under the general antifraud provisions of the federal securities laws. The classic enforcement mechanism used by both federal regulators, such as the SEC and Department of Justice (DOJ), and by private parties is section 10(b) and Rule 10b-5. Section 10(b) prohibits the use of "any manipulative or deceptive device or contrivance in contravention" of SEC rules.[54] Rule 10b-5 takes matters a little further by prohibiting certain acts or omissions that result in fraud or deceit in connection with the purchase or sale of any security.[55]

Illegal market manipulation by investment advisers under the Exchange Act generally fits into two categories of conduct. One deals with failing to disclose conflicts of interest, and the other is knowingly or recklessly making a false or misleading statement about an issuer of a publicly traded security whether or not one has a position in that security. In the first situation, it is often illegal to make a public statement about a company without disclosing material information about one's own position in the company.[56] Courts have routinely held that not disclosing a personal financial interest in a security or issuer that a person or entity recommends is material, "no matter how small the stake."[57] Moreover, courts have also found a duty to disclose in such situations.[58] Failing to disclose such conflicts is a rare occurrence, however, and this article focuses more on the second category—materially false and misleading statements.

In pursuing investigations of manipulative short selling, the SEC and other authorities need to carefully differentiate between legitimate short selling and short selling that unlawfully manipulates stock prices. This distinction is not always clear. While short sellers who engage in other clearly manipulative or deceptive behaviors may present easier enforcement cases, there is some confusion regarding whether aggressive short selling unaccompanied by other deceptive conduct may ever be charged as market manipulation, even if the short seller intends to affect the price of securities.[59]

The focus here is on the first situation, where there is potentially manipulative or deceptive behavior accompanying funds' investments, namely that the hedge funds are also disseminating misleading information about their position. Imposing liability under Section 10(b), however, is not as easy as it sounds. There are quite a few elements that need to be shown in order to bring a claim.[60] Some of these elements would be relatively easy to prove in this type of situation. For example, a private plaintiff should be able to show a connection with the purchase or sale of a security and—assuming the plaintiff actually relied on the statements or information provided by the fund—reliance, loss, and causation without too much trouble. It is the failure to prove that the statements or information provided are material misrepresentations and also the failure to show the requisite intent that stall these actions.[61]

The scienter element requires proving that the funds intentionally, or possibly recklessly, provided false or misleading information, or omitted to disclose information to make the statements not false or misleading.[62] Therefore, it appears that section 10(b) can only be used to prohibit hedge fund market manipulation if the hedge funds are blatantly lying about the company in order to move the stock price, if they are reckless in what they say, or if they conceal something about their own position in the company that should be disclosed. The problem is that these things are very difficult to prove.[63]

2. Section 206(4) of the Advisers Act

The Advisers Act generally requires persons and firms receiving compensation for providing advice about securities to register with the SEC, including hedge fund managers with at least $150 million in assets under management. Under section 206(4):

> It shall be unlawful for any investment adviser, by the use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.[64]

The SEC has promulgated one rule under this section related to "pooled investment vehicles."[65] The rule establishes that a "fraudulent, deceptive, or manipulative act, practice, or course of business within the meaning of section 206(4)," only applies to untrue statements or omissions of material fact or other fraudulent, deceptive, or manipulative conduct by an investment adviser to any investor or prospective investor in the pooled investment vehicle.[66] Accordingly, the rule makes section 206(4) applicable *only* to investors or prospective investors *in the pooled investment vehicle.*

The rule does not prohibit any fraudulent or deceptive conduct by investment advisers to any other investors; it is aimed only at protecting "clients" of the fund. Neither does the rule create a private right of action, but is only enforceable by the SEC.[67] The rule does, however, make enforcement significantly easier for the SEC than under Rule 10b-5 in a couple of ways. It prohibits advisers from making any materially false or misleading statements to investors in the pool regardless of whether the pool is offering, selling, or redeeming securities.[68] Additionally, the SEC would not need to demonstrate that an adviser violating Rule 206(4)-8 acted with scienter.[69]

In all, Section 206(4) and Rule 206(4)-8 would not be of any use to private investors who were burned by a hedge fund manipulating a stock since there is no private right of action, or to the SEC in trying to prevent or punish fraudulent or deceptive conduct to investors outside of the fund. Therefore, while these regulations do provide benefits to enforcement not available under the Exchange Act regulations, Section 10(b) and Rule 10b-5 are the only available means of redress in those situations.[70] The next Part evaluates whether any of the hedge fund conduct in the Herbalife example would violate these current regulations and suggests adopting a new rule under the Advisers Act that would better resolve this problem.

III. Analysis

A. Examining the Herbalife Conduct

As discussed in more detail in Part II.B, there have been many different statements from several different investment advisers regarding Herbalife as a company and its stock. While most of these statements appear to be legal under current securities law, some of them are cutting it very close. Additionally, some may actually be fraudulent or deceptive, but it is nearly impossible to prove this.[71] This section will show why investment advisers need to be held to a higher standard than they currently are under Section 10(b).

1. Ackman and Pershing Square

Ackman started everything when he publicly christened Herbalife as a pyramid scheme at the Sohn Conference at the end of 2012.[72] Pershing Square backed up this claim with a lengthy presentation and follow-up reports.[73] The question is whether the fund or Ackman materially mischaracterized any information in these statements or left out any information that should have been included, *and* whether this was done intentionally (or possibly recklessly).[74]

Pershing Square states many different reasons for its conclusion that Herbalife was a pyramid scheme, all of which cannot be addressed in this section.[75] One of Pershing Square's biggest claims was that independent distributors of Herbalife earned ten times as much from recruitment as they did by selling the company's products to bona fide retail customers.[76] Some of the other hotly disputed accusations appear to be that Herbalife used inflated pricing, misleading sales data, and complicated incentives to hide the scheme.[77] Herbalife responded by arguing that Ackman's presentation was based largely on "outdated, distorted[,] and inaccurate information."[78] The company also said that Ackman cherry-picked data and made outright misrepresentations of the company's financial statements.[79] Herbalife hired Lieberman Research Worldwide to conduct a survey aimed at quantifying how much of the company's sales occurred outside its networks of distributors.[80] The survey of 2,000 people found that 5% of U.S. households reported purchasing the company's products, with 90% of sales coming externally.[81] Such results would make Pershing Square's statements that Herbalife distributors' true retail profits are de minimis seem questionable.[82]

But Ackman responded by arguing that Herbalife "distorted, mischaracterized, and outright ignored large portions of our presentation," specifically "our identification of overstatements and inaccuracies in the company's earnings statement for distributors, which among other deceptions, excludes the 93% of distributors that have zero gross earnings."[83] All-in-all, the two parties just kept pointing fingers at each other, saying that it was the other side that was the one who's lying. Without conducting a serious and timely investigation into each statement and all the relevant information, which is highly unlikely, the SEC would never be able to support a claim of a section 10(b) violation. Even worse, the chances of a private plaintiff getting beyond the motion to dismiss stage, especially without discovery, are nil.

2. Daniel Loeb

Loeb was the first to publicly invest in Herbalife in opposition to Ackman. As discussed earlier, Loeb wrote a letter to his investors explaining why he thought Herbalife was such a "compelling long investment."[84] In this letter he hyped Herbalife's shares as being worth at least $55 per share, and probably as much as $70 per share or more.[85] However, barely a month later, when Icahn bought in and sent the shares soaring up to the mid- to high-40s, Loeb didn't hesitate to significantly trim his position and take a quick profit.[86] This, in the author's opinion, is much more on the borderline of illegal conduct.

First, Loeb's conduct is actually a potential violation of Section 206(4). Because he made his statements in a letter to his fund's investors, he meets one of the requirements for violation of this section. The biggest issue is whether his statements that the stock was worth between $55 and $68 per share are materially fraudulent or deceptive. The SEC would have a difficult time proving this, but by selling a majority of the fund's position well below that range, there is a pretty strong inference of deception. Moreover, the SEC would not have to show intent to defraud or damages, for that matter,[87] which is critical since investors in his fund didn't suffer any damages.[88] That raises the question, even if the SEC could show a violation under this section, of what would be the proper remedy.[89]

Second, his conduct also could possibly support a claim under section 10(b) and Rule 10b-5.[90] Here, however, the trouble will be proving that Loeb made the statements with the requisite intent to deceive. Again, he made comments that the stock was worth at least a certain amount, and then he sold out shortly afterward well below that price. These actions give the inference of deception, but without more, are probably not enough to result in liability.

3. Carl Icahn

Lastly, Icahn of Icahn Enterprises got involved in the middle of February 2013. While Icahn's investment in the company also sent shares soaring after the information was made public, he did not make any statements about the company or its stock prices that could be considered fraudulent or deceptive, as did the other two advisers. At most, he argued that Ackman was completely wrong about his view of Herbalife as a pyramid scheme and that the company had a lot of opportunities for growth.[91] Taking an aggressive position in the company by itself is not enough to be considered market manipulation, even if such a position causes shares to move drastically and the seller had the intent that it so move.[92] Therefore, Icahn would be the least likely of the advisers to be held liable for market manipulation. However, as this section demonstrates, hedge fund advisers like these are able to take incredible advantage of their positions and have the ability to move the price of their own investments in a favorable direction with a few swift public comments. Under current regulations, it is much too easy for them to get away with making questionable statements that assist in that manipulation.

B. The SEC Should Adopt a New Advisers Act Rule 206(4)-9

There is a gap in securities regulation that allows investment advisers—such as the hedge fund managers involved in the Herbalife dispute—to effectively manipulate stock in their position's favor by making misleading statements because it is too difficult to prove certain elements of the current rules. Section 10(b) and Rule 10b-5 prohibit this conduct, but require proof that the statements were made intentionally or recklessly.[93] Section 17(a) of the Securities Act also generally prohibits fraud and misrepresentation without the requirement of scienter,[94] but does not allow private actions,[95] and most importantly, that section only applies to fraud in the offer or sale of securities, which would not cover the actions presented here. Finally, Section 206(4) of the Advisers Act specifically targets this kind of conduct by investment advisers and also does not require scienter, but the section does not allow private actions, and Rule 206(4)-8 limits the reach of the statute to statements or conduct directed to investors in the investment pool of the adviser.[96] The author proposes that the SEC adopt a new rule under Section 206(4) of the Advisers Act that blends these three antifraud regulations to specifically prohibit negligent material misrepresentations or other fraudulent or deceptive conduct by investment advisers that causes harm to investors outside the advisers' funds who rely upon the misrepresentations or other conduct.

1. Proposed Rule 206(4)-9

The basic gist of the proposed rule would be to eliminate the scienter requirement of Rule 10b-5, but limit application of the new rule to investment advisers as defined in the Advisers Act[97] and to allow enforcement only by the government. The new rule would eliminate the language of Rule 206(4)-8 that requires the untrue statement or other fraudulent conduct to be "to any investor or prospective investor in the pooled investment vehicle."[98] It would also reinstate the "in connection with the purchase or sale of any security" requirement of Rule

10b-5. Since the goal is to protect investors outside of the fund of the adviser, there is no need to protect against most of the fraudulent activity that getting rid of that requirement prohibits, for example, misrepresenting the value of the fund or the credentials of the adviser. Similar to Rule 206(4)-8, the new rule would be interpreted to be enforceable in civil actions only by the SEC.[99] All in all, the rule would provide a workable solution that prohibits general fraud and deception, like Rule 10b-5, but has a narrow scope that is applicable only to investment advisers (like Rule 206(4)-8), and eliminates the requirement that the SEC has to prove scienter (like Section 17(a) and Rule 206(4)-8).

2. Cost-Benefit Analysis

Whenever the SEC promulgates new rules, it tries to carefully balance the costs imposed against the benefits derived.[100] Comparable to Rule 206(4)-8, the proposed new rule would achieve a reasonable balance of providing important benefits to investors at an acceptable cost.

First, because the new rule eliminates the scienter requirement, it would expose investment advisers to liability for untrue statements or other fraudulent or deceptive conduct without any proof of wrongful intent or recklessness, in effect making it easier to support claims of a violation. This potential cost is balanced by allowing civil actions to be brought only by the SEC. Therefore, there would not be the risk of an influx of private suits and substantially increased liability for such advisers. Moreover, those private investors are not without recourse as they can still bring claims under Section 10(b), albeit with the burden of proving scienter.

Second, there would not be any real uncertainty regarding what kind of conduct is prohibited by the new rule. Because the rule basically prohibits similar, or the same kind of, conduct that is currently prohibited by other provisions of the antifraud laws, there already exists a wealth of interpretation regarding the main issues.[101] For example, what constitutes a "material" fact is already well-settled.[102] This factor is directly related to the next one.

Third, the cost of compliance is always an important issue. Three commenters on Rule 206(4)-8 raised concerns that the rule would increase advisers' cost of compliance by making it necessary for advisers to conduct extensive reviews of all communications with clients.[103] The Commission dismissed this concern for exactly the reason discussed in the above factor. Investment advisers to pooled investment vehicles should already be complying with both Rule 206(4)-8 and the proposed new rule because they should not be making any untrue statements or omitting material facts or otherwise be engaging in fraud because, in most cases, the conduct the rule prohibits is already prohibited by other federal laws, as well as state law.[104] Furthermore, the proposed new rule would only affect advisers that are making false or misleading statements to the public and investors outside of the advisers' own investment pools. And since the advisers do not have to make any disclosures or statements to this group in the first place, as they must to their own investors, there is no added cost of compliance beyond what Rule 206(4)-8 and the other antifraud laws already impose.

Finally, advisers may argue that by eliminating the scienter requirement for statements made beyond their own investment pools, the proposed new rule will "chill" their first amendment rights to make such statements to the public because of the fear of liability for making an unintentional false statement. This argument is also addressed by the reasons just described. The advisers are not being held liable for anything for which they were not already liable—material untrue statements and omissions or other fraudulent and deceptive conduct. The Commission believes that, by taking sufficient care to avoid negligent conduct, advisers will be more likely to avoid reckless deception.[105] The advisers should already be taking enough care to prevent violating the new rule.

In addition, however, the proposed new rule should only apply to investment advisers regarding their position in a stock for the benefit of the fund they are advising. Because of the fiduciary duties the advisers owe to their fund to not make any negligent bad investments,[106] the rule would be effective in preventing the advisers from then dumping the bad position on the public by making false or misleading statements about it. In contrast, the rule should not apply to investment advisers investing their own money. Here, the intentional or reckless standard should still apply to avoid any overbroad and unfair restrictions on speech. The same fiduciary duties don't apply in this situation.[107]

IV. Conclusion

This article addresses how large hedge fund managers are able to effectively manipulate the market to move stocks in whatever way they are currently invested by making certain statements to the public about a specific company or its stock. Often these statements are dangerously close to being fraudulent or deceptive. Even if they are, under current law, it is nearly impossible to prove that the statements were intentionally false or misleading, with the exception of blatant lies or completely fraudulent schemes. The article examined the current hedge fund battle over Herbalife as a typical example of this conduct and addressed why the current laws are inadequate to deal with the problem. Finally, the author proposed that the SEC adopt a new rule that is a hybrid of current antifraud securities regulations that would specifically target this behavior and allow the SEC to more effectively deter it.

Endnotes

1. Herbalife, Ltd. (NYSE: HLF).

2. Pershing Square Capital Management, L.P., Who Wants to be a Millionaire, *available at* http://factsaboutherbalife.com/wp-content/uploads/2013/01/Who-wants-to-be-a-Millionaire.pdf.

3. Duane D. Stanford & Kelly Bit, *Herbalife Drops After Ackman Says He's Shorting Shares*, Bloomberg (Dec. 20, 2012), http://www.bloomberg.com/news/2012-12-20/herbalife-drops-after-ackman-says-he-s-shorting-shares.html.

4. On December 18, 2012, the stock was at $42.50 per share, and on December 24, 2012, the stock was at $26.06 per share. *Herbalife Ltd. (HLF)*,Yahoo! Finance, http://finance.yahoo.com/echarts?s=HLF+Interactive#symbol=hlf;range=20121218,20121224;compare=;indicator=volume;charttype=area;crosshair=on;ohlcvalues=0;logscale=off;source=undefined.

5. William D. Cohan, *Herbalife Battle Shows How the Game Is Rigged*, Bloomberg (Feb. 24, 2013), http://www.bloomberg.com/news/2013-02-24/herbalife-battle-shows-how-the-game-is-rigged.html.

6. *Id.* Loeb wrote in a letter to his investors that the stock price could easily return to a price of about $70 per share, but at a minimum, should be valued at $55 to $68 per share. *Id.*

7. *Id.*

8. The following schemes are better understood as fraud rather than market manipulation since the harm to the other market participants results from the false statements and not as much from the trades themselves. *See* Daniel R. Fischel & David J. Ross, *Should the Law Prohibit 'Manipulation' in Financial Markets?*, 105 Harv. L. Rev. 503, 526 (1991). However, I will refer to them as market manipulation for the sake of ease and uniformity.

9. *Id.* at 507.

10. *See, e.g.*, David B. Kramer, *The Way It Is and the Way It Should Be: Liability Under § 10(b) of the Exchange Act and Rule 10b-5 Thereunder for Making False and Misleading Statements As Part of a Scheme to 'Pump and Dump' a Stock*, 13 U. Miami Bus. L. Rev. 243, 245 (2005).

11. *Id.*; *'Pump-and-Dumps' and Market Manipulations*, U.S. Sec. & Exch. Comm'n, http://www.sec.gov/answers/pumpdump.htm.

12. *Pump and Dump*, Investopedia, http://www.investopedia.com/terms/p/pumpanddump.asp.

13. *Id.*

14. Rick Wayman, *The Short and Distort: Stock Manipulation in a Bear Market*, Investopedia (Feb. 26, 2009), http://www.investopedia.com/articles/analyst/030102.asp.

15. *Id.*; Joanna Glasner, *New Market Trend: Short, Distort*, Wired (June 3, 2002), http://www.wired.com/techbiz/media/news/2002/06/52785?currentPage=all.

16. *See* Wayman, *supra* note 14.

17. *See, e.g.*, *Lay, Skilling Guilty on Nearly All Counts*, NBCNEWS.com, http://www.nbcnews.com/id/12968481/#.UUpYUlfiGSo (discussing the officers of Enron being charged for one of the biggest corporate scandals in history).

18. *See The Case Against Lehman Brothers*, CBSNEWS.com (Aug. 19, 2012), http://www.cbsnews.com/8301-18560_162-57491089/the-case-against-lehman-brothers/.

19. *See* Glasner, *supra* note 15 ("While most traders have learned to cast suspicion on overly positive corporate press releases or puffy analyst reports, market psychologists say investors are less aware of the threat of negative rumormongering. Post-Enron skittishness exacerbates the situation.").

20. For example, an individual might use a screen name or e-mail address that implies that he or she is associated with the SEC or FINRA to give the illusion of authority. *See* Wayman, *supra* note 14.

21. Kara Scannell & Jenny Strasburg, *Hedge Funds Subpoenaed in SEC Probe*, The Wall Street Journal, http://online.wsj.com/article/SB121608395388753035.html. The SEC subpoenaed more than fifty hedge fund advisers seeking trading and communications data related to short selling and options trading in the companies. The probe came around the same time the SEC and other Wall Street regulators "launched examinations of investment banks and hedge fund advisers' compliance programs to ensure that they have the right training and policies in place to detect market manipulation that can include rumor mongering." *Id.*

22. Herbalife, Ltd., Annual Report (Form 10-K) 4 (Feb. 21, 2012).

23. *Id.*

24. *Id.*

25. Julia La Roche, *Bill Ackman Has Added a New Short Position to Pershing Square's Portfolio*, Business Insider (June 12, 2012), http://www.businessinsider.com/bill-ackman-new-short-2012-6. In October Ackman stated that the country would be better off when the company he was shorting went out of business, but would not reveal his short at that time. Julia La Roche, *Bill Ackman Says He Has a 'Patriotic' Short Bet and the Country Will Be Better Off When the Company Goes Bust*, Business Insider (Oct. 2, 2012), http://www.businessinsider.com/bill-ackmans-patriotic-short-2012-10.

26. Julia La Roche, *Bill Ackman is Short Herbalife and the Stock is Diving*, Business Insider (Dec. 19, 2012), http://www.businessinsider.com/cnbc-bill-ackman-is-short-herbalife-and-the-stock-is-diving-2012-12. Stock fell 12.14% the day of the disclosure to close at $37.34 per share.

27. Julia La Roche, *HERBALIFE CEO: "The U.S. Will Be Better When Bill Ackman is Gone,"* Business Insider (Dec. 19, 2012), http://www.businessinsider.com/herbalife-ceo-the-us-will-be-better-when-bill-ackman-is-gone-2012-12.

28. Pershing Square Capital Management, L.P., *Who Wants to be a Millionaire?* Executive Summary 1, http://factsaboutherbalife.com/wp-content/uploads/2012/12/Final-Exec-Summary-1.pdf.

29. Diane Brady, *Bill Ackman's Crusade to Crush Herbalife*, Bloomberg Businessweek (Dec. 20, 2012), http://www.businessweek.com/articles/2012-12-20/bill-ackman-and-his-crusade-to-crush-herbalife. In other words, Ackman is betting the federal regulators such as the SEC will shut the company down.

30. *See* Executive Summary, *supra* note 28, at 14.

31. *See* Pershing Square Capital Management, L.P., Facts About Herbalife, http://factsaboutherbalife.com/.

32. *Id.*

33. Julia La Roche, *HERBALIFE: We Are 'Not an Illegal Pyramid Scheme'*, Business Insider (Dec. 21, 2012), http://www.businessinsider.com/herbalife-not-an-illegal-pyramid-scheme-2012-12.

34. Juliet Chung, *Showdown Over Herbalife Spotlights New Wall Street*, The Wall Street Journal (Jan. 9, 2013), http://online.wsj.com/article/SB10001424127887324081704578231522781739266.html.

35. Andrew Ross Sorkin & Michael J. De La Merced, *Loeb Explains His Herbalife Bet*, DealBook (Jan. 9, 2013), http://dealbook.nytimes.com/2013/01/09/loeb-explains-his-herbalife-bet/.

36. *Id. But cf.* Brian Mahany, *Feds Bust Longest Running Ponzi Scheme*, Due Diligence, http://www.mahanyertl.com/mahanyertl/feds-bust-longest-running-ponzi-scheme/720/ (stating that Philip Barry was convicted in 2009 of running a Ponzi scheme that he started in 1978).

37. *See* Sorkin & De La Merced *supra* note 35.

38. *Id.*

39. Duane D. Stanford, *Herbalife in Investor Meeting Says Ackman Pyramid Case Wrong*, Bloomberg, (Jan. 10, 2013) http://www.bloomberg.com/news/2013-01-10/herbalife-in-investor-meeting-says-ackman-pyramid-case-is-wrong.html.

40. *Id.*

41. *See id.*

42. Julia La Roche, *Bill Ackman Fights Back!*, Business Insider (Jan. 10, 2013), http://www.businessinsider.com/ackman-respond-to-herbalife-presentation-2013-1.

43. *See Questions for Herbalife*, Facts About Herbalife (Feb. 7, 2013) *available at* http://factsaboutherbalife.com/wp-content/uploads/2013/04/Key-Herbalife-Questions_Final_4_9_13.pdf.

44. Julia La Roche, *Shares of Herbalife Have Rallied Back to Above Where They Were When Ackman Confirmed His Massive Short*, Business Insider (Jan. 15, 2013), http://www.businessinsider.com/shares-of-herbalife-have-rallied-back-2013-1.

45. *Icahn Buys 14 Million Shares of Herbalife for 12.98% Stake*, CNBC.com (Feb. 14, 2013), http://www.cnbc.com/id/100461655.

46. *Id.*

47. Herbalife, Ltd., Statement of Changes in Beneficial Ownership (Form 13D) (Feb. 4, 2013). Icahn's involvement in the company could be more than to simply make money. Icahn and Ackman are known rivals, which dates back to a decade-old legal dispute between the two. Icahn even called Ackman a "crybaby" in a verbal argument on CNBC in January, 2013. *See* John Melloy, *Icahn vs. Ackman: Is It Business, or Personal?*, CNBC.com (Feb. 15, 2013), http://www.cnbc.com/id/100464074.

48. Michelle Celarier, *Loeb Trims Stake in Herbalife*, New York Post, *available at* http://www.nypost.com/p/news/business/loeb_trims_stake_in_herbalife_5XO4iam2xBG1qO3MUHu4jO (Feb. 18, 2013).

49. *Id.*

50. *See, e.g.*, William D. Cohan, *Herbalife Battle Shows How the Game Is Rigged*, Bloomberg (Feb. 24, 2013), http://www.bloomberg.com/news/2013-02-24/herbalife-battle-shows-how-the-game-is-rigged.html.

51. *Id.*

52. Generally, hedge fund managers with at least $150 million in assets under management fall under these regulations. Investment advisers with less than $100 million in assets under management are regulated on the state level.

53. This article also does not discuss the Commodity Futures Trading Commission Act of 1974, which created the Commodity Futures Trading Commission to serve as an independent federal agency that monitors and regulates market manipulation in the futures and options markets and some aspects of derivative trading. This article only focuses on market manipulation related to long and short positions of hedge funds.

54. 15 U.S.C. § 78j(b).

55. 17 C.F.R. § 240.10b-5. The rule in full provides that:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

56. *See* Jill I. Gross, *Securities Analysts' Undisclosed Conflicts of Interest: Unfair Dealing or Securities Fraud?*, 2002 Colum. Bus. L. Rev. 631, 661 (2002). Gross said she was "unaware of any case awarding damages to an investor who brought a claim for securities fraud under the [Exchange Act] against an analyst or other industry participant lacking a fiduciary duty to the investor for recommending a security in a research report without disclosing conflicts of interest." *Id.* However, where an investor invests in reliance on such a report liability should follow, as the conduct appears to satisfy the elements a private plaintiff needs to prove in a section 10(b) or Rule 10b-5 case. *Id. See infra* note 60 for a list of the elements.

    It is also illegal for an investment adviser to recommend securities to clients without disclosing that he or she has a personal stake in the security under the Investment Advisers Act. *See SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 181–82 (1963) (holding that the SEC may enforce an injunction requiring advisers to make full disclosure of "scalping" practices to clients).

57. Gross, *supra* note 56, at 662–63.

58. *See, e.g.*, *SEC v. Park*, 99 F. Supp. 2d 889, 900 (N.D. Ill. 2000); *United States v. Eisenberg*, 773 F. Supp. 662, 723 (D.N.J. 1991). The courts have found an even stronger duty for investment advisers because of the fiduciary duties imposed on them. *See Penny Stock Newsletter, Inc.*, 32 S.E.C. Docket 84, 1984 WL 472325, at *4 (S.E.C. Dec. 19, 1984) ("[S]ection 10(b) of the Exchange Act requires an investment adviser to disclose potential conflicts of interest"); *SEC v. Blavin*, 557 F. Supp. 1304, 1311 (E.D. Mich. 1983) (declining to identify a "duty to disclose" as an independent element of a section 10(b) violation, but recognizing the fiduciary duty imposed by the Investment Advisers Act).

59. *See, e.g.*, *ATSI Commc'ns, Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87, 100–101 (2d Cir. 2007). The Third and Seventh Circuits appear to have concluded that intent to depress stocks by aggressive short selling alone is not enough when the transactions involve "real" buyers and sellers. *See Sullivan & Long v. Scattered Corp.*, 47 F.3d 857, 864 (7th Cir. 1995); *GFL Advantage Fund, Ltd. v. Colkitt*, 272 F.3d 189, 204 (3d Cir. 2001) (requiring a showing of manipulative intent *plus* other deceptive conduct). Conversely, the Second Circuit has opened the door to conflicting interpretations of its opinion, in *ATSI Communications, Inc. v. Shaar Fund, Ltd.*, that short selling alone, if accompanied by intent to affect stock prices, could be charged as an "open-market" manipulation. 493 F.3d at 100–01.

60. *See Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 341–42 (2005) ("[T]he action's basic elements include: (1) a material misrepresentation (or omission); (2) scienter, i.e., a wrongful state of mind; (3) a connection with the purchase or sale of a security; (4) reliance…; (5) economic loss; and (6) 'loss causation,' i.e., a causal connection between the material misrepresentation and the loss."). *But cf. SEC v. Pirate Investor L.L.C.*, 580 F.3d 233, 239 (4th Cir. 2009) (listing only the first three elements for a civil enforcement action by the SEC). The reliance, economic loss, and causation elements do *not* apply to actions brought by the SEC or DOJ. *Id.*

61. And therefore, it is just as difficult for the SEC or DOJ to bring these types of actions even though they have fewer general elements to prove.

62. *See Ernst & Ernst v. Hochfefelder*, 425 U.S. 185, 193 n.12 (1976):

> "[S]cienter" refers to a mental state embracing intent to deceive, manipulate, or defraud. In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some acts. We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5.

63. Especially in light of the procedural requirements imposed by the Private Securities Litigation Reform Act of 1995, which imposes heightened pleading requirements and a mandatory judicial stay of discovery during the pendency of a motion to dismiss. *See* 15 U.S.C. § 78u-4(b)(1)–(3).

64. 15 U.S.C. § 80b-6(4).

65. *See* 17 C.F.R. § 275.206(4)-8. "Pooled investment vehicles" under this section are defined broadly by subpart (b) of the rule and the rule applies to advisers of hedge funds, private equity funds, venture capital funds, and other types of privately offered pools that invest in securities, as well as to advisers to investment companies that are registered with the SEC. Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, 72 Fed. Reg. 44,756, 44,758 (Aug. 9, 2007) (to be codified at 17 C.F.R. pt. 275).

66. 17 C.F.R. § 275.206(4)-8(a). The rule prohibits any investment adviser to a pooled investment vehicle to:

    (1) Make any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle; or

    (2) Otherwise engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle.

    Id. at § 275.206(4)-8(a)(1)–(2).

67. Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, 72 Fed. Reg. at 44,756, 44,760.

68. *Id.* at 44,759. This provision differs from Rule 10b-5 in that the fraudulent conduct need not occur in connection with the purchase or sale of a security. *Id.* at 44, 760. This rule would additionally prohibit, for example, materially false or misleading statements regarding investment strategies a pooled fund will pursue, among other things, which would not be prohibited under Rule 10b-5. *Id.*

69. *Id.* at 44, 759 ("We read the language of section 206(4) as not by its terms limited to knowing or deliberate conduct…thereby reaching conduct that is negligently deceptive as well as conduct that is recklessly or deliberately deceptive."). *See also SEC v. Steadman*, 967 F.2d 636, 647 (D.C. Cir. 1992) (concluding that scienter is not required under Section 206(4) by analogizing the section to section 17(a)(3) of the Securities Act, which the Supreme Court held does not require a finding of scienter, in *Aaron v. SEC*, 446 U.S 680, 697 (1980)).

70. Once again, there may be other possible remedies in certain circumstances (*e.g.*, federal criminal statutes or state law), but this article focuses on civil enforcement under federal law.

71. All the investors in this example properly disclosed their own positions before making any statements. *See, e.g.*, Executive Summary, *supra* note 28, at 14. Therefore, as mentioned above, this article will not focus on the duty to disclose conflicts of interest any further.

72. *See* La Roche, *supra* note 26.

73. *See* Facts About Herbalife, http://factsaboutherbalife.com/ (including, among other documents and reports, the original Sohn Conference presentation and an executive summary).

74. *See* 15 U.S.C. § 78j(b) (2006); Employment of Manipulative and Deceptive Devices, 17 C.F.R. § 240.10b-5 (2013) (Presumably, section 206(4) would not apply to the conduct of Ackman or Pershing Square, since none of their statements was made directly to their own investors.).

75. *See* Pershing Square Capital Management, L.P., *Who Wants to be a Millionaire*, Facts About Herbalife, http://factsaboutherbalife.com/wp-content/uploads/2013/01/Who-wants-to-be-a-Millionaire.pdf.

76. Executive Summary, *supra* note 28, at 1.

77. Duane D. Stanford, *Herbalife Director Dunn Says Ackman Throwing Rocks*, Bloomberg (Mar. 5, 2013), http://www.bloomberg.com/news/2013-03-05/herbalife-director-dunn-says-ackman-throwing-rocks.html (stating that Director Jeff Dunn said Ackman was wrong in his analysis and that he was just "throwing rocks" to support his short position).

78. La Roche, *supra* note 33.

79. Steve Schaefer, *Herbalife Takes on Pershing's 'Myth,' Ackman Not Backing Down*, Forbes (Jan. 10, 2013), http://www.forbes.com/sites/steveschaefer/2013/01/10/herbalife-takes-on-pershings-myth-ackman-not-backing-down/.

80. *Id.*

81. *Id.*

82. *See* Executive Summary, *supra* note 28, at 7.

83. Schaefer, *supra* note 79.

84. *See* Sorkin & De La Merced, *supra* note 35.

85. *Id.*

86. *See* Celarier, *supra* note 48.

87. *E.g.*, *Sheldon Co. Profit Sharing Plan & Trust v. Smith*, 828 F. Supp. 1262, 1284 (W.D. Mich. 1993) ("A violation of section 206(2) can be supported without a showing of scienter, and without actual injury to any client."); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963) ("Congress, in empowering the courts to enjoin any practice which operates as a fraud or deceit upon a client, did not intend to require proof of intent to injure and actual injury to the client.") (internal quotations omitted).

88. *See* Adam Clark Estes, *Somehow, Everybody Came Out a Winner in the Herbalife Battle Royale*, The Atlantic Wire (Mar. 31, 2013), http://www.theatlanticwire.com/business/2013/03/somehow-everybody-came-out-winner-herbalife-battle-royale/63725/ (noting that Icahn earned about $50 million from his Herbalife investment).

89. An injunction would not be very useful since Loeb already realized most of his profit from the position. Disgorgement may be the proper award and has been allowed in some situations. *See, e.g.*, *SEC v. Blavin*, 557 F. Supp. 1304 (E.D. Mich. 1983). This question, however, is beyond the scope of this article.

90. Under this claim, the plaintiffs would have to be either the SEC again or investors outside of Loeb's fund that suffered damages from relying on his statements. As mentioned above, the investors inside the fund did not suffer any damages, and thus could not meet that requirement of the claim.

91. *See, e.g.*, James O'Toole, *Icahn Challenges Ackman with 13% Herbalife Stake*, CNNMoney (Feb. 14, 2013), *available* at http://money.cnn.com/2013/02/14/investing/icahn-herbalife/index.html.

92. *Cf. supra* note 56 (referring to aggressive short selling).

93. *Supra* notes 59–60 and accompanying text.

94. *See Aaron v. SEC*, 446 U.S. 680 (1980) (holding that the language of § 17(a)(1) requires scienter, but not § 17(a)(2) or § 17(a)(3)).

95. *See, e.g.*, *Maldonado v. Dominguez*, 137 F.3d 1 (1st Cir. 1998).

96. *See supra* Part II.C.2.

97. Section 202(a)(11) of the Act defines an investment adviser as any person or firm that (i) for compensation (ii) is engaged in the business of (iii) providing advice to others or issuing reports or analyses regarding securities. 15 U.S.C. § 80b-2(a)(11) (2006). For a detailed analysis of the definition and the exceptions, see Staff of the Investment Adviser Regulation Office, *Regulation of Investment Advisers by the U.S. Securities and Exchange Commission* (Mar. 2013), http://www.sec.gov/about/offices/oia/oia_investman/rplaze-042012.pdf.

98. *See* 17 C.F.R. § 275.206(4)-8(a)(1) & (2) (2013).

99. *See supra* note 64 and accompanying text. The Supreme Court has held that "there exists a limited private remedy under the [Advisers Act] to void an investment adviser's contract, but that the Act confers no other private causes of action, legal or equitable." *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 24 (1979) (footnote omitted).

100. *See, e.g.*, 72 Fed. Reg. 44,756, 44,760 (Aug. 9, 2007) ("The Commission is sensitive to costs imposed by our rules and the benefits that derive from them.").

101. *Id.* at 44,759 ("For these reasons, and because the nature of the duty to communicate without false statements is so well developed in current law, we believe that commenters' concerns about the breadth of the prohibition or any chilling effect [Rule 206(4)-8] might have on investor communications are misplaced.").

102. A fact is material if there is a substantial likelihood that a reasonable investor in making an investment decision would consider it as having significantly altered the total mix of information available. *Basic, Inc. v. Levinson*, 485 U.S. 224, 231–32 (1988); *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

103. 72 Fed. Reg. 44,756, 44,760 (Aug. 9, 2007).

104. *Id.*

105. *Id.* at 44,759.

106. *See, e.g.*, *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191 (1963) ("The Investment Advisers Act of 1940 thus reflects a congressional recognition of the delicate fiduciary nature of an investment advisory relationship…."); *see also Investment Trusts and Investment Companies: Hearing on S. 3580 Before a Subcomm. of the S. Comm. on Banking & Currency*, 76th Cong. 719, 716 (1940) (statements of leading investment advisers) (emphasizing that the investment adviser profession is a relationship of "trust and confidence" with clients and the importance of "strict limitation of [advisers' rights] to buy and sell securities in the normal way if there is any chance at all that to do so might seem to operate against the interests of clients and the public").

107. But advisers must still disclose their personal positions in a security before recommending that security to their own clients. *See Capital Gains Research*, 375 U.S. at 181–82; *supra* note 56.

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SEC Repeals Ban on General Solicitation in Private Placements, Adds a Disqualification for Bad Actors and Proposes New Reg. D Requirements

By Guy P. Lander, Steven J. Glusband and Avinash V. Ganatra

Introduction

On July 10, 2013, the Securities and Exchange Commission ("SEC") adopted several significant amendments that will change the way private placements are conducted. The SEC adopted the following amendments:

I. Repeal of the ban on general solicitation in private offerings conducted under Rule 506 of Regulation D and Rule 144A under the U.S. Securities Act of 1933 (the "Securities Act"), as required by Section 210(a) of the Jumpstart Our Business Startups Act ("JOBS Act").

II. Disqualification of "bad actors" from participating in securities offerings under the Rule, as required by Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").

III. Proposed new amendments to Regulation D, Form D, and Rule 156 under the Securities Act. If adopted, these proposals would impose additional Form D filing requirements, including before the use of general solicitation, and would penalize an issuer for not filing a Form D.[1]

The final amendments became effective and the comment period for the proposed amendments ended on November 4, 2013.

This article will explain the new rules in detail and their effects as well as describe the opportunities that are now available.

I. Repeal of the Ban on General Solicitation for Private Placements

Introduction

The SEC approved the long awaited rules that eliminate the prohibition against general solicitation in offerings under Rule 506 of Regulation D and Rule 144A under the Securities Act.

Existing Safe Harbor under Rule 506(b) Remains

Existing Rule 506 permits sales to an unlimited number of accredited investors and up to 35 non-accredited investors, so long as there is no general solicitation, appropriate resale limitations are imposed, applicable information requirements are satisfied, and the other conditions of the rule are met.[2] Rule 506 is the most widely used of the three exemptive rules for limited offerings under Regulation D, accounting for an estimated 90% to 95% of all Regulation D offerings.[3]

Essentially, the new amendments create a new and distinct method of conducting private offerings, leaving the old methods untouched and available for use. Companies seeking investments can now choose whether they want to use one of the classic private placement methods or, alternatively, the new method that permits general solicitation and advertising.

As expected, the new method introduced by the SEC is a mixed blessing. To protect potential investors that may be affected and influenced by public solicitations, the new rules contain a set of checks and balances that, in some cases, may be more burdensome than the classic methods (which require avoiding general solicitation).

An analysis of the choices of private placement exemptions is attached as Appendix 1.

New Rule 506(c) Permits Private Placements with General Solicitation

The SEC has adopted new Rule 506(c), which permits an issuer to offer and sell securities by means of general solicitation, provided that the following conditions are met:

- All purchasers of the securities must be accredited investors (as defined in Rule 501(a) of Regulation D), at the time of the sale of the securities, i.e., either they in fact are all accredited investors or the issuer reasonably believes that they are.[4]
- The issuer takes "reasonable steps to verify" that all purchasers of the securities are accredited investors (see detailed analysis below).
- All other conditions of existing Rules 501 (definitions), 502(a) (integration restriction) and 502(d) (resale limitations) of Regulation D are met.

Reasonable Steps to Verify Accredited Investor Status Is Left Flexible

Verification Required

Under Rule 506(c) issuers must take "reasonable steps to verify" that purchasers of the offered securities are accredited investors. This requirement is separate from the requirement that sales must be limited to accredited investors and must be satisfied even if all purchasers are accredited investors.

Generally, under the new Rule 506(c), it is not sufficient verification for issuers to solely rely on "self-certification" by potential investors who merely check a box in a questionnaire or sign a document containing investor representations. Consequently, issuers conducting an offering under new Rule 506(c) must supplement investor self-certification methods with additional reasonable steps to verify accredited investor status.

Reasonable Verification Steps Must Be Taken

The SEC did not mandate any specific verification steps. Rather, whether the steps taken are "reasonable" will be an objective determination by the issuer (or those acting on its behalf), dependent on the particular facts and circumstances of each purchaser and transaction. This principles-based method of verification by consideration of the particular facts and circumstances of each purchaser and transaction includes a consideration of:

1. The nature of the purchaser and the type of accredited investor that the purchaser claims to be.
2. The amount and type of information that the issuer has about the purchaser.
3. The nature of the offering, such as the manner in which the purchaser was solicited to participate in the offering, and the terms of the offering, such as the minimum investment amount.

Nature of the Purchaser

The steps that will be reasonable to verify whether a purchaser is an accredited investor will vary depending on the type of accredited investor that the purchaser claims to be. For instance, verification of accredited investor status of natural persons poses greater practical difficulties than other categories of accredited investors. Natural persons may be accredited investors based on either a "net worth test" or an "income test."[5] It might be more difficult for an issuer to obtain information about the assets and liabilities that determine a person's net worth, particularly the liabilities, than it would be to obtain information about a person's annual income. There could also be privacy concerns with either test.

Information About the Purchaser

The more information an issuer has indicating that a prospective purchaser is an accredited investor, the fewer additional verification steps it may have to take, and vice versa. If an issuer has actual knowledge that the purchaser is an accredited investor, then the issuer will not have to take any additional verification steps at all. The following are examples of the types of information an issuer could rely upon:

- Publicly available information in filings with a federal, state or local regulatory body.
- Third-party information that provides reasonably reliable evidence that a person is an accredited investor, such as Form W-2 provided by a natural person.
- Third-party verification of a person's status as an accredited investor, provided that the issuer has a reasonable basis to rely on the third-party verification.

The Nature and Terms of the Offering

An issuer that solicits new investors from the general public (e.g., through a generally accessible website, a widely disseminated email, social media, or through print media, such as a newspaper), will likely have to take greater measures to verify accredited investor status than an issuer that solicits new investors from a database of pre-screened accredited investors created and maintained by a reasonably reliable third party (provided that the issuer has a reasonable basis to rely on that third-party verification).

Additionally, if a purchaser must meet a minimum investment amount that is sufficiently high such that only accredited investors could reasonably be expected to participate, and the issuer has taken reasonable steps to verify that such purchaser's investment is not being financed by the issuer or by any third party, then such minimum investment requirement might be considered sufficient verification, and the issuer need not take any additional steps to verify the purchasers' accredited investor status. However, the SEC did not provide any guidance as to what amount might be high enough.

The principles described above are interconnected and would affect the types of steps that would be reasonable to take to verify a purchaser's accredited investor status. After considering the facts and circumstances of the purchaser and of the transaction, the more likely it appears that a purchaser qualifies as an accredited investor, the fewer steps the issuer would have to take to verify accredited investor status, and vice versa.

Issuer Must Keep Adequate Records of Verification Steps

The issuer has the burden of demonstrating that its offering is entitled to an exemption from the registration requirement of Section 5 of the Securities Act. Consequently, issuers and their verification service providers must retain adequate records of the steps taken to verify that a purchaser was an accredited investor.

Appendix 2 is a chart describing the interaction of the verification factors described above.

Non-Exclusive, Optional Methods of Verifying Accredited Investor Status of Natural Persons

In addition to the principles-based approach to verification described above, the SEC included in Rule 506(c) four specific "safe harbor" methods of verifying accredited investor status for natural persons that, if used, meet the verification requirement in Rule 506(c). However, if the issuer or its agent has actual knowledge that the purchaser is not an accredited investor, none of these methods will meet the verification requirement. These methods are not exclusive and issuers are not required to use any of the methods discussed below. Issuers can alternatively use the principles-based approach by applying the reasonableness standard directly to the specific facts and circumstances presented by the offering and the investors.

Reports to the IRS

For verifying a natural person as an accredited investor on the basis of income, an issuer may rely on any Internal Revenue Service ("IRS") form that reports income[6] for the two most recent years, along with obtaining a written representation from the person that he or she has a reasonable expectation of reaching the income level necessary to qualify as an accredited investor during the current year.[7]

Financial Reports

For verifying a natural person as an accredited investor on the basis of net worth, an issuer will rely on one or more of the following types of documentation, dated within the prior three months, together with a written representation from the person that all liabilities necessary to make a determination of net worth have been disclosed.[8]

A. **For assets**: bank statements, brokerage statements and other statements of securities holdings, certificates of deposit, tax assessments and appraisal reports issued by independent third parties; and

B. **For liabilities**: a consumer report (i.e., a credit report) from at least one of the nationwide consumer reporting agencies.

Third Party Certifications

For verifying a natural person as an accredited investor under either the "income test" or the "net worth test," an issuer may rely on a written confirmation from a registered broker-dealer, a registered investment adviser, a licensed attorney, or a certified public accountant that such person or entity has taken reasonable steps to verify that the purchaser is an accredited investor within the prior three months and has determined that such purchaser is an accredited investor. An issuer may rely on the verification of accredited investor status by a person or entity other than one of these parties, provided that the third party takes reasonable steps to verify that purchasers are accredited investors and the issuer has a reasonable basis to rely on the verification.

Prior Investments

For any natural person who invested in an issuer's Rule 506(b) offering as an accredited investor before the effective date of Rule 506(c) and remains an investor of the issuer, then for any Rule 506(c) offering conducted by the same issuer, the issuer may rely on a certification by that investor at the time of sale that he or she qualifies as an accredited investor.

Rule 506(c) Securities are "Covered Securities" for Blue Sky Purposes

As new Rule 506(c) will continue to be treated as a regulation issued under Section 4(a)(2), the securities issued in a Rule 506(c) offering will be "covered securities" for purposes of Section 18(b)(4)(E) of the Securities Act. Therefore, state "blue sky" registration requirements will be pre-empted and not apply to securities offered and sold in Rule 506(c) offerings.

Form D Check the Box for Rule 506(c) Offerings

Form D is the notice of sales, which is filed for an exempt offering of securities conducted under Regulation D. An issuer offering or selling securities in reliance on Rule 506 must file a Form D with the SEC for each new offering of securities within 15 calendar days after the first sale of securities in the offering. Issuers conducting a Rule 506(c) offering must indicate that they are relying on the Rule 506(c) exemption by marking a new check box in Item 6 of Form D. An issuer will not be permitted to check both the Rule 506(b) and Rule 506(c) boxes at the same time for the same offering because once a general solicitation has been made to the purchasers in the offering, an issuer cannot rely on Rule 506(b) (because it remains subject to the prohibition against general solicitation).

Implications for Private Funds

Private investment funds typically rely on the Section 3(c)(1) or 3(c)(7) exclusion from registration under the Investment Company Act of 1940 (the "Investment Company Act"), which prohibits issuers relying on those exclusions from making a public offering of their securities. The SEC confirmed that private funds may engage in a Rule 506(c) offering with general solicitation and still rely on Section 3(c)(1) or (7). However, the rule amendments did not address CFTC exemptions relating to "marketing to the public." Additionally, if private funds choose to engage in general solicitation, they should review their policies and procedures regarding the nature and content of their sales literature so that those policies and procedures are reasonably designed to prevent the use of fraudulent or misleading materials.

Pre-Existing Substantive Relationships With Investors

The SEC also reaffirmed its 2007 guidance regarding general solicitation and pre-existing, substantive relationships. Consequently, where an issuer had pre-existing, substantive relationships with the offerees, it may still rely on Rule 506(b) notwithstanding a general solicitation.[9]

Inability to Fall back on the General 4(a)(2) Exemption

The elimination of the ban on general solicitation applies only for offerings conducted under Rule 506(c), and not to offerings conducted under Section 4(a)(2).

Therefore, an issuer relying on Section 4(a)(2) will not be permitted to make public communications to solicit investors for its offering. Accordingly, an issuer engaging in a general solicitation under Rule 506(c) must take particular care to satisfy all the Rule's requirements because Section 4(a)(2) will not be available for a failed Rule 506(c) offering.

General Solicitation Permitted in Rule 144A Offerings

The SEC revised Rule 144A to provide that in a Rule 144A offering, securities may be offered to persons who are not qualified institutional buyers ("QIBs"), including by means of general solicitation, provided the securities are sold only to persons that the seller and any person acting on its behalf reasonably believe is a QIB.

The SEC also amended Regulation M (Rules 101, 102 and 104) to permit transactions in Rule 144A securities during a distribution of those securities under Rule 144A, even if the securities were offered to non-QIBs.

The general solicitation that is now permitted in Rule 144A resales from the initial purchaser to the QIBs will not affect the availability of the Section 4(a)(2) exemption or the Regulation S exclusion for the initial sale of securities by the issuer to the initial purchaser.

Regulation S Offerings Remain Unaffected

Regulation S provides a safe harbor for offers and sales of securities outside the United States, provided that the securities are sold in an offshore transaction and the issuer has not engaged in any "directed selling efforts" in the United States. Consistent with the historical treatment of concurrent Regulation S and Rule 144A / Rule 506 offerings, offerings outside the United States under Regulation S will not be integrated with concurrent unregistered offerings in the United States under Rule 506(c) or Rule 144A with general solicitation.

Transition

For an ongoing offering under Rule 506 that commenced before November 4, 2013, the effective date of new Rule 506(c), the issuer may choose to continue the offering after the effective date under either Rule 506(b) or Rule 506(c). If an issuer chooses to continue the offering under Rule 506(c), any general solicitation after the effective date will not affect the exempt status of offers and sales of securities that occurred before the effective date under Rule 506(b).

Considerations for Broker-Dealers Participating in Offerings under Rule 506(c)

Regulation of broker-dealers has consistently increased and become more complex in the past few years, requiring more diligence on the part of broker-dealers and a higher standard of investigation. This level of regulation will only increase once general solicitation is permitted in private placements. Broker-dealers participating in offerings with issuers relying on Rule 506(c) will face new challenges and obligations in their compliance efforts, which include:

Due Diligence

A broker-dealer participating in a private placement must exercise a "high degree of care" in conducting a due diligence investigation of the issuer and the securities being sold through the private placement. While a broker-dealer's participation in the general solicitation of a private placement through the use or distribution of marketing or offering materials does not, by itself, require the broker-dealer to conduct an analysis of whether the recommended transaction is "suitable" for the investor, the broker-dealer does have a duty to conduct adequate due diligence. Broker-dealers will also likely be called on by issuers to assist in the investor verification process.

Communications with the Public

Broker-dealers engaged in preparing general solicitation offering materials must ensure that the materials comply with all FINRA Rules relating to communications with the public,[10] which, among other things (a) generally require all member communications to be based on principles of fair dealing and good faith, to be fair and balanced and to provide a sound basis for evaluating the facts in regard to any particular security, industry or service; and (b) prohibit broker-dealers from making false, exaggerated, unwarranted, promises or misleading statements or claims in any communications.

Filing Requirements

On June 20, 2013, FINRA amended Rule 5123 to require the electronic filing of certain information and to seek due diligence information (to the extent known by the broker-dealers) concerning the offering, the issuer and its management by asking several new questions, including whether the issuer engaged, or is anticipated to engage, in general solicitation. These new disclosure obligations are an easy means for FINRA to determine whether members are satisfying their due diligence obligations in private placements, and it is expected that examinations and disciplinary actions will result from the new disclosure requirement.

II. New Rule 506(d) Disqualifies "Bad Actors" From Rule 506 Private Placements

Introduction

The SEC adopted Rule 506(d), which added "bad actor" disqualification provisions to Rule 506 of the Securities Act of 1933 (the "Securities Act"). These provisions render the Rule 506 exemption unavailable for an offering in which certain disqualified persons participate. This disqualification provision is triggered if the issuer or other "covered persons" (i.e., the issuers, underwriters, placement agents, directors, executive officers and significant shareholders) have been convicted of, or are subject to court or administrative sanctions for, securities fraud or other violations of specified laws. Before this amendment, Rule 506 did not contain a "bad actor" disqualification provision. These amendments have been adopted in order to implement Section 926 of Dodd-Frank.

The final rules went into effect November 4, 2013.

Who Is a "Bad Actor"?

The new disqualification provisions of Rule 506(d) apply to the following "covered persons:"

- the issuer and any predecessor of the issuer or affiliated issuer;
- any director, executive officer,[11] other officer participating in the offering, any general partner or managing member of the issuer;
- any beneficial owner of 20% or more of the issuer's outstanding voting equity securities, calculated based on total voting power of all equity securities;
- any investment manager[12] or an issuer that is a pooled investment fund and any director, executive officer, other officer participating in the offering, general partner or managing member of the investment manager as well as any director, executive officer or participating officer of any such general partner or managing member;
- any promoter[13] connected with the issuer in any capacity at the time of the sale;
- any person that has been or will be paid (directly or indirectly) for soliciting purchasers in connection with sales of securities in the offering (a "compensated solicitor"); and
- any director, executive officer, other officer participating in the offering, general partner or managing member of any compensated solicitor.

Although covered persons include affiliated issuers, Rule 506(d) does not disqualify certain affiliated issuers if the disqualifying event pre-dates the affiliate relationship.[14] Accordingly, orders, judgments and decrees entered against affiliated issuers before the affiliation arose do not disqualify an offering if the affiliated issuer is not (a) in control of the issuer, or (b) under common control with the issuer by a third party that controlled the affiliated issuer when the disqualifying event occurred.[15]

What Is a "Disqualifying Event"?

The following are "Disqualifying Events" under new Rule 506(d):

- a criminal conviction (felony or misdemeanor), entered within the last ten years for covered persons (five years for issuers): (a) in connection with the purchase or sale of any security, (b) involving the making of a false filing with the SEC, or (c) arising out of the conduct of the business of certain financial intermediaries (i.e., an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities);
- a court injunction or restraining order entered within five years before the sale, that restrains or enjoins such person from engaging in any conduct: (a) in connection with the purchase or sale of any security, (b) involving the making of a false filing with the SEC, or (c) arising out of the conduct of the business of certain financial intermediaries (i.e., an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities);[16]
- a final order issued by the CFTC, a federal banking agency, the National Credit Union Administration or a state regulator of securities, insurance, banking, savings associations, or credit unions, that either: (a) bars the person from associating with any entity regulated by the regulator, or from engaging in the business of securities, insurance or banking or from savings association or credit union activities; or (b) is based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct within ten years of the proposed sale of securities;
- a SEC disciplinary order[17] relating to a broker-dealer, municipal securities dealer, investment company or investment adviser that:
    a. Suspends or revokes such person's registration;
    b. Places limitations on the activities, functions or operations of such person; or
    c. Bars such person from being associated with any entity or from participating in the offering of a penny stock;
- an SEC cease-and-desist order, entered within five years before the sale, relating to a violation (or further violation) of a security-based anti-fraud provision of the federal securities laws or relating to a violation of Section 5 of the Securities Act:[18]
- a suspension, expulsion or bar from membership in an SRO or from associating with a member of, an SRO;[19]
- an SEC stop order applicable to a registration statement or order suspending use of the Regulation A exemption within the last five years or which is the subject at the time of sale of a proceeding to determine whether such a stop or suspension order should be issued; and
- a U.S. Postal Service false representation order entered within the last five years.

The new rule limits the term “final order” to one issued under statutory authority (including statutes, rules and regulations) that provides for notice and an opportunity for hearing. Thus, ex parte orders issued under statutory authority that do not provide for notice and an opportunity for hearing will not trigger disqualification. However, a hearing need not actually occur, which means that a settlement effected without a hearing may involve a final order. Additionally, an order may be final even if it is still subject to appeal.

Can You Avoid These New Regulations? Exemptions and Waivers

- *Reasonable Care Exemption*—New Rule 506(d) provides an exemption from disqualification for an offering if the issuer establishes that it did not know and, in the exercise of reasonable care, could not have known that a disqualifying event existed because of the presence or participation of another covered person. To establish the exercise of “reasonable care,” an issuer must make a factual inquiry into whether any disqualification exists, the extent of which will depend on the particular facts and circumstances. Questionnaires or certifications perhaps with contractual representations and agreements may be sufficient in some circumstances. The SEC also amended the signature block of Form D to include a certification for Rule 506 offerings that the offering is not disqualified for any of the reasons stated in Rule 506(d).

  For continuous or delayed offerings, reasonable care would include updating the factual inquiry on a reasonable basis dependent upon the circumstances. In the absence of facts indicating that close monitoring is needed, periodic updating is enough.

- *Waiver for Good Cause Shown*—The SEC may waive a disqualification if it determines upon a showing of good cause and without prejudice to any other action by the SEC that disqualification is not necessary under the circumstances.

- *Waiver Based on Determination of Issuing Authority*—If, before the relevant sale, the court or regulatory authority that entered the relevant order, judgment or decree advises in writing either in the order or separately to the SEC Staff that the order, judgment or decree should not result in disqualification under Rule 506, the SEC may grant a waiver.

Transition

Disqualification will apply only for triggering events that occur after the effective date of the amendments, i.e., November 4, 2013. However, prior events that would have triggered disqualification if they had occurred after the effective date will be subject to mandatory written disclosure. This disclosure must be provided a reasonable time before sale and be reasonably prominent and appropriately presented.

Sales of securities made before the effective date will not be affected by any disclosure or disqualification requirement, even if those sales are part of an offering that continues after the effective date.

The final amendments took effect November 4, 2013.

Procedures

Issuers and other participants that anticipate being involved in private placements relying on Rule 506 should develop procedures to: (a) identify the “covered persons” in the transaction, and (b) determine that no covered persons for such offerings have any disqualifying events. This stands true for both isolated and ongoing offerings.

III. Proposed Amendments to Regulation D, Form D, and Rule 156

Introduction

Several commentators voiced concerns about possible increased fraudulent activity in Rule 506 offerings as a result of lifting the ban on general solicitation and the resulting need to protect investors. Consequently, the SEC proposed amendments to Regulation D, Form D, and Rule 156 under the Securities Act to “enhance the SEC’s ability to evaluate the development of market practices in Rule 506 offerings and to address concerns that may arise with permitting issuers to engage in general solicitation under new Rule 506(c).”

Generally, the proposed amendments to Regulation D would require issuers to file a Form D in Rule 506(c) offerings before engaging in general solicitation, require issuers to file a closing amendment to Form D after the end of any Rule 506(c) offering, require certain legends and disclosures in general solicitation materials to be used in Rule 506(c) offerings, temporarily require submissions of written general solicitation materials used in Rule 506(c) offerings, and disqualify an issuer from depending on Rule 506 for one year for future offerings for failure to comply with Rule 506 Form D filing requirements in the last five years. The proposed amendments to Form D would oblige an issuer to provide additional information about offerings that rely on Regulation D, and the proposed amendments to Rule 156 would extend the rule’s guidance against fraud to apply to sales literature of private funds.

Proposed Amendments to Form D

A. Advance Filing of Form D at Least 15 Days Before Engaging in General Solicitation

The SEC has proposed changing the timing for filing Form Ds—requiring issuers that plan to engage in general solicitation for a Rule 506(c) offering to file an initial Form D. Currently, Rule 503 of Regulation D requires an issuer selling securities to file Form D within 15 calendar days of the first sale of securities in the offering. The proposed amendment would instead require issuers intending to engage in general solicitation under Rule 506(c) to file an initial Form D ("Advance Form D") at least 15 calendar days before commencing any general solicitation. After filing the Advance Form D, the issuer must file and amend the Form D to provide the remaining information required by Form D as well as update the information previously provided. Alternatively, an issuer could provide all the required information in its Advance Form D filing if possible. In Rule 506(b) offerings, the initial filing would be required to be made within 15 days after the first sale, i.e., the current filing requirement would remain unchanged.

The Advance Form D for a Rule 506(c) offering would require the following information:

1. Basic identifying information on the issuer;
2. Information on the issuer's principal place of business and contact information;
3. Information on related persons;
4. Information on the issuer's industry group;
5. Identification of the exemption or exemptions being claimed for the offering;
6. Indication of whether the filing is a new filing or an amendment;
7. Information on the type(s) of security to be offered;
8. Indication of whether the offering is related to a business combination;
9. Information on persons receiving sales compensation; and
10. Information on the use of proceeds from the offering.

This proposed amendment is intended to facilitate the SEC's efforts to assess the use of Rule 506(c).

B. Form D Closing Amendment Would Need to Be Filed After Terminating Any Rule 506 Offering

Issuers would be required to file a closing amendment to Form D within 30 days after the termination of any offering conducted under Rule 506(b) or Rule 506(c). Until this termination amendment is filed, the offering would be deemed ongoing and the issuer would be subject to the current requirements to file amendments to Form D at least annually and as otherwise needed to reflect changes in previously filed information.

C. Proposed Amendments Expanding the Information Requirements of Form D

The proposed revisions to Form D would require issuers to provide additional information for all offerings under Regulation D. This additional information is intended to enable the SEC to better understand the impact of Rule 506(c) on the Rule 506 offering market as well as to enhance an investor's understanding of issuers and their offerings.

The chart attached as Appendix 3 details the additional information that would be required.

One-Year Disqualification Penalty for Not Complying with Form D Filing Requirements

The SEC has also proposed an amendment to Rule 507 intended to improve filing compliance for Rule 506(c) offerings. Currently, Rule 507 disqualifies an issuer from using Regulation D only if a court enjoins the issuer or a predecessor or affiliate from violating the Form D filing requirements of Rule 503. The proposed amendment would automatically disqualify an issuer from relying on Rule 506 in any offering for one year if, within the past five years, the issuer or a predecessor or affiliate did not comply with the Form D filing requirements for a Rule 506 offering.[20] However, failure to comply with the filing requirements for a particular offering that has been completed or is ongoing would not preclude the availability of the exemption for that offering if the conditions of Rule 506 were met. Additionally, the five year look-back period would not extend to offerings made before the effective date of the proposed amendment.

The issuer would still be able to resort to a 30-day cure period if a Form D or amendment is not timely filed. However, the issuer would be able to rely on this cure period only once during each Rule 506 offering. The Director of the Division of Corporation Finance would also have discretion to waive a disqualification under appropriate circumstances.

Proposed Rule Amendments to Solicitation Materials

A. Legends and Disclosures for General Solicitation Materials Would Be Required

The SEC proposed new Rule 509, which requires issuers to include the following legends in all written general solicitation materials:

a. The securities may be sold only to accredited investors, which for natural persons, are investors who meet certain annual income or net worth thresholds;

b. The securities are being offered in reliance on an exemption from the registration requirement of the Securities Act and are not required to comply with specific disclosure requirements that apply to registration under the Securities Act;

c. The SEC has not passed upon the merits of or given its approval to the securities, the terms of the offering, or the accuracy or completeness of any offering materials;

d. The securities are subject to legal restrictions on transfer and resale and investors should not assume they will be able to resell their securities; and

e. Investing in securities involves risk, and investors should be able to bear the loss of their investment.

The written solicitation materials may combine two or more of the legends in a single sentence or use other wording, provided each disclosure is clear and easy to understand.

The SEC also addressed private funds (i.e., hedge funds, venture capital funds and private equity funds) and their ability to advertise to the general public in Rule 506(c) offerings. For private funds, the SEC proposed additional legends and disclosure requirements in their written general solicitation material. The additional required disclosure would be:

a. A legend indicating that the securities offered are not afforded the protection of the Investment Company Act.

b. If the materials include performance data, the issuer would have to include a legend providing either a telephone number or a website address where investors may obtain current performance data and state that:

   i. Performance data represents past performance;

   ii. Past performance does not guarantee future results;

   iii. Current performance may be higher or lower than the performance data presented;

   iv. The private fund is not required by law to follow any standard methodology when calculating and representing performance data; and

   v. The performance of the fund may not be directly comparable to the performance of other private or registered funds.

Any performance data included in written general solicitation materials would be required to reflect that of the most recent possible date considering the type of private fund and the media through which the data is to be conveyed, as well as require the issuer to indicate the time period for which the performance data coincides. If written general solicitation materials with performance data do not reflect a deduction of fees and expenses, the issuer would be required to disclose that fees and expenses have not been deducted and that performance may have been lower than presented had such fees and expenses been deducted.

The legend and other disclosures requirements proposed in Rule 509 would not be conditions for a Rule 506(c) exemption. Rather, the proposed amendment to Rule 507 would disqualify an issuer from using Rule 506 in later offerings if the issuer, or any of its predecessors or affiliates, has been enjoined by court order for non-compliance with proposed Rule 509.

B. Proposed Amendments to Rule 156

Rule 156 under the Securities Act provides guidance as to the types of information in sales literature for investment companies that would be fraudulent or misleading under the federal securities laws. The SEC proposed amending Rule 156 of the Securities Act to extend its guidance to sales literature of private funds (i.e., Section 3(c)(1) or 3(c)(7) exempt funds), whether in Rule 506(c) offerings or otherwise. Here, "sales literature" means any communication used to offer or sell securities of an investment company or private fund. In particular, the SEC is concerned that statements regarding past performance or performance outlook could mislead investors, as performance is often a primary factor when evaluating investment alternatives.

Proposed Two-Year Temporary Rule for Mandatory Submission of Written General Solicitation Materials

The SEC proposed new Rule 510T, which would require an issuer conducting a Rule 506(c) offering to submit to the SEC any written general solicitation materials prepared by or on behalf of the issuer and used in the offering. The issuer would be required to submit the materials via an intake page on the SEC's website on or before the date of first use. Materials so submitted would not be treated as "filed" or "furnished" under the Securities Act or Exchange Act,[21] including for purposes of the liability provisions of those Acts, and would not be made publically available nor subject to SEC Staff review. Rule 510T is intended to be a temporary measure, designed to expire two years after its effective date.

Complying with the submission requirements of proposed Rule 510T would not be a condition for a Rule 506(c) exemption. Instead, an issuer would be disqualified from using Rule 506 in later offerings if the issuer, or any of its predecessors or affiliates, has been enjoined by the court for non-compliance with proposed Rule 510T.

Endnotes

1. The rule releases are as follows:

   a. Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Release Nos. 33-9415, 34-69959, IA-3624 (July 10, 2013), *available at* http://www.sec.gov/rules/final/2013/33-9415.pdf.

   b. Disqualification of Felons and Other "Bad Actors," from Rule 506 Offerings, Release No. 33-9414 (July 10, 2013), *available at* http://www.sec.gov/rules/final/2013/33-9414.pdf.

c. Amendments to Regulation D, Form D and Rule 56, Proposed Rule Release Nos. 33-9416, 34-69960, IC-30595 (July 10, 2013), *available at* http://www.sec.gov/rules/proposed/2013/33-9416.pdf.

2. *See* 17 C.F.R. §§ 230.501–230.506 (2013).
3. *See supra* note 1-b, n.15.
4. If a person who does not meet the criteria for any category of accredited investor purchases securities in a Rule 506(c) offering, then the SEC believes that the issuer will not lose the ability to rely on Rule 506(c) for that offering, so long as the issuer took reasonable steps to verify that the purchaser was an accredited investor and had a reasonable belief that such purchaser was an accredited investor at the time of sale.
5. Under Rule 501(a)(5) of Regulation D, a natural person whose individual net worth, or joint net worth with that person's spouse, exceeds $1,000,000, excluding the value of the person's primary residence, is an accredited investor (the "net worth test"). Under Rule 501(a)(6) of Regulation D, a natural person who had an individual income in excess of $200,000 in each of the two most recent years, or joint income with that person's spouse in excess of $300,000 in each of those years, and has a reasonable expectation of reaching the same level of income in the current year, is an accredited investor (the "income test").
6. This includes a Form W-2 ("Wage and Tax Statement"), Form 1099 (report of various types of income), Schedule K-1 of Form 1065 ("Partner's Share of Income, Deductions, Credits, etc."), and a copy of a filed Form 1040 ("U.S. Individual Income Tax Return").
7. For a person who qualifies as an accredited investor based on joint income with that person's spouse, an issuer would meet the verification requirement in Rule 506(c) by reviewing copies of these forms for the two most recent years for, and obtaining written representations from, both the person and the spouse.
8. For a person who qualifies as an accredited investor based on joint net worth with that person's spouse, an issuer would meet the verification requirement in Rule 506(c) by reviewing the documentation described above for, and obtaining representations from, both the person and the spouse.
9. Securities &Exchange Commission, Reviews of Limiting Offering Exemptions in Regulation D, Release No. 33-8828 (2007), *available at* http://www.sec.gov/rules/proposed/2007/33-8828.pdf.
10. *See* FINRA Rule 2210. Further, FINRA already requires the pre-review of advertising materials and the same will be true for those materials distributed in a general solicitation. Accordingly, FINRA members may find it difficult to advertise effectively while still complying with FINRA rules.
11. The term "executive officer" is defined in Rule 501(f) of Regulation D (and in Rule 405) to mean a company's "president, any vice president in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy making function or any other person who performs similar policy making functions." Securities Act of 1933 Rule 501(f), 17 C.F.R. § 230.501(f) (2013); *see also* 17 C.F.R. § 230.405.
12. The SEC used the term "investment manager" rather than the narrower term "investment adviser," so as to capture control persons of funds that invest in assets other than securities.
13. In Rule 504, the term "promoter" captures all individuals and entities that have the relevant relationships with the issuer or to the offerings. 17 C.F.R. § 230.405. Rule 506(d) covers "any promoter connected with the issuer in any capacity at the time of such sale." 17 C.F.R. § 230.506(d).
14. *See* 17 C.F.R.§ 230.506(d)(3) (Rule 506(d)(3)).
15. *See supra* note 1-b.
16. Orders that have expired or are otherwise no longer in effect are not disqualifying, even if they were issued within the relevant look-back period. *Id.* at 36 n.113. A person is "subject to" an order only if specifically named in the order. *Id.*
17. SEC disciplinary orders are disqualifying only for as long as some act is prohibited or required to be performed. Thus, censures and orders to pay civil money penalties (if paid) are not disqualifying, and a disqualification based on a suspension or limitation of activities expires when the suspension or limitation expires.
18. Section 5 of the Securities Act is a strict liability provision.
19. "Self Regulatory Organizations" i.e., a registered national securities exchange or a registered national or affiliated securities association.
20. The one-year period would begin once all required Form D filings are made.
21. However, the materials would probably be accessible through a Freedom of Information Act request.
22. Amendments to Regulation D, Form D and Rule 156 under the Securities Act, 78 Fed. Reg. 44,806, (Jul. 10, 2013) (to be codified at 17 C.F.R. pt. 203 & 239) (stating generally, "this amendment would be relevant only to issuers that have securities of the same class as the offered securities traded on a national securities exchange, alternative trading system…or any other organized trading venue").
23. *Id.* (stating the SEC would be interested in learning how the proceeds would be used "(1) to repurchase or retire the issuer's existing securities; (2) to pay offering expenses; (3) to acquire assets, otherwise than in the ordinary course of business; (4) to finance acquisitions of other businesses; (5) for working capital; and (6) to discharge indebtedness").

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Appendix 1
The Choice of Private Placement Exemptions

The following table summarizes the main differences between the three main private placement exemptions from registration:

<table>
<tr><th></th><th>4(a)(2) Offering</th><th>506(b) Offering</th><th>506(c) Offering</th></tr>
<tr><td>Manner of Offering: General Solicitation</td><td colspan="2">Publicity is restricted; no general solicitation is permitted to solicit investors.

Generally, only permissible offerees are those with pre-existing, substantive relationship.</td><td>General Solicitation Permitted.</td></tr>
<tr><td>Eligible Investors</td><td>Number of offerees and sales are limited.

Offerees must be sophisticated (e.g., accredited investors).</td><td>Unlimited accredited investors and up to 35 non-accredited, sophisticated investors.</td><td>Accredited investors only.</td></tr>
<tr><td>Verification Requirements</td><td colspan="2">No verification required by the issuer.

Self-certification by the investor of qualification as an accredited investor is sufficient.</td><td>The issuer must take “reasonable steps” to verify that each investor is an accredited investor. What steps will be considered reasonable depend on the nature of the investor, the information the issuer has about the investor and the nature of the offering (see Appendix 2).</td></tr>
<tr><td>Limitations on Resale</td><td colspan="3">Securities acquired in a private placement are subject to resale restrictions for six months or one year.</td></tr>
<tr><td>Inadvertent Compliance Failure</td><td>No safe harbor.</td><td>Can rely on 4(a)(2) offering.</td><td>4(a)(2) offering is not available because of general solicitation.</td></tr>
<tr><td rowspan="2">Anti-Fraud Rules</td><td colspan="3">Communications under all offerings are subject to the general anti-fraud provisions of federal securities laws.</td></tr>
<tr><td colspan="2"></td><td>Greater risk of running afoul of the anti-fraud rules while engaging in general solicitation.</td></tr>
<tr><td>Filing; Notice of Sale</td><td>No filing.</td><td>Filing Form D within 15 days after first sale.</td><td>Advance filing; proposed filing of advance Form D would be required at least 15 days before commencing general solicitation.

The advance filing will require additional disclosure.

The issuer will also be required to amend the Form D within 15 days after the sale of securities to provide any remaining information.</td></tr>
</table>

<table>
<tr><td rowspan="2">Blue Sky Preemption</td><td rowspan="2">No preemption; state blue sky rules apply.</td><td colspan="2">Securities issued under either a Rule 506(b) or 506(c) offering are considered “covered securities”; state blue sky registration requirements do not apply (notice and fees remain).</td></tr>
<tr><td></td><td>In states that have exemptions based upon private offerings where general solicitation is not permitted, 506(c) offerings may be required to provide additional notice filings and fees.</td></tr>
<tr><td>Integration</td><td>Five factors test to determine integration of offerings.</td><td colspan="2">Safe harbor from integration provided for 6 month gap with no offers or sales of securities between offerings; otherwise, five factors test.</td></tr>
<tr><td>Possibility to Continue the Offering Under a Different Method</td><td colspan="2">It is possible to terminate or complete a private placement under 4(a)(2) or 506(b) offering and commence a 506(c) offering.

Not yet clear whether an issuer may convert an ongoing offering to a 506(c) offering due to an inadvertent general solicitation, because 506(c) requires filing of Form D 15 days prior to such publication.</td><td>After engaging in general solicitation, an issuer cannot use 4(a)(2) or 506(b) offering.</td></tr>
</table>

The advantages and disadvantages of the new 506(c) offering compared to the regular 506(b) offering are as follows:

Main Advantage	Main Disadvantages
Availability of general solicitation and advertising	Verification requirements for accredited investor status of investors; more burdensome if including sales to natural persons.
	More burdensome Form D filing requirements may be required.
	Heightened exposure to anti-fraud rules.
	Inability to rely on the general 4(a)(2) exemption in the event of a failure to comply with a specific safe harbor requirement.
	Possible inability to transfer to a different exemption after general solicitation has been commenced.
	Possibly more state blue sky filing requirements (because of lack of pre-emption).
	Inability to have 35 non-accredited investors.

Appendix 2
Verification of Accredited Investor Status

Factors Issuers Should Consider	Specific Factors	“Reasonable Steps”
Nature of the purchaser and the type of accredited investor that the purchaser claims to be	Entity v. Natural Persons	The verification requirements, as applied to entities, may generally be more lenient than the requirements for natural persons.
	Entity: Purchaser’s status	Some entities may be accredited investors based on their status alone, such as a registered broker-dealer, a registered investment company or a business development company.
	Entity: Combination of purchaser’s status and amount of total assets	Some entities may be accredited investors based on a combination of their status and total assets, such as: a. *Status*: an employee benefit plan, plan established and maintained by the state or its political subdivisions, IRC Section 501(c)(3) organization, corporation, Massachusetts or similar business trust, partnership, or limited liability company, each with b. *Total assets* exceeding $5 million, and c. Not formed for the specific purpose of acquiring the securities offered.
	Natural Persons: Net worth or annual income	Natural persons may be accredited investors based on their net worth or annual income if: The person’s individual net worth, or joint net worth with his / her spouse, is in excess of $1 million, excluding the person’s primary residence; or The person had an individual income in excess of $200,000 in each of the last two years, or had a joint income with his / her spouse in excess of $300,000 in each of those years, and reasonably expects to reach the same income level in the current year.
The amount and type of information that the issuer has about the purchaser	Publicly available information in filings with a federal, state or local regulatory body	An issuer may have taken reasonable steps if the purchaser is named executive officer of an Exchange Act registrant, and the registrant’s proxy statement discloses the purchaser’s compensation; or the purchaser claims to be an IRC Section 510(c)(3) organization with $5 million in assets and the organization’s Form 990 series return indicates the organization’s total assets.
	Third-party information	Third-party information that provides reasonably reliable evidence that a person falls under the accredited investor definition may constitute reasonable steps for verification.
	Third-party verification	Third-party verification of a person’s status as an accredited investor, as long as the issuer has a reasonable basis to rely on such third party verification, may constitute reasonable steps.
	Actual knowledge	If an issuer has actual knowledge that the purchaser is an accredited investor, no additional steps are need.
	Questionnaire or form	An issuer that publicly solicits investors—through a public website, widely circulated email, social media, or print media—will likely need to take more steps, unlike an issuer that relies on a pre-screened database of accredited investors maintained by a reliable third-party.
The nature and terms of the offering	Minimum investment amount	A purchaser’s ability to satisfy high minimum investment amounts with a direct cash investment that is not financed by the issuer or by a third-party, may help verify a purchaser’s accredited investor status.

Four Methods to Verify Accredited Investor Status for Natural Persons (Non-Exclusive List)	
Basis	**Verification Method for the Issuer**
Income	Review copies of all IRS forms that report income for the two most recent years and obtain a written representation from such person that he or she has a reasonable expectation of reaching the income level necessary to be considered an accredited investor for the current year.
Net worth	Review one or more of the following documents dated within the prior three months, and obtain a written representation from such person that all liabilities affecting net worth have been disclosed: For assets: bank statements, brokerage statements and other security holdings statements, certificates of deposit, tax assessments and appraisal reports. For liabilities: consumer reports (credit report) from one of the nationwide reporting agencies.
Written confirmation from a third party	Obtain written confirmation from a registered broker-dealer, registered investment adviser, a certified public accountant, or a licensed attorney that the person or entity has taken reasonable steps to verify the purchaser's status as an accredited investor within the prior three months and has determined that such purchaser is an accredited investor.
Grandfathering of existing investors	Obtain certification from existing investors that invested in an issuer's Rule 506(b) offering as an accredited investor before the effective date of Rule 506(c), stating that such investors qualify as accredited investors.

Appendix 3
Proposed Amendments to Form D Information Requirements

Item #	Current Information Requirement	Proposed Revision
2	Issuer's principal place of business and contact information	Add issuer's publicly accessible website address.
3	Information about "related persons"—executive officers, directors, persons performing similar tasks as the issuer, and persons who have functioned as an issuer's promoter within the last five years	Name and address of any person who directly or indirectly controls the issuer.
4	The issuer must designate its industry group from a stated list	Require clarification if the issuer chooses "Other."
5	Information on the issuer's size	Include a "Not Available to Public" option instead of the existing "Decline to Disclose" option.
7	Indicate whether a Form D is an initial filing or an amendment	Specify whether the form is an Advance Form D or a closing Form D.
9	Identify the types of securities offered	Include information about the trading symbol and a generally available security identifier.[22]
14	Information on whether securities may have been or may be sold to non-accredited investors and the number of investors who have already invested in the offering	Information on the non-accredited and accredited investors that have taken part in the offering, their classification as a natural person or legal entity, and the amount invested by each category.
16	Use of proceeds from the offering	Identify how the issuer used or plans to use the gross proceeds of the offering for payments to related persons.[23]
17 through 22		Provide additional information, including information about the types of accredited investors that purchased securities, whether the securities are on any organized trading venue or registered under the Exchange Act, whether the issuer used a registered broker-dealer in the offering, whether any general solicitation materials were filed with FINRA, information for each pooled investment fund adviser functioning as the issuer's direct or indirect promoter, the types of general solicitation materials used or to be used in Rule 506(c) offerings, and the methods used to verify accredited investor status in Rule 506(c) offerings.

The End of Conflicts of Interest?: Courts Warm Up to Advance Waivers

By C. Evan Stewart

One of the greatest comedic teams of the 20th Century was George Burns and Gracie Allen. Their television show, which came after a long career in vaudeville and radio, ran from October 12, 1950 until September 22, 1958; it was (and is) a classic. Burns, the straightman, would end each show with "Say goodnight, Gracie." Allen's response: "Goodnight."[1] Pretty simple, huh?

We lawyers, of course, love the opposite: complexity. And no part of lawyers' ethical obligations seems quite as complex as that of conflicts of interest; and within that field itself, the most puzzling set of issues tends to relate to the doctrine of advance waivers.

The "Good" Old Days?

Once upon a time, advance waivers were looked upon with a high level of suspicion, at best.[2] After all, the notion of a lawyer asking her client to agree to the lawyer being adverse to it at some point in the future does seem to run counter to the historical, laser-like beam of undivided (and zealous) loyalty that is at the bedrock of our profession.[3]

But the American Bar Association seemed eager to change all that in 2002, when it enacted the current version of Model Rule 1.7; advance waivers were now to be countenanced, so long as the client gives "informed" consent. According to the ABA, informed consent requires that a waiving client must "reasonably understand[ ] the material risk that the waiver entails."[4] The criteria for such an understanding include, *inter alia*: (i) a (more) detailed statement of the type of engagements that might be undertaken; (ii) a (more) detailed statement of the "reasonably foreseeable adverse consequences" of said engagements; (iii) whether the "particular type of conflict" is one with which the waiving client is familiar; (iv) whether the waiving client is "an experienced user of the legal services" at issue; (v) whether the waiving client is represented by other counsel for purposes of giving consent; and (vi) whether the consent is limited to prospective engagements unrelated to the current representation.[5]

In the years that followed the 2002 version of ABA Model Rule 1.7, courts took dramatically different approaches to advance waivers,[6] and even practitioners that routinely used advance waivers in client retainer agreements doubted their efficacy.[7] Two new cases, however, would suggest that the future has arrived, big time.

A "Brave" New World?

The first case is *Galderma Laboratories v. Actavis Mid Atlantic*.[8] There, a federal judge in the Northern District of Texas ruled that a general, open-ended advance waiver with a sophisticated corporate client represented by in-house counsel made it permissible for Vinson & Elkins to represent the client's opponent in unrelated litigation.

The client that sought Vinson's disqualification was Galderma Laboratories (and two of its affiliates). Galderma had first retained Vinson in 2003 for advice on employment and H.R. issues. At that time, the company's general counsel executed Vinson's retainer agreement, which included the following provision:

> We [Vinson] understand and agree that this is not an exclusive agreement, and you [Galderma] are free to retain any other counsel of your choosing. We recognize that we shall be disqualified from representing any other client with interests materially and directly adverse to yours (i) in any matter which is substantially related to our representation of you and (ii) with respect to any matter where there is a reasonable probability that confidential information you furnished to us could be used to your disadvantage. You understand and agree that, with those exceptions, we are free to represent other clients, including clients whose interests may conflict with yours in litigation, business transactions, or other legal matters. *You agree that our representing you in this matter will not prevent or disqualify us from representing clients adverse to you in other matters and that you consent in advance to our undertaking such adverse representations*. (emphasis added).

Fast forward to 2012, when Galderma brought a patent infringement case against Actavis Mid Atlantic. Vinson, which had previously represented Actavis on intellectual property matters, was retained to defend the company. Galderma asked Vinson to stand down. Vinson instead terminated its attorney-client relationship with Galderma. Galderma's motion to disqualify followed shortly thereafter.

Interestingly, Judge Ed Kinkeade did not apply Texas state ethics rules in ruling on the disqualification motion

(Texas allows lawyers to oppose current clients in most unrelated matters *without* getting the client's informed consent). Rather, he looked to the ABA's Model Rule 1.7 because he wanted to apply the "national" standard. Judge Kinkeade then broke down the informed consent issue into two questions: (i) did Vinson give reasonably adequate disclosure for a generic client; and (ii) was such disclosure adequate for *this* client. He answered yes to both questions and then denied Galderma's motion.

The key to Judge Kinkeade's ruling appears to have been his focus on the sophistication of the company, the top-flight law firms the company regularly retains (beyond Vinson), and (most particularly) the expertise and experience of Galderma's general counsel—who was the signatory to the 2003 retainer agreement. In reaching his decision, Judge Kinkeade recognized that he was doing so in the face of a prior federal court decision on very similar facts: *Celgene Corp. v. KV Pharm Co.*[9] Taking that decision head on, the judge found it inapposite for several reasons: (i) he noted that New Jersey has a different, stricter standard of what constitutes "full disclosure and consultation;" (ii) he found that the *Celgene* court's looking to whether the waiver identified particular risks (e.g., potential classes of adversaries or disputes) was no longer important in light of the ABA's 2002 action; and (iii) he disagreed that having "independent" counsel judge the advance waiver was important (following *Celgene* "would ignore the knowledge and advantage that clients gain by employing their own counsel to advise them").

Judge Kinkeade did acknowledge that Vinson's general waiver language might not work in all cases.[10] But in this one, and for Galderma, he ruled that it did.

Even more recently, New York's First Department upheld an advance waiver in *Macy's Inc. v. J.C. Penney Corp.*[11] There, the court affirmed a lower court's ruling that allowed the Jones Day law firm to represent Macy's in a bitter contract dispute with J.C. Penney over the use of Martha Stewart's products.

In 2008, Jones Day had been retained by J.C. Penney to represent the company with respect to Asian trademark matters. The law firm's engagement letter included a very broad advance waiver provision:

> Jones Day represents and in the future will represent many other clients. Some may be direct competitors of J.C. Penney or otherwise may have business interests that are contrary to J.C. Penney's interests. It is even possible that, during the time we are working for you, an existing or future client may seek to engage us in connection with an actual or potential transaction or pending or potential litigation or other dispute resolution proceeding in which such client's interests are or potentially may become adverse to J.C. Penney's interests.
>
> Jones Day cannot enter into this engagement if it could interfere with our ability to represent existing or future clients who develop relationships or interests adverse to J.C. Penney. We therefore ask J.C. Penney to confirm that Jones Day may continue to represent or may undertake in the future to represent any existing or future client in any matter (including but not limited to transactions, litigation or other dispute resolutions), even if the interests of that client in that other matter are directly adverse to Jones Day's representation of J.C. Penney, as long as that other matter is not substantially related to this or our other engagements on behalf of J.C. Penney. In the event of our representation of another client in a matter directly adverse to J. C. Penney, however, Jones Day lawyers or other service providers who have worked with J.C. Penney will not work for such other client, and appropriate measures will be taken to assure that proprietary or other confidential information of a non-public nature concerning J.C. Penney acquired by Jones Day as a result of our representation of J.C. Penney will not be transmitted to our lawyers or others in the Firm involved in such matter.
>
> In other words, we request that J.C. Penney confirm that (1) no engagement that we have undertaken or may undertake on behalf of J.C. Penney will be asserted by J.C. Penney either as a conflict or interest with respect to, or as a basis to preclude, challenge or otherwise disqualify Jones Day from, any current or future representation of any client in any matter, including without limitation any representations in negotiations, transactions, counseling or litigation adverse to J.C. Penney, as long as that other matter is not substantially related to any of our engagements on behalf of J.C. Penney, (2) *J.C. Penney hereby waives any conflict of interest that exists or might be asserted to exist and any other basis that might be asserted to preclude, challenge or otherwise disqualify Jones Day in any representation of any other client with respect to any such matter,* (3) J.C. Penney has been advised by Jones Day, and has had the opportunity to consult with other counsel, with respect to

the terms and conditions of these provisions and its prospective waiver, (4) J.C. Penney's consent to these provisions is both voluntary and fully informed, and (5) J.C. Penney intends for its consent to be effective and fully enforceable, and to be relied upon by Jones Day.

***

Please sign and return to us the enclosed copy of this letter in order to confirm that it accurately reflects the scope, terms and conditions with respect to this engagement. However, please note that your instructing us or continuing to instruct us on this matter will constitute your full acceptance of the terms set out above and attached. If you would like to discuss any of these matters, please give me a call. (emphasis added).

J.C. Penney never signed the retainer letter. Notwithstanding, Jones Day went forward with representing the company, and several years later it also sued J.C. Penney on behalf of Macy's.

In the litigation with Macy's, J.C. Penney sought Jones Day's disqualification, arguing that this was the broadest, most open-ended advance waiver provision, with no attempt whatsoever to identify the types of possible future adverse representations, clients, or matters.[12] Not surprisingly, the company also contended that it had never agreed to such a waiver, noting that it did not execute the retainer agreement.

Neither argument was persuasive, however. The First Department emphasized the clear and unambiguous language of the waiver; clearly the Macy's case is subsumed under that language. As for the non-execution issue, the court ruled that J.C. Penney's conduct constituted a contractual "yes," given that the retainer agreement had an express negative consent provision (which is highlighted above); thus, the fact that Jones Day actually did the Asian trademark work equaled the client's complete assent to all the contractual terms of the retainer agreement.

Lessons to Be Learned

As we watch the dust settle, the quick and dirty lessons from these two decisions are at least the following. The first is: make sure what law applies to the retainer agreement. That Judge Kinkeade blithely brushed aside (seemingly applicable) Texas law to apply instead ABA Model Rule 1.7 is troubling; the ABA's Model Rules, after all, are not the "national" standard of anything—they are merely an aspirational set of rules which bind **no one** (each state is free to follow, amend, or reject each and every ABA Model Rule).[13] Given the continuing disparity in states' rules, as well as court rulings (*e.g.*, *Galderma v. Celgene*), making clear what law governs the attorney-client relationship is an important and necessary first step in this process.[14]

Next up would be for clients to take retainer agreements a little more seriously. Given the clear trend lines (disturbing as they are) to allow lawyers to bend and twist like pretzels in order to search for the deepest pocketed client, often at the expense of less well-heeled clients,[15] all clients need to think about pushing back on these advance waiver provisions. Once thought to be unenforceable (even by the lawyers who drafted them), a blind man can see that this is not where the case law is developing. Here is an area where in-house counsel can really earn their pay, or not (*e.g.*, the Galderma general counsel) because after the agreement is inked, it will be too late.[16]

And that leads to the last lesson: it would appear that sometimes a one-sided contract (drafted by one party) which is **not** executed **can** be an enforceable agreement. The First Department's decision in *Macy's* seems quite troublesome; indeed, it would have come as a big surprise to my very distinguished professor of contracts at law school! Whether the decision is good law outside of New York is unknown; but it is obviously good law (at least) in the First Department. Clearly, clients faced with this precedent cannot just say "no" silently or to themselves only.[17]

Conclusion

Chico Marx once famously remarked in *Duck Soup*, "Well, who you gonna believe, me or your own eyes?"[18] Prior to the *Galderma* and *Macy's* decisions, I would not have believed that the law with respect to advance waivers would today be where it appears to be. And given lawyers' desires to be on all sides of conflicted clients, it is just possible that the law in this area will get even whackier.[19] Stay tuned!

Endnotes

1. Contrary to legend, Allen never responded "Goodnight, Gracie." Burns was once asked why they did not use what he acknowledged would have been a funny line. His response: "Incredibly enough, no one ever thought of it."
2. *See, e.g.*, ABA Formal Op. 93-372 (1993); Richard W. Painter, *Advance Waiver of Conflicts*, 13 Geo. J. Legal Ethics 289 (2000).
3. *See* S. Rifkind, *The Lawyer's Role and Responsibility in Modern Society*, 30 The Record 534 (1975).
4. Model Rules of Prof'l Conudct R. 1.7 cmt. 22 (2011).
5. *Id.* These criteria differ from the prior criteria, which required a pretty specific identification of the nature of the likely future matter and the potential party or class of parties likely to be adverse. See ABA Formal Op. 05-436 (2005) (withdrawing ABA Formal Op. 93-372 and endorsing "open-ended" waivers where the waiving client is sophisticated or represented by counsel).
6. Compare Bringham Young Univ. v. Pfizer, Inc., 2010 WL 3855347 (D. Utah Sept. 29, 2010); Concat LP v. Unilever, PLC, 350 F. Supp.

2d 796 (N.D. Cal. 2004); McKesson Info. Solutions v. Duane Morris, No. 2006 CV 12110 (Fult. Super. GA 2006); Avocent Redmond Corp. v. Rose Electronics, 491 F. Supp. 2d 1000 (W.D. Wash. 2007); Colene Corp. v. KV Pharmaceutical Co., 2008 WL 2937415 (D.N.J. July 28, 2008) (all rejecting advance waivers) with Visa, U.S.A., Inc. v. First Data Corp., 241 F. Supp. 2d 1100 (N.D. Cal. 2003); St. Barnabas Hosp. v. New York City Health & Hosp. Corp., 7 A.D.3d 83, 775 N.Y.S.2d 9 (1st Dept. 2004); In re Shared Memory Graphics LLC, 659 F.3d 1336 (Fed. Cir. 2011); Gen. Cigar Holdings, Inc. v. Altadis, S.A., 54 F. App'x 492 (11th Cir. 2002) (all okaying advance waivers).

7. *See, e.g., ABA/BNA Lawyers' Manual on Professional Conduct*, 21 ABA / BNA Law, Manual on Prof. Conduct 96, 96–97 (Feb. 23, 2005) ("Advance consents are uniformly being used in large law firms, even though lawyers are doubtful that they'll hold up.") (Comment of Diane Karpman); *see also* Samson Habte, *In-House and Outside Counsel Often Divided on Issue of Advance Waivers, Panelists Say*, 29 ABA / BNA Law, Manual on Prof. Conduct 2, 2–3 (June 15, 2013).

8. Galderma Labs. v. Actavis Mid Atlantic, LLC, 927 F. Supp. 2d 390 (N.D. Tex. 2013).

9. 2008 WL 2937415 (D.N.J. July 29, 2008).

10. *See, e.g.*, GSI Commerce Solutions, Inc. v. Baby-Center, LLC, 618 F.3d 204 (2d Cir. 2010) (applying, *inter alia*, Model Rule 1.7 to bar advance waiver with respect to a corporate affiliate).

11. 107 A.D.3d 616 (1st Dept. June 27, 2013), *reported in* ABA / BNA Lawyer's Manual on Professional Conduct 393 (July 3, 2013).

12. *See supra* note 4.

13. See C. E. Stewart, *Lawyers and the Border Patrol: The Challenge of Multi-Jurisdictional Practice*, NY Business Law Journal 17 (Summer 2011).

14. Importantly, the ABA has recently "tweaked" ABA Model Rule 8.5 to allow for lawyers and clients to enter into a written agreement that specifies which jurisdiction's law will govern disputes with respect to conflicts of interest. See Model Rules of Prof'l Conduct R. 8.5 cmt. 5 (2011) ("With respect to conflicts of interest, in determining a lawyer's reasonable belief under paragraph (b)(2), a written agreement between the lawyer and client that reasonably specifies a particular jurisdiction as within the scope of that paragraph may be considered if the agreement was obtained with the client's informed consent confirmed in the agreement.").

15. See *supra* note 13.

16. Obviously, the maximum point of client leverage on this point is *before* the outside firm is retained.

17. Unfortunately, this is not the first idiosyncratic (and troubling) decision by the state courts of New York recently. *See* C.E. Stewart, *Ohio Takes a Bite Out of the Big Apple*, New York Business Law Journal (Fall 2012); C. E. Stewart, *Just When Lawyers Thought It Was Safe to Go Back Into the Water*, New York Business Law Journal (Fall 2011).

18. This famous line is frequently attributed to Chico's brother Groucho. In fact, it is delivered by Chico's character, Chicolini, who at that point in the movie is impersonating Rufus T. Firefly (Groucho). *Duck Soup* (Paramount 1933) is generally considered the Marx Brothers' best film.

19. My "favorite" example of this—thus far—is Pioneer-Standard Electronics Inc. v. Cape Gemini America Inc., 2002 WL 553460 (N.D. Ohio 2002) (court rejected Shearman & Sterling's attempt to drop a client like a "hot potato," instead allowing the firm to represent adverse clients in separate cases "with equal vigor").

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Inside the Courts

Prepared by Attorneys at Skadden Arps

AUDITOR LIABILITY

District of Columbia Lifts Stay on SEC Action Seeking to Enforce Subpoena for Audit Work-Papers Regarding U.S.-listed Chinese Foreign Issuer

***Sec. & Exch. Comm'n v. Deloitte Touche Tohmatsu CPA Ltd.*, No. 11-mc-512 (DAR); 2013 WL 1720512 (D.D.C. Apr. 22, 2013)**

Judge Gladys Kessler of the U.S. District Court for the District of Columbia granted the SEC's motion to lift the stay on an action seeking to enforce a subpoena for Deloitte's audit work-papers in connection with an ongoing SEC investigation into a U.S.-listed Chinese company. The action was previously stayed in light of a SEC administrative proceeding occurring in parallel and seeking to bar five accounting firms—including a China-based member audit firm of Deloitte—from practicing in front of the SEC. At issue in both proceedings is a refusal to produce audit work-papers to the SEC on the grounds that, under Chinese law, doing so would expose the firm to criminal liability in China. However, the Court held that Deloitte was unable to show that lifting the stay would cause substantial hardship or inequity—even though the subject of both proceedings overlapped to a certain extent—because (1) the proceedings sought different remedies, (2) the SEC's purported statutory basis for the two actions was different, and (3) both the administrative decision and the court's ruling on the subpoena would be appealable to the U.S. Court of Appeals for the District of Columbia Circuit, eliminating the risk of inconsistent rulings.

CONFIDENTIAL WITNESSES

S.D.N.Y. Grants Defendants' Request for Identities of Confidential Witnesses, Ruling the Names Are Not Protected by the Work Product Doctrine

***Fort Worth Emps. Ret. Fund v. J.P. Morgan Chase & Co.*, 862 F. Supp. 2d 322 (S.D.N.Y. 2013)**

In a securities class action, Judge James C. Francis of the U.S. District Court for the Southern District of New York granted the defendants' request for the identities of confidential witnesses relied upon in the complaint. Although the plaintiffs disclosed a list of 44 potential witnesses with information relevant to the case, they refused to identify the confidential witnesses. The court ruled that the names of confidential witnesses are not protected by the work product doctrine, even though some disagreement exists within the Southern District of New York. Further, the plaintiffs failed to show any concerns—such as employment retaliation—in disclosing the confidential witnesses, but the court allowed the plaintiffs to submit a supplementary affidavit identifying any such concerns. The court also granted the defendants' request for the dates on which the lead plaintiffs retained counsel because those dates were relevant to the defendants' statute of limitations argument. The court denied, however, requests for retainer agreements and agreements with counsel to monitor the status of the lead plaintiffs' investments because the defendants could not show that those documents were relevant to any claims or defenses, and the information contained by the documents could be elicited during depositions.

Derivative Litigation/Books and Records

District of New Jersey Orders Production of Corporate Books and Records Following Dismissal Without Prejudice of Underlying Derivative Suit

***City of Roseville Emp. Ret. Sys. v. Crain*, No. 11-2919 (JLL); 2011 WL 5042061 (D.N.J. Oct. 24, 2012)**

Magistrate Judge Michael A. Hammer of the U.S. District Court for the District of New Jersey ordered production of corporate books and records following the dismissal without prejudice of an underlying derivative suit for failure to adequately plead demand futility.

In so ruling, the court first determined that it had supplemental jurisdiction over the plaintiff's books and records made under New Jersey law despite the dismissal of the underlying derivative complaint because a without-prejudice dismissal "is not final for purposes of jurisdiction." Because jurisdiction was supplemental, the court found, in what it described as a "unique" procedural posture, that the plaintiff's inspection right must be "strictly limited" to the allegations made in the underlying dismissed complaint. The court also noted that a books and records request made pursuant to New Jersey Statute 14A: 5-28(4)—a statute modeled after the Model Business Corporation Act—must be "circumscribed with rifle precision" to a plaintiff's proper purpose. Recognizing that the company had already produced certain board and executive committee minutes, the court explained that a stockholder's inspection rights under New Jersey law are "broad" if properly connected to a proper purpose. Thus, the court ordered the further production of documents that "directly related" to certain allegations that were made in the dismissed complaint and that were "necessary" to address the plaintiff's demand futility deficiencies as discussed in the dismissal opinion.

DIRECTORS AND DIRECTORS' DUTIES

Bylaws

Delaware Court of Chancery Upholds Director-Enacted Forum Selection Bylaws

***Boilermakers Local 154 Ret. Fund v. Chevron Corp.*, 73 A.3d 934 (Del. Ch. 2013)**

Chancellor Leo E. Strine Jr. of the Delaware Court of Chancery held that director-enacted bylaws containing an exclusive forum provision are valid and enforceable as a matter of Delaware law. The forum selection bylaws at issue specified the Delaware courts as the exclusive forum in which stockholder derivative suits, fiduciary duty claims and other intra-corporate actions must be brought, unless otherwise consented to by the company. The court explained that the Delaware General Corporation Law "allows the corporation, through the certificate of incorporation, to grant the directors the power to adopt and amend the bylaws unilaterally. The certificates of incorporation of [the defendant corporations] authorize their boards to amend the bylaws…. In other words, an essential part of the contract stockholders assent to when they buy stock in [the defendant corporations] is one that presupposes the board's authority to adopt binding bylaws consistent with 8 *Del. C.* § 109.…Therefore, this court will enforce the forum selection bylaws in the same way it enforces any other forum selection clause…." The court noted, however, that "as-applied challenges to the reasonableness of a forum selection clause should be made by a real plaintiff whose real case is affected by the operation of the forum selection clause." The plaintiffs are pursuing an appeal of the decision.

Mergers and Acquisitions

Delaware Court of Chancery Dismisses Stockholders Complaint Challenging Acquisition, Applying the Enhanced Scrutiny of *Revlon*

***In re Morton's Rest. Grp., Inc. S'holders Litig.*, 74 A.3d 656 (Del. Ch. 2013)**

Chancellor Leo E. Strine Jr. of the Delaware Court of Chancery granted the defendants' motion to dismiss a complaint by stockholders challenging the purchase of Morton's Restaurant Group by affiliates of Landry's, Inc. The court applied the enhanced scrutiny of *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986), not the entire fairness standard of review, to the plaintiffs' fiduciary duty claims. In so doing, the court rejected the plaintiffs' argument that a large private equity stockholder's alleged need for liquidity required entire fairness review. The court explained that the plaintiffs "point to no authority under Delaware law that a stockholder with only a 27.7% block and whose employees comprise only two out of ten board seats creates a rational inference that it was a controlling stockholder," and even if they had, the plaintiffs "have failed to make any well-pled allegations indicating that [the private equity stockholder] had a conflict of interest with the other stockholders of Morton's."

In applying *Revlon*, the court explained that "[w]hen in the course of the pleading stage, the plaintiffs concede that the board reaches out to over 100 buyers, signs up over 50 confidentiality agreements, treats all bidders evenhandedly, and employs two qualified investment banks to help test the market, they provide no basis for the court to infer that there was any *Revlon* breach, much less a non-exculpated one, under our Supreme Court precedent in cases like *Lyondell Chemical Co. v. Ryan*." The court concluded by remarking that "[i]t is an example of a now too common invocation of the iconic *Revlon* case in a circumstance where the key problem in *Revlon*—board resistance to the highest bidder based on a bias against that bidder—is entirely absent."

Delaware Court of Chancery Applies Business Judgment Rule to Controlling Stockholder Going-Private Transaction

***In re MFW S'holders Litig.*, 67 A.3d 496 (Del. Ch. 2013)**

Chancellor Leo E. Strine Jr. of the Delaware Court of Chancery granted summary judgment in favor of the defendants in litigation following a controlling stockholder going-private transaction. The court held that the business judgment rule will apply to a merger proposed by a controlling stockholder where, from the outset, the offer is conditioned upon the "(i) negotiation and approval by a special committee of independent directors fully empowered to say no, and (ii) approval by an uncoerced, fully informed vote of a majority of the minority investors." The court emphasized that for the business judgment rule to apply, it must "be clear that the procedural protections employed qualify to be given cleansing credit…." The plaintiffs have appealed the decision.

Delaware Court of Chancery Explicates a Board's Duties in a Single-Bidder Change-of-Control Transaction

***Koehler v. NetSpend Holdings Inc.*, No. 8373-VCG; 2013 WL 2181518 (Del. Ch. May 21, 2013)**

Vice Chancellor Sam Glasscock III of the Delaware Court of Chancery denied a stockholder plaintiff's motion for preliminary injunction, and in the process explicated a board's duties in a single-bidder change-of-control transaction. The court explained that "[u]nder *Revlon*… a board may dispense with a market check where 'the directors possess a body of reliable evidence with which to evaluate the fairness of a transaction.'" Nevertheless, "[w]here a board decides to forgo a market check and focus on a single bidder, that decision must inform its actions regarding the sale going forward, which in toto must produce a process reasonably designed to maximize price."

The court explained that "[t]he combination" of a lack of market check, reliance on a "weak" fairness opinion, acquiescence to strong deal protection provisions, including the failure to waive certain "don't ask don't waive" standstill provisions, and an anticipated "short period" between signing and closing "resulted in the Board's approving the merger consideration without adequately informing itself of whether $16.00 per share was the highest price it could reasonably attain for the stockholders." The court, however, refused to enjoin the transaction because an injunction "presents a possibility that the stockholders will lose their chance to receive a substantial premium over market for their shares…and because no other potential bidders have appeared."

DODD-FRANK/WHISTLEBLOWER PROTECTION

Fifth Circuit Limits Dodd-Frank Whistleblower Protection to Those Who Report Possible Securities Law Violations to the SEC

***Asadi v. G.E. Energy (USA), L.L.C.*, 720 F. 3d 620 (5th Cir. 2013)**

The U.S. Court of Appeals for the Fifth Circuit affirmed the dismissal of a former executive's Dodd-Frank whistleblower-retaliation claim, holding that he was not a "whistleblower" within the plain meaning of the statute. The plaintiff, a former GE Energy executive located in Jordan, was allegedly fired for reporting a possible Foreign Corrupt Practices Act violation to his superior at GE Energy, even though he did not report it to the SEC. The district court held that the statute did not apply extraterritorially and thus dismissed on that basis. On appeal, the Fifth Circuit did not address the extraterritorial reach of the statute, but instead considered whether the plaintiff qualified as a "whistleblower." The Fifth Circuit rejected the view taken by district courts in the Second and Sixth Circuits that the statute may extend to protect certain individuals who do not make disclosures to the SEC, and concluded that the Dodd-Frank whistleblower-protection provision unambiguously requires individuals to provide information relating to a violation of the securities laws to the SEC to qualify for protection from retaliation.

DUTY TO DISCLOSE

District of New Jersey Dismisses Claims That Company Allegedly Misrepresented Its Tenuous Financial Position Amid the Recession

***Rescue Mission of El Paso, Inc. v. K-Sea Transp. Partners L.P.*, No. 12-cv-00509 (WHW); 2013 WL 3087078 (D.N.J. June 14, 2013)**

Judge William H. Walls of the U.S. District Court for the District of New Jersey dismissed claims that a marine transporter violated Section 10(b) of the Securities Exchange Act by allegedly misrepresenting its tenuous financial position amid the recession. The company's officers were not required to disclose certain financial information, even though the information may have been material, because the company had no affirmative duty beyond its general reporting requirements to disclose fiscal results. Additionally, the challenged statements discussing the company's health were measured and qualified and the company adequately warned plaintiffs that conditions going forward may be choppy due to the changing economic landscape and decreased demand for ships. Further, the plaintiffs failed to adequately show that the challenged statements were reckless, and there was no indication that executives benefited as a result.

ERISA

Ninth Circuit Holds Plaintiffs Can Use Federal Securities Law Violations to Allege ERISA Breach of Duty Claims Because the Presumption of Prudence Does Not Apply

***Harris v. Amgen, Inc.*, 717 F.3d 1042 (9th Cir. 2013)**

The U.S. Court of Appeals for the Ninth Circuit, in reversing the dismissal of an ERISA class action, held that the plaintiffs sufficiently alleged the defendants violated the duty of care they owe as fiduciaries under ERISA.

The case arises from the same underlying facts as the Supreme Court's recent decision in *Amgen Inc. v. Connecticut Retirement Plans and Trust Funds*, 133 S. Ct. 1184 (2013), which held that plaintiffs need not establish the materiality of alleged fraudulent statements to obtain class certification based on a fraud-on-the-market theory. In addition to those securities fraud claims, a putative class of Amgen, Inc.'s employees brought ERISA-based claims against Amgen and the plan administrators of Amgen's retirement plans, which held Amgen stock.

The defendants won dismissal below, arguing that they were entitled to a presumption of prudence under *Quan v. Computer Sciences Corp.*, 623 F.3d 870 (9th Cir. 2010), in determining whether their decisions constituted breaches of duty under ERISA because their plans encourage the fiduciary to invest primarily in employer stock. The Ninth Circuit disagreed and held that the explicit statement in the defendants' plan that fiduciaries *may* offer a company stock fund as an investment to participants does not suggest that they were *encouraged* to do so, and thus the *Quan* presumption of prudence did not apply. Instead, the Ninth Circuit held the normal, more stringent, prudent man standard applied to the defendants' investment decisions as fiduciaries under the plans.

Under this standard, the Ninth Circuit determined that the alleged misrepresentations and omissions, scienter and resulting decline in share price in *Amgen* were sufficient to state a claim that the defendants violated their duty of care under ERISA in this case. The Ninth Circuit reasoned that the fiduciaries knew or should have known that the Amgen common stock fund was purchasing stock at an artificially inflated price due to material misrepresentations and omissions by company officers, as well as by allegedly improper off-label marketing, but they nevertheless continued to allow plan participants to invest in the fund.

The Ninth Circuit also held that the plaintiffs sufficiently alleged that the defendants violated their duties by failing to provide material information to plan participants about investment in the Amgen common stock fund. Rejecting the defendants' argument that plaintiffs failed to allege reliance, the Ninth Circuit held that ERISA plan participants who invest in a company stock fund whose assets consist solely of publicly traded common stock can rely on the fraud-on-the-market theory, just as any other investor in publicly traded stock would.

Finally, Amgen argued that it should be dismissed from the case because it was not a fiduciary under the plan and had delegated its discretionary authority. Because the Amgen plan provided that Amgen was the named fiduciary and plan sponsor, and because the plan did not mention delegating exclusive authority to trustees and investment managers, the Ninth Circuit held that Amgen was a fiduciary. The Ninth Circuit reversed the district court's dismissal of Amgen and the plan administrators and remanded for further proceedings.

INSIDER TRADING CLAIMS

Ninth Circuit, Affirming Lower Courts, Holds That Federal Securities Law Preempts Enforcement of California's Forced-Patronage Statute

***McDaniel v. Wells Fargo Invs., LLC*, 717 F.3d 668 (9th Cir. 2013)**

The U.S. Court of Appeals for the Ninth Circuit affirmed four district court decisions granting motions to dismiss. In each of the four cases, former employees of the defendants in the field of financial advising filed four separate class actions. The plaintiffs alleged that because the defendants' trading policies allowed employees to open self-directed trading accounts only in-house, they forced each employee to patronize his or her employer in the purchase of a thing of value. The plaintiffs alleged this amounted to "forced patronage" in violation of Section 450(a) of the California Labor Code.

To meet the federal requirement that broker firms take reasonably designed measures to prevent their employees from misusing material, nonpublic information, the defendants enacted policies prohibiting their financial advisers from opening self-directed trading accounts outside the firm.

The Ninth Circuit concluded that federal securities law preempts a challenge to such a policy based on the forced patronage provision of the California Labor Code because the state law is a significant obstacle to the congressional goal of preventing insider trading. While the plaintiffs argued that there were less stringent ways in which the defendants could guard against insider trading, the Ninth Circuit emphasized that the SEC has noted favorably that almost all firms require employees to maintain accounts with the firm and that NYSE Rule 407(b) codifies the no-outside-account policy as a default rule. Because the state law claims were preempted, the Ninth Circuit affirmed the dismissals.

LOSS CAUSATION

First Circuit Vacates Dismissal of Claims That CVS Allegedly Misrepresented The Success of Its Computer System Integration Following Caremark Merger

***Mass. Ret. Sys. v. CVS Caremark Corp.*, 716 F.3d 229 (1st Cir. 2013)**

The U.S. Court of Appeals for the First Circuit vacated dismissal and remanded for further consideration of claims that CVS violated Section 10(b) of the Securities Exchange Act by allegedly misrepresenting the success of the company's computer system integration following its merger with Caremark. The district court previously determined that the plaintiffs failed to sufficiently allege loss causation. The First Circuit, however, held those allegations sufficient: CVS allegedly falsely reported that the companies' systems were working together correctly, problems with integration caused the loss of two Caremark clients, and the market price fell when the system problems were revealed by analysts. Although the analyst reports were not based on a direct disclosure, a prior earnings call discussing certain "service issues" and the loss of two Caremark clients was sufficient for analysts to infer problems with integration and, therefore, the reports constituted corrective disclosures. In addition, the size of the accounts lost, alleged changes in the way the company described the operational success of its prescription management business, and the retirement of the executive responsible for implementing the integration would have tipped analysts to the alleged integration problems.

Eleventh Circuit Affirms Dismissal of Class Action, Holding None of the Alleged "Corrective Disclosures" Described by the Plaintiff Established Loss Causation

***Meyer v. Greene*, 710 F.3d 1189 (11th Cir. 2013)**

The U.S. Court of Appeals for the Eleventh Circuit affirmed the dismissal of a consolidated class action securities fraud complaint for failure to adequately plead loss causation, determining that when a plaintiff invokes the fraud-on-the-market theory to prove reliance, a "corrective disclosure" used to allege loss causation must present facts to the market that are publicly revealed for the first time and that reveal to the market that previous statements were false or fraudulent.

The City of Southfield Fire & Police Retirement System brought a consolidated class action securities fraud complaint against the St. Joe Company and its current and former officers for failing to write down the value of certain real estate assets in St. Joe's quarterly and annual reports to the SEC, thus overstating the value of its holdings and performance during the class period. The plaintiffs claimed three purported "corrective disclosures" alleging loss causation: (1) a presentation given by hedge fund investor David Einhorn suggesting St. Joe's assets were significantly overvalued, (2) St. Joe's disclosure of an informal SEC investigation, and (3) St. Joe's announcement that the SEC's informal investigation had ripened into a "private order of investigation."

Determining that plaintiffs had failed to allege loss causation, the district court granted the defendants' motion to dismiss, with prejudice, and the Eleventh Circuit affirmed. The Eleventh Circuit determined that none of the alleged "corrective disclosures" described by the plaintiffs were in fact corrective disclosures sufficient to establish loss causation. With regard to the Einhorn presentation, the Eleventh Circuit noted that the presentation contained a disclaimer on the second slide stating that all of the information in the presentation was "obtained from publicly available sources." As such, the presentation did not contain facts that were newly presented to the market. The Eleventh Circuit reasoned that because an efficient market theory assumes that all publicly available information is digested and incorporated into a price of a security, a corollary of the efficient market theory is that disclosure of information already known by the market will not cause a change in the stock price—such a disclosure cannot show loss causation. With regard to St. Joe's two disclosures related to the SEC investigation, the Eleventh Circuit held these also were not "corrective disclosures" because they did not reveal to the market the falsity of a prior misstatement. The announcement of an investigation does not reveal to the market that a company's previous statements were false or fraudulent, it merely reveals an investigation is under way. The Eleventh Circuit held that because neither the Einhorn presentation nor the announcements regarding the SEC investigations were corrective disclosures, the plaintiffs' complaint failed to adequately allege a causal connection between the alleged misrepresentation and the investment's subsequent decline in value.

MISREPRESENTATIONS

Texas District Court Dismisses Vast Majority of Securities Claims Against Anadarko

In re Anadarko Petroleum Corp. Class Action Litig., No. 4:12-cv-0900; 2013 WL 3753972 (S.D. Tex. July 15, 2013)

Judge Keith P. Ellison of the U.S. District Court for the Southern District of Texas dismissed the vast majority of securities claims against Anadarko Petroleum Corporation and its key executives. Anadarko was a passive, non-operating investor in the Macondo well that BP was drilling when the Gulf of Mexico oil spill and explosion occurred in April 2010. After the spill, a putative class of Anadarko shareholders sued, alleging that the defendants misled investors about the company's involvement in the Macondo project, as well as its safety practices, risk management, and insurance reserves and coverage. The court said that the majority of the allegedly misleading statements attributed to the defendants were "too squishy, too untethered to anything measurable, to communicate anything that a reasonable person would deem to be important to a securities investment decision." The court further held that the Supreme Court's decision in *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011), barred the plaintiffs' claim that Anadarko should be liable for BP's pre- and post-spill statements related to the accident. The court allowed only one claim to survive, related to a response to a question on a post-spill earnings call, but suggested that the plaintiffs will face an uphill battle to prove the claim. According to the court, the fact that the statement was an isolated occurrence and the executive did not try to sell stock at the time "suggests that [the executive] simply misspoke on the conference call, and that the statement was not part of a coordinated scheme to blunt the effect of the oil spill on Anadarko's share price."

MORTGAGE-BACKED SECURITIES

Seventh Circuit Ends Legal Battle Over Hedge Fund's Ill-Fated Investment in Freddie Mac Securities

Gandhi v. Sitara Capital Mgmt., LLC, 721 F.3d 865 (7th Cir. 2013)

The U.S. Court of Appeals for the Seventh Circuit affirmed summary judgment for Sitara Capital Management, holding that the Northern District of Illinois properly rejected a motion by investors to file a third amended complaint based on the hedge fund's ill-fated investments in Freddie Mac. The case proceeded to discovery on only a handful of counts, including breach of fiduciary duty under the Employee Retirement Income Security Act (ERISA) and the failure to register investment advisers and securities.

On the day dispositive motions were due, Sitara moved for summary judgment. The plaintiffs, meanwhile, requested leave to file their third amended complaint, this time alleging securities fraud related to facts discovered during a recent deposition. The court granted Sitara's motion and denied the plaintiffs' request. On appeal, the Seventh Circuit affirmed, holding that the new allegations of fraud would be futile because the plaintiffs could not establish the falsity of the statements on which they allegedly relied. Moreover, the court held that the plaintiffs failed to allege fraud with the requisite degree of particularity despite conducting extensive discovery. Accordingly, the Seventh Circuit granted the defendants' motion for summary judgment and denied the plaintiffs' leave to file an amended complaint.

SCIENTER

District Court Refuses to Dismiss Claims That KV Pharmaceutical Failed to Disclose FDA Compliance Problems

***Pub. Pension Fund Grp. v. KV Pharm. Co.*, 705 F. Supp. 2d 1088 (E.D. Mo. 2013)**

Judge Carol Jackson of the U.S. District Court for the Eastern District of Missouri refused to dismiss an action against KV Pharmaceutical relating to statements made about the company's compliance with FDA regulations between 2003 and 2009. The court initially had dismissed the complaint for failure to state a claim, but was reversed in part by the U.S. Court of Appeals for the Eighth Circuit, which determined that the complaint adequately pleaded that relevant statements by KV and its former CEO about the company's FDA compliance were false and misleading. The Eighth Circuit remanded for consideration of whether the complaint also properly pleaded scienter and loss causation.

On remand, the district court held that the plaintiffs had established that KV's CEO acted with the requisite state of mind by alleging the following facts: that he knew of and had discussed the violations with the FDA; that he signed a consent decree with the government that reflected his knowledge of the issues; that he was terminated for cause, "with full knowledge of all pertinent facts"; and that the ongoing fraudulent scheme could not have been perpetrated without the knowledge and involvement of company executives at the highest level. The court further determined that the plaintiffs adequately alleged a causal connection between the misstatements and their losses by pleading that the monetary losses were foreseeable and caused by the corrective disclosure of the concealed risk.

SEC ENFORCEMENT

S.D.N.Y. Grants Summary Judgment, in Part, on Claims That Defendants Allegedly Evaded Federal Securities Laws by Hiding Their Ownership of Four Public Companies

***Sec. & Exch. Comm'n v. Wyly*, No. 10 Civ. 5760 (SAS); 2013 WL 2450545 (S.D.N.Y. June 6, 2013)**

In an SEC enforcement action, Judge Shira A. Scheindlin of the U.S. District Court for the Southern District of New York granted, in part, summary judgment on claims that the defendants evaded federal securities laws by allegedly hiding their ownership of, and trading activity in, four public companies through various offshore trusts and subsidiary entities in the Isle of Man and the Cayman Islands. Some of the SEC's claims were time-barred by the five-year statute of limitations, and the limitations period was not equitably tolled because the SEC failed to sufficiently show acts of concealment. However, the court denied summary judgment motions, in part, as to other claims because the SEC adequately demonstrated that the nonpublic information transmitted by the defendants pertaining to the sale of one defendant's company was material. Further, the insider controlled the potential sale, personally transacted with the stocks of that company, and knew the transaction was likely to be "bullish and massive" and acted on that knowledge.

S.D.N.Y. Denies Summary Judgment on Claims That Marketing and Sale of Interests in CDO Allegedly Misrepresented Its Status and Performance

***Sec. & Exch. Comm'n v. Tourre*, No. 10 Civ. 3229 (KBF); 2013 WL 2407172 (S.D.N.Y. June 4, 2013)**

Judge Katherine B. Forrest of the U.S. District Court for the Southern District of New York denied summary judgment on claims that the marketing and sale of interests in a synthetic collateralized debt obligation (CDO) violated Section 10(b) of the Securities Exchange Act by misrepresenting the status and performance of the CDO. The offers were "domestic" under *Morrison v. National Australia Bank Ltd.*, 130 S. Ct. 2869 (2010), because the offeror was in the United States at the time of the offer. In addition, evidence was sufficient to show that the defendant had personally sold the securities because the defendant was a "necessary participant" in the sale. The defendant also had a central role in the development of a fraudulent term sheet and flip-book and participated in email and other marketing. Furthermore, the defendant engaged in interstate commerce by use of the telephone and Internet to accomplish the alleged fraud.

Southern District of California Holds That the SEC Sufficiently Alleged That General Partnership Interests Were Securities Under the Agency's Statutory Authority

***Sec. & Exch. Comm'n v. Schooler*, 902 F. Supp. 2d 1341 (S.D. Cal. 2013)**

Judge Gonzalo P. Curiel of the U.S. District Court for the Southern District of California denied a motion to dismiss, rejecting the defendants' argument that the SEC did not have statutory authority to bring its claims. The SEC alleged that since 2007, the defendants defrauded thousands of investors by offering and selling $50 million worth of general partnerships without disclosing the true value of land underlying the investments, mortgages encumbering those properties and when exactly the land was transferred from the defendants to the general partnerships.

On the defendants' motion to dismiss, the court determined that the general partnerships, as alleged, were securities because they were "investment contracts" under the definitions in the Securities Act and the Securities Exchange Act. To determine whether the general partnerships are investment contracts, the court applied the three-part test from *Williamson v. Tucker*, 645 F.2d 404, 424 (5th Cir. 1981), which recognizes an investment contract if at least one of the following factors is present: (1) the general partnership agreement leaves so little in the hands of the partners that the arrangement is, in fact, a limited partnership, (2) the partners are so inexperienced and unknowledgeable in the general partnership business affairs that they are incapable of intelligently exercising their partnership powers, or (3) the partners are so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that they cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers.

The court held that the SEC had sufficiently alleged the second and third factors. Under the first factor—the distribution of power—the court noted that the partnership agreements themselves left significant control in the general partners' hands, defeating the SEC's allegation that the investments really operated as limited partnerships. However, under the second factor, the SEC sufficiently alleged that the partners were unsophisticated in business affairs enough to show that the "partnerships" were really investment contracts. Relatedly, under the third factor, the SEC had alleged that the unsophisticated partners were dependent on the promoter based on the promoter's representations to investors that his expertise was crucial to the success of the investments. Because the SEC adequately pleaded at least one of the *Williamson* factors, the court denied the motion to dismiss.

District of Columbia Circuit Vacates SEC Lifetime Bar Order for Failure to Address Potentially Mitigating Factors

***Saad v. Sec. & Exch. Comm'n*, 718 F.3d 904 (D.C. Cir. 2013)**

The U.S. Court of Appeals for the District of Columbia vacated a SEC lifetime bar order against the petitioner and remanded the matter for further consideration because the commission failed to adequately address all of the potentially mitigating factors when determining the appropriate sanction against the petitioner. The petitioner, a former registered general securities representative and principal, violated FINRA rules by submitting false expense reports to his employer and subsequently trying to conceal his misconduct. He was discharged by his employer. After his termination, the petitioner was sanctioned by the FINRA Hearing Panel, which imposed a permanent bar against the petitioner's association with a member firm in any capacity—"the securities industry equivalent of capital punishment." The SEC affirmed. On review, the D.C. Court of Appeals vacated the commission's lifetime bar order and remanded the matter for further consideration. The court determined that the SEC abused its discretion by ignoring several potentially mitigating factors asserted by the petitioner that were supported by evidence in the record. In particular, the commission and FINRA decisions did not address the fact that the petitioner's former firm had already disciplined him by terminating his employment prior to FINRA's institution of regulatory proceedings, or the fact that the petitioner was under extreme personal and professional stress at the time of the misconduct because he had received a production warning from his employer while his infant child was being hospitalized for a serious stomach disorder. The SEC claimed that it had "implicitly" considered but rejected these facts, which the court said was insufficient. The D.C. Court of Appeals took no position on the proper outcome of the case. Rather, the court remanded the matter for the commission to "carefully and thoughtfully address each potentially mitigating factor supported by the record."

SECURITIES ACT CLAIMS

Sixth Circuit Finds No Obligation to Allege "Knowledge of Falsity" Under Section 11

***Ind. State Dist. Council of Laborers & Hod Carriers Pension & Welfare Fund v. Omnicare, Inc.*, 719 F.3d 498 (6th Cir. 2013)**

The U.S. Court of Appeals for the Sixth Circuit partly reversed the dismissal of a putative securities class action against Omnicare and its fiduciaries, holding that the plaintiffs were not required to plead knowledge of falsity in actions under Section 11 of the Securities Act. The opinion marked a departure from the reasoning of the U.S. Courts of Appeals for the Second and Ninth Circuits, which required plaintiffs to allege subjective falsity in Section 11 claims that are based on statements of opinion or belief. See *Fait v. Regions Financial Corp.*, 655 F.3d 105, 113 (2d Cir. 2011); *Rubke v. Capitol Bancorp Ltd.*, 551 F.3d 1156, 1162 (9th Cir. 2009).

The plaintiffs were Omnicare investors who alleged the company's public statements of legal compliance were materially false because Omnicare was engaged in a variety of illegal activities. The district court dismissed the action on two grounds: (1) the plaintiffs failed to allege the defendants knew their statements were false, and (2) the plaintiffs failed the heightened pleading standard of Rule 9(b), which applied despite the plaintiffs' brief disclaimer that their complaint did not sound in fraud. On appeal, the Sixth Circuit partly reversed, holding that the plaintiffs were subject to Rule 9(b) but were not required to plead knowledge of falsity for their claims under Section 11. Distinguishing precedent that imposed a requirement of subjective falsity for limited numbers of claims under Section 10(b) of the Securities Exchange Act, the court held that a defendant's mental state was irrelevant to an action under Section 11, which imposes strict liability. Nor was the court persuaded by the reasoning of the Second and Ninth Circuits, which argued for a "subjective falsity" requirement by analogizing to cases interpreting Section 14(a) of the Securities Exchange Act. Although objective falsity—and not mere disbelief—was necessary to plead a violation of Section 14(a), the Sixth Circuit held that the reasoning did not extend to an action under Section 11. Accordingly, the court partly reversed the dismissal of the action, holding that knowledge of falsity was not a requirement under Section 11.

SECURITIES EXCHANGE ACT DISCLOSURES

Nevada Supreme Court Holds Communications About Alleged Illegal Acts Are Subject to an Absolute Privilege in a Defamation Action

***Cucinotta v. Deloitte & Touche*, LLP, 302 P.3d 1099 (Nev. 2013)**

In a matter of first impression, the Supreme Court of Nevada held that an individual who is required by law to communicate allegedly defamatory matter, including information divulged in compliance with the Securities Exchange Act, is absolutely privileged in making such statements.

While performing a financial audit for Global Cash Access Holdings, Inc. (GCA), Deloitte & Touche, LLP obtained an intelligence bulletin authored by the FBI that contained information about alleged illegal acts committed by GCA and two members of its board of directors. Deloitte discharged its duty under federal securities law to disclose the allegations to GCA's audit committee. After an internal investigation revealed no evidence of misconduct on the part of GCA or the two members of its board of directors, the two members of GCA's board of directors brought a defamation and tortious interference action against Deloitte and the Deloitte accountant who disclosed the information to GCA's audit committee.

The district court granted Deloitte's motion for summary judgment, concluding that Deloitte's communications were protected by a conditional privilege because the plaintiffs did not present evidence that Deloitte acted with actual malice. On appeal, the Supreme Court of Nevada affirmed the district court's summary judgment, but held that Deloitte's communications were protected by an absolute privilege, rather than a conditional one. The court reasoned that those who are required by law to publish allegedly defamatory statements should not incur any liability for doing so. The court held that one who is required by law to publish allegedly defamatory matter is absolutely privileged to publish it when (1) the communications are made pursuant to a lawful process, and (2) the communications are made to a qualified person. The court said Deloitte was subject to an absolute privilege and affirmed summary judgment because Deloitte (1) discharged its duty pursuant to the lawful process set forth in 15 U.S.C. § 78j-1 and (2) made the communication to GCA's audit committee—a qualified person.

SECURITIES FRAUD PLEADING STANDARDS

Second Circuit Affirms Dismissal of Claims Related to Fannie Mae's Capital Reserves and Write-Downs Relating to Subprime Mortgage Holdings

***In re Fannie Mae 2008 Sec. Litig.*, 525 F. App'x 16 (2d Cir. 2013)**

The U.S. Court of Appeals for the Second Circuit affirmed the dismissal of claims that Fannie Mae violated Section 10(b) of the Securities Exchange Act by allegedly misrepresenting the organization's capital reserves and concealing the inadequacy of write-downs relating to sub-prime mortgage holdings. The claims constituted fraud by hindsight because the plaintiffs alleged only that Fannie Mae's initial write-down should have been larger because Fannie Mae decided to make additional write-downs as a result of further deterioration of the subprime mortgage market. Although evidence of subsequent write-downs may, in some circumstances, indicate fraud, the facts as alleged indicated that the need for additional write-downs was a product of imperfect business judgment during tumultuous economic conditions and not fraud.

S.D.N.Y. Dismisses Claims That Bank Allegedly Participated in LIBOR Rate Manipulation Scheme

***Gusinsky v. Barclays PLC*, No. 12 Civ. 5329 (SAS); 2013 WL 1955881 (S.D.N.Y. May 13, 2013)**

Judge Shira A. Scheindlin of the U.S. District Court for the Southern District of New York dismissed claims that a bank violated Section 10(b) of the Securities Exchange Act by allegedly participating in a LIBOR rate manipulation scheme. The court held that statements about the bank's business practices were not false and misleading because its business ethics representations constituted inactionable puffery and statements regarding risk management and compliance procedures were not sufficiently connected to the bank's alleged involvement in the LIBOR scheme. In addition, the bank did not conceal any alleged contingent liabilities arising from the LIBOR scheme because possible liabilities need not be disclosed when the violation happens, but rather at the point during a company's investigation when the possibility of liability becomes more than remote, and the bank disclosed the possibility of regulatory penalties during its internal investigation. The court also dismissed claims that the bank's allegedly false LIBOR submissions themselves (allegedly submitted to manipulate the LIBOR rate) were false and misleading because the plaintiffs failed to show loss causation. Even if the false LIBOR submissions caused the price of the bank's stock to rise at the time, disclosure of the bank's conduct was preceded by a three-year gap during which no fraudulent activity was alleged, so any inflation in the bank's stock would have dissipated prior to the first corrective disclosure.

District of New Jersey Dismisses Claims That Pfizer Allegedly Misrepresented the Effectiveness of Drug Meant to Treat Alzheimer's

***Sec. Police & Fire Prof'ls of Am. Ret. Fund v. Pfizer, Inc.*, No. 10-cv-3105 (SDW) (MCA); 2012 WL 458431 (D.N.J. Apr. 22, 2013)**

Judge Susan D. Wigenton of the U.S. District Court for the District of New Jersey dismissed claims that Pfizer violated Section 10(b) of the Securities Exchange Act by allegedly misrepresenting the effectiveness of a drug meant to treat Alzheimer's disease. The plaintiff challenged statements in two press releases. In the first press release, the challenged statement read in context was not misleading. As to the statement in the second press release, Pfizer had no independent duty of disclosure as to "Phase II" results. Further, Pfizer did not make an affirmative statement about "Phase II," and therefore did not put the issue "in play," requiring additional statements to prevent the press releases from being allegedly misleading.

SLUSA PREEMPTION

District Court Dismisses Contractual and Fiduciary Duty Claims Against JP Morgan as Precluded by SLUSA

***Holtz v. J.P. Morgan Sec. LLC*, No. 12-cv-7080; 2013 WL 3240181 (N.D. Ill. June 26, 2013)**

Judge John W. Darrah of the U.S. District Court for the Northern District of Illinois dismissed a putative class action brought on behalf of JP Morgan's financial advisory clients as precluded by the U.S. Securities and Litigation Uniform Standards Act (SLUSA). The plaintiffs brought claims for breach of contract, breach of fiduciary duty and unjust enrichment in connection with an alleged scheme that required JP Morgan financial advisers to push the defendants' own proprietary mutual funds and investments, as opposed to funds and investments managed by third parties, even where doing so was contrary to clients' interests. The plaintiffs attempted to limit their pleadings to their stated claims and specifically disclaimed that their allegations were to be construed as allegations of fraud, misrepresentation or material omission. The court nonetheless dismissed the complaint as precluded by SLUSA, holding that, despite the plaintiffs' artful pleading, the substance of the allegations amounted to a claim of fraudulent concealment in connection with the sale of securities. The court reasoned that it would be "difficult and maybe impossible to disentangle" the allegations of fraud from the plaintiffs' other claims, and dismissed the complaint with prejudice.

STATUTES OF REPOSE

Second Circuit Affirms Partial Denial of Motion to Intervene by Absent Class Members in Action Against IndyMac

***Police & Fire Ret. Sys. of Detroit v. IndyMac MBS, Inc.*, 721 F.3d 95 (2d Cir. 2013)**

The U.S. Court of Appeals for the Second Circuit affirmed the partial denial of motions to intervene by five absent class members in a putative class action alleging that IndyMac violated Sections 11, 12(a) and 15 of the Securities Act by allegedly misrepresenting the underwriting standards, real estate appraisal practices, and the processes used to rate mortgage-backed securities that it issued. The proposed intervenors filed their motions after the district court had dismissed the claims related to MBSs that the lead plaintiffs had not purchased. The motions were untimely because they were filed after Section 13's three-year repose period had expired, and that period was not tolled by *American Pipe & Construction Co. v. Utah*, 414 U.S. 538 (1974). Equitable tolling principles do not apply to statutes of repose, like Section 13, and even if tolling under *American Pipe* is considered to be a legal doctrine, the Rules Enabling Act bars the courts from changing substantive rights of the parties. In addition, under Rule 15(c) of the Federal Rules of Civil Procedure, the proposed amended complaint does not relate back to a prior, timely complaint because lack of jurisdiction cannot be aided by intervention.

S.D.N.Y. Dismisses Claims That Deutsche Bank Allegedly Misrepresented the Quality of Collateralized Loan Obligations in Credit Default Swap Agreements

***Arco Capital Corps. Ltd. v. Deutsche Bank AG*, No. 12 Civ. 7270, 2013 WL 2467986 (S.D.N.Y. June 6, 2013)**

Judge Robert W. Sweet of the U.S. District Court for the Southern District of New York dismissed claims that Deutsche Bank violated Section 10(b) of the Securities Exchange Act by allegedly misrepresenting the quality of collateralized loan obligations, and the underlying loans, in certain credit default swap agreements. The claims were untimely under the five-year statute of repose, which begins to run on the date of the transaction rather than on the date of the last misrepresentation in cases (such as here) where the alleged representations occurred post-purchase. Additionally, the claims were barred by 28 U.S.C. § 1658(b), which requires that Section 10(b) claims be brought within two years of the date upon which a reasonable plaintiff would have sufficient information to adequately allege a violation. However, the court did determine that the transaction was domestic under *Morrison v. National Australia Bank Ltd.*, 130 S. Ct. 2869 (2010), even though the transaction was executed by a foreign issuer and purchaser, because the notes at issue were expressly nonbinding until payment was received by the trustee in New York.

Identity Theft—Know the Law

By Clifford S. Weber

Identity theft pervades our personal and professional lives. Consumer groups warn about its perils and vendors hawk their products' defenses against it, while the Federal Trade Commission reports that in 2012, identity theft topped the list for the 13th consecutive year in its annual compilation of consumer complaints.

Bankers know about identity theft from both actual experience, as well as regulators' alerts about its financial and reputational risks. While they typically know about the operational and technological aspects of identity theft, bankers may be unfamiliar with the governing laws and regulations. To make well-informed decisions about their human and financial investment in identity theft detection and prevention, compliance officers should understand the basic legal framework, especially the extent to which it favors consumers.

Account Hijacking

Identity theft takes many forms. Account hijacking is a kind of identity theft to which financial institutions are particularly vulnerable because they house mountains of deposit and loan account data. Hijackers get account information by penetrating security measures through the telephone, email or other electronic media. Once the information is acquired, the hijacker accesses account funds and, through one device or another, steals them. A recent case shows how the law treats the victim bank and customer.

A husband and wife maintained a checking account and a $150,000 home equity line of credit at a community financial institution. The accounts were linked in a typical arrangement so that the customers could draw down HELOC funds and transfer them to the checking account. They could access the account by telephone with a pre-set voice activated code.

On a Thursday before a holiday weekend, a thief acquired the depositors' phone access code and penetrated into the linked accounts through the phone system. Before this security breach, the depositors had only drawn about $6,000 in HELOC funds, leaving a $144,000 balance available and they had only transferred funds between the accounts once, when they moved the $6,000 to the checking account to pay a bill. They had never used the telephone access system.

The hijackers worked fast. By the close of business on Friday, they had tested the bank's security features with 16 transfers back and forth between the checking account and the HELOC. No alarm sounded, no wires tripped, so they emptied the HELOC balance into the checking account. The following Tuesday, the bank received a fax from the thief, instructing it to wire the $144,000 to a South Korean bank account. The depositors had never before wired funds from the account to anywhere, let alone South Korea. Without inquiry or notification to the customers, the bank complied with the imposter's directions. Later that day, an employee notified the depositors of the account transfers and the wire. By that time, of course, the money was long gone, beyond recall.

The Law

Even in a world without federal consumer protection laws, this bank would have been in trouble. Numerous intra-account transfers in previously quiet accounts, poor voice/code security and reliance on an unverified fax to wire the entire HELOC balance to Korea, all add up to plain old negligence. But of course we do have a federal consumer protection law that covers the case, and that is the Electronic Funds Transfer Act ("EFTA")[1] and its implementing Regulation E.[2]

EFTA/Regulation E

Congress enacted EFTA in 1968 to "provide a basic framework establishing the rights, liabilities, and responsibilities of participants in electronic fund and remittance transfer systems."[3] As noted in Regulation E, EFTA's primary purpose is "the protection of individual consumers engaging in electronic funds transfers…."[4]

EFTA provides that an electronic funds transfer is any transfer of funds initiated through an electronic terminal, telephone, computer or magnetic tape for the purpose of ordering, instructing or authorizing a financial institution to debit or credit a consumer account.[5] Even though telephone transfers are included in the general language, EFTA and Reg. E specifically exclude them from coverage as an electronic funds transfer, unless they take place under a written plan in which periodic or recurring transfers are contemplated.[6] Unfortunately for banks, the Official Interpretations of EFTA (formerly administered by the Federal Reserve, now transferred to the Consumer Financial Protection Bureau under the Dodd-Frank Act) define a written plan quite broadly to include written statements available to the account holder that describe a telephone transfer initiation system, for example, a "brochure or material included with periodic statements."[7]

The husband and wife depositors in this case had received just such a brochure in the form of a booklet that described a telephonic audio response access service for their accounts. Since the brochure amounted to a written plan, the 16 transfers between the HELOC and the checking account qualified as electronic funds transfers.

More importantly, each transfer was an "unauthorized electronic funds transfer" because it was made by a person without actual authority to initiate the transfer, the customers received no benefit from the transfer, and they did not furnish the hijacker with an access code or card.[8] Since they were unauthorized electronic funds transfers, the bank was liable for all but $50.00 of the loss resulting from the drawdown of HELOC funds to the checking account, from which the money was wired to Korea.

UCC

Article 4-A of the Uniform Commercial Code governs wire transfers. The UCC generally imposes liability on the bank for unauthorized transfers ("interloper fraud," in the words of a federal court decision).[9] Liability shifts to the customer where the bank and the customer have agreed to an authentication security procedure that is commercially reasonable and the bank accepts the payment order (i.e., the fax) in good faith and in compliance with the procedure.[10]

In this case, the bank hadn't agreed to *any* security procedures with the customers, so the question of commercial reasonableness never arose. The bank was liable to the customers for the full amount of the funds wired from the checking account to Korea.

Thoughts

The facts here were extreme: in fact they were so one-sidedly in favor of the customers under the UCC and the EFTA that the bank settled with them by refunding the full amount of the wired funds. The customers just had to furnish forgery affidavits in support of the bank's claim for insurance coverage.

Most banks have much better security controls and procedures to deter identity theft. Still, this case is instructive because it shows what happens when systems fail or don't exist: the law takes over, and that law is designed to protect consumers, not banks. That's the real takeaway.

Endnotes

1. 15 U.S.C § 1693 (2013).
2. *See* 12 C.F.R. pt. 1005 (2013).
3. 15 U.S.C § 1693(b).
4. 12 C.F.R. § 1005.1(b).
5. 15 U.S.C § 1693a(7) (2013).
6. 15 U.S.C § 1693a(7)(E); 12 C.F.R. § 1005.3(b)(6)(ii).
7. Official Staff Interpretation 3(c)(6), http://www.bankersonline.com/regs/205/regecomm.html.
8. 15 U.S.C § 1693a(12); 12 C.F.R. § 1005.2(m).
9. *Regatos v. North Fork Bank and New Commercial Bank of New York*, 257 F. Supp. 2d 632, 640–41, n. 16 (S.D.N.Y. 2003).
10. U.C.C. §§ 4-A-202, 4-A-204.

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New York Trust Law 7-2.4, Securitization Failure, Why Late Loan Transfers to REMICs Are Void, Part One

By Charles Wallshein

A mortgage securitization is created when a group of [several thousand] mortgages, commercial or residential, are pooled into a security known as a Mortgage Backed Security (MBS). The MBS is sold as a security and is usually traded on the Over the Counter "pink sheet" market. These securities are likewise registered with the Securities and Exchange Commission.

The basic economic principles of the secondary mortgage market apply to MBS transactions. The MBS investors, known as trust certificate holders, pay the aggregator of the mortgage pool, also known as the "seller," a premium for the present value of the future cash flow from the mortgage pool. This is commonly known as the "discount." The seller's profit comes from the "spread." The investor's benefit is receiving stable cash flow from an investment grade security.

However, RMBS (Residential Mortgage Backed Securities) transactions are different from traditional loan sale transactions in one remarkable way. RMBS transactions are so designed that they are subject to income-tax taxation at the investor level only. REMIC trusts avoid entry-level taxation. The millions of dollars of income generated annually by the thousands of mortgages in the mortgage pool are taxed at the investor-certificate holder level only.

To accomplish this, the mortgage pool must be set up as a Real Estate Mortgage Investment Conduit or "REMIC."[1] If the mortgage pool is not set up as a REMIC, the income from the pool could and would be taxed twice by the IRS (and the states), once at the pool level and then again at the certificate-holder level. It is therefore crucial that the REMIC rules governing RMBS trust construction are followed to the letter of the law. REMICs are created as New York common law trusts so that the trust assets are insulated from creditors who may seek to "claw back" trust assets that were transferred from insolvent transferors.

To achieve REMIC status, the RMBS must meet three specific criteria. First, the RMBS mortgage pool must be static. Once it is created, it cannot accept any new assets into the pool. The assets must be specifically identified and vested in the trust within a statutory [IRC § 860(d)] time frame.

Second, the trust must take good title, in its name, to the assets (mortgages and notes) deposited into the trust.

Third, the assets in the trust must be insulated from creditors. This is accomplished with a series of fully documented sales (negotiations) starting from the originator and culminating with a sale from the Depositor to the Trustee on behalf of the Trust. If this series of sales is properly done, the trust assets cannot be reached by creditors in the event the seller / originator of the loans that constitute the corpus of the trust files for bankruptcy. This is called "bankruptcy remoteness."

In order for the RMBS transaction to meet all three criteria, a trust must be created. The trust creation document is usually referred to as a Pooling and Servicing Agreement or PSA. The PSA is the document that both creates the trust and governs all trust activities. Securitization failure or REMIC failure occurs when the loans intended for the trust fail to be vested within the trust in accordance with the rules set forth in the trust document.

New York and Delaware laws are unique in that these two jurisdictions provide a protective "void" cocoon over the trust to protect the beneficiaries [certificate holders]. The void *ab initio* doctrine of New York and Delaware law operates to exclude from a trust, as a matter of law, those assets that would or could threaten the trust asset[s'] tax-free pass through status and / or bankruptcy remote status.

Securitization failure destroys the marketability of title to real property. The practitioner asserting the securitization failure defense must understand EPTL § 7-2.4 in the context and construction of New York's trust law as a whole and why it is relevant to foreclosure. Courts must also understand the historical context and application of ultra vires acts of a trustee being null and void *ab initio*. Without understanding the reason for applying the statute, EPTL § 7-2.4 appears to be a draconian rule, with a resulting draconian "remedy" for what appears to be a ministerial error by REMIC trustees and those parties that created and funded the REMIC trusts.

The failure by the above-mentioned participants to abide by the terms of the REMIC trust is anything but a ministerial error. Ultra vires acts of REMIC trustees result in devolution of title to every deed that was and will be passed in a REMIC foreclosure. The ultimate outcome of these ultra vires acts is that every deed passed pursuant to a REMIC foreclosure is a nullity, rendering the transferees of title holding nothing more than a worthless deed,[2] thus the necessity of applying EPTL § 7-2.4 in its literal interpretation.

Several jurisdictions interpret New York Estates Powers and Trust Law Section 7-2.4 in the context of securitization failure. These courts have declared that transfers to the trust that violated the terms of the REMIC Pooling and Servicing Agreements are therefore void *ab initio*.[3] If the transfers to the respective trusts are void, then millions of foreclosures have been and are being prosecuted by parties that have no interest in the underlying note obligations. Likewise, many liens and deeds of trust were, and are now, in the hands of entities that do not possess the right to enforce the equitable remedy of foreclosure.

Section 7-2.4 states:

> If the trust is expressed in the instrument creating the estate of the trustee, every sale, conveyance or other act of the trustee in contravention of the trust, except as authorized by this article and by any other provision of law, is void.[4]

New York shares the void rather than voidable position with only one other jurisdiction, Delaware.[5] Nearly all REMICs were created under the laws of these two jurisdictions to comply with the Internal Revenue Code REMIC statute's dual requirement that the REMIC trust insulate the beneficiaries from creditors (bankruptcy remoteness) and that the trusts be "closed."[6]

The affirmative defense that a plaintiff does not own the loan is a result of the untimely transfer of the loan to the trust and the acceptance by the trustee thereof. Very often the transfer of the loan to the trust occurred years after the specified "cutoff date," if at all. Pursuant to New York and Delaware laws, the acceptance by the trust in contravention of the terms of the trust is void.[7]

As a practical matter, the transfer date is an evidentiary issue that would require discovery and a determination at a motion for accelerated judgment or trial. All the information pertaining to the factual issue is in the exclusive possession of the foreclosing entity or its predecessors in interest. The public real property record may contain some information relevant to the date of transfer of the loan. However, the record of document transfers between the participants is wholly proprietary to the trustee and the appointed trustee document custodian(s).

You Cannot Give What You Do Not Have

Devolution in title due to securitization failure has consequences before and after transfer of title. Prior to a transfer of title, devolution is relevant to the identity of the entity that has the authority to affect the satisfaction, modification or consolidation of the mortgage. After transfer of title, devolution is an issue because the entity that satisfied or foreclosed the mortgage had no authority to do so, and the person who took title either took it subject to an unsatisfied lien or subject to a defective foreclosure.

The entities that had the authority to foreclose did not foreclose. The wrong party foreclosed and either holds title or has transferred title to an unsuspecting transferee who believes that it is a bona fide purchaser, whereas in reality, that person is anything but.[8] Transferees of foreclosure deeds have taken title from an entity that had no interest in the property to transfer. *Nemo dat quod non habet*. You cannot give what you do not have. *Nemo dat* trumps bona fide purchaser every time. This is why we purchase fee policies when we buy real estate.

However, finding a title insurance company that will insure your fee interest in real estate is not the same as receiving marketable title. Insurable title is not marketable title. Marketable title is title that is free from reasonable doubt or any sort of threat of litigation. In the case of real estate that is encumbered by a mortgage that was placed into an MBS, the source of the satisfaction of the lien may be in question.[9]

In *Voorheesville Rod & Gun Club Inc. v. E.W. Tompkins Co.*, 82 N.Y. 2d 564 (1993), the court of appeals defined marketable title as follows:

> We have said that a "purchaser ought not to be compelled to take property, the possession or title of which he may be obliged to defend by litigation. He should have a title that will enable him to hold his land free from probable claim by another, and one which, if he wishes to sell, would be reasonably free from any doubt which would interfere with its market value." As can be seen from these definitions, marketability of title is concerned with impairments on title to a property, i.e., the right to unencumbered ownership and possession….[10]

The RMBS transaction and REMIC failure create uncertainty concerning the legal effect of any action taken by the trustee or its agents concerning rights in that property. This uncertainty applies specifically to the authority of the trustee or its agents to satisfy a mortgage that the trust does not own.

A break in the chain of title to the mortgage results in the fee owner being unable to transfer title to any person free and clear of encumbrances.[11] If the satisfaction of that mortgage is made without the authority of the person entitled to enforce the note and without the authority of the last lawful mortgagee of record, the note is not discharged and the lien continues to exist.

Devolution in Title to the Mortgage

Devolution in title would occur if any party other than the last mortgagee of record executes the satisfaction of mortgage. Devolution is simply a break in the chain of rights in real estate.[12] The only party that can affect an interest in real estate is the party [or that party's lawful agent] that has an interest in the real estate. Every state defines "interest in real estate" by statute or by common law interpreting statutory construction.

The issues in MBS transactions concern the chain of authority derived from the original mortgagee of record. We will begin with the assumption that the original mortgage and note were prima facie valid. The only party that has the right to assign or transfer those rights in the mortgage begins with the original mortgagee. Likewise, the only entity that has the right to exercise rights under the mortgage, such as the right to satisfy the lien or foreclose on the lien / deed of trust, is the entity that is the last mortgagee of record or its successor and / or assign.

Seen in this context, there is no difference in the rules for any entity that claims an interest in real property. The authority to affect an interest in real property can only be vested in the entity that is designated on the instrument that created that particular interest.[13] This same principle applies to deeds, mortgages, agrarian, riparian, leases, air, subterranean, easement, license, restrictive covenant and every other stick in the "bundle" of rights associated with ownership of rights in real property. The reason we maintain a public property record is to give the world constructive notice of the identity of the entities that hold rights in real property and the time those rights were created and transferred.

Every jurisdiction has laws that govern the creation of these rights including a statute of frauds that demands the rights be created by an instrument in writing, how the person granting those rights is given the authority to do so, how or if the instrument needs to be acknowledged [notarized] and if the instrument needs to be recorded in the public land record to be valid.[14]

The lender seeking to enforce the loan can choose one of two remedies. The first is the right to enforce the lien "at equity." This involves the exercise of the power of sale (non-judicial) or obtaining a judgment of foreclosure and sale and selling the property at auction (judicial). The other remedy involves the entity's disregarding the lien or deed in trust altogether and choosing to seek a money judgment only. This is referred to as the remedy "at law." The entity enforcing must choose a remedy. It cannot elect both.

Foreclosure is the involuntary transfer of title pursuant to a judgment of sale (judicial) or power of sale (non-judicial). What is actually being foreclosed is the fee owner's right of redemption. The right of redemption can only be foreclosed by the entity that has the right / authority to enforce the contractual debt (note). The property must be titled to the successful bidder after the sale or to the plaintiff if there is no successful bidder.[15] In New York, the RPAPL requires that title passed post-sale be "sourced" via the recording of the mortgage or assignment of mortgage prior to the sale. The referee cannot pass title until the [foreclosed] mortgage is recorded.

In New York, the referee can only transfer title under authority of the judgment of sale. This is to ensure that any successive purchaser has certainty that title was derived pursuant to lawful sale by a lawful party entitled to enforce not only the underlying indebtedness but also by the party who was entitled to enforce that indebtedness to foreclose the borrower's [fee owner's] right of redemption. Similar principles apply in other jurisdictions under different statutory constructions. Nevertheless, the overriding policy considerations are the same; the chain of title to real property [via the lien or deed of trust] is preserved and remains certain throughout the foreclosure process.

The issue in RMBS foreclosure is that the entity foreclosing is either the trust itself or the trust's agent designated as such by agreement. If the trust cannot or could not take lawful possession of the note due to a restriction in the trust agreement, then the trust has no authority to affect any aspect of the loan's servicing, management, right to declare a default or foreclosure. This is the definition of securitization failure. The trust does not and cannot ever own the loan.

Why Void?

The legal principles and policy considerations of EPTL § 7-2.4 date back to ancient common law. EPTL § 7-2.4 was born out of those sections of the New York Code that dealt with title to real and personal property owned by a trust. In 1966, EPTL § 14-1.1 repealed all those laws, which were consolidated into one statute, EPTL § 7-2.4. The New York Code contained special provisions that any person with actual knowledge of the fact that real or personal property was owned by or titled to a trust was charged with constructive knowledge of the terms of the trust.

These were known colloquially as the "widows and orphans laws." These laws were written so that an evil, corrupt and mean-spirited trustee could not unlawfully sell trust assets to an "innocent" purchaser to the detriment of the trust's purpose. The converse is also held to apply, wherein a trustee exceeds its authority to acquire assets. Any purchaser / seller of assets to or from a trust is charged with having knowledge that the transfer was with the trustee's powers. In *In re Pepi*, the court held:

> Since the appellants had reason to know that the conveyance was made in contravention of the trust, the transaction is void (*see,* EPTL 7–2.4; *see also, National Sur. Co. v. Manhattan Mtge. Co.,* 185 App Div. 733, 736–737, 174 N.Y.S. 9, *aff'd.* 230 N.Y. 545; *Boskowitz v. Held,* 15 App Div. 306, 310–311, *aff'd.* 153 N.Y. 666).[16]

This principle of common law prevented a seller of property to a trust or a purchaser of property from a trust in contravention of the terms of the trust to be able to claim bona fide purchaser status. These principles were recognized in *National Surety v. Manhattan Mortgage Co.*, 185 A.D. 733 (2nd Dept. 1919), *affirmed* 230 N.Y. 545 (Ct.

App. 1920). In that case, Manhattan Mortgage, the third party defendant, was held liable for the malfeasance of the trustee because it had actual knowledge that the property interest transferred was held in trust. The Court's decision used common law from other Court of Final Review level decisions to support its reasoning. The Court stated:

> In *Clark v. Whitaker* (19 Conn. 319), it was held: "Where a party was not personally engaged in the acts of taking possession, using and disposing of the property in question, but co-operated with the principal actor, by aiding and abetting him in doing those acts, and subsequently recognized and approved of them; he was held to be chargeable with the conversion." In *Moore v. Eldred* (42 Vt. 13) it was held that if one having reason to believe that personal property in the possession of another person has not been lawfully acquired, advises or co-operates with such person to induce him to make a sale of it, he may be held liable directly as for a conversion. In *Cone v. Ivinson* (4 Wyo. 230, 230; 35 Pac. 933) it is held that one who instigates a conversion is as much a principal as the one performing the act of conversion. These authorities are directly in point because a trustee who wastes the property of an estate and is guilty of a devastavit, converts that property and may be held liable in an action for conversion. Whether or not, therefore, the defendant may be held to have acted as vendor of a part of the mortgage, or as agent for the guardian in the purchasing of the mortgage interest, or even as merely aiding or abetting in the use of these funds, known by him to be unlawful, it has become liable to the plaintiff for the injuries sustained. The judgment should therefore be reversed, and judgment directed for the plaintiff as demanded in the complaint. Findings and judgment to be settled upon notice.[17]

The principles described in *National Surety* evolved into New York's rule that imposes constructive knowledge of the terms of the trust if the parties to the transaction have actual or constructive knowledge that the property is held by a trust.[18] New York made a policy decision long ago that it did not want to litigate the issue of actual knowledge by a transferee of property from a trust.[19] A bright line rule was established at common law, and then codified, that states a transferee with knowledge that property is in a trust has constructive knowledge of the terms of the trust. [20] New York courts limited their review to interpreting trust construction to determine the nature of the trustee's authority.[21]

New York law states that an ultra vires transfer of assets to or by a trustee on behalf of a trust is void rather than voidable. If the transfer were voidable, then the damaged party would have to bring an action against the misfeasing parties to have the transfer declared void.[22] In New York the transaction is void *ab initio*, just as though it never happened. The trustee's defense would have to be that it had no knowledge of the terms of the trust. This would of course be an absurd proposition and would be stricken. The trustee has actual knowledge of the terms of its own trust.[23]

The person or entity that has authority to make lawful transfers of the note and mortgage within the RMBS varies depending on what stage of the transaction the transfer was made. The transfer to the trustee must be lawful pursuant to a document or writing that does not create a presumption that the transfer violates state law or any other controlling trust document. This is not a form over substance argument. In RMBS transactions, a violation of state law or of the PSA would open the trust to liability from creditors and the loss of tax free pass through status to the asset[s] that were transferred in violation of the trust document.

In particular, the entity that presumably needs standing to enforce the mortgage needs to prove as a threshold matter that it has the lawful authority to do so.[24] Since there have been numerous transfers of the note and mortgage, the downstream holder of the note and mortgage must rely on the proper and lawful transfer of those documents throughout the chain of possession and title respectively.[25]

Pleading REMIC Failure

REMIC failure is a proper defense to mortgagors because REMIC failure destroys the marketability of the mortgagors' title. Every mortgagor has a right to know who owns its loan. Successor mortgagees, mortgagees that are not the original payees on the loan, claim that mortgagors do not have standing to assert the ultra vires/REMIC failure defense. However, every mortgagor has the right to know the identity of the entity to which it should pay. Mortgagors also have the right to an explanation as to how the presumptive mortgagees obtained "title" to the mortgage or deed of trust. The REMIC mortgagee's classic argument essentially states that mortgagors have no right to know how the successor mortgagee became the successor mortgagee. This is absurd.

The legal result of the successor mortgagee's argument is that successor transferees of title to the real property, whether through foreclosure or arm's length contractual transfer, have no right to know if they are receiving title to real property free and clear of liens or encumbrances. If the entity that purports to satisfy the lien has no authority to do so, then the mortgagor/homeowner cannot pass marketable title. Likewise, the purchaser has not taken marketable title and that title may be subject to attack by the true owner of the note.[26]

Transfers of loans to REMIC trusts fail due to the ultra vires acts of the REMIC trustee. The most common and most easily discovered ultra vires act as relates to an affirmative defense to the foreclosure is the trustee's acceptance of the loan past the trust's cutoff date. The cutoff date is usually defined in Section 1.01 of the trust's Pooling and Servicing Agreement. The PSA is the document that creates the trust. All the contractual obligations among the trustee, the certificate holders, the depositor and the master servicer are contained in the PSA.

A breach of any contractual obligation by the trustee with relation to any loan is an ultra vires act. An act by the trustee not specifically granted by the trust document is void as per the rule pertaining to common law trusts created under the laws of New York. This rule is in place to protect the trust and the certificate holders from acts by the trustee or its agents that are ultra vires of those powers specifically granted to the trustee. The purpose behind New York as the choice of law jurisdiction that governs these trusts is that, in New York, the ultra vires acts of a trustee are treated as if they never happened. This has been the rule in New York for well over one hundred years.

The affirmative defense that plaintiff cannot be the proper party in the action is the mirror image of the counterclaim for a declaratory judgment as to the identity of the entity that has the right to enforce the loan. A demand for trial is made in the counterclaim concerning the determination of the identity of the entity that is the person entitled to enforce the note and assert the equitable remedy of foreclosure. In this sense, the factual basis for the affirmative defense is similar to the counterclaim.

However, the difference between the affirmative defense and the counterclaim is that the affirmative defense of "plaintiff lacks standing" is only asserted against the plaintiff. The counterclaim involves naming every party to the REMIC transaction that had an interest in the note. A determination by the court that plaintiff lacks standing is non-instructive as to the identity of the person entitled to enforce.

To determine the identity of the proper party with authority to enforce the note, every entity that had a role in the RMBS transaction would have to be a third party defendant named in the counterclaim. In other words, defendant may owe someone money, but it is not the trust. Once the court determines it is not and cannot be the trust, the third party defendants will have to fight it out amongst each other. The end result is that foreclosures commenced in the name of an improper party will be dismissed. The mortgage lien still exists against the property in the name of some entity.[27]

It is clear that the REMIC is constructed as a common law trust with a "commercial" purpose. This alleged dual function has raised form versus substance arguments as to REMIC classification and treatment under New York trust law.[28] This issue is just being addressed by courts in New York and various other jurisdictions, with widely varying results.

Endnotes

1. REMICs are distinguished from Fannie Mae, Freddie Mac and Ginnie Mae RMBS. In FNMA, FHLMC & GNMA RMBS the tranche structure is different, and Fannie and Freddie are government-sponsored entities (GSEs). However, to a large degree the same principles of document transfer apply.
2. *Barnard v. Campbell*, 55 N.Y. 456 (1873).

    > But good faith, and a parting of value by the one, will not alone determine who should have the loss, or fix the ownership of the property fraudulently purchased from the one and sold to the other. The general rule is that a purchaser of property takes only such title as his seller has, and is authorized to transfer; that he acquires precisely the interest which the seller owns, and no other or greater. *Nemo plus juris ad alium transferre potest quam ipse habet*. (Broom's Leg. Max., 452). The general rule of law is undoubted that no one can transfer a better title than he himself possesses. *Nemo dat quod non habet*. (Per WILLES, J., *Whistler v. Forster*, 14 C. B. [N. S.], 248.)

    Id. at 461.
3. *Wells Fargo v. Erobobo*, 2013 N.Y. Slip Op. 50675(U) (Sup. Ct., Kings Co. Apr. 29, 2013); *Glaski v. Bank of America*, 160 Cal. Rptr. 3d 449 (2013); *In re Saldivar*, 2013 WL 2452699 (Bankr. S.D. Tex.).
4. N.Y. Est. Powers & Trusts Law § 7-2.4 (EPTL).
5. Del. Code tit. 12, ch. 35, 38 (2013). The Delaware statute states that a court could elect, as one of nine remedies, a declaration of "void" to the transaction.
6. 26 U.S.C. § 860 (2013). The Internal Revenue Code states:

    > (a) General rule.—For purposes of this title, the terms ''real estate mortgage investment conduit'' and ''REMIC'' mean any entity—
    >
    > (1) to which an election to be treated as a REMIC applies for the taxable year and all prior taxable years,
    >
    > (2) all of the interests in which are regular interests or residual interests,
    >
    > (3) which has 1 (and only 1) class of residual interests (and all distributions, if any, with respect to such interests are pro-rata),
    >
    > (4) *as of the close of the 3rd month beginning after the startup day and at all times thereafter, substantially all of the assets of which consist of qualified mortgages and permitted investments,*
    >
    > (5) which has a taxable year which is a calendar year, and
    >
    > (6) with respect to which there are reasonable arrangements designed to ensure that—
    >
    > (A) *residual interests in such entity are not held by disqualified organizations(as defined in section 860E(e)(5))*, and
    >
    > (B) information necessary for the application of section 860E(e) will be made available by the entity. In the case of a qualified liquidation (as defined in section 860F(a)(4)(A)), paragraph (4) shall not

> apply during the liquidation period (as defined in section860F(a)(4)(B)) (emphasis added).

26 U.S.C. § 860D.

7. New York and Delaware were chosen as the jurisdictions of governing law for the creation of REMIC trusts specifically because those jurisdictions strictly interpret the ultra vires acts of common law trustees as "void" not "voidable."

8. In *Kirsch v. Tozier*, 143 N.Y. 390 (1894) the Court affirmed the lower court in a case that determined the assignment of a mortgage to a third party void as the transfer of the mortgage was in contravention of the terms of the trust and exceeded the powers of the trustee.

> A purchaser is not required to use the utmost circumspection. He is bound to act as an ordinarily prudent and careful man would do under the circumstances. He cannot act in contravention to the dictates of reasonable prudence, or refuse to inquire when the propriety of inquiry is naturally suggested by circumstances known to him. The circumstances of this case made it, we think, the duty of the bank to inquire in respect to the authority of Tozier to discharge the prior mortgage, and, having failed to do so it is not entitled to protection as a *bona fide* purchaser.

Id. at 397.

9. "Marketable Title" is defined in this definition by exclusion. The ALTA 1992 form policy defines "unmarketability of the title" as:

> An alleged or apparent matter affecting the title to the land, not excluded or excepted from coverage, which would entitle a purchaser of the estate or interest described in Schedule A to be released from the obligation to purchase by virtue of a contractual condition requiring the delivery of marketable title.

S.H. Spencer Compton, *The State ofMarketable Title*, First American Title Insurance Company of New York, http://www.firstamny.com/detail.aspx?id=142. This is a circular definition at best, but one that establishes the conditions under which a marketability issue will be considered covered under the policy and, therefore, ripe as a claim of loss or defense. A claim is ripe if title is encumbered by an "alleged or apparent" defect. Note that there is no requirement to prove that the defect is real. Further, a claim is covered only if it is "not excluded or excepted from coverage." No matter how severe an effect the defect has on merchantability of title, there is no coverage for any defect disclosed by or excluded from the policy.

10. *Voorheesville Rod & Gun Club, Inc., v. E.W. Tompkins Co.*, 82 N.Y. 2d 564, 571 (1993) (*quoting Dyker Meadow Lane & Improvement Co., v. Cook*, 159 N.Y. 6, 15 (1899)).

11. Contracts for sale of real property are conditioned upon the transfer of "good and marketable title."

12. The robo-signing scandal raised questions concerning the authority of the signatories to execute the documents. Robo-signing concerned itself with agency issues under the statute of frauds.

13. *McPherson v. Rollins*, 107 N.Y. 316 (NY. 1887).

> The important inquiry before the referee was, whether the defendants had any notice, actual or constructive, of the plaintiff's rights, or of the character in which Deming held the mortgage. His finding that they had no actual notice reduces our inquiry to the effect of the recording act. As intending purchasers they must be presumed to investigate the title and to examine every deed or instrument forming a part of it, especially if recorded; they must, therefore, be deemed to have known every fact so disclosed (*Acer v. Westcott*, 46 N. Y. 384), and every other fact which an inquiry suggested by those records would have led up to. Thus they are plainly chargeable with notice of the mortgage and of all the facts of which the mortgage could inform them.

Id. at 322.

14. New York does not require the assignee of a mortgage to record its satisfaction for the assignment to be valid. New York does require recording of the assignment in order for the assignee to be protected under the race-notice statute. N.Y. Real Prop. § 291 (McKinney 2013). As a practical matter, devolution occurs where a satisfaction of mortgage is filed by an entity that is not the last mortgagee of record. The remedy for devolution is to locate the entity(ies) that should have been the assignor(s) of the missing assignment(s) and have them execute the appropriate instrument. In the alternative, if the party that could lawfully execute the necessary instrument cannot be located or refuses to cooperate, the remedy would be a judgment for quiet title.

15. The successful bid may be assigned to a third party.

16. *In re Pepi*, 268 A.D.2d 477, 478 (2d Dep't 2000).

17. *Nat'l Surety Co. v. Manhattan Mortg. Co.*, 185 A.D. 733, 738–39 (1st Dep't 1919).

18. *McPherson v. Rollins*, 107 N.Y. 316 (NY. 1887). In an action to foreclose the mortgage, the court held, that a valid and irrevocable trust was created thereby, and as the same had in no way been renounced by the cestui que trust, the discharge was in contravention of the trust and was, therefore void. It was also held, that the grantees were chargeable with notice that plaintiff had a beneficial interest under the mortgage, and that the satisfaction thereof was an act not in the execution of the trust and was beyond the power of the trustee.

> He had no power to vary its terms nor receive payment in anticipation of the times fixed by the mortgage. His declaration or certificate that he had been paid was, therefore, of no avail against the express provisions of the instrument by which his power was defined. In case of default on the part of the mortgagor in paying, the mortgagee might, as the appellants say, foreclose, for power to do so is expressly given by the mortgage, but whether the security for future payments would then be found in the decree or otherwise would depend on circumstances not pertinent to the present inquiry. A point is made that the plaintiff is not the owner of the mortgage and cannot maintain the action.

19. This is the historical common law imposition of "constructive notice" of the terms of the trust upon a transferor/transferee of assets to or from a trust that operates to establish as a matter of law the definition of an ultra vires act by a trustee.

20. *See In re Pepi*.

21. *Cumming v. Williamson*, 2 N.Y. Leg. Obs. 153 (1843). The Court held a mortgage to be void as violative of the terms of the trust governing the property and the act of the trustee exceeding his authority granted therein. "I must hold that this mortgage is inoperative. The legal estate in fee was vested in Williamson on a trust which did not authorize him to mortgage. No consent or request of Mr. and Mrs. Cochran could confer upon him an authority to deviate from the terms of that trust. Nor could they institute any title in the premises, except in pursuance of the trust deed. (1 Rev. Stat. 730, §§ 63. 65;) Wood v. Wood, (5 Paige, 600;) Hawley v. James, (16 Wend. 164-5, per Bronson, J.)." *Id.*

22. The "voidable" versus "void" argument would inure to the benefit of the ultra vires trustee. A "voidable" act logically suggests that the transfer to the trust was effective when it allegedly occurred, even if the act violated the terms of the trust. Thus "voidable" is not, and has never been, the rule in New York.

23. In REMIC transactions the "depositor" is the direct predecessor in interest [of the loans] to the trust. The "depositor" is the entity that creates the trust and, likewise, as such cannot claim ignorance of the substance of the trust document.

24. That party must either own the mortgage and the note or be legally empowered to act on the note-owner's behalf. Servicers acting on behalf of a trust or an originator do not own the mortgage, but by contract are granted the ability to act on behalf of the trust or the originator. *See* Federal Trade Commission, *Facts for Consumers* (online at www.ftc.gov / bcp / edu / pubs / consumer / homes / rea10.shtm).

25. Under the terms of the trust, the contracts between the parties or UCC 9-203(b)(1)(2)(3) would require the chain of title by the foreclosing entity to be qualified as a "PETE" (person entitled to enforce). In other words, there is no valid PETE in the case of transfers made by single endorsements in blank. Furthermore, to argue that any party who is in possession of a note, even a thief is a PETE is absurd and should not be considered.

26. One of the curious aspects of REMIC loan servicing is that the trust beneficiaries, the trust certificate holders, do not know if any particular loan is in default by the borrower. They only know whether payment is being made to them on their certificates by the loan servicer. In this respect, the performance of individual loans is hidden behind an opaque curtain. At some point in the future, when the trust is liquidated, certificate holders may discover that the expected residual interests in the derivative certificates do not exist. All REMIC trusts have a certain duration that is based upon the life of the asset the trust was created to hold. In the case of REMIC trusts, the life expectancy of a trust cannot exceed the lives of the loans. The assets are 30-year [or less] mortgages. The day of reckoning for certificate holders discovering that their investments have been dissipated by the trustees and the servicing agents may be many years in the future. However, there will be a day of reckoning.

27. The author is not suggesting this is a problem without a solution. Every case where REMIC failure is in issue will require the mortgagor and the presumptive mortgagee to remake the note and mortgage and for the mortgagee to assume the role of indemnitor to subsequent bona fide purchasers and subsequent mortgagees.

28. The debate centers on the classification of REMICs as business trusts versus common law trusts. Business trusts are created to operate like corporations. Business trusts and some common law trusts can be of perpetual duration, can buy, sell and trade assets and engage in business activities. A REMIC by definition is not permitted to operate as a business trust as per 26 U.S.C. § 860D. There is likewise no need for business trust classification, as REMICs by their very definition cannot ever violate the rule against perpetuities because the assets they hold, mortgages, are not of perpetual duration. New York does not have a business trust statute; however, a trust may be organized as such under New York common law. Business trusts were first created by statute in Massachusetts in the 19th Century. Massachusetts Trusts operated exactly like corporations and shared no commonality with common law grantor trusts other than the fact that there were "trustees" governing the business trust instead of a board of directors as in a corporation.

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Stub Rent Under Section 365(d)(3) of the Bankruptcy Code: Proration Should Be Uniformly Applied

By Benjamin P. Chapple

I. Introduction

In 1984 Congress promulgated § 365(d)(3) of the Bankruptcy Code in order to remedy substantial burdens placed on landlords[1] and their solvent tenants.[2] Moreover, Congress sought to provide landlords with "current payment for current services," specifically current payment for "stub rent."[3] Stub rent is the amount a debtor-tenant owes to a landlord for the interim period between the day on which a debtor files its petition for bankruptcy and the end of the debtor's first month in bankruptcy.[4] Although there is consensus regarding Congress' reasons for enacting § 365(d)(3), there has been great debate regarding the proper interpretation of this statute.[5] Two distinct methods for calculating stub rent have emerged, with circuit courts on both sides,[6] known respectively as "billing-date" and "proration."[7] Depending on which methods a court employs, stub rent may be deemed to arise "pre-petition," the period before a debtor files for bankruptcy,[8] or "post-petition."[9] As explained *infra*, whether stub rent is considered to arise pre-petition or post-petition often has significant financial effects.

Part II of this article begins by explaining how and why Congress prioritizes post-petition over pre-petition claims. Part II continues by examining the background preceding § 365(d)(3)'s enactment, and highlights the reasons Congress was compelled to adopt the statute. Part III explains proration and the billing-date method, as well as identifies the reasons why certain courts adopt one method over the alternative. Part IV then analyzes why proration should be uniformly adopted throughout the United States for calculating stub rent, and discusses the ramifications of adopting the billing-date method. Part V concludes by summarizing the benefits of proration as well as the detriments of the billing-date method, and urges Congress or the United States Supreme Court to resolve the circuit split in favor of proration.

II. Background

A. Prioritization of Claims

Congress, through the Bankruptcy Code, favors facilitating debtors' reorganization and recovery from economic failure.[10] Congress realized that creditors would avoid dealing with entities after they filed a petition for bankruptcy and therefore created an incentive.[11] In order to induce suppliers and other creditors, who would otherwise be too concerned about the entities' insolvency, Congress provides special priority to creditors who provide post-petition services or sales to bankruptcy debtors.[12] Claims resulting from post-petition transactions are deemed "administrative claims" under the Code and have priority for repayment over all other unsecured claims, namely pre-petition claims, pursuant to § 507(a)(1).[13] Therefore, if rent is deemed to arise post-petition, the landlord will be entitled to an administrative claim.[14] Conversely, if the rent arose pre-petition the landlord will likely only recover pennies on the dollar since most, if not all, of the debtors' assets will first compensate administrative claim holders.[15] Because a landlord's recovery is affected, the determination whether a claim arose pre-petition or post-petition is very important.

B. Stub Rent Was Prorated Prior to § 365(d)(3)

Prior to the enactment of § 365(d)(3) the landlord would file an administrative claim for stub rent pursuant to § 503(b)(1).[16] Under § 503(b)(1), the court prorated the amount the debtor-tenant owed the landlord based on the number of days the debtor occupied the premises during the period following the entry of the petition and until the time the debtor assumed or rejected the lease.[17] For example, if the debtor occupied the premises for fifteen days after the petition was filed and before it rejected the lease, the landlord would have an administrative claim only for those fifteen days.[18]

C. § 503(b)(1) Created a Need for Congressional Intervention

Congress realized that § 503(b)(1) created significant problems that demanded immediate resolution.[19] First, the process for receiving stub rent was extremely burdensome on the landlord.[20] The landlord had to take the initiative to fill out an application, give notice, and then attend a hearing.[21] Second, even if the landlord received a favorable outcome with that process, the landlord could only recover the "reasonable value" for the "actual use" of the premises.[22] Although the rate stipulated in the lease agreement was typically presumptive of the reasonable market value, the debtor-tenant could offer evidence of a more appropriate amount as reflected by the current market.[23] The actual use was determined by evaluating the percentage of the rental space the debtor-tenant physically occupied and then calculating the pro-rata amount based on the reasonable value.[24] For example, if the debtor vacated half of the rental space, then it would be liable for only fifty percent of the rent.[25]

Third, Congress and the courts recognized that § 503(b)(1) almost always resulted in administrative expenses, regardless of the amount, not being awarded until the end of the case, potentially years after they were due.[26] By forcing the landlord to wait until the end of the case, there was also a definite risk that the debtor would be administratively insolvent and therefore the landlord would be paid less than one hundred percent of the likely already reduced compensation.[27] Fourth, other tenants were burdened by § 503(b)

(1) because they were forced to collectively cover common area maintenance expenses that the debtor-tenant failed to pay.[28] Since tenants often share common area maintenance expenses, a burden was placed on the solvent tenants to compensate for the financial deficiency of their neighboring debtor-tenant.[29]

Finally, relying on § 503(b)(1) for recovery placed the landlord in a precarious position during the post-petition, pre-rejection period.[30] During this period, an automatic stay is entered that prevents the landlord from evicting the debtor-tenant while the debtor decides whether to assume or reject the lease.[31] The landlord, therefore, is forced to provide current services without current payment, a position that no other creditor is put into.[32]

Congress sought to alleviate the disparity between landlords and other post-petition creditors with the enactment of § 365(d)(3).[33] Senator Hatch spoke in a Congressional session regarding the need to "lessen the [landlords'] problems by requiring the trustee to perform all the obligations of the debtor…at the time required in the lease."[34] Congress enacted § 365(d)(3) to place landlords on equal footing as similarly situated post-petition creditors, and accordingly provide faster compensation.[35]

III. Analysis

A. Section 365(d)(3): Ambiguous or Unambiguous?

While most courts agree that the purpose behind § 365(d)(3) was to improve landlords' ability to recover stub rent and other charges relating to the post-petition period as administrative claims, there is wide disagreement about proper application of the statute when calculating stub rent.[36] Section 365(d)(3) reads in pertinent part that "[t]he trustee shall timely perform all the obligations of the debtor…arising from and after the order for relief…until such lease is assumed or rejected, notwithstanding section 503(b)(1) of this title."[37] Put simply, courts are split regarding whether § 365(d)(3) is ambiguous, leading some courts to conclude that stub rent is a post-petition administrative claim, while other courts conclude the claim is pre-petition, notwithstanding the fact that two courts are applying the same statute to the same commercial lease.[38] Whether stub rent is considered to arise pre-petition or post-petition has significant financial effects, because, as explained in *supra* Part II.A., post-petition claims are given administrative priority.[39]

1. Unambiguous

Nearly all courts that find the section to be unambiguous state that they find both "arise" and "obligations" to have an unambiguous plain meaning.[40] These courts, which favor the billing-date method, argue that the debtor's obligations, as well as when they arise, are governed by the express terms of the lease.[41] For example, when the Third Circuit analyzed "what Congress meant when it referred to 'obligations of the debtor arising under a lease after the order of relief,'"[42] the court considered whether the quoted phrase: (1) "require[s] payment by the trustee of all amounts that first become due and enforceable after the order under the terms of the lease," or (2) "require[s] the proration of such amounts based upon whether the landlord's obligation to pay the [amount owed] accrued before or after the [bankruptcy] order."[43] According to the Third Circuit, "to state these questions is to answer them," because

> [t]he clear and express intent of § 365(d)(3) is to require the trustee to perform the lease in accordance with its terms. To be consistent with this intent, any interpretation must look to the terms of the lease to determine both the nature of the "obligation" and when it "arises."[44]

Furthermore, courts applying the billing-date method state that it is not a court's role to make arguably better law and criticize proponents of proration as judicial activists.[45] Moreover, proponents of the billing-date method argue that when a provision is unambiguous it is a court's duty to apply the law as written.[46]

2. Is "Arises" Ambiguous?

Many courts that find ambiguity agree that the lease dictates the debtor's obligations, but argue that when the obligations arise is most definitely ambiguous.[47] These courts find ambiguity, stating that "arise" can be interpreted to mean (1) based on the strict terms of the lease or (2) in an accrual / piecemeal sense.[48] For example, if the obligation to pay rent arises on the first of March, but the debtor-tenant's bankruptcy petition is not entered until the second of March, then under the strict terms of the lease that obligation "arose" pre-petition and therefore is not entitled to administrative status pursuant to that interpretation of § 365(d)(3).[49] On the other hand, applying the second method, accrual, the result would be very different.[50] In that case, the obligation to pay rent would be deemed to arise "piecemeal"[51] every day; therefore, the landlord would have an administrative claim for all but the first day of the month, because the obligation to pay for thirty of the thirty-one days of March arose post-petition.[52] The accrual interpretation of "arise" derives support from the fact that Congress juxtaposed the word "arising" with the time period for which it corresponds, *e.g.*, "from and after the order for relief."[53]

3. Is "Until Such Lease Is Assumed or Rejected" Ambiguous?

Courts have also found considerable ambiguity in the phrase "until such lease is assumed or rejected."[54] Courts finding ambiguity with this phrase state that it can be construed as modifying either (1) "perform" or (2) "obligations."[55] If the phrase modifies perform, it would support enforcing obligations based on the terms of the lease, i.e., the strict sense of "obligations" discussed above.[56] On the other hand, if the phrase modifies "obligations," it would support the accrual approach.[57]

4. Legislative History

Unless a court is completely certain that a statute is unambiguous, legislative history should still be examined in order to ensure that the plain meaning of the statute "does not produce a result demonstrably at odds with the intention of its drafters."[58] Based on the aforementioned split in authority, regarding only the ambiguity, and not yet discussing the disparity of outcomes that results from choosing one interpretation over the other, the statute appears to be ambiguous enough to warrant examining the legislative history.[59] When considering the legislative history of § 365(d)(3), however, courts and scholars still disagree over the intention of Congress.[60]

B. Calculating Stub Rent Under § 365(d)(3): Arguments for Applying One Method Over the Alternative

Two distinct methods have developed to calculate stub rent under § 365(d)(3), with circuit courts on both sides, known as "proration" and "billing date."[61] As previously discussed, those courts following the billing-date method maintain that recovery for stub rent under § 365(d)(3) is entirely contingent on when the debtor-tenant's rent payment is due, regardless of whether the bill reflects a pre-petition and / or post-rejection expense.[62] On the other hand, courts following proration disregard when the debtor's payment is *due* and focus on the number of days the debtor was actually in possession of the property during the post-petition, pre-rejection period.[63]

1. Proration

Proponents of proration argue that the billing-date method goes far beyond Congress' goal of providing landlords with "current payment for current services."[64] Furthermore, they point out that when a debtor-tenant rejects a lease it no longer has the right to use, occupy, and enjoy the rental property.[65] Moreover, under the billing-date method, if the lease calls for the monthly rent payment in full on the first day of the month, and the debtor rejects the lease at any time before the last day of that month, the debtor will then be forced to pay for a period when he has no legal right to use the property.[66] Additionally, requiring payment, as an administrative expense, for the post-rejection period, while still allowing the landlord to rent the property to another tenant, could result in the landlord receiving a double recovery.[67]

Furthermore, some also argue that the billing-date method encourages debtor-tenants to strategically time their bankruptcy filing, which is repugnant to the policy of the Bankruptcy Code.[68] The moment of this argument stems from cases like *In re Koenig Sporting Goods, Inc.*, where the debtor tenant vacated the property on November second, but was still ordered to pay a full month's rent.[69] Although *Koenig* resulted in a windfall for the landlord, that win soon became another landlord's loss in *In re 1/2 Off Card Shop*.[70] In *In re 1/2 Off Card Shop, Inc.*, the debtor filed the petition on the second of June, and was therefore not required to pay rent for almost the entire month, because the obligation to pay came and passed on June first.[71] The *1/2 Off Card Shop* court relied heavily on *Koenig*.[72]

Additionally, courts favoring proration argue that the billing-date method gives unwarranted preference to landlords, over other similarly situated creditors, for recovery of pre-petition debts.[73] In circumstances where the rent is billed in arrears, as is often the case with percentage based rent,[74] proponents of proration argue that the landlord can submit a bill for pre-petition rent after the petition has been filed.[75] Under the billing-date method, the landlord will have an unwarranted administrative claim simply based on the happenstance of when the bill arrived.[76] A similarly situated creditor would not recover for goods it sent the debtor pre-petition regardless of whether the invoice was received post-petition.[77]

Finally, some courts argue that proration is the only acceptable interpretation of § 365(d)(3) when considering other sections of the Code, namely § 365(g) and § 502(g).[78] Congress directed the federal courts, with the enactment of both the former and latter sections, to treat claims for breach of lease obligations during the post-rejection period as pre-petition claims.[79] However, based on the billing-date method, ordering payment for obligations in that post-rejection period as administrative expenses would directly contradict the plain meaning and undisputed purpose of § 365(g) and § 502(g) of converting claims for an estate's failure to honor obligations after rejection into pre-petition claims.[80] Moreover, it is argued that when considering § 365(g) and § 502(g), the only cogent interpretation of § 365(d)(3) is proration.[81]

2. Billing-Date

Courts following the billing-date method fail to acknowledge the effect of § 365(g) and § 502(g), but instead rely heavily on a statement made by Senator Hatch during a Congressional session regarding § 365(d)(3)'s purpose.[82] These courts find great significance in the Senator's statement that § 365(d)(3) would address the "landlord's problems by requiring the trustee to perform all…obligations of the debtor under [a] lease…*at the time required in the lease*."[83] These courts seize upon the wording "at the time required in the lease" as conclusive evidence that Congress intended the terms of the lease to dictate when the obligation arose, not the date the petition was entered.[84] Accordingly, courts favoring the billing-date method argue that "a court should assume, absent specific indication to the contrary, that Congress intends the words in its enactments to carry their ordinary, contemporary, common meaning."[85]

Most courts applying the billing-date method concede that this approach can result in a windfall for both the debtor-tenant and the landlord depending on when the bankruptcy petition is entered.[86] Of those courts applying this method, some have argued that it is not unfair to the debtor-tenant, because it has control over when to file for bankruptcy.[87] Furthermore, these courts have somewhat encouraged debtors to strategically time their bankruptcy filing to avoid almost a full month's rent.[88] Although some courts have stated that the debtor has control over when to file,[89] other courts that also support the billing-date method have argued that the debtor often does not have control over its filing date, and therefore will not have the ability to manipulate it.[90] Thus, the inconsistency behind the reasoning of the different courts applying the same billing-date method is evident.[91]

Proponents of the billing-date method often state that proration is an unwarranted exercise of judicial discretion and the billing-date method is in accordance with the plain meaning of the statute.[92] Moreover, these courts argue that § 365(d)(3) is unambiguous, and therefore it is the courts' duty to enforce[93] the rules and not make them.[94] Many courts stating that the statute is unambiguous cite precedent decisions holding the same, but do not delve deeply into analyzing why their interpretation is the only appropriate one.[95] Opponents of the billing-date method counter this plain meaning argument proffered by proponents by stating that if § 365(d)(3) really were unambiguous, there would not be such wide disagreement among the circuit courts.[96]

IV. Argument: Proration Should Be Uniformly Adopted and Applied

Proration should be universally adopted and uniformly applied throughout the United States. First, proration is consistent with the overriding policy of the Bankruptcy Code, favoring equality of treatment of similarly situated creditors.[97] Second, proration will prevent the inevitable windfall that either the debtor-tenant or the landlord will receive if the billing-date method is used.[98] Finally, proration best accomplishes Congress' purpose behind § 365(d)(3) of "providing landlords with current pay for current services."[99]

A. Equal Treatment of Creditors

One of the "fundamental policies underlying the Bankruptcy Code is that similarly situated creditors be treated equally."[100] Applying the billing-date method allows pre-petition rent, which would otherwise not be entitled to administrative status, to be converted into a post-petition administrative claim simply based on the fortuity of when the payment is due.[101] This problem is very apparent when payment is due in arrears.[102] If the debtor-tenant files a petition for bankruptcy on March thirtieth and the rent for the month of March is due on the thirty-first, the bill would arrive post-petition.[103] Although thirty of the thirty-one days should be deemed pre-petition, because it was not until March thirtieth that the petition was entered, courts applying the billing-date method would allow the entire period to be treated as post-petition.[104] Moreover, these courts ignore the plain fact that the bill substantially reflects pre-petition rent, but nevertheless order it paid simply because the bill came one day into the post-petition period.[105] Although the landlord receives such favorable treatment, no other creditor would.[106] For example, if a widget manufacturer were to ship the same debtor-tenant one hundred crates of widgets on March twenty-first, but the debtor did not receive the invoice until March thirty-first, that widget manufacturer would not have a post-petition claim simply because the invoice came post-petition.[107] Congress intended § 365(d)(3) "to put landlords on an equal footing, not to grant them a windfall at the expense of other creditors."[108]

B. Proration Prevents Unwarranted Windfalls

Uniformly adopting proration will ensure that neither debtors nor landlords receive an undeserved windfall or detriment.[109] Courts applying the billing-date method leave the rights of the landlords and debtors open to turn on the happenstance of when the bill arrives in the mail.[110] Such an approach has left both creditors[111] and debtors[112] with severe windfalls, as well as significant unwarranted losses, and will continue to do so unless proration is uniformly adopted.[113] The court in *In re Koenig Sporting Goods, Inc.*, found that the debtor-tenant had to pay the full month's rent that was due on the first of the month even though the debtor only occupied the premises for two days of that month.[114] The court's decision resulted in the landlord being paid for services he never provided, as well as the debtor-tenant paying for services he never received.[115] Shortly after *Koenig* was decided, it was relied upon heavily in *In re 1/2 Off Card Shop, Inc.*[116] In that case, rent was also due in full on the first of the month; however, the debtor-tenant filed on the second of the month, and therefore the landlord was not entitled to a post-petition claim for that month.[117] In both of the previous examples, one party received a windfall to the other party's detriment.[118] As courts have noted, "the rug can be cut both ways," but is that really the best outcome?[119]

Applying proration to both of the aforementioned examples would result in an equitable outcome, with neither party receiving a windfall.[120] Every day the debtor-tenant occupies the premises after the petition is entered, the landlord would have a post-petition administrative claim, which is what Congress intended.[121] Furthermore, the debtor would be unable to strategically file its petition immediately after rent was due in order to force the landlord to recover the rent as an unsecured pre-petition claim.[122] Accordingly, proration must be adopted to ensure the debtor or landlord does not receive a windfall.

C. Proration Best Accomplishes Congress' Intent

Proration must be uniformly adopted because it best serves Congress' goal behind the enactment of § 365(d)(3) of providing landlords with current payment for current services.[123] Congress promulgated § 365(d)(3) because section § 507(a)(1) prevented landlords from evicting debtor-tenants[124] while they were still not ensured current payment, unlike other similarly situated creditors.[125] Applying the billing-date method would not accomplish Congress' goal because that approach can easily be manipulated to turn post-petition occupancy into a pre-petition claim, thereby circumventing payment for current services.[126] The debtor is often in a good position to control the timing of the bankruptcy filing, thereby allowing it to strategically file the petition immediately after rent comes due.[127] Under billing-date jurisdictions, if the rent is due only one day before the petition is entered, the landlord will not be provided with an administrative claim even though it is forced to provide post-petition services.[128] This is entirely repugnant to the intention of Congress as it directly violates the undisputed purpose behind the enactment of § 365(d)(3) because it leaves landlords without current payment for current services.[129]

V. Conclusion

Courts should uniformly adopt and apply the proration method when calculating stub rent under § 365(d)(3). Proration will best serve the underlying policy of the Bankruptcy Code and the legislative purpose of the provision. The goal of bankruptcy courts is to facilitate the reorganization of bankruptcy entities and grant equitable decisions. The inequitable and potentially unconscionable decisions that could result from applying the billing-date method make the decision to uniformly adopt proration clear. Applying proration allows courts to serve the exact purpose of § 365(d)(3), namely to provide landlords with current payment for current services just as other similarly situated creditors receive. Congress never intended the provision to be misconstrued in a way that could potentially elevate landlords over other similarly situated creditors while at the same time allowing debtor-tenants to circumvent the system by strategically filing for bankruptcy so as to prevent landlords from receiving current payment for their current services. Respectfully, proration is the only appropriate method for achieving Congress' purpose behind § 365(d)(3).

Endnotes

1. *E.g.*, Joshua Fruchter, *To Bind or Not to Bind—Bankruptcy Code § 365(d)(3): Statutory Minefield*, 68 Am. Bankr. L.J. 437, 438–39 (1994) ("Congress moved to alleviate the burdens imposed on landlords as a result of a tenant's bankruptcy by enacting § 365(d)(3) as part of the Bankruptcy Amendments and Federal Judgeship Act of 1984.").
2. *Id.* at 464 ("Senator Hatch's remarks…indicates that [a] purpose of § 365(d)(3) was to equalize the status of the debtor with that of other nondebtor tenants, who without § 365(d)(3), might otherwise be forced 'to increase their own payments to compensate for the trustee's or debtor's failure to make his own.'").
3. *E.g.*, *In re Ames Dep't Stores, Inc.*, 306 B.R. 43, 68 (Bankr. S.D.N.Y. 2004) ("Prior to…365(d)(3)…landlords could be required to wait for [bankruptcy plan] confirmation to recover their administrative claims for post-petition rent, even though landlords were required to continue to provide their property and services to the debtor's estate on an ongoing basis, starting with the earliest days of the bankruptcy case."); *see also* Newman v. McCrory Corp., 210 B.R. 934, 938 (Bankr. S.D.N.Y. 1997).
4. *In re Stone Barn Manhattan LLC*, 398 B.R. 359, 360 (Bankr. S.D.N.Y. 2008).
5. *Id.* at 362 (noting the consensus is that § 365(d)(3) required timely payment of rent, and it eliminated the discretion that courts had previously exercised to establish a market rent for use and occupancy, fixing the amount payable for use and occupancy at the rate provided in the lease).
6. *E.g.*, Josef S. Athanas & Scott A. Semenek, *Pro-Ration of Rent Dead in Third and Sixth Circuits—Landlords Won the Battle, but Will They Lose the War?*, 19 Bankr. Dev. J. 123, 131 (2002).
7. Fruchter, *supra* note 1, at 442 ("Specifically, courts disagree as to whether the requirement that a DIP [debtor in possession] 'timely perform all of its obligations from and after the order for relief… until [such] lease is rejected' requires the court to calculate the pro rata amount of rent, taxes and other expenses attributable to the prerejection period and to order the DIP to pay only that sum (the 'proration theory'), or whether a court should order the DIP to pay all bills submitted by the landlord during the prerejection period regardless of whether a portion of the bill corresponds to charges that accrued prepetition (the 'billing date theory').").
8. *Id.* at 437 ("[I]f the acts or wrongdoing giving rise to the creditor's claim occurred prior to the filing of the debtor's bankruptcy petition, then the creditor possesses a prepetition claim, and can probably expect to receive a distribution from the debtor's estate upon the confirmation of a chapter 11 plan of reorganization or a chapter 7 liquidation.").
9. *Id.*
10. *E.g.*, *Child World, Inc. v. Campbell Trust*, 161 B.R. 571, 574 Bankr. (S.D.N.Y. 1993) (explaining that the Bankruptcy Code is structured to promote bankrupt entities' economic rehabilitation).
11. *Id.*
12. *E.g.*, Fruchter, *supra* note 1, at 437 ("Congress sanctioned special treatment for the claims of parties who provide postpetition goods and services to a debtor.").
13. *Id.* at 438 ("In a chapter 11 case…the debtor's plan of reorganization must provide for cash payment in full to all administrative expense holders, unless a claimant agrees to a different method."). Although post-petition obligations are ordinarily given payment priority as administrative expenses, such claims are still subjected to the "standard procedures of notice and a hearing to demonstrate that the costs were actual, necessary expenses of preserving the estate." *In re Goody's Family Clothing Inc.*, 610 F.3d 812, 817 (3d Cir. 2010); *see also* 11 U.S.C. § 503(b) (2006) ("After notice and a hearing, there shall be allowed administrative expenses,…including…the actual, necessary costs and expenses of preserving the estate.").
14. *E.g.*, *In re Trak Auto Corp.*, 277 B.R. 655, 664 (Bankr. E.D. Va. 2002) ("Anything accruing after the entry for the order for relief is a post-petition charge that may be elevated to administrative priority under § 507(a).").
15. Athanas & Semenek, *supra* note 6, at 125 ("[A] prepetition unsecured claim for rent [will] ultimately [be] satisfied with pennies on the dollar at the conclusion of the debtor's bankruptcy case."); *see also* Fruchter, *supra* note 1, at 437–38.
16. *See In re Stone Barn Manhattan LLC*, 398 B.R. 359, 361–62 (Bankr. S.D.N.Y. 2008) (noting that prior to the 1984 amendments administrative claims were construed narrowly).
17. *See In re Krystal Co.*, 194 B.R. 161, 163 (Bankr. E.D. Tenn. 1996) ("Courts adopting the accrual theory believe [§ 365(d)(3)] allows them to adhere to the pre-1984 practice of prorating…between the prepetition [period] and prerejection period."); *see also In re Ames Dep't Stores, Inc.*, 306 B.R. 43, 69 (Bankr. S.D.N.Y. 2004) ("[N]othing in the legislative history indicates that Congress intended 365(d)(3) to overturn the long-standing practice under 503(b)(1) of prorating debtor-tenants' rent to cover only the postpetition, prerejection period, regardless of billing date.").
18. *See In re Ames Dep't Stores, Inc.*, 306 B.R. at 69.
19. *See, e.g.*, Fruchter, *supra* note 1, at 438–39 (discussing the problems that landlords encountered as a result of relying on § 507(b)(1) for recovery of stub rent).
20. *E.g.*, *Centerpoint Prop. v. Montgomery Ward Holding Corp.*, 268 F.3d 205, 213 (3d Cir. 2001).
21. *E.g.*, *id.* (explaining the burdens § 503(b)(1) placed on landlords).
22. *E.g.*, *id.*
23. Fruchter, *supra* note 1, at 438 n.14 ("[O]rdinarily…courts fix a landlord's award at the rate set forth in the lease. Some courts even held that there was a rebuttable presumption that the contractual rent was a fair and reasonable charge."); *see also In re Stone Barn Manhattan LLC*, 398 B.R. 359, 361 (Bankr. S.D.N.Y. 2008).
24. Fruchter, *supra* note 1, at 438–49.
25. *See In re Montgomery Ward Holding Corp.*, 268 F.3d at 213.

26. *See id.*

27. Robert L. LeHane, Gilbert R. Saydah Jr. & Heather E. Allen, *Stub Rent and the Way Around Montgomery Ward*, Am. Bankr. Inst. J. 20, July–Aug. 2009 ("Rather than having [a] claim paid 'timely' as required by § 365(d)(3), § 503(b)(1) claims are usually paid at the end of the case, alongside other administrative claims. Request for immediate payment of administrative claims are generally denied.").

28. *E.g., In re Krystal Co*., 194 B.R. 161, 163–64 (Bankr. E.D. Tenn. 1996) ("[One] problem is that during the time the debtor has vacated the space but has not yet decided whether to assume or reject the lease, the trustee has stopped making payments due under the lease. These payments include…common area charges which are paid by all the tenants according to the amount of space they lease. In this situation…other tenants often must increase their common area charge payments to compensate for the trustee's failure to make the required payments for the debtor.").

29. *Id.* (discussing the burden placed on co-tenants of the debtor).

30. *In re Handy Andy Home Improvement Centers, Inc.*, 144 F.3d 1125 (7th Cir. 1998).

31. *Id.*

32. *E.g.*, Fruchter, *supra* note 1, at 463 ("[D]uring the time the debtor has vacated…but has not yet decided whether to assume or reject the lease, the trustee has stopped making payments due under the lease [and] the landlord is forced to provide current services…without current payment. No other creditor is put in this position."); *see also In re Handy Andy Home Improvement Centers, Inc.*, 144 F.3d at 1128 ("[M]ost of the other [creditors] were dealing voluntarily with a bankrupt [entity] and thus [were] knowingly assuming the risk of not being fully compensated for their services, while the landlord was forced to deal with his bankrupt tenant on whatever terms the bankruptcy court imposed because he could not evict him.").

33. Fruchter, *supra* note 1, at 463.

34. *See, e.g.*, *In re Krystal Co.*, 194 B.R. 161, 164 (Bankr. E.D. Tenn. 1996) ("[T]his timely performance requirement will ensure that debtor-tenants pay their rent, common area, and other charges on time pending the trustee's assumption or rejection of the lease.").

35. *E.g.*, *In re Trak Auto Corp.*, 277 B.R. 655, 663 (Bankr. E.D. Va. 2002) ("[A] goal in enacting [365(d)(3)] was to 'put landlords on an equal footing.'"); *see also Centerpoint Prop. v. Montgomery Ward Holding Corp*. (*In re Montgomery Ward Holding Corp.*), 268 F.3d 205, 215 (3d Cir. 2001) ("[N]othing in the text or legislative history suggests that Congress wished to go beyond putting landlords on the same footing with other trade creditors.").

36. *See, e.g.*, *In re Stone Barn Manhattan LLC*, 398 B.R. 359, 362 (Bankr. S.D.N.Y. 2008).

37. 11 U.S.C. § 365(d)(3) (2006). "The purpose of § 365(d)(3) is to protect landlords from the burdensome requirements of § 503(b)(1) in securing payment from non-occupying debtors; it would be perverse…to conclude that it…precluded the use of § 503(b)(1) to secure 'stub rent' from a debtor actually occupying the premises." *In re Goody's Family Clothing Inc*., 610 F.3d 812, 818 (3d Cir. 2010).

38. *Compare In re Ames Dep't Stores, Inc*., 306 B.R. 43, 66–67 (Bankr. S.D.N.Y. 2004) (finding proration to be the appropriate method), *with Centerpoint Prop. v. Montgomery Ward Holding Corp*. (*In re Montgomery Ward Holding Corp*.), 268 F.3d 205, 215 (3d Cir. 2001) (concluding that the billing-date method is proper); *see also* Athanas & Semenek, *supra* note 6, at 131 (noting the split in authority).

39. *See supra* notes 10–15 (explaining how Congress, through the Bankruptcy Code, prioritizes recovery for post-petition administrative claims over pre-petition claims).

40. In re Montgomery Ward Holding Corp., 268 F.3d at 209; *In re Ames Dep't Stores, Inc.*, 306 B.R. at 66.

41. *See In re Montgomery Ward Holding Corp.*, 268 F.3d at 209 (it is well settled in the Third Circuit that, in the context of section 365(d)(3), the plain meaning of "obligation is something that one is legally required to perform under the terms of the lease." Moreover, "an obligation [only] arises when one becomes legally obligated to perform it.").

42. *Id.* at 208.

43. *Id.* at 209.

44. *Id.*

45. *See In re Montgomery Holding Ward Co.*, at 211.

46. *See, e.g.*, *In re Ames Dep't Stores, Inc*., 306 B.R. 43, 66 (Bankr. S.D.N.Y. 2004) ("[U]nambiguous statutes are to be applied in accordance with their terms…even when inconsistent with what many would regard as the preferred result."). *But see, e.g.*, *In re Stone Barn Manhattan LLC*, 398 B.R. 359, 367 (Bankr. S.D.N.Y. 2008) (noting when the "literal application of a statute will produce a result demonstrably at odds with the intentions of its drafters…the intention of the drafters, rather than the strict language, controls.").

47. *In re Montgomery Ward Holding Corp*., 268 F.3d at 213 (Mansmann, J., dissenting) ("[w]hile I agree that the terms of the lease determine the obligation, the statute says nothing about how to determine when the obligation arises.…I can find no indication of a specific intent to displace proration with the billing date approach.").

48. *E.g.*, *In re Ames Dep't Stores, Inc*., 306 B.R. at 67–68.

49. *See* Athanas & Semenek, *supra* note 6, at 136.

50. *See* Michael J. Lichtenstein, *The Payment of "Stub Rent" Under the Bankruptcy Code*, 36 Real Est. L.J. 144, 147 (2007) ("A debtor is required by section 365(d)(3) to timely pay those amounts due under a lease that pertain to the benefits realized by the estate during the post-petition, pre-rejection period regardless of when the payment(s) became due. In other words, the obligations arising under a lease are prorated based upon whether and to the extent that they relate to benefits that were enjoyed by the debtor on a pre-petition basis or a post-petition, pre-rejection basis.").

51. *See, e.g.*, *In re Ames Dep't Stores, Inc*., 306 B.R. 43,79–80 (Bankr. S.D.N.Y. 2004) (while "*Handy Andy* endorsed an accrual approach, with respect to [taxes] that 'could realistically be said to have arisen piecemeal' every day of the relevant time period, that approach would be no less applicable…with respect to a landlord's rental claim, which likewise would arise piecemeal over any given period of time."); *see also In re Nettel Corp. Inc. and Nettel Commc'n Inc*., 289 B.R. 486, 491 (Bankr. D.C. 2002).

52. *See* Lichtenstein, *supra* note 50, at 3.

53. Fruchter, *supra* note 1, at 453 ("The syntax of the statute…suggests that it is the date of the petition, not the terms of the lease, that constitutes the decisive factor in determining which obligations are subject to the 'timely perform' obligation.").

54. *See In re Ames Dep't Stores, Inc*., 306 B.R. at 67 ("The clause 'until such lease is assumed or rejected' is of critical importance….").

55. *Id.* ("[I]t is the modifiers associated with 'obligations'—modifiers describing *which* obligations are the subject of the section 365(d)(3)'s coverage and to what the clause beginning 'arising' refers, rather than the word 'obligations' itself—that create the ambiguity. The clause 'until such lease is assumed or rejected' is of critical importance to any analysis, in this Court's view, particularly in light of sections 365(g) and 502(g) which treat failures to honor lease obligations after rejection as pre-petition claims.").

56. *Id.*

57. *Id.*

58. Fruchter, *supra* note 1, at 453.

59. *Id.* ("[I]nterpreting the language of § 365(d)(3) is far from plain. It is possible that Congress intended a debtor to pay immediately only those obligations accruing after the order for relief, and that the use of the word 'obligation,' rather than 'debt,' constituted a drafting oversight. Alternatively, perhaps Congress deliberately used the word 'obligation' instead of 'debt,' and the word 'arising' means 'becoming fixed.' In any event, it seems the statute is ambiguous

enough to make examining the purpose of [it], as expressed in the legislative history, worthwhile.”).

60. *Compare* Fruchter, *supra* note 1, at 463 (“Some courts seize upon Senator Hatch’s observation that, under the pre-1984 Code, landlords were forced to ‘provide current services…without current payment,’ as proof that Congress still envisioned proration. The ‘current services’ comment, however, merely *describes the problem* identified by Congress; it does not *describe the solution* enacted. Only later, at the end of the second quoted paragraph, does Senator Hatch describe the relief enacted when he states that ‘[t]his bill would lessen [landlords’] problems by requiring the trustee to perform *all the obligations of the debtor under a lease…at the time required in the lease*. This language should clearly demonstrate that Senator Hatch anticipated (i) that the trustee [or debtor in possession] would be bound to perform all of the obligations imposed on the prebankruptcy debtor by the lease, and (ii) that the terms of the lease would govern when payments were due and for what amounts.’”), *with In re Montgomery Ward Holding Corp.*, 268 F.3d 205, 215 (3d Cir. 2001) (“[Courts following the billing-date method seek] to marshal support for [their] interpretation from the remarks of Senator Hatch in the legislative history. However, the Senator’s observations that the trustee must perform ‘all the obligations…at the time required in the lease’ simply has no bearing on the question before us. The quoted passage merely indicates when an obligation must be *performed*…. It simply does not address how to determine when the obligation *arises*.”).

61. Athanas & Semenek, *supra* note 6, at 129–131.

62. Lichtenstein, *supra* note 50, at 146.

63. *E.g.*, *id.* at 147 (“[T]he obligations arising under a lease are prorated based upon whether and [only] to the extent that they relate to benefits that were enjoyed by the debtor on a…post-petition, prerejection basis.”).

64. *See, e.g.*, *In re Ames Dep’t Stores, Inc.*, 306 B.R. 43, 70–71 (Bankr. S.D.N.Y. 2004) (“Senator Hatch noted, in explaining the rationale for the enactment of section 365(d)(3)…‘that the landlord is forced to provide *current services*…without current payment.’… A landlord would not be providing ‘current services’ after the debtor rejects a lease, for at that time the debtor would have no right to continued occupancy, or to services from the landlord.”).

65. *E.g., In re Nettel Corp. and Nettle Commn’c, Inc.*, 289 B.R. 486, 492 (Bankr. D.C. 2002) (“[T]here ought not be any administrative claim attributable to the estate’s nonexistent right of occupancy during the postrejection period, otherwise the estate will be saddled with a burden that rejection is designed to avoid.”); *see also In re Ames Dep’t Stores, Inc.*, 306 B.R. at 70–71.

66. *E.g., In re Ames Dep’t Stores, Inc.*, 306 B.R. at 71.

67. *E.g.*, *id.*

68. Athanas & Semenek, *supra* note 6, at 125 (“Every retail debtor will file its chapter 11 case on the second day of a month. Why not? Under Koenig and Montgomery Ward, filing on the second day of the month entitles the debtor to utilize the leased premises for a month without paying rent due. Instead of receiving rent when due…landlords will merely have a prepetition unsecured claim for the rent, ultimately satisfied with pennies on the dollar at the conclusion of the debtor’s bankruptcy case.”); *Id.* (“Debtors will wait for large annual bills…to arrive just prior to filing as well. A properly timed chapter 11 filing will enable debtors to receive millions in postpetition benefits from landlords while the landlords get only prepetition unsecured claims in return.”).

69. *See Koenig Sporting Goods, Inc., v. Morse Road Co.* (*In re Koenig Sporting Goods, Inc.*), 203 F.3d 986, 989 (6th Cir. 2000).

70. *See* Athanas & Semenek, *supra* note 6, at 136.

71. *E.g.*, *id.*

72. *Id.* (explaining that *Koenig* and *1/2 Off Card Shop* opened the door for debtors manipulating the bankruptcy system by strategically filing their bankruptcy petition the day after rent is due).

73. *See, e.g.*, *Child World, Inc. v. Campbell Trust* (*In re Child World, Inc.*), 161 B.R. 571, 576 (S.D.N.Y. 1993).

74. *In re Ames Dep’t Stores, Inc.*, 306 B.R. 43, 71 (Bankr. S.D.N.Y. 2008) (“Percentage rent, which typically is computed based on past sales—may be ascertainable only in retrospect, and may thus be billed by landlords in arrears.”).

75. *See In re Child World, Inc.*, 161 B.R. at 576 (“Allowing landlords to recover for items of rent which are billed during the postpetition, prerejection period, but which represent payment for services rendered by the landlord outside this period, would grant landlords a windfall payment, to the detriment of other creditors, without any support from the legislative history.”).

76. *E.g., In re Ames Dep’t Stores, Inc.*, 306 B.R. at 71 (“Depriving landlords of payment for…post-petition, pre-rejection obligations, based on the happenstance that they could not be ascertained in advance and billed prior to rejection, would be unfair to landlords, just as billing debtors for post-rejection occupancy is unfair to the other creditors.”).

77. Athanas & Semenek, *supra* note 6, at 139–40.

78. *See In re Ames Dep’t Stores, Inc.*, 306 B.R. at 70.

79. *E.g.*, *id.*

80. *Id.* at 68 (explaining the purpose of § 365(g) and § 502(g)).

81. *See id.* at 70.

82. *See, e.g.*, Fruchter, *supra* note 1, at 463 (emphasis added).

83. *See id.*

84. *See id.* (“The ‘current services’ comment…merely *describes the problem* identified by Congress; it does not *describe the solution* enacted. Only later…does Senator Hatch describe the relief enacted when he states that ‘[t]his bill would lessen [landlords’] problems by requiring the trustee to perform *all the obligations of the debtor under a lease…at the time required in the lease*. The language should clearly demonstrate that Senator Hatch anticipated (i) that the trustee [or debtor in possession] would be bound to perform all of the obligations imposed on the prebankruptcy debtor by the lease, and (ii) that the terms of the lease would govern when payments were due and for what amounts.”).

85. *E.g.*, *id.* at 451–52.

86. *See* Athanas & Semenek, *supra* note 6, at 136–37 (discussing that the *In re 1/2 Off Card Shop* court conceded that under the billing-date method “the rug can be cut both ways” for landlords and debtors, depending on the date a petition is filed).

87. *E.g.*, *In re Stone Barn Manhattan LLC*, 398 B.R. 359, 367–68 (Bankr. S.D.N.Y. 2008).

88. *See* Lichtenstein, *supra* note 50, at 2 (noting that in *In re Ha-Lo Industries, Inc.*, the Seventh Circuit pointed out that the debtor controlled the timing and could have rejected the lease effective October 31, rather than November 2, in order to avoid paying the rent).

89. *In re Stone Barn Manhattan LLC*, 398 B.R. at 367–368.

90. Athanas & Semenek, *supra* note 6, at 137–37.

91. *Compare In re Stone Barn Manhattan LLC*, 398 B.R. at 367–68 (“Many of the judges who have rejected the proration approach…have stressed that the billing date principle is not unfair to a debtor because the debtor has control over the date of contract rejection and could plan to avoid an extra month’s rent.”), *with* Athanas & Semenek, *supra* note 6, at 137 (“Rather than addressing the debtor’s ability to manipulate the filing date, however, the court [in *In re 1/2 Off Card Shop*] merely stated that the debtor often does not have control over its own filing date.”).

92. *See, e.g.*, *In re Stone Barn Manhattan LLC*, 398 B.R. at 364 (discussing how proration is repugnant to the plain meaning of the statute).

93. *See In re Goody’s Family Clothing Inc.*, 392 B.R. 604, 608 (Bankr. Del. 2008) (“[T]he starting point of statutory analysis is the plain meaning of the text of the statute…when the statute’s language is

plain, the sole function of the court . . .is to enforce it according to its terms."); *see also id.* ("Congress says in a statute what it means and means in a statute what it says there.").

94. *Centerpoint Props. v. Montgomery Ward Holding Corp.* (*In re Montgomery Ward Holding Corp.)*, 268 F.3d 205, 211 (3d Cir. 2001) ("We acknowledge that there are aspects to a proration approach that Congress might have found desirable. It is not our role, however, to make arguably better laws than those fashioned by Congress.").

95. *See In re Ames Dep't Stores, Inc.*, 306 B.R. 43, 76–77 (Bankr. S.D.N.Y. 2004) ("[T]he *Koenig* court…with no more discussion of section 365(d)(3)'s language than a quotation of it,…held that 365(d)(3) is unambiguous.…In particular, it failed to discuss what it believed 'until such lease is assumed or rejected' refers to. And it never mentioned sections 365(g) and 502(g)…or how section 365(d)(3) can be construed consistent with the requirements of those provisions."); *see also id.* (discussing *In re HA-LO*).

96. Athanas & Semenek, *supra* note 6, at 131.

97. *E.g.*, Fruchter, *supra* note 1, at 448 (explaining that one of the fundamental policies underlying the Bankruptcy Code is that similarly situated creditors be treated equally: "allowing landlords to recover for prepetition services, by invoicing such services postpetition, constituted an unfair windfall to landlords at the expense of other creditors").

98. *See, e.g.*, Athanas & Semenek, *supra* note 6, at 137 ("The accrual method is also fundamentally fair, whereas the billing method ensures that either a landlord or a debtor will receive an unfair windfall not once in a while, but in practically every case.").

99. *See In re Comdisco, Inc.*, 272 B.R. 671, 675–76 (Bankr. N.D. Ill. 2002) ("[The billing-date] construction of § 365(d)(3) risks undermining bankruptcy reorganizations by imposing costs that are unnecessary."); *see also id.* ("Proration…would not defeat the purpose of § 365(d)(3) or seriously injure the landlords because they would still be paid for current services at the lease rates.").

100. Athanas & Semenek, *supra* note 6, at 129 (discussing that equality of treatment among similarly situated creditors is fundamental to the policy behind the Bankruptcy Code).

101. *See, e.g.*, *In re Nettel Corp. Inc. v. Nettel Commc'n, Inc.*, 289 B.R. 486, 490 (Bankr. D.C. 2002) ("Unless § 365(d)(3) has a plain meaning that precludes any other interpretation, it is undesirable to interpret it as operating in a manner (as it would under the [billing-date method]) that depends on the fortuity of the time of the month of the order for relief or the rejection of the lease.").

102. *In re Ames Dep't Stores, Inc.*, 306 B.R. 43, 71 (Bankr. S.D.N.Y. 2004).

103. *See* Fruchter, *supra* note 1, at 442.

104. *See Koenig Sporting Goods, Inc. v. Morse Road Co.* (*In re Koenig Sporting Goods, Inc.)*, 203 F.3d 986, 989 (6th Cir. 2000) ("Under the terms of the lease the debtor was obligated to pay [the landlord] $8,500 in advance on the first of each month for that month's rent. The specific obligation to pay rent for December 1997 arose on December 1, which was during the postpetition, prerejection period. Under these circumstances, § 365(d)(3) is unambiguous as to the debtor's rent obligations and requires payment of the full month's rent" even though the debtor vacated on December 2.).

105. *See id.*

106. Athanas & Semenek, *supra* note 6, at 139–40 ("If a vendor ships goods to a debtor on January 1 and the debtor files on January 2, the vendor does not get paid in full for those goods regardless of whether the vendor sends the invoice on January 1 or January 4.").

107. *Id.*

108. *In re Ames Dep't Stores, Inc.*, 306 B.R. 43, 69 (Bankr. S.D.N.Y. 2004); *id.* at 73 (explaining that under the billing-date method, a debtor-tenant or trustee would be ordered to pay for a full year's rent that came due immediately after the petition was entered, even if the debtor rejected the lease and vacated the property prior to the commencement of the term covered by that annual payment).

109. *See supra* note 98.

110. *In re Ames Dep't Stores, Inc.*, 306 B.R. at 71. (discussing how basing recovery based on fortuity is undesirable).

111. *See Koenig Sporting Goods, Inc. v. Morse Road Co.*, 203 F.3d 986, 989 (6th Cir. 2000) (finding a windfall for landlord).

112. *See* Athanas & Semenek, *supra* note 6, at 136 (finding a windfall for debtor-tenant).

113. *Compare Koenig Sporting Goods, Inc.*, *supra* note 111, at 989 (stating "The specific obligation to pay rent for December 1997 arose on December 1, which was during the postpetition, prerejection period. Under these circumstances, § 365(d)(3) is unambiguous as to the debtor's rent obligations and requires payment of the full month's rent" even though the debtor vacated on December 2), *with* Athanas & Semenek, *supra* note 6, at 136 ("The bankruptcy court…held that because rent for the entire month of June was due June 1, the day prior to the petition date, the debtor did not have to pay any rent for the month of June. Instead, the landlords were only entitled to a prepetition claim for the full amount of the June rent.").

114. *Koenig Sporting Goods, Inc.*, *supra* note 111 at 988–89.

115. *See id.* at 989 (noting the landlord's windfall could have been avoided if the debtor strategically filed the petition).

116. Athanas & Semenek, *supra* note 6, at 136.

117. *Id.*

118. *See id.*

119. *Id.* (explaining proration is a better alternative to the billing-date method).

120. *See* Lichtenstein, *supra* note 50, at 1 (stating "[i]n a jurisdiction that has adopted [proration], a debtor tenant will be liable for a pro-rated share of administrative rent, determined by the date of filing through the end of the month.").

121. *Id.*

122. *See In re Trak Auto Corp.*, 277 B.R. 655, 663 (Bankr. E.D. Va. 2002) (discussing how it is undesirable to base recovery on when bills arrive because it promotes manipulation of the bankruptcy system).

123. *See In re Comdisco, Inc.*, 272 B.R. 671, 675–76 (Bankr. N.D. Ill. 2002).

124. *El Paso Prop. Corp. v. Gonzales*, 282 B.R. 60, 69–70 (10th Cir. 2002) (noting that § 507(a)(1) prevented landlords from evicting the debtor-tenant).

125. *Newman v. McCrory Corp.*, 210 B.R. 934, 938 (S.D.N.Y. 1997).

126. *See, e.g.*, *In re Trak Auto Corp.*, *supra* note 122 (discussing how the billing-date method will promote manipulation of the bankruptcy system); *see also* Athanas & Semenek, *supra* note 6, at 136.

127. *In re Stone Barn Manhattan LLC*, 398 B.R. 359, 367–68 (Bankr. S.D.N.Y. 2008) (noting that the debtor is in a good position to manipulate the date of filing a petition for bankruptcy).

128. *See* Athanas & Semenek, *supra* note 6, at 136.

129. *Id.* at 142 (explaining the result of applying the billing-date method can easily leave landlords without current payment for the current services they are forced to provide).

Benjamin P. Chapple was a third-year law student at Widener University School of Law when he wrote this article. He graduated in the Spring of 2013 with a concentration in Business Organizations Law. He served on the *Delaware Journal of Corporate Law*'s Editorial Board as an Articles Editor. Further, during his studies, Mr. Chapple completed judicial internships at the United States Court of Appeals for the Third Circuit and the Superior Court of Delaware.

Committee Reports

Report of the Section Chair

The Business Law Section needs you, every one of you. In my article about our Section in the September State Bar *Journal*, I wrote about the Section's Committees and what we can offer to you. Now I am going to turn the tables. The Business Law Section is only as good as its members. Thousands of the best business lawyers in the state are members of our Section, and we are asking each of you to give us some of your time and some of your expertise.

We need people to write articles; we need bloggers to keep our Business Law Section Blog current; we need Executive Committee members to provide direction to our Section; we need speakers to share their knowledge at our CLE sessions; we need drafters to help draft proposed legislation and regulatory comment letters; we need officers to organize our CLE sessions and other things that we do; we need people to give us ideas on new programs and initiatives we haven't even thought of yet; and we need the rest of you to help move our Section forward. If you are willing to volunteer to help us…whether in a leadership role or just as an occasional contributor, e-mail me at BLSCHAIR@GMAIL.COM and I will help you find an appropriate niche.

Jay L. Hack, Chair, Business Law Section

Report of the Section Program Chair

The NYSBA Business Law Section nestled its annual Fall Meeting among the early autumn's gently changing leaves and morning-mist enshrouded mountains surrounding the Cranwell Resort & Spa in Lenox, Massachusetts on Friday, October 4 and Saturday, October 5, 2013. General CLE sessions focused on the legal and ethical ramifications of cyber security, cyber liability, data loss, privacy claims, and clients' and firms' social media exposures. Each of these probed the many exposures that statutory schemes, regulators, and an increasingly creative plaintiff's bar present to businesses and their lawyers, and how each can take preventive measures to identify, quantify, and control those risks and develop the most efficient and effective responses to litigation challenges.

The general sessions were followed by various section committee meetings. The Banking Law Committee heard about ethical considerations from experts on corporate governance and ethics issues and public and private securities offerings. The Bankruptcy Law Committee considered counsels' right to fees in insolvency cases and strategies for recovery of those fees from secured, general unsecured, and priority creditors. The Corporations Committee heard about the current legal landscape and judicial recognition of various methods of appraising and valuing companies, shares, and damages. These are discussed in more detail in the individual Committee reports, below.

Finally, after cocktails and an elegant dinner, the Section's own David Glass put into words that which so many have known intuitively for so long but had not been able to express—that the Beatles truly did both remake—and save—popular music. By comparing the compositional techniques of the Beatles to those of composers from Bach to Bernstein, David brought to life how the Beatles took what was familiar and made it revolutionary—while saving popular music from a dead end of monotone monochromes.

The Business Law section's meeting, then, from locale to subject matter to entertainment, brought together a unique blend of color and excitement. We look forward to seeing you at the January annual NYSBA meeting!

James Everett, Program Chair

Banking Law Committee

The chairmanship of the Banking Law Committee passed to me June 1, and I have big shoes to fill—David Glass has been a great chair of the committee, and fortunately he remains a member of the committee and has been of great assistance helping me learn the ropes.

At the October 3-5, 2013, Business Law Section Fall Meeting held at the Cranwell Resort in Lenox, Massachusetts, a meeting of the members of the Banking Law Committee (and anyone else who wished to attend) was held on Friday, October 4. The title of the program was "Current Ethical Issues for Banking Law Practitioners," and we had as our distinguished guests Robert Mundheim and Robert Evans III, both of Shearman & Sterling LLP and both experts on ethics issues. The panel and attendees discussed several interesting hypotheticals, each of which raised questions that many of the attendees had seen come up in their own practices. This meeting also provided the opportunity to obtain those all-important Ethics CLE credits that all New York lawyers need. We hope to have Messrs. Mundheim and Evans present again at a future meeting.

The next formal meeting of the Banking Law Committee will be held during the NYSBA Annual Meeting in January 2014. Following up on comments made at the May meeting, when a representative of the Federal Reserve Bank of New York spoke about the FRB's supervisory concerns regarding foreign and large domestic financial institutions that it oversees, I am working at putting together a program at the January meeting that focuses on supervisory issues for community banks, with a panel of state and federal banking regulators to discuss those issues.

Suggestions have been made about having additional meetings during the year that focus on current issues, and I am pursuing that suggestion and will be surveying the committee members to determine the format and frequency of such meetings, which we may be able to do via webcast.

Kathleen A. Scott, Chair

Bankruptcy Committee

Since we last reported in the Summer 2013 issue of the *Journal*, the Bankruptcy Committee met at the spring Business Law Section meeting, at which a presentation on "Current Issues in Bankruptcy and Real Estate" was given. The committee also met at the Fall Meeting of the Section, which included a panel discussion on "Creditors' Attorneys Fees in Bankruptcy." Our committee will also be co-sponsoring a practical skills program with the NYSBA Committee on Continuing Legal Education, entitled "Basics of Bankruptcy Practice" in November and December 2013 in Buffalo, Melville, Manhattan, Albany and Syracuse.

Kevin Newman, Chair

Corporation Law Committee

At a meeting in New York City on May 10, 2013, the Corporation Law Committee sponsored a program entitled NYSBA "Proposed Revision of the New York Not-For-Profit Corporation Law." The program featured Frederick G. Attea of Phillips Lytle, Michael A. deFreitas of William C. Moran & Associates, and Joshua E. Gewolb of Harter Secrest & Emery. All three of our speakers have been actively involved for many years in drafting pending legislation that would modernize the New York Not-For-Profit law. At the same meeting, Richard De Rose gave a presentation comparing certain salient aspects of New York corporate law with counterpart provisions in the Delaware General Corporation Law.

On October 5, 2013, at the Fall Meeting at the Cranwell Resort, Richard De Rose presented on "Valuation in a Legal Context," highlighting the methodologies that investment bankers and financial advisors use in valuing companies and securities and discussing the cases that have discussed those methodologies.

Richard De Rose, Chair

Derivatives and Structured Products Committee

No report submitted.

Franchise, Distribution and Licensing Law Committee

Since the last report of the Franchise, Distribution and Licensing Law Committee, the Committee's activities have primarily been focused on tracking and analyzing the progress with respect to our proposed modifications to the New York Franchise Sales Act and the accompanying regulations thereto. The Committee is coordinating with the Legislative Affairs Committee of the Business Law Section in planning a strategy to effectuate the arduous task of shepherding the proposed changes to the Franchise Sales Act through the State legislative process. As we have previously noted to members of the NYSBA, certain inconsistencies exist between the present New York statute and the amended Federal Franchise Rule, and the legislative changes proposed by the Committee are designed to make the New York statute more consistent with the Federal Rule and, in addition, to make New York State a more attractive venue for franchisors who, in the past, have shied away from setting up their franchise "base" within our State.

Several members of the Committee attended the Fall meeting of the Business Law Section, including a meeting of the Section's Executive Committee, held October 3-5 in Lenox, Massachusetts. At this meeting, amongst other things, the proposed changes to the New York State Franchise Sales Act were discussed, and the Legislative Affairs Committee indicated that our proposed legislation was high on its "list of priorities" to pursue. Finally, the Committee plans on holding its next meeting in conjunction with the Annual Meeting of the New York State Bar Association, scheduled to be held on January 28, 2014 in New York City. For further information regarding the Committee and its activities or with respect to the next Committee meeting, please contact Committee Chair Richard L. Rosen (rlr@rosenlawpllc.com or at 212-644-6644).

Richard L. Rosen, Chair

Insurance Law Committee

The recent months have seen a host of important regulatory developments in the insurance industry, including: initiatives by the New York Department of Financial Services with respect to reserving issues and the use of captive reinsurance by life insurers and on a number of other fronts; related activity and dialogue within working groups of the National Association of Insurance Commissioners; and, at the federal level, the activities of the Federal Insurance Office and the Financial Stability Oversight Council's steps toward designating some insurance groups as systemically significant financial institutions subject to oversight by the Federal Reserve Board. The Committee plans to review these developments and the outlook going forward at a meeting to be held in January 2014 in connection with the next Annual Meeting.

Thomas M. Kelly, Chair

Legislative Affairs Committee

Members of the Legislative Affairs Committee met September 17, 2013. We discussed pending legislative initiatives and the committee's role in commenting on proposed legislation that affects business in New York and initiating new proposed legislation. I suggested that the committee have a mission: to improve New York laws in ways that reinforce New York's stature as a center of commerce. State laws should facilitate doing business in New York. They should not be an obstacle.

A major project the Business Law Section undertook some years ago was to modernize the NY Not-for-Profit Corporation Law. After years of hard work and the support of the NYSBA, the bill proposed by the Business Law Section was approved by both houses of the state legislature in the 2013 session, but at this writing had not yet been signed by the Governor.

Amendment of the New York Franchise Act is next in line. The Business Law Section proposed amendments to this law in November of 2009. The proposal would correct large portions of the law that have been preempted by the Federal Trade Commission's trade regulation rule on franchising. It would improve the business climate in NY at no cost to taxpayers. The proposal would dramatically eliminate traps for the unwary. The Section is seeking to have the franchise law proposal included among the NYSBA's legislative priorities for 2014. Kevin Kerwin, Associate Director of the NYSBA's Department of Governmental Affairs, informed the committee that the Association can lobby for a bill that has been approved by the Association's Executive Committee regardless of whether it is one of the Association's priorities. The Executive Committee of the NYSBA approved the proposal in January 2010.

There is plenty of room for improvement of any number of other business laws, including the laws governing New York corporations and limited liability companies and securities offerings. The committee also supports a UCC modernization bill initiated by the New York City Bar Association.

We encourage participation on the Legislative Affairs Committee from members of all other Business Law Section committees. Each committee should designate at least one person to focus on legislative needs, consider improvements to existing law, be prepared to respond to proposed legislation from others, and work with our committee.

Thomas Pitegoff, Chair

Public Utility Law Committee

Thanks to the efforts of Kevin Lang of Couch White and Mary Krayeske of Consolidated Edison Company, along with committee members Grace Kurdian and Elise Hiller, on November 15, 2013, at this writing the NYSBA Public Utility Law Committee held a full day CLE conference at the Bar Association Center in Albany. The Program covered the following topics:

1) **Cyber Security**, with a panel comprised of Carl Patka—NYISO; Will Pegrin, President and CEO—Center for Internet Security; and Robert Mayer, Vice President of Industry and State Affairs—United States Telecom Association

2) **Utility/Business Ethics**, with a panel including Kate Burgess, Secretary—New York State Public Service Commission, and Kimberly Strong, Vice President, Business Ethics—Consolidated Edison

3) **Luncheon speaker**, Audrey Zibelman, Public Service Commission Chair

4) **Energy Efficiency**, with a panel including Franz Litz—Pace University, Janet Audunson—National Grid, and Peter Keane—NYSERDA

5) **Ethics,** featuring Bob Freeman—Executive Director, Committee on Open Government

At this time we are also exploring whether it would be feasible to have a dinner for Committee members during the Winter Meeting. Public Service Commissioner Gregg Sayre has agreed to speak, but we are concerned that hotel space might be a problem for out-of-town members due to the Super Bowl being held that weekend.

We are also working on revitalizing the Committee and expanding and updating the Committee member list.

Bruce V. Miller, Chair

Securities Regulation Committee Report

The Securities Regulation Committee combines experienced securities practitioners, new lawyers and those in between. The securities laws are complex and always changing, so we all have plenty to learn and talk about. The Committee has dinner meetings generally on the third Wednesday of every month, with two hours of presentations (for CLE credit) on topics from every corner of the securities laws. In recent months we've heard about the amendments to the SEC's private placement rule, Rule 506, to permit general solicitation and disqualify so-called bad actors, amendments to SEC rules on financial responsibility and reporting by broker-dealers, changes to FINRA's Corporate Financing Rule and the related filing and review process, and the SEC's proposed rule on pay ratio disclosure and other rulemaking on compensation disclosure mandated by the Dodd-Frank Act. The Committee also comments on rule proposals, and in September we submitted a comment letter on the SEC's proposed additional amendments to Rule 506, Rule 156 and Form D.

In June, Howard Dicker completed a three-and-a-half year tenure as Chair of the Committee. Howard was not only knowledgeable and insightful, and able to attract consistently interesting speakers to meetings, but also a warm and engaging host. His years of service to the Committee are very much appreciated, and we're glad that he will still be involved in the Section's leadership.

Peter W. LaVigne, Chair

Technology and Venture Law Committee

The Technology and Venture Law Committee (TVLC) focuses on legal developments, including those in the intellectual property, corporate, securities and employment areas, relevant to technology and emerging growth companies and their financing sources, especially venture capital firms.

Recent programs have included "JOBS Act Alternatives to Public Offerings and Reward-Based Crowdfunding" and "Academic Tech Transfer Deals: University and Company Perspectives." The JOBS Act program, held during the Business Law Section's 2013 Annual Meeting, featured Jeffrey W. Rubin, former Chair of the NYSBA and ABA Securities Committees, and David Postolski, a patent attorney with Day Pitney LLP. Jeffrey Rubin discussed JOBS Act fundraising initiatives, including crowdfunding and proposed SEC rules regarding general solicitation in certain private offerings. David Postolski discussed business and legal issues raised by the use of reward-based fundraising sites like Kickstarter and RocketHub, especially intellectual property concerns related to the disclosure of technology-related initiatives by those soliciting funds.

The tech transfer program, held during the Business Law Section's 2013 Spring Meeting, featured Karen Y. Hui, Esq., Associate General Counsel at Columbia University, Andrew Koopman, Manager of New Venture Development at the NYU Office of Industrial Liaison, Andrew D. Maslow, an attorney in private practice and former Director of the Office of Technology Development at Memorial Sloan-Kettering Cancer Center, and Donna See, a Director at Columbia Technology Ventures and the Chair of the Committee. The panelists provided a broad-ranging presentation and discussion covering the basics of tech transfer transactions and the key legal and transactional issues in research and licensing deals involving universities and academic institutions.

Our Committee will be meeting during the Business Law Section's 2014 Annual Meeting, and we expect to present a number of programs in 2014 covering legal and transactional developments in a variety of tech-related arenas. Please stay tuned for further details. Members of the Committee are also working on a joint NYSBA / Albany Law School program about legal issues in the lifecycle of an emerging growth company, which will be held in March 2014. We look forward to hearing from current and new members about their practices and programming interests.

Shalom Leaf, Chair

From the NYSBA Book Store

Business/Corporate and Banking Law Practice

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This edition is expanded to include a new section on Banking Law. It also covers many issues including the best form of business entity for clients and complicated tax implications of various business entities. Updated case and statutory references and numerous forms following each section, along with the practice guides and table of authorities, makes this edition of *Business/Corporate and Banking Law Practice* a must-have introductory reference.

The 2013–2014 release is current through the 2013 New York legislative session and is even more valuable with the inclusion of **Forms on CD**.

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Book Review: *Business and Commercial Litigation in Federal Courts*

Reviewed by Samuel F. Abernethy

Robert L. Haig and his team of 251 "principal authors" have undertaken and successfully completed the Herculean task of updating *Business and Commercial Litigation in Federal Courts* (Thomson West), now in its third edition. I say Herculean because the treatise is now contained in 11 volumes, containing 96 chapters, 34 of which are new, and 63 of which are substantive law chapters. Haig, a litigation partner in the firm of Kelley Drye & Warren LLP and an active Bar Association leader, has been the editor-in-chief of this treatise since it was first published in 1998, and he displays excellent judgment for the proper balance of scope and depth of coverage.

Since the second edition appeared in 2007, there have been significant changes in the litigation landscape. *Ashcroft v. Iqbal* and *Bell Atlantic v. Twombly* have changed the pleading standards, and litigants, litigators, and judges have all come to recognize the excessive delays and costs of litigating, many of which are due to the new electronic media for communicating and storing documentation. As a result, the Civil Rules Advisory Committee of the Judicial Conference of the United States has been addressing the need to more efficiently manage litigation, and district courts are experimenting with methods to better manage the litigation process, including discovery. The treatise discusses the various approaches to case management through pre-trial conferences and case management orders.

The third edition is ideally suited to be a resource for litigators who are venturing into a substantive field of business law with which they are unfamiliar. Found in volumes 6 through 11, each of the 63 substantive law chapters addresses the critical issues and decision points in either initiating or responding to litigation, discovery and motion practice, and in actual trial of the case, including supplying jury instructions. The volumes provide a comprehensive, sophisticated summary of the elements of a claim, the pitfalls in pleading, the practical considerations in preparing a pleading and presenting the claims to the court and to the adversary. While these chapters no doubt will not be the only resource for the litigator, he will receive a practical and in-depth introduction to virtually every substantive area of the law.

The treatise's discussion of antitrust law is illustrative of the overall strengths (and occasional weaknesses) of the series. The sweep of the antitrust chapter is quite broad, addressing most of the procedural (and many of the legal) issues that may arise in private antitrust litigation. Haig and his antitrust authors provide clear, pragmatic guidance to both plaintiff and defense counsel through all steps of the case, especially in a very helpful selection of model pleadings and jury instructions. The chapter cites an excellent selection range of cases, invariably listing the leading cases where they exist, and often highlighting more esoteric recent cases that would otherwise be a chore to track down.

At the same time, the treatise does not attempt to replace all other sources of antitrust guidance. Treatment of specific types of anticompetitive conduct is usually sufficient to get the reader started down productive avenues of research, but it does not provide exhaustive answers to the substantive questions that arise. Monopolization offenses such as resale price maintenance and predatory pricing are treated with greater optimism for a plaintiff's case than may perhaps be warranted, and virtually no mention is made of the recently significant tensions between antitrust and patent law. Likewise, there is little focus on the tensions that arise where overlapping criminal and civil actions are brought in multiple jurisdictions. These quibbles notwithstanding, for a litigator without any familiarity with the idiosyncrasies of antitrust litigation, the guidance provided is invaluable. As a roadmap to antitrust litigation, Haig's treatise is very strong.

At the same time, *Business and Commercial Litigation in Federal Courts* (3rd ed.) is an invaluable aid to the business lawyer who finds herself called upon to litigate, or to supervise outside litigation counsel. The first two volumes address in a comprehensive way case evaluation, jurisdiction, venue, forum selection, pleading preparation, third-party practice, alternative dispute resolution, removal to federal court, multidistrict litigation, issue and claim preclusion, class actions, and derivative actions, among other topics that typically are addressed at the initial stages of litigation. From there, volumes 3 through 5 cover discovery, motion practice, use of magistrate judges and special masters, pre-trial conferences, jury selection, motions *in limine*, and finally the full panoply of trial activities, including opening statements, presentation of the claims, cross-examination, expert witnesses, damages, final argument and trial and post-trial arguments. All of these topics are dealt with in depth, with citations to case law and other relevant sources. Haig and his distinguished team deal with the practical and strategic considerations that are part of a good litigator's deliberations.

The 11-volume set comes with a CD containing useful forms. One might hope that in the future the library of forms will be amplified, but those that are there are useful.

Putting together this treatise was a prodigious task, and the result reflects the hard work and superior qualifications of the Haig team. The crisp writing and clear organization do a good job of orienting the reader and alerting the practitioner to the complications that may lie ahead, and the level of depth and the wide scope of substantive business law make *Business and Commercial Litigation in Federal Courts* (3rd ed.) a very useful tool for any law firm or in-house legal department.

Samuel F. Abernethy is a partner in Menaker & Hermann LLP in New York City. He is a member of the New York State Bar Association's Executive Committee and its House of Delegates, and is a past chair of the NYSBA's Business Law Section.

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