NYSBA SUMMER 2012 | VOL. 16 | NO. 1

NY Business Law Journal

A publication of the Business Law Section
of the New York State Bar Association

Inside

NEW YORK STATE BAR ASSOCIATION

Business Law Section

ANNUAL STUDENT WRITING COMPETITION

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

Articles submitted will be judged on the following criteria:

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

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

To enter, the student should submit an original, unpublished manuscript in Word format to David L. Glass, Editor-in-Chief, NYSBA *NY Business Law Journal* (david.glass@macquarie.com).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

NY BUSINESS LAW JOURNAL

Summer 2012

Vol. 16, No. 1

THE BUSINESS LAW SECTION
NEW YORK STATE BAR ASSOCIATION

in cooperation with

NEW YORK LAW SCHOOL

ISSN 1521-7183 (print) ISSN 1933-8562 (online)

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NY BUSINESS LAW JOURNAL

HeadNotes

One of the satisfactions of serving as Editor of the NYSBA *NY Business Law Journal* is the opportunity to review the work of many talented New York law students and bring the best of their business law writing to our readers. Meritorious student writings submitted to the *Journal* for possible publication are automatically entered in the Business Law Section's annual student writing competition, and are eligible to win cash prizes as well as publication in the *Journal*. I am pleased to announce that the student authors of two outstanding contributions to the *Journal* in 2011 have been awarded first and second prize by the editors. First prize, including a check for $1,500, went to Manny Alicandro for his article in the Summer 2011 issue, "An Analysis of High-Frequency Trading." Focusing on the "flash crash" of May 2010, Mr. Alicandro lucidly explained how computers programmed to trade automatically are posing increasing challenges for the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC") as the regulators of trading in securities and futures, respectively, and how the regulators are attempting to meet this challenge. A graduate of New York Law School, Mr. Alicandro now works for the NASDAQ. Second prize (a close second, indeed!) went to Ms. Kristine Antoja for her article in the Winter 2011 issue, "The Dodd-Frank Act's One-Year Anniversary: Evaluating the Volcker Rule and the Swaps Push-Out Rule." The article ambitiously tackled two of the most problematical areas of Dodd-Frank compliance, and explained their purposes and objectives clearly and coherently. Ms. Antoja received the JD degree in the evening session at St. John's School of Law and is now working as an intern for AllianceBernstein, the large fund management company. In addition to being timely and well written, both of these articles approached their subjects on a level of knowledge and sophistication befitting an experienced practitioner. On behalf of the Section, we again extend our thanks and congratulations to Mr. Alicandro and Ms. Antoja for their fine contribution to the *Journal.* We urge our readers to encourage talented law students to submit their work to the *Journal* for consideration for publication, and possible prizes, in 2012.

Leading off this issue is a comprehensive overview by Marjorie Gross, the former general counsel of the New York State Banking Department and currently in private practice, of New York's new Department of Financial Services ("DFS"), created last year through the merger of the former Banking and Insurance Departments as part of Governor Cuomo's plan to streamline and economize State government. As Ms. Gross explains, the purpose of establishing the DFS at this time was twofold—to better protect consumers and to save money for taxpayers by reducing the cost of maintaining separate organizations. But, as she notes, one of the great unknowns is the extent to which banking and insurance regulation can in practice be effectively integrated. Many of the states that have combined their banking and insurance departments (and sometimes other financial services regulators as well) report that their various divisions continue to operate largely as separate silos. Integrating the supervision of banks and insurance companies is particularly difficult because the applicable laws and regulations are quite different. Also, banks are subject to federal as well as state supervision, while insurance companies continue to be exclusively regulated by the states. One clear effect of the reorganization is to give substantially enhanced authority to the Superintendent of the DFS; in addition to consolidating his power over the two agencies, along with explicit consumer protection and criminal enforcement responsibilities, the new structure abolishes the Banking Board, which formerly acted on various applications by banks, and gives the Superintendent direct decision-making authority over more of these matters. Ms. Gross brings her knowledge and background to bear with a fascinating "inside baseball" account of how the reorganization came to pass and what it implies for the future of financial services regulation in the State going forward.

With social media very much in the headlines (Facebook was headed toward its much-awaited IPO as this issue went to press), it behooves business lawyers to be up to speed on the social media revolution generally, and particularly how the developing law surrounding the use of social media can affect their clients. In "Who Owns Your Social Media Account?" attorney Adam Walker addresses the case of *PhoneDog v. Kravitz*, currently pending in the Northern District of California, which, the author notes, has the potential to significantly alter the legal landscape regarding rights within social media accounts. While he was employed by the plaintiff, the defendant's duties included posting his opinion of various mobile products through a Twitter account, which eventually accumulated some 17,000 followers. When he left the company, he changed the "handle" on the account and continued to publish his views on his own. The employer sued, alleging misappropriation of trade secrets and various tort theories. As Mr. Walker explains, Twitter's terms of service created a significant, albeit generally unnoticed, distinction between ownership of the account and ownership of the content. It appears that this distinction may significantly impact the rights of all Twitter users to ownership of the account, ownership of the content, and (perhaps most importantly), ownership of the followers of a user account.

Next up is this issue's contribution by our ethics guru, Evan Stewart of Zuckerman Spaeder LLP. In "A Tale of Two Judges," Mr. Stewart explores the approaches taken by two federal judges in cases arising from the ongoing fallout from the financial crisis. First, he reviews the decision of Judge Kaplan of the Southern District of New York in the *Stein* cases, in which the judge took an unusual approach to reining in the Department of Justice's overreaching under the infamous "Thompson Memo" issued by the Department of Justice in 2003. Written by then-deputy Attorney General Larry Thompson, the Memo suggested that companies under investigation would be viewed more favorably as having "cooperated" with the government if i) they waived the attorney-client privilege, and ii) they agreed to forgo the practice of covering attorneys' fees for individual officers and employees. Second, he reviews a series of decisions by Judge Jed Rakoff, also of the Southern District, rejecting or refashioning settlements reached by the Securities & Exchange Commission with various financial market participants in the interest of justice. Mr. Stewart explains how, in his view, the actions of both of these judges help to establish an appropriate balance between the roles of the Executive and Judicial branches of government.

All business attorneys are well familiar with the principle that courts will not look behind the corporate form to impose liability directly on the owners—referred to as "piercing the corporate veil"—unless the corporation is being used for an illegitimate business purpose or is simply acting as the "alter ego" of the owner, without regard to its separate and independent corporate existence. Less well known is the principle of "reverse piercing"— i.e., imposing liability that otherwise attaches to the individual owner upon the corporation. In "Reverse Piercing of the Corporate Veil: A Straightforward Path to Justice," St. John's Law student Nicholas Allen argues that, while reverse piercing by third party creditors should not be the norm, there are instances in which it may be the only way to ensure equal justice. Mr. Allen, an editor of the *St. John's Law Review*, proposes that the doctrine be applied permissively against both legal and equitable owners, but only when traditional, less intrusive remedies are insufficient. His thorough and well-reasoned exposition also addresses the problem of innocent shareholders, and the issue of conflicts between and among competing creditors.

In the insurance world, an ongoing area of controversy has been so-called "viatical" or life settlements, whereby a terminally ill individual transfers his interest in the proceeds of a life insurance policy to an investor, in return for a cash payment. In "Stranger-Initiated Annuity Transactions and the Case for Insurable Interest," attorneys David T. McDowell, Thomas F.A. Hetherington and Kendall J. Burr of the Houston, Texas firm Edison, McDowell & Hetherington LLP, explore an issue with similar overtones: the "stranger-initiated annuity transaction," or STAT. In a STAT situation, an investor recruits a terminally ill individual to serve as the measuring life for a variable annuity with a built-in death benefit, which provides a full and prompt refund of the investors' premiums if their high-risk investments go awry. The ill individual often claims not to have understood that his or her poor health was being exploited as a hedge against market losses by a total stranger. A significant legal question is thereby presented: should these STATs be treated as unlawful wagers on human lives, subject to rescission for violating the well-established "insurable interest" requirement applied in life insurance cases? The authors examine in depth the pertinent laws applicable to annuities and life insurance, including the "gray area" of stranger-originated life insurance ("STOLI"). They conclude that "persuasive arguments can be made that insurable interest laws apply to annuity products, and that stranger investors may not use the products to profit from the deaths of other human beings."

"Inside the Courts," a summary of currently active securities litigation prepared by the attorneys at Skadden Arps, is next. This superlative compendium of new and ongoing litigation, as concise as it is comprehensive, is a regular feature of the *Journal* and one that is indispensable to all who practice in securities regulation and corporate law generally. This issue's version covers the gamut from auction rate securities (ARS) to statutes of limitation. Of particular interest to corporate lawyers generally are the currently pending cases affecting directors' rights and duties.

Another predictable outcome of turbulent economic markets is the tendency of politicians and others to blame "speculators" for market action perceived to be adverse. We saw this phenomenon in action when the price of oil spiked. Another manifestation is the finger-pointing at "short sellers" as being responsible for declines in the stock market or the prices of individual securities. "Short selling" refers, in general, to the sale of a security that one does not own, in the expectation that the price of the security will decline and it can be repurchased at a lower price, thereby earning a profit for the seller. In "The Possible Demise of Short Sale Regulation," Louis Incatasciato, a JD candidate at Brooklyn Law School, discusses what he perceives as a threat to the ability of the SEC to regulate short selling—the use of futures on individual securities, which can also be used to bet on an expected decline in the price of the security. Because the Commodity Futures Trading Commission ("CFTC") has primary jurisdiction over futures, Mr. Incatasciato argues that the SEC lacks the tools it needs to completely regulate short selling. His article traces the history of short selling regulation to the stock market crash of 1929 and the Securities Exchange Act of 1934, in which the SEC was empowered to regulate short selling, and is a valuable primer on this key aspect of market regulation.

Among the ongoing, and unhappy, consequences of the recent financial meltdown are a plethora of issues related to residential mortgage foreclosure. Recent headlines have focused on developments such as the "robo-signing" scandal, whereby it appeared that officers of foreclosing lenders were executing mortgage documents verifying knowledge of certain facts when, in fact, they had no such knowledge. In "Advanced Standing Issues in Securitized Mortgage Foreclosure," attorney Charles Wallshein explores some of the issues that may have more far-reaching effects on the enforceability of mortgages sold into securitization pools to secure residential mortgage-backed securities ("RMBS"). Mr. Wallshein, who has previously contributed to the *Journal* on commercial real estate finance matters, notes that these issues have arisen because RMBS participants were in a rush to "get their deals done" and cash in on their securitizations at the height of the boom, before the crash of this market that began in 2007. As he explains, "[t]he practical problem is that RMBS participants simply did not follow their own rules to the detriment of *interest in real property* ownership principles that span two millennia." The article offers a wealth of background information on real estate finance and the history of its development.

David L. Glass
Editor-in-Chief

New York's Financial Services Law: A Whole New Ball Game?

By Marjorie E. Gross

On October 3, 2011, the functions of the Banking and Insurance Departments of New York State were transferred to a new department—the Department of Financial Services ("DFS" or the "Department"). The Banking and Insurance Departments were abolished.[1] Much about the regulation of financial services in New York will stay the same, but much will change. Let us explore some of the changes.

The Rationale for the New Department

In his first State of the State message, given shortly after he was inaugurated, New York Governor Andrew Cuomo spoke about the financial crisis that had resulted in the highest unemployment rate in the state in 26 years. While admitting that Washington was primarily responsible for the crisis, he stated that New York could have done a better job of regulation.[2] The reason state government had not been more effective, he posited, was that it was not organized in the way that Wall Street works any more: "These divisions of insurance and banking and consumer protection don't exist in the marketplace and much of the activity is falling between the cracks of our regulatory entities."[3] He therefore proposed to consolidate the regulation of banking and insurance and the protection of consumers into a single department of financial regulation. The purpose of the DFS was therefore twofold: to better protect consumers, and to save money for taxpayers by reducing the cost of three separate organizations.[4]

A bill to create the Department of Financial Services was introduced as part of the Governor's budget proposal on February 1, 2011[5] and, after a short period of negotiation,[6] was signed by the Governor on March 31.

Structure of Part A of the Agency Merger Bill

The first 114 sections of Part A deal with the creation of DFS and Banking-Insurance Consolidation. Section 1 of the bill adds a new chapter 18-A to New York Law, known as the Financial Services Law ("FSL"). About twenty sections of the bill amend the Banking Law[7] and about 37 sections amend the Insurance Law. With the exception of these few amendments, the Banking Law and Insurance Law remain outstanding. Approximately 33 sections of Part A distribute powers of the Consumer Protection Board to the Department of State or replace the Executive Director of the Consumer Protection Board on various state boards.[8] The remaining sections of the bill effectuate the transfers of functions and employees of the Banking and Insurance Departments to the DFS.[9]

The Financial Services Law

Overview

The FSL has five articles:

The first article covers general provisions, and most importantly contains some important definitions that are used throughout the new law.

The second article sets forth the organization of the Department. It also sets forth the legislative declaration of policy, which includes supervising the business of, and the persons providing, financial products and services, including not only persons subject to the Banking Law and the Insurance Law, but also other persons who provide financial products and services. (The FSL actually has numerous sections containing findings, goals and policies, including §§ 101-a, 102, 201 and 402.[10] None are operative requirements. All, however, may be cited as indicating the legislative intent as to the interpretation of the new law and the power of the new agency to adopt regulations that are consistent with the statutory language or its underlying purposes.[11])

The third article sets out administrative and procedural provisions, including the powers of the superintendent, the superintendent's authority to adopt regulations, and provisions regarding things such as orders, notices, hearings, injunctions and judicial review.

The fourth article contains provisions regarding the Department's financial frauds and consumer protection unit (which the Superintendent has renamed the Financial Frauds and Consumer Protection Division). This includes the powers of the division, immunity for whistleblowers, and civil penalties.

Finally, the fifth article of the FSL provides the ethics rules for Department officers and employees. Officers and employees are subject not only to the ethics restrictions of the Public Officers Law, but also to restrictions on loans from and investments in regulated persons, which are contained in the Financial Services Law.

Structure of the DFS

The Financial Services Law declares the legislative intent to consolidate the Banking and Insurance Departments and to provide for the enforcement of the Banking, Insurance and Financial Services Laws under the auspices of a single state agency, to be known as the "Department of Financial Services."[12] The head of the DFS is the Superintendent of Financial Services (the "Superintendent").[13] The Superintendent is appointed by the Governor, and holds office at the pleasure of the Governor. In contrast, although both the Superintendent of Banks and the Superintendent of Insurance were appointed by the Governor, each served "until the end of the term of the governor by whom he was appointed."[14] This gave them an important degree of statutory independence that set them apart from the heads of other State departments—denominated as "Commissioners," and widely viewed as serving the Governor's political agenda.

The Superintendent is required to establish an insurance division and a banking division.[15] Beyond those, the Superintendent is granted great discretion to establish such bureaus, divisions and other units within the Department as may be necessary to operate the Department (or consolidate or abolish divisions), and to determine the functions of those units.[16] At the launch of the DFS on October 3, 2011, the Superintendent announced[17] that the Department would have five main divisions:

- The Insurance Division will carry on the core functions of regulating all insurance activities in New York, including life, property and health insurance.
- The Banking Division will continue regulating state-chartered banks, along with other financial services providers such as mortgage servicers and originators, check cashers, money transmitters and budget planners.
- The Financial Frauds and Consumer Protection Division will protect and educate consumers of financial products and services and fight financial fraud. The Division will pursue civil and criminal investigations and bring enforcement proceedings as appropriate.
- The Real Estate Finance Division will focus on all aspects of the mortgage industry to ensure that the lessons from the recent financial crisis are learned and new reforms are instituted.[18] (The Superintendent later explained that this Division would focus on issues involving real estate lending, mortgage origination and servicing, foreclosure, title insurance and related issues, and that one of its top priorities would be to find creative ways to improve the foreclosure landscape in New York.)[19]
- The Capital Markets Division will actively monitor the latest developments and products and help the Department better police systemic risk.

One of the great unknowns about the DFS is the extent to which banking and insurance regulation can be integrated. Many of the states that have combined their banking and insurance departments (and sometimes other financial services regulators) report that their various divisions largely operate in silos. However, integrating the supervision of banks and insurance companies is difficult because the applicable laws and regulations are quite different, and apply not only in New York but also in other states, and, in the case of banks, at the federal level. Indeed, in the Section 203-b Report discussed below, the Superintendent reported that several non-regulatory units in the two former departments had been integrated, including administration, personnel, information technology and legal services. The Capital Markets Division of the DFS is clearly an attempt to create a group of examiners who can apply best practices with respect to risk management to entities regulated by both the Banking and Insurance Divisions. Nevertheless, the question remains whether these principles can be applied to other units of the DFS.

Section 205-b of the FSL required the Governor to create a working group to examine ways to improve the efficiency and effectiveness of banking and insurance regulation in New York, including opportunities to integrate regulatory activities under the Banking and Insurance Laws. The working group was required to consult with representatives of the banking, insurance and financial services industries. It also required the Superintendent, by January 1, 2012, to issue a report to the Governor, the Speaker of the Assembly and the Temporary President of the Senate with the results of this examination. On December 20, 2011, the Department issued this report (hereinafter "the Section 203-b Report"). This report was issued on December 30, 2011.[20]

On October 3, Superintendent Benjamin Lawsky announced that one of the Department's three main goals was to serve as a model of efficient government. He also announced that the new Department is on track to achieve more than $25 million in budget savings in its first year.[21]

Elimination of the Banking Board; Creation of State Charter Advisory Board

The Agency Merger Bill eliminated the Banking Board, effective October 3, 2011, and transferred all the responsibilities of the Banking Board to the Superintendent.[22] The Banking Board was not a part of the Banking Department when it was first formed in 1851. It was added in the 1930s to advise the Superintendent in determining when banks should be closed on safety and soundness grounds.[23]

The powers of the Banking Board were set forth in Section 14 of the Banking Law. The three subdivisions of Section 14 gave the Banking Board three different categories of responsibilities. The first category concerned the power to adopt and amend rules and regulations consistent with law, and set forth 23 specific items on which the Board had the authority to act. The second authorized the Board to consider, make recommendations, and pass upon, any matter that the Superintendent might submit to it. The third authorized the Board to give the Superintendent proposals for amending the Banking Law.

Many of the 23 items specified in Section 14(1) had been supplanted by Federal regulation. This includes, for example, approving foreign bank licenses; determining whether capital notes or debentures may be treated as capital stock; prescribing the rates of interest on deposits; regulating withdrawals of deposits in extraordinary circumstances; prescribing reserves on deposits; allowing banks to issue, underwrite or distribute securities; prescribing methods for doing examinations and valuing bank assets; prescribing the form and content of periodic reports of condition; and defining what is an unsafe condition or manner of conducting business.

Only about 50% of states utilize a Banking Board or Commission, and, in some of those, the commission is comprised of state officials rather than representatives of regulated entities or the public. Most importantly, the Insurance Department's governance model did not utilize such a board; the Superintendent of Insurance had complete control over licensing and rulemaking, two of the most important remaining functions of the Banking Board. Consequently, the Governor's consolidation proposal eliminated the Banking Board.

The banking industry, however, was reluctant to lose all formal input to the Superintendent. The FSL therefore created a 9-member State Charter Advisory Board to work with the Superintendent to maintain the attractiveness of the state banking charter.[24] The Board is to have nine members appointed by the Superintendent for three-year terms, one each representing consumers, credit unions and foreign banks, and six representing banks of diverse size and geography, including at least one with assets above $3 billion and at least two with assets below $500 million.[25] On October 3, 2011, DFS adopted on an emergency basis rules for the nomination of members of the Advisory Board and simultaneously proposed those rules for public comment.[26] It adopted those rules in final form effective December 28, 2011. The 203-b Report states that the Governor will shortly be announcing the members of the Advisory Board.

The Advisory Board will meet three times a year. There is no provision for reimbursement of travel expenses. The statute specifically authorizes meetings by telephone conference call. The statute specifies five areas in which the Advisory Board may give advice: (1) maintaining the state charter as a viable and attractive option (including bringing to the Superintendent's attention issues of concern to state-chartered banking institutions), (2) recommending ways to encourage banking institutions to offer a diversity of financial products and services throughout the state, (3) recommending new laws, or the amendment or repeal of existing laws, (4) recommending rules or the amendment or repeal of existing rules; and (5) giving comments on regulations proposed by the Superintendent. However, the statute specifically provides that the Advisory Board will have no executive, administrative or appointive powers or duties.[27] It also provides that the Advisory Board will sunset on October 3, 2016.[28] Of course, the Legislature and the Governor have the option to extend or eliminate the sunset date in the future.

Jurisdiction of DFS

The declaration of policy in the FSL[29] states the legislative intent for the Superintendent to supervise the business of, and the persons providing, financial products and services, which includes, but is not limited to, persons who are subject to the provisions of the Insurance Law and the Banking Law.[30] Clearly, the definition of "financial products and services" is key.

As defined in Section 104, the definition is somewhat circular, since the defined term is used in the definition. It means (1) any financial product or service offered or provided by a person regulated or required to be regulated under the Banking Law or the Insurance Law, or (2) any financial product or service offered or sold to consumers.[31] There are, however, a number of exceptions.

First, the term does not include a financial product or service regulated for the purpose of consumer or investor protection by another New York State agency, which includes (a) one of which registration or licensing is required under New York law for either the financial product or service or the provider, (b) a financial product or service as to which consumer or investor protection provisions are specifically set forth by state law or rule, and (c) securities, commodities and real property subject to Article 23-A of the General Business Law. The first clause would cover, for example, real estate agents, who are licensed by the Department of State. The second clause might cover certain products that were regulated by the Consumer Protection Board (now a division of the Department of State). The third clause was designed to prevent overlap in the jurisdiction of the State Attorney General under the Martin Act.

A second exception from the definition of financial product or service covers a financial product or service regulated under exclusive jurisdiction of a federal agency. This, for example, would exclude regulation of large investment advisers.[32] The Federal Consumer Financial Protection Bureau does not have exclusive jurisdiction over consumer financial protection.[33]

A third exception covers a financial product or service where rules of the Superintendent would be preempted by Federal law. This would include not only circumstances where a federal statute specifically gives exclusive jurisdiction to a federal agency, but those where a court finds implied preemption from the structure or purpose of the statute.[34]

A fourth exception covers certain services when offered or provided by a provider of consumer goods or services, including (a) an extension of credit directly to a consumer solely to purchase the consumer good or service directly from the seller; (b) the collection of a debt arising from such credit, or (c) the sale or conveyance of such debt that is delinquent or in default. This exception is similar to one for merchants, retailers and other sellers of nonfinancial goods or services when they offer consumer financial products or services in connection with the sale or brokerage of nonfinancial goods or services.[35] It was widely reported as requested by auto dealers.

Powers of the Superintendent

The Superintendent of Financial Services has all the powers granted to the Superintendent under the Banking Law, the Insurance Law and other state laws (such as the Real Property Actions and Proceedings Law and numerous state laws that refer to the usury interest rate established by the Superintendent). The Superintendent also has the additional powers granted by the Financial Services Law.[36]

The Financial Services Law specifies a number of additional powers. These include the following: (1) conducting investigations, research, studies and analyses of matters affecting consumers of financial products and services, (2) educating consumers of financial products and services, (3) receiving and tracking complaints from consumers of financial products and services, (4) mediating complaints between consumers and providers of financial products and services, (5) promoting and encouraging the protection of the legitimate interests of users of financial products and services, (6) expanding the detection, investigation and prevention of insurance fraud.[37]

Perhaps the most interesting powers of the Superintendent are the power to prescribe rules and issue guidance involving financial products and services and the power to bring civil enforcement actions against the providers of financial products and services, whether or not such providers are otherwise regulated entities under the Banking and Insurance Laws.

Rulemaking Under the Financial Services Law

The Financial Services Law gives the Superintendent of Financial Services the authority to prescribe regulations and guidance involving financial products and services, as long as they are not inconsistent with any law in which the Superintendent is given authority.[38] Such regulations may effectuate a power given to the Superintendent; interpret the FSL, the Banking Law, the Insurance Law or any other applicable law; or establish procedures to be followed in the practice of the DFS.

These broad rulemaking powers will enable the Department to regulate new financial products and services as they are developed, without waiting for specific statutory authorization. They will also enable the Department to regulate the provision of financial products and services without registering the providers. Previously, both the Banking and Insurance Departments regulated only providers who were chartered or licensed by them.

This new regulatory scheme has obvious benefits. It is often difficult to pass legislation in New York. In each of the last four years, the Banking Department has proposed several bills to modernize the Banking Law, but all of its bills were not passed that year. It often takes several years to secure passage of a bill, and there are often disagreements about whether or how to regulate. For example, in the past few years, there have been long-standing debates about whether to regulate loan modification consultants or debt settlement consultants.[39] Parts of the regulatory community believe it is important to establish rules for such financial services, because they are widely advertised, often come with large fees, and frequently do not improve, and often make significantly worse, the financial condition of a debtor or homeowner. Consumer groups have been opposed to licensing the providers of these services, because they believe consumers will be misled by the significance of a license from a state agency. The result has been legislative gridlock and an increase in television, radio and Internet advertising by the purveyors of these services. Under the Financial Services Act, the Department has the authority to regulate the purveyors of such financial products and services without giving them a license, by adopting regulations.

The new regulatory scheme is not without drawbacks. Both the Banking and Insurance Departments have helped to ensure compliance with law by doing regular examinations of regulated entities, and paying for the necessary examination staff through assessments of regulated entities. However, as noted below, the Financial Services Law does not provide for assessments against persons that are not chartered or licensed (although the Superintendent may assess regulated entities under the Banking and Insurance Laws to pay the remaining costs of the Department).[40] Consequently, the principal method of ensuring compliance by persons subject to Section 302 Regulation is likely to be enforcement actions that result from consumer complaints.

The Governor's original proposal would have given the DFS jurisdiction over investment products.[41] Although both these provisions were narrowed significantly, the DFS appears to have limited jurisdiction with respect to investor protection. Section 104(2) of the Financial Services Law—the definition of Financial Product or Service—excludes persons and products regulated for consumer or investor protection by another state agency. The implication is that any such products that are not regulated by another agency are Financial Products or Services under the FSL.[42] Under Section 301(c)(3), the Superintendent may conduct studies and advise the Governor on matters affecting consumers of and investors in financial products or services. Under Section 301(c)(4) the Superintendent may cooperate with and refer matters to the Attorney General in connection with the AG's responsibilities for the protection of consumers and investors.

Finally, it is worth noting that the new rules on nominating members of the State Charter Advisory board indicate that the rules will be in a new Title 23 of the New York Code of Rules and Regulations (NYCRR). The Banking Department rules are currently in Title 3 and those of the Insurance Department in Title 11. The DFS will presumably combine all its rules in new Title 23 in due course.

The Financial Frauds and Consumer Protection Division

The Financial Frauds and Consumer Protection Division ("FFCPD") is the cornerstone of the Governor's promise to better protect consumers. The FFCPD will include the Criminal Investigations Bureau of the Banking Department[43] and the Frauds Bureau of the Department of Insurance.[44] It will also have a Consumer Complaint Unit, which will combine the Consumer Help Unit of the Banking Department and the Consumer Services Bureau of the Insurance Department, and will handle complaints concerning additional financial products and services under the Financial Services Law. On October 3, 2011, Superintendent Lawsky announced the creation of a new executive level position, a Director of Enforcement, who will oversee all criminal investigations. Since the criminal investigations bureaus of the Banking and Insurance Departments are part of the FFCPD, this seems to imply that the FFCPD will have separate criminal and civil units, and that the head of each unit reports to the Superintendent.

The Department has not defined the relationship between the examination staff in the Banking and Insurance Divisions and the enforcement staff in the FFCPD. For example, the product of a normal examination of a banking organization or non-bank licensee/registrant of the Banking Division is a report of examination pointing out safety and soundness concerns and de minimis violations of laws or regulations. A more serious or repeat violation may result in an informal or formal enforcement action.[45] It is not clear whether such "enforcement" actions will continue to be handled by the examination staff or will be considered to be the province of the civil enforcement side of the FFCPD.

Recently, the FFCPD has had key roles in several "agreements" with mortgage loan servicers adopting expanded conduct of business "practices."[46] The press releases note that the agreements were arranged through the work of Executive Deputy Superintendent of the Financial Frauds and Consumer Protection Division Joy Feigenbaum, and several lawyers from the FFCPD, with the "assistance" of Deputy Superintendent of Mortgage Banking Rholda Ricketts. Although the press release quotes a consumer advocate congratulating the DFS for adopting "tough but fair rules" for mortgage loan servicing, the new standards were not adopted in a rulemaking proceeding under the State Administrative Procedure Act. On the other hand, they were not enforcement actions[47] and were consensual.

The Banking Department, like the Federal Regulators, has generally raised compliance concerns in reports of examination and in informal (non-public) enforcement actions. It remains to be seen whether the FFCPD will result in a new formal enforcement approach. Although the recent actions were consensual, the context of the Goldman and Morgan Stanley agreements[48] may indicate even less bargaining power than a regulated entity normally has when negotiating with its regulator. The Department did not seek any public input to the new standards, as would have been the case if it had adopted the standards in a rulemaking proceeding.

The powers of the FFCPD are set forth in section 404 of the Financial Services Law. They include

- investigating activities that may constitute violations subject to Section 408 of the Financial Services Law or violations of the Insurance Law or the Banking Law, and
- if the FFCPD has a reasonable suspicion that a person or entity has engaged or is engaging in fraud or misconduct[49] under the Banking Law, the Insurance Law, the Financial Services Law or other laws under which the Superintendent has investigatory or enforcement powers, investigating such fraud or misconduct, and
- assisting any entity in an investigation involving any violation of law.

Section 408 sets forth the civil penalties that may be assessed by the Superintendent. It provides that the Superintendent may levy a civil penalty for (A) any intentional fraud or intentional misrepresentation of a material fact with respect to a financial product or service or involving any person offering to provide or providing financial products or services,[50] (B) any violation of state or federal fair debt collection protections or state fair lending law, or (C) any other violation of the Financial Services Law or its regulations.[51] Thus, for most regulated banking organizations, insurance companies, and licensed or registered non-bank financial services providers, the principal jurisdiction of the FFCPD is intentional fraud or misrepresentation with respect to financial products or services, fair lending and fair debt collection violations and investigations of consumer complaints.

The penalty for the violations set forth in Section 408 for the violations described in clauses A and B above is not more than $5,000 per offense, and the penalty for the violations described in clause C above is not more than $1,000 per offense. However, Section 408 provides that the penalties for persons regulated under the Banking Law or the Insurance Law will be as provided for in the Banking Law or the Insurance Law and not as set forth in Section 408. Under the Banking Law, the penalties for most violations are found in section 44, and vary between (i) depository institutions and (ii) other licensees or registrants and safe deposit companies. The penalty for many violations by non-depositories is up to $2,500 for each day during which the violation continues; the penalty for certain reckless violations is up to $15,000 for each day during which the violation continues; and the penalty for certain knowing and willful violations is up to $75,000 for each day during which the violation continues. The similar amounts for depository institutions are $5,000 daily; $25,000 daily and the lesser of $250,000 or one percent of the total assets of the banking organization daily.

Funding of DFS

The funding provisions of the Financial Services Law take pains to preserve, to the greatest extent possible, the current funding mechanisms under the Banking and Insurance Laws. Prior to the merger, regulated entities under the Banking Law paid all of the costs of running the Banking Department, plus about $1.5 million in sub-allocations to the Attorney General and the Inspector General in connection with activities of the Banking Department. Regulated entities under the Insurance Law paid the costs of running the Insurance Department, plus over $300 million in "sub-allocations" to cover various state expenditures deemed to benefit insurance companies.[52] In addition, regulated entities under the Banking and Insurance Laws pay the costs of the Holocaust Claims Processing Office.

Section 206 of the Financial Services Law, like the Banking and Insurance Laws, provides for assessments to defray the operating expenses of the Department. Persons regulated under the Insurance Law will be assessed for operating expenses solely attributable to regulating persons under the Insurance Law, including expenses that were permissible to be assessed in FY 2009-10. The allocation method for such assessments will be the same as existed prior to October 3, 2011; that is, they will be allocated pro rata on all domestic insurers and all licensed U.S. branches of alien insurers domiciled in New York, in proportion to the gross direct premiums and other considerations written or received in New York for property or risks resident or located in New York, the issuance of which requires a New York license. Persons regulated under the Banking Law will be assessed for operating expenses solely attributable to regulating persons under the Banking Law, in such proportions as the Superintendent deems just and reasonable. The remaining expenses will be allocated between persons regulated under the Banking Law and the Insurance Law (with minor exceptions) in such proportions as the Superintendent deems just and reasonable. The remaining expenses include the Department's costs of regulating entities that are not chartered, licensed or registered under the Banking Law or the Insurance Law, such as entities regulated under regulations adopted under Section 302 of the Financial Services Law.[53] However, such persons may receive a rebate, paid out of civil penalties collected by the FFCPD, of any operating expenses of the FFCPD not attributable to regulation under the Banking Law or the Insurance Law, which will be applied against the following year's assessments.[54]

Other Amendments to the Banking and Insurance Laws

The agency merger law contains a number of amendments to the Banking and Insurance Laws. They fall generally into four categories. Some of the amendments repeal sections on the operation of the Banking or Insurance Departments, because they have been replaced by comparable provisions in the Financial Services Law. Some are more substantive. For example, § 87 deletes BL § 3, creating Banking Districts; § 95 extends the wildcard authorization in BL § 12-a until September 10, 2014; § 55 amends Insurance Law § 209 to increase the penalty for a violation of the Insurance Law from $500 to $1,000 per violation, and to codify prior Insurance Department practice that a single transaction may be subject to multiple fines for violations of the Insurance Law. Many of the amendments eliminate reports to the Governor and/or Legislature that previously were statutorily required. The final category of amendments relates to terminology. Section 104 of the merger law changes the terms "Banking Department," "Insurance Department," "Superintendent of Banks," "Superintendent of Insurance" and "Banking Board," to "Department of Financial Services" and "Superintendent of Financial Services," as appropriate, wherever they appear in the Consolidated and Unconsolidated Laws of New York. Section 104(h) of Chapter 62 authorizes the Legislative Bill Drafting Commission to effectuate this provision, under the guidance of a memorandum of instruction to be transmitted by the Governor, the Temporary President of the Senate and the Speaker of the Assembly or their designees. The versions of the Banking and Insurance Laws that appear on the websites of the New York Legislature and Department of State reflect these changes.[55]

Conclusion

Since the Banking Law and Insurance Law and all regulations previously adopted under them remain outstanding, both the broad outlines and much of the detail about the regulation of banks and insurance companies will not change. The extent to which the DFS will use the Superintendent's new powers to regulate financial products and services not covered under the Banking and Insurance Laws remains to be seen. However, the new Department is clearly serious about achieving the two goals outlined in the Governor's State of the State message—reducing costs and increasing consumer protection. The budget numbers for the Department make it clear that cost cutting is a fact of life for the new Department. And the mortgage loan servicer agreements make it clear that the Department of Financial Services is taking seriously its mission to improve consumer protection. While New York has a long history of advocacy on behalf of consumers, the new focus on consumer protection may indeed mean it is a whole new ball game.

Endnotes

1. *See* 2011 N.Y. Sess. Laws Ch. 62 (S. 2812-C) (McKinney) [hereinafter Chapter 62], §§ 98, 99.
2. The Governor did not identify particular shortcomings. He may have been thinking about the well-publicized problems of AIG Financial Services—an insurance company affiliate—with credit default swaps. The regulation of insurance company affiliates was addressed in the Governor's initial agency merger proposal. *See* Assemb. 4012 § 68 (N.Y. 2011). An amendment to Section 1504(b) of the Insurance law would have permitted the Superintendent to examine each holding company and controlled person of the holding company that might impact an insurer within the holding company group. However, that provision was eliminated in the first round of amendments to the merger proposal. *See id*. Assemb. 4012-A. Another contributor to the financial crisis was toxic mortgages. New York has long been in the forefront of state efforts to protect mortgage consumers. *See, e.g.*, *infra* note 18.
3. Governor Andrew M. Cuomo, State of the State Address (Jan. 5, 2011), *available at* http://www.governor.ny.gov/sl2/stateofthestate2011transcript.
4. The Governor's budget, as originally introduced, recommended an appropriation of $564 million for the Department of Financial Services, reflecting a net increase of approximately $6.4 million (1.1%) over the combined 2010-11 budgets of the Banking and Insurance Departments, despite 10 percent reductions at other agencies. *See* 2011-12 Executive Budget, Agency Presentations, New York State Division of the Budget 1, 131, http://www.budget.ny.gov/pubs/archive/fy1112archive/eBudget1112/agencyPresentations/pdf/AgencyPresentations. While the increase could have been justified by merger costs and by the increased personnel costs of the Consumer Protection Bureau, it was criticized as inconsistent with the Governor's cost-cutting objective. The Governor later announced that, as a result of faulty assumptions, the proposal was being decreased. By the time of the midyear budget corrections in November 2011, the total spending of the DFS had been reduced significantly ($490.5 million, compared to $507.4 million in FY 2010-11). Personal services disbursements were projected at $136.4 million, compared to $152.1 million in FY 2010-11. *See* New York State Mid-Year Financial Plan Update: FY 2012 Through FY 2015, New York State Division of the Budget, http://publications.budget.ny.gov/budgetFP/midYearUpdate/FY2012_Mid-YearUpdate.pdf. The consolidation of the Banking and Insurance Departments will not save money for taxpayers generally, since the cost of both departments is assessed to regulated entities. This fact results in an interesting dynamic. Any decreases in the Department's appropriations potentially result in less regulation and redound primarily to the benefit of regulated entities in lower assessments. *See* Sonja Ryst, *New York launches state department of financial services*, Business Insurance (Oct. 3, 2011), http://www.businessinsurance.com/article/20111003/NEWS04/111009989, quoting Superintendent Lawsky as stating: "If our budget is smaller, that means we're assessing the industry less and taxing the industry less to pay for our regulations and our operations."
5. Assemb. 4012. The original bill would have merged 11 state agencies into 5. The portion relating to the Banking and Insurance Departments and the creation of the DFS was Part A of the bill.
6. Article VII, subdivision 3 of the Constitution gives the Governor 30 days from the date of initial submission to submit amendments to any budget bills. However, Section 22(16) of the State Finance Law provides that the Governor will use his or her best efforts to submit such amendments within 21 days. Such amendments are therefore known as "21-day amendments." The Governor's 21-day amendments were printed on February 25, 2011. Assemb. 4012A. The bill was amended two additional times before passage.
7. For a discussion of the amendments, *see infra* Part entitled "Other Amendments to the Banking and Insurance Laws."
8. In the Governor's original proposal, the Consumer Protection Board would have been eliminated and its functions relating to financial services would have been transferred to the DFS. This proposal was controversial with consumer groups, and it was eventually determined that the Consumer Protection Board would become a division of the Department of State. *See* Chapter 62 §§ 94-a.
9. *See, e.g.*, Chapter 62, §§ 98 (transfer of powers, 99 (abolition of Banking and Insurance Departments), 100 (continuation of authority in DFS), 101 (transfer of records), 102 (completion of unfinished business), 105 (preservation of existing rights and remedies), 106 (pending actions not affected), 107 (continuation of rules, regulations and licenses, 109 (transfer of employees). Although FSL § 102 refers to the consolidation of the Banking and Insurance Departments, agency "mergers" in New York are not effectuated in the same manner as corporate mergers. The functions of existing agencies are transferred to a new agency, and the old agencies are eliminated, although the new agency is deemed to continue all the functions and powers of the old agencies and is also deemed not to be a different agency. Chapter 62, Section 100.
10. The latter two were contained in the Governor's original proposals. Section 101-a and the goals in section 102 were added in the negotiations on the bill and are believed to have been requested by the banking industry. Compare S.2812/A4012 as introduced by the Governor with S.2812-C /A.4012-C—the versions which were passed by the Legislature.
11. *See In re* of Gen. Elec. Capital Corp. v. New York State Div. of Tax Appeals, 2 N.Y.3d 249, 254, 810 N.E.2d 864, 867, 778 N.Y.S.2d 412, 415 (N.Y. 2004) ("The cornerstone of administrative law is derived from the principle that the legislature may declare its will, and after fixing a primary standard, endow administrative agencies with the power to fill in the interstices in the legislative product by prescribing rules and regulations consistent with the enabling legislation.")
12. NY Fin. Serv. Law § 102 (McKinney 2012).
13. *Id.* § 201.
14. N.Y. Banking Law § 12(1) (McKinney 2011), *repealed by* Laws of 2011, ch. 62, pt. A, § 12).
15. NY Fin. Serv. Law § 205 (McKinney 2012).
16. *Id.*
17. Press Release, Superintendent Lawsky Announces Launch of New Department of Financial Services, Department of Financial Services (Oct. 3, 2011), *available at* http://www.dfs.ny.gov/about/press/pr1110031.htm [hereinafter DFS October 3 Press Release].
18. The distinction between the Real Estate Finance Division and the Mortgage Banking Group within the Banking Division is not entirely clear from the DFS October 3 Press Release. The Mortgage Banking Group continues to be responsible for the registration and examination of mortgage bankers, brokers, servicers and loan originators. The Real Estate Finance Division is advising the Superintendent with respect to other policy issues involving mortgage finance. The Banking Department has long been on the cutting edge of consumer protection with respect to residential mortgages. In 1980, it limited the types of "alternative mortgages"—i.e., mortgages other than fixed-rate self-amortizing loans—that state-regulated lenders could make. *See* Banking Law ("BL") § 6-f, added by Laws of 1980, c. 883. When Congress, in 1982, passed the Alternative Mortgage Transaction Act, which overrode state laws prohibiting "alternative mortgages," New

York was one of only five states that opted out of the law. *See* BL § 6-g, added by the Laws of 1983, c. 1. Certain types of "alternative mortgages," such as option adjustable rate mortgages and other mortgages with negative amortization, are widely considered to be among the most toxic of the mortgage crisis. In 1986, New York adopted legislation to regulate non-bank mortgage bankers and mortgage brokers. *See* BL Chapter 12-D, added by Laws of 1986, c. 371. New York was one of the first states to regulate high-cost mortgages, adding extensive underwriting standards that were designed to shut down abusive lending practices that were targeted at the elderly and unsophisticated. *See* BL § 6-l, added by Laws of 2002, c. 626. New York was one of the first states to recognize the conflicts of interest that affected mortgage loan originators, passing legislation to require the training and registration of MLOs. *See* Laws of 2006, c. 744. This was two years before the U.S. Congress passed the S.A.F.E. Mortgage Licensing Act. *See* Housing and Economic Recovery Act of 2008, Pub L. No. 110–289, § 1501, 122 Stat. 2654 (2008). The Banking Department participated in the pilot program of the Conference of State Banking Supervisors that developed the Nationwide Mortgage Licensing System (NMLS). When the effects of the mortgage crisis became more widespread, Governor David Paterson's administration secured passage of two major program bills to assist mortgage consumers—one that extended the mortgage underwriting standards to "subprime" mortgages, and one that addressed the foreclosure crisis and was designed to assist homeowners at risk of foreclosure. *See* Laws of 2008, c. 472; Laws of 2009, c. 507. Under authority set forth in the latter act, the Banking Department adopted cutting edge conduct-of-business rules to govern the activities of mortgage loan servicers. *See* N.Y. Comp. Codes R. & Regs. tit. 3, § 419 (2012).

19. *See* Section 203-b Report, *infra*, note 20 at pp. 4 and 12.

20. N.Y.S. Dep't of Financial Services, *Working Group Report on Ways to Improve Efficiency and Effectiveness of Regulation* (Dec. 30, 2011), *available at*: http://www.dfs.ny.gov/reportpub/dfsrpt_205a.pdf.

21. Press Release, N.Y.S. Dep't of Financial Services, Superintendent Lawsky Announces Launch of New Department of Financial Services (October 3, 2011) http://www.dfs.ny.gov/about/press/pr1110031.htm (last accessed May 1, 2012).

22. *See* Chapter 62, § 17 (repealing former § 13 of the Banking Law); §§ 89, 90 (transferring the functions and powers of the Banking Board to the Superintendent, and amending § 14 of the Banking Law to reflect that transfer.)

23. N.Y. Legis., Rep. Jt. Legis. Comm. on Banking and Investment Trusts (1932) at p. 4 (recommending the formation of the Banking Board). The banks apparently thought the Superintendent was too quick to shut down banking organizations. They therefore convinced the Legislature to add the Banking Board to advise the Superintendent on a number of issues, including defining what is an unsafe manner of conducting business, BL § 14(1)(n), granting new banking charters, BL § 14(1)(a), setting interest rates on deposits, BL § 14(1)(g), setting the usury rate for all lenders in New York, General Obligations Law § 5-301, and prescribing the methods for conducting bank examinations, BL § 14(1)(k).

24. *See* N.Y. Fin. Serv. Law § 205-b (McKinney 2012).

25. *Id*.

26. The emergency rule/proposed rule was published in the State Register on October 19, 2011, with a comment period of 45 days. There were no comments and the final rule was published in the State Register on December 28, 2011.

27. N.Y. Fin. Serv. Law § 205-b.

28. Chapter 62, § 114(e).

29. N.Y. Fin. Serv. Law § 201(a) (McKinney 2012).

30. It would not matter if the provider had a place of business in New York. While an internet website alone will not be enough to constitute doing business in New York or to confer personal jurisdiction over an out-of-state provider, *Pearson Educ. Inc. v. Yi Shi*, 525 F. Supp.2d 551, 556 (S.D.N.Y. 2007), out-of-state providers who solicit business and knowingly make sales to users in New York from out of state will trigger New York jurisdiction, as long as the contact is continuous and systematic. *Mattel Inc. v. Adventure Apparel*, 2001 U.S. Dist. Lexis 3179 at 7-8 (S.D.N.Y. July 29, 2009), *Sandoval v. Abaco Club on Winding Bay*, 57 F. Sup.2d 312 (S.D.N.Y. 2007), *Sound Around v. Audiobahn Inc.*, 2008 U.S. Dist. Lexis 108263 (E.D.N.Y. Sept. 18, 2008) (using "solicitation plus" analysis). Cf. *Quik Payday, Inc. v. Stork*, 549 F.3d 1302 (10th Cir. 2008) (upholding Kansas requirement for registration of lenders that was challenged by a Utah-based internet payday lender on commerce clause grounds).

31. The FSL does not define the term "consumer." Compare that with the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") § 1002(4), which defines "consumer" as an individual or an agent, trustee, or representative acting on behalf of an individual. The FSL occasionally refers to businesses, § 102(g) (New York citizens, businesses and consumers), and users, §§ 102(l), 201(b)(4) and (7), 301 (c). However, it is not clear whether the term "consumer" is limited to individuals.

32. For a discussion of the Department's jurisdiction over investment products, *see* text at note 41.

33. *See* Dodd-Frank Act § 1041. However, there is still preemption under the National Bank Act, where a state law "prevents or significantly impairs" the exercise of a national bank power, as provided in *Barnett Bank of Marion County, N.A. v. Nelson*, 517 U.S. 25, 116 S. Ct. 1101 (1996) ("Barnett").

34. *See*, e.g. *Barnett* at 31; Fidelity Fed. Sav. & Loan Assn. v. De la Cuesta, 458 U.S. 141, 152-153, 102 S. Ct. 3014, (1982).

35. *See* Dodd-Frank Act § 1027.

36. N.Y. Fin. Serv. Law § 301(a) (McKinney 2012).

37. N.Y. Fin. Serv. Law § 301(b) (McKinney 2012).

38. N.Y. Fin. Serv. Law § 302(a) (McKinney 2012).

39. The New York Real Property Law placed restrictions on contracts entered into by loan modification consultants (denominated "distressed property consultants"), but did not register them. N.Y. Real Property Law § 265-b (McKinney 2012). A legislative proposal to register and regulate debt settlement consultants has been proposed in one house but not acted upon. *See* N.Y. Legislature (2011 Legislative Session) A8341.

40. *See* "Funding of DFS" and notes 53 and 54, *infra*.

41. *See* Proposed Financial Regulation and Protection Law Section 102 (Legislature declares that the purpose of the new chapter is to consolidate financial regulation and consumer and investor protection in the new department), Section 104(2) (Definition of "financial product or service" included any investment, credit, debt, lien, deposit, derivative, money management device).

42. *See* N.Y. Fin. Serv. Law § 104(2-a) (McKinney 2012) (definition of "financial product or service regulated for the purpose of consumer or investor protection").

43. *See* N.Y. Banking Law § 78 (McKinney 2012) (Article II-B, which now has only one section).

44. *See* N.Y. Ins. Law Article 4 (McKinney 2012).

45. Informal enforcement actions are not statutory. Ones used by the Banking Department have included a board resolution, in which the banking organization's Board of Directors acknowledges the problem and commits to correcting it, and a memorandum of understanding, which is a formal agreement with the Department. Informal enforcement actions are not made public. Formal enforcement actions have included written agreements (often used when a federal regulator is taking formal action under 12 U.S.C. § 1818(b)), an order to make good a capital deficiency, or a cease and desist order. *See* BL § 39 (McKinney 2012). The Banking Law also provides for civil money penalties (called "fines") for any violation of the Banking Law and regulations. *See* BL § 44 (McKinney 2012). The latter actions are made public and may be found on

the Department's website. *See also* Board of Governors of the Federal Reserve System, Commercial Bank Examination Manual, Section 6000.1 (distinction between Matters Requiring Immediate Attention, Matters Requiring Attention and Observations) and Branch and Agency Examination Manual § 2040.1 (Informal and Formal Supervisory Actions).

46. *See* Press Releases, N.Y. Dep't of Financial Services, Superintendent Lawsky Announces Agreements With Morgan Stanley, Saxon, AHMSI & Vericrest On Groundbreaking New Mortgage Practices (Nov. 10, 2011) (hereafter, the "Saxon Press Release") http://www.dfs.ny.gov/about/press/pr1111101.htm (last accessed May 1, 2012); *see also* Press Release, Superintendent Lawsky Announces Agreement With Goldman Sachs, Ocwen, Litton On Groundbreaking New Mortgage Practices (Sept. 1, 2011) http://www.dfs.ny.gov/about/press/pr110901.htm (last accessed May 1, 2012) (hereafter, the "Litton Press Release"); *see also* Press Release, Superintendent Lawsky Protects Homeowners From Delays Caused By Abusive Law Firm's Closing (Dec. 16, 2011) http://www.dfs.ny.gov/about/press/pr1112161.htm (last accessed May 1, 2012) (stating that an additional agreement has been entered into with Specialized Loan Servicing LLC).

47. In each case, the N.Y. Dep't of Financial Services reserved the right to take future action.

48. The Litton Press Release notes that "the agreement was required by the Superintendent as a condition to allowing Ocwen's acquisition today of Goldman Sachs' mortgage servicing subsidiary, Litton." The Saxon Press Release does not contain similar language. However, each firm was the subject of a control or license application. The Department's September 30, 2011 Weekly Bulletin notes that, the previous week, AHMSI Holdings, Inc. had filed an application to acquire an interest in American Home Mortgage Servicing, Inc. A number of individuals filed an application for a servicing license for Vericrest Financial, Inc. on March 21, 2011.

49. There is no definition of the term "misconduct" under the Banking Law or the Insurance Law, although both have sections or articles relating to specified misconduct. *See e.g*. N.Y. Banking Law Article 13-D (McKinney 2012) (entitled "Misconduct Relating to Banking Organizations," which lists certain actions that constitute misconduct with respect to banking organizations (e.g., making guaranties or endorsements beyond the legal lending limit, making certain unauthorized investments, spreading false rumors about a banking institution)); *see also* N.Y. Ins. Law Article 26 (McKinney 2012). However, the term is also used elsewhere in each statute with a more general meaning. *See e.g.* BL §§ 44(c1)(c) (pattern of misconduct) 44(3)(b) (pattern of misconduct), 579(4) (misconduct by Budget Planner), 591(4) (misconduct by Mortgage Banker), 591-a(4) (misconduct by Mortgage Broker) (McKinney 2012).

50. For an example of such investigations conducted before the merger, *see N.Y. State Insurance Department Conducting Preliminary Investigation Into Fraud Claims by Bond Insurers*, Dow Jones, December 30, 2010, *available at*: http://www.programbusiness.com/News/NY-State-Insurance-Department-Conducting-Preliminary-Investigation-Into-Fraud-Claims-by-Bond-Insurers (reporting that the Insurance Department was considering whether to conduct an "all-out" investigation on banks and other agents being accused by financial guaranty insurers of misrepresenting material facts on structured finance transactions insured by the financial guarantors).

51. The original version of the Governor's bill contained a defined term, "financial fraud," which was much broader. It included any deceptive act or practice or false advertising under article 22-A of the General Business Law, and any activity that violates one of 12 enumerated sections of the Penal Law or sections 352 or 353 of the GBL. As a result of strong objections by the industry, the references to the General Business Law (which is enforced by the Attorney General) were removed, as were the references to the Penal Law sections. The defined term was eliminated and the much narrower concept was added to section 408. The references to the Penal Law sections remain in Section 78 of the Banking Law, where they have always been part of the jurisdiction of the Criminal Investigations Bureau.

52. *See* N.Y. Ins. Law § 332 (McKinney 2012); *see also* S2800/A4000 (2011-12 Appropriations Bill), which includes Insurance Department sub-allocations to the Department of Law, the Department of Health, the Division of Criminal Justice Services, the Division of Homeland Security, and the Department of State, among others.

53. It is not clear whether an entity subject to Section 302 regulation could be made subject to assessments. An administrative agency engaged in regulatory activity can assess a fee that has not been legislatively authorized, provided the fee is reasonably necessary to the accomplishment of the regulatory program. The fees must bear a rough correlation to either: (l) the expense to which the State is put in administering its licensing procedures; or (2) the benefits those who make the payments receive. S*ee,* In the Matter of Homestead Funding Corp. v. State of New York Banking Department, slip opinion, (Sup. Ct. 2d Dep't 2011); *see also* Walton v. New York State Dept. of Correctional Services, 13 N.Y.3d 475, 485 (2009). Section 206, like Banking Law § 17, authorizes assessments only against persons regulated under the Insurance Law or the Banking Law—not the Financial Services Law.

54. N.Y. Fin. Serv. Law § 408(b) (McKinney 2012).

55. Certain additional changes were not considered to be covered by the merger law, and thus will need to be made separately. For example, in 30 provisions where references to the Banking Board were changed to references to the Superintendent, the provision refers to the Superintendent acting "by a vote of three-fifths of its members." *See e.g.* §§ 6-k, 14-b, 28-b, 97, 98, 103 and 235.

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Who Owns Your Social Media Account?

By Adam S. Walker

Throughout history, technological and societal advances have led to the creation of new property rights.[1]

I. Introduction

Communication through interactive dialogue, otherwise known as social media, is reshaping the way those in society interact with one another. As social media accounts continually become more intertwined with the daily routines of our lives, the accounts themselves become increasingly more valuable to businesses. *PhoneDog v. Krazitz*,[2] a case currently pending in the Northern District of California, has the potential to significantly alter the legal landscape regarding social media rights. The claims in the case are rooted, at least in part, in ownership of various aspects of a social media user account, and the case raises an important question: to what extent does a social media account belong to the user?

II. Background

In April 2006, Noah Kravitz began working at PhoneDog.com ("PhoneDog"), a mobile news and review resource company. Kravitz's duties required Kravitz, under the Twitter handle @PhoneDog_Noah, accessed only through a password, to regularly post his opinions and reviews of mobile products and services.[3] During Kravitz's employment with PhoneDog, the @PhoneDog_Noah accumulated approximately 17,000 Twitter followers.[4] In October, 2010, Kravitz's employment with PhoneDog ceased, and PhoneDog requested that Kravitz turn over to it control of the account and all account followers. Instead of complying, however, Kravitz changed the account handle to @noahkravitz and continued to post regularly.

PhoneDog sued Kravitz in the Northern District of California for: "(1) misappropriation of trade secrets; (2) intentional interference with prospective economic advantage; (3) negligent interference with prospective economic advantage; and (4) conversion."[5]

On November 8, 2011, the initial complaint survived a motion to dismiss filed by Kravitz. The court allowed the misappropriation of trade secrets and conversion claims to stand, and gave PhoneDog leave to amend its claim for intentional interference with prospective economic advantage.[6] Following the filing of the amended complaint, on January 30, 2012, the court denied Kravitz's motion to dismiss the tortious interference claim.[7]

III. Who Has Ownership Rights to User Accounts?

The procedures to create an account on Twitter are simple. After accessing the Twitter website, a registrant needs to submit a name and an email address, create a user name and a password, and accept Twitter's terms of service to activate the account. Though the registration is fairly straightforward, the terms of service, to which every user must agree, include language that creates a significant, yet overlooked, distinction between ownership rights to the website and the website's services—the account and use of the account—on the one hand, and ownership of the account and ownership of the content, on the other.

Twitter's terms of service state: "All right, title and interest in and to the Services [defined as a user's "access to and use of the services and Twitter's websites"] (excluding Content provided by users) are and will remain the exclusive property of Twitter and its licensors."[8] These rights appear to be all-encompassing and to grant Twitter rights to the website, including all services provided. But the terms also state: "[y]ou retain your rights to any Content [any information, text, graphics, photos or other materials uploaded, downloaded or appearing on the Services] you submit, post or display on or through the Services."[9] The terms also provide:

> [b]y submitting, posting or displaying Content on or through the Services, you grant us a worldwide, non-exclusive, royalty-free license (with the right to sublicense) to use, copy, reproduce, process, adapt, modify, publish, transmit, display and distribute such Content in any and all media or distribution methods (now known or later developed).[10]

Although the terms of service specifically state that they govern a user's "access to" and "use of" Twitter, they do not convey ownership rights to anything other than content posted by the user. The language in the terms clearly attempts to distinguish between ownership of the content (by the user) and of the website and its services (by Twitter).

In addition to contractual ownership rights in the website, the terms of service also assert intellectual property rights in the website and its services: "[t]he Services are protected by copyright, trademark, and other laws of both the United States and foreign countries."[11] Assuming that the Twitter software and the user account computer program(s) are copyrightable and Twitter is the "creator," as a matter of copyright law, all copyright rights in the software belong to Twitter. As a result, Twitter owns the user account, whereas the user holds a right or license to *use* the account. In any event, the terms of service between Twitter and all users grant Twitter exclusive ownership of all aspects of the website. These contractual rights almost certainly would extend to ownership of the user accounts themselves (since the user accounts are part of the website) and to the right to allow use of a user account (a service offered by the website). The terms do not grant users ownership rights to any aspect of the Twitter services except content ownership.

In addition, as will be examined more hereafter, Twitter, not the user, exerts dominion and control over the user accounts. Twitter is the only entity that has the ability to activate and remove user accounts from the website, social network and the underlining software codes where the accounts are stored. Twitter's authority over the website reinforces the distinction between the rights of Twitter and the limited rights of users.

The question of who owns the website and user accounts has not yet been decided. In *PhoneDog*, Kravitz raised the issue in his initial motion to dismiss, but the judge refused to answer until more facts were in the record,[12] but copyright and contract law appear to lead to the same conclusion: the user accounts, either as a service offered by Twitter or as part of Twitter, are owned exclusively by Twitter. If this is true, PhoneDog may have a significant hurdle to overcome, particularly on its conversion claim, as it does not appear to be the owner of the services to and in Twitter's website and/or the user account in question. Demonstrating such ownership rights will be necessary for PhoneDog to prevail on its conversion claim.

IV. Who Owns User-Posted Content?

To most individuals, Tweets (a post or status update on a user's Twitter account) appear to be nothing more than inconsequential mishmashes of 140 characters or less. In situations where an individual has created and/or is using an account for primarily personal, non-employment related postings, the posted content may be of little or no value to anyone. However, the importance of content ownership has increased dramatically since companies like PhoneDog have begun employing individuals to administer company social media accounts and make regular posts as part of the company's business.

Ownership rights in content posted by an employee ultimately may be determined by the circumstances in which the content was created, such as whether the content is copyrightable and whether the employer has an agreement with the employee regarding ownership of the content.

Under U.S. copyright law, with certain exceptions, such as works made for hire, once an original work is fixed in a tangible medium of expression,[13] the creator of the work owns the copyright.[14] Although the "originality" threshold is low under the law, the work must contain some minimal amount of creativity.[15] Meeting this standard may be difficult for Twitter users, since the radically compacted way Twitter promotes communication stifles creativity. Many posts of 140 characters or less about one's everyday occurrences lack any semblance of creativity. By contrast, someone who crafts something such as a poem is more likely to meet the creativity threshold since some level of creativeness has been exerted. As a result, whether a user's post on his or her Twitter account will be copyrightable will need to be determined on a case-by-case basis.

If posted content is not copyrightable, the determination of ownership is likely to depend on a number of factors, the most important of which may be whether the employer has affirmatively addressed the issue in an employment agreement, social media policy, etc. with clear language transferring all rights to content posted to the employer. Absent such language, the employer may still retain ownership of posted social media content if the posts were made within the employee's scope of employment and, under the law of agency,[16] all benefits and rights resulting from the actions of the agent will be attributed to the employer.[17]

With respect to copyrightable posts, the employer may own the copyright as a work-for-hire (1) if the work was created within the scope of the employee's work duties or (2) if the work was specially ordered or commissioned.[18] To determine who is an employee under the work-for-hire doctrine, courts look to a number of factors under the general common law of agency, such as: (1) control by the employer over the work; (2) control by the employer over the employee; and (3) the status and conduct of the employer.[19] "Specially ordered or commissioned work" applies to works created by independent contractors who are not employees under the general common law of agency. Work performed by independent contractors will be a work-for-hire only if *both* of the following conditions are met: (1) the work was performed within one of the nine categories of work listed under the statutory definition, and (2) there is a written agreement between the parties specifying that the work is a work-for-hire.[20] Failure to satisfy these requirements will result in the independent contractor, and not the employer, retaining ownership in the copyrights created.

Nothing in the record in *PhoneDog* indicates that Kravitz was acting as an independent contractor, and neither party disputes that the posts were done outside the scope of his employment or outside the instruction of PhoneDog.[21] An employer-employee relationship appears to have existed between Kravitz and PhoneDog. If the posts are copyrightable, PhoneDog is likely to maintain copyright ownership.

Finally, situations where copyrightable posts are created that have no relation to the employee's work and/or were created outside the scope of the employee's duties will likely result in the employee retaining rights in the content posted. Essentially, the less a correlation there is between the content posted by an individual and his or her employment duties with the employer, the less likely the employer will be able to make an argument that the content was posted in furtherance of or as part of, the employee's employment duties; as a result, the content posted will be deemed to be the property of the employee and not the employer. This may seem obvious, but as Twitter and other social media platforms become increasingly intertwined with the way companies do business, and as social media usage by individuals becomes increasingly popular, the line between personal and professional content becomes blurred.

Although ownership of the content posted on social media accounts may seem of no great consequence in light of the fact that a user could attempt to recreate a similar or identical post, maintaining ownership of the content significantly limits the possibility that an ex-employee will be able to benefit from content created on behalf of the company—especially if the work is copyrightable, is difficult to recreate, and/or is highly valuable to the company. As noted, determining ownership of the content could depend on one or more of the following: the nature of the content; what agreements, if any, the employer and employee have with each other; and the relationship between the postings and the employee's employment duties.

Although there is no evidence in the *PhoneDog* trial record of any intention by PhoneDog to claim ownership of the posts at issue or of the existence of an employment agreement specifying control over the Twitter account, an employer-employee relationship appears to have existed that will convey all benefits of Kravitz's work to PhoneDog, including ownership of the posted content and/or any copyrights in the posts.

V. Who Owns the Followers of a User Account?

Invariably, one of the true benefits of Twitter, Facebook or any other social media platform is the user's ability to subscribe to another user's post, status, etc. Those subscribing to the feed are known as *followers.* One element of the *PhoneDog* litigation is PhoneDog's belief that a follower is of economic value and benefit to a user and that users "own" their followers. But whether a follower is of economic benefit to a user, and, more important, whether a follower has monetary value, is a question that in *PhoneDog* will likely be subsidiary to the issue, raised by PhoneDog's conversion claim, of whether a user owns his followers.

The elements of conversion, similar to most theft-based tort claims, are intertwined with one's right to own or possess[22] tangible and, depending on the jurisdiction, intangible property as well.[23] According to *Black's Law Dictionary*, ownership "implies the right to possess a thing;"[24] "possession" is defined as "the exercise of dominion over property."[25] Examining PhoneDog's conversion claim based on Twitter's terms of service casts doubt on whether a user has ownership rights over followers on a social media platform.

Twitter's terms of service provide that Twitter retains exclusive ownership rights to the website and to services offered by the website and/or intellectual property embodied in the website—all of which, either individually or combined, are likely to entail rights to the user accounts. This conclusion is strengthened by Twitter's exercise of dominion and control over all accounts.

Twitter's terms of service state: "We [Twitter] reserve the right at all times (but will not have an obligation) to remove or refuse to distribute any Content on the Services and to terminate users or reclaim usernames."[26] Even if a user "deactivates" his account, Twitter does not remove the code from its operating programs; only the visual representation of the account is removed, i.e., the account name and listing. When a user "reactivates" a recently deactivated account, all of her prior information is reinstated. This is because Twitter, not the users, retains control over the source code or software that contains all account information. Possession of the user accounts belongs solely to Twitter; users simply have the right to use an account.[27] Thus, if all followers are account holders, and if Twitter owns all rights to all accounts, then it follows that a user cannot own a follower.

Twitter and other social media platforms afford users the ability to be self-selecting. Users are free to be friends with only those they wish and to follow only the feeds that interest them. More importantly, users are free to de-friend those with whom they do not wish to be friends, and users are a click away from removing themselves from following people and things they no longer want to follow. This self-selection ability illustrates that a follower cannot be owned, at least by another user, because the holder of the account being followed has no control over—and thus no ownership rights in—the account's followers.

Due to the contractual limitations imposed in Twitter's terms of service and/or the lack of dominion and control over account followers, PhoneDog's claim of ownership in the account followers is significantly diminished. Unless PhoneDog is able to assert legal control and/or possession over account followers, PhoneDog is unlikely to meet its burden of proof for conversion of the account followers by Kravitz.

VI. What Should Businesses Do?

The facts of *PhoneDog* illustrate that as a company's business model becomes increasingly intertwined with social networking, businesses need to take steps to alleviate any confusion as to use and/or control over company controlled social media accounts and content.

Protecting a company's rights in social media accounts can be achieved in a variety of ways. Registering user accounts under the company's name will minimize confusion as to the purpose of the account and for whose benefit it exists. Companies also can seek injunctive relief against infringement of their trademarks[28] and/or dilution[29] in social media. A number of social media sites offer the option to terminate or transfer ownership of accounts that infringe third-party rights or have the potential to confuse other users.[30] Both seeking injunctive relief and/or utilizing social media remedial procedures are ways to combat unauthorized use of a company's intellectual property or other tortious conduct. Preventing access to the account upon termination of an employee reduces the risk of an embattled ex-employee hampering or damaging the company's social media presence. Conversely, if companies are hesitant to grant access and use of the account to a select few individuals, certain social media platforms allow more than one person to be an administrator of an account.

As may be evident from *PhoneDog,* arguably the most important measure a company can take to protect its interest in a user account is to establish clear and concise contractual rights as to all aspects of the company's social media account(s) in the event of termination of the administrator of the account. In addition, specifying precisely the scope of the employee's duties can minimize confusion as to whether the employee's actions were or were not job-related. Although, as discussed above, an employment contract may not be able to convey ownership rights in the account to the employer (because the service operator is the owner), a contract can, at a minimum, specify control over use of the account—thus reducing the potential for a dispute such as that between PhoneDog and Kravitz.

VII. Conclusion

Examining Twitter's terms of service reveals that users maintain no ownership rights, aside from ownership in the posted content, to the services of or in the Twitter website; users merely have the right to use or access the services and the website. Users also lack ownership rights to account followers since users exercise no dominion and control over followers, because followers are self-selecting and are free to decide and choose their actions without interference or influence from the account holder. Due to the limited rights afforded to it, PhoneDog is unlikely to succeed in meeting its burden of proof to any claim of conversion or theft of account followers.

In order to adequately protect themselves from the pitfalls currently facing PhoneDog, companies should familiarize themselves with the rights afforded to them under a social media website's terms of service, and craft clear and concise social media guidelines and/or language in the company's employment contracts that address control and use of any company social media account and social media content posted by the user prior to account activation.

Endnotes

1. Courtney W. Franks, *Analyzing the Urge to Merge: Conversion of Intangible Property and the Merger Doctrine in the Wake of Kremen v. Cohen*, 42 Hous. L. Rev . 489, 503 (2005) (quoting Juliet M. Moringiello, *Seizing Domain Names to Enforce Judgments: Looking Back to Look to the Future*, 72 U. Cin. L. Rev. 95, 115 (2003)) (examining how a party maintains ownership rights in intangible property).
2. PhoneDog v. Kravitz, No. C 11-03474, 2011 WL 5415612 (N.D. Cal Nov. 8, 2011).
3. *See id.* at *1.
4. *Id.*
5. *Id.*
6. *See id.* at *7, 10.
7. *See* PhoneDog v. Kravitz, No. C 11-03474, 2012 WL 273323, at *1 (N.D. Cal. Jan. 30, 2012) (dismissing Kravitz's motion to dismiss based on PhoneDog's amended complaint, alleging tortious interference). The court stated that it was "able to draw the reasonable inference that PhoneDog had an economic relationship with at least one-third party advertiser that was disrupted by Kravitz's alleged conduct, causing it economic harm." *Id.*
8. Twitter Terms of Service, Twitter, https://twitter.com/tos (last visited Mar. 18, 2012).
9. *Id.*
10. *Id.*
11. *Id.*
12. PhoneDog v. Kravitz, No. C 11-03474, 2011 WL 5415612 at *5–6.
13. 17 U.S.C. § 102 (2010).
14. *See id.* at § 201(a).
15. *See* Feist Publ'n v. Rural Tel. Serv., 499 U.S. 340, 358 (1991). The Court held that the "originality requirement [of copyright law] is not particularly stringent," requiring only "some minimal level of creativity." *Id.*
16. Restatement (third) of Agency § 1.01 (2006) (defining agency as "the fiduciary relationship that arises when one person (a "principal") manifests assent to another person (an "agent") [acting] on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents so to act").
17. *See id.* at § 3.05. The employer must still ratify the actions of the employee to be binding under agency law.
18. *See* 17 U.S.C. §§ 101, 201(b) (2012).
19. *See* Cmty. for Creative Non-Violence v. Reid, 490 U.S. 730 (1989).
20. *See* 17 U.S.C. § 101. The nine categories of a work made for hire are (1) contribution to a collective work, (2) part of a motion picture or other audiovisual work, (3) a translation, (4) a supplementary work, (5) a compilation, (6) an instructional text, (7) a test, (8) answer material for a test, or (9) an atlas.
21. *See* PhoneDog v. Kravitz, No. C 11-03474, 2011 WL 5415612 at *2 (N.D. Cal. Nov. 8, 2011).
22. Restatment (Second) of Torts § 222A (1965). Conversion is defined as "an intentional exercise of dominion or control over a chattel which so seriously interferes with the right of another to control it that the actor may justly be required to pay the other the full value of the chattel."
23. Courts are split as to whether ownership rights can extend to intangible property. Jurisdictions that recognize ownership rights in intangible property generally do so when the intangible property is "merged" into a tangible medium; *see* Brass Metal Prods., Inc. v. E-J Enters., Inc., 984 A.2d 361 378 (Md. App. 2009) (citing Allied Inv. Corp. v. Jasen, 731 A.2d 957, 965 (1999) (stating that to succeed on a claim for conversion of intangible property,

the Maryland courts have held that the owner's rights must be "merged or incorporated into a transferable document.")).

24. Black's Law Dictionary (9th ed. West 2009).

25. *Id.*

26. https://twitter.com/tos.

27. *Id.* The beginning clause of Twitter's terms of service states: "These Terms of Service ("Terms") govern your access to and use of the services and Twitter's websites (the "Services"), and any information, text, graphics, photos or other materials uploaded, downloaded or appearing on the Services (collectively referred to as "Content"). Your access to and use of the Services is conditioned on your acceptance of and compliance with these Terms. By accessing or using the Services you agree to be bound by these Terms." The language carefully states "your access to and use of the services…." Nowhere in this section, or any other section in the terms of service, except in the User's Rights section, does Twitter use the words "rights to, rights in, ownership in," etc.; rather, the wording relating to users always states "access to" and "use of."

28. *See* Lanham Act, 15 U.S.C. § 114, which states that one is liable for trademark infringement if he or she "use[s] in commerce any reproduction, counterfeit, copy, or colorable imitation of a registered mark in connection with the sale, offering for sale, distribution, or advertising of any goods or services on or in connection with which such use is likely to cause confusion, or to cause mistake, or to deceive.…" In order to be liable for trademark infringement in the social media realm the account must satisfy the "use in commerce" requirement, such as selling goods through the account.

29. *See id.*; *see also* 15 U.S.C. § 1127. Remedies for dilution extend only to famous marks.

30. *See* http://support.twitter.com/articles/18367-trademark-policy Twitter's policy] (last accessed May 1, 2012); *see also* http://www.facebook.com/legal/copyright.php (last accessed May 1, 2012) [Facebook policy].

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A Tale of Two Judges

By C. Evan Stewart

Someone once wrote: "[i]t was the best of times, it was the worst of times…."[1] Many people might say that that sentiment captures our current times pretty well. Events involving two well-known federal judges might make the legal highlights film for that conflicted proposition, and they have some important take-homes for all of us.

Judge Kaplan and the Department of Justice

The issue of cooperation with the government (a/k/a the "800 pound gorilla") has been with us for some time.[2] The perception (and reality) has been that under-investigation companies, attempting to curry favor with the government, would do almost *anything* to have the government call off the dogs.

This situation arguably reached its pinnacle (or nadir) in *United States v. Stein*.[3] In *Stein*, KPMG—one of the country's largest accounting firms—was attempting to avoid indictment by the federal government; having seen what happened to competitor Arthur Andersen only a few years before, this was not an irrational business judgment.[4] At that time, the Justice Department had in effect a 2003 memorandum issued by then-Deputy Attorney General Larry Thompson. The Thompson memorandum had been issued to give guidance to corporations under the government's gun as to what the DOJ would consider constituting "cooperation," and through such "cooperation," corporations could hope for more lenient treatment. Two of the more controversial components of the Thompson memorandum were: (1) corporate "cooperation" with the government would be favorably judged if companies waived the attorney-client privilege (and other applicable privileges); and (2) said "cooperation" would also be favorably judged if companies forwent the advancement of attorneys' fees for employees targeted by the government (notwithstanding corporate by-laws either mandating or allowing for attorneys' fees to be advanced).[5]

For KPMG, waiving any and all privileges and giving up materials to the U.S. Attorney's office was a no-brainer. Harder was the decision-making process regarding the thirteen former partners and employees of the firm who were individual targets. All thirteen had retained skilled (and expensive) counsel based upon KPMG's time-honored practice of advancing attorneys' fees to its current and former employees with respect to job-related conduct. But after some very significant jaw-boning by two Assistant U.S. Attorneys, the company threw its former (now indicted) colleagues under the bus and shut off the money spigot.

After the indictments were handed down, the individual defendants moved before Judge Kaplan to dismiss the indictments based upon the government's interference with KPMG's advancement of fees. The Judge then held an extensive evidentiary hearing to determine the government's role in KPMG's decision vis-à-vis the advancing of fees. Based upon that hearing, Judge Kaplan ruled (1) that the defendants had a fundamental right under the Fifth Amendment to fairness in the criminal process (including the right to get all "resources lawfully available to him or her [without] government interference");[6] and (2) that the defendants' Sixth Amendment rights (to choose the lawyer he or she desires) had been violated by the government's conduct. Ultimately, finding that the prosecutors' conduct "independently shock[s] the conscience" (so much so, that he singled out and referenced the Assistant U.S. Attorneys by name), Judge Kaplan dismissed the indictments because there was no alternative remedy that would put the defendants in the position they would have been, "but for" the government's misconduct.[7]

The government appealed the dismissal of the indictments. At this point I must admit I was unsure as to what would happen in the Second Circuit. On the one hand, what the government had done was truly shocking and wrong.[8] But the problem was that KPMG was not a public corporation with corporate by-law or statutory obligations; instead, it was a private partnership in which the advancement history was merely a time-honored practice, not something whereby you could point to a legal obligation mandating advancement.[9] Perhaps this would be the unusual case where a wrong had no remedy?

The Second Circuit affirmed Judge Kaplan,[10] but to reach that result they chose an unusual route. Making extensive use of the factual findings made by the lower court (i.e., the government **made** KPMG do it)—which the Second Circuit panel was of the view it was not empowered to challenge or overturn,[11] the Court of Appeals ruled that the Sixth Amendment rights of the individual defendants had been violated and that Judge Kaplan's remedy was appropriate. Since the Court of Appeals could not look to corporate by-laws or state law requiring advancement of fees, the Second Circuit based its analysis and ruling on the doctrine of state action.

As the Second Circuit acknowledged, the jurisprudence of state action "'ha[s] not been a model of consistency.'"[12] And it then went on to show why. First off, it opined that to wrap up a private entity (i.e., KPMG) as an instrumentality of the government, it must be "'operat[ing] as a *willful participant* in joint activity' with the government…."[13] The notion that KPMG—faced with a possible criminal indictment—was a "willful participant" with the government is, of course, absurd; the accounting firm was about as adversarial to the government as possible, and it caved into the pressure from the two Assistant U.S. Attorneys only under extreme duress.

And besides overcoming that bizarre legal and factual situation, the Second Circuit also had to deal with its own precedent to the contrary. In *D.L. Cromwell Investments, Inc. v. NASD Regulation, Inc.*,[14] the Court of Appeals affirmed a decision by Judge Kaplan, which involved parallel investigations being conducted by the DOJ and the NASD (the forerunner of FINRA) where the NASD lawyers were working with their DOJ counterparts and receiving information that was helping their investigation. Four brokers, who were also targets of the DOJ, sought to enjoin the NASD from compelling their testimony for fear it would be used by the DOJ.[15] Judge Kaplan ruled (and the Second Circuit agreed) that there would be no Fifth Amendment problem because the NASD is/was not a government entity, and thus the doctrine of state action would not be implicated. Huh? The two entities were not only indisputably working together "willful[ly]" in parallel investigations (and sharing information), but the NASD was a quasi-governmental entity (as is FINRA), specifically regulated by the Securities and Exchange Commission pursuant to the Securities Exchange Act of 1934. While "foolish consistency [may be] the hobgoblin of little minds,"[16] the Second Circuit in *Cromwell* found no state action, where there was state action; and in *KPMG*, the court found state action, where there was no state action.

What should we make of these rather hard to rationalize judicial rulings? One man's perspective is that the *Cromwell* situation probably did not seem to Judge Kaplan and the Second Circuit as being enough of a big deal (and both courts likely expected NASD lawyers would be more careful (or at least more circumspect) going forward with respect to information sharing in parallel investigations).[17] As to the *KPMG* situation, however, the two courts seemed to have been genuinely concerned about extreme overreaching by the government and, in particular, by the two Assistant U.S. Attorneys—both of whom were repeatedly identified by name in the two opinions.[18] The naming of those lawyers, I believe, had as much of an impact on the Justice Department ultimately tweaking the Thompson memorandum (to remove affirmative "requests" for privilege waivers and denials of advancement), as did the substantive decisions by Judge Kaplan and the Second Circuit.[19] In the end, and irrespective of judicial inconsistencies, it is heartening that the Judicial Branch stands ready to stare down the Executive Branch when it goes too far and threatens important individual liberties (i.e., the ability of individuals to defend themselves against the overwhelming power of the government).[20]

Judge Rakoff and the Securities and Exchange Commission

For what seems like an eternity, the Securities and Exchange Commission has regularly entered into settlements with corporations, with such settlements having as their centerpieces (i) the corporations neither admitting nor denying liability, and (ii) the SEC asking a federal district court judge to impose his or her imprimatur on the settlement, thereby getting an injunction against future violations of the law. The first centerpiece has traditionally been justified on two grounds: first, that it saves the SEC resources by not having to litigate and prove wrongdoing at trial; and second, that it allows corporations the ability thereafter to litigate trail-along civil litigation brought by private plaintiffs (and the plaintiffs' bar). The second centerpiece is more of a historical artifact: it dates back several decades to when the SEC had very few weapons in its enforcement arsenal to penalize and deter corporate wrongdoing.

I thought that at least part of this settlement pattern was going to be affected when Judge Rakoff rejected a $33 million settlement between the SEC and Bank of America. According to the SEC, Bank of America had "materially lied" to Bank of America shareholders by failing to disclose, prior to a December 5, 2008 vote on Bank of America's proposed acquisition of Merrill Lynch, that $5.8 billion in bonuses were going to be paid to Merrill Lynch employees. In rejecting that settlement, Judge Rakoff opined that it did "not comport with the most elementary notions of justice and morality." Upset that Bank of America shareholders were both victimized and were also being made to bear the financial penalty for the alleged misconduct, the Judge ruled that the settlement was merely "a contrivance designed to provide the SEC with the façade of enforcement and the management of the bank with a quiet resolution of an embarrassing inquiry." Ultimately, and only grudgingly (and only after Bank of America had turned itself inside-out to meet the Judge's demands),[21] Judge Rakoff approved a $150 million settlement which hardly seemed like an SEC triumph.[22]

After the SEC was put through that difficult gauntlet, I thought there were two alternative ways to handle such matters going forward: either the SEC would utilize its administrative proceedings to effect the same settlements (and thus avoid the scrutiny of Article III judges), or the SEC would continue to seek such scrutiny in order to be able to invoke federal courts' contempt powers.[23] The SEC, for some reason, chose the latter.

Fast forward to March of 2011, when the SEC again found itself before Judge Rakoff with a settlement he found less than compelling.[24] Although Judge Rakoff decided to approve the settlement (largely because two of the individuals involved had pleaded guilty to related criminal charges and the company, despite being destitute, had paid a multimillion dollar penalty),[25] he opined that the "disservice to the public interest in such a [settlement] practice is palpable."[26] More generally, Judge Rakoff decried the SEC's seeking a federal court's imprimatur on such settlements, tracing the rationale for that protocol back to the above-referenced era when the Commission's enforcement powers were limited; the SEC's current enforcement powers are now both wide and deep (which they can invoke without ever having to go to court).

With that past as prologue, the SEC went for a trifecta in October of 2011, filing a complaint in federal court in New York, charging Citigroup with securities fraud in connection with a synthetic collateralized debt obligation ("CDO") it sold to investors in 2007. Simultaneous with the court filing, the SEC: (i) announced it was settling the matter with Citigroup for $285 million; (ii) filed a separate lawsuit against a former Citigroup employee it claimed was the principal individual responsible for the CDO fraud; and (iii) instituted settled administrative proceedings against two Credit Suisse entities and a Credit Suisse employee for their roles in the CDO transaction.[27] The judge who drew the task of overseeing and approving the SEC's settlement with Citigroup: Judge Rakoff.

At the same time the SEC was going public with its spin on the resolution of this allegedly fraudulent securities transaction, Citigroup issued its own press release. On top of the settlement tracking the traditional mantra of neither admitting nor denying wrongdoing, Citigroup highlighted for the investing public the fact that the SEC had not charged the company with "intentional or reckless misconduct."

Perhaps in response to these public releases ("How can a securities fraud of this nature and magnitude be the result simply of negligence?"), Judge Rakoff scheduled a settlement hearing, in advance of which he asked the settling parties to answer nine questions relating to whether the settlement was "fair, adequate, and reasonable." Not satisfied with the answers he received, Judge Rakoff rejected the settlement, a rejection that has been appealed by both the SEC and Citigroup.

Since the appeal was lodged to the Second Circuit, a few things have happened. First was the "dramatic" announcement by the SEC that it was changing its policy on neither admitting nor denying liability;[28] this policy change, however, was much ado about nothing—now, firms pleading guilty to *criminal* felonies will no longer be allowed to agree to *civil* settlements in which they neither admit nor deny *civil* liability. Next up, an enterprising *New York Times* reporter revealed that, over a decade-long period, the SEC has given 350 waivers to financial institutions that have existing injunctions not to commit securities fraud again;[29] in other words, the contempt "teeth" sought by the SEC in going to a federal judge to approve settlements has simply not been used to restrain or punish corporate recidivism. Third, by increasing numbers, more federal judges have started to follow Judge Rakoff's lead in questioning civil settlements brought for their approval by the federal government.[30] But then, just as suddenly, a Second Circuit panel, ruling on the SEC's motion for a stay of the Citigroup proceedings before Judge Rakoff pending its (and Citigroup's) appeal, granted that motion in light of the SEC's "strong likelihood of success" in demonstrating that the settlement was not "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with the law."[31]

So, what is there to be learned from Judge Rakoff's face-off with the SEC? As an initial matter, while it would appear likely that the Second Circuit will reverse his rejection of the Citigroup settlement, do not place *all* of your chips on that bet in Vegas.[32] There are at least four ways the Court of Appeals could approach this case (and the Court could mix and match): first, it could agree with Judge Rakoff's threshold complaint—that the SEC need not be bringing each and every settlement into federal district court, especially given the indisputable fact that the Commission never seems to invoke the injunctive power it is so eager to engraft as part of these settlements; second, it could agree with Judge Rakoff's second point—that if the SEC is going to come into federal district court, then the judge is not to be a mere "potted plant," but is instead supposed to exercise his or her judgment in assessing whether the settlement is appropriate; third, assuming the Second Circuit takes that second step, hopefully the Court would then articulate some constructive guidelines to help all concerned (i.e., the SEC, corporations, judges) understand how settlements will be reviewed; and finally, it seems likely that the Second Circuit will ultimately rule that Judge Rakoff went a bridge too far in criticizing and rejecting the SEC's policy of neither admitting nor denying liability—in its initial ruling on the motion for a stay, the Second Circuit (correctly, I believe) made it clear that such a policy is properly within the province of the Executive Branch, and the Judicial Branch does not have a role in passing judgment on the wisdom of the Executive Branch's decision-making in that realm.

If the Second Circuit does some or all of the foregoing, will that curb the growing appetite of federal district judges to question governmental settlements? My guess would be: probably yes. But such an outcome will not, I hope, curb federal judges from stepping in to restrain the 800-pound gorilla when and where such intervention is appropriate.

In fact, Judge Rakoff, even with the pendency of the Citigroup appeal hanging over him, has shown that he has not lost any of his courage in this regard. In the insider trading case brought by the government against Rajat Gupta,[33] Judge Rakoff issued a most important pre-trial ruling that will have a significant impact going forward on parallel investigations undertaken by the DOJ and the SEC. On Mr. Gupta's motion, the Judge ruled that joint interviews conducted by DOJ and SEC lawyers—and memoranda created by *both* sets of lawyers thereafter—were subject to the government's *Brady* obligations;[34] thus, all exculpatory evidence was required to be turned over from all of those sources (i.e., it could not be hidden in the SEC work papers). This bold and common-sense ruling is certainly a good thing for all citizens who want a level playing field when faced with the 800 pound gorilla.

Conclusion

We give Article III judges not only enormous power, but also lifetime tenure. And while that can sometimes lead to excesses, in the hands of intelligent and courageous men and women that power can help protect our liberties. Whether one agrees completely or even partially with the actions of Messrs. Kaplan and Rakoff, we are lucky that those men have committed their lives to public service.

Endnotes

1. *See* Charles Dickens, A Tale of Two Cities 1 (Andrew Sanders, ed., Oxford University Press 1990) (1859). There have been at least five movies based upon Dickens' classic work, the most famous of which is the 1935 MGM production, starring Ronald Colman (the film was nominated for an Oscar for Best Picture). Star Trek II: The Wrath of Khan (Paramount Pictures1982) pays homage to the book, with Spock (Leonard Nimoy) sacrificing his life to save the USS Enterprise.
2. *See, e.g.*, C. Evan Stewart, *The False Promise of 'Reform,'* N.Y.L.J. (2008); C. Evan Stewart, *'Carnacking' the Future*, N.Y.L.J. (2007); C. Evan Stewart, *When the Government Comes Knocking*, N.Y.L.J. (2005).
3. United States v. Stein, 435 F. Supp. 2d 330 (S.D.N.Y. 2006), *aff'd*, 541 F.3d 130 (2d Cir. 2008) ("*Stein I*"); *see also* United States v. Stein, 495 F. Supp. 2d 390 (S.D.N.Y. 2007) ("*Stein IV*"); United States v. Stein, 452 F. Supp. 2d 230 (S.D.N.Y. 2006), *vacated sub nom.*, Stein v. KPMG, LLP, 486 F.3d 753 (2d Cir. 2007) ("*Stein III*"); United States v. Stein, 440 F. Supp. 2d 315 (S.D.N.Y. 2006) ("*Stein II*").
4. *See* C. Evan Stewart, *The Post-Enron Pendulum: Is It Swinging Back (and in What Direction)?*, Am. Banker (2005); C. Evan Stewart, *The Ethics of Document Destruction: Andersen Agonistes*, N.Y.L.J. (2002).
5. *See* Del. Code Ann. tit. 8, § 145 (2012).
6. *Stein I*, 435 F. Supp. 2d at 361.
7. *Stein IV*, 495 F. Supp. 2d at 412, 419–28.
8. Having had one client go up against the New York Attorney General, who attempted to shut down the advancement of fees (happily, unsuccessfully), I believe the government's attempt to deny citizens the right to defend themselves in criminal trials to be downright un-American. *See When the Government Comes Knocking*, *supra* note 2.
9. *See* tit. 8, § 145.
10. United States v. Stein, 541 F.3d 130, 136 (2d Cir. 2008).
11. *Id.* at 142–44.
12. *Id*. at 147 (quoting Edmonson v. Leesville Concrete Co., 500 U.S. 614, 632 (1992) (O'Connor, J., dissenting)).
13. *Id.* at 147 (emphasis added) (quoting Flagg v. Yonkers Sav. & Loan Ass'n, 396 F.3d 178, 187 (2d Cir. 2005).
14. D.L. Cromwell Investments, Inc. v. NASD Regulation, Inc., 279 F.3d 155 (2d Cir. 2002), *aff'g* 132 F. Supp. 2d 248 (S.D.N.Y. 2001).
15. As a practical matter, individuals subject to an NASD/FINRA investigation do not have Fifth Amendment rights because, if they invoke that Constitutional right, FINRA (as did the NASD) will ensure that they are barred from the securities industry.
16. *See* Bartlett's Familiar Quotations 606 (14th ed. 1968) (quoting Ralph Waldo Emerson).
17. Whether or not that has been true is open to question. *See* U.S. v. Stringer, 408 F. Supp. 2d 1083 (D. Or. 2006), *rev'd*, 521 F.3d 1189 (9th Cir. 2008).
18. The U.S. Attorney had petitioned Judge Kaplan to delete their names from his initial decision; he specifically refused to do so.
19. *See Carnacking the Future*, *supra* note 2. It is indeed only "tweaking" because corporations that reach these decisions "on their own" are still eligible for more lenient treatment.
20. And while the DOJ has "tweaked" the Thompson memorandum slightly (its successor is named after Paul McNulty, Mr. Thompson's successor), that has not stopped the DOJ from envelope-pushing prosecutions, *see* C. Evan Stewart, *Corporate Criminal Liability Run Amok*, N.Y.L.J. (Nov. 15, 2007), or the SEC from bringing astonishing cases against those folks most beloved by readers of this journal—i.e., lawyers. *See, e.g.*, *In re John E. Isselmann, Jr.*, *Litigation Release No. 18896*, Securities and Exchange Commission,Sept. 23, 2004, http://www.sec.gov/litigation/litreleases/lr18896.htm (last accessed Apr. 26, 2012; *In re Jordan H. Mintz, Litigation Release No. 59296*, Securities And Exchange Commission, Jan. 26, 2009, http://www.sec.gov/litigation/admin/2009/34-59296.pdf (last accessed Apr. 26, 2012); *In re Rex. R. Rogers*, *Litigation Release No. 59297*, Securities and Exchange Commission, Jan. 26, 2009, http://www.sec.gov/litigation/admin/2009/34-59297.pdf (last accessed Apr. 26, 2012).
21. *See* C.E. Stewart, *Pandora's Box and the Bank of America*, N.Y.L.J., (Nov. 4, 2009).
22. *See* J. Coffee, *Illusory Victories?: Do SEC Settlements Deter?*, N.Y.L.J. (Nov. 18, 2010) (the SEC/Bank of America settlement "caused reputational harm").
23. *See* Stewart, *supra* note 21.
24. SEC v. Vitesse Semiconductor Corp., 771 F.Supp.2d 304 (S.D.N.Y. 2011).
25. As such, Judge Rakoff, citing the case's "unusual circumstances," decided to reserve "for the future substantial questions of whether the Court can approve other settlements that involve the practice of 'neither admitting nor denying.'" *Id.* at 310.
26. Judge Rakoff further opined that the practice creates "a stew of confusion and hypocrisy unworthy of such a proud agency as the SEC," and that "only one thing is certain: the public will never know whether the SEC's charges are true, at least not in a way that they can take as established by these proceedings." *Id.* at 309.
27. *See In re Brian H. Stoker, Litigation Release No. 22134*, Securities and Exchange Commission, October 19, 2011, http://www.sec.gov/litigation/litreleases/2011/lr22134.htm (last accessed May 1, 2012). (The Credit Suisse entities paid $2.5 million in disgorged fees and penalties; the individual was suspended from the securities industry for six months.).
28. *See* E. Wyatt, *S.E.C. Changes Policy on Firms' Admission of Guilt*, New York Times B1 (January 7, 2012) http://www.nytimes.com/2012/01/07/business/sec-to-change-policy-on-companies-admission-of-guilt.html (last accessed May 1, 2012).
29. *See* E. Wyatt, *S.E.C. Is Avoiding Tough Sanctions For Large Banks*, New York Times 1 (February 3, 2012) http://www.nytimes.com/2012/02/03/business/sec-is-avoiding-tough-sanctions-for-large-banks.html?pagewanted=all (last accessed May 1, 2012).
30. *See* E. Wyatt, *Settlements Without Admissions Get Scrutiny*, New York Times B1 (February 25, 2012) http://www.nytimes.com/2012/02/25/business/neither-admit-nor-deny-settlements-draw-judges-scrutiny.html (last accessed May 1, 2012); SEC v. Koss Corp., No. 11 Civ. 00991 (RTR) (E.D. Wis. December 20, 2011).
31. SEC v. Citigroup Global Markets Inc., No. 11-5227 (2d Cir. March 15, 2012). *See Evaluating SEC Non-Prosecution and Deferred Prosecution Agreements*, 44 Sec. Reg. & L. Rep. (BNA) 666 (April 2, 2012).
32. The Second Circuit, in appointing counsel to represent Judge Rakoff on the appeal, obviously recognizes that this case presents numerous and complex issues. *See Group, Citing 'Good Cause,' Asks Again for Enhanced Role in SEC/CitiGroup Case*, 44 Sec. Reg. & L. Rep. (BNA) 710 (April 9, 2012). With oral argument set for the latter half of September *(see SEC, Citing 2d Circuit Order, Asks Court to Approve Deal with Bear Stearns Execs*, 44 Sec. Reg. & L. Rep. (BNA) 604 (March 26, 2012)), much of what is set forth above may be moot (to the nth degree) as of the time this is being read. Nonetheless, I stand by the comments expressed above, whether or not my Nostradamus skills are vindicated.
33. This case is highlighted in C. Evan Stewart, *The SEC and Litigation: Oil and Water?*, N.Y.L.J. (November 8, 2011).
34. Brady v. Maryland, 373 U.S. 83 (1963). *See SEC OCIE Chief Outlines Plan to Tackle Private Fund Advisers*, 44 Sec. Reg. & L. Rep. (BNA) 561 (March 19, 2012).

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Reverse Piercing of the Corporate Veil: A Straightforward Path to Justice

By Nicholas Allen

Introduction

It is textbook law that a stockholder's exercise of control over a corporation does not create liability beyond the assets of that corporation.[1] This concept of limited liability for corporations is "deeply 'ingrained'" in both American legal and economic systems.[2] Indeed, judicial acknowledgement of a corporation as a separate and distinct entity is a cornerstone of American enterprise, and benefits such as encouraging shareholder investment by limiting investor risk exposure are essential.[3]

However, limited liability has its limits. When a corporation is used as a shield for liability or for an illegitimate business purpose, courts will exercise their equitable power by applying the "equally fundamental principle" of piercing the corporate veil.[4] Piercing the corporate veil allows one to puncture the "veil" of limited liability in order to hold a shareholder liable for the corporation's conduct.[5]

While exact definitions vary by state, courts will disregard the corporate entity, or pierce the corporate veil, when it is shown that a corporation is an "alter ego." A corporation is an alter ego when it is used as a "mere instrumentality for the transaction of [the shareholders'] affairs without regard to separate and independent corporate existence.…"[6] The "paramount goal" of traditional veil piercing is to achieve an equitable result.[7] "Traditional piercing"[8] jurisprudence is well established and, despite some differences in formulation, universally followed by American courts.

The practice of reverse piercing the corporate veil is less well established.[9] Where it is available, both corporate insiders and outside third parties have the opportunity to reverse pierce the corporate veil.[10] In outside reverse piercing, a third-party creditor seeks to recover debts owed by a corporation's owner from the corporation itself or to allow a third-party creditor to recover debts owed by a parent corporation from a subsidiary corporation.[11] Although several states have expressly rejected the doctrine,[12] there is a growing trend toward recognizing reverse piercing as a theory of recovery.[13] Nonetheless, the approaches taken in states that have allowed reverse piercing are far from uniform.[14] The various approaches reflect attempts to weigh the interests of the plaintiff, innocent shareholders and other corporate creditors.[15] These approaches are unlike traditional piercing, where the shareholder is held liable for her proactive role in creating the wrong; there, the corporation, its creditors, and other shareholders are not adversely affected. Conflicting interests mandate that any allowance of reverse piercing delicately balance the needs of all involved parties to protect adequately all those involved.

This article argues that while outside reverse piercing should not be the norm, there are instances when application of the doctrine is the only way to ensure equal justice. Because of the competing interests reverse piercing implicates, this article proposes that the doctrine be permitted against both legal and equitable owners, but only when traditional, less intrusive remedies are insufficient. Additionally, any innocent shareholders would be permitted a capital exemption prior to payment of the plaintiff's claim when that claim would liquidate the corporation. Finally, disputes amongst creditors should be dealt with using preexisting priority laws. Part I will discuss both traditional and outside reverse veil piercing. Part II will discuss the arguments for and against the various methods of outside reverse piercing through a case law analysis. Finally, Part III will advance a solution that safeguards the interests of all involved parties by first identifying the shortcomings of more traditional remedies and then proposing a new approach.

I. Overview of Veil Piercing: Traditional and Reverse

Because reverse piercing is a variation of traditional veil piercing, Part I begins by detailing traditional veil piercing case law and analyzing the various approaches before delving into reverse piercing.

A. Traditional Veil Piercing

All corporations exist behind the "corporate veil" and are entitled to a legal assumption that the acts of the corporation are independent from the acts of its shareholders. This ensures that shareholders, or another corporation, are exempt from liability for the corporation's actions.[16] This assumption of limited liability is "the rule not the exception."[17]

Piercing the corporate veil, however, places an outer limitation on this assumption.[18] Veil piercing is not a separate cause of action against a corporation, but rather an "assertion of facts and circumstances which will persuade the court to impose the corporate obligation on its owners."[19]

While small differences exist among the states,[20] a traditional veil piercing claim generally requires that (1) the owners exercised complete domination of the corporation in respect to the transaction attacked, and (2) that such domination was used to commit a fraud or wrong against the plaintiff.[21] Although some states purport to have three elements to allow a plaintiff to pierce the veil, the third being a causation or equitable results prong, the analysis is nearly identical.[22] If a plaintiff proves these elements, the court imposes liability on the individual because the corporation is a mere "instrumentality" or "alter ego" of its owner.[23]

The first prong of piercing the corporate veil, domination, is met when the owners use the corporate form to further their own personal goals.[24] The control that accompanies stock ownership and management is not enough to show domination.[25] Instead, the actions taken must circumvent legitimate corporate purposes, so as to make the corporation a mere "alter ego."[26] States are split as to who may dominate a corporation, although many take a liberal approach, allowing both legal and equitable owners.[27] The vast majority of cases involving reverse piercing implicate closely held organizations,[28] not publicly traded companies.[29] This article only addresses reverse piercing in the context of a closely held corporation.

While a finding that a corporation is an alter ego necessarily depends on the facts of each case, courts have identified certain factors that provide evidence of domination: (1) the absence of corporate formalities; (2) inadequate capitalization; (3) commingling funds; (4) overlap in ownership, officers, directors, and personnel; and (5) shared address, office space, and other similar indicia.[30] A finding of domination depends on the totality of the circumstances, so no one factor is dispositive.[31]

Once domination is established, a plaintiff attempting to pierce the veil must prove that a shareholder exercised her domination to commit a fraud or wrong against the plaintiff.[32] Stated differently, a plaintiff must show that adherence to the corporation's separate existence would further a fraud or promote injustice.[33] This element does not require actual fraud, complete with a showing of intent.[34] Rather, plaintiffs only need to show that retention of the corporate form would produce inequitable consequences.[35] Inequitable consequences can be the violation of a statute or other positive legal duty, a dishonest or unjust act in contravention of a plaintiff's legal rights,[36] or a "manifest abuse of the corporate form," including "intent to use the corporation as a shield for fraud."[37] Mere inability to collect on a judgment is not an "inequitable consequence[]," as this risk is inherent in all dealings with a corporate entity.[38]

B. Reverse Piercing Generally

Whereas traditional piercing holds an individual liable for the acts of a corporation, or a parent liable for the acts of a subsidiary, reverse piercing imposes liability on a corporation for the obligations of an individual shareholder, or on a subsidiary corporation for the acts of a parent corporation.[39] Despite the differences, reverse piercing initially requires the same two-pronged analysis of domination and promotion of fraud or injustice.[40] There are two types of reverse piercing: inside[41] and outside—depending on the relationship of the party attempting to pierce the corporate veil.[42] The two types of reverse piercing implicate different interests and diverse policy concerns. To permit a comprehensive analysis, this article will only address outside reverse piercing.

i. Outside Reverse Piercing[43]

In an outside reverse piercing claim, the plaintiff, an "outside" third party, seeks to pierce the corporate veil to impose liability on the corporation to satisfy the debt of an individual shareholder.[44] The "outsider" is asserting a claim against the corporation, not for a harm procured by the corporation itself, but rather for the actions of an individual shareholder.[45] Similarly, outside reverse piercing is used to impose liability on a subsidiary corporation for the debts of a parent corporation,[46] or to hold one controlled corporation liable for the debts of an affiliated corporation.[47]

The concept of reverse piercing[48] first arose in the landmark case[49] of *Kingston Dry Dock Co. v. Lake Champlain Transportation Co.*,[50] decided by Judge Learned Hand. In *Kingston Dry Dock*, the plaintiff, Kingston, repaired a ship owned by the defendant Champlain's subsidiary.[51] Champlain, not the subsidiary, requested the repairs, and plaintiff entered into the agreement with Champlain.[52] Champlain and its subsidiary shared nearly identical boards, but both companies kept separate identities, with decisions made independently.[53] Following default by Champlain, Kingston attached the boats to satisfy the debt owed by Champlain.[54] The trial court permitted plaintiff's attachment, but Judge Hand reversed.[55] In doing so, Judge Hand greatly limited the potential scope of reverse piercing, holding that, while it may "be too much to say that a subsidiary can never be liable for a transaction done in the name of a parent…such instances, if possible at all, must be extremely rare.…"[56]

Following Judge Hand's admonition in *Kingston*, courts refused to entertain reverse-piercing cases for nearly thirty years. The doctrine finally reemerged and gained acceptance in a marital property case, *W.G. Platts, Inc. v. Platts*.[57] In *Platts*, the plaintiff sought to impose liability on her husband's corporation in order to satisfy her share of the assets per their divorce decree.[58] The court held the corporation was an alter ego of the husband and permitted piercing in order to satisfy the divorce decree.[59] This opinion offered little precedential value for reverse piercing, however, as the court relied heavily on the fact that the ex-husband voluntarily proffered the corporation's assets for inclusion in the decree and a subsequent avoidance of that offering by his alter ego corporation "would be unconscionable and a denial of justice."[60]

Just two years after *Platts*, a district court in Colorado adopted a broad definition of reverse piercing in *Shamrock Oil & Gas v. Ethridge*.[61] There, a third-party creditor held an unsatisfied judgment against the defendant corporation's owner in his individual capacity.[62] Plaintiff attached the corporation's main asset, an oil-drilling rig, in order to satisfy his judgment.[63] The court permitted this reverse piercing since the corporation was a "mere dummy" of the individual defendant who shifted his assets to the corporation and habitually commingled funds.[64] The court stressed that "[t]he abstraction of the corporate entity *should never* be allowed to bar out and pervert the real and obvious truth."[65]

Reverse piercing has met the least resistance when invoked by the government, most commonly to obtain payment of taxes owed by individuals. The government first attempted reverse piercing in 1976 in *G.M. Leasing Corp. v. United States*.[66] The individual was not an incorporator, director, or officer of G.M. Leasing, but the court still permitted reverse piercing after finding that the individual was an equitable owner.[67] *Valley Finance* furthered the acceptability of reverse piercing by holding the government's inability to satisfy legitimate tax debts provides a "sound basis" for reverse piercing of the corporate veil.[68] Today, reverse piercing is a "well-established theory" in federal tax cases as the IRS routinely uses the remedy to attach assets of a corporation to satisfy debts owed by individual shareholders.[69]

II. Mixed Reviews: How Courts Have Applied Reverse Piercing and Why Some Have Rejected It

Part II, section A provides an in-depth analysis of two different approaches courts have taken in implementing reverse piercing.[70] Part II, section B discusses the various reasons put forth by courts in rejecting reverse piercing.

A. All in Favor…Reasons Supporting Courts' Various Approaches to Reverse Piercing

Courts have taken two approaches to reverse piercing. This article will refer to the first as the "inverse method." The inverse method simply takes the requirements of traditional veil piercing and applies them in the context of a reverse pierce.[71] The second method is the "equitable results" approach. Rather than simply carry over the requirements of traditional veil piercing, this approach imposes additional requirements to better protect the diverse interests implicated by reverse piercing.

A hypothetical will be used, along with case law, to allow for an "apples to apples" comparison between various theories and remedies while highlighting their nuances. The hypothetical is as follows: Lady *X* (Lady) wants to form Corporation *X* (X Corp.), a wholesale health supplement distribution company. She needs $35,000 in startup funds. To get the money, she liquidates her life savings of $5,000. She convinces her longtime friend (Friend) and brother (Brother) to contribute $5,000 each. Lady also gets two separate loans from two different banks, each for $10,000. Bank One decides to secure the loan by acquiring a UCC Article 9 lien on X Corp's inventory; Bank Two does not secure its loan. With her capital in hand, Lady forms X Corp., an S-Corp., and assumes the role of president. Lady does not receive any shares—those are instead split 50-50 between Friend and Brother. In addition to the shares, Friend and Brother are given positions on the Board of Directors. Despite Friend and Brother's stake in X Corp., they receive no dividends or disbursements, do not inquire as to the dealings of the business and do not attend board meetings as none are regularly held. Lady conducts business in the name of the company, which does have several monthly retail customers. Lady purchases a new car and condominium in the corporation's name, although they are solely for her personal use. She also uses the corporation's revenue to pay all of her personal expenses. Despite her "arduous" labor for X Corp., Lady takes no salary. Judgment Creditor (JC), after finding Lady to be insolvent, attempts to satisfy his $150,000 judgment—stemming from a tort claim against Lady—by securing assets of X Corp. X Corp. has $3,000 in inventory, the condominium and car Lady purchased, two computers—worth $4,000—and $1,500 in a bank account.[72]

i. The "Inverse Method" of Reverse Piercing

The inverse method of reverse piercing has been, by far, the most widely accepted approach to reverse piercing, with at least ten states utilizing the same test for both traditional and reverse veil piercing.[73] This approach permits recovery in a wide variety of cases because of its limited analysis into interests outside of the plaintiff's; when applied to the Lady X hypothetical; this method permits JC to recover on his claim.

Behind the inverse method of reverse piercing is the view that, despite the different corporate interests implicated, the remedy is a logical extension of traditional veil piercing because the underlying equitable goals remain unchanged.[74] These cases place emphasis on the function of the corporation, rather than the form. In accepting reverse piercing, a Connecticut court stressed the need for courts "to 'avoid an over-rigid preoccupation with questions of structure…and apply the preexisting and overarching principle that liability is imposed to reach an equitable result.'"[75] The status as a separate entity granted to corporations was introduced to subserve the ends of justice, not subvert them.[76] These arguments all stand for the proposition that in the event of potential misuse the courts will flex their equitable powers by circumventing limited liability, from either direction, by viewing a corporation as nothing more than a collection of individuals.

Equitable similarities aside, there are some differences that have precluded courts from simply copying the traditional veil-piercing test for reverse piercing. The biggest difference is the definition of "domination."[77] As discussed previously, "domination" requires an exercise of control to such an extent that the corporation or subsidiary has become a mere "alter ego" or "instrumentality" for the controlling party or corporation.[78] Applied to reverse piercing, this would impose on a plaintiff the seemingly impossible task of showing that a corporation dominated an individual or that a subsidiary dominated its parent corporation.[79] To avoid imposing this insurmountable burden on plaintiffs, courts have adopted a lesser standard of control based on the same factors considered in traditional piercing cases.[80]

Certain factors relevant in analyzing traditional veil piercing, while often cited, should also be reconsidered when assessing whether a corporation is an alter ego for reverse veil piercing purposes. One such example is that of undercapitalization. In traditional veil piercing, alter ego corporations often operate with insufficient assets, precluding a judgment creditor from satisfying a judgment against the corporation. In reverse piercing, it is more than likely that a third-party creditor is alleging that an individual is incapable of satisfying a debt because she has divested all her assets into a corporate alter ego. Thus, overcapitalization of a corporate alter ego could provide evidence of fraud and serve as a basis for reverse piercing the corporate veil.[81]

To better understand the implications of the inverse method of reverse piercing, consider the doctrine in light of the Lady X hypothetical. To show domination, JC would point to the level of control Lady exerted over X Corp., including the intermingling of corporate and personal funds, sharing her personal and business address, lack of corporate formalities, and overcapitalization. JC would argue that by divesting her assets to, and purchasing assets with, X Corp., Lady has sheltered her assets in the corporation, rendering her judgment-proof. Under the inverse method, satisfaction of those two elements would entitle JC to a judgment against X Corp. The court would disregard the potential claims of the innocent shareholders, Brother and Friend, and Bank Two,[82] because if Lady "was not deterred by the fact that [s]he did not hold all of the stock…why should h[er] creditors be?"[83]

ii. The "Equitable Results" Approach[84]

The Colorado Supreme Court directly confronted the often-cited downsides to reverse piercing[85] and acknowledged that when "inartfully performed," reverse piercing can negatively impact innocent third parties.[86] Rather than use the doctrinal shortcomings as support for an outright rejection of the doctrine, however, the court tried to craft a remedy that could protect the interests of judgment creditors, innocent shareholders, and corporate creditors alike. This effort swung the pendulum too far in the opposite direction; however, the shortcomings of the equitable results approach—as interpreted through subsequent case law—make it ill-suited to deal with the factual situations presented in many reverse-piercing cases.[87] The Lady X hypothetical reaffirms that assertion, as this method would prevent JC from recovering. This section will first analyze the additional factor imposed by this method and then survey subsequent case law to better define the conditions it imposes, before ultimately applying this approach to the Lady X hypothetical.

In addition to the requirements of domination and a showing of fraud or injustice, Colorado requires that "an equitable result [be] achieved by piercing."[88] The court defined "equitable result[s]" to mean that neither innocent shareholders nor corporate creditors would be prejudiced by allowing reverse piercing.[89] This requires an analysis to assess the availability of other, less intrusive remedies, and discourages reverse piercing when such remedies are viable alternatives.[90] In *In re Phillips*, the court found that because the shareholder's personal creditors were identical to the corporation's creditors, no harm would come to the creditors by reverse piercing.[91] Similarly, reverse piercing did not injure innocent shareholders, as the individual defendant owned the corporation outright.[92] The court left further decisions to determine whether any injury, no matter how minute, to creditors or shareholders would be sufficient to overrule a reverse piercing claim.

Since *In re Phillips*, there have been just four reverse piercing cases in Colorado. These cases have failed to contribute objective methodology to the lip service *In re Phillips* paid to equitable results. The subsequent cases forgo the in-depth analysis necessary to obtain "equitable results," opting instead for a mechanical application of the elements.[93] The first case, *Stimpson v. Goldberg*,[94] misinterpreted the third prong of the reverse piercing test, finding the defendant's ability to move assets beyond the plaintiff's reach "manifestly inequitable and unfair" in satisfaction of the third prong.[95] Two years later, in *GRY Partners LLP v. Tabernash Meadows Water and Sanitation District*,[96] the court, in authorizing reverse piercing, noted that the limited liability partnership had no creditors and the only other partner was the individual defendant's wife, who contributed no capital to the partnership.[97] This holding begged the question of whether a capital investment would have prevented plaintiff from reverse piercing the corporation.

The last of the *In re Phillips* progeny, *Shem, LLC v. Buhler*,[98] provides an answer to the question posed by *GRY Partners*.[99] Here, the plaintiff attempted to reverse pierce all of the corporations in which the individual defendant was involved, but succeeded only on those that the defendant wholly owned.[100] The depthless analysis proffered by the court in these cases falls far short of that required to ensure equitable results.

Using the equitable results approach, JC would not be able to recover against Lady X—as he did under the inverse method. As a preliminary matter, there is a split as to whether Lady—an equitable owner—can be found to have dominated X Corp., although *Shem* seems to mandate that she cannot. The fact that she does not own any shares would prevent a finding of domination.[101] Assuming, *arguendo*, that she could be found to dominate the corporation, the question then turns on whether Brother and Friend's investments would serve as a bar to reverse piercing, a question unanswered in *GRY*. The court could respond to Brother's and Friend's capital investment in one of three ways: it could (1) hold that their investments serve as an absolute bar to reverse piercing; (2) deduct the total amount of their investments from the corporation's total assets and allow JC to recover; or (3) allow JC to reverse pierce and ignore their investments entirely. Based on the logic of *Shem*, the court would presumably choose the first approach, barring JC from recovery since Brother and Friend each invested in X Corp. and each owned fifty percent of X Corp.[102]

Thus, the "equitable results" approach fails to achieve equity. By not analyzing the effects, impact and involvement of innocent shareholders and creditors, courts give blind deference to a corporation's form rather than its substance. They are withholding justice from rightful plaintiffs on the chance that others may be adversely affected. Such precautions are wholly unnecessary, as only the facts of each individual case will reveal whether such "chance" is present. Such deference to form obviates the need for reverse piercing by essentially precluding judgment for a plaintiff against any well-counseled defendant who has added shareholders to prevent such claims.

B. All Opposed…Reasons for Supporting Courts' Rejection of Reverse Piercing

Rather than adopt either the inverse or equitable results method, many courts simply reject reverse piercing.[103] These courts cite several common objections. First, they say reverse piercing violates normal judgment collection procedures.[104] Second, courts point out the potential harm reverse piercing could bring to both innocent shareholders and corporate creditors.[105] Third, they argue that other, more traditional, remedies exist to provide plaintiffs with redress without resorting to the drastic remedy of reverse piercing the corporate veil.[106] Fourth, courts refuse to lessen the "domination" standard adopted in *FMC Finance Corp. v. Murphee*,[107] instead agreeing with Judge Hand that "outside reverse piercing is only appropriate in the rare case of a subsidiary dominating its parent."[108] Finally, several courts have expressed added disdain for reverse piercing when the plaintiff is a voluntary contract creditor as opposed to an involuntary tort creditor.[109]

Normal judgment collection procedures permit a judgment creditor to attach an individual defendant's stock in a corporation.[110] Reverse piercing, however, allows an individual to skip this step by levying directly against the corporation's assets.[111] If successful in a reverse piercing action, the plaintiff would then be able to force a sale of the attached assets belonging to the corporation.

Courts highlight the negative effects that selling off the assets of a corporation could have. They stress the impact on non-culpable shareholders who would witness the value, and potentially the earning capacity of their corporation, be sold off due to the actions of one individual shareholder.[112] Additionally, creditors who extended credit to the corporation in reliance on its assets would be left unprotected if those assets were sold off to satisfy a judgment unrelated to the corporation.[113] These arguments, taken to the extreme, lead courts to conclude that the unnerving prospect of losing out to an individual shareholder's creditors will ultimately reduce the effectiveness of corporations as a means of raising credit.[114] While the equitable results approach takes account of these interests, this approach was discredited by a California court as creating requirements that "essentially eliminate the outside reverse piercing doctrine as a practical matter."[115]

Courts further contend that reverse piercing and its associated risks are unnecessary given the availability of alternative, more traditional, remedies.[116] The alternatives put forth include conversion, fraudulent conveyance, respondeat superior, and conventional agency law.[117] With such a wide gamut of remedies already available, courts insist there is no need to "invent" a new theory of liability.[118]

Additionally, in relying on Judge Hand's reasoning in *Kingston*, some courts claim reverse piercing is only appropriate in the rare instance that a subsidiary corporation dominates its parent.[119] Agreeing with Judge Hand, they argue that the nature of the parent-subsidiary relationship makes it nearly, if not completely, impossible for a subsidiary to interject itself in the affairs of a parent to the extent necessary to make the parent a mere instrumentality or alter ego.[120] Courts hold that traditional veil piercing mandates this standard be served, and further believe lessening the standard with the potential downsides presented by reverse piercing would be unduly fair to a creditor of the corporation.[121] Indeed, Judge Hand's labeling such an instance as this "extremely rare" seems correct.[122] If courts apply this standard, most, if not all, reverse piercing claims would be denied.[123]

Lastly, several courts that have considered reverse piercing also criticize a doctrine that would permit voluntary creditors of an individual, or corporation, to recover from another corporation.[124] At a minimum, courts suggest a distinction between voluntary and involuntary creditors given the distinct public policy issues each raises.[125] Judge Hand articulated this fear in *Kingston Dry Dock*, writing, "[a]ll that has really happened is that the [plaintiff], being dissatisfied with the credit of the company with which [he] dealt now seeks to involve its creature."[126] These courts contend that because voluntary creditors choose the parties with whom they deal, they can take precautions necessary to protect their interests, and to permit reverse piercing would only reward a creditor's failure to take such precautions, at the expense of other creditors.[127]

III. The Need for Reverse Piercing: How a Hybrid Approach Can Protect the Interests of All Parties

When reverse piercing is "inartfully performed," its disadvantages—such as injuries to innocent shareholders and corporate creditors—easily outweigh the benefits, allowing a judgment creditor to recover.[128] Failure to allow reverse piercing in certain instances, however, essentially provides "a roadmap" to debtors on how to avoid payment of their outstanding obligations by crafting the outer limits of traditional remedies and placing action outside those limits beyond the reach of judicial intervention.[129] Part III first provides a brief overview of oft-cited alternative remedies and their shortcomings. It then proposes an alternative balancing test for reverse piercing that weighs the conflicting interests of all involved parties.

A. The Inadequacy of Alternative Remedies

i. Fraudulent Conveyance

Courts often cite fraudulent conveyance law as an adequate alternative to reverse piercing. While this may suffice in many situations, there are instances where fraudulent conveyance law alone proves insufficient to promote justice. The existence of a separate corporate entity can allow a debtor to circumvent the transfer requirement by utilizing corporate assets as a personal piggybank instead of transferring personal assets to the corporation, thus making it hard to prove fraudulent intent. Employment of fraudulent conveyance law to the Lady *X* hypothetical brings this shortcoming to the forefront, as fraudulent conveyance law will prove useless to JC.[130] This section will discuss the scope and requirements of fraudulent transfer law, before applying it to the Lady *X* hypothetical. The remedy will then be applied to *Postal Instant Press* to show that, despite the court's assertion, fraudulent conveyance law is not an adequate alternative to reverse piercing.

Fraudulent conveyance law has remained largely unchanged[131] for five hundred years[132] and entitles creditors to avoid transfers made either (1) "with actual intent to hinder, delay, or defraud any creditor of the debtor; or (2) without receiving a reasonably equivalent value in exchange for the transfer or obligation" when other conditions[133] are met.[134] To aid in determining "actual intent," the relevant statute lists eleven "badges of fraud."[135] Fraudulent conveyance law has a statute of limitations of four years—as proposed in the Uniform Fraudulent Transfer Act—although many states have either increased or decreased this statutory period.[136]

If proven, fraudulent conveyance law affords a plaintiff limited remedies. The primary remedy is avoidance of the fraudulent transfer.[137] Some states also permit attachment or other provisional remedies against the asset transferred.[138] Additionally, a plaintiff is entitled to the value of the asset transferred when a fraudulent transferee subsequently transfers the asset.[139] This right, however, is lost when the transferee, without knowledge of the fraud, purchases the asset for fair consideration.[140]

Applied to the Lady *X* hypo, fraudulent conveyance law provides JC with little help. Under fraudulent conveyance doctrine, JC would not be able to seek attachment on either the apartment or the car owned by the corporation since those assets were acquired by the corporation, not transferred to it. Even though Lady uses them for her personal use, they are corporate property and JC's judgment is against Lady. The only potential basis for a fraudulent transfer action would be Lady's investing her life savings in the corporation, as it is this transfer that made her insolvent. This claim would fall under Uniform Fraudulent Transfer Act § 4(a) (1), requiring JC to show actual intent.[141] Here, the only badge of fraud that could support JC's claim would be Lady's transfer of all her personal assets—her life savings—to an insider, Corp. X.[142]

Even if deemed an insider, it is equally probable—and arguably more likely—that this badge of fraud will be found to be a valid investment in Lady's company—her first step down the road of entrepreneurship—not an illegal transfer. Her argument will likely succeed because the badges of fraud are only presumptions, and her motive could easily rebut the presumption of fraudulent intent. Furthermore, no single presumption is dispositive, and here JC can only point to one of the eleven badges. The only scenario that would permit Lady's investment in X Corp. to be found a fraudulent transfer would be if the "investment" came after she had already been sued or threatened with a lawsuit. In that scenario, especially given Lady's retained use of the property to pay her expenses, there would likely be enough to show actual intent to defraud given the pending litigation. As the facts are, however, JC would be unable to use this remedy to recover against Lady.

A look at the complicated facts of *Postal Instant Press, Inc. v. Kaswa Corp.*[143] shows that even in less "prototypical" reverse piercing cases, fraudulent conveyance alone can fall short of achieving equitable results.[144] In *Kaswa*, the defendant, Mr. Rangoonwala, purchased a Postal Instant Press (PIP) franchise from a third party.[145] PIP consented to the assignment and was a party to the agreement.[146] Following the purchase, Rangoonwala and a friend ran the franchise as general partners.[147] After several years of operating as partners, Rangoonwala created Kaswa Corp. for the sole purpose of operating the PIP franchise.[148] Thus, Kaswa, and not Rangoonwala, owned all the franchise assets.[149] Kaswa later merged with another company called The Print Works, but maintained the name Kaswa.[150] Upon being sued, Kaswa sold the assets to another company for fair value.[151] After obtaining a judgment against Rangoonwala for non-payment of franchise fees, PIP attempted to levy against the franchise assets, but learned of the transfer and sale of the assets.[152] PIP attempted to add Kaswa as a judgment debtor under the theory of reverse piercing.[153] The court rejected PIP's argument and refused to add Kaswa as a judgment debtor, in part because of the availability of other remedies such as fraudulent conveyance law.[154] An analysis, however, shows PIP would have likely been unable to recover using fraudulent conveyance law.

One way of showing fraudulent transfer would be to prove actual intent to hinder or defraud a creditor. There seems to be no problem with the initial transfer of the franchise assets to Kaswa. The corporation was capitalized and also had the franchise assets as collateral. It seems unlikely that Rangoonwala had fraudulent intent as he requested permission from PIP to add Kaswa to the franchise agreement. Again, the only "badge of fraud" that seems applicable is that the transfer was to an insider as defined in the UFTA.[155] Because these factors are only presumptive, it is unlikely that showing just one would convince a trier of fact of fraud.

The other way to prove a fraudulent transfer would be to show that the transfer was made without an exchange of equivalent value if also accompanied by one of two other conditions. PIP could likely prove this element as Rangoonwala transferred the equipment from himself to his corporation without receiving a reasonably equivalent value in exchange. However, the exchange of value may not have been required as Rangoonwala, at the time, was the president and sole owner of Kaswa. His control of the transferee makes this different from an exchange to a third party for less than reasonable value. Assuming Rangoonwala's transfer to Kaswa did satisfy the equivalent value element, PIP would still have to prove Rangoonwala was either (a) about to engage in a transaction with unreasonably small assets in relation to that transaction, or (b) that he intended to incur debts beyond his ability to pay. The first option is inapplicable here because Rangoonwala did not enter into any further transactions in either his individual capacity or through Kaswa. The second option is, at best, debatable when applied to these facts. Rangoonwala could have known that following the transfer he would fail to make franchise payments to PIP, ultimately resulting in his inability to pay the amounts owed, but for nearly three years post-transfer, Rangoonwala continued to make royalty payments. The fact that he continued to pay for so long would make it difficult for PIP to prove this second option. PIP, therefore, would not be able to show Rangoonwala's transfer to Kaswa Corp. was fraudulent.

PIP would, however, be able to prove Kaswa fraudulently transferred the franchise assets when it sold them upon learning of PIP's action against Rangoonwala. That transfer was made with actual intent to defraud a creditor. While PIP could not have avoided the transfer—because the buyer purchased for reasonably equivalent value—it would have been entitled to Kaswa's accounts for the sale of the franchise assets. This argument, however, is moot because Kaswa could only have been held liable for PIP's judgment against Rangoonwala if the court permitted PIP to reverse pierce and hold Kaswa liable for that judgment. Thus, despite the court's assertion to the contrary, fraudulent conveyance law would not in fact serve as an alternative remedy for PIP. Reverse piercing offers PIP its only chance at justice.

As these examples illustrate, there are instances where fraudulent conveyance law is unable to ensure just results, namely when an individual acquires assets via a corporation for the sole purpose of limiting personal liability. Even in those situations where fraudulent conveyance law may be applicable, the limited remedies available can cause undue hardship on plaintiffs while potentially benefiting the wrongdoing party. Furthermore, the statute of limitations, which could serve as a bar to recovery in fraudulent conveyance actions, would not preclude a judgment in a reverse piercing case. In reverse piercing, the wrong complained of—abusing the corporate form—is ongoing; it is the continued operation of the corporation that allows the defendant to elude liability.

ii. Bypassing Normal Judgment Collection Procedures

While attaching shares is preferable to attaching assets—because the former only negatively implicates the liable shareholder—the realities of most alter ego corporations make attaching shares impractical, if not impossible. Traditional attachment presents four potential problems in the reverse piercing context. First, many closely held alter ego corporations do not issue stock. Second, even when stock is issued, valuing these businesses is a difficult task. Third, even when the stock is valued, many closely held corporations place limitations on the alienability of the stock.[156] Finally, if the individual defendant is an equitable owner, she will not have any shares to attach. The Lady *X* hypothetical illustrates several of these shortcomings.

Shares in a corporation are considered part of an individual's assets. To satisfy one's judgment, a creditor can simply attach the judgment debtor's shares or rights to cash distributions.[157] Many closely held alter ego corporations, however, never issue stock.[158] In fact, limited liability companies (LLCs) cannot issue stock at all—issuing instead membership interests.[159] Furthermore, even when a closely held alter ego corporation does issue stock, most do not pay dividends and avoid regular disbursements, opting instead to use the corporation's assets as a personal piggybank.[160] The absence of distributions negates any chance of recovering money via successful attachment. The only option for the plaintiff after attachment would be to sell the shares; given the corporate abuse, even if successful this would not net much. Such a corporate structure thus deprives plaintiffs of "any means" of collecting on their judgments.[161]

While not easy, a failure to issue stock does not preclude attachment as courts have ways to evaluate the worth of a closely held corporation. Valuing a company is described as a "pseudoscience" or an "art form" because there are countless methods used to determine worth.[162] Regardless of the approach, factors of importance include property to be valued, the business history of the enterprise, the economic outlook of the industry, and the earning capacity of the company.[163] Once a valuation is determined, courts must then determine the market value of the stock by establishing a proper ratio between valuation factors and the price per share that a reasonable buyer would be willing to pay.[164] The reality of alter ego corporations—with neglected formalities and commingled funds—only makes these calculations more difficult. For instance, several factors, including dividends and expenses, would commonly be non-existent or vastly skewed because of the defendant's misuse of the corporate form. While not impossible, accurately valuing a closely held alter ego corporation would be a protracted process with no great probability of an accurate outcome.

Even if defendant's alter ego corporation did issue stock and the corporation is accurately valued, attaching shares still may not be a viable option. In closely held corporations, there are often limitations on alienability. Stock ownership limitations can be imposed by a corporation's chosen structure. For instance, if the alter ego corporation is an S-Corporation, no other corporations or LLCs can be shareholders.[165] Similarly, most LLCs do not permit transfer of membership interests absent approval from other members.[166] Owners can place additional restrictions on alienability through the Articles of Organization and the corporation's bylaws.[167] These restrictions can include qualifications and restrictions on the ownership of stock subject to a right to repurchase in the event of a violation.[168] Even if not an outright impediment, restrictions on alienability also lower the stock's marketability, and consequently the price.[169] Alienability is crucial in a free market, and restrictions on it could cause concern to a hypothetical buyer regarding the presence of a ready market for the corporation's stock.[170]

The Lady *X* hypo highlights several of the above-mentioned weaknesses of attaching stock in reverse piercing actions. A preliminary issue here is who actually owns the shares; Lady is only an equitable owner, and as such, she does not own X Corp. stock.[171] Lady also receives no cash distribution—be it dividends, profits, or salary—for her involvement. She instead pays personal expenses using corporate funds, which places the assets out of reach of attachment. If this matter were somehow addressed, courts would then have to attempt to value X Corp. This would involve poring over accounts that may have been improperly maintained to determine the profitability of the corporation. Each expense would need to be scrutinized given the intermingling of funds and use of corporate assets for payment of personal expenses. Furthermore, there may or may not be restrictions on the alienability of X Corp.'s shares.

Accordingly, even when courts are able to move past issues of valuation and alienability, they may run into additional problems as traditional judgment collection procedures are incapable of penalizing an equitable owner who uses a corporation to judgment-proof herself.

iii. Agency and Respondeat Superior[172]

Agency generally "encompasses the legal consequences of consensual relationships."[173] A principal, by manifesting consent for another (the agent) to work subject to the principal's right of control, gives the agent the power to "affect the principal's legal relations through the agent's acts and on the principal's behalf."[174] In a reverse piercing context, this would require the individual debtor to have been acting as an agent of the alter ego corporation when she committed the wrong, so liability could be imputed to the corporation. While individual state laws vary slightly, this requires a plaintiff to show that (1) the individual was authorized by another to act for or in place of another person or corporation and (2) the act leading to the claim occurred within the scope of authority.[175]

While agency principles can impute liability in specific instances, once the use of the corporate form to shelter personal assets is acknowledged, the limitations of agency principles of liability become clear. An individual debtor is essentially judgment-proof provided the original cause of action falls outside the corporation's scope. Thus, in the Lady *X* hypo, despite Lady*'s* personal insolvency, JC would be unable to attach the corporation's assets because JC's tort claim arose from conduct falling outside Lady's scope of employment with X Corp.

The facts of *Bennett v. Reynolds*[176] proved conducive to remedy via agency principles. There, the Supreme Court of Texas rejected an attempt to reverse pierce the corporate veil, choosing instead to impute liability to the corporation by applying agency principles.[177] Plaintiff had a longstanding feud with the individual defendant and after discovering defendant auctioned off thirteen of his cattle, plaintiff sued both the individual defendant and defendant's corporation for conversion.[178] The individual defendant resided on property owned by the defendant corporation.[179] The individual defendant's conversion of the plaintiff's cattle also occurred on the corporation's land.[180] While the corporation itself did not raise cattle, the individual defendant did use the corporation's land for that purpose.[181] The individual defendant owned no part of the corporation—his daughters did— but defendant was the president and admitted that he "ma[d]e the decisions" and "r[a]n the ranch."[182] Plaintiff attempted to hold the corporation liable on a reverse piercing theory.[183] The court, however, held that because the individual defendant "used *corporate* authority over *corporate* employees, on *corporate* land, to convert cattle using *corporate* equipment," traditional agency principles were sufficient to hold the corporation liable for the conversion.[184]

Many times, however, the individual defendant's actions will not fall within the scope of corporate activity.[185] Limiting liability to situations involving an agency relationship assumes that the corporate form can only be misused by the acts of its agents—ignoring the possibility that the corporate form itself could be used to procure a wrong by using it as a shelter for personal assets.[186]

iv. Conversion

Conversion is another oft-cited alternative to reverse piercing. The tort of conversion, however, has a very limited scope and is only effective in very specific factual situations, as is evidenced by its inapplicability to the Lady X hypothetical. This section will first discuss the elements of conversion, and then apply it to the hypothetical, before finally applying the doctrine to a recent case to highlight the remedy's limited scope.

Conversion is an intentional exercise of dominion or control over another's property that so seriously interferes with that other's right to control it that the actor may be required to pay the other the property's full value.[187] There are several factors considered in determining the severity of an exercise of dominion, including the duration and the intent to assert a right inconsistent with the other's right of control.[188] The initial requirement, however, for any action in conversion is that the plaintiff had a legal right to the converted property prior to the defendant's taking it.

The square peg of conversion would be inapplicable to the "circle" of facts implicated by the Lady *X* hypothetical. Prior to the battery, JC had no legal rights in any of the assets belonging to *X* Corp. and thus would not be able to claim conversion. Furthermore, the judgment obtained against Lady would not be sufficient to vest JC with any legal rights in the assets of *X* Corp.

In the *Bennett* case, the plaintiff's primary cause of action was for conversion.[189] The defendant knowingly took the plaintiff's cattle and sold them off at an auction.[190] Even there, however, the tort of conversion was insufficient for plaintiff to recover. Conversion allowed the plaintiff to impose liability on the defendant as an individual. The defendant, however, was insolvent because his alter-ego corporation owned all his assets, including the farm he lived on.[191] Thus, absent a way to attach corporate assets, the plaintiff's judgment for conversion against the individual defendant would have been meaningless.[192]

Conversion seems ill-suited to deal with the problem of "judgment-proofing" by use of the corporate form to hide assets. While cases like *Bennett* and *Postal Instant Press* could provide a basis for conversion, most reverse piercing cases involve corporations sheltering the defendant's personal assets, as opposed to assets belonging to the plaintiff. *Bennett* and *Postal Instant Press* highlight the futility in permitting a judgment against an insolvent defendant. Even if successful, a plaintiff could be left sitting with an unsatisfied judgment while the wrongdoer is free to continue living off the funds hidden in an alter ego corporation.

B. Reverse Piercing: A New Approach

It is the task of the court "to do justice to each litigant."[193] As Section III.A illustrates, there are instances where, despite blatant misuse of the corporate form, justice dies on the doorstep of the court.[194] In the name of judicial convenience, courts have adopted overly simplistic standards that overlook the interests of involved parties, or have adopted strict requirements, if any at all, that again fail to do justice to each litigant. By (1) requiring plaintiff to show the inadequacy of other remedies, (2) permitting recovery against equitable owners, (3) permitting a capital exemption for innocent shareholders, and (4) applying preexisting creditor-priority laws, courts can safeguard the interests of all parties at the expense of none.

i. Ownership Requirement v. "Domination"

Ownership as a prerequisite to reverse piercing is easily circumvented, facilitating the practice of "judgment-proofing."[195] One would be able to shirk responsibility merely by including alternate shareholders in the corporate charter; indeed, that is exactly what many judgment debtors have done.[196] The sole protection afforded by requiring ownership is that it ensures no innocent shareholders will be adversely affected by a decision to reverse pierce. The protection of innocent shareholders, while vital, does not necessitate that their mere existence should preclude a plaintiff from reverse piercing. In many closely held corporations—often the subject of reverse piercing—these other shareholders are family and friends who receive no compensation and are not even able to explain their responsibilities within the corporation.[197] This protection of innocent shareholders, while necessary, can be achieved by much less restrictive means.[198] In attempting to get around their own judicially imposed requirement, courts have stretched the ownership requirement beyond reason.[199]

To prevent inequity, all courts should apply a "domination" standard. The disallowance of reverse piercing for a lack of legal ownership is a denial of justice because of a mere technicality. Additionally, mandating ownership simply permits those who wish to escape liability to do so by having other shareholders. Such a standard would not lower the threshold to permit piercing. Plaintiff would still need to show that the individual exercised control over a corporation to such an extent that the corporation is but a mere alter ego or instrumentality. The only difference would be that a corporation could then be reverse pierced because of the actions of both legal *and* equitable owners. This standard is currently used by many courts and prevents injustice because it is malleable to the truth of a particular situation, rather than emphasizing legal form over function.[200] By applying a "domination" standard that permits reverse piercing because of the actions of an equitable owner, courts would no longer have to resort to nominal ownership and, more importantly, judgment debtors could not immunize themselves with the stroke of a pen on a stock certificate. Applied to the Lady *X* hypothetical, such a standard would allow JC to reverse pierce X Corp. for the judgment against Lady despite her lack of legal ownership in the corporation.

ii. Innocent Shareholders

Small businesses are an integral part of the national economy[201] and investment is the engine that runs small business.[202] Those looking to start up a business or to capitalize their small business often rely on investments from friends, family, venture capitalists, angel investors, and the like.[203] It is not uncommon for these investors to require ownership interest or a board position, or both, as a prerequisite to their investment.[204] No remedy for reverse piercing that failed to take the interests of the investor into account would be beneficial to society. This section proposes guidelines to first determine the innocence of a shareholder and then provides safeguards for truly innocent shareholders. Finally, the proposal will be illustrated by application to the Lady *X* hypo.

Investors who negotiate for power within a corporation are in a position to insulate the corporation from reverse piercing claims through adherence to corporate formalities and adequate oversight.[205] All stockholders in a closely held corporation have fiduciary duties of the "utmost good faith and loyalty," requiring them to act in the best interests of the corporation.[206] These stockholders can use the power they have to ensure that the activities that give rise to a finding of domination do not transpire either through traditional corporate means or, if necessary, by judicial intervention.[207]

Despite a member's potential breach of this fiduciary duty leading to a reverse piercing claim, permitting a shareholder's loss of capital in these instances could have negative effects on investment in small companies. Given the importance of such investments and the reality that not all investors with power will utilize it, any exercise in reverse piercing needs to take adequate measures to protect shareholders. The best way to protect the interests of both the shareholders and plaintiffs would be to permit a capital exemption, when the enforcement of a judgment would liquidate the alter ego corporation. This would allow reimbursement to shareholders of their initial investment, provided the shareholder did not directly benefit from the dominator's abuse of the corporate form.

A capital exemption would allow any shareholder to receive a return on his initial investment amount prior to any disbursement to the plaintiff, ensuring that he or she does not sustain a loss due to reverse piercing. The capital exemption would only be triggered when a plaintiff's claim would drain the corporation of all its assets. Yet, by potentially depriving a shareholder of revenue, dividends, and disbursements, it encourages shareholders to protect themselves by taking an active role in the oversight of the corporation in which they invest and bargaining for more power to protect such interests. To prevent fraud amongst family and close friends, there would be an exemption for those instances where the shareholder benefits directly from the fraud. A shareholder benefits directly when he or she receives some financial benefit because of the fraudulent arrangement.[208]

To illustrate the capital exemption theory, it will be applied to two versions of the Lady *X* hypothetical.[209]

X Corp. only has $1,500 in liquid assets—only one one-hundredth of the judgment owed to JC. Thus, JC would have to attach assets belonging to X Corp. in order to satisfy his $150,000 judgment. JC could attach both the car and the condominium belonging to X Corp. If these two assets totaled $170,000, JC would be able to satisfy his judgment and X Corp. would still have all of its inventory and equipment, plus $20,000 resulting from the sale of the assets. As the purchase of these assets was in and of itself an abuse of the corporate form, their sale would not adversely affect X Corp. as would the sale of inventory or company equipment, which are necessary to its continued operation.[210] Furthermore, X Corp. would still have more than enough value remaining[211] to cover both Friend and Brother's initial $5,000 investments and the loans from Banks One and Two and continue with business as usual.

Suppose, however, that the sale of the car and condo only totaled $125,000. That amount would be insufficient to satisfy JC's judgment—even after adding the remaining assets[212]—thus requiring him to attach other assets belonging to the corporation. Following sale of the assets, JC would not receive the entire $133,500. Friend and Brother would first be entitled to a return of their initial $5,000 investments. JC may try to argue that Friend and Brother benefitted from the fraud because of their relationship to Lady, but that would require a showing of some financial gain as a result of the abuse of the corporate form, not present on these facts. Absent such a showing, JC would not be able to prevent Friend and Brother from recovering their initial investments. The remaining $123,500 would be divided amongst JC and Banks One and Two.

iii. Corporate Creditors

In rejecting reverse piercing, courts cite a voluntary judgment creditor's ability to protect itself as contributing to the doctrine's redundancy.[213] The rationale is that voluntary creditors, by definition, have chosen to deal with the individual defendant and thus have some ability to protect themselves.[214] Thus, they argue that a distinction should be made between tort and contract judgment creditors. While this rationale is valid, such logic ignores the fact that *all* voluntary creditors have that ability to protect themselves, be it a creditor of the individual or of the corporation. Because not all creditors sufficiently insulate themselves in the event of a breach, there are well-established laws governing the rights of such creditors and it is these laws that should govern in reverse piercing cases. This section will first discuss the various risks all creditors face and the means by which such creditors can protect their interests. It will then look to pre-existing creditor and bankruptcy laws and apply those laws to the Lady *X* hypothetical.

Much is made of the chilling effect that would ensue were a corporate creditor to be superseded by a judgment creditor, yet, this is exactly what already happens.[215] Unsecured creditors[216] face a variety of risks, including those of judgment creditors of the corporation itself and even some creditors of an individual shareholder.[217] In spite of that ever-present risk, creditors continue to lend to small businesses. Accordingly, considering that loans to closely held corporations are made despite the nearly infinite grounds upon which a corporation could face its own action, it cannot then be said that the risk of judgment against a corporation, stemming from an action against an individual, would deter loans to closely held corporations. Furthermore, unsecured creditors already face some risks from reverse piercing by the IRS as the doctrine has widespread acceptance in federal tax cases.[218]

Unsecured corporate creditors also face risks should the corporation declare bankruptcy. Debts owed to unsecured creditors are secondary to those of secured creditors.[219] It is only after all secured debts are settled that unsecured creditors are entitled to the corporation's remaining assets on a pro rata basis.[220] In most instances, the remaining unsecured creditors do not receive full payment from the debtor's estate. Furthermore, bankruptcy law exposes a creditor to the exact same risks as reverse piercing—a corporation being held liable for the actions of an individual shareholder—through a process known as substantive consolidation. Substantive consolidation has been described as the "federal analogue of veil-piercing."[221] This bankruptcy practice pools together the assets of multiple entities and permits creditors to recover their ratable share from the combined assets.[222]

The risks reverse piercing poses to corporate creditors are not unique to that remedy. All voluntary creditors, be they of the individual or the corporation, have the opportunity to protect themselves from other creditors. If an individual's creditor is able to reverse pierce, it necessarily means the corporate form is being used to procure a fraud. To permit recovery to those creditors dealing with the corporation who fail to protect themselves over those who work with a fraudulent individual is unjust. An alter ego corporation is one that has been dominated to the extent that the corporation and the individual are essentially one entity;[223] accordingly, their creditors should all be placed on an equal footing.

Assume that the sale of all X Corp.'s assets, including the car and condominium, nets $100,000. X Corp. cannot cover all of its outstanding debts, which total $170,000. Bank One, which took a secured interest in X Corp.'s inventory, would automatically receive the proceeds from the sale of the inventory, $3,000, bringing the amount it is owed down to $7,000.[224] Deducting that amount, and Brother's and Friend's capital exemptions, X Corp. is left with $87,000 to cover $167,000 in debt. The court would distribute these remaining funds pro rata among the three creditors. This would result in JC receiving $78,143 towards his claim, Bank One receiving an additional $3,647, and Bank Two receiving $5,210. Applying preexisting creditor priority laws ensures each creditor some return on the amount owed to it. These laws do not disturb the expectations of creditors because they are the very laws that govern all transactions entered into by creditors. Those creditors, like Bank One, who take measures to protect their interests are rewarded; Bank One received 66.5% of its original loan back, compared to the approximately 52% received by the other creditors—and had Bank One required additional collateral as security, it could have recovered the entire amount owed it by X Corp.

Conclusion

"Fraud is infinite."[225] The law cannot rely solely on traditional remedies or it will find itself "perpetually eluded by new schemes" contrived by "the fertility of man's invention."[226] The privilege of the corporate form need be used for "*legitimate* business purposes and must not be perverted."[227] By failing to permit reverse piercing, courts bless this perversion and deprive plaintiffs of a needed remedy, while simultaneously rewarding wrongdoers who shield their assets through corporate misuse. Traditional remedies are unable to combat the types of fraud that give rise to reverse piercing claims and failure to adopt new remedies will lead to justice being "eluded by new schemes."[228] By permitting reverse piercing when (1) traditional remedies are inadequate (2) against both legal and equitable owners (3) with a capital investment exception for innocent shareholders, and (4) relying on preexisting creditor priority rules, courts protect the interests of all involved parties. These factors, as detailed, are not so overbearing as to enfeeble this remedy, which is what has occurred with the "equitable results" approach. Instead, this analysis provides meaningful and objective measures by which a court can assess all the implications and cater to each one accordingly.

Endnotes

1. *See* United States v. Bestfoods, 524 U.S. 51, 61–62 (1998).
2. *Id.* at 61 (quoting William O. Douglas & Carrol M. Shanks, *Insulation from Liability Through Subsidiary Corporations*, 39 Yale L.J. 193 (1929)).
3. *See* Gregory S. Crespi, *The Reverse Pierce Doctrine: Applying Appropriate Standards*, 16 J. Corp. L. 33, 34 (1990).
4. *Bestfoods*, 524 U.S. at 62.
5. *See id.*; *see also* Anderson v. Abbott, 321 U.S. 349, 362 (1944). This principle has remained largely unchanged for over a century of corporate jurisprudence. *See, e.g.*, First Nat'l Bank of Chicago v. F.C. Trebein Co., 52 N.E. 834, 837 (Ohio 1898) (courts have confined "the fiction by which an ideal legal entity is attributed to a duly-formed incorporated company, existing separate and apart from the individuals composing it…to the purposes for which it was adopted,—convenience in the transaction of business…and have repudiated it in all cases where it has been insisted on as a protection to fraud or any other illegal transaction.").
6. Gorsich v. Double B Trading Co., 893 P.2d 1357, 1362 (Colo. App. 1994).
7. In re Phillips, 139 P.3d 639, 644 (Colo. 2006).
8. "Traditional Piercing" involves a claim brought against the shareholders of a corporation in their individual capacities resulting from a wrong procured by the corporation. For more information concerning traditional piercing, see *infra* Part I.A.

9. *See* W. Fletcher, Cyclopedia of the Law of Private Corporations, §41.70, at 458–59 (1983 & Supp. 1989).

10. When performed by an insider, it is called "inside reverse piercing." Similarly, when performed by a third party, it is called "outside reverse piercing." This article focuses on outside reverse piercing; for more information in regards to both inside and outside reverse piercing, see *infra* Part I.B.

11. *See, e.g.*, *id.*; In re Phillips, 139 P.3d at 645; Goya Foods, Inc. v. Unanue-Casal, 982 F. Supp. 103, 108 (D.P.R. 1997).

12. *See, e.g.*, Postal Instant Press, Inc. v. Kaswa Corp., 162 Cal. App. 4th 1510, 1513 (Cal. Ct. App. 2008) (refusing to adopt reverse piercing); Acree v. McMahan, 585 S.E.2d 873, 874 (Ga. 2003) (rejecting reverse piercing); Transamerica Cash Reserve v. Dixie Power and Water, 789 P.2d 24, 26 (Utah 1990) (refusing to apply reverse piercing to current case, without directly rejecting doctrine); McIntyre v. Nice, 2001 WL 1708832, at *6 (Me. Super. Ct. May 17, 2001) (noting that the court has never recognized reverse piercing and has stated the weight of authority is against the doctrine).

13. *See* Litchfield Asset Mgmt.Corp. v. Howell, 799 A.2d 298, 312 (Conn. App. Ct. 2002) ("[There is] a growing recognition of the doctrine of reverse piercing of the corporate veil.").

14. *C.f.* In re Phillips, 129 P.3d at 641 (holding Colorado law requires proof that no innocent shareholders or creditors would be prejudiced by reverse piercing), *with* State v. Easton, 647 N.Y.S.2d 904, 908–10 (N.Y. Sup. Ct. 1995) (holding that New York only requires a showing that a corporation is the alter ego of the individual, and failure to disregard corporate entity would procure a fraud to plaintiff), *with* Towe Antique Ford Found. v. I.R.S., 999 F.2d 1387, 1390 (9th Cir. 1993) (holding that Montana law does not require a showing of fraud to allow reverse piercing, at least in tax collection cases).

15. *See* In re Phillips, 139 P.3d at 645; *see also* Cascade Energy & Metals Corp. v. Banks, 896 F.2d 1557, 1577 (10th Cir. 1990).

16. *See* Black's Law Dictionary (9th ed. 2009).

17. Anderson v. Abbott, 321 U.S. 349, 362 (1944).

18. *See Easton*, 647 N.Y.S.2d at 908.

19. *Id.*

20. For instance, California and Illinois require ownership as a prerequisite to alter ego liability. *See* S.E.C. v. Hickey, 322 F.3d 1123, 1128 (9th Cir. 2003); *see also* Trossman v. Philipsborn, 869 N.E.2d 1147, 1171 (Ill. App. Ct. 2007) (holding that to permit reverse piercing an insider must own "all, or substantially all, of the stock"). *But see Easton*, 647 N.Y.S.2d at 909 (holding that an equitable owner can satisfy the domination requirement; "legal" ownership is not a requirement).

21. *See Easton*, 647 N.Y.S.2d at 908–09. *See also* Sea-Land Servs., Inc. v. Pepper Source, 941 F.2d 519, 520 (7th Cir. 1991) (holding that in Illinois, there are two requirements to permit veil piercing: "[F]irst, there must be such unity of interest and ownership that the separate personalities of the corporation and the individual [or other corporation] no longer exist; and second, circumstances must be such that adherence to the fiction of separate corporate existence would sanction a fraud or promote injustice." *Id.* (quoting Van Dorn Co. v. Future Chem. & Oil Corp., 753 F.2d 565, 569–70 (7th Cir. 1985))).

22. *See, e.g.*, In re Phillips, 139 P.3d 639, 646 (Colo. 2006) (stating that Colorado law requires that the insider and corporation be alter egos, that justice requires recognizing the substance of the relationship over the form because adherence to the corporate form would sanction a fraud, and that an inequitable result be achieved by piercing).

23. *See* WM. Passalacqua Builders, Inc. v. Resnick Developers S., Inc., 933 F.2d 131, 134 (2d Cir. 1991). Accordingly, veil-piercing is often referred to as the "alter ego" theory.

24. *Easton*, 647 N.Y.S.2d at 909.

25. *See* Angelo Tomasso, Inc. v. Armor Constr. & Paving, Inc., 447 A.2d 406, 411 (Conn. 1982). *See also In re* Aoki, 323 B.R. 803, 811 (B.A.P. 1st Cir. 2005); In re Plantation Realty Trust, 232 B.R. 279, 282 (Bankr. D. Mass. 1999).

26. *Easton*, 647 N.Y.S.2d at 909.

27. *See supra* text accompanying note 20.

28. A closely held corporation is generally described as "'a corporation with a few shareholders and whose corporate shares are not generally traded on a securities market.'" DiPasquale v. Costas, 926 N.E.2d 682, 707 (Ohio Ct. App. 2010) (quoting Crosby v. Beam, 548 N.E.2d 217, 218 (Ohio 1989)).

29. This is in part because most publicly traded companies adhere to corporate formalities, thus making it difficult to satisfy the domination element of alter ego. For an example of a reverse piercing case involving a publicly traded company, see Cascade Energy & Metals Corp. v. Banks, 896 F.2d 1557, 1577 (10th Cir. 1990). A cursory assessment would suggest any reverse piercing action against a publicly traded company would necessarily implicate innocent shareholders and should accordingly fail. All subsequent references to a corporation are to a closely held corporation, unless explicitly stated otherwise.

30. *See* WM. Passalacqua Builders, Inc. v. Resnick Developers S., Inc., 933 F.2d 131, 139 (2d Cir. 1991). Additional factors include the amount of business discretion displayed by the dominated corporation, whether related corporations deal at "arm's length," whether corporations are treated as independent profit centers, the personal payment or guarantee of corporate debts or guarantees by other corporations, and whether the corporation in question had property used by an owner or another corporation as if it were his or its own. *See id.* For additional factors courts have relied on, *see also* Associated Vendors, Inc. v. Oakland Meat Co., 26 Cal. Rptr. 806, 813–15 (Cal. Dist. Ct. App. 1963). *See also* Robert's Hawaii Sch. Bus, Inc. v. Laupahoehoe Transp. Co., Inc., 982 P.2d 853, 870–72 (Haw. 1999).

31. *See generally* Meshel v. Ohev Sholom Talmud Torah, 869 A.2d 343 (D.C. Cir. 2005); Fantazia Int'l Corp. v. CPL Furs NY, Inc., 67 N.Y.S.2d 28 (N.Y. App. Div. 2009).

32. *See* State v. Easton, 647 N.Y.S.2d 904, 908 (N.Y. Sup. Ct. 1995).

33. *See* Sea-Land Servs., Inc. v. Pepper Source, 941 F.2d 519, 520 (7th Cir. 1991) (citing Van Dorn Co. v. Future Chem. & Oil Corp., 753 F.2d 565, 569–70 (7th Cir. 1985)).

34. *See* Shamrock Oil & Gas Co. v. Ethridge, 159 F. Supp. 693, 696 (D. Colo. 1958).

35. *See id.*

36. *See* Fischer Inv. Capital, Inc. v. Catawba Dev. Corp., 689 S.E.2d 143, 147 (N.C. Ct. App. 2009).

37. Walk-In Med. Ctrs., Inc. v. Breuer Capital Corp., 778 F. Supp. 1116, 1123 (D. Colo. 1993) (citing Ward v. Cooper, 685 P.2d 1382, 1383 (Colo. App. 1984)).

38. *Shamrock*, 159 F. Supp. at 696 (internal quotation marks omitted).

39. *See* In re Phillips, 139 P.3d 639, 644 (Colo. 2006).

40. *See* State v. Easton, 647 N.Y.S.2d 904, 909 (N.Y. Sup. Ct. 1995). For states like Colorado, that require a three-pronged analysis for traditional piercing, the same three-pronged test is carried over in reverse piercing cases. *See* In re Phillips, 139 P.3d at 646. For a discussion of additional elements courts have imposed in reverse piercing cases, see *infra* Part II.

41. Insider reverse piercing claims involve a corporate insider attempting to pierce the corporate veil to take advantage of corporate claims that she would be unable to bring in her individual capacity. *See* In re Phillips, 139 P.3d at 644–45. For an example of inside piercing, see Roepke v. W. Nat'l Mutual Ins. Co., 302 N.W.2d 350, 353 (Minn. 1981), which allowed a corporate insider to pierce the veil so that she could "stack" (redeem multiple insurance policies) six insurance policies, instead of receiving

the benefits of only one policy—the ability to "stack" was only available to the corporation itself. While not widely accepted, several states have allowed inside reverse piercing claims. *See, e.g.*, *id.*; Earp v. Schmitz, 79 N.E.2d 637, 641 (Ill. App. Ct. 1948); U.S. Gypsum Co. v. Mackey Wall Plaster Co., 199 P. 249, 252 (Mont. 1921). *But see, e.g.*, In re Beck Indus., 479 F.2d 410, 418 (2d Cir. 1973); Terry v. Yancey, 344 F.2d 789, 790 (4th Cir. 1965); Messick v. PHD Trucking Serv., Inc., 678 P.2d 791, 794–95 (Utah 1984). Those states that have rejected inside veil piercing claim it allows a corporation's owner to "have it both ways" by limiting the owner's liability, while allowing her to capitalize on the benefits of the corporate form. In re Beck Indus., 479 F.2d at 418 (holding that a parent corporation could not inside pierce the veil of its subsidiary, commenting that the veil "'will not be disregarded where those in control have deliberately adopted the corporate form in order to secure its advantages….'" (quoting Schenley Distillers Corp. v. United States, 326 U.S. 432, 437 (1946))). For a more comprehensive analysis of inside reverse piercing, see Crespi, *supra* note 3, at 38–55.

42. *See* In re Phillips, 139 P.3d at 644–45.

43. Outsider reverse piercing is also referred to as "reverse alter ego." *See* Acree v. McMahan, 585 S.E.2d 873, 874 (Ga. 2003).

44. *See* Crespi, *supra* note 3, at 37.

45. *See* In re Phillips, 139 P.3d at 645.

46. *See* FMC Fin. Corp. v. Murphree, 632 F.2d 413, 421 (5th Cir. 1980).

47. Gary J. Mennitt, *Reverse and Triangular Piercing of the Corporate Veil*, 223 N.Y.L.J 1 (2000). This is also referred to as triangular piercing because liability moves up, from one affiliate to the dominant individual, then flows back down to the second affiliate. *Id.*

48. "Reverse piercing," from here on, refers to outside reverse piercing, unless specifically stated otherwise.

49. *See* Postal Instant Press, Inc. v. Kaswa Corp., 77 Cal. Rptr. 3d 96, 101 (Cal. Ct. App. 2008) ("Perhaps the oldest reverse piercing case is *Kingston*….").

50. Kingston Dry Dock Co. v. Lake Champlain Transp. Co., 31 F.2d 265 (2d Cir. 1929). While Judge Hand described the facts of a typical outside reverse pierce case, he did not use the term "reverse pierce." The first mention of the term "reverse pierce" came 45 years later in a Georgia case. *See* Kingston Dev. Co. v. Kenerly, 208 S.E.2d 118, 122 (Ga. Ct. App. 1974).

51. *Kingston Dry Dock*, 31 F.2d at 266.

52. *See id.*

53. *See id.*

54. *See id.*

55. *Id.* at 267.

56. *Id.*

57. W. G. Platts, Inc. v. Platts, 298 P.2d 1107 (Wash. 1956).

58. *See id.* at 1108.

59. *See id.* at 1109.

60. *Id.* at 1111.

61. 159 F. Supp. 693 (D. Colo. 1958).

62. *See id.* at 694–95.

63. *See id.* at 695.

64. *Id.* at 698.

65. *Id.* at 696 (emphasis added). Following *Shamrock*, reverse piercing claims became more frequent, albeit with mixed success. *See, e.g.*, Divco-Wayne Sales Financial Corp. v. Martin Motor Vehicle Sales, Inc., 195 N.E.2d 287 (Ill. 1963) (denying an outside reverse piercing claim); Olympic Capital Corp v. Newman, 276 F. Supp. 646 (C.D. Cal. 1967) (rejecting outside reverse piercing); Central Nat'l Bank & Trust Co. of Des Moines v. Wagener, 183 N.W.2d 678 (Iowa 1971) (allowing a third-party creditor of an individual to reverse pierce a corporation in which he was a majority shareholder).

66. *See* 514. F.2d 935 (10th Cir. 1975) (*rev'd in part on other grounds* by 429 U.S. 338 (1977)).

67. *See id.* at 939.

68. Valley Finance, Inc. v. United States, 629 F.2d 162, 172 (D.C. Cir. 1980).

69. United States v. Scherping, 187 F.3d 796, 803 (8th Cir. 1999).

70. While much of what is to come does apply equally to both inside and outside reverse piercing, not all does. Accordingly, unless "inside" is specifically included, "reverse piercing" refers to outside reverse piercing.

71. Reverse piercing does necessitate some slight alterations to the traditional veil piercing methodology. *See infra* Part II(A)(i).

72. All subsequent applications of the "Lady *X* Hypothetical" will assume that the domination and fraud/injustice requirement have been satisfied to highlight the impact that subsequent conditions, or the lack thereof, have on the interests of shareholders, corporate creditors, and the judgment creditor.

73. While not exhaustive, states that have adopted the inverse method of piercing include New York, Connecticut, Nevada, Oregon, Virginia, Iowa Idaho, Wisconsin, Illinois, Texas, and Kentucky. *See* Bollore S.A. v. Import Warehouse, Inc., 448 F.3d 317 (5th Cir. 2006) (citing Zahra Spiritual Trust v. United States, 910 F.2d 240 (5th Cir, 1990); C.F. Trust, Inc. v. First Flight Ltd. Partnership, 140 F. Supp. 2d 628 (E.D. Va. 2001) (citing Greenberg v. Commonwealth, 499 S.E.2d 266 (Va. 1988) (rejecting reverse piercing not because VA law precluded the remedy, but only because plaintiff failed to show corporation was in fact an alter ego of individual debtor)); Litchfield Asset Management Corp. v. Howell, 799 A.2d 298, 312 (Conn. App. Ct. 2002); Minich v. Gem State Developers, Inc., 591 P.2d 1078 (Idaho 1979) *rev'd in part on other grounds*; Crum v. Krol, 425 N.E.2d 1081 (Ill. 1981); Central Nat'l Bank & Trust Company of Des Moines v. Wagener, 183 N.W.2d 678 (Iowa 1971); Nutrition Rich Products v. Nutritional Resources, No. 99-CI-00483, 2003 WL 1339309 (Ky. App. Feb. 21, 2003); State v. Easton, 169 Misc. 2d 282, 647 N.Y.S.2d 904 (Sup. Ct. 1995); LFC Marketing Group, Inc. v. Loomis, 8 P.3d 841 (Nev. 2000); Amfac Foods v. Int'l Systems, 654 P.2d 1092 (Or. 1982); American Petroleum Exchange, Inc. v. Lord, 399 S.W.2d 213 (Tex. App.1966)); Olen v. Phelps, 546 N.W.2d 176 (Wis. 1996).

74. *See* Postal Instant Press v. Kaswa Corp., 162 Cal. App. 4th 1510, 1522 (Cal. Ct. App. 2008).

75. *Litchfield Asset Management Corp.*, 799 A.2d, at 312.

76. Shamrock Oil & Gas, Co. v. Ethridge, 159 F. Supp 693, 697 (D. Colo. 1958).

77. See *infra* Part II (A)(ii) for an alternative view on how to deal with domination in a reverse piercing context.

78. *See supra* notes 24–29 and accompanying text.

79. *See* FMC Finance Corp. v. Murphree, 632 F.2d 413, 422 (5th Cir. 1980) ("[T]here is factually no way that the subsidiary can interpose itself in the conduct of the parent's affairs.").

80. *See id.*

81. *See* Pac. Dev., Inc. v. United States, 1979 WL 1283, at *2 (D.D.C. Jan. 3, 1979).

82. Because Bank One secured its loan under Article 9, it would have priority over Lady's claim even under this approach.

83. Sea-Land Servs., Inc. v. Pepper Source, 941 F.2d 519, 521–22 (7th Cir. 1991).

84. This article will refer to the three-pronged approach taken by the Colorado Supreme Court in In re Phillips as the "equitable results" approach because it is the third element, an equitable results condition, which distinguishes this method of reverse piercing from the inverse method.

85. For a detailed discussion of the criticisms of reverse piercing see *infra* Part II.B.

86. In re Phillips, 139 P.3d 639, 645 (Colo. 2006) (en banc).

87. As the subsequent application will reveal, JC would be unable to recover from Lady X under this method.

88. *See Phillips*, 139 P.3d at 641. The requirement that an equitable result be achieved also exists in traditional veil piercing cases. Previously, however, this requirement was routinely incorporated into the second prong requiring a showing of fraud or injustice.

89. *See id.* at 646.

90. *See id.* at 647.

91. *See id.* at 646.

92. *See* In re Phillips, 139 P.3d at 646.

93. The most recent case, Carreras v. Lemon, No. 07-cv-00739-MSK-KMT, 2008 WL 3895527, at *2 (D. Colo. Aug. 22, 2008) dismisses a plaintiff's claim for reverse piercing for failure to provide any factual basis, as to any of the three elements, to entitle plaintiff to relief.

94. No. 2004CV1563, 2006 WL 3949633 (Colo. Dist. Ct. Nov. 8, 2006).

95. *Id.* at *10.

96. No. 2006CV220, 2008 WL 5597587 (Colo. Dist. Ct. June 12, 2008).

97. *Id.* at *8.

98. No. 06 CV 687, 2008 WL 4532827 (Colo. Dist. Ct. June 27, 2008), *aff'd*, No. 08CA2138, 2009 WL 2810330 (Colo. App. Sept. 3, 2009).

99. *See id.* at *2–6.

100. *See id.* at *1, *5–6. The court did no further analysis as to the corporations' involvement with or relations to the other shareholders, finding their mere existence to be sufficient to override the plaintiff's interest in reverse piercing. *Id.*

101. In *Shem*, plaintiff was not allowed to reverse pierce a company where the individual defendant owned seventy percent and the other thirty percent consisted of various family members each with a five percent or less interest. *See id.*

102. *See id.*

103. States that have expressly rejected reverse piercing include Georgia, Utah, and California. *See* Postal Instant Press v. Kaswa Corp., 77 Cal. Rptr. 3d 96, 102 (Cal. 2008); Acree v. McMahan, 585 S.E.2d 873, 874 (Ga. 2003); Transamerica Cash Reserve Inc. v. Dixie Power & Water, 789 P.2d 24, 26 (Utah 1990). The Tenth Circuit has also rejected the doctrine. *See* Cascade Energy & Metals Corp. v. Banks, 896 F.2d 1557, 1577 (10th Cir. 1990) (rejecting reverse piercing under Utah law; decided before *Transamerica*, 789 P.2d 24); *see also* Floyd v. IRS, 151 F.3d 1295, 1298–1300 (10th Cir. 1998) (rejecting reverse piercing under Kansas law).

104. *See e.g.*, *Cascade Energy & Metals Corp.*, 896 F.2d at 1577. For a rejection of the arguments against veil piercing, see *infra* Part 3A.

105. *See, e.g.*, *Cascade*, 896 F.2d at 1577.

106. *See Floyd*, 151 F.3d at 1300.

107. 632 F.2d 413, 422 n.8 (5th Cir. 1980).

108. *Floyd*, 151 F.3d at 1299–1300 (citing Kingston Dry Dock Co. v. Lake Champlain Transp. Co., 31 F.2d 265, 267 (2d Cir. 1929).

109. *See id.*

110. *See, e.g.*, *Cascade*, 896 F.2d at 1577.

111. *See id.*

112. *See id.*

113. *See id.*

114. *See* Acree v. McMahan, 585 S.E.2d 873, 874–75 (Ga. 2003).

115. *See* Postal Instant Press, Inc. v. Kaswa Corp., 77 Cal. Rptr. 3d 96, 106 (Cal. Ct. App. 2008).

116. *See, e.g.*, Floyd v. IRS, 151 F.3d 1295, 1300 (10th Cir. 1998).

117. *See, e.g.*, *id.*

118. *See id.*

119. *See Acree*, 585 S.E.2d at 875 (citing Kingston Dry Dock Co. v. Lake Champlain Transp. Co., 31 F.2d 265, 267 (2d Cir. 1929)).

120. *See Kingston Dry Dock*, 31 F.2d at 267.

121. *See Floyd*, 151 F.3d at 1299.

122. *Kingston Dry Dock*, 31 F.2d at 267.

123. *See* Crespi, *supra* note 3, at 68.

124. *See* Cascade Energy & Metals Corp. v. Banks, 896 F.2d 1557, 1577 (10th Cir. 1990) ("[T]he analysis of corporate veil issues is different in a consensual transaction, such as a breach of contract case, than in a nonconsensual transaction….").

125. *See id.*; *see also* Edwards v. Monogram Indus, 730 F.2d 977, 980–84 (5th Cir. 1984) (discussing the differences between tort and contract cases in the veil piercing context); Frank H. Easterbrook and Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. Chi. L. Rev. 89, 112 (1985) (discussing the economic reasons for making a tort/contract distinction when piercing the corporate veil).

126. *Kingston Dry Dock*, 31 F.2d at 267.

127. *See* Postal Instant Press v. Kaswa Corp., 77 Cal. Rptr. 3d 96, 105 (Cal. Ct. App. 2008); *see also Cascade*, 896 F.2d at 1577.

128. In re Phillips, 139 P.3d 639, 645 (Colo. 2006).

129. C.F. Trust, Inc. v. First Flight Ltd. P'ship, 140 F. Supp. 2d 628, 642 (E.D. Va. 2001).

130. For a description of the elements giving rise to fraudulent conveyance, *see infra* note 133 and accompanying text. *See also* Unif. Fradulent Transfer Act. § 4(a) (1984).

131. *See* BFP v. Resolution Trust Corp., 511 U.S. 531, 540–41 (1994).

132. The prototypical, and most oft-cited, fraudulent conveyance case is *Twyne's Case*, where Pierce, a debtor with a creditor's action pending, created a secret deed gifting all his personal property to Twyne, to whom Pierce also owed money. 76 Eng. Rep. 809, 811–14 (1601). Following the transfer, Pierce continued to use his property, even branding and selling the sheep he had "gifted." *Id.* at 811. The court held that while the transfer as payment of the debt owed to Twyne could ordinarily constitute valid consideration, the circumstances surrounding this transfer made it fraudulent. *Id.* at 812–13.

133. The other conditions require that the debtor either (a) "was engaged or was about to engage in a business or transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction;" or (b) "intended to incur, or believed or reasonably should have believed that he [or she] would incur, debts beyond his [or her] ability to pay as they became due." U.F.T.A. §§ 4(a)(2)(i) & (ii) (1984).

134. U.F.T.A. § 4 (a) (1984). The UFTA has been adopted in 43 states and the District of Columbia.

135. *BFP*, 511 U.S. at 535, 541. The eleven badges of fraud are "(1) the transfer or obligation was to an insider; (2) the debtor retained possession or control of the property transferred after the transfer; (3) the transfer or obligation was disclosed or concealed; (4) before the transfer was made or obligation was incurred the debtor had been sued or threatened with suit; (5) the transfer was of substantially all the debtor's assets; (6) the debtor absconded; (7) the debtor removed or concealed assets; (8) the value of consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred; (9) the debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred; (10) the transfer occurred shortly before or after a substantial debt was incurred; (11) the debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor." U.F.T.A. § 4(b) (1984). These badges of fraud are not presumptions of fraud, but merely relevant evidence. *See id.* at § 4, Comment 5.

136. *See, e.g.* Fla. Stat. Ann. § 56.29(6)(a) (2005) (creating a one-year statute of limitations when a judgment has already been obtained); N.Y. C.P.L.R. § 213 (2004) (establishing a six-year statute of limitations for fraudulent transfers). Federal Bankruptcy Law covers any transfers made within two years of the filing of a petition. *See* 11 U.S.C § 548. Regardless of the time frame, the statute of limitations begins running when the claim or transfer occurs and not when the plaintiff's claim has been reduced to judgment. *See* Sands v. New Age Family P'ship, Ltd., 897 P.2d 917, 920 (Colo. App. Ct. 1995) (citing Fish v. East, 114 F.2d 177 (10th Cir. 1940)).

137. *See* U.F.T.A. § 7(a)(1) (1984). *See also id.* at Comment 2.

138. *See* U.F.T.A. § 7 Comment 2 (1984). While attachment is available, practical considerations weigh against attachment prior to the conveyance being set aside. *See* Peter A. Alces & Luther M. Dorr, Jr., *A Critical Analysis of the New Uniform Fraudulent Transfer Act*, 1985 U. Ill. L. Rev. 527, 545 (1985).

139. U.F.T.A. § 8(b) (1984). The plaintiff is also entitled to any depreciation in value of the asset while in the possession of the fraudulent transferee. *See id.* at § 8(c).

140. *See* U.F.T.A. § 8(a).

141. JC must show there was a transfer to an insider made with "actual intent to hinder, delay, or defraud any creditor of the debtor." U.F.T.A. § 4(a)(1) (1984).

142. There would also be an issue as to whether the corporation is in fact an insider, since Lady is an equitable, not legal, owner. This analysis has been omitted because, even if X Corp. is an insider, the remedy proves inadequate.

143. Postal Instant Press, Inc. v. Kaswa Corp., 77 Cal. Rptr. 3d 96 (Cal. App. Ct. 2008).

144. The facts of *Kaswa* also presented issues of harm to an innocent shareholder and a voluntary/involuntary distinction. While these factors should be considered in any reverse piercing effort, they are omitted from discussion in this section, which focuses solely on the adequacy of fraudulent conveyance law as a substitute remedy for reverse piercing. For a discussion of the voluntary/involuntary creditor distinction and the impact of innocent shareholders, see *infra* Part III(B)(i) and Part III(B)(ii), respectively.

145. *Postal Instant Press, Inc.*, 77 Cal. Rptr. 3d at 98.

146. *See id.*

147. *See id.*

148. *See id.* at 98–99.

149. *See id.*

150. *See id.* at 99.

151. *See id.*

152. *See id.* at 98–99.

153. *See id.* at 100, 101–02.

154. *See id.* at 105.

155. *See* U.F.T.A. § 1(7)(i)(D) (1984).

156. A closely held alter ego corporation refers to a corporation that has already met the two elements required to prove alter ego. Maroun v. Wyreless Systems, Inc., 114 P.3d 974, 987 (Idaho 2005). Accordingly, it infers a lack of corporate formalities.

157. Litchfield Asset Mgmt. Corp. v. Howell, 799 A.2d 298. 312 note 14 (Conn. App. Ct. 2002).

158. *See* Mix v. Plaza Redondo, Ltd., No. YC023339, 2002 WL 34239685 at *4 (Cal. Super. Ct. February 15, 2002).

159. Mark A. Sargent, *Are Limited Liability Company Interests Securities?*, 19 Pepp. L. Rev. 1069, 1095 (1992).

160. *See, e.g.*, Goya Foods, Inc. v. Unanue, 233 F.3d 38 (1st Cir. 2000) (holding that a closely held corporation was the alter ego of the judgment debtor because he used its assets as a personal piggybank).

161. *See Litchfield Asset Mgmt. Corp*, 799 A.2d at 314.

162. Stanley J. Feldman, *Business Valuation 101: The Five Myths of Valuing a Private Business*, Score, www.score.org/article_business-valuation-101.html (last visited May 10, 2012). The IRS recognizes three valuation approaches: the asset-based approach, the market approach, and the income approach—though all three need not be mutually exclusive. *See* IRS Business Valuation Guidelines § 4.48.4.2.3(2) (2006). There are, however, eight valuation methods routinely used by appraisers, investors, and business owners. *See* Irving L. Blackman, Valuing Your Privately Held Business, 57 Rev. Ed. (2005). For an overview of these valuation approaches, *see id.* at 57–64.

163. *See* IRS Bus. Valuation Guidelines §§ 4.48.4.2.2, 4.48.4.2.3. Other factors include the book value of the stock or interest and the financial condition of the business, the dividend-paying capacity, and the market price of stocks of corporations in a similar line of business. *See id.* § 4.48.4.2.3. Valuators also need to consider intangible property, including everything from patents and software to customer lists and forecasts. *See id.*

164. *See* 22 A.L.R. Fed. 31 § 4.

165. *S Corporation vs. C Corporation: A Comparison*, Bizfilings, http://www.bizfilings.com/learn/s-corporation-vs-c-corporation.aspx (last visited May 10, 2012).

166. *LLC vs. S Corp: Which Business Type is Right for Me?*, Bizfilings, http://www.bizfilings.com/learn/llc-vs-s-corp.aspx (last visited May 10, 2012).

167. Edward D. Tarlow, *Creative Succession Planning for Managing and Owning the Family Business*, FindLaw, library.findlaw.com/1999/Aug/1/126127.html (last visited May 10, 2012).

168. *See id.*

169. Cook v. Commisioner of I.R.S., 349 F.3d 850, 856 (5th Cir. 2003).

170. *See* Estate of Jung v. Comm'r, 101 T.C. 412, 434 (1993); *See also* Trust Services of Am., Inc. v. United States, 885 F.2d 561, 569 (9th Cir. 1989) (holding resale restrictions may require discount to accurately value the stock).

171. For a discussion of the need for imposing liability on equitable owners, see *infra* Part III(B)(1).

172. Because respondeat superior is merely a specific type of agency, employer liability, this section will only refer to agency. *See* Restatement (Third) of Agency Intro ("The common law of agency in the United States encompasses the principle of respondeat superior…").

173. *Id.*

174. *Id.*

175. *See* Bennett v. Reynolds, 242 S.W.3d 866, 896 (Tex. 2007) *rev'd in part on other grounds* by 315 S.W.3d 867 (Tex, 2010).

176. *Id.*

177. *See id.*

178. *Id.* at 869–71.

179. *Id.* at 871.

180. *Id.*

181. *See id.* at 869–70.

182. *See id.* at 898.

183. *See id.*

184. *Id.* at 885 (emphasis added).

185. *See, e.g.,* Goya Foods, Inc. v. Unanue, 233 F.3d 38 (1st Cir. 2000); Fischer Inv. Capital, Inc. v. Catawba Dev. Corp., 689 S.E.2d 143 (N.C. 2009); C.F. Trust, Inc. v. First Flight Ltd. P'ship (E.D. Va. 2001).

186. *See Fischer Inv. Capital, Inc.*, 689 S.E.2d at 151–52.

187. Restatement (Second) of Torts § 222(A)(1).

188. *See id.* at (A)(2). Other factors considered are the actor's good faith, the extent and duration of the resulting interference, the harm done

to the chattel, and the inconvenience and expense caused to the other.

189. Bennett v. Reynolds, 242 S.W.3d 866, 896 (Tex. 2007).

190. *See id.*

191. *See id.* at 871–72, 896.

192. In this case, the court applied agency principles because defendant's business involved the raising of cattle. *See id.* at 896. Had defendant been involved in a different line of business, however, the only means by which plaintiff could have satisfied his judgment would have been through reverse piercing the corporate veil.

193. Desist v. United States, 394 U.S. 244, 259 (1969).

194. *See supra*, Part III.A.

195. Judgment-proofing occurs when a creditor is unable to satisfy an actual or potential judgment for money damages because the debtor has no property, does not own enough property within the court's jurisdiction to satisfy the judgment, or claims the benefit of statutorily exempt property. Black's Law Dictionary 921 (9th ed. 2009).

196. *See, e.g.*, Shem, LLC v. Buhler, No. 06 CV 687, 2008 WL 4532827 (Colo. Dist. Ct. June 27, 2008) (denying plaintiff's reverse piercing claim because the individual defendant "[was] not the sole owner").

197. *See id.*

198. For a suggested approach to protecting innocent shareholders, *see infra*, Part III(B)(ii).

199. *See* Riddle v. Leuschner, 335 P.2d 107, 111 (Cal. 1959) (holding ownership requirement satisfied as to individual defendant who owned one share and didn't participate in business, but not as to other individual defendant who owned no shares but served as the manager of the corporation and made all business decisions).

200. *See, e.g.*, Sheffield Servs. Co. v. Trowbridge, 211 P.3d 714, 720 (Colo. App. 2009) (requiring ownership "would open the door to fraud"); State v. Easton, 169 Misc. 2d 282, 289, 647 N.Y.S.2d 904, 909 (Sup. Ct. Albany County 1995).

201. Small businesses represent over ninety-nine percent of the nation's employers and over fifty percent of its private sector employment. *See* U.S. Small Business Administration, Office of Advocacy, Small Business Profile (Oct., 2009), *available at* www.sba.gov/advo/research/profiles/09us.pdf.

202. Credit also plays a critical role in the capitalization of small businesses. For a discussion of the importance of corporate creditors, *see infra*, Part III(B)(iii).

203. *See* U.S. Small Business Administration, Office of Advocacy, *Small Business Research Summary* (Sept., 2008), *available at* http://archive.sba.gov/advo/research/rs331.pdf; Entrepreneur, *Startup Financing*, http://www.entrepreneur.com/money/howtoguide/article52718.html (last visited July 4, 2011).

204. *See* Robert C. Illig, *Minority Investor Protections as Default Norms: Using Price to Illuminate the Deal in Close Corporations*, 56 Am. U. L. Rev. 275, 325 (2006). *See also Angel* Investors, Small Business Notes, http://www.smallbusinessnotes.com/financing/angelinvestors.html (last visited Jul. 10, 2011).

205. *See* Illig, *supra* note 204 (explaining all investors are in a position to negotiate for power, though some investors accept lower purchase prices in exchange for limited power).

206. Wilkes v. Springside Nursing Home, Inc., 353 N.E.2d 657, 661 (Mass. 1976) *quoting* Cardullo v. Landau, 105 N.E.2d 843 (Mass. 1952).

207. *See id.* at 663. *See also* Smith v. Atlantic Props., Inc., 422 N.E.2d 798, 803 fn.9 (Mass. Appeals Ct. 1981) ("The majority may not exercise their corporate powers in a manner which is clearly intended to be and is in fact inimical to the corporate interest….") *quoting* J.A.C. Hetherington, *The Minority's Duty of Loyalty in Close Corporations*, 1972 Duke L.J. 921, 946 (1972).

208. For example, suppose a boyfriend "invests" $10,000 in his live-in girlfriend's corporation. The girlfriend has no money of her own, but uses her corporation to pay all their expenses. If a plaintiff attempted to reverse pierce the girlfriend's corporation, the boyfriend would not be eligible for the capital exemption as he prospered from the misuse of the corporation.

209. This section will only discuss the ramifications for X Corp.'s two shareholders, Friend and Brother; for a discussion of issues concerning X Corp.'s creditors, see *infra* Part III(B)(iii).

210. Arguably, the sale of these assets could actually benefit the corporation because Lady has been using corporate funds to pay for her personal expenses, including those related to these personal items belonging to the corporation.

211. X Corp. would still have $3,000 in inventory, two computers worth $4,000, and $21,500 in cash—counting the $1,500 previously in the bank and the proceeds from the sale.

212. The only remaining assets are the inventory, the bank account, and the two computers, which combined only amount to $8,500.

213. *See, e.g.*, Cascade Energy & Metals Corp. v. Banks, 896 F.2d 1557, 1577 (10th Cir. 1990) ("The analysis of corporate veil issues is different in a consensual transaction…than in a nonconsensual transaction…").

214. *See id.*

215. *See* UCC 9-317(a)(2).

216. Unsecured creditors are those creditors who have not taken out a lien (security interest) in a debtor's assets as collateral in the event of a breach. *See* Black's Law Dictionary 425 (9th ed. 2009). Transactions involving security agreements are governed by UCC Article 9. *See generally* U.C.C. § 9-101 (2011).

217. *See* United States v. Scherping, 187 F.3d 796, 803 (8th Cir. 1999); *see also* Timothy E. Graulich, Thesis, *Substantive Consolidation—A Post-Modern Trend*, 14 Am. Bankr. Inst. L. Rev. 527, 538 n. 50 (2006) (citing Douglas G. Baird, *Substantive Consolidation Today*, 47 B.C. L. Rev. 5, 11 (2005).

218. *See, e.g.*, *Scherping*, 187 F.3d at 803 ("[R]everse piercing is a well-established theory in the federal tax realm.").

219. *See* UCC § 9-317(a); *see also* 11 U.S.C. § 546(b)(1) (2006).

220. 11 U.S.C.A. § 726(b) (West 2011).

221. *See* Graulich, *supra* note 217.

222. *Id.* at 527.

223. *See* Gorsich v. Double B Trading Co., 893 P.2d 1357, 1362 (Colo. App. 1994).

224. For simplicity, additional factors such as interest are omitted.

225. Letter from Lord Hardwicke to Lord Kaimes (June 30, 1759), *quoted in* 1 Joseph Story, Commentaries on Equity Jurisprudence as Administered in England and America 262 n. 1 (14th ed. 1918) (hereinafter "Lord Hardwicke Letter").

226. *Id.*

227. Postal Instant Press, Inc. v. Kaswa Corp., 77 Cal. Rptr. 3d 96, 102 (Cal. Ct. App. 2008) (emphasis added).

228. Lord Hardwicke Letter, *supra* note 225.

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Stranger-Initiated Annuity Transactions and the Case for Insurable Interest

By David T. McDowell, Thomas F.A. Hetherington and Kendall J. Burr

I. Introduction

Variable annuities have traditionally been viewed as long-term investment vehicles that offer a number of desirable benefits, including a guaranteed future income stream, favorable tax treatment, and standard or enhanced death benefits paid to a beneficiary in the event of untimely death. Savvy investors, however, claim to have discovered a "loophole" in these products, exploiting them to invest aggressively in the securities markets with the assurance that any short-term losses will be borne by the insurance company. To implement their strategy, they recruit terminally ill individuals to serve as the measuring lives for annuities with built-in death benefits, which provide a full and prompt refund of the investors' premiums if their high-risk investments go awry. This predation on sick individuals—who often claim not to have understood that their poor health was being exploited as a hedge against market losses by a total stranger—raises a significant legal question: should these "Stranger-Originated Annuity Transactions," or "STATs,"[1] be rescinded as unlawful wagers on human lives, violating the well-established "insurable interest" requirement applied in life insurance cases? Examining the pertinent laws applicable to annuities and life insurance, persuasive arguments can be made that insurable interest laws apply to annuity products, and that stranger investors may not use the products to profit from the deaths of other human beings.

II. The Product: Variable Annuities

A variable annuity is a product, primarily sold by life insurance companies, that incorporates certain features of an investment account and life insurance. Fundamentally, an annuity is a contract pursuant to which a purchaser agrees to make one or more premium payments to the issuer up front, during an "accumulation phase," and the issuer agrees to make a series of payments thereafter, either to the purchaser or to a designated beneficiary, during a "payout phase." Thus, an annuity is essentially a loan from the purchaser that the insurer pays back over time. An annuity may be "fixed," meaning the insurance company promises to pay a minimum rate of interest or a set dollar amount for each periodic payment, or "variable," allowing the premiums to be invested in mutual funds or other options in the bond and equity markets.[2] Variable annuity products offer a range of benefits that make them appealing to individuals interested in both preparing for retirement and safeguarding against untimely death. Variable annuities typically offer three major categories of benefits: guaranteed income distribution, favorable tax treatment, and death benefits.[3]

First, variable annuities provide a guaranteed distribution of periodic income. An annuity may be structured so as to make payments for a period certain, but is more commonly structured as a "life annuity," made payable for the duration of the lifetime of a designated "annuitant." The income distribution schedule and amounts are typically fixed at the time of annuitization, the point at which the contract owner agrees to freeze all or some of the funds invested in the accumulation phase and use them to commence distributions in a payout phase. Thus, a fundamental characteristic of a life annuity is its ability to provide a guaranteed source of income lasting as long as the uncertain lifetime of the annuitant. This offers a form of "longevity insurance," protecting the designated beneficiary against the possibility that the annuitant will outlive the assets available from the accumulated value of the investment at the point of annuitization. Given this framework, a purchaser of a variable annuity will often name the same person as both annuitant and beneficiary, or will designate one person as the annuitant and his or her spouse, child, or other family member as the beneficiary.

The second attractive feature of a variable annuity is its favorable tax treatment. Under the Internal Revenue Code, variable annuities owned by individuals may be invested during the accumulation phase in a tax-deferred manner,[4] much like a Roth 401(k). As a variable annuity is funded during the accumulation phase with after-tax dollars, any internal accumulation remains tax free. Once annuitized, any amounts withdrawn from the annuity during the payout phase over and above the amounts contributed are taxable. These market profits are taxed at ordinary income tax rates rather than capital gains rates. As such, the utility of the variable annuity is maximized if used as a long-term investment vehicle.

Third, a variable annuity typically includes a "Guaranteed Minimum Death Benefit" ("GMDB") to be provided to the beneficiary upon the annuitant's death. Usually, the life insurer offers a standard death benefit provision already built into the base contract, generally guaranteeing the beneficiary an amount no less than the greater of (1) the total face value of the account, or (2) the total of all premiums paid, minus any adjusted withdrawals from the account. Enhanced or "stepped-up" GMDB options are often available à la carte for additional fees, either as part of the annuity contract or as a contract rider. A stepped-up GMDB option may, for example, allow the customer to "lock in" the account's face value as of a specified date, if the account's investments have been performing well. The issuer may also offer a "high water mark" or "anniversary ratchet" option, which looks at the account face value on each contract anniversary date and guarantees a minimum GMDB based on the highest account value as of any of those dates. Or the company might offer a "roll-up" option, guaranteeing a minimum rate of return on the invested funds. Various combinations of these enhanced options may also be available.

While other elective features may also be available for additional fees,[5] these three main advantages—guaranteed income distribution, tax-deferred investment, and death benefits—are the defining features of a variable annuity. Because these products incorporate death benefits, as well as lifetime benefits whose duration is tied to the date of the annuitant's death, they are often treated as an insurance contract, or as a hybrid product combining features of an investment product and life insurance. Whether a variable annuity is actually *legally* defined as life insurance varies from state to state, as discussed in further detail below.

III. The Backdrop: STOLI

Before examining how the death benefit component of variable annuities has been recently exploited to pursue risk-free investment opportunities by third-party investors, it is first necessary to examine recent developments in the life insurance industry.

Over the past decade, investors and agents have developed a gray market in life insurance known as Stranger Originated Life Insurance ("STOLI").[6] STOLI refers to any transaction or arrangement by which an investor seeks to purchase a life insurance policy on the life of an individual, typically an elderly insured, even though the investor does not have an insurable interest in the insured's life. The investor typically pays the premiums and structures the transaction so that the investor obtains ownership of the policy, the beneficial interest of a trust holding the policy, or otherwise secures control of the policy through a variety of clandestine transactions, enabling it to re-sell the policy or its controlling interest on the life settlement market. STOLI promoters use various methods to acquire interests in life insurance policies. The investor might agree to buy the policy outright from the insured on a pre-determined date, or purchase a beneficial interest in a trust holding the policy.[7] Or the policy might be funded by premium financing for a period of two years (the typical statutory contestability period of a life insurance policy), after which the insured is given the option of either paying off the loan, which typically has large administrative fees and a high interest rate, or surrendering the policy to the investor in full satisfaction of the loan.[8]

STOLI practices pose significant problems for the life insurance industry. STOLI often promotes fraud, incentivizing investors and agents to encourage exaggeration of the insured's net worth and income in order to qualify for larger death benefits,[9] and sometimes takes place even without the knowledge or complicity of the insured.[10]

The most significant problem posed by STOLI, however, is its noncompliance with the well-established requirement that a life insurance policy's initial owner, beneficiary, or both must possess an insurable interest in the life of the insured. This requirement is based on public policy and is designed to prevent wagering on human lives, which creates perverse economic incentives to hasten the insured's death.[11] As discussed in further detail below, nearly all states impose insurable interest requirements in a life insurance transaction. Due to the proliferation of STOLI practices in the last decade, many states have also recently enacted additional statutes specifically targeting STOLI transactions and clarifying that they violate the insurable interest requirement. For example, the California Insurance Code, as amended in 2009, defines entering into a STOLI arrangement as a "fraudulent life settlement act,"[12] and defines "STOLI" to include any arrangement designed to "initiate the issuance of a life insurance policy in this state for the benefit of a third-party investor who, at the time of policy origination, has no insurable interest, under the laws of this state, in the life of the insured."[13] A majority of states have already enacted legislation specifically targeting STOLI practices just in the past few years,[14] with additional legislation in other states likely to follow.

Thus, the past few years have witnessed a flurry of legislation and an industry-wide spotlight on the STOLI issue. Legislators and life insurers, focusing their efforts solely on life insurance policies owned by strangers, apparently did not foresee that despite these tightened restrictions, some opportunistic investors would move on to exploit variable annuities in an analogous but unanticipated manner.

IV. STATs

The life insurance industry is now facing a new challenge from brokers and investors orchestrating the purchase of variable annuities offered by life insurance companies, referred to as "Stranger-Originated Annuity Transactions," or "STATs." STATs are the subject of several well-publicized lawsuits currently pending in federal court in the District of Rhode Island,[15] in which two life insurance companies, Transamerica Life Insurance Company and Western Reserve Life Assurance Company of Ohio, claim to have been defrauded by STAT arrangements masterminded by Rhode Island attorney Joseph Caramadre and carried out with the collaboration of investors and brokerage firms.[16]

Caramadre, a real-estate specialist, believed he had discovered a "loophole" in the variable annuity product that allowed its use to facilitate aggressive short-term investments.[17] By locating individuals with extremely poor health and a short life expectancy who would be willing to act as "annuitants" for variable annuities with GDMBs, Caramadre realized that one could engage in high-risk, short-term investments with the expectation that any potential losses would be borne by the insurance company upon the individual's death.

To implement their strategy, STAT originators like Caramadre first seek out potential annuitants with terminal illnesses, recruiting such individuals through a number of unsavory methods that have drawn national attention. Caramadre, for example, published advertisements in the *Rhode Island Catholic*, an official diocese publication, stating "Terminal Illness? $2,000 in CASH, Immediately Available."[18] The ads further promised that the funds were offered by "a compassionate organization [hoping] to provide financial assistance for those near death."[19] STAT originators also target church patrons and workers and patients in nursing homes, hospices, and hospitals, circulating flyers or through direct solicitation[20] and generally offering between $2,000 and $5,000 for their participation.[21]

Once a terminally ill individual is identified, the STAT originator arranges for a licensed agent of an annuities brokerage firm to provide and sign an application for a variable annuity, designating an investor as the owner and beneficiary and having the terminally ill individual serve as the annuitant. The annuitization date is usually far enough in the future that a terminally ill annuitant will likely never receive an annuity payment. STAT sponsors opt on the application for either a standard or stepped-up GMDB, guaranteeing that the beneficiaries will receive a death benefit totaling at least the amount of premiums paid, and in some cases also purchasing additional enhanced benefits.[22] The GMDB acts as a safety net, allowing the investor to make aggressive investments within the variable annuity with the expectation that, if they do not perform well, the insurance company will pay out at least the total of all premiums paid upon the annuitant's death.

V. The National Response

STATs have been widely criticized since coming to national attention over the past two years, with particular focus on the disturbing manner in which terminally ill annuitants are recruited. Often, the individuals or their families claim to have been misled about the nature of the arrangement, believing that the solicitors were simply offering charity.[23] As one such individual later testified to the National Association of Insurance Commissioners ("NAIC"), "What if I die now? He's going to collect. I don't want to see him get that kind of money. Not for bodies. I'm not going to sell my body."[24] Another individual testified to a federal grand jury that Caramadre and his associates never mentioned annuities at all, and never told him that someone would profit from his wife's death, saying, "They preyed on the sick and the weak at a vulnerable time."[25] The plaintiffs in the Rhode Island cases have even alleged that some of the annuitants' signatures may have been forged.[26]

However unsavory and exploitative STAT tactics may appear, questions still remain regarding their legality. The similarities between STATs and STOLI practices are obvious, particularly their exploitation of elderly or ill individuals for the profit of investors with no genuine interest in the continued life of those individuals. But despite the flurry of recent statutory enactments relating to STOLI, legislatures have yet to expressly tackle STATs. The NAIC held hearings in May 2010 at which numerous groups, including the Life Insurance Settlement Association ("LISA"), the National Association of Insurance and Financial Advisors ("NAIFA"), and the American Council of Life Insurers ("ACLI"), testified in condemnation of STATs and described them as sharing many of the same troubling characteristics of STOLI practices, but not all groups were yet prepared to announce their support for implementing new regulation or legislation to directly address STATs.[27] Several state insurance departments have issued bulletins regarding the potential harms of STATs, but they have not openly condemned them as illegal *per se*, instead opting to merely warn life insurers and recommend the implementation of safeguards.[28]

Courts have yet to resolve open questions regarding the legality of STATs. The Securities and Exchange Commission is investigating Caramadre and his associates for possible violations of the securities laws,[29] but that investigation is still ongoing. Outside of Rhode Island, several other lawsuits have been filed involving disputes regarding the validity and enforceability of stranger-initiated annuities, and whether insurance companies must remain bound to those contracts.[30] However, only one court, the District of Rhode Island in dealing with Caramadre's scheme, has thus far rendered a substantive decision directly addressing the validity of STATs, in *Western Reserve Life Assurance Co. of Ohio v. Conreal LLC* (hereinafter "*Conreal*").[31] Moreover, that court's conclusion, that the contracts were *not* voidable for lack of insurable interest nor contestable on fraud grounds, is based on a tenuous interpretation of Rhode Island statutes and, as discussed further below, raises more questions than it answers. Regardless, in at least forty-nine states, the question as to whether STATs should be viewed as analogous to STOLI policies, and potentially subject to rescission under existing insurable interest laws, remains a matter of first impression.

VI. Comparing and Contrasting STATs and STOLI

STATs and STOLI arrangements share several key elements. For both types of transactions, a third-party investor is the real party in interest acquiring the product, despite having no familial relationship or other interest in the life of the individual insured or annuitant. Both also involve the exploitation of a product offered by life insurance companies, and both involve products that guarantee a death benefit. But obvious distinctions also exist between life insurance policies and variable annuities worth consideration before addressing whether STATs should be subject to insurable interest requirements.

First, life insurance policies and variable annuities trigger different financial obligations on the part of the issuing insurer during the named individual's lifetime and after his or her death, and thus implicate different interests for the insurer with respect to that individual's longevity. In the case of life insurance, the insurer hopes to benefit by continuing to receive premium payments for the duration of the insured's life. As such, insurance companies have a clear interest in obtaining more thorough information from applicants seeking life insurance that will enable them to more accurately assess the mortality risk of persons and determine proper risk classes for each policy, so as to maximize average expected profits.

By contrast, issuers of variable life annuities only continue to receive premium payments during the accumulation phase, but not after the contracts are annuitized. Moreover, before STAT exploitation, the only perceived profitable use of variable annuities was for long-term investments. Customers who purchase annuities were therefore viewed as self-selecting, being highly unlikely to commit large proportions of their funds to a long-term investment if their health was poor.[32] Thus, for a typical non-STAT annuity with a GMDB, the initial mortality rate is roughly 1%.[33] Based on this risk assessment, most insurers did not see a need to engage in extensive underwriting, and structured their variable annuity applications and contracts accordingly, unaware that the mortality risk for a STAT, by definition, would approach 100%.[34] Thus, insurance companies have historically had comparatively few financial incentives to examine a prospective annuitant's health or life expectancy, and thus do not engage in the same degree of underwriting they ordinarily require of prospective insureds.

These different underwriting requirements may make it more difficult for an insurer to prove fraud in a STAT case than in a STOLI case. STOLI disputes are likely to involve more clear evidence of fraud and misrepresentation, given that applicants must answer direct questions on the policy applications regarding their medical condition and finances. Annuity applications often do not ask such questions. Of course, the evidence in a particular STAT case may still show express misrepresentations, or a failure to disclose the annuitant's failing health or the fact that the beneficiary and the annuitant are total strangers, despite a duty to do so. The Rhode Island plaintiffs, for example, allege that Caramadre set up a relatively low initial premium on the application, invested conservatively, to avoid arousing the suspicions of the insurer, and then, after issuance, dramatically increased the premium payments and transferred the funds into riskier investment options.[35] Caramadre and his associates, however, respond that the insurer does not request medical information or inquire about the relationship between the annuitant and the beneficiary, and argue that the application, contract, or prospectus is silent on such issues.[36]

Another key difference between life insurance policies and variable annuities relates to the duration of the contract's contestability period. Life insurance policies typically have clauses providing that they are contestable on grounds of material misrepresentation for a period of two years, and most states have enacted statutes requiring insurers to promise no more than two years of contestability in life insurance contracts.[37] But although state statutes sometimes allow insurers to also provide for up to two years of contestability for annuity contracts,[38] some insurers still opt for a shorter contestability period and choose to make their annuity contracts incontestable from the date of contract issuance.[39] Again, such business decisions reflect the perceived self-selective nature of annuity applicants, and demonstrate how insurers simply did not foresee how variable annuity products might be exploited by stranger investors.

The *Conreal* opinion shows that such business decisions may come back to haunt the insurer. There, the court determined that the fact that the insurers drafted their annuity contracts as incontestable from the "policy date" foreclosed any argument by the insurers that the policies should be rescinded due to fraud.[40] Notably, the court still allowed the insurers to pursue fraud claims seeking damages from Caramadre and his associated sponsors, agents, and brokers, noting that "unlike Harry Potter's 'Invisibility Cloak,' which could conceal not only Harry, but anyone who wore it," the incontestability clauses could not be invoked by third parties to the contract.[41] But as to the owners of the annuities, and the validity of the contracts themselves, the court dismissed all fraud claims as incontestable.[42]

Still, despite these varied distinctions, a key functional similarity between a life insurance policy and a variable annuity with a GMDB remains: both products provide a death benefit, and if purchased by a stranger investor, can therefore be exploited to provide a significant monetary payout upon the death of an individual in whom the purchaser has no insurable interest.

VII. Legal Distinctions Between "Insurance" and "Annuities"

Before addressing whether insurable interest rules should apply to annuity products, it must be noted that courts have long recognized various legal similarities and distinctions between life insurance policies and variable annuities, and in various contexts. Courts have treated the two types of products differently for such varied purposes as to compel issuers of variable annuities to comply with securities laws,[43] to allow national banks to sell annuities,[44] or to address their tax treatment.[45] But as the Seventh Circuit noted after examining numerous cases and treatises addressing the similarities and differences between insurance and annuity products, "[t]he most we can conclude from these long lists of cases and treatises is that annuities are not *exactly* insurance policies, but that the two have multiple similarities. Thus courts and treatise writers have stated that the two products are different in some situations, and the same in others."[46] The court then concluded that "none of the cases or treatises authoritatively answers the question that we must decide."[47] While the issue before that court is not pertinent here,[48] it demonstrates that given the numerous similarities and differences between the two types of products, any analysis of whether they should be treated similarly or differently depends entirely upon the nature of the legal issue being considered. Here, the salient question is whether insurable interest requirements should apply to both products.

VIII. Public Policy Reasons for Requiring Insurable Interest for Variable Annuities

A review of the historical development of the insurable interest requirement suggests that it should apply equally to variable annuities with GMDBs for the same reasons it applies to life insurance policies. The requirement was first imposed in eighteenth-century Great Britain in an effort to combat the so-called "dead pools" or "death pools" popular at the time, in which aristocratic gamblers wagered on when royals and other celebrities would die first.[49] Prior to 1750, the common law had only condemned wagers on human life when accompanied by a criminal act, such as murder to collect on a policy.[50] In the third quarter of the eighteenth century, however, gambling on human life began to be seen as an independent moral hazard, a concern plausibly related to growing unease over slavery and the concept of trafficking in the commerce of human lives.[51] Thus, Parliament enacted the Life Assurance Act in 1774, holding that any insurance policy made to benefit a person who had "no interest" in the life of the person insured would be deemed "null and void."[52]

This insurable interest requirement was reinforced in the common law of the United States as a matter of public policy. For example, the United States Supreme Court recognized this public policy requirement in 1881 in *Warnock v. Davis*, explaining that without such an interest, "the contract is a mere wager, by which the party taking the policy is directly interested in the early death of the assured. Such policies have a tendency to create a desire for the event."[53] The Supreme Court reiterated the same concerns in *Grigsby v. Russell*, a 1911 opinion rendered by Justice Oliver Wendell Holmes: "[a] contract of insurance upon a life in which the insured has no interest is a pure wager that gives the insured a sinister counter interest in having the life come to an end."[54] The "very meaning" of insurable interest, Justice Holmes explained, "is an interest in having the life continue."[55] Recent court decisions addressing STOLI disputes have reiterated these principles in holding that modern statutes imposing insurable interest requirements are based on these fundamental public policy concerns.[56]

Thus, although the insurable interest requirement has since been incorporated into the insurance codes of nearly every state,[57] the requirement is not a creature of statute. As the Supreme Court recognized in *Warnock*, the prohibition on the wagering on human lives is founded in public policy, "independently of any statute on the subject."[58] This distinction is reflected in recent statutory amendments addressing STOLI cases, which are typically worded so as to reflect that insurable interest statutes recognize and apply pre-existing insurable interest requirements, which are based on public policy and common law.

California's new 2009 legislation, for example, added a subsection providing that certain STOLI arrangements through the use of trusts or special purpose entities "violate the insurable interest laws and the prohibition against wagering on life,"[59] plainly recognizing and referring to pre-existing legal standards. Another provision in the same section, which existed both before and after the 2009 amendment, adds, "[t]his section shall not be interpreted to define all instances in which an insurable interest exists."[60] In other words, the California legislature recognized that the contours of the insurable interest laws were incapable of being precisely defined by statute. To expect otherwise of state legislators is unreasonable, particularly in a modern world where investors continue to invent new and unanticipated ways to exploit human lives for profit. Thus, by specifically prohibiting certain STOLI practices in 2009, the California legislature was not trying to fix a pre-existing statutory loophole or create a new rule of law, but to confirm that a new, previously unforeseen type of transaction was of a nature that violated existing laws.

When examining the scope of state laws on insurable interest, courts should therefore be mindful not only of pertinent statutes and case law, but also of the fundamental public policy interests underlying those statutes and judicial opinions. Such interests are implicated no differently by STATs than by STOLI policies, both of which are structured to provide a death benefit to a third-party investor who stands to gain financially from the death of a human being. The twin public policy rationales historically given for the insurable interest requirement—prohibiting the morbid practice of gambling on human lives and eliminating a perverse incentive to commit murder (sometimes called the "moral hazard" rationale)—have in some circles been attacked as no longer being compelling concerns in a modern world.[61] However, as demonstrated by the eagerness of modern legislatures to enact laws prohibiting STOLI practices,[62] modern societies do apparently continue to believe that wagers on human lives by disinterested investors still pose a legitimate threat to the public interest.[63]

STAT cases create these same risks; indeed, at least one STAT plaintiff has alleged that the annuitant had voiced fears that STAT originators sought to kill her.[64] Although it may arguably be difficult to imagine a white-collar STAT investor carrying out or orchestrating a calculated killing for profit, the moral hazard public policy rationale has never targeted a specific demographic of suspected would-be murderers. Indeed, such temptations could theoretically be exacerbated in STAT cases, given the volatility of the stock market. One might imagine, for example, a sudden downturn decimating the investor's high-risk portfolio, and an urgent need for cash flow that a GMDB payout might provide. Although STAT annuitants are selected with the expectation that they will pass away soon, the uncertainty as to the timing of that passing may prove frustrating for an investor with substantial sums invested in a fluctuating market. A STAT investor might even have fewer qualms about orchestrating the carrying out of such a deed given the individual's terminal illness. The objective of the public policy is simply to eliminate such incentives that could conceivably result in disastrous consequences.

Another public policy concern that supports an insurable interest requirement for STATs is their negative impact on the market itself. The other parties to a STAT investor's high-risk speculation do not know that the investor is not actually undertaking such risks, given its concealed knowledge of the GMDB safety net. Such conduct may expose the investor to liability to such third parties, and, as in Caramadre's case, may also invite investigation by the S.E.C. But it can also be seen as sufficiently damaging to the market to justify another public policy rationale for preventing STATs. The securities laws themselves, and related doctrines such as the fraud-on-the-market theory, are based on similar public policy concerns that the integrity of the securities markets requires a "philosophy of full disclosure."[65] The imposition of an insurable interest requirement for STATs would be an effective way to reduce such risks.

With the exception of this last proposal for a market-based justification, the other public policy interests noted above are well-established and provide the basis for current statutes codifying insurable interest requirements. As examined below, these public policy concerns are not in conflict with such statutes. These concerns, however, were inexplicably ignored by the Rhode Island District Court in *Conreal*.

IX. The Flawed Analysis in *Conreal*

Conreal is the sole judicial opinion thus far addressing the applicability of the insurable interest requirement to stranger-originated variable annuities. The justification for that conclusion, however, is flawed in several respects.

First, the court assumed that the insurable interest requirement only applied to products fitting statutory definitions of "insurance."[66] The court presupposed that the sole basis for the requirement was statutory, citing a provision in the state insurance code prohibiting the procurement of an "insurance contract" without an insurable interest.[67] Thus, the court's entire discussion is framed exclusively within the limited confines of an analysis of whether annuities can be considered "insurance products" or as "hybrid products" under statutory definitions.[68] But the court did not seriously consider the possibility that other non-statutory bases for an insurable interest requirement existed based on common law and public policy.[69]

The court did briefly examine state cases in seeking to differentiate annuities from life insurance, quoting an 1877 Rhode Island Supreme Court decision noting that other transactions resulting in "speculation upon the chances of human life," such as "when a man takes a transfer of an annuity," have not been held void.[70] But a "transfer of an annuity" is an entirely different type of transaction from a STAT. An annuity purchaser buys the right to receive annuity payments lasting as long as the duration of the annuitant's life, and thus has every hope that the annuitant stays alive. STAT originators, by contrast, set up the transaction from its inception so as to benefit the investor when the annuitant dies. Not until recently, and certainly not in 1877, could the Rhode Island Supreme Court have anticipated that annuities could be exploited in a manner which gave a stranger a contractual right to benefit from another's death.

In fact, the *Conreal* court went out of its way to deliberately skirt the question regarding the pertinence of the moral hazard rationale. The court did briefly acknowledge the possibility that STATs may create a "temptation to shorten life,"[71] but did not go on to consider whether such a danger was of public concern. Instead, the court focused its discussion solely on a critique of the plaintiff insurers for their failure to ensure that their application procedures screened for insurable interest.[72] Thus, by censuring the insurers for the fact that they did not foresee how variable annuity products might be exploited by investors recruiting terminally ill annuitants,[73] the court sidestepped the more important question of whether there existed a valid *public* interest in eliminating an incentive to shorten life.

Further, the *Conreal* opinion is based on a tenuous interpretation of the pertinent state statutes. It noted that the Rhode Island Insurance Code had separately defined the terms "life insurance" and "annuities,"[74] but failed to examine why that distinction mattered in the STAT context. As noted above, although treatises and cases alike conclude that the products are similar in numerous respects, various reasons exist for distinguishing between the two products in certain contexts, such as for purposes of taxation or securities registration. Thus, while many states define "life insurance" as including annuities, others, like Rhode Island, have defined the term differently.[75] The key question, then, is not whether annuities "are" insurance products, but whether certain rules historically applied to insurance policies should also apply to annuity contracts that have only recently begun to be used in a similar manner. There is no evidence that the Rhode Island General Assembly defined the terms "life insurance" and "annuity" for the purpose of excluding annuities from insurable interest requirements.

The *Conreal* court, however, asserted that the General Assembly "reinforced the statutory distinction" between the two when it failed to mention annuities in the Life Settlements Act ("LSA"), which addressed STOLI practices.[76] But as noted above,[77] Rhode Island is but one of many states to recently enact STOLI legislation. Like many other states, the General Assembly based the LSA on a model act recommended by the National Conference of Insurance Legislators.[78] The model act and the LSA were both drafted well before STATs came to national attention in the past two years. Thus, it is likely that the omission of any reference to STATs in the LSA was not a conscious exclusion, but a reflection of the fact that the legislature was simply unaware that variable annuities could similarly be exploited by stranger investors.

Moreover, the language of the LSA itself again indicates that insurable interest legislation is designed to codify pre-existing insurable interest requirements. Like the California anti-STOLI legislation cited above, Rhode Island's LSA provides that STOLI arrangements through the use of trusts "violate insurable interest laws and the prohibition against wagering on life."[79] Thus, the statute sought to clarify that STOLI arrangements violate existing laws, not to announce that all other hitherto-unknown schemes to wager on human life were fair game.

Further, even if it were true that the court was constrained by the statutory language to restrict insurable interest requirements to "insurance" or "hybrid" products, the court still erred in concluding that they were *not* hybrid products, contending that GMDBs merely "sweeten the deal."[80] While that might be the case for non-STAT annuities, where the purchaser expects the annuitant to live long enough to justify pursuing a traditional investment strategy, the GMDB is a fundamental component of a STAT transaction. By placing a wager on whether aggressive investments will turn a profit before a stranger dies, and putting the entire risk of loss on the insurance company, STAT promoters have certainly made the life insurance component of the scam more than a mere "ancillary perk."[81]

X. A Survey of State Laws Relating to Annuities and Insurable Interest

Conreal is the sole judicial opinion thus far rendered that examines whether insurable interest requirements might apply to variable annuities. But even if later Rhode Island courts or statutes do not overrule or contradict its holding, *Conreal* does not necessarily spell disaster for insurers or annuitants wishing to declare STATs void under the laws of other states. An examination of other statutory schemes and related case law reveals that the framework underlying *Conreal*'s conclusion is not at all typical, and that in each state, sufficient statutory or common-law authority may already exist to support contrary conclusions.

Two considerations are important in this analysis. First, how states define the terms "life insurance" and "annuities" may or may not indicate whether the legislature intended that the latter should be treated as insurance products. Thirteen states, including California,[82] Colorado,[83] Florida,[84] Illinois,[85] Michigan,[86] Mississippi,[87] Nebraska,[88] New Mexico,[89] North Dakota,[90] South Carolina,[91] Tennessee,[92] Texas,[93] and West Virginia,[94] have statutes or case law that expressly define annuities as insurance products. Further, their rules relating to insurable interest do not seek to carve out annuities or other specific types of insurance products.[95] Nebraska even expressly *includes* annuity contracts in its insurable interest statute.[96] Other states are not quite as explicit as Nebraska—which is not surprising, given the very recent advent of STATs—but the fact that these thirteen states define annuities as insurance suggests that courts confronted with STAT disputes in those states would have little choice but to distinguish *Conreal*.

But the second consideration in examining state statutes is far more important: regardless of whether a state legislature or court has chosen to define the products separately, the language of the state's insurable interest laws may already be broad enough to cover annuities. Many states do not expressly define annuities as insurance, and sometimes even define them as separate products, but their insurance codes still make clear that insurable interest requirements apply to annuities. For example, New Jersey's insurable interest statute, like Nebraska's, *explicitly* applies to annuities[97] even though the code elsewhere defines them as separate from insurance products.[98] In other states, it is clear from the structure of the code that the insurable interest requirement applies to annuities. For example, Arizona's insurance code provides, "[e]xcept as exemption or other provision is made, all provisions in this title applicable to life insurance shall be deemed applicable also to annuities."[99] That title includes an insurable interest statute that does not make any "exemption or other provision" excluding annuities from the requirement.[100] This type of statutory framework is especially common. Eighteen states, including Alabama,[101] Alaska,[102] Arizona,[103] Arkansas,[104] Delaware,[105] Georgia,[106] Idaho,[107] Indiana,[108] Kentucky,[109] Louisiana,[110] Maine,[111] Maryland,[112] Nevada,[113] New Jersey,[114] Oklahoma,[115] South Dakota,[116] Utah,[117] and Wyoming,[118] similarly have enacted statutes that either expressly state, or whose structure and placement in the code imply, that annuities are subject to the same insurable interest requirements as life insurance policies.

Altogether, this review indicates that thirty-one of the fifty states either expressly define annuities as insurance products or otherwise indicate that insurable interest requirements apply to annuities. In each of these states, strong arguments could be made that insurable interest requirements already apply to STATs under existing law.

Such arguments might also be made as to *some* variable annuities in Hawaii and Washington, which have developed an interesting approach to the definitional question that is of direct relevance to STATs. Both states have enacted statutes providing that whether life insurance rules apply to annuities depends on the nature of the death benefit. If the GMDB is "not in excess of the greater of the sum of the premiums or stipulated payments paid under the contract or the value of the contract at time of death," the provision "shall not be deemed to be life insurance and therefore not subject to the provisions of this code governing life insurance carriers."[119] But "[a] provision for any other benefit on death during the deferred period *shall* be subject to such insurance provisions."[120] Presumably, that would include being subject to insurable interest laws.[121] Thus, in these states, a STAT that is limited to a standard GMDB allowing it to pursue risk-free investment, with a safety net promising only a premium refund, would arguably *not* be subject to insurable interest requirements, whereas a STAT with an enhanced or "stepped-up" death benefit, such as the "lock in," "anniversary ratchet," or "roll-up" options described above, would more clearly run afoul of insurable interest requirements.

Insurers seeking to rescind STATs in the remaining seventeen states will have to deal with a variety of statutes and cases—or, in some states, an absence thereof—that may make it more difficult to establish that insurable interest is required for variable annuities. Eight of these states—including Connecticut,[122] Minnesota,[123] Missouri,[124] Montana,[125] New York,[126] North Carolina,[127] Vermont,[128] and of course, Rhode Island— present a statutory framework similar to that considered in *Conreal*. In those states, statutes define annuities as separate products from life insurance, but do not explicitly speak to the issue of whether insurable interest laws apply to those separately defined annuities. But again, that fact does not necessarily suggest that the legislatures in those seventeen states meant to *exclude* STATs. Rather, it suggests only that those legislatures have not yet been confronted with the possibility that variable annuities might be exploited by strangers lacking insurable interests in the lives of terminally ill annuitants.[129] Four other states, including Massachusetts,[130] Oregon,[131] Virginia,[132] and Wisconsin,[133] have insurable interest statutes whose phrasing or placement in the code suggests that the legislature did not intend them to apply to annuities. And finally, as to the last five states—Iowa,[134] Kansas,[135] New Hampshire,[136] Ohio,[137] and Pennsylvania[138]—the statutory framework and case law do not provide a concrete answer.

While this review does not exhaustively examine every potentially pertinent statute or case in each state, it at least suggests that *Conreal* should not necessarily be viewed as a dangerous precedent or as an invitation to STAT promoters to target other markets. Because Rhode Island's statutory scheme is unlike those of most other states, *Conreal* is easily distinguishable.[139]

XI. Other Potential Issues in STAT Disputes

Even if a STAT dispute does not result in judicial rescission of the annuity contract on insurable interest grounds, other potential arguments might be made by insurers seeking to recover market losses paid to the investors in the form of GMDBs, such as by bringing causes of action for fraud or material misrepresentations. The annuity contract's contestability clause may bar such claims against the contract owner. However, courts may, as in *Conreal*, still allow insurers to seek fraud damages from the other various sponsors, agents, and collaborators in STAT schemes.[140] An insurer might also claim that conduct by participating agents breached brokerage service agreements with the company,[141] or a covenant of good faith and fair dealing implied in such contracts.[142] STAT promoters might also be subject to criminal liability and potential civil actions relating thereto, such as for forging annuitant signatures,[143] paying money in exchange for such signatures,[144] or insurance fraud.[145]

Insurance companies should be well-prepared for the possibility that courts and juries may be skeptical of insurers' claims because of companies' failure to eliminate the potential risks of STATs. Insurers draft the annuity applications, contracts, and prospectuses. They do not request additional information or engage in thorough underwriting before issuing a variable annuity. They control the assumptions used to set prices for the annuity fees, and have decided that the annuitant's health is not a relevant factor. Yet, none of these arguments should have any impact on whether a court is willing to enforce the public policy that is part and parcel of an insurable interest analysis. Further, insurers might contend that they had no way of knowing that their annuity products would be exploited in this manner, and that their business decisions regarding the degree of underwriting needed were reasonable in light of historically low mortality rates for annuity applicants. Even *Conreal*, after condemning the insurers for their lack of foresight in declining to recognize an insurable interest requirement,[146] still allowed the insurers to proceed with their fraud claims against the non-owner defendants despite their not having specifically asked for the information withheld.[147]

Conreal also acknowledged additional arguments for voiding the contracts that, like insurable interest, could "rope the owners back into the lawsuits" despite the contestability clauses.[148] The plaintiff insurers raised arguments that the contracts might be void due to forgery of the annuitant's signatures and fraud in the factum, based on the theory that the annuitants were tricked into signing without knowing the contracts' true nature or contents. The court declined to address the merits of such arguments, noting that the complaints had failed to adequately plead such claims, but it did grant them leave to amend.[149] Importantly, the court recognized that such forgery or fraud in the factum could render the annuity contracts "void and not merely voidable," thus depriving the owners of their incontestability defense because the pertinent clauses "never would have come into effect."[150] Thus, depending on the facts of a particular STAT case, such arguments could certainly be made to suggest that the annuity contracts were not validly formed and should be held void.

One other potential argument relating to valid contract formation is also worth discussing, that there was no meeting of the minds between the owner and the insurer. In other words, the insurer might contend that there was a mistake of fact—that the insurer reasonably believed that the selected annuitant was a typical, self-selecting individual whose life expectancy would be of sufficient duration to justify the long-term investment strategy ordinarily expected of the variable annuity product. Mistake arguments, however, have historically been rejected in cases involving annuitants whose health problems were unknown at the time of the annuity purchase.[151] Such cases might theoretically be distinguished based on the fact that they were *mutual* mistake cases brought by unknowingly ill annuitants,[152] while STATs involve a *unilateral* mistake on the insurer's part. But the problem with a unilateral mistake argument, again, is the insurer's typical decision not to inquire as to the annuitant's health. The Restatement of Contracts, for example, holds that the mistake of one party makes a contract voidable only when the mistaken party does not "bear the risk of the mistake."[153] It further explains that a party *does* bear the risk of a mistake—and thus, is not entitled to rescission—if "he is aware, at the time the contract is made, that he has only limited knowledge with respect to the facts to which the mistake relates but treats his limited knowledge as sufficient."[154] An insurer invoking the "meeting of the minds" argument should be prepared to address these considerations.

In sum, various remedies might be sought from collaborators in STAT schemes. Insurers may even in some cases be able to establish that the contracts should be held void for fraud vis-à-vis the annuitant. But if the annuitant did participate knowingly, or there is not enough evidence to prove otherwise, rescission of a STAT contract will likely hinge on whether the insurable interest requirement applies to variable annuities under applicable state laws.

XII. Conclusion

STAT investors exploit a *practical* loophole in the variable annuity product, but it is far from clear whether there exists a *legal* loophole making such exploitation lawful. To address the former, insurance companies should consider whether it still makes business sense to continue to engage in limited underwriting of annuity applications, and whether contestability clauses in their annuity contracts should be revised. With respect to the latter, however, it is not yet clear how legislatures and courts will address the issue. Insurable interest requirements at common law and based upon public policy concerns may, depending on the laws of the pertinent jurisdiction, arguably already prohibit any stranger-originated contracts that enable the stranger to benefit from the death of another human being. Insurers may also pursue a number of other arguments if considering legal actions against the STAT originators and agents, but rescission of the annuity contracts will in many cases hinge on how courts choose to interpret the scope of existing insurable interest laws.

Endnotes

1. Also sometimes referred to as "Stranger-Originated Annuities" ("STOAs") or "Stranger Originated Life Annuities" ("STOLAs" or "STOAs").
2. Variable annuities are regulated by the Securities and Exchange Commission, whereas fixed annuities are not considered securities and are therefore not regulated by the SEC. *See* Annuities, U.S. Securities and Exchange Commission, http://www.sec.gov/answers/annuity.htm (last visited Mar. 24, 2012).http://www.sec.gov/answers/annuity.htm.
3. *See* Variable Annuities: What You Should Know, U.S. Securities and Exchange Commission, http://www.sec.gov/investor/pubs/varannty.htm#vch (last visited Mar. 24, 2012). http://www.sec.gov/investor/pubs/varannty.htm#vch.
4. *See* 26 U.S.C. § 72 (2012).
5. Insurers may, for example, offer various guaranteed *lifetime* benefits for an additional charge, such as a guaranteed minimum income benefit ("GMIB") promising a minimum income stream during the payout phase, or a guaranteed minimum accumulation benefit ("GMAB") pursuant to which after a set period of time (usually 10 or 20 years), the account's value may be reset to a guaranteed accumulation amount. Insurers also sometimes offer "bonus credit" features, such as a promise to add a bonus contribution to the accumulated value based on a specified percentage of purchase payments, typically ranging from 1% to 5%.
6. Also referred to as Investor-Owned or Stranger-Owned Life Insurance ("SOLI" or "IOLI").
7. *See* Life Prod. Clearing House, LLC v. Angel, 530 F. Supp. 2d 646, 649 (S.D.N.Y. 2008) (describing a STOLI scheme whereby policy was owned by an irrevocable trust and the insured, who had initially named himself as trust beneficiary, sold his beneficial interest to a funding third-party investor shortly after policy issuance).
8. *See* Lincoln Nat. Life Ins. Co. v. Calhoun, 596 F. Supp. 2d 882, 885 (D.N.J. 2009) (describing a "typical STOLI transaction" as involving an up-front cash payment in exchange for a promise of a future sale of the policy, use of a trust to hold the policy, and funding of premiums through non-recourse premium financing).
9. *See, e.g.*, Settlement Funding, LLC v. AXA Equitable Life Ins. Co., No. 06 CV 5743, 2010 WL 3825735, at *1 (S.D.N.Y. Sept. 30, 2010) (describing a STOLI policy on life of elderly insured that was based on an application claiming that she had a net worth in excess of $12 million, even though she lived in an apartment and had assets of less than $100,000).
10. *See, e.g.*, *id.* (explaining that evidence showed that the insured's signature was forged on a trust agreement, and that insured was not in the same state as where the agreement was purportedly signed, and notary had never met the insured or notarized the trust agreement).
11. Warnock v. Davis, 104 U.S. 775, 779 (1881) (explaining that the insurable interest requirement was a matter of public policy to avoid the issuance of life insurance where the party taking the policy has a direct interest in the early death of the assured).
12. Cal. Ins. Code § 10113.1(g)(1)(B) (West 2010).
13. *Id.* § 10113.1(w) ("Trusts that are created to give the appearance of insurable interest and that are used to initiate policies for investors violate insurable interest laws and the prohibition against wagering on life."); *see also id.* § 10110.1(e) (same).
14. At least twenty-seven states thus far have enacted statutes specifically defining and prohibiting STOLI practices, nearly all since 2008, including Arizona, Arkansas, California, Connecticut, Georgia, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Maine, Minnesota, New Hampshire, New York, North Dakota, Ohio, Oklahoma, Oregon, Rhode Island, Tennessee, Utah, Vermont, Washington, West Virgina, and Wisconsin. *See* Ariz. Rev. Stat. Ann. § 20-443.02 (2012) (prohibiting STOLI); Ark. Code Ann. § 23-81-802(24) (2011) (defining STOLI as an unlawful practice); Cal. Ins. Code §§ 10113.1(g)(1)(B) and (w) (West 2012) (describing STOLI as fraudulent life settlement act); Conn. Gen. Stat. §§ 38a-465 (2012) (defining STOLI) and 38a-465j (stating that entry into any practice or plan that involves STOLI constitutes fraud); Ga. Code Ann. § 33-59-2(24) (2011) (defining STOLI as unlawful practice); Haw. Rev. Stat. Ann. §§ 431E-2 (defining STOLI) and 431E-24 (prohibiting entering into any practice or plan that involves STOLI); Idaho Code Ann. §§ 41-1951(15) (2012) (defining STOLI) and 41-1962(1) (prohibiting any act that constitutes or promotes STOLI); 215 Ill. Comp. Stat. 159/5 (2011) (defining STOLI), 215 Ill. Comp. Stat. 159/50 (2011) (prohibiting entering into STOLI) and Ill. Comp. Stat. 159/72 (2011) (explaining that crime of life settlement fraud includes entering into

any arrangement which involves STOLI); IND. CODE §§ 27-8-19.8-7.8 (2011) (defining STOLI) and 27-8-19.8-20.1 (prohibiting the issuance, solicitation, or promotion of STOLI); IOWA CODE § 508E.2(12) (2012) (defining STOLI as unlawful practice); KAN. STAT. ANN. § 40-5002(l) (2011) (defining STOLI as unlawful practice); KY. REV. STAT. ANN. § 304.15-020(15) (West 2011) (defining STOLI as unlawful practice); ME. REV. STAT. tit. 24-A, § 6802-A(12-A) (2011) (defining STOLI as unlawful practice); MINN. STAT. §§ 60A.0782(12) (2012) (defining "STOLI practices"), 60A.0784 (making it "unlawful" to "engage in STOLI practices or otherwise wager on life"), 60A.0786(1) (creating presumption of STOLI practices where, *inter alia*, the premiums are financed by means other than the assets of the insured or someone "closely related to the insured by blood or law"), and 60A.0789 (insurer may bring declaratory judgment action to declare STOLI policies void); N.H. REV. STAT. ANN. §§ 408-D:2(XVI) (2011) (defining STOLI) and 408-D:12(I) (prohibiting the solicitation, promotion, or knowing participation in any STOLI activities); N.Y. INS. LAW § 7815 (McKinney 2011) (defining STOLI as prohibited practice); N.D. CENT. CODE § 26.1-33.4-01(23) (2011) (defining STOLI as a prohibited practice); OHIO REV. CODE ANN. §§ 3916.01(W) (LexisNexis 2011) (defining STOLI), 3916.172 (stating that any contract, arrangement or transaction entered into in furtherance of STOLI act is "void and unenforceable"), and 3916.171 (promoting STOLI constitutes fraud); OKLA. STAT. tit. 36, § 4055.2(13) (2011) (defining STOLI as unlawful practice); OR. REV. STAT. §§ 744.318(18) (2012) (defining STOLI) and 744.369 (prohibiting entering into any practice or plan involving STOLI); R.I. GEN. LAWS § 27-72-2(26) (2011) (defining STOLI as unlawful practice); TENN. CODE ANN. § 56-50-102(12) (2012) (defining STOLI as unlawful practice); UTAH CODE ANN. §§ 31A-36-102(18) (LexisNexis 2011) (defining STOLI) and 31A-36-113(2)(a)(iii) (prohibiting the entering into any practice involving stranger-originated life insurance); VT. STAT. ANN. tit. 8, §§ 3835(18) (2012) (defining STOLI) and 3844(a)(2) (prohibiting any activities resulting in or intending to result in the issuance of STOLI); WASH. REV. CODE § 48.102.006 (2012) (defining STOLI as unlawful practice); W. VA. CODE § 33-13C-2(18) (2012) (defining STOLI as unlawful practice); WIS. STAT. 632.69(w) (2012) (defining STOLI as unlawful practice).

15. These include seven separate, but related lawsuits, all pending before District Judge William E. Smith, styled, W. Reserve Life Assur. Co. of Ohio v. Conreal LLC, No. 1:09-cv-00470-S-DLM (D.R.I.); Transamerica Life Ins. Co. v. Caramadre, No. 1:09-cv-00471-S-DLM (D.R.I.); W. Reserve Life Assur. Co. of Ohio v. Caramadre, No. 1:09cv00472-S-DLM (D.R.I.); W. Reserve Life Assur. Co. of Ohio v. Caramadre, No. 1:09cv00473-S-DLM (D.R.I.); W. Reserve Life Assur. Co. of Ohio v. Caramadre, No. 1:09cv00502-S-DLM (D.R.I.); Transamerica Life Ins. Co. v. Lifemark Sec. Corp., No. 1:09-cv-00549-S-DLM (D.R.I.); and W. Reserve Life Assur. Co. of Ohio v. Caramadre, No. 1:09cv00564-S-DLM (D.R.I.).

16. *See* Amended Complaint for Petitioner, Dkt. No. 27 in No. 1:09-cv-00564-S-DLM (D.R.I.).

17. *See id.* ¶ 12–13, 20; *see also* Mark Maremont & Leslie Scism, *Investors Recruit Terminally Ill to Outwit Insurers on Annuities*, The WALL ST. J. (Feb. 16, 2010), http://online.wsj.com/article/SB10001424052748704479704575061392800740492.html.

18. Maremont, *supra* note 17 (internal quotation marks omitted).

19. *Id.* (internal quotation marks omitted).

20. *See, e.g.*, RI Complaint, *supra* note 16, at ¶ 17; Jim Connolly, *Senior Recounts Brush with STOA as Commissioners Determine Tools to Fight It*, THE INSURANCE BELLWETHER (May 21, 2010), http://www.theinsurancebellwether.com/2010/05/senior-recounts-brush-with-stoa-as.html. http://www.theinsurancebellwether.com/2010/05/senior-recounts-brush-with-stoa-as.html.

21. Linda Koco, *Feature: Testimony Rips into Stranger-Originated Annuities in Different Ways*, LIFEHEALTHPRO (June 14, 2010), http://www.lifehealthpro.com/2010/06/14/feature-testimony-rips-into-strangeroriginated-ann.

22. *See* RI Complaint, *supra* note 16, at ¶¶ 19, 28, 45, 62.

23. Koco, *supra* note 21 (noting testimony from Rhode Island's Superintendent of Insurance that the annuitants "are unclear on their participation in the annuity contract" and believe that they are receiving a charitable gift); *see also* Olsen Testifies to NAIC: Annuity Transactions Raise Regulatory Questions, ACTUARIAL UPDATE (July 2010), *available at* http://www.actuary.org/update/pdf/0710.pdf. http://www.actuary.org/update/pdf/0710.pdf.

24. Connolly, *supra* note 20 (internal quotation marks omitted).

25. Katie Mulvaney, *Philanthropist Accused of Profiting from Terminally Ill*, PROVIDENCE JOURNAL BULLETIN (Mar. 7, 2010).

26. *See, e.g.*, RI Complaint, *supra* note 16, at ¶ 24.

27. *See* Statements of Gary A. Sanders on behalf of NAIFA, Doug Head on behalf of LISA, and the ACLI at the May 20, 2010 NAIC hearing, NAIC, a*vailable at* http://www.naic.org/committees_a.htm. http://www.naic.org/committees_a.htm.

28. *See, e.g.*, Bulletins issued by the Departments of Insurance of the states of Ohio and Louisiana, Companies Encouraged to Have Safeguards in Place to Limit Potential Exposure to Stranger Originated Annuity Transactions, OHIO DEPARTMENT OF INSURANCE OFFICE OF FRAUD (Apr. 6, 2009), *available at* http://www.insurance.ohio.gov/Consumer/Documents/Stranger%20Originated%20Annuity%20Transactions.pdf; , Bulletin No. 2010-02, James J. Donelon, Comm'r of Ins., La. Dep't of Ins., "Stranger Originated Annuity Transactions," to All Life Insurance Companies and All Producers Licensed to Sell Life and Annuity Products in Louisiana (July 6, 2010), *available at* http://www.ldi.state.la.us/docs/CommissionersOffice/legal/Bulletins/Bul2010-02_cur_StrangerOriginatedAn.pdf. http://www.insurance.ohio.gov/Consumer/Documents/Stranger%20Originated%20Annuity%20Transactions.pdf. http://www.ldi.state.la.us/docs/CommissionersOffice/legal/Bulletins/Bul2010-02_cur_StrangerOriginatedAn.pdf.

29. *See* Dkt. No. 1 in Securities and Exchange Commission v. Caramadre et al., Civ. No. 1:10mc00052-S-DLM (D.R.I.).

30. For example, in *MetLife Investors USA Insurance Company v. Zeidman*, a STAT was issued and the terminally ill annuitant, Sherry Pratt, died twelve days later. MetLife Investors USA Ins. Co. v. Zeidman, 734 F. Supp. 2d 304, 308 (E.D.N.Y. 2010). MetLife later investigated and then rescinded the annuity, and the contract owner, the Ziedman Trust, did not contest rescission; it sought only the return of the $975,000 purchase price for the annuity. *Id.* MetLife thereafter interpleaded those funds with the court, citing competing claims to the funds by the Ziedman Trust and the estate of Ms. Pratt. *Id.* The court issued an opinion addressing various claims asserted by Ms. Pratt's estate against the Ziedman Trust and MetLife, ultimately holding that the estate had failed to adequately allege its claims. *Id.* The only claim by the estate against MetLife was an alleged violation of the Illinois Right of Publicity Act, claiming that MetLife had used Ms. Pratt's identity for an annuity without her consent, but the court dismissed that claim because the statute required a "public" use of one's identity to be actionable. *See id.* at 311–12. The Court then granted MetLife's petition for discharge. *Id.* at 315. The decision did not involve any discussion regarding the validity or enforceability of the annuity itself, however, given the Ziedman Trust's concession to rescission. *See id.* at 315–16.

31. W. Reserve Life Assur. Co. of Ohio v. Conreal LLC, 715 F. Supp. 2d 270 (D.R.I. 2010), *on reconsideration in part sub nom.,* W. Reserve Life Assur. Co. of Ohio v. Caramadre, No. CA 09-470 S, 2012 WL 399184 (D.R.I. Feb. 7, 2012).

32. *See* Statements of ACLI to the NAIC, *supra* note 27, at 4.

33. Memorandum from Am. Acad. of Actuaries' Life Prods. Comm., "Actuarial Considerations of Stranger Initiated Annuity Transactions," to Senator Ralph Hudgens, Chair, Life Ins. and Fin. Planning Comm. (July 2, 2010), *available at* http://www.actuary.org/pdf/life/AAA%20Comments%20to%20NCOIL%20on%20Stranger%20Originated%20Annuities%20final%207-9-2010.pdf.

34. *Id*.

35. RI Complaint, *supra* note 16, at ¶ 21.

36. *See generally* defendant Lifemark Securities Corp.'s Answer and Counterclaim, Dkt. No. 60 in No. 1:09cv00471-S-DLM (D.R.I.).

37. *See, e.g.*, CAL. INS. CODE § 10113.5 (West 2012); FLA. STAT. § 627.455 (2012); 215 ILL. COMP. STAT. 5/224(c) (2011); N.Y. INS. LAW § 3203(a)(3) (McKinney 2011); TEX. INS. CODE ANN. § 1101.006(a) (West 2011).

38. *See, e.g.*, ALA. CODE § 27-15-18 (2012); FLA. STAT. § 627.466 (2012).

39. For example, the Rhode Island STATs cases all appear to have involved contracts providing that they were incontestable from the "policy date." *See* W. Reserve Life Assur. Co. of Ohio v. Conreal LLC, 715 F. Supp. 2d 270, 280 (D.R.I. 2010), *on reconsideration in part sub nom.* W. Reserve Life Assur. Co. of Ohio v. Caramadre, No. CA 09-470 S, 2012 WL 399184 (D.R.I. Feb. 7, 2012).

40. *Conreal*, 715 F. Supp. 2d at 279.

41. *Id.* at 281.

42. Insurable interest claims, however, would in most states survive the contract's contestability period. Most state laws provide, at least in the insurance context, that insurable interest is an issue that goes to contract formation, rendering the contract void *ab initio*, and thus may be raised at any time regardless of any contestability clause therein. *See* 17 Couch on Ins. § 240:82 (3d ed. 2011) ("The majority of jurisdictions follow the view that an incontestable clause does not prohibit insurers from resisting payment on the ground that the policy was issued to one having no insurable interest—such a defense may be raised despite the fact that the period of contestability has expired.").

43. *See* Sec. & Exch. Comm'n v. Variable Annuity Life Ins. Co. of Am., 359 U.S. 65, 79 S. Ct. 618, 3 L. Ed. 2d 640 (1959) (discussing the differences between life insurance and variable annuities and concluding that the latter had to be registered under the Securities Act of 1933). Interestingly, a key reason for the Supreme Court's conclusion was its understanding that a variable annuity "places all of the investment risk on the annuitant, none on the company.… The companies that issue these annuities take the risk of failure. But they guarantee nothing to the annuitant except an interest in a portfolio of common stocks or other equities—an interest that has a ceiling but no floor." *Id.* at 71–72, 79 S. Ct. at 622. STATs, however, do not follow these conventions; the investor is guaranteed a floor in the form of a GMDB, and the insurer is misled into unwittingly assuming all of the risks in the investment portfolio.

44. NationsBank of N. Carolina, N.A. v. Variable Annuity Life Ins. Co., 513 U.S. 251, 255, 264 115 S. Ct. 810, 813, 817, 130 L. Ed. 2d 740 (1995) (noting various similarities and distinctions between annuities and insurance and deferring to the Comptroller of the Currency's decision to treat them as distinct products for purposes of the National Bank Act, noting that his conclusion was "at least reasonable").

45. Helvering v. Le Gierse, 312 U.S. 531, 539, 61 S. Ct. 646, 649, 85 L. Ed. 996 (1941) (focusing on the differences between insurance risks and investment risks in examining estate tax dispute).

46. Am. Deposit Corp. v. Schacht, 84 F.3d 834, 840 n. 4 (7th Cir. 1996).

47. *Id.*

48. *Id.* (examining the specific question as to whether annuities should be considered to be "insurance" for purposes of the McCarran Ferguson Act).

49. *See* Timothy Alborn, *A License to Bet: Life Insurance and the Gambling Act in the British Courts*, 14 Conn. Ins. L.J. 1, 1–2 (2007).

50. *Id.* at 2.

51. *Id.* (citing GEOFFREY CLARK, BETTING ON LIVES: THE CULTURE OF LIFE INSURANCE IN ENGLAND 1965-1775, 62–63 (Manchester University Press 1999).

52. Life Assurance Act, 1774, 14 Geo. 3, c. 48, § 1 (Eng.) (also known as the "Gambling Act of 1774").

53. Warnock v. Davis, 104 U.S. 775, 779, 26 L. Ed. 924 (1881).

54. Grigsby v. Russell, 222 U.S. 149, 154–55, 32 S. Ct. 58, 58, 56 L. Ed. 133 (1911) (adding, "[a]lthough that counter interest always exists,…the chance that in some cases it may prove a sufficient motive for crime is greatly enhanced if the whole world of the unscrupulous are free to bet on what life they choose"). *Id.* at 155.

55. *Id. Warnock* and *Grigsby* also address a key issue more applicable to STOLI policies than to STATs, namely the alienation of the contract to one with no insurable interest. While *Warnock* invalidated an assignment of ninety percent of a policy's proceeds executed contemporaneously with the application for the policy (104 U.S. at 779-80, 26 L. Ed. at 924), *Grigsby* clarified that a lack of insurable interest on the part of a prospective assignee does not bar the sale of an in-force life insurance policy. *Grigsby*, 222 U.S. at 156–57, 32 S. Ct. at 58. *Grigsby* clarified that this freedom to alienate only applies to policies that are issued with a valid insurable interest in the first instance and there is no pre-existing agreement to assign, noting an important distinction: "[a]nd cases in which a person having an interest lends himself to one without any, as a cloak to what is, in its inception, a wager, have no similarity to those where an honest contract is sold in good faith." *Id*. at 156, 32 S. Ct. at 59. While assignment or some other method of alienation is frequently a key component of a STOLI transaction, however, STATs often involve no alienation at all. The application typically just names the third-party investor as owner and beneficiary, and the annuitant signs the application as the annuitant only. *See, e.g.*, *Conreal*, 2010 WL 2222409, at *2.

56. *See, e.g.*, Life Prod. Clearing, LLC v. Angel, 530 F. Supp. 2d 646, 652–55 (S.D.N.Y 2008) (analyzing rationales given in *Warnock* and *Grigsby* as well as a December 19, 2005 opinion by the Office of General Counsel on behalf of the New York State Insurance Department noting that STOLI activities seeking to procure a policy "solely as a speculative investment for the ultimate benefit of a disinterested third party…[are] contrary to the long established public policy against 'gaming' through life insurance purchases."); Lincoln Nat. Life Ins. Co. v. Schwarz, CIV.A. 09-03361 FLW, 2010 WL 3283550, *7 (D.N.J. Aug. 18, 2010); Lincoln Nat. Life Ins. Co. v. Calhoun, 596 F. Supp. 2d 882, 888–89 (D.N.J 2009).

57. *See* discussion *infra* Part X.

58. *Warnock*, 104 U.S. at 779, 26 L. Ed. 924; *see also Schwartz*, 2010 WL 3283550, at *7 (citing *Warnock* and holding that the original public policy interest in precluding insurance absent an insurable interest "is the law in New York").

59. CAL. INS. CODE § 10110.1(d) (2012).

60. CAL. INS. CODE § 10110.1(i) (prior to 2009, codified at § 10110.1(g)).

61. *See, e.g.*, Roy Kreitner, *Speculations of Contract, or How Contract Law Stopped Worrying and Learned to Love Risk*, 100 COLUM. L. REV. 1096, 1123 (2000) (arguing that the gambling rationale has been only paid "lip service" in court decisions like *Grigsby*, and that courts instead relied more heavily on the moral hazard concern implicated by an incentive to hasten another's death); Jacob Loshin, *Insurance Law's Hapless Busybody: A Case Against the Insurable Interest Requirement*, 117 YALE L.J. 474, 483–90 (2007) (arguing that even the moral hazard rationale is too imprecise to justify an insurable interest requirement).

62. *See supra* note 14.

63. Indeed, at least one recent case suggests that the moral hazard concern is not just paranoia of the past. In September 2008, 74-year-old Germaine Tomlinson was mysteriously found drowned in her bathtub in Indiana, fully clothed and wearing high heels. The last person to see her alive was her son-in-law, the beneficiary of a $15 million insurance policy on her life, who had been with Ms. Tomlinson at a bar the night of her death, drove her home, and escorted her into the house. Police first concluded that the death was accidental, but reopened their investigation after learning that Ms. Tomlinson died the day before her son-in-law's deadline to either repay a $1.3 million loan he had taken out to finance the policy premiums or risk surrendering the policy to the lender. *See* Mark Maremont & Leslie Scism, *Inquiry Into Death in Indiana Reopened*, WALL. ST. J. (May 13, 2010). Police were unable to find clear evidence of foul play, but courts are allowing civil suits to proceed. *See Drama Builds in Suit Over Hilbert Mother-in-Law's Life Policy*, INDIANAPOLIS BUS. J. (Nov. 6, 2010).

64. *See, e.g.*, Complaint filed in the First Judicial Circuit, Cook County in Illinois State Court, *Pratt v. Flowers et al.*, Civ. No. 2010 L 002155,

at ¶¶ 44-45 (alleging that annuitant had stated her fear that "these people are trying to kill me").

65. Tad E. Thompson, *Messin' with Texas: How the Fifth Circuit's Decision in Oscar Private Equity Misinterprets the Fraud-on-the-Market Theory*, 86 N.C. L. Rev. 1086, 1093 (2008) (discussing public policy interests underlying Rule 10b-5 and the fraud-on-the-market theory) (quoting Basic Inc. v. Levinson, 485 U.S. 224, 230, 108 S. Ct. 978, 983, 99 L. Ed. 2d 194 (1988)).

66. W. Reserve Life Assur. Co. of Ohio v. Conreal LLC, 715 F. Supp. 2d 270, 276 (D.R.I. 2010), *on reconsideration in part sub nom.,* W. Reserve Life Assur. Co. of Ohio v. Caramadre, No. CA 09-470 S, 2012 WL 399184 (D.R.I. Feb. 7, 2012).

67. *Id*. (citing R.I. Gen. Laws § 27-4-27(a)).

68. *Id.* at 277–78.

69. The court even quoted language from an older Rhode Island case that arguably supported a common-law argument for applying the doctrine outside the context of insurance, holding that "a purely speculative *contract* on the life of another is...objectionable on the grounds of public policy." *Id.* at 276 (quoting Cronin v. Vt. Life Ins. Co., 20 R.I. 570, 570, 40 A. 497, 497 (1898)). This language, unlike the statute cited above, is not constrained to life insurance contracts.

70. *Conreal*, 715 F. Supp. 2d at 278 (citing Clark v. Allen, 11 R.I. 439, 444, 1877 WL 4932, at *4 (1877)).

71. *Id.* at 279 (quoting *Cronin*, 40 A. at 497).

72. *Id.*

73. *Id.* at 274. Interestingly, the court also appeared to recognize that these novel schemes were unanticipated, describing Caramadre as having "discovered" a loophole in the product itself, and describing his strategy as based on his "insight" regarding how the product could be exploited. *Id.* at 273. The court later described the STAT originators as having "figured out how to game a flaw in the product." *Id.* at 278. The court almost appeared to be praising Caramadre for his ingenuity, but condemning the insurers for failing to come to the same realization first.

74. *Id.* at 276–77 (citing R.I. Gen. Laws § 27-4-0.1).

75. *See infra* notes 82–94 and accompanying text.

76. *Conreal*, at 277 (referring to R.I. Gen. Laws § 27-72-2).

77. *See supra* note 14.

78. Trevor Thomas, *Rhode Island Enacts Settlements Law*, National Underwriter (Nov. 11, 2009), http://www.lifeandhealthinsurancenews.com/News/2009/11/Pages/Rhode-Island-Enacts-Settlements-Law.aspx.

79. R.I. Gen. Laws § 27-72-2(26) (2011).

80. *Conreal*, 715 F. Supp.2d at 278.

81. *Id.* at 279.

82. Cal. Ins. Code § 101 (2012) ("Life insurance includes insurance upon the lives of persons or appertaining thereto, and the granting, purchasing, or disposing of annuities.").

83. Colo. Rev. Stat. § 10-1-102 (2012) ("'Insurance' means a contract whereby one, for consideration, undertakes to indemnify another or to pay a specified or ascertainable amount or benefit upon determinable risk contingencies, and includes annuities.").

84. Fla. Stat. § 624.602(1) (2012) ("The transaction of life insurance includes also the granting of annuity contracts, including, but not limited to, fixed or variable annuity contracts.").

85. 215 Ill. Comp. Stat. 5/4(2011). ("classes of insurance" "Life. Insurance on the lives of persons and every insurance appertaining thereto or connected therewith and granting, purchasing or disposing of annuities.").

86. Mich. Comp. Laws § 500.602(1) (2012) ("'Life' insurance is insurance upon the lives and health of persons and every insurance pertaining thereto, and to grant, purchase, or dispose of annuities.").

87. Hamilton v. Penn Mut. Life Ins. Co., 17 So. 2d 278, 280 (1944) (annuities not technically life insurance policies but are subject to provisions of insurance code regulating life insurance); State *ex rel*. Gully v. Mut. Life Ins. Co. of New York, 196 So. 796, 799 (1940), *overruled in part on other grounds,* 198 So. 763 (1940).

88. Neb. Rev. Stat. § 44-704 (2011) (requiring benefits of any "policy of insurance" to be payable to person with insurable interest in person's life, and expressly providing that the term "policy of insurance" includes annuity contracts).

89. N.M. Stat. Ann. § 59A-7-2 (2011) ("'Life' insurance is insurance of human lives and every insurance appertaining thereto, and the granting, purchasing or disposing of annuities….").

90. N.D. Cent. Code §§ 26.1-26-11 (2011) (stating that variable annuities categorized along with variable life insurance contracts as "insurance coverage") and 26.1-05-02 (stating variable annuities categorized along with variable life insurance contracts as "insurance coverage"); N.D. Cent. Code § 26.1-34.2-02(2) (2011) (containing a definitions section relating to annuities including definitions referring to "insurance, including annuities" and "insurance products, including annuities.").

91. S.C. Code Ann. § 38-1-20(25) (2012) ("The term 'insurance' includes annuities.").

92. Tenn. Code Ann. § 56-2-201 (2012) ("For the purposes of this title, the transacting of life insurance includes the granting of annuities, both with and without a life or mortality contingency or element…."); *see also* H & R Block E. Tax Services, Inc. v. State, Dept. of Commerce & Ins., Div. of Ins., 267 S.W.3d 848, 858 (Tenn. Ct. App. 2008) (noting that statutory definitions of "contract of insurance" and "insurable interest" were circular and ambiguous, and that the broad definition could cover various types of contracts).

93. Tex. Ins. Code Ann. § 1102.001 (2011) (defining "insurance policy" as including annuity contracts).

94. W. Va. Code § 33-1-10 (2012) ("*Life insurance*. Life insurance is insurance on human lives including endowment benefits, additional benefits in the event of death or dismemberment by accident or accidental means, additional benefits for disability and annuities.").

95. *See*, *e.g.*, Cal. Ins. Code § 10110.1 (2012) (stating that the insurable interest requirement does not carve out annuities); Fla. Stat. § 627.404 (2012) (stating that the insurable interest requirement does not carve out annuities); Mich. Comp. Laws § 500.2207 (2012) (stating that the insurable interest requirement does not carve out annuities); N.M. Stat. Ann. §§ 59A-18-4 and 59A-18-5 (2011) (setting forth insurable interest requirements) and § 59A-18-1 (chapter applies as to all insurance policies and annuity contracts); Tex. Ins. Code Ann. § 1103.052 (2011) (subchapter relating to insurable interest for life insurance policies "shall be liberally construed to implement the purposes of this subchapter"); W. Va. Code § 33-6-2 (2012) (insurable interest statute with no carve-out for annuities).

96. Neb. Rev. Stat. § 44-704 (2011).

97. N.J. Stat. Ann. § 17B:24-1.1 (2011) (setting forth insurable interest requirement and providing that it applies to life insurance, health insurance and annuities).

98. N.J. Stat. Ann. § 17B:17-5 (2011) (defining "annuity" and noting that a contract that includes life insurance death benefits is still deemed to be an annuity "if such extra benefits constitute a subsidiary or incidental part of the entire contract").

99. Ariz. Rev. Stat. Ann. § 20-254.01 (2012).

100. Ariz. Rev. Stat. Ann. § 20-1104 (2012); *see also* § 20-1101 (clarifying scope of article that includes insurable interest requirement and excluding certain products, but not annuities).

101. Ala. Code §§ 27-14-2 (2012) ("[T]his chapter applies as to all insurance contracts and annuity contracts.") and 2714-3 (stating insurable interest requirement without any carveout for annuities). Alabama thus makes its insurable interest requirement applicable to annuities even though it defines them as separate products elsewhere in the code. Ala. Code § 27-5-3 (defining "annuity" as a separate type of contract from a life insurance policy as defined in § 27-5-2, and noting that a contract that includes certain life insurance death benefits is still deemed to be an annuity "if such extra benefits constitute a subsidiary or incidental part of the entire contract").

102. Alaska Stat. § 21.42.020 (2012) (defining insurable interest requirement as referring to "life, annuity, or health insurance").

103. *See supra* note 99.

104. Ark. Code Ann. §§ 23-79-103 (2011) (defining insurable interest requirement) and 23-79-102 (clarifying scope of chapter and excluding certain products, but not annuities).

105. Del. Code Ann. tit. 18, §§ 2701 (2011) ("This chapter applies to all insurance contracts and annuity contracts….") and 2704 (stating that the insurable interest requirement does not carve-out for annuities).

106. Ga. Code Ann. § 33-24-3 (2011) (defining insurable interest requirement) and 33-24-2 (clarifying scope of chapter and excluding certain products, but not annuities).

107. Idaho Code Ann. §§ 41-1804 (2012) (defining insurable interest requirement) and 41-1801 (chapter of code applies "as to all insurance contracts and annuity contracts").

108. Ind. Code § 27-1-15.6-31 (2011) (insurable interest law applies to annuities in context of requiring producer to have an insurable interest in life of annuitant in order to have an interest therein); In re Estate of Powers, 849 N.E.2d 1212 (Ind. Ct. App. 2006) (same).

109. Ky. Rev. Stat. Ann. §§ 304.14-040 (West 2011) (defining insurable interest requirement) and 304.15-010 (subtitle in code applies to annuities as well as life insurance). Like Alabama, Kentucky has this framework despite explicitly defining annuities as separate products from life insurance. *See* Ky. Rev. Stat. Ann., § 304.5-030.

110. La. Rev. Stat. Ann. §§ 22:914 (2011) (defining provisions of insurance code apply to variable annuity contracts) and 22:901 (defining insurable interest requirement); *see also* Bulletin issued by the state insurance department taking the position that STATs would violate insurable interest laws, *supra* note 28.

111. Me. Rev. Stat. tit. 24-A, §§ 2404 (2011) (defining insurable interest requirement) and 2401 ("applies as to all insurance contracts and annuity contracts"). Maine has this framework despite some arguable inconsistencies in its code relating to whether annuities are deemed insurance products. *Compare* Me. Rev. Stat. tit. 24-A, § 3 (defining "insurance" broadly to include annuities) *with* Me. Rev. Stat. tit. 24-A, § 703 (defining "annuity" as a separate type of contract from a life insurance policy per § 702).

112. Md. Code. Ann., Ins. §§ 12-201 (West 2012) (defining insurable interest requirement) and 12-102 (article applies to insurance and annuity contracts). This framework applies even though annuities are not defined in the code as life insurance products. Md. Code Ann., Ins. § 1-101(d)(3) (defining "annuity" as providing that it "does not include life insurance"); *see also* Matthews v. Matthews, 647 A.2d 812, 817 (1994) (holding that annuity contracts are not technically life insurance).

113. Nev. Rev. Stat. §§ 687B.040 (2010) (defining insurable interest requirement) and 687B.010 (explaining that the scope of chapter of code "applies to all insurance contracts and annuity contracts"). The statutes so provide despite having defined annuities as separate from insurance. *See* Nev. Rev. Stat. § 688A.020.

114. *See supra* note 97.

115. Okla. Stat. tit. 36, § 3604 (2011) (defining insurable interest requirement) and 3601 (clarifying scope of chapter and excluding certain products, but not annuities); *see also* Baird v. Wainwright, 260 P.2d 1060, 1064 (1953) (stating that where annuity certificate provided a monthly annuity for insured during his lifetime, and at his death if aggregate of annuities was less than the premium paid the difference was payable to the beneficiary named in the policy, the contract was a combination life and annuity policy authorized to be executed by an insurance company).

116. S.D. Codified Laws §§ 58-10-4 (2011) (defining insurable interest requirement) and 58-10-1 ("Chapters 58-10 to 58-12, inclusive, apply as to all insurance contracts and annuity contracts").

117. Utah Code Ann. §§ 31A-21-104 (2012) (defining insurable interest requirement) and § 31A-21-101 (defining scope of chapter and not carving out annuities); *see also* Utah Code Ann. § 31A-1-301 (2012) (including various definitions of terms that include annuities, including "business of life insurance" and "insurance business"); *but see In re* Estate of Clark, 10 Utah 2d 427, 434, 354 P.2d 112, 117 (1960) (analyzing statutory definitions of life insurance and annuities in context of tax dispute, and holding, "We find nothing in these sections to justify the claim that an annuity contract such as herein involved should be classified as life insurance either for the purpose of estate tax or otherwise.").

118. Wyo. Stat. Ann. §§ 26-15-102 (2012) (setting forth insurable interest requirement) and § 26-15-101 (2012) ("This chapter applies to all insurance contracts and annuity contracts").

119. Haw. Rev. Stat. Ann. § 431:10D-118 (LexisNexis 2012); *see also*, Wash. Rev. Code Ann. § 48.18A.030 (LexisNexis 2012).

120. Haw. Rev. Stat. Ann. § 431:10D-118 (LexisNexis 2012) (emphasis added); *see also* Wash. Rev. Code Ann. § 48.18A.030 (LexisNexis 2012).

121. *E.g.*, Wash. Rev. Code Ann. § 48.18.030 (LexisNexis 2012) (imposing insurable interest statute as applying to life insurance).

122. Conn. Gen. Stat. Ann. § 38a-1 (West 2012) (defining annuities and stating, "This definition does not apply to payments made under a policy of life insurance").

123. Minn. Stat. Ann. § 61A.021 (West 2012) (sale of life insurance and annuity as a single product, e.g. with a rider or otherwise, expressly prohibited in Minnesota).

124. Mo. Ann. Stat. § 376.671(10) (West 2012) (where annuity contracts also provide death benefits by rider, the annuity and life insurance portions of the benefits shall be calculated separately as though by a separate contract); *see also Carroll v. Equitable Life Assur. Soc. of U.S.*, 9 F. Supp. 223, 224 (W.D. Mo. 1934) (emphasizing distinct characteristics between annuities and life insurance contracts).

125. Mont. Code Ann. § 33-1-208 (2012) (defining life insurance without referencing annuities); *see also* Estate of Miles v. Miles, 298 Mont. 312, 320, 994 P.2d 1139, 1144 (2000) (analyzing code in detail and noting that legislature could have, but did not, define annuities as life insurance or provided that they should be similarly treated).

126. N.Y. Ins. Law § 1113(a)(1) and (2) (McKinney's 2012) (defining annuities and life insurance policies as separate types of contracts); *see also* N.Y. Ins. Law § 3205 (insurable interest requirement only refers to life insurance contracts).

127. N.C. Gen. Stat. Ann. § 58-7-15 (defining life insurance and annuities as separate products); *see also* N.C. Gen. Stat. Ann. §§ 58-58-70 through 58-58-86 (statutes relating to insurable interest without speaking to which types of contracts require such an interest).

128. Vt. Stat. Ann. tit. 8, § 3717 (an annuity with death benefits of the kind provided by life insurance "shall nevertheless be deemed to be an annuity if such extra benefits constitute a subsidiary or incidental part of the entire contract").

129. As argued above, if these states later enact legislation making insurable interest a requirement for annuities, such enactments would arguably not reflect a "change" to state law, but a recognition that STATs violate existing common-law and public policy grounds prohibiting the procurement of contracts by total strangers who stand to gain from another's death.

130. Mass. Gen. Laws Ann. ch. 175, § 123 (West 2012) (section requiring assent of insured not applicable to "contracts based upon the continuance of life, such as annuity or pure endowment contract").

131. Or. Rev. Stat. Ann. § 743.024 (West 2012) (setting forth insurable interest requirement for personal insurance but then stating, "[T]his section does not apply to annuity policies."). This statute does so despite the fact that the Oregon code defines insurance to include annuities. Or. Rev. Stat. Ann. § 731.102 (West 2012) ("'Insurance' so defined includes annuities."); Or. Rev. Stat. Ann. § 731.170 (West 2012) ("For convenience, reference to "life insurance" in the Insurance Code includes life insurance as defined in subsection (1) of this section and annuities as defined in ORS 731.154, except if the inclusion of annuities obviously is inapplicable or if the context requires, or the Insurance Code provides, otherwise.").

132. Va. Code Ann. §§ 38.2.301 (West 2012) (setting forth insurable interest requirement) and 38.2.300 (chapter does not apply to annuities). This carve-out for annuities is made despite the fact that other statutes define annuities as insurance. *See* Va. Code Ann. §§ 38.2-602 (West 2012) ("'Life insurance' includes annuities.") and 38.2-501 ("Insurance policy" or "insurance contract" includes annuities….").

133. Wis. Stat. Ann. § 631.01 (West 2012) (chapters addressing life insurance, which include provisions relating to insurable interest, "do not apply to annuities").

134. *See*, *e.g.*, Hult v. Home Life Ins. Co. of New York, 213 Iowa 890, 240 N.W. 218 (1932) ("a life insurance contract must be based upon an insurable interest, in the absence of which it becomes a wager contract"). *Hult* involved claims by an executor seeking to rescind annuity contracts that the deceased had purchased on her own life. Although the court declined to apply the insurable interest rule to rescind the contracts at bar, its rationale for doing so arguably suggests that it would have reached a different result in a STAT case: "If a person takes out a life insurance policy on the life of one in whom he has no insurable interest, there are three parties involved: First, the party who procures the insurance; second, the insurance company; third, the party insured. Not so in this case. Here there are but the two parties, the one to whom the contract runs and the insurance company, which makes the contract. There is here no disinterested third party, *whether viewed as an annuity contract or an insurance contract*." *Id.* (emphasis added).

135. Kansas has a statute prohibiting a "life insurance contract" without insurable interest (Kan. Stat. Ann. § 40-450 (2012)), but the insurance code does not purport to define that term or to distinguish it from annuity contracts.

136. New Hampshire law requires insurable interest for a "policy of life or endowment insurance" (N.H. Rev. Stat. Ann. § 408:2 (2012)), but the insurance code does not define that term or distinguish it from annuity contracts. *But see* Frederick v. Frederick, 141 N.H. 530, 533, 687 A.2d 711, 714 (1996) (noting "long history of cases" viewing annuity beneficiaries with the same analysis used in the life insurance context).

137. Ohio's code does not define insurance or annuities, and its insurable interest rules are primarily based on common law, with uncertain applicability to annuities. *See*, *e.g.*, Donahue v. Carpenter, 91WD057, 1992 WL 66564 (Ohio Ct. App. Mar. 31, 1992) (sustaining appeal of judgment on interpleaded proceeds of annuity contract, but not directly addressing the parties' dispute regarding whether insurable interest rules applied to annuities).

138. Pennsylvania's insurable interest requirement (40 Pa. Stat. Ann. § 512) only applies to a "policy of life insurance," but the code does not define that term or distinguish it from annuities. Some case law exists distinguishing the two types of products, but not in the context of insurable interest, e.g., In re Estate of Bayer, 345 Pa. 308, 26 A.2d 202 (1942) (noting "obvious differences" between annuities and life insurance contracts and finding that they are to be treated differently for taxation purposes).

139. *See Conreal*, 2010 WL 2222409 at **4-7.

140. *See Conreal*, 2010 WL 2222409 at **9-14.

141. Such contracts, for example, often require the brokerage firm to train and supervise its agents, to indemnify the insurer for its agents' wrongful acts (*see*, *e.g.*, RI complaint, *supra* note 16 at ¶¶ 92-97), and might also obligate agents to use only approved materials to market the insurer's products (which, presumably, do not include flyers distributed at hospices and churches).

142. *E.g.* RI complaint, *supra* note 16 at ¶¶ 99-102.

143. *E.g. id.* at ¶ 108.

144. *See* Consolidated Memorandum in Response to Defendants' Motions to Dismiss in *Trasamerica Life Ins. Co. v. Lifemark Securities Corp.*, Civ. No. 1:09-cv-00549 (D.R.I. Feb. 1, 2010), at 47.

145. *E.g. id.* at ¶ 107.

146. *Conreal*, 2010 WL 2222409 at *7.

147. *Id*. at **11-13.

148. *Conreal*, 2010 WL 2222409 at *14 n.16.

149. *Id*.

150. *Id*. (citing R.I. Depositors Econ. Protection Corp. v. Bowen Court Assoc., 763 A.2d 1005, 1009 (R.I. 2001); Giannone v. Ayne Inst., 290 F.Supp.2d 553, 563 (E.D. Pa. 2003).

151. *See*, *e.g.*, Aldrich v. Travelers Ins. Co., 317 Mass. 86, 89, 56 N.E.2d 888, 889 (1944) ("It is difficult to see how any company could carry on an annuity business if the estate of an annuitant could rescind whenever it turned out that the condition of his health did not 'warrant a reasonable expectation of life.'"); Woodworth v. Connecticut Mut. Life Ins. Co., 27 F. Supp. 732 (S.D.N.Y. 1939); Am. State Bank of Bloomington v. Nat'l Life Ins. Co., 297 Ill. App. 137, 17 N.E.2d 256 (Ill. App. Ct. 1938).

152. Such cases typically involve suits by the annuitant's estate, seeking to rescind a policy based on the fact that neither the annuitant nor the insurance company knew of the annuitant's failing health. *See generally* cases cited *supra* note 151.

153. Restatement (Second) of Contracts § 153 (1981).

154. *Id.* § 154.

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Inside the Courts: An Update on Securities Litigation

Prepared by attorneys at Skadden Arps

U.S. SUPREME COURT

Statutes of Limitations

Supreme Court Rejects Ninth Circuit's Tolling Rule for Section 16(b) Claims

***Credit Suisse Sec. (USA) LLC v. Simmonds*, No. 10-1261 (U.S. Mar. 26, 2012)**

The U.S. Supreme Court unanimously held that the statute of limitations governing the recovery of "short-swing" profits from corporate insiders under Section 16(b) of the Securities Exchange Act can begin to run regardless of whether the insiders filed a public disclosure of their transactions under Section 16(a). Section 16(b) gives corporations and their beneficial owners a private cause of action against insiders owning more than 10 percent of any one class of security. The provision imposes strict liability on the insiders for any profits realized from the purchase-and-sale or sale-and-purchase of the corporation's securities within any six-month period. Suits must be brought, under Section 16(b), within "two years after the date such profit was realized." Section 16(a) contains the disclosure requirement, mandating that insiders governed by Section 16 report changes in their ownership interests publicly.

In 2007, plaintiff Vanessa Simmonds filed 55 Section 16(b) complaints against the underwriters of several IPOs that occurred in the 1990s and 2000s. The district court dismissed the 24 complaints at issue as time-barred by the two-year limitations period. The Ninth Circuit reversed under its 1981 decision in *Whittaker v. Whittaker Corp.*, 639 F.2d 516 (9th Cir. 1981), which held that the limitations period is tolled until the Section 16(a) disclosure occurs, regardless of whether the plaintiff has actual or constructive knowledge of her claim, because the underwriter defendants had never filed any Section 16(a) disclosures.

A unanimous opinion authored by Justice Antonin Scalia reversed the Ninth Circuit's bright-line rule. The Court noted that the Securities Exchange Act's plain text provides that the period for recovering short-swing profits commences on the "date such profit was realized." 15 U.S.C. § 78p(b). If Congress intended the limitations period to be tied to the disclosure requirement under Section 16(a), it could have easily so provided. The Court also rejected the notion that equitable tolling should invariably delay accrual until disclosure regardless of the plaintiff's knowledge of her claim. Such a rule would discourage diligence in plaintiffs and unfairly subject defendants to perpetual potential exposure, especially defendants who had a good faith belief that a 16(a) disclosure was not required of them, such as the underwriter defendants at issue.

The Court was evenly split 4-4 regarding whether Section 16(b) provided a statute of repose rather than a limitations period.

AUDITOR LIABILITY

S.D.N.Y. Remands Case Related to Lehman Brothers Collapse to State Court

***In re Lehman Bros. Sec. & ERISA Litig.*, No. 09 MD 2017 (LAK) (S.D.N.Y. Mar. 22, 2012)**

Judge Lewis A. Kaplan of the U.S. District Court for the Southern District of New York remanded to state court Martin Act claims filed by the New York Attorney General against Ernst & Young in connection with its role in the Lehman Brothers collapse because the court lacked federal jurisdiction. Ernst & Young argued that the attorney general's allegation that the auditor had not conducted its reviews in accordance with PCAOB standards arose under federal law because determining what PCAOB standards require is a question of federal law. Although the determination of PCAOB standards was a federal question, the court ruled that such a determination was not necessary to resolve the case because New York could get all of the relief it sought without a finding that Ernst & Young violated the PCAOB's standards. Thus, the action did not arise under federal law.

CLASS ACTIONS

Appointment of Lead Plaintiff and Counsel

California Federal Court Appoints Lead Plaintiff and Orders Due Diligence Conducted on Selection of Class Counsel

***In re Diamond Foods, Inc., Sec. Litig.*, No. C 11-05386 WHA (N.D. Cal. Mar. 20, 2012)**

Judge William Alsup of the U.S. District Court for the Northern District of California appointed Mississippi Public Employees' Retirement System (Mississippi PERS) as lead plaintiff in a securities class action lawsuit against defendants Diamond Foods, Inc. and its board chair, president and CEO Michael J. Mendes and CFO Steven M. Neil. Initially, six securities class actions were filed in the Northern District and were consolidated into *In re Diamond Foods, Inc., Securities Litigation*. Two institutional investors, Mississippi PERS and New England Carpenters, both moved for appointment as lead plaintiff.

The court appointed Mississippi PERS as lead plaintiff because it suffered the greater loss and had the greater financial interest in the litigation. The court rejected New England Carpenters' argument that the Private Securities Litigation Reform Act's professional plaintiff bar prevented Mississippi PERS from serving as lead plaintiff, noting that the bar likely did not apply to institutional investors. Even if it did apply, the court held that it had discretion to lift the bar. Lifting the bar is appropriate here because the purpose of the statute would be served by appointing Mississippi PERS, the plaintiff with the greatest financial interest, as lead plaintiff, the court said.

Having appointed Mississippi PERS lead plaintiff, the court ordered it to conduct due diligence in selecting class counsel and, in doing so, stated that it should interview appropriate candidates. Further, the court noted that the motion for appointment of class counsel should include declarations from the lead plaintiff explaining the diligence undertaken and why the counsel selected was favored over other candidates. The declarations should be filed under seal, but served on defense counsel, the court said.

Class Action Fairness Act

Eighth Circuit Holds Plaintiffs Are Bound by Damages Representations Made to Limit Amount in Controversy Under CAFA

***Rolwing v. Nestle Holdings, Inc.*, No. 11-3445 (8th Cir. Feb. 2, 2012)**

The U.S. Court of Appeals for the Eighth Circuit affirmed a decision remanding a putative class action to Missouri state court where the complaint included allegations and stipulations that attempted to limit the matter in controversy to below $5 million in order to avoid removal to federal court under the Class Action Fairness Act of 2005 (CAFA). The case is significant because the appellate court's holding places the plaintiffs in a Catch-22: They may avoid removal to federal court by pleading a lower amount of damages, but then are for the remainder of the case limited to that maximum recovery.

In the suit, which arose out of a merger between Nestle and Ralston Purina Company, a shareholder of the latter contended that payments to Ralston Purina shareholders for their shares were made six days late; therefore, under a Missouri statute regarding interest rates, Nestle owed more than $13 million to shareholders. The complaint, however, included a prayer for relief requesting a judgment not to exceed $4,999,999, and further stated that "[p]laintiff and the class do not seek—and will not accept—any recovery of damages (in the form of statutory interest) and any other relief, in total, in excess of $4,999,999." Nestle removed the case to federal court, asserting that the case clearly comprehended the possibility of damages in excess of $5 million, and thus fell within the jurisdiction of CAFA. The district court granted the plaintiff's motion to remand the action to state court, finding his stipulations as to the requested relief binding.

The Eighth Circuit, on appeal, first held that Nestle had established that the actual amount in controversy exceeded $5 million, and thus, "for a remand to be justified, Rolwing must show that it is legally certain that recovery in this case cannot exceed $5 million." The court then held that the plaintiff had met this burden because his stipulations limiting the recovery sought in the action were enforceable under Missouri's doctrine of judicial estoppel. The court stated that, "by defeating removal through asserting the position that he will not accept more than $4,999,999 in damages on behalf of the class he is seeking to represent, Rolwing is estopped from later accepting damages that exceed that amount."

Class Certification

Second Circuit Affirms Denial of Class Certification in MBS Suit

***N.J. Carpenters Health Fund v. RALI Series 2006-QO1 Tr.*, No. 11-1683-cv (2d Cir. Apr. 30, 2012)**

In a summary order on a Federal Rule of Civil Procedure 23(f) appeal, the U.S. Court of Appeals for the Second Circuit affirmed the denial of class certification under Rule 23(b)(3) in two mortgage-backed securities (MBS) suits alleging violations of Sections 11 and 12 of the Securities Act, because individual questions of each investor's knowledge of the alleged misrepresentations or omissions would predominate. A plaintiff cannot assert claims for violation of Section 11 based on alleged misrepresentations or omissions if the plaintiff had actual knowledge of the untruth or omission. Because the plaintiffs' proposed class was not limited to a specific purchase date, the defendant's evidence that information regarding mortgage-backed securities was publicly available—which could be circumstantial evidence of individual purchaser knowledge—would change depending on the date of purchase. Thus, without the benefit of discovery from absent class members, the district court's determination that the issue of knowledge would require individual proceedings was not a reversible error. Acknowledging the fact that courts have both granted and denied class certification motions in many MBS suits, the panel also noted that "both grants and denials of class certification in MBS litigation may fall within the range of a district court's discretion." Further, because Section 12 claims are derivative of Section 11 claims, class certification also was properly denied as to those claims.

Minnesota Federal Court Certifies Class Action Claiming Wells Fargo Breached Terms of Securities Investment Contracts

***City of Farmington Hills Emps. Ret. Sys. v. Wells Fargo Bank, N.A.*, No. 10-4372 (D. Minn. Mar. 27, 2012)**

Judge Donovan Frank of the U.S. District Court for the District of Minnesota certified a class of more than 100 institutional investors that participated in a securities lending program offered through Wells Fargo Bank, N.A. As part of the program, investors signed securities lending agreements that permitted the bank to lend the investors' securities to third-party borrowers in return for cash collateral. Wells Fargo would then invest that collateral and share a percentage of the revenues with the original investors. According to the investors, Wells Fargo failed to ensure that the collateral funds were invested in safe, short-term investments as required by the lending agreements. The investors brought suit against the bank on a number of theories—breach of fiduciary duty, breach of contract and violation of consumer fraud statutes—and sought class certification for their claims.

The court certified the class because the similarities among the securities lending agreements signed by the class members supported treatment of the case as a class action. The court rejected Wells Fargo's argument that the class did not meet the typicality requirement for certification under Rule 23 because class members signed different agreements, participated in different investment pools and withdrew from the program at different times. Because they pursued the same legal theories and would likely use the same generalized evidence regarding Wells Fargo's conduct, the class members met the typicality requirement, the court reasoned. In analyzing the predominance requirement under Rule 23, the court also noted that all class members received the same statements regarding the safety and liquidity of the investment portfolio as part of the securities loan agreement. Although the court noted that some consumer fraud claims are not suitable for class certification due to issues of individual reliance, it concluded that common questions predominated because the consumer fraud claims could be established on a classwide basis through the use of generalized evidence and each member of the putative class signed a securities loan agreement containing the alleged misrepresentation.

S.D.N.Y. Denies Class Certification, Determining That the Plaintiff's Expert's Testimony Was Unreliable

***In re Fed. Home Loan Mortg. Corp. (Freddie Mac) Sec. Litig.*, Nos. 09 Civ. 832 (MGC), 09 MD 2072 (MGC) (S.D.N.Y. Mar. 27, 2012)**

Judge Miriam Goldman Cedarbaum of the U.S. District Court for the Southern District of New York denied class certification on claims that Freddie Mac's former CEO and former CFO violated Section 10(b) of the Securities Exchange Act because the plaintiff did not show that the market for Freddie Mac's Series Z preferred shares was efficient. The plaintiff presented two event studies, and Freddie Mac presented expert testimony refuting those studies' conclusion that the Series Z shares were sold in an efficient market. After an evidentiary hearing, the court determined that the plaintiff's expert's testimony was unreliable because his event studies and testimony were flawed and inconsistent. The plaintiff's expert changed the dates he considered relevant news dates in preparing his two event studies and changed them again while testifying, and he did not control for dates where the Series Z share price produced an abnormal return that was in the "wrong" direction given the news (*e.g.*, the share price gained more than expected even though the news was negative). The expert's study also showed that the Series Z share price only responded to material news 28 percent of the time, which was insufficient to show a cause-and-effect relationship between unexpected news and changes in share price. Therefore, the plaintiff did not establish that the market for the Series Z shares was efficient. Consequently, the plaintiff was not entitled to a presumption of reliance, and the proposed class did not satisfy Rule 23(b)(3)'s predominance requirement.

S.D.N.Y. Certifies Class Action Related to a Securitized Mortgage Offering

***Pub. Emps.' Ret. Sys. of Miss. v. Goldman Sachs Grp., Inc.*, No. 09 CV 1110 (HB) (S.D.N.Y. Feb. 2, 2012)**

Judge Harold Baer Jr. of the U.S. District Court for the Southern District of New York certified a class of plaintiffs alleging that Goldman Sachs did not conduct adequate diligence on an offering of securitized mortgages in violation of Sections 11 and 12(a)(2) of the Securities Act. Although certain tranches of the securities had been purchased by only a few putative class members, the court found no reason to assume the differences between tranches would create interclass conflict, and so it did not count the classes separately. The court also determined that inquiries regarding individual investor knowledge would not predominate. The court distinguished its previous holding in *N.J. Carpenters Health Fund v. Residential Capital, LLC*, 272 F.R.D. 160 (S.D.N.Y. 2011), because the defendant did not show that specific investors knew of the defendant's alleged misconduct. Individualized statute of limitations issues also did not predominate because the defendant only cited general public knowledge that was available to all class members.

S.D.N.Y. Certifies Class Against Sallie Mae Related to Purchases of Private Student Loans

***In re SLM Corp. Sec. Litig.*, No. 08 Civ. 1029 (WHP) (S.D.N.Y. Jan. 24, 2012)**

Judge William H. Pauley III of the U.S. District Court for the Southern District of New York certified a class against Sallie Mae on claims that it purportedly violated Section 10(b) of the Securities Exchange Act by making allegedly fraudulent statements regarding its purchases of private student loans. Although the plaintiffs' expert did not offer an opinion on the materiality of the alleged misrepresentations and omissions, the court ruled that the plaintiffs satisfied the predominance requirement with respect to materiality based on Sallie Mae's own statements regarding the private student loans. The court also rejected Sallie Mae's argument that a deal with private equity investors—which contained a fixed strike price—made the alleged misrepresentations and omissions immaterial because Sallie Mae could not show that negative disclosure would not have affected the deal's terms. In addition, the lead plaintiff's options trading did not make it atypical and inadequate, and the lead plaintiff's amendments to its certification (about its trading in Sallie Mae stock) did not impact the litigation or prejudice Sallie Mae.

CONFIDENTIAL WITNESSES

S.D.N.Y. Orders Plaintiffs to Reveal the Identities of Confidential Witnesses

***In re Am. Int'l Grp., Inc. 2008 Sec. Litig.*, No. 08 Civ. 4772 (LTS) (DF) (S.D.N.Y. Mar. 6, 2012)**

In a securities fraud action, Magistrate Judge Debra Freeman of the U.S. District Court for the Southern District of New York ordered the plaintiffs to reveal the identities of confidential witnesses upon which the plaintiffs had relied in successfully opposing the defendants' motion to dismiss. Relying on *In re Bear Stearns Cos., Inc. Securities, Derivative, and ERISA Litigation*, 08 MDL No. 1963 (RWS), 2012 WL 259326 (S.D.N.Y. Jan. 27, 2012) (but recognizing that the law is not uniform), the court concluded that the witnesses' identities were not work product. But, even if they were, the defendants would face a significant hardship without the disclosure, overcoming the potential work-product protection. In addition, the confidentiality order entered in the action could address any specific confidentiality concerns of the witnesses.

DIRECTORS AND DIRECTORS' DUTIES

Derivative Litigation

Court of Chancery Sanctions Lead Plaintiff for Trading on Information Obtained Through the Litigation

***Steinhardt v. Howard-Anderson*, C.A. No. 5878-VCL (Del. Ch. Jan. 6, 2012)**

Vice Chancellor J. Travis Laster of the Delaware Court of Chancery issued an opinion sanctioning a lead plaintiff in a stockholder class action for trading on information obtained through the litigation, in violation of a confidentiality order. The court disqualified the lead plaintiff and required him to self-report the matter to the SEC, disclose the improper trading in future applications for lead plaintiff and disgorge more than $530,000 in profits. The plaintiffs included professional investor Michael Steinhardt and a former Steinhardt associate, Herb Chen, who were significant (19 percent) stockholders of Occam Networks, Inc. prior to its acquisition by Calix, Inc. The plaintiffs sought to enjoin the merger, and the parties engaged in expedited discovery. The court entered a standard confidentiality order requiring that confidential discovery material be used solely for purposes of the litigation and also barring trading in securities on the basis of confidential information. After a short injunction pending additional disclosures and the deposition of an investment banker, the merger was approved by stockholders and consummated.

After the injunction hearing, the defendants served discovery requests seeking information about the plaintiffs' trading activities. The discovery established that Steinhardt began short-selling Calix stock in the course of the litigation even though he was receiving regular detailed written and oral reports from Chen about the progress of the litigation. The discovery also established that Chen knew that Steinhardt was short-selling and warned him not to, but nevertheless continued to provide him information about the litigation. The court explained that Chen also had mistakenly sold a limited amount of Occam stock to make a margin call. The court found that Steinhardt had violated his fiduciary duty as a class representative, stating that it "is unacceptable for a plaintiff-fiduciary to trade on the basis of non-public information obtained through litigation." However, the court held that "it would be inequitable to sanction Chen" because of the "small size" and inadvertent nature of his trades. The court was "more troubled by Chen's decision to continue providing Steinhardt with written and oral updates on the litigation despite knowing that Steinhardt was shorting Calix...," but because Chen proved to be a highly motivated and effective representative plaintiff, the court concluded that his conduct did not warrant an additional sanction.

Mergers and Acquisitions

Court of Chancery Approves Settlement for Therapeutic Benefits of Two-Step Merger

***In re Celera Corp. S'holder Litig.*, C.A. No. 6304-VCP (Del. Ch. Mar. 23, 2012)**

Vice Chancellor Donald F. Parsons of the Delaware Court of Chancery overruled an objection and approved the settlement of litigation challenging a two-step merger transaction. The lead plaintiff, New Orleans Employees' Retirement System (NOERS), a stockholder of Celera, accused various defendants, including the Celera board members, of breaching their fiduciary duties in connection with the deal. During briefing on a motion for a preliminary injunction, the parties entered into a memorandum of understanding (MOU) that contemplated a settlement for therapeutic benefits but no increase in the merger price. Thereafter, the tender offer succeeded, Quest exercised a top-up option and the merger closed.

Celera's largest shareholder (BVF) objected to the settlement. The court rejected, among other arguments, arguments from objector BVF concerning the defense of acquiescence, typicality and adequacy under Rule 23(a). BVF argued that NOERS was subject to the unique defense of acquiescence, and could not adequately represent it through confirmatory discovery and settlement. The court disagreed, reasoning that, if new information in confirmatory discovery had caused NOERS to rescind the MOU (and it had not), NOERS could not have been "fully informed" when it sold its shares as required for an acquiescence defense. Calling NOERS's decision to sell its shares "careless and cavalier," the court found NOERS satisfied the adequacy of representation requirements of Rule 23, albeit barely. The court stated that, as a prophylactic measure, it "may well employ a more bright line test in the future," and reject as inadequate lead plaintiffs who sell prior to settlement.

The settlement provided class members with the following therapeutic benefits: (i) a reduction in a termination fee from $23.45 million (or 3.5 percent of transaction size, described by the court as "the high end of the generally acceptable range") to $15.6 million (or 2.3 percent of transaction size); (ii) modification of a no-solicitation provision to potentially invite competing offers from potential bidders subject to a "Don't-Ask-Don't-Waive" standstill agreement; (iii) extension of the tender offer for seven days; and (iv) supplemental disclosures concerning the process leading to the deal and Celera's banker's analysis. The court held that these "therapeutic deal changes may represent the maximum relief that Plaintiffs could have obtained." In particular, the court noted that "Plaintiffs may have been able to show that the combined potency of the Don't-Ask-Don't-Waive Standstills and the No Solicitation Provision was problematic." The court indicated that, in isolation, these provisions arguably foster legitimate objectives, but taken together, they are "more problematic" because the "Don't-Ask-Don't-Waive Standstills block at least a handful of once-interested parties from informing the Board of their willingness to bid (including indirectly by asking a third party, such as an investment bank, to do so on their behalf), and the No Solicitation Provision blocks the Board from inquiring further into those parties' interest. Thus, Plaintiffs have at least a colorable argument that these constraints collectively operate to ensure an informational vacuum. Moreover, the increased risk that the Board would outright lack adequate information arguably emasculates whatever protections the No Solicitation Provision's fiduciary out otherwise could have provided. Once resigned to a measure of willful blindness, the Board would lack the information to determine whether continued compliance with the Merger Agreement would violate its fiduciary duty to consider superior offers. Contracting into such a state conceivably could constitute a breach of fiduciary duty." The court approved the settlement and awarded $1.35 million in attorneys' fees for the therapeutic benefits.

Court of Chancery Declines to Enjoin Sale Despite Likelihood of Demonstrating That Founder Violated Duties to Stockholders

***In re Delphi Fin. Grp. S'holder Litig.*, C.A. No. 7144-VCG (Del. Ch. Mar. 6, 2012)**

Vice Chancellor Sam Glasscock III of the Delaware Court of Chancery declined to enjoin the proposed sale of Delphi Financial Group, Inc. to Tokio Marine Holdings, Inc. (TMH), despite finding that the plaintiffs demonstrated a likelihood of success on the merits with respect to their allegations against Delphi's founder and controlling stockholder, Robert Rosenkranz. Although Rosenkranz retained less than 13 percent of all outstanding shares, he maintained control of Delphi because of his ownership of high-vote Class B stock. However, a charter provision, which was in force at Delphi's initial public offering, directed that, upon the sale of the company or sale of control, each Class B share would be converted to Class A; therefore, Rosenkranz was unable to transfer his controlling position. The court stated, "This concession to the Class A stockholders resulted, presumably, in a higher purchase price for Class A stock than would have been the case without the provision." The Delphi board set up a committee of directors to negotiate a differential for the Class B stock with Rosenkranz. However, Rosenkranz continued to negotiate with TMS on behalf of Delphi. The court found that "on the present record... the Plaintiffs bought Delphi's stock with the understanding that the Charter structured the corporation in such a way that denied Rosenkranz a control premium." Therefore, the court held, "Plaintiffs are reasonably likely to be able to demonstrate at trial that in negotiating for disparate consideration and only agreeing to support the merger if he received it, Rosenkranz violated duties to the stockholders." However, because the deal represented a large premium, damages were available and no other potential purchaser had emerged, the balance of equities did not favor an injunction over letting stockholders exercise their franchise.

Court of Chancery Declines to Enjoin Sale Despite Likelihood of Proving That Merger Was "Tainted by Disloyalty"

***In re El Paso Corp. S'holder Litig.*, C.A. No. 6949-CS (Del. Ch. Feb. 29, 2012)**

Chancellor Leo E. Strine Jr. of the Delaware Court of Chancery declined to enjoin the proposed sale of El Paso Corporation to Kinder Morgan despite finding that the plaintiffs had established a likelihood of success on the merits that the merger was "tainted by disloyalty."

The court examined “troubling” undisclosed conflicts of interest on the part of El Paso’s CEO and key negotiator and its financial advisor. According to the court, El Paso’s CEO, who “undertook sole responsibility for negotiating” the deal, was tasked with getting the highest price for the company in the merger, but failed to disclose his intent to work with other El Paso executives to bid for one of the company’s businesses after the merger with Kinder Morgan was consummated. The court also explained that El Paso’s financial advisor owned 19 percent of Kinder Morgan (a $4 billion investment) and controlled two Kinder Morgan board seats. Although this conflict was disclosed, the court found the financial advisor’s “Chinese wall” and other efforts to address those conflicts were inadequate. In addition, the lead banker on the deal failed to disclose that he owned an approximate $340,000 interest in Kinder Morgan stock. The court concluded that the “record...persuades me that the plaintiffs have a reasonable likelihood of success in proving that the Merger was tainted by disloyalty.” However, the court ultimately denied the motion for a preliminary injunction because El Paso stockholders could turn down the deal if they did not like the price, and because no rival bid existed. Nevertheless, the court left open the possibility of a post-merger money damages case, noting that “plaintiffs have a probability of showing that more faithful, unconflicted parties could have secured a better price from Kinder Morgan.”

Court of Chancery Denies Attempt to Enjoin Amgen’s Acquisition of Micromet

***In re Micromet, Inc. S’holder Litig.*, C.A. No. 7197-VCP (Del. Ch. Feb. 29, 2012)**

Vice Chancellor Donald F. Parsons of the Delaware Court of Chancery denied the shareholder plaintiffs’ attempt to enjoin an all-cash negotiated tender offer for all the shares of Micromet, a biopharmaceutical company.

The court held that *Revlon* duties only attached when the Micromet board “resolved to enter into serious merger negotiations with Amgen and instructed [the financial advisor] to conduct a market check of other potential acquirors.” The court stated that, once *Revlon* attached, “the Board decided to undertake a market check to test the adequacy of Amgen’s offer and see if it could obtain a higher price from another potential acquiror.” The court rejected the plaintiffs’ challenge to the scope of this premerger market check and found it was “adequate and consistent with the Board’s well-informed understanding of the industry and Micromet’s needs.” The court also held that, for similar reasons, “Micromet’s decision to eschew contacting any private equity buyers also seems reasonable.” Likewise, the plaintiffs’ attack on the premerger market check as “unreasonably short” failed. The court rejected the notion that providing the other potential suitors with a “week-long diligence” period improperly tipped the bidding process in Amgen’s favor. As for the post-signing market check, the court held that the combination of the no-shop, matching rights, information rights and change of recommendation provisions in the merger agreement did not restrict the board from timely exercising its fiduciary duties in the event those provisions were triggered.

The court also rejected the plaintiffs’ disclosure claims. First, the court held that Micromet was not required to disclose the basis and criteria for the selection of the probability of success rates for certain clinical trial drugs that were supplied to Goldman for its financial analysis. Second, the court held that there was no need to disclose fees paid by Micromet to Goldman over the past two years or Goldman’s interest in Amgen stock. Third, the court rejected a claim that a more detailed disclosure about net operating loss-related projections was needed, saying such detail was “a level of granular disclosure” not required by Delaware law. Fourth, the court held that Goldman’s “Sum of the Parts” analysis did not need to be disclosed as it was not relied on by Goldman in providing its fairness opinion. Lastly, the court rejected claims that “upside case” projections not relied upon by Goldman needed to be disclosed.

DODD-FRANK ACT

California Superior Court Sustains Demurrer with Prejudice

***Jacobs Eng’g Grp., Inc. Consol. S’holder Derivative Litig.*, No. BC454543 (Cal. Super. Ct. Mar. 6, 2012)**

Judge Kenneth R. Freeman of the California Superior Court for the County of Los Angeles sustained the defendants’ demurrer without leave to amend in a suit alleging that Jacobs Engineering Group, Inc. overpaid its senior management. The plaintiffs brought suit against Jacobs, certain senior officers and its compensation consultant. The court held that the plaintiffs failed to show (i) demand futility; (ii) the disinterestedness of a majority of the board of directors; and (iii) that the compensation plan was not the exercise of valid business judgment. The court rejected the plaintiffs’ argument that the directors were interested because they approved the compensation plan after a majority of the shareholders rejected the plan. Expressly rejecting the plaintiffs’ reliance on the Dodd-Frank Act, the court stated that the shareholder vote is “advisory only” and held that “[m]erely ignoring a non-binding vote of the shareholders and approving an increase in executive compensation is decidedly not a breach of fiduciary duty, by itself, under Dodd-Frank.” Similarly, because the shareholder vote is advisory only, the court rejected the plaintiffs’ argument that the board violated the business judgment rule by approving the plan. Finally, the court noted that even if the plaintiffs had alleged demand futility, they did not allege facts sufficient to support a claim. The court also sustained the individual defendants’ demurrers without leave to amend.

EXPERT WITNESSES

Massachusetts Federal Court Precludes Expert Report and *Sua Sponte* Grants Summary Judgment

***Bricklayers & Trowel Trades Int'l Pension Fund v. Credit Suisse First Bos.*, No. 02-12146-NMG (D. Mass. Jan. 13, 2012)**

In a securities fraud class action, Judge Nathaniel M. Gorton of the U.S. District Court for the District of Massachusetts precluded on *Daubert* grounds an expert report that formed the basis of the plaintiffs' fraud-on-the-market claims and *sua sponte* granted summary judgment for Credit Suisse. The plaintiffs' expert presented an event study that purportedly measured the impact of the defendants' allegedly fraudulent statements and omissions on AOL's stock price; however, that event study was unreliable because the plaintiffs' expert (i) "cherry-picked" days with volatile trading, (ii) made too frequent use of dummy variables, (iii) attributed changes in AOL's stock price to factors that had already been disclosed to the market, and (iv) failed to isolate the effects of potentially confounding news regarding AOL. Because the expert's event study and testimony were the plaintiffs' only evidence of loss causation and were not reliable, the plaintiffs could not show a genuine issue of fact on loss causation. Consequently, the court *sua sponte* granted summary judgment in favor of Credit Suisse.

FOREIGN CORPORATIONS

Second Circuit Holds That Foreign Funds' Claims Failed Under *Morrison*, but Leaves Room for Amended Complaint

***Absolute Activist Value Master Fund Ltd. v. Ficeto*, No. 11-0221-cv (2d Cir. Mar. 1, 2012)**

The U.S. Court of Appeals for the Second Circuit held that the plaintiff foreign funds did not show that their purchases and sales of unlisted securities through PIPE transactions were domestic transactions under *Morrison v. National Australia Bank Ltd.*, 130 S. Ct. 2869 (2010), because the plaintiffs did not adequately allege that irrevocable liability was incurred or that title was transferred within the United States. The foreign funds purchased and sold securities issued by U.S. companies brokered through a U.S. broker-dealer. The court initially determined that, pursuant to *Morrison*, Section 10(b) of the Securities Exchange Act would apply to the funds' transactions only if either (i) one of the parties to the securities transaction incurred irrevocable liability within the U.S. to take or deliver the security, or (ii) title to the securities was transferred within the United States. Because the plaintiffs failed to adequately allege the existence of either of these conditions, their claims failed under *Morrison*. However, the plaintiffs were entitled to amend their complaint because it had been drafted prior to the *Morrison* decision and amendment would not clearly be futile.

S.D.N.Y. Dismisses Claims Relating to Vivendi's Ordinary Shares

***In re Vivendi Universal, S.A., Sec. Litig.*, No. 02 Civ. 5571 (RJH) (S.D.N.Y. Jan. 27, 2012)**

Judge Richard J. Holwell of the U.S. District Court for the Southern District of New York dismissed claims alleging violations of Section 10(b) of the Securities Exchange Act and Sections 11 and 12(a)(2) of the Securities Act under *Morrison v. National Australia Bank Ltd.*, 130 S. Ct. 2869 (2010). Vivendi's ordinary shares did not trade on an American exchange, and so, applying *Morrison*, the court dismissed the plaintiffs' Section 10(b) claims relating to Vivendi's ordinary shares. The court also determined that *Morrison* applied to the plaintiffs' Section 11 and 12(a)(2) claims because its underlying logic applied to the Securities Act claims, and dismissed those claims.

FORWARD-LOOKING STATEMENTS

First Circuit Affirms Summary Judgment in Case Involving "Aggressive Discounting"

***In re Smith & Wesson Holding Corp. Sec. Litig.*, No. 11-1436 (1st Cir. Feb. 17, 2012)**

The U.S. Court of Appeals for the First Circuit affirmed summary judgment in favor of Smith & Wesson on claims that it violated Section 10(b) of the Securities Exchange Act by allegedly making misleading statements in its quarterly forecasts. The plaintiffs alleged that Smith & Wesson's aggressive discounting front-loaded its sales figures, making those figures, on which its forecasts relied, materially misleading. But the plaintiffs did not show that Smith & Wesson's discounting during the class period was materially different from its discounting in previous years. In addition, the plaintiffs failed to plead scienter, because Smith & Wesson's purported misstatements and omissions were not so clearly improper as to create an inference of recklessness.

INSIDER TRADING CLAIMS

Second Circuit Determines That a Beneficial Owner's Acquisition of Securities Directly from an Issuer Was a "Purchase" Under Section 16(b)

***Huppe v. WPCS Int'l Inc.*, No. 08-4463-cv (2d Cir. Jan. 20, 2012)**

Affirming the district court, the U.S. Court of Appeals for the Second Circuit determined that a beneficial owner's acquisition of securities directly from an issuer—at the issuer's request and with the board's approval—was a "purchase" under Section 16(b) of the Securities Exchange

Act. The defendants—two limited partnerships—purchased a large quantity of securities directly from the issuer, with the approval of the issuer's board. At the time of purchase, the defendants owned more than 10 percent of the issuer's securities, and had traded in the issuer's securities in the prior six months. The court determined that trades by 10 percent holders were potentially susceptible to the speculative abuse of inside information, even when directly negotiated with the issuer and approved by the issuer's board, and so did not fall within any exceptions to Section 16(b)'s ban on short-swing trading by insiders. In addition, although the limited partnerships' agreements had delegated decision-making to their general partners' agents, the limited partnerships were still "beneficial owners" under Section 16(b).

MERGERS AND ACQUISITIONS

Massachusetts Federal Court Stays Claims Pending Outcome of Related Action in Delaware Court of Chancery

***In re Novell, Inc. S'holder Litig.*, No. 10-12076-RWZ (D. Mass. Feb. 10, 2012)**

Judge Rya W. Zobel of the U.S. District Court for the District of Massachusetts stayed claims that certain former directors of Novell violated Section 14(a) of the Securities Exchange Act in connection with the company's merger with Attachmate pending the outcome of a related action in the Delaware Court of Chancery. Although federal courts have exclusive jurisdiction over Section 14(a) claims, the claims in the Chancery Court were parallel because they involved the same facts and standards. Consequently, the court determined that a stay was appropriate under *Colorado River Water Conservation District v. United States*, 424 U.S. 800 (1976), because (i) the stay would avoid piecemeal litigation, and the state court would apply the same standards to the same facts and potentially provide a predicate for collateral estoppel to the Section 14(a) claims; and (ii) the parties had already engaged in significant discovery in the state action.

PONZI SCHEMES

Eleventh Circuit Court of Appeals Affirms Dismissal with Prejudice

***Lawrence v. Bank of Am., N.A.*, No. 11-12401 (11th Cir. Jan. 11, 2012)**

In an unpublished opinion, the U.S. Court of Appeals for the Eleventh Circuit affirmed the dismissal with prejudice of a putative class action against Bank of America. Plaintiffs alleged that Bank of America had aided and abetted an individual Bank of America customer, Beau Diamond, in operating a Ponzi scheme by ignoring unusual account activity in his accounts with the bank. The Complaint alleged three causes of action against Bank of America: (i) common law fraud, (ii) conversion and (iii) breach of fiduciary duty. All three causes of action were based on Bank of America's alleged knowing support and facilitation of Diamond's Ponzi scheme. The court held that the plaintiffs' complaint did not raise a plausible inference that Bank of America had knowledge of the Ponzi scheme. The court noted that "[a]lthough Plaintiffs alleged the transactions were atypical and therefore Bank of America should have known of the Ponzi scheme, such allegations are insufficient under Florida law to trigger liability. Florida law does not require banking institutions to investigate transactions." The court also affirmed the denial of leave to amend because the plaintiffs' proposed new allegations were insufficient to state a claim; therefore, amendment would be futile.

Pennsylvania Federal Court Rules Fund Not Liable for Employee's Ponzi Scheme

***Belmont v. MB Inv. Partners, Inc.*, No. 09-4951 (E.D. Pa. Jan. 5, 2012)**

Judge Berle Schiller of the U.S. District Court for the Eastern District of Pennsylvania granted summary judgment to an investment management fund on claims that it allegedly violated Section 20(a) of the Securities Exchange Act in connection with a Ponzi scheme perpetrated by the fund's former employee. The plaintiffs alleged that the fund furthered the employee's scheme by failing to create a "culture of compliance." However, the court determined that the plaintiffs presented no evidence that the fund actively participated in the fraud, and the fund's mere failure to discover the fraud was insufficient to establish control person liability. In addition, the fund was not liable under the doctrine of respondeat superior because the former employee had not been acting on the fund's behalf in running the Ponzi scheme through a separate entity.

SCIENTER

N.J. Federal Court Dismisses 10(b) Claims Against Kid Brands

***Rahman v. Kid Brands, Inc.*, No. 11-1624 (JLL) (D.N.J. Mar. 8, 2012)**

Judge Jose L. Linares of the U.S. District Court for the District of New Jersey dismissed claims that Kid Brands violated Section 10(b) of the Securities Exchange Act in connection with purported violations of anti-dumping laws by Kid Brands' subsidiaries because the plaintiff did not adequately plead scienter. The plaintiff could not rely on its confidential witnesses because he did not adequately describe their jobs, the information the witnesses received or how they accessed that information. Because the plaintiff had relied only on allegations from the confidential witnesses to allege individual scienter, without the confidential witnesses the plaintiff did not sufficiently plead scienter as to any individual defendants. The plaintiff also failed to plead corporate scienter (which the court assumed, *arguendo*, applied in the Third Circuit) because he did not allege the pervasiveness of the violations at Kid Brands' subsidiaries.

Vermont Federal Court Dismisses 10(b) Claims Against Green Mountain Coffee

***Warchol v. Green Mountain Coffee Roasters, Inc.*, No. 2:10-cv-227(D. Vt. Jan. 27, 2012)**

Judge William K. Sessions III of the U.S. District Court for the District of Vermont dismissed claims that a coffee company violated Section 10(b) of the Securities Exchange Act because the plaintiffs did not adequately plead scienter. First, the plaintiffs' confidential witnesses' testimony failed to create an inference of scienter because they could not testify to whether the company's officers knew of the allegedly improper accounting. Second, none of the company's officers who allegedly fraudulently inflated the company's stock sold the company's stock during the class period. Third, neither of the deals the company signed during the class period created an inference of fraud because they closed after the company's alleged corrective disclosures.

SEC ENFORCEMENT

Second Circuit Grants Stay in SEC-Citigroup Settlement Proceedings

***Sec. & Exch. Comm'n v. Citigroup Global Mkts. Inc.*, No. 11-5227-cv (L) (2d Cir. Mar. 15, 2012)**

The U.S. Court of Appeals for the Second Circuit granted a stay of proceedings in the district court pending its review of the district court's rejection of a settlement agreement between the SEC and Citigroup. Both the SEC and Citigroup appealed the decision, and the court determined that their appeal was likely to succeed. First, the court determined that the district court did not appear to give proper deference to the SEC's policy decisions, instead substituting the district court's policy judgment. The policy decisions of an administrative agency are entitled to the courts' deference. Second, it was unlikely that the district court had the discretion to overrule a private party's determination of what constituted that party's best interests. Third, the district court likely did not have discretion to reject a settlement unless liability was admitted or conclusively determined. The court also determined that the stay was necessary to prevent irreparable harm, because the district court's decision had essentially precluded the possibility of a new settlement. In addition, the court deferred to the SEC's judgment that a stay would be in the public interest.

Florida Federal Court Grants SEC's Motion for Summary Judgment

***Sec. & Exch. Comm'n v. Weintraub*, No. 11-21549-CIV (S.D. Fla. Dec. 30, 2011)**

Judge Paul C. Huck of the U.S. District Court for the Southern District of Florida granted the SEC's motion for summary judgment, finding defendant Allen E. Weintraub violated Sections 10(b) and 14(e) of the Securities Exchange Act and Rules 10b-5 and 14e-8 promulgated thereunder. Defendant Weintraub, the sole owner, officer, director and employee of Sterling Global, an inactive Florida corporation, emailed two written tender offer letters to various board members, officers and public relations representatives of Eastman Kodak Company and AMR Corporation. Weintraub also emailed the tender offer letters to numerous media outlets. The letters offered to purchase shares of the companies' stock at substantial premiums. Weintraub later represented to the media that his AMR offer had the backing of "several large [financial] institutions." However, Weintraub never obtained a letter of credit or other written financing agreement and had been declined by several banks. The tender offer letters also failed to disclose several aspects of Weintraub's background, including that Weintraub (i) pleaded guilty to two felony counts of organized fraud and one count of felony money laundering; (ii) was on probation when he submitted the tender offer letters; (iii) was permanently enjoined from acting as an officer or director of any public company as a result of previous violations of federal securities law; (iv) had yet to satisfy a $1,050,000 judgment entered against him by the court for previous violations of federal securities law and (v) filed for bankruptcy in 2007. The tender offer letters also failed to disclose that Sterling Global was administratively dissolved in 2010 for failing to file its annual report.

Against this background, the court held that there was no genuine dispute as to any material fact regarding the liability of Weintraub for violating antifraud provisions of federal securities laws. With respect to Section 10(b) liability, the court found that Weintraub made numerous false and misleading statements regarding his ability and intent to consummate the deals, his personal background and his representations to media outlets. The Court found the statements were material, noting that "[n]ews of a tender offer is generally considered material" and "[c]ourts have repeatedly found the failure to disclose bankruptcies and court orders—such as those entered against Mr. Weintraub—to be material admissions in securities fraud enforcement actions." Further, the statements were made "in connection with the purchase or sale of a security" because they were "disseminated to the public in a medium upon which a reasonable investor would rely, and…they were material when disseminated." Finally, scienter was demonstrated by Weintraub's creation of documents he knew were false—as the facts contained therein were within his personal knowledge.

The court also held that Weintraub violated Section 14(e), the Securities Exchange Act's broad antifraud prohibition for tender offers, noting "[t]he SEC has provided notice that communications that are made at any time' will be subject to the antifraud provisions of Rule 10b-5 under the Exchange Act, as well as to the antifraud provisions of Rule 14a-9 and Section 14(e) if a transaction involves...proxy or tender offer rules respectively." Here, Weintraub's tender offer letters and related communications were pre-commencement communications that fall under Rule 14e-8. With liability established, the court ordered that the case proceed to trial only on the issue of remedies.

SECURITIES ACT CLAIMS

Massachusetts Federal Court Dismisses Claims Against *Princeton Review*

***Washtenaw Cnty. Emps.' Ret. Sys. v. Princeton Review, Inc.*, No. 11-11359-RGS (D. Mass. Mar. 6, 2012)**

Judge Richard G. Stearns of the U.S. District Court for the District of Massachusetts dismissed with prejudice claims that the *Princeton Review* and its officers and directors violated Sections 11 and 12(a)(2) of the Securities Act in connection with a securities offering. Although the defendants did not disclose advanced booking information, they had no duty to disclose forecasts, and the plaintiffs did not allege any incomplete or misleading disclosure in the offering documents that would have created such a duty. In addition, because the defendants adequately disclosed the risk factors that led to a decline in the *Princeton Review*'s share price, those factors could not form the basis of a material misrepresentation.

S.D.N.Y. Dismisses Section 11 Claims Against Online Retailer

***Arfa v. Mecox Lane Ltd.*, No. 10 Civ. 9053 (S.D.N.Y. Mar. 1, 2012)**

Judge Robert W. Sweet of the U.S. District Court for the Southern District of New York dismissed claims that a Chinese online retailer and its underwriters violated Section 11 of the Securities Act because the offering documents for the retailer's IPO allegedly contained false and misleading statements about the retailer's plans for opening physical stores and its growth and margins. The court initially determined that Rule 9(b)'s heightened pleading standards did not apply because the plaintiffs did not allege that the defendants acted with scienter, and so the claims did not sound in fraud. However, the offering documents adequately disclosed that the retailer closed some physical stores in 2010, and that the retailer relied heavily on online sales for revenue and growth. The offering documents also disclosed declines in gross margins and increases in expenses. In addition, the plaintiffs did not present evidence regarding the retailer's advertising strategy or its internal controls that contradicted statements in the offering documents.

SECURITIES FRAUD PLEADING STANDARDS

Second Circuit Affirms Dismissal of 10(b) Claims Against Investment Company

***Capital Mgmt. Select Fund Ltd. v. Bennett*, No. 08-6166-cv(L) (2d Cir. Jan. 10, 2012)**

The U.S. Court of Appeals for the Second Circuit affirmed the dismissal of claims that an investment company violated Section 10(b) of the Securities Exchange Act because the plaintiffs could not show that their agreements with the investment company were misleading. The plaintiffs alleged that the investment company violated its agreements with the plaintiffs when it used plaintiffs' securities as collateral for additional borrowing, even when those securities were not deemed collateral. But the plaintiffs relied only on the agreements' language to show material misrepresentations, and a reasonable reading of that language allowed the investment company to reuse plaintiffs' securities as collateral. In addition, the investment company did not impliedly represent that it would follow certain state and federal securities laws that limit such use of plaintiffs' securities, because the investment company disclosed that it was not a U.S.-regulated company.

N.J. Federal Court Dismisses 10(b) Claims Against Pfizer

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

Judge Susan D. Wigenton of the U.S. District Court for the District of New Jersey dismissed claims that Pfizer, as successor-in-interest to Wyeth, violated Section 10(b) of the Securities Exchange Act by allegedly making material misstatements and omissions regarding the results of "Phase II" testing of a drug. Although Wyeth had initially stated that it would not move to Phase III testing of the drug unless Phase II results were "spectacular," the cautionary language in Wyeth's announcement that it was beginning Phase III testing cured any alleged misstatement because it disclosed that no conclusions could be drawn from the Phase II study at that time. In addition, Wyeth did not have a duty to disclose certain specific results of the Phase II study.

SECURITIES INVESTOR PROTECTION ACT (SIPA)

D.C. Federal Court Rules on SIPC's Role in Stanford Proceedings

***Sec. & Exch. Comm'n v. Sec. Investor Prot. Corp.*, No. 11-mc-678 (RLW) (D.D.C. Feb. 9, 2012)**

Judge Robert L. Wilkins of the U.S. District Court for the District of Columbia granted the SEC's motion for an order to show cause and ordered SIPC to show why it should not be required to file an application for a protective decree in Texas federal court. That application, if granted, would force Stanford's fund into bankruptcy proceedings and entitle the fund's customers to compensation from the SIPC. The SIPC argued that SIPA requires the SEC to file a formal complaint, and that the matter should proceed as a normal civil action. But the court determined that the language and purpose of the statute required only a summary hearing. The court also rejected the SEC's argument that its determination that the SIPC should file the application for a protective decree was not reviewable.

SLUSA

Seventh Circuit Affirms Dismissal of Action Alleging That Brokerage Overcharged for Postage and Handling Fees

***Appert v. Morgan Stanley Dean Witter, Inc.*, No. 11-1095 (7th Cir. Mar. 8, 2012)**

The U.S. Court of Appeals for the Seventh Circuit upheld the dismissal of an action for breach of fiduciary duty and unjust enrichment associated with brokerage fees that allegedly bore no relation to actual costs. Appert filed an action in state court alleging that Morgan Stanley charged its customers a fee for handling, postage and insurance (HPI) that bore no relationship, and was grossly disproportionate, to its actual transaction costs. Morgan Stanley removed the action to federal court, asserting jurisdiction pursuant to the Class Action Fairness Act of 2005 (CAFA) or alternatively, the Securities Litigation Uniform Standards Act (SLUSA), and moved for dismissal. The district court granted Morgan Stanley's motion, but allowed plaintiff to file an amended complaint. After the plaintiff amended her complaint, Morgan Stanley again moved to dismiss, arguing that SLUSA barred the plaintiff's suit, or alternatively, that the plaintiff failed to state a claim. The district court again dismissed the action.

On appeal, the Seventh Circuit affirmed dismissal of the action, finding that the federal court had jurisdiction and that the plaintiff failed to state a claim. The court first concluded that SLUSA did not apply, because any alleged misrepresentation that stated that the HPI fee was tied to actual costs was not "material" to investors' decisions to buy or sell securities. The court further concluded that the defendant instead established federal jurisdiction pursuant to CAFA, and that the plaintiff did not establish that the action fell within CAFA's securities exception. Finally, the court affirmed dismissal of the action for failure to state a claim, agreeing that the contract did not suggest that the HPI fee represented Morgan Stanley's actual costs, that it was not reasonable to read this into the agreement, and that Morgan Stanley had no implied duty to charge a fee that was reasonably proportionate to actual costs where it notified customers in advance of its charges and customers were free to decide whether to continue to do business with the firm.

STATUTES OF LIMITATIONS

S.D.N.Y. Determines 10(b) Claims Against Former Vivendi CFO Not Time-Barred

***In re Vivendi Universal, S.A. Sec. Litig.*, No. 02 Civ. 5571 (SAS) (S.D.N.Y. Mar. 20, 2012)**

Judge Shira A. Scheindlin of the U.S. District Court for the Southern District of New York determined that claims asserting violations of Section 10(b) of the Securities Exchange Act against Vivendi's former CFO were not time-barred. The plaintiffs originally had been part of a proposed class in 2002, but they filed a new complaint after being excluded from the class. That new complaint was governed by the two-year statute of limitations, which had been extended from one year after the filing of the original complaint. Although the plaintiffs filed their new complaint more than two years after the order dismissing them from the initial class action, the court determined that the filing of a Rule 23(f) petition seeking interlocutory review of a class certification decision tolled the statute of limitations while the petition was pending. Because the plaintiffs filed their new complaint within two years of the decision denying interlocutory appeal, their action was timely.

SUCCESSOR OBLIGOR CLAUSES

Chancery Court Enjoins BankAtlantic Sale to BB&T

***In re BankAtlantic Bancorp Inc. Litig.*, C.A. No. 7068-VCL (Del. Ch. Feb. 27, 2012)**

Vice Chancellor J. Travis Laster of the Delaware Court of Chancery permanently enjoined BankAtlantic Bancorp, Inc. (Bancorp), a company which holds 100 percent equity in BankAtlantic, a federal savings bank, from selling BankAtlantic to BB&T Corporation. To attract bidders, the deal was structured as a "good bank/bad bank" transaction where the performing assets were separated from the nonperforming assets. Pursuant to the merger agreement, the performing assets were to be sold to BB&T Company and Bancorp was to retain the non-performing assets as consideration. If the transaction were consummated, Bancorp no longer would have been a federally regulated bank holding company. The plaintiffs filed suit alleging the transaction violated debt covenants that prohibited Bancorp from selling "all or substantially all" of its assets where the acquirer had not assumed the debt. The court held that, under New York law, the transaction constituted substantially all of Bancorp's assets and the ensuing default would cause irreparable harm to plaintiffs.

The court began its analysis by stating that New York law considers both quantitative and qualitative factors when determining whether a transaction conveys "substantially all" of a company's assets for purposes of a successor obligor provision. The court held that "[f]rom a quantitative standpoint, Bancorp is selling 85-90% of its assets in the Sale Transaction." The court reached this percentage by comparing the value of Bancorp's total assets with the value of BankAtlantic as listed in the most recent Form 10-K and 10-Q. Further, the court stated that "[i]t is difficult to imagine a transaction that would have a greater qualitative impact on Bancorp" because it would leave Bancorp with "no brand, no banking franchise, no deposit base, no branches, eight current employees, and a portfolio of criticized assets." The court held that "[t]aken as a whole, the evidence at trial establishe[d] that the Sale Transaction will constitute a transfer of substantially all of Bancorp's assets. Because BB&T is not assuming the Debt Securities, the Sale Transaction will breach the Successor Obligor Provision." The court therefore permanently enjoined the transaction.

WHISTLEBLOWER PROTECTION

First Circuit Holds SOX Whistleblower Provision Limited to Public Company Employees

***Lawson v. FMR LLC*, No. 10-2240 (1st Cir. Feb. 3, 2012)**

The U.S. Court of Appeals for the First Circuit held that employees of a nonpublic company who are working as contractors to a public company are not protected by the whistleblower provision of Section 806 of the Sarbanes-Oxley Act, affirming the dismissal of those claims on a motion to dismiss. The plaintiffs, former employees of nonpublic investment advisers to public companies, alleged that their former employers had retaliated against them for raising concerns about possible securities violations at the public companies that their former employers advised. However, based on the express language of Section 806 and the act's legislative history, the court determined that Congress intended for the whistleblower protections to apply only to employees of public companies and invited it to amend the statutory provisions if broader applications were intended.

The Possible Demise of Short Sale Regulation

By Louis Incatasciato

I. Introduction

Short selling has been criticized for years as the cause of multiple financial crises.[1] An example is Lehman Brothers, that blamed "abusive short selling" as the cause of the demise of the company.[2] In a traditional short sale, the investor borrows the stock in order to sell.[3] Then, at some future point, the investor returns the borrowed stock to the lender by purchasing the stock on the market.[4] If the price decreased from the time when the investor sold the stock, then the investor made a profit.[5] If the price increased, then the investor endured a loss. Another way an investor could take the short position was through a naked short sale, which has similar mechanics to a traditional short sale, except for the fact that the investor sold the stock without previously borrowing it.[6]

Despite the criticism, the Securities and Exchange Commission ("SEC") has not created an overall ban on short selling. Rather the SEC has chosen to regulate short selling. However, there exists a potential threat that can be used to undermine the SEC's short sale regulation. The threat is single-stock futures. A single-stock future is a futures contract where the underlying asset is the stock of a single company.[7] The threat created by single-stock futures is that a single-stock future is the economic equivalent of a short sale, but is not subject to the SEC's short sale regulation.[8] As a result, single-stock futures can be used to undermine the SEC's short sale regulation. In order to avoid such a threat, the SEC must be given plenary authority to regulate single-stock futures. Once the SEC is given the exclusive authority to regulate single-stock futures, the SEC will be able to pass the necessary rules that will preserve its short sale regulation.

This article will discuss the dangers that single-stock futures pose to the SEC's short sale regulation, why the SEC needs plenary authority over single-stock futures, and the possible rules that could prevent single-stock futures from undermining the SEC's short sale regulation. Part II provides an overview of traditional short selling by looking at the mechanics of a traditional short sale, the benefits provided by traditional short selling, and the history of regulation. Part III provides an overview of naked short selling by describing what naked short selling is, the dangers of naked short selling, and the history of regulation. Part IV provides an overview of single-stock futures by explaining what a single-stock future is and the history of regulation. Part V explains how single-stock futures can undermine the SEC's short sale regulation. Part VI argues why the SEC needs plenary authority over single-stock futures. Finally, Part VII suggests three possible rules the SEC could pass, if it is given the plenary authority to regulate single-stock futures, in order to preserve short sale regulation.

II. Traditional Short Selling

A. What Is Traditional Short Selling?

Short selling is defined as the "sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller."[9] In order to achieve a short sale, multiple steps must be taken. First, the investor sells a security which he does not own but rather has borrowed.[10] Next, this borrowed security is delivered to the buyer.[11] Lastly, the short seller, at some later point, covers his position.[12] A position is covered when the short seller buys the security on the open market and returns it to the lender.[13]

The manner in which the short seller profits is in direct contrast to the manner in which the investor taking the "long" position profits. When an investor takes the long position, the investor is "purchas[ing]…stock with the expectation that its price will rise."[14] Hence, the investor profits when the stock's value increases. In contrast, when an investor takes a short position, the investor is "sell[ing borrowed] stock…in the expectation of lower prices in the future."[15] Hence, the investor profits when the stock's value decreases. A profit from short selling occurs when the stock's price decreases because the investor's selling price is greater than his purchase price. Essentially, the short seller is following the same "buy low, sell high" strategy that the investor in the long position takes, but in reverse order.[16]

B. The Benefits of Traditional Short Selling

Short selling has encountered hostility by some members of the financial community.[17] One reason for the lack of full support is based on the mechanics of short selling.[18] A short seller profits when the stock price declines. Hence, the only time the short seller would profit is when a traditional investor would sustain a loss. As a result, short selling has been viewed as a "'bet[] against the team.'"[19] Another reason is based on a fear that exists within the financial community, which is that short sellers are capable of benefiting from market manipulation.[20] The fear is based on the theory that short sellers can manipulate the market by continually short selling a stock, which would cause the stock price to decline.[21] Once the price declines, the short seller would be able to cover his position at a price lower than what he sold the stock for, which would result in a profit for the short seller.

Contrary to the negative perception of short selling, it provides the market with several benefits.[22] First, short selling provides price efficiency.[23] The security's price is dependent upon investors.[24] When an investor takes a long position, he is optimistic about the security's future.[25] The optimistic investor's action provides the market with information that the stock is undervalued so the price should increase.[26] On the other hand, when an investor takes a short position, he is pessimistic about the security's future.[27] The pessimistic investor's action provides the market with information that the stock is overvalued so the price should decrease.[28] If short selling was banned or did not occur, then the market would contain less pessimistic views about the security's future and, as a result, the market price would represent an overvaluation.[29] Thus, by allowing short selling, the market can be informed about the pessimistic view of a security's future, which allows the market price to move closer to equilibrium.[30]

Second, short selling provides liquidity.[31] Liquidity is the "ease with which an asset can be converted to cash…."[32] When a short seller covers his position, he is buying the security on the open market. Hence, short selling provides an opportunity for a security to be converted into cash, and thus, provides liquidity.

Finally, short selling assists in exposing corporate fraud.[33] Short sellers pay close attention to a company's financial statements[34] and are often one of the most informed investors.[35] As a result of this close scrutiny, short sellers are in a position to detect fraud before regulators do.[36]

C. The History of Regulation of Traditional Short Selling

After the 1929 stock market crash, there was a common belief that investors had caused the crash by using short selling to accelerate the stock market decline.[37] As a result, short sale regulation became the focus point of legislation,[38] and Congress passed §10(a) of the Securities Exchange Act of 1934 ("1934 Act"), which delegated authority to the SEC to regulate short sales of any security registered on a national securities exchange.[39] With this authority, the SEC adopted Rule 10a-1 on February 8, 1938.[40] Rule 10a-1 prohibited the short sale of any exchange-traded security that was not sold on a plus-tick or a zero-plus tick.[41] A security is sold on a plus-tick when the price at which the short sale occurred is greater than the last previous sale price.[42] A security is sold on a zero-plus tick when the price at which the short sale occurred is the same price as the last previous price so long as that price is higher than the preceding sale price of the security.[43] For example, assume the stock is sold at time T, T+1, and T+2. If the stock was sold for more at T+1 than at T, then the plus-tick requirement has been satisfied. If the stock was sold at T+2 for the same amount as at T+1 but more than at T, then the zero-plus tick requirement has been satisfied.

Despite the creation of some exceptions, the main provisions of the Rule remained unchanged for almost 70 years.[44] Then, in 2007, the SEC rescinded Rule 10a-1 due to decimalization, which caused the Rule to be less effective.[45] Before decimalization, stocks were priced in 1/16th increments, which was equivalent to $0.0625.[46] Now, under a decimalized trading system, stocks are priced on $0.01 increments.[47] Decimalization affects the efficacy of Rule 10a-1 because it is less effective at slowing down short sellers since an investor would just have to increase the price by $0.01, as opposed to $0.0625, from the previous price to satisfy the plus-tick requirement.[48]

Once Rule 10a-1 was rescinded, there were no rules in place that explicitly regulated short sales. This changed on September 18, 2008, when the SEC used the authority granted to it in §12(k)(2) of the 1934 Act to issue an emergency order that temporarily banned short selling in all financial stocks.[49] The initial list contained 750 stocks that could not be short sold.[50] A few days later, on September 22, 2008, the SEC expanded the list to include additional stocks.[51] Since this emergency order was only temporary, the ban on short selling came to an end on October 17, 2008.[52]

In hindsight, former SEC Chairman Cox stated that the biggest mistake of his tenure was agreeing to this short selling ban.[53] The empirical evidence indicates that the short selling ban had a negative impact on the market.[54] The ban caused a decline in trading because investors could not hedge their long positions with short positions.[55] As a result, there was an increase in trading costs.[56] In addition, the ban was "detrimental for liquidity, slowed price discovery, and failed to support prices."[57]

With the expiration of the temporary ban, there was once again no explicit rule that regulated short sales. However, in 2009, the SEC decided to take another look at short sale regulation.[58] In April 2009, the SEC sought formal comment on two suggested approaches in regards to regulating short sales.[59] One was the market-wide approach, which contained a permanent rule that regulated short selling.[60] The other was the circuit-breaker approach, which would impose a short sale regulation once the security's price dropped to a certain level.[61] Finally, in February 2010, the SEC adopted Rule 201.[62] Rule 201 followed the circuit-breaker approach since the rule takes effect when "the price of a 'covered security' drops by 10% or more from [the] closing price as determined by the listing market as of the end of regular trading hours on the prior trading day."[63] A covered security is any security traded on an exchange or in the over-the-counter market that is listed on a National Market System.[64] Notwithstanding the wide scope of Rule 201, it does not apply to options or other derivatives.[65] Once the rule is activated, a short sale may only occur at a price above the current national best bid.[66] Further, the rule will be in effect for the remainder of the trading day as well as the following day.[67]

III. Naked Short Selling

A. What Is Naked Short Selling?

Naked short selling is a variation of traditional short selling. In a traditional short sale, the investor sells stock that he does not own but has borrowed or made an arrangement to borrow stock in order to deliver to the buyer. On the contrary, a naked short sale is "selling short without borrowing the security to make delivery."[68] Hence, the buyer does not receive the stock when he purchases from a naked short sale.

In addition, when a short seller covers his position in a traditional short sale, the short seller is purchasing the stock on the market to deliver to the lender. On the other hand, in a naked short sale, the short seller covers his position by purchasing the stock on the market to deliver to the buyer. The naked short seller covers his position by delivering to the buyer instead of to the lender because the naked short seller never borrowed the stock, so there is no lender. The only open position the naked short seller has is with the buyer who has not yet received the stock he has purchased.

B. The Dangers of Naked Short Selling

Naked short selling poses a grave danger by providing a way for short sellers to manipulate the market.[69] Through naked short selling, the market can be manipulated in two ways.[70] First, the naked short seller is able to flood the market with artificial shares, which drives the stock's price downward.[71] Artificial stock represents stock that is not issued by the corporation but rather created by naked short selling.[72] The process begins when the naked short seller fails to deliver the stock.[73] Due to this failure, the Depository Trust and Clearing Corporation ("DTCC") issues a "fails to deliver" ("FTD").[74] The result is that the buyer receives an electronic book entry denoting ownership of the stock even though the buyer has not received the actual stock yet.[75] The buyer may not even be aware that he has received an FTD because his brokerage account statement will indicate that he owns the purchased shares.[76] Further, the buyer can trade the stock that he purchased from the naked short seller even though he has not yet received the stock.[77] The result is that it is possible that more shares of a company are being traded than the company has issued, and hence, the creation of artificial stock.

The second way naked short selling can be used to manipulate the market is through high levels of short selling.[78] Since the investor is not borrowing the security in a naked short sale,[79] the investor can reach levels of short selling that are not possible through traditional short selling.[80] Instead of being limited by the availability of a stock or the borrowing cost, the investor in a naked short sale can continue short selling.[81] The high levels of short selling can drive a price downward because they present the market with pessimistic views about the stock's future, which informs the market that the stock is overvalued.[82]

C. The History of Regulation of Naked Short Selling

Originally, the only regulation for all forms of short selling was Rule 10a-1.[83] However, in response to the dangers of naked short selling, the SEC passed Regulation SHO in August 2004.[84] Regulation SHO was the first regulation passed by the SEC to explicitly combat naked short selling.[85] The regulation consists of two parts.[86] The first part is the locate requirement, which prohibits a broker-dealer from conducting a short sale unless the investor has already borrowed the shares or has entered into an arrangement to do so.[87] The second part is the close-out requirement, which mandates that a broker-dealer cover the investor's position in "threshold securities" if the investor has failed to do so for thirteen days.[88] Hence, the broker-dealer would buy the shares on the market and deliver the stock to the buyer on the fourteenth day.[89] A threshold security is a security that "is issued by an SEC reporting company and, over any running five-day period, fails to deliver equaled or exceeded 10,000 shares and 0.5 percent of the issuing company's outstanding shares."[90]

Regulation SHO contained an important exception, which was the market maker exception.[91] According to the market maker exception, the locate requirement did not apply to "bona fide" market makers.[92] A market maker is a "dealer[] who stand[s] ready to buy or sell a stock at any time and who publish[es] the prices at which… [he is] willing to trade."[93] A bona fide market maker partakes in activities that "inject liquidity especially into thinly-traded securities and…buffer[s] sharp swings in share prices."[94] The purpose of the exception was to avoid delays created by the locate requirement.[95] However, the by-product of this exception was the creation of artificial stock. Since the locate requirement did not apply to bona fide market makers, this allowed the market maker to sell stock that he has not borrowed.[96] As a result, the buyer did not receive the stock, but rather an FTD. Thus, the market maker exception allowed for the creation of artificial stock.[97]

Despite Regulation SHO, which stated that the exception was limited to bona fide market makers, the exception was subject to abuse.[98] Due to the fact that almost anyone can become a marker maker, investors were capable of taking advantage of the exception.[99] Hence, the exception provided a loophole that allowed an investor to manipulate the market through naked short selling.[100]

Fortunately, Regulation SHO was not the last attempt by the SEC to regulate naked short sales. In July 2008, the SEC, under a temporary rule, suspended the locate requirement for nineteen financial stocks.[101] In addition, the rule required that if an investor is short selling in one of these nineteen stocks, then the investor would have to either borrow the stock before short selling or have an arrangement to borrow the stock that would allow the investor to deliver it to the buyer no later than three days after the sale.[102] Because this rule was temporary, it expired in August 2008.[103] However, in September 2008, the SEC decided to make the temporary rule permanent.[104] When the SEC was adopting the temporary rule, it decided to make an adjustment, which was to expand the scope of the rule so that it would apply to all equity securities.[105] In addition to making the temporary rule permanent, the SEC also decided to eliminate the market maker exception.[106] As a result of the SEC's actions in September 2008, the new regulations provided an effective ban on naked short selling.

IV. Single-Stock Futures

A. What Is a Single-Stock Future?

A single-stock future is a type of futures contract.[107] A futures contract is "an agreement to buy or sell an asset at a set price and at a set time in the future."[108] Unlike a forward contract, a futures contract is a standardized contract where the purchase price of the asset is the only negotiated term.[109] This purchase price is negotiated and agreed upon at the time the contract is created, but the payment does not occur until the settlement date as set out in the contract.[110]

When the futures contract is a single-stock future, the asset that is involved is the stock of a single company.[111] Therefore, following from the definition of a futures contract, a single-stock future is an agreement to buy or sell a stock at a set price and at a set time in the future.

When entering into a single-stock future, neither party is required to have ownership of the underlying stock.[112] Hence, a single-stock future provides a way to speculate on the stock's future value without taking ownership in the stock.[113]

In a single-stock future there are two settlement options.[114] One option is a physical settlement, which provides that the selling party physically transfers the stock to the buying party.[115] When the single-stock future is a physical settlement, the buyer does not take ownership of the stock until the settlement date.[116] The other option is a cash settlement, which provides that the stock is not exchanged, but rather the appropriate party pays the difference between the contract price and the market value of the stock on the settlement date.[117] For example, assume Buyer B and Seller S enter into a single-stock future that S will sell B one share of stock for $10, and B and S elect to use the cash settlement option. If the stock's value increases to $15 on the settlement date, B would profit by $5 if he purchases the stock for $10 from S on the settlement day. Thus, S would pay B $5 instead of purchasing the stock for $15 and selling it to B for $10. If the price were to decrease below $10, then B would pay S the difference. Under a cash settlement, since the parties are not exchanging stock, the buyer would never take ownership.[118]

As illustrated in the cash settlement example, an investor in a single-stock future either earns a profit or suffers a loss, depending upon the movement of the underlying stock price. The seller will profit if the stock price decreases below the contract price.[119] On the other hand, the buyer will profit if the stock price increases above the contract price.[120]

B. The History of Regulation of Single-Stock Futures

Originally, a futures contract was used to cover agricultural commodities such as wheat and cotton.[121] Then, in the 1970s, there was a push for futures contracts to cover financial assets,[122] which resulted in the birth of the single-stock future. From the very beginning, the SEC and the Commodity Futures Trading Commission ("CFTC") disagreed over which agency had jurisdiction over single-stock futures.[123] The root of the disagreement was the ambiguous language of the Commodity Exchange Act ("CEA").[124] The CEA granted the CFTC exclusive authority over commodities and reaffirmed that the SEC had exclusive authority over securities.[125] However, according to the language of the CEA, a single-stock future could fall under both agencies' authority.[126] The term "commodity" is broadly defined as any tangible or intangible asset; hence, a security can be considered a commodity since it is an intangible asset.[127] Thus, a single-stock future would fall under the CFTC's authority. On the other hand, a single-stock future could be considered a security-based product due to the fact that the underlying asset is a security, which would grant the SEC authority.[128] As a result, both the CFTC and the SEC claimed to have authority to regulate single-stock futures.[129]

In the power struggle over single-stock futures, the two agencies disagreed over the benefits of single-stock futures.[130] The SEC strongly opposed the trading of single-stock futures.[131] The main reason behind the SEC's objection was that it believed that single-stock futures could become more popular than securities due to an advantage which single-stock futures had over securities trading.[132] The single-stock future was a direct substitute for securities trading, and thus, the SEC's regulations would not apply to single-stock futures.[133] As a result, investors could turn to single-stock futures to perform actions that were the economic equivalent of a securities trade but were not subject to securities regulation.[134] Due to this possibility, the SEC feared that securities could be replaced by single-stock futures, which would undermine the SEC's regulation of the securities market.[135]

Nevertheless, the SEC and CFTC reached an agreement in 1981 on how to regulate single-stock futures.[136] Under the agreement, which is known as the Shad-Johnson Accord, single-stock futures were banned.[137]

The ban on single-stock futures remained intact until December 2000, when the Commodity Futures Modernization Act ("CFMA") was enacted.[138] Under the

CFMA, a single-stock future is subject to both the SEC's and CFTC's authority.[139] Since the single-stock future is subject to both agencies' authority, it is subject to both federal securities and commodities laws.[140] However, despite the applicability of the securities laws, single-stock futures are not subject to short sale regulation.[141] Short sale regulation only applies to a short sale, which is defined as a "sale of a security which the seller does not own or any sale which is consummated by the delivery of a [borrowed] security."[142] A single-stock future does not involve the sale of a security, but rather, is simply an agreement to sell in the future. Since a single-stock future does not involve selling a security, a single-stock future cannot be considered a short sale, which implies that a single-stock future is not subject to short sale regulation.

V. Single-Stock Futures Undermine Short Sale Regulation

The SEC's fear of single-stock futures was not unwarranted because single-stock futures contain two major threats to the SEC's short sale regulation.[143] The first threat is that single-stock futures may be used by investors as an alternative to short selling. This is possible because the single-stock future is the economic equivalent of a short sale.[144] The single-stock future allows an investor to take a short position on the stock by being the selling party.[145] When the investor takes such a position, his profit or loss is calculated by taking the difference between the sale price and the price of the stock on the settlement date. Similarly, a short seller's profit or loss is calculated by taking the difference between the short sale price and the price of the stock when the short seller covers his position. Hence, the selling party in a single-stock future is in the same economic position as if he were short selling the underlying stock covered in the futures contract.

In addition to the fact that a single-stock future is the economic equivalent of short selling, an investor may prefer single-stock futures instead of short selling because of the advantages granted to the investor. Due to the fact that the SEC's short sale regulation does not apply to single-stock futures, the investor could use a single-stock future to take a short position that would not be possible through short selling, where Rule 201 applies. Once the circuit breaker is activated, the investor could only short sell at a price greater than the national best bid. However, if the investor were to use a single-stock future, the investor could take the selling position at a price lower than the national best bid. Another advantage that single-stock futures grant investors is the availability of cheaper transactions. First, single-stock futures provide lower margin requirements.[146] Currently, in order for the investor to short sell, he must satisfy the 50% margin requirement,[147] which requires the investor to put up 50% of the short sale value.[148] On the other hand, if the investor were to use a single-stock future, the margin requirement is only 20%.[149] Second, an investor is not required to take possession of the underlying stock before entering into a single-stock future, but the short seller is required to borrow the stock before conducting the short sale. As a result, the short seller will have to incur a borrowing cost which an investor conducting a single-stock future is able to avoid.

Since the single-stock future is the economic equivalent of a short sale but at a lower cost and allows the investor to escape the SEC's short sale regulation, investors may well prefer single-stock futures over short selling. Thus, once investors start using single-stock futures instead of short selling, the SEC's short sale regulation will be undermined because it will no longer provide an effective way to protect investors from other investors who take a short position.

The second threat is that single-stock futures provide a way for investors to manipulate the market similar to naked short selling. The extent of the manipulation will not reach the levels that naked short selling achieves because single-stock futures cannot create artificial stock. In a naked short sale, the artificial stock is created upon an FTD. However, in a single-stock future there is no failed to deliver.[150] Without this fail to deliver, there is no creation of artificial stock. Although single-stock futures are thus not able to create artificial stock, they are still able to manipulate the market similar to naked short selling through high levels of shorting. In naked short selling, the investor is able to short sell at levels not attainable through traditional short selling because the investor does not have to borrow the stock before the sale. Likewise, the selling party in a single-stock future does not have to own the stock before entering into the agreement. As a result, there is a theoretically unlimited supply of short positions that can be taken through a single-stock future.[151] Similar to what happens in naked short selling, the selling party in a single-stock future can use the theoretically unlimited supply to achieve high levels of shorting to drive the price of the underlying stock downward. Notwithstanding the similarities to naked short selling, the naked short sale ban does not apply to single-stock futures. Thus, single-stock futures can still be used to manipulate the market in a way similar to naked short selling.

VI. The SEC and Authority Over Single-Stock Futures

In order to prevent the SEC's short sale regulation from being undermined by single-stock futures, new rules must be passed. Under the CFMA, a new rule regarding single-stock futures can only be passed when it is approved by both the SEC and the CFTC.[152] Due to this dual regulation system, new rulemaking would probably be very difficult to achieve because the SEC and the CFTC have different regulatory policies. The first major conflict would be caused by the different regimes the SEC and the CFTC have in place.[153] The SEC uses a rule-based regime, whereas the CFTC uses a principle-based regime.[154] Under a rule-based regime, an exhaustive list of rules is required in order to regulate every relevant aspect of the financial industry.[155] On the contrary, a principle-based regime sets forth a list of rules that sets goals and provides the industry freedom to choose the means to reach these goals.[156] Since the SEC and the CFTC have different regimes, each agency will try to pass a different type of rule. The SEC would suggest a rule that controls the means taken to reach the end. On the other hand, the CFTC would suggest a rule that establishes the end and allows the industry to choose the means to reach this end. Since a CFTC-style rule would not mesh with the SEC's regime and vice versa, neither agency would approve a rule set forth by the other.

The other major conflict would be caused by the different goals of the agencies. The SEC's primary focus is protecting investors, while the CFTC's primary focus is enhancing price discovery and spreading risk.[157] Due to these different goals, it is doubtful whether the agencies could be able to agree upon new rules. The SEC would probably propose rules that protect investors. Such rules would make single-stock futures a less attractive alternative to short selling, which would deter investors from using single-stock futures. As a result, investors would prefer short selling, which would allow the SEC to protect investors through short sale regulation. Adversely, the CFTC would probably disagree with the SEC's proposal because it would contradict the CFTC's regulatory policy. The suggested SEC proposal would deter investors from using single-stock futures. By deterring investors from using single-stock futures, the rule would be deterring speculation, which would contradict the CFTC's goal of enhancing price discovery and spreading risk.[158] A similar result would likely occur for the CFTC's proposal. The CFTC would probably propose a rule that allows speculation because it would enhance price discovery and spread risk. However, the SEC would, in all likelihood, object to such a proposal because the rule would contradict the SEC's goal. A rule that allows for speculation leaves the door open for market manipulation and thus fails to provide protection to investors.

Due to these two conflicts, it could be expected that the SEC and the CFTC would not be able to reach an agreement on a new rule. However, a new rule must be passed in order to prevent the SEC's short sale regulation from being undermined. Hence, there must be a change in the regulation of single-stock futures by giving the SEC or the CFTC exclusive authority to regulate. But giving the CFTC exclusive authority would not solve the problem because it would probably not pass stricter requirements. On the contrary, it may loosen the requirements on single-stock futures.[159] Since the current regulation of single-stock futures is threatening to the regulation of short sales, loosening the requirements is definitely not the solution. Hence, the CFTC should not be given the exclusive authority to regulate single-stock futures.

Therefore, the SEC should be given plenary authority to regulate single-stock futures. Once the SEC is given exclusive authority, it would be able to pass the rules necessary to prevent short sale regulation from being undermined.

VII. Regulations the SEC Should Pass to Preserve Short Sale Regulation

Assuming the SEC is granted exclusive authority to regulate single-stock futures, the SEC will need to pass rules in order to prevent the short sale regulation from being undermined. The new rules should not entail a simple expansion of the short sale regulation to include single-stock futures. A single-stock future is technically not a short sale, so not all of the rules within the short sale regulation would be applicable, such as the delivery requirement. In the delivery requirement, the short seller has three days after the sale to deliver the stock to the buyer.[160] However, in a single-stock future, the selling party either delivers on the settlement date or never delivers due to the cash settlement agreement. In both scenarios, the selling party never delivers on the date the single-stock future is created, and quite possibly may not deliver within three days after the sale.

Rather than expand the scope of the short sale regulation to apply to single-stock futures, a better alternative would be to take certain aspects of the regulation and apply them to single-stock futures. There are three aspects that, if applied to single-stock futures, will prevent the undermining of short sale regulation.

First, the SEC should raise the margin requirement for single-stock futures. Under the current regulation, the margin requirement for single-stock futures is 20%, whereas the margin requirement for securities trading is 50%. Since a single-stock future can produce the same economic outcome as a short sale, the transaction costs for both need to be equal. If there is a difference in the transaction costs, then investors may stop conducting short sales and turn to single-stock futures. Once investors turn to single-stock futures, the SEC's short sale regulation will not apply to those transactions. However, if the SEC were to raise the margin requirement to 50%, then single-stock futures would become a less attractive alternative to short selling. Hence, the increased margin requirement would remove one of the incentives of entering into a single-stock future instead of conducting a short sale. Thus, the increased margin requirement would assist in preventing investors from escaping the SEC's short sale regulation.

Second, the SEC should ban investors from entering into a single-stock future once Rule 201 has been activated.[161] Since a single-stock future creates the economic equivalent of a short sale, when short sales are encountering tightened regulation, investors could turn to single-stock futures to avoid the regulation. In order to prevent such a strategy, single-stock futures must also be faced with tightened regulation during this very period.

The tightened regulation the SEC should impose on single-stock futures should not be an exact replica of the short sale restrictions during the activated period. Unlike a short sale, the sale in a single-stock future does not occur until a future date. At this future date, the national best bid may be different from the national best bid on the date when the single-stock future was created. Hence, it cannot be known whether the single-stock future, at the time the parties entered into the agreement, will satisfy the national best bid requirement. Thus, the national best bid requirement of Rule 201 is not adaptable to single-stock futures.

An alternative rule for the SEC could be to require the parties to create the single-stock future so that the sale price would be the national best bid at the time of the settlement. However, such a rule contains a flaw. The selling party would be in a position of zero risk because the national best bid will always be greater than the market price of the stock. Hence, the seller in such a single-stock future would always be in a profitable position because the buyer would be forced to purchase the underlying stock at a price greater than the market price. As a result, no rational buyer would enter into such a single-stock future.

Instead of having a rule where the buyers are forced to protect themselves, the better alternative for the SEC would be to ban investors from entering into a single-stock future once Rule 201 has been activated. This rule would satisfy the goal of protecting the SEC's short sale regulation by preventing investors from turning to single-stock futures instead of short sales during the activation period. In addition, this rule is able to protect the short sale regulation without putting the buyers of the single-stock futures at risk.

Lastly, the SEC should require the parties to have possession of the underlying stock before entering into the single-stock future. This requirement creates two benefits. First, the possession requirement would increase the transaction cost of conducting a single-stock future because an investor could no longer avoid the cost of acquiring or borrowing the security. Hence, a single-stock future would become a less attractive alternative to a short sale. Second, the possession requirement would prevent the theoretically unlimited supply of short positions, which can be used to manipulate the market.[162] Through requiring possession of the underlying stock, the amount of single-stock futures will be limited to the amount of stock issued by the corporation. As a result, there will no longer be a theoretically unlimited supply of short positions through single-stock futures. Due to the limited supply of short positions, it will become more difficult for an investor to reach high levels of short positions, and thus more difficult for him to manipulate the market through single-stock futures. Hence, such a rule would further strengthen the SEC's regulation of naked short selling and market manipulation.

VIII. Conclusion

Over the years, the SEC has been refining its short sale regulation to better serve its goal of investor protection. One way the SEC has achieved this goal is through preventing market manipulation.[163] However, the very regulation that the SEC uses to protect investors from abusive short sellers is in jeopardy due to single-stock futures.

Single-stock futures could be used to undermine short sale regulation unless new rules are passed that change the regulation of single-stock futures. But, under the dual regulatory system of the CFMA, the SEC and the CFTC would most likely have a difficult time agreeing upon any new rules. Hence, the SEC must be given plenary authority over single-stock futures in order to prevent the undermining of its short sale regulation.

Further, once the SEC is granted this authority, it should pass the following regulations: (1) increase the margin requirement for single-stock futures; (2) ban investors from entering into a single-stock future once Rule 201 has been activated; and (3) require investors to have possession of the underlying stock before entering into the single-stock future. If the SEC were to pass these regulations, then the several advantages single-stock futures had over short sales would be removed. Thus, these suggested rules would prevent an investor from using a single-stock future to perform an action he could not perform under short selling, which, as a result, will help preserve the SEC's short sale regulation.

Endnotes

1. *See* Jeana Bisnar, *100% Capitalist, 90% of the Time: The 20 Day Short-Sale Ban*, 66 N.Y.U. Ann. Surv. Am. L. 299, 302 (2010).
2. *See* Roberta S. Karmel, *Bowing to Political, Media Pressure SEC Issues New Rules on Short Sales*, N.Y. L.J. 1, 3 (Apr. 15, 2010).
3. Melissa W. Palombo, *Why a Short Sale Price Test Rule Is Necessary in Today's Markets*, 75 Brook. L. Rev. 1447, 1448 (2010).
4. *Id.*
5. *Id.*
6. *See* Douglas M. Branson, *Nibbling at the Edges—Regulation of Short Selling: Policing Fails to Deliver and Restoration of an Uptick Rule*, 65 Bus. Law. 67, 68 (2009).
7. *See* Eric J. Pan, *Single Stock Futures and Cross-Border Access for U.S. Investors*, 14 Stan. J.L. Bus. & Fin. 221, 221 (2008) ("[Single-stock futures] are futures contracts based on the shares of individual companies.").
8. *Id.* at 238 ("[Single-stock futures] allow the investor to take…short positions on the stock.").
9. 17 C.F.R. § 242.200(a) (2010).
10. Scott Rothbort, *The Street, How Short Selling Works*, The Street (Oct. 8, 2007), http://www.thestreet.com/story/10383365/1/how-short-selling-works.htmlwww.thestreet.com/story/10383365/1/how-short-selling-works.htmlwww.thestreet.com/story/10383365/1/how-short-selling-works.html.
11. *See id.*
12. *Id.*

13. *See id.*

14. Long Position, Investor Glossary, http://www.investorglossary.com/long-position.htm (last visited Mar. 16, 2012).

15. *Id.*

16. Bisnar, *supra* note 1, at 303.

17. *See id.* at 302–03.

18. *See* Palombo, *supra* note 3, at 1454–55.

19. *Id.* at 1454 (quoting Jonathan R. Macey, *Restrictions on Short Sales: An Analysis of the Uptick Rule and Its Role in View of the October 1987 Stock Market Crash*, 74 Cornell L. Rev. 799, 800 (1989)).

20. *Id.* at 1455.

21. *See id.*

22. *See id.* at 1458.

23. *Id.*

24. Kevin A. Crisp, *Giving Investors Short Shrift: How Short Sale Constraints Decrease Market Efficiency and A Modest Proposal for Letting More Shorts Go Naked*, 8 J. Bus. & Sec. L. 135, 139 (2008).

25. *See id.*

26. *See* Bisnar, *supra* note 1, at 305.

27. Crisp, *supra* note 24, at 139.

28. Bisnar, *supra* note 1, at 305–06.

29. *Id.* at 306.

30. Palombo, *supra* note 3, at 1458.

31. *Id.* at 1459.

32. Bisnar, *supra* note 1, at 307.

33. *Id.* at 306.

34. *See id.*

35. Palombo, *supra* note 3, at 1459.

36. *Id.*

37. John C. Coffee, Jr. & Hillary A. Sale, Securities Regulation Cases and Materials 650 (Robert C. Clark ed., Foundation Press 11th ed. 2009).

38. *See* Palombo, *supra* note 3, at 1460.

39. Coffee, *supra* note 37, at 650.

40. Kay A. Gordon, *Regulation of Short Selling in the U.S.*, 43 Rev. Sec. & Commodities Reg. 179, 180 (2010).

41. Coffee, *supra* note 37, at 650.

42. *Id.*

43. *Id.* at 651.

44. Gordon, *supra* note 40.

45. Coffee, *supra* note 37, at 651.

46. Palombo, *supra* note 3, at 1467.

47. *Id.*

48. *Id.*

49. Erik R. Sirri, *Regulatory Politics and Short Selling*, 71 U. Pitt. L. Rev. 517, 528 (2010).

50. Branson, *supra* note 6, at 81.

51. *Id.*

52. *Id.* at 82.

53. Sirri, *supra* note 49, at 536.

54. Bisnar, *supra* note 1, at 332.

55. *Id.*

56. *Id.*

57. *Id.*

58. Palombo, *supra* note 3, at 1470.

59. *Id.*

60. *Id.*

61. *Id.*

62. *Id.* at 1472–73.

63. Gordon, *supra* 40, at 183.

64. Davis Polk & Wardwell LLP Client Memorandum on The SEC's New Short Sale Rule: Implications and Ambiguities, at 2 (Mar. 8, 2010) (*available at* http://www.davispolk.com/files/Publication/d03c58f9-d69e-4d99-9076-4de64d43e5b2/Presentation/PublicationAttachment/2c637f2a-5c10-466c-bfc3-5b1e-f56eaa2c/030810_Short_Sales.pdf).

65. *Id.*

66. Palombo, *supra* note 3, at 1473.

67. *Id.*

68. Short Sales, 68 Fed. Reg. 62972, 62975, 63006 (Nov. 6, 2003).

69. James W. Christian, Robert Shapiro & John-Paul Whalen, *Naked Short Selling: How Exposed are Investors?*, 43 Hous. L. Rev. 1033, 1045–46 (2006).

70. Letter from Robert J. Shapiro to the SEC Rules Comm. (Dec. 24, 2003), *available at* http://www.sec.gov/rules/proposed/s72303/rshapiro122403.htm (last visited on March 10, 2011).

71. *Id.*

72. Alexis Brown Stokes, *In Pursuit of the Naked Short*, 5 N.Y.U.J. L. & Bus. 1, 7 (2009).

73. *Id.* at 6.

74. *Id.*

75. Christian, Shapiro & Whalen, *supra* note 69, at 1046.

76. *Id.*

77. Stokes, *supra* note 72.

78. *Id.*

79. *Id.*

80. Christian, Shapiro & Whalen, *supra* note 69, at 1059.

81. *Id.*

82. Bisnar, *supra* note 1, at 305-306.

83. *Id.* at 1068.

84. *Id.*

85. Douglas M. Branson, *More Muscle Behind Regulation SHO? Short Selling and the Regulation of Stock Borrowing Programs*, 5 Va. L. & Bus. Rev. 1, 6 (2010).

86. Branson, *supra* note 6, at 77-78.

87. *Id.* at 77.

88. *Id.* at 77-78.

89. *Id.*

90. *Id.* at 78.

91. Christian, Shapiro, and Whalen, *supra* note 69, at 1072.

92. *Id.*

93. Stokes, *supra* note 72, at 48.

94. Letter from Dr. Jim DeCosta to Nancy Morris, Secretary, Securities and Exchange Commission(Sept. 27, 2006) (on Amendments to Regulation SHO) (*available at* http://www.sec.gov/comments/s7-12-06/ddecosta1993.pdf (last visited on March 24, 2012)).

95. Christian, Shapiro, and Whalen, *supra* note 69, at 1072.

96. *Id*. at 54.

97. *See supra* Part III.B for a detailed explanation of how an FTD results in the creation of artificial stock.

98. John W. Welborn, *The 'Phantom Shares' Menace*, REGULATION 52, 57 (Spring 2008), *available at* http://www.cato.org/pubs/regulation/regv31n1/v31n1-7.pdf (last visited on March 24, 2012).

99. Stokes, *supra* note 72, at 48.

100. Welborn, *supra* note 98, at 56.

101. Branson, *supra* note 6, at 78.

102. *Id*.

103. *Id*. at 80.

104. *Id*. at 89.

105. *Id*.

106. Stokes, *supra* note 72, at 51.

107. Pan, *supra* note 7, at 237.

108. *Id*. at 236.

109. *Id*.

110. *Id*.

111. *Id*. at 237.

112. *Id*. at 226.

113. *Id*.

114. *Id*. at 237.

115. *Id*.

116. *Id*. at 241.

117. *Id*. at 237.

118. *Id*.

119. Frank Partnoy, *Multinational Regulatory Competition and Single-Stock Futures*, 21 NW. J. INT'L L. & BUS. 641, 642 (2001).

120. *Id*.

121. Pan, *supra* note 7, at 236.

122. *Id*. at 237.

123. *Id*. at 244.

124. *Id*.

125. *Id*. at 243-244.

126. Partnoy, *supra* note 119 at 243-244.

127. *Id*. at 243.

128. *Id*. at 244.

129. *Id*.

130. *Id*. at 221.

131. *Id*. at 244.

132. *Id*.

133. Partnoy, *supra* note 119 at 244.

134. *Id*.

135. *Id*.

136. *Id*. at 245.

137. *Id*.

138. *Id*. at 247.

139. Parnoy *supra* note 119 at 243.

140. *Id*. at 247.

141. *Id*. at 238.

142. 17 C.F.R. §242.200(a) (2007).

143. Although it is possible that single-stock futures contain threats to other aspects of the SEC's regulation, this paper is only focused on the threats to short-sale regulation.

144. Pan, *supra* note 7, at 237.

145. *Id*. at 238.

146. *Id*. at 239.

147. *Id*.

148. Investopedia, *What are the Minimum Margin Requirements for a Short Sale Account?*, *available at*: http://www.investopedia.com/ask/answers/05/shortmarginrequirements.asp (last accessed on May 1, 2011).

149. Pan, *supra* note 7, at 239.

150. Investopedia, *The Truth About Naked Short Selling*, *available at*: http://www.investopedia.com/articles/optioninvestor/09/naked-short-selling.asp (last accessed May 1, 2012).

151. Partnoy, *supra* note 119, at 654.

152. Pan, *supra* note 7, at 256.

153. Roberta S. Karmel, *The Future of the Securities and Exchange Commission as a Market Regulator*, 78 U. CIN. L. REV. 501, 509 (2009).

154. *Id*.

155. Jerry W. Markham, *Merging the SEC and CFTC—A Clash of Cultures*, 78 U. CIN. L. REV. 537, 544 (2009).

156. *Id*.

157. Karmel, *supra* note 153.

158. Markham, *supra* note 155, at 597.

159. *Id*. (Single-stock futures face restrictions that other futures do not face, such as higher margin requirements and a "prospectus-like requirement").

160. Branson, *supra* note 6, at 79.

161. When I say the rule has been activated, I mean that there has been a 10% decline in the stock's price and the short sale regulations are being applied.

162. *See* Part V.

163. Palombo, *supra* note 3, at 1479.

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Advanced Standing Issues in Securitized Mortgage Foreclosure

By Charles H. Wallshein

In the fall of 2010, a series of revelations about foreclosure documentation irregularities hit the housing markets. The transfer of a property's title from the mortgagor (the homeowner) to the mortgagee (typically a bank or a trust) necessary for a successful foreclosure requires a series of steps established by state law. The securitized mortgage transaction adds additional steps necessary to the process and procedure required to pass "good title" to loan documents between and among participants in the transaction. Deficiencies in the transfers of loan documents may threaten the enforceability of mortgages held as securitized paper, or as it is more commonly known, RMBS.[1]

Depositions taken in a number of lawsuits by borrower-defendants uncovered the systematic robo-signing of foreclosure documents by plaintiffs and their attorneys. The irregularities consisted of "officers" of the plaintiff verifying that they had actual knowledge of the facts and circumstances when in fact they did not. Upon these revelations, the courts dismissed many of these cases without prejudice, only to have the plaintiffs correct the irregularities and commence another foreclosure action.

More recently, it has come to light that there are potentially fatal irregularities in the mortgage origination and pooling process. The impact of these irregularities could be far broader, affecting a vast number of investors in the residential mortgage-backed securities (RMBS) market.[2] These irregularities would affect already completed foreclosures, properties currently in foreclosure, delinquent borrowers and current homeowners that are in the modification process.

The lawful and enforceable transfer of interests in real estate depends on parties to the transaction being able to answer three simple questions: who owns the property? How did they come to own it? And is there another party that can make a competing claim to it? The documentary irregularities in securitized mortgage transactions and perhaps the securitized mortgage business model itself have the potential to make these three seemingly simple questions extremely complex.

Even outside a foreclosure scenario, in order for a possessor of an *interest in real property* to be able to lawfully affect title, that person or entity must have an interest under color of law. This means that parties seeking to transfer, subordinate, encumber, satisfy, modify or bring an action pursuant to their interest in real property must be able to prove that they are in fact the possessor of those rights. This is a threshold requirement that is codified and expanded by common law in all 50 states.

With reference to foreclosure of mortgages, a party seeking to enforce the rights associated with a mortgage must prove that it is a real party in interest to have "standing" in court. The Restatement of Property (Third) states:

> Only the proven mortgagee may maintain a foreclosure action. The requirement that a foreclosure action be brought only by the actual mortgagee is at the heart of the issues with foreclosure irregularities. If the homeowner or the court challenges the claim of the party bringing a foreclosure action that it is the mortgagee (and was when the foreclosure was filed), then evidentiary issues arise as to whether the party bringing the foreclosure can in fact prove that it is the mortgagee. The issues involved are highly complex areas of law, but despite the complexity of these issues, they should not be dismissed as mere technicalities. Rather, they are legal requirements that must be observed both as part of due process and as part of the contractual bargain made between borrowers and lenders.[3]

Mortgages may be enforced only by, or on behalf of, the entity that is entitled to enforce the obligation the mortgage secures. The underlying obligation in all cases is a promissory note. The mortgage is the security instrument that secures the indebtedness created by the note to the real property.

It is with the answers to these three questions that the mortgage securitization transaction creates uncertainty in the chain of title to real property. Uncertainty is caused by the transaction's lack of transparency and the blurred definitions of the participants' roles created by the agreements between them. When courts are asked to interpret these irregularities and errors, judges should analyze these transactions with an eye on the ramifications on the chain of title and the preservation of the rights of bona fide purchasers of real property.

The current scenario has resulted in extensive litigation, an extended freeze in the restructuring of residential mortgage debt, the unwinding of unrecoverable debt through foreclosure, and significant stress on bank and non-bank balance sheets arising from the substantial repurchase liability that is arising from mistakes and misrepresentations in mortgage documents.[4]

There is no question that mortgage securitization is the most efficient business model for putting responsible borrowers together with lenders. Securitization allows the distribution of risk among sophisticated investors to invest in what should be a stable and predictable income stream. Securitization also lowers the cost of the mortgage transaction to borrowers wherein economies of scale make participation accessible to a broader pool of investors. It is imperative that the mortgage securitization transaction become more transparent such that bona fide purchasers have absolute certainty and are legally protected by the chain of title of secured interests and title to the properties secured by same.

The Mortgage Securitization Transaction

In 1986, Congress changed the tax code. One of these changes was the creation of the Real Estate Mortgage Investment Conduit (REMIC).[5] A REMIC or special purpose vehicle (SPV) is an entity that is created for the specific purpose of being a tax-free pass-through for interest income generated by pooled mortgages.[6] This allowed investors to purchase shares or certificates in a mortgage pool that was only taxed once at the investor level. The REMIC rules allowed the mortgage pools to collect interest income from the pool and disburse that income to the certificate holders tax-free at the pool level. Prior to the REMIC, interest income from pooled mortgage investments were taxed twice, once at the pool level and again at the investor level.

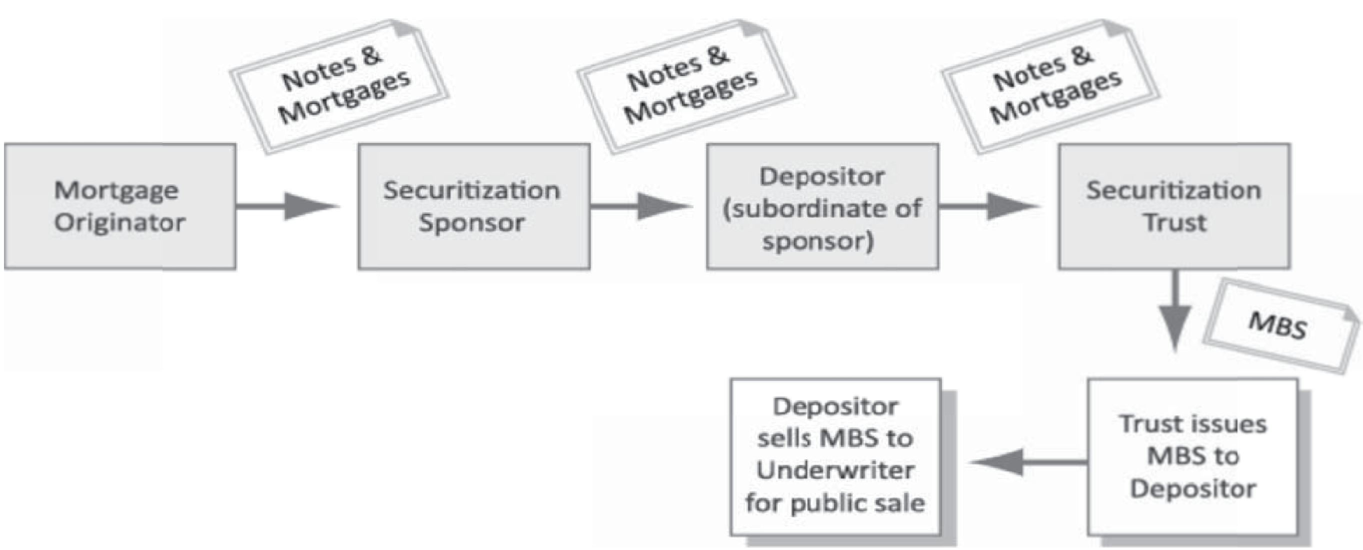
REMIC rules are very specific, and to qualify as a REMIC under federal and state tax codes, the SPV had to meet very stringent requirements.[7] With respect to RMBS the controlling trust document is known as the Pooling and Servicing Agreement (PSA). One function of the PSA is to establish the rules governing the trust such that the trust's activities and management conform to IRC 860. If the trust did not conform, it could lose its REMIC status and its tax-free pass-through status.[8]

REMIC structure allows SPVs to create tremendous efficiency in the capital markets. A secondary market was created where mortgage loans could be turned into bond-like securities and traded on an open market. The capital markets adapted quickly, and entire institutions were created to service this new financial instrument. The SPV allowed originators of residential and commercial mortgages access to capital and a competitive market where they could sell their loans. Aggregators and depositors facilitated mortgage pooling. Investment banks and commercial banks turned the mortgage pools into securities and marketed them to investors. Servicing agents monitored the loans in the pool trusts for the pool trustees.[9] Pool trustees acted on behalf of the trust certificate holders (investors).

Securitization Loan Document Flow Chart

Securitizations of mortgages require multiple transfers, and accordingly, multiple endorsements and assignments of the mortgage. Securitized mortgages were typically originated through commercial banks and mortgage banks and brokers. These are the "originators." Next they were securitized by investment banks ("sponsors"). The sponsors set up SPVs (bankruptcy-remote, tax-exempt vehicles) that pooled the mortgages transferred to them and sold interests in the income from those mortgages to investors in the form of certificates. The pools were collateralized by the borrowers' homes.

The diagram below illustrates the flow of the loan documentation in a securitized loan transaction. The flow of the documentation differs from the flow of the funds. The diagram of the flow of funds between the borrower and the entity lawfully authorized to receive funds looks somewhat different depending upon the terms set forth in the pooling and servicing agreement and various other agreements between the parties on the lender's side of the transaction. The flow of funds is addressed in the next section.



Prior to securitization most residential loans were kept in a portfolio as "whole loans." The loan was usually serviced by the institution that originated the loan. Fannie Mae and Freddie Mac[10] developed the business model of securitizing the cash flow from residential mortgages. The GSEs insured investors in securities backed by residential mortgages. The government-insured Fannie and Freddie loans, therefore, had very high credit ratings. Fannie and Freddie loans were underwritten to very strict standards.[11] In the late 1980s and early 1990s the business model expanded, and private label, non-GSE, non-insured products became available to the general public from various investment banks.

The non-GSE products could not compete with the GSE products because the GSEs had the competitive advantage of inexpensive credit directly from the U.S. Treasury and the government's guarantee that gave GSE securities an A++ credit rating comparable to a treasury bond. The non-GSE paper could be underwritten and sold via a securitization model that resembled the GSE. The most remarkable differences between GSE and non-GSE paper were the underwriting standards and the sources of credit used to fund the mortgages. Also important was the fact that the loan servicing functions were usually outsourced from the originator of the loan to a third party whose sole function and purpose was to service mortgage loans.[12]

Many of the commercial banks set up separate servicing departments that serviced the loans in the securitized pools they created. Many of these bank servicers also serviced loans for other pools they did not create. Moreover, these new institutions were charged with self-regulation and thereby literally wrote their own rules and business practices to conform to existing federal and state securities, trust, banking and real estate laws.[13]

The role of servicing agents was largely administrative. They were hired by the RMBS investors to handle all back-office functions for existing loans, and generally acted as intermediaries between borrowers and the investors. Their function could be best described as performing customer service and bookkeeping functions.

When the number of delinquencies began to rise, the role of servicers evolved from customer service and bookkeeping to include loss mitigation. Servicers found themselves responsible for processing all defaults including forbearance agreements, modifications, short sales, and foreclosures and post-foreclosure property management. The servicers themselves have admitted that they were simply not prepared for the volume of work that the crisis generated.[14]

Servicers work for and are contracted by the trustees of the trust to handle all administrative and legal functions associated with the management of the mortgage trust pool. Servicers hire outside counsel to foreclose and provide a bevy of other real estate services associated with the management of the real estate (REO) and assets of the pool.

Every mortgage transaction begins with a lender and a borrower. The lender lends money to the borrower in exchange for the borrower's promise to repay (promissory note) the loan with interest and the security instrument (mortgage)[15] that secures the note to the property. The prerequisite for the lender is that it is lending money and taking a security interest from the person(s) who actually have clean title to the property. The mortgagee wants to be assured and insured that its security interest/lien position will be superior to all others. To accomplish this, it has to do two things. First, the mortgagee has to obtain a title report and a lender's policy from a title insurance company insuring the mortgagee's first lien position, and be assured and insured of the borrower's legal ability as owner of the property to pledge the property as secured collateral for the loan.

The lender in a securitized mortgage transaction is called the "originator." The originator sells the loan (note and mortgage) to the "securitization sponsor" (sponsor). Upon sale or transfer, the mortgage is assigned to the sponsor and the note is endorsed to the sponsor. The sponsor's possession of the note without assignment of the mortgage means that the underlying debt is still valid but the mortgagee cannot foreclose because he has not been assigned rights to enforce the security agreement. Obtaining assignment of the mortgage without having possession of the note renders the mortgage completely unenforceable. Assignment of the mortgage without the underlying promise to pay is a nullity.[16]

Transfer of the Note

There are two methods by which a promissory note may be transferred, negotiation[17] and by sale contract (MLPA).[18] Transfer of notes is governed by the trust's pooling and servicing agreements (PSAs). PSAs generally contemplate transfer through negotiation. Typical language in PSAs requires the delivery to the securitization trust of the notes indorsed to the trustee or in blank.[19] For example:

> Pay to the order of ________________
>
> Without Recourse

Alternatively, a promissory note may be transferred by a sale contract, also governed by whether a state has adopted particular revisions to the UCC. In many states, in order for a transfer to take place under the relevant portion of the UCC, there are only three requirements: the buyer of the promissory note must give value, there must be an authenticated document of sale that describes the promissory note (MLPA or Purchase and Sale Agreement), and the seller must have rights in the promissory note being sold.[20]

In most securitizations the first two criteria are easily met. In nearly all RMBS transactions the transfer of the mortgage loans at each stage of the securitization involves the buyer giving the seller value and a document of sale (a mortgage purchase and sale agreement or a MLPA) that should include a schedule identifying the promissory notes involved. The MLPA is a list of all the loans sold in a particular transaction, analogous to an itemized invoice/bill of sale.

The third criterion requires an unbroken chain of title of the promissory note back to the loan's originator. Unlike assignments of mortgages that are recorded at the county clerk's office for the county in which the property is located, loan (note) sale documents (plus their schedules) are not recorded.[21] Even though the note and loan sale documents are evidence of such a chain of title, unrecorded MLPAs do not and cannot establish that the loan was not previously sold to another party. Transfers of the note in RMBS transactions are completely opaque to the general public.

Up to this point in the transaction the discussion centers on a lawful chain of possession of the note from the originator to the trust to ensure the note's enforceability by the trust. In RMBS transactions the lawful method by which the trust obtained physical possession of the note is determinate as to its lawful possession such that the trust or its lawful agents are *persons entitled to enforce* (P.E.T.E). This may seem an obvious statement; however, standing in an action to enforce the note's security agreement is complicated by the authority the entity has as a result of the terms contained not only in the note and security agreement, but also the terms contained in the pooling and servicing agreement.

The Pooling and Servicing Agreement

Prior to RMBS, lenders wrote loans that contained a note and a mortgage. After the loan funded, the originator could sell the loan to another party. The sale transferred all the rights the originator had in the loan to collect payment and also assigned the mortgage, the security instrument, so the new note owner could record the mortgage with the county clerk to afford priority of lien protection. Once the mortgage was recorded in the county clerk's office, the world was put on notice that the lien existed, the date of its existence, the amount of the lien, and the owner of the lien. Notice is the core purpose of all recording statutes.[22]

RMBS transactions had to accommodate a new set of legal issues besides notice. Residential Mortgage Backed Securities had to satisfy Internal Revenue Code § 860 to maintain tax-free pass-through status for the certificate holders. As a practical matter RMBS was efficient at very large economies of scale. The securities themselves typically contained, at minimum, hundreds of millions of dollars of mortgages and, at maximum, billions. For example, if the average loan in an RMBS was $200,000, there would be 5,000 loans in a 1-billion dollar securitization. That is a lot of loans to move from originators to the trusts, while complying with state recording statutes, proper note endorsements and the terms of the trust's PSA. Also consider that the GSEs and private label trust generated over 7 trillion (with a "T") dollars' worth of RMBS paper.

RMBS redefined the identity of the owner of the loan. The fact is that RMBS created classes of investors in RMBS pools that were entitled to receive *derivative* income depending on what class of certificate they held. So instead of having an individual or an entity owning a loan or a pool of "whole" loans, RMBS trusts split the pool income into a series of beneficial interests in the pool's income stream (and residual value) defined by the certificate class, in turn defined by the PSA. Certificate holders were segregated as to what class had what rights as to payment preference, subordinate position and rights in default (among other rights not mentioned here). Therefore, our older concept of "*A Bank*" as owner of a pool of loans controlling the disposition of their purchase, sale, servicing and administration is archaic.

The How and When

One function of the Pooling and Servicing Agreement is to govern how notes are transferred into and out of the trust. Some PSAs require a complete chain of endorsements on the notes from originator (Lender) up to the depositor, with a final endorsement to the trust in blank. The critical function is to ensure that the loans were deposited into the trust before the trust cut-off date or closing date.[23] IRC § 860(d) states that in order to have lawful tax-free status, the loan must be deposited into the trust within 90 days of the trust's *start-up date*. This is known as the *cut-off* date. The law is clear; if the loan was not lawfully deposited in the trust before the cut-off date, the trust cannot claim the income stream from that loan with tax-free pass-through status. The trust would have to pay an income tax penalty on the income from that loan.

Every RMBS trust's PSA recites the IRC §860(d) requirement for depositing loans into the trust before the cut-off date. By the terms of the PSA itself, the trust cannot accept any loans into the trust in any manner other than as defined in the PSA. If the trust or its agents violate the terms of the PSA, the investors may have a right to treat that act as an *ultra vires* act by the trust, triggering liability to the servicers and the Trustees. From this point forward it is necessary to understand the relationship between the entity that has authority to act on behalf of the trust and the entities that rely on those acts as bona-fide possessors *of interests in real property*.

The Who

The person or entity that has authority to make lawful transfers of the note and mortgage within the RMBS varies depending on at what stage of the transaction the transfer was made. The transfer 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. 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 upstream holder of the note and mortgage must rely on the proper and lawful transfer of those documents throughout the chain of possession and title.[25]

Collateral attacks on the validity of transfer of notes and mortgages may be made, and are being made, by third parties to the PSA. There are divergent holdings from various courts as to who has standing to object to violations of the PSA committed by servicers, trustees, originators, document custodians, nominees and other parties with privity to the PSA.[26] The bases for these attacks are that the unlawful transfers in the chain of possession/title would open certain parties to tax liability, trigger indemnification rights within the trust, create litigation, create the possibility of a *put back,* affect the value of the security, affect the marketability of title to the underlying collateral, allow exposure to claw-back in a bankruptcy, affect the rights of junior lien holders, and unleash a torrent of title claims as to transfers of real property through foreclosure proceedings.[27]

Governing Law

Most PSAs are governed by New York law and create trusts governed by New York law.[28] New York trust law requires strict compliance with the trust documents; any transaction by the trust that is in contravention of the trust documents is void, meaning that the transfer is an *ultra vires* act and may be unlawful. Pooling and Servicing Agreements are also unrecorded and unavailable to the general public.[29] Within the RMBS transaction, the general public has no way to know if a note actually is owned by the entity that is foreclosing. This information is privy only to the servicer, the trustee and the document custodian who derive their rights, authority to act and role in the transaction from the terms contained in the PSA.

In the absence of an agreement otherwise, the requirements governing the transfer of documents are contained in Pooling and Servicing Agreements.[30] However, parties are free to contract out of the Uniform Commercial Code and provide other terms and requirements for transfer of notes by agreement. Many RMBS PSAs contain contractual document transfer provisions that do not follow the Uniform Commercial Code.

Flow of Funds and the Role of the Servicer

RMBS loans and the rights to service them often are bought and sold. In many cases, the company that you send your payment to is not the company that owns your loan. The flow of funds from mortgage payments goes from borrower to servicer to trust to investor. The servicer is responsible for making sure that the real estate taxes are paid, the hazard insurance policy is paid and the certificate holders are paid.

In most cases the servicer is a bank with a nationally recognized name. Besides engaging in commercial banking, these banks service loans. It is a common misconception among borrowers that because “BANK A” is a bank, “BANK A” is the lender or owner of their loan. When the borrower makes monthly payment to “BANK A,” it is more likely than not that “BANK A” is acting only as a servicer for the trust (or one of the trust’s successors or assignees) where the loan was securitized. In a typical RMBS, “BANK A” could be the originator of the loan, and the trustee of the loan, as the loan’s servicing agent. “BANK A” could wear all three hats, two of the three, or one of the three. In any event, “BANK A” is not the “owner” of the loan within the meaning of the term as it relates to RMBS. It is the trust certificate holders that “own” the loans, or at the very least, the beneficial interests from derivative portions of those loans. The trust is the title owner of the notes and mortgages, and the certificate holders own beneficial interests to receive income from the loans. Meanwhile, it is only the servicing agent that is visible to the world and that holds itself out as the entity that has authority to act on behalf of the trust and the certificate holders.

The Scope of the Problem

There are approximately 40 million securitized loans in the United States, representing an amount in excess of 7 trillion dollars. In the RMBS scenario a single loan may have been transferred among various institutions several times from the time it was originated to where it allegedly lies now. It became apparent to RMBS market participants that their recording fees with the “ink & paper” recording process would become very costly. The reason given as their “official statement” is that the various county clerks’ offices could not accommodate RMBS’s need for the rapid and multiple transfers of loan documents that these transactions require. Their response to the “inadequacy” of the “ink & paper” process was to devise their own systems and processes that could handle the volume of transactions at tremendous speed. However, the ability of these processes and procedures to handle volume with speed came at the expense of transparency and notice within the [recorded] chain of title of the documents required by state recording statutes. Electronic registration (MERS loans) and tracking of mortgage documents by and among RMBS market participants created transfers that were invisible to the general public.[31]

Most of the internal transfers of RMBS paper are not recorded where the transfers are visible to the general public. The transfers lack transparency, and therefore any deviation from state law or from the rules governing such transfers in the pooling and servicing agreement could subject the transfer to attack by any number of parties to the transaction, including parties that had no connection to the original transaction.[32]

Marketable title is the foundation of the real estate market.[33] Owners of properties that are encumbered by RMBS mortgages could find that they cannot transfer marketable title. Purchasers could find that they cannot get financing on a property that was encumbered by RMBS paper. Junior lien holders, such as those holding second mortgages and home equity lines of credit, may not be able to protect their positions. In short, the validity of the security interest that depends on the lawful transfer of the note could be in question for every RMBS loan.

A larger and more perplexing question arises when it is determined that the trust acted *ultra vires.* If the trust has no authority over the note and mortgage, who does? The rightful owner of the note would be found by tracing the chain of possession in reverse chronology to the last lawful owner. In this scenario two things would happen. Pursuant to the *representations and warranties* contained in the PSA and the MLPA, the loans could be *put back* to their original owners. The trusts would be reimbursed[34] by the sponsors. This could create liability to the sponsoring entities to the tune of hundreds of billions of dollars. Very often the last lawful owner of the note is either defunct, bankrupt or has been absorbed by one of the large commercial banks. If the certificate holders cannot obtain recourse on *ultra vires* loans, they will have to absorb the loss themselves.

The "ink & paper" recording system provides actual notice to the world of a party's interest in real estate. Once the paperwork was properly recorded, the entity with *an interest in real estate* (such as a deed or a mortgage) had assurance that its recordable interest was protected by law as to priority over other competing interests. RMBS changed all of that. RMBS added another layer, an invisible layer, outside of the chain of title, outside the recording system, that defeated the recording system and made opaque the chain of lawful possession of *interests in real estate.*

From a practitioner's point of view, as long as transfers of *interests in real estate* are dependent upon the terms of a pooling and servicing agreement, the lawful chain of title may be affected by any entity that has acted under the alleged authority of a PSA anywhere in the chain.

In the "old days" the check a person (seller, purchaser, title company etc.,) received at closing was signed by a person with "wet ink." The person signing the check was an officer of the lender or a person (such as a bank attorney) who had actual written authority to act on the lender's behalf. When the mortgage was assigned from one lender to another, or the mortgage was modified, or satisfied, it was done by a person with actual authority to do so who signed his or her name in "wet ink" on the document that affected an *interest in real estate*. If that document needed to be recorded with the county clerk, the entity did so right away so as to protect that entity's lien position pursuant to the jurisdiction's "race" aspect of the recording statute.[35]

In RMBS transactions, not only do lenders and upstream transferees of *interests in real estate* have to conform to the "wet ink" requirements of the recording statutes, they also have to conform to the terms contained in the PSAs that govern the transfer of documents into and out of the trusts. An attack upon the transfer of loan documents based on *ultra vires* acts of the trust will render those transfers unlawful and void as a matter of law. The result seems potentially catastrophic to secured lenders, and it very well may be. Entities that took title to *interests in real estate* could possibly lose their status or their position as *bona fide purchasers.*

As a matter of law in all 50 jurisdictions, an entity cannot take a better *interest in real estate* than the entity had that granted it. If a person does not have good title, he or she cannot pass good title. This law is not something invented here in the United States within the last few hundred years. This is "ancient law" dating back to Rome. This is why every real estate transaction in the country is (or should be) insured with title insurance to the owner by a fee policy and to the lender by a lender's (or mortgage) policy.

Practical Matters

As a practical matter, collateral attacks on the chain of title of *interests in real property* are not an invention of creative attorneys representing certificate holders seeking to *put back* non-performing loans. Nor are these attacks an invention of crafty foreclosure defense lawyers seeking to find a loophole in a foreclosure proceeding to protect homeowners. Failures in accurate and transparent recordkeeping that are consistent with recording statutes and *bona fide purchaser* law are already creating litigation and will continue to do so. It is apparent that the custodians, servicers and trustees charged with the lawful transfer of RMBS loan documents between and among RMBS participants did so without regard to the preservation of the *bona fide purchaser* status of downstream possessors of those interests.

We are now at the stage where RMBS foreclosure plaintiffs are forced to rely on contortions of the Uniform Commercial Code, securities law, trust and estates law, the incident-precedent rule and real property law to maintain standing in foreclosure actions. None of this would be necessary if RMBS participants were not in such a rush to "get their deals done" and cash in on their securitizations. There is nothing wrong, unlawful or illegal with the theoretical structure of the RMBS transaction. The practical problem is that RMBS participants simply did not follow their own rules, to the detriment of *interest in real property* ownership principles that span two millennia. How our legal system addresses this widespread failure on a county by county level will determine the quality and reliability of our recorded land records for the foreseeable future of our State and Nation.

Endnotes

1. Residential Mortgage Backed Securities.
2. RMBS are securities that were sold in the Over-the-Counter "OTC" stock market as "Pink Slips."
3. Restatement (Third) of Property: Mortgages § 5.4(c) (1997).
4. In the fall of 2010, a series of revelations about foreclosure documentation irregularities hit the housing markets. The transfer of a property's title from the mortgagor (the homeowner) to the mortgagee (typically a bank or a trust) necessary for a successful foreclosure requires a series of steps established by state law.
5. *See* 26 U.S.C. § 860 (2012).
6. SPVs are considered to be limited to self-amortizing mortgages that do not require active asset management for income flow.
7. IRC 860 requires that, among other things, the REMIC trust be a "closed entity" and "bankruptcy remote." New York's Estate Powers & Trust laws were chosen by RMBS sponsors (in the PSAs) as the "controlling" statutes to govern REMIC trusts, as the EPTL's rules and concomitant common law establish "common law trusts" that conform the REMIC tax free pass-through requirements.
8. If a tax-free pass-through trust lost its REMIC status, the tax penalties to an investor that purchased certificates would be devastating. It would also trigger an event called a "put back." There was considerable argument over whether these trusts were "business" trusts or common law trusts, but the trend appears to be a judicial recognition that they are in fact common law trusts.
9. Servicer duties include customer service for borrowers, collecting mortgage payments from the borrowers, and remitting mortgage payments to the trust.
10. Fannie Mae and Freddie Mac are known as Government Sponsored Entities (GSEs).
11. The requirements for loan-to-value, debt-to-income ratio, credit score, and loan limits, deposit sourcing, income verification, etc., were uniform for GSE products of each particular type.
12. Servicers were paid a fee of 25 basis points (.25%) of the loan to service the loan. Mortgage loans became easier to service with the use of specialized software developed specifically for loan servicing. The system was very profitable because it had become largely automated, with very little need for human interaction and the associated labor costs.
13. To meet these requirements the SPVs were created as trusts. More than 95% of the SPVs were created pursuant to New York State Trust law as "common law trusts."
14. Congressional Oversight Panel, *March Oversight Report: Foreclosure Crisis: Working Toward a Solution*, at 39 (Mar. 6, 2009) (hereinafter "March, 2009 COP").
15. New York and other lien theory states have mortgages where the borrower retains legal title to the property. In other states with title theory there is a deed of trust where the borrower retains an "equity/right of redemption."
16. Carpenter v. Longan 83 U.S. 16 Wall. 271 (1872). Carpenter established the rule that the security interest necessarily follows the promissory note, and a security interest is a nullity without the underlying promise to pay.
17. "Negotiation" is the signing over of individual promissory notes through endorsement, pursuant to UCC §§ 3-201, 3-203.
18. MLPAs (Mortgage Loan Purchase Agreements) are also known as Purchase and Sale Agreements (not to be confused with Pooling and Servicing Agreements). Sample in hyperlink: http://agreements.realdealdocs.com/Mortgage-Agreement/MORTGAGE-LOAN-PURCHASE-AGREEMENT-2067437/.
19. Usually the onus is on the Trustee or Servicer to complete the endorsements in the funding window.
20. Pursuant to UCC § 9-203(a)-(b).
21. Mortgages and assignments of mortgages are recorded with the county clerk. Promissory notes are not. There is no public record of the chain of possession for promissory notes and their allonges.
22. Actual Notice is deemed given upon delivery to the county clerk for recording. Recording covers the "race" aspect of the recording statute. The "notice" requirement for a *bona fide purchaser* relies on the person or entity taking title without "constructive notice" of a defect.
23. 26 U.S.C. § 860D (2012) states: *REMIC Defined:*

    (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) <u>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,</u>

    (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)).

    (b) Election. (1) In general.

    An entity (otherwise meeting the requirements of subsection(a)) may elect to be treated as a REMIC for its 1st taxable year. Such an election shall be made on its return for such 1st taxable year. Except as provided in paragraph (2), such an election shall apply to the taxable year for which made and all subsequent taxable years.

"Section 5 of Article One of the Tax Law exempts the REMIC from taxation. An entity that is treated for federal income tax purposes as a real estate mortgage investment conduit (REMIC), as such term is defined in IRC Section 860 D, shall be exempt from all taxation imposed or authorized under the tax law, upon its capital stock, franchises or income. A REMIC shall not be treated as a corporation, partnership or trust for purposes of the tax law. The assets of a REMIC shall not be included in the calculation of any franchise tax liability under the tax law. This provision does not exempt the holders of regular or residual interests from tax." *New York's REMIC Tax Law*, New York State Department of Taxation and Finance, http://www.tax.ny.gov/pdf/memos/multitax/m87_22c_22i.pdf (last accessed Apr. 26, 2012).

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 Facts for Consumers*, Federal Trade Commission, http://www.ftc.gov/bcp/edu/pubs/consumer/homes/rea10.shtm) (last accessed Apr. 26, 2012).

25. Under either the terms of the trust, the contracts between the parties or UCC § 9 would require the chain of title by the foreclosing entity to be qualified as a "PETE" (person entitled to enforce). In other words, single endorsements in blank, and claiming that any party in possession of a note, can enforce a note, even a thief, does not work.

26. With particular reference to foreclosure proceedings, opinions from courts diverge as to whether borrowers have standing to raise violations of the PSA as an affirmative defense.

27. These are just a few of the ramifications, parties and actions that could be brought as a result of *ultra vires* acts of the trust.

28. N.Y. Estate Powers & Trusts Law § 7-2.4.

29. Pooling and Servicing Agreements are available on-line at the Securities and Exchange Commission's "EDGAR" website. However, these are only for publicly traded trusts that were required to file by law.

30. Sales agreements (MLPAs) are governed by the UCC, but the PSA is a trust agreement and the transfers of assets set out therein are the terms of the funding of the trust under New York law. This requires the depositor to complete the transfer in accordance with the law of gifts under the State law of New York. That requires compliance with the letter and spirit of the agreement and the steps required to effect the transfer would result in the assets being unquestionably delivered to the trustee for the particular trust by the proper endorsement of the note and the proper assignment of the mortgage.

31. Transfers pursuant to the *Mortgage Electronic Registrations System* have come under attack under numerous legal theories. The three most notable are that: The actual possession of documents in MERS is completely opaque to the general public; MERS loans are transferred without the express authority of the lender, and MERS loans bifurcate the promise to pay from the security interest at inception.

32. These parties include upstream purchasers of the financial instruments (trust certificates), successors in interest to the originators, subsequent purchasers of the collateral (real estate) and junior lien holders.

33. Marketable Title is defined as [in the ALTA 1992 form policy]:

    "[a}n 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."

    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. That said, judicial interpretation—state law—determines what does and does not constitute unmarketable title such that a purchaser could be released from its obligation to buy.

34. This would entail a reimbursement to the trust certificate holders.

35. *See* N.Y. Real Prop. § 291 (McKinney's 2012).

Charles Wallshein is an attorney admitted in the State of New York. Mr. Wallshein acts as outside counsel to small and mid-cap community and thrift institutions in reviewing loan portfolios with reference to regulatory issues affecting loan valuation. He is a partner of Asset Quality Solutions, a banking consulting and information technologies firm that focuses on asset valuation methodologies, policies and procedures governing management information systems. He is a member of the Nassau County and New York State Bar Associations.

Committee Reports

From the Section Chair

As the following reports from the individual Committee chairs demonstrate, 2012 has been off to an active start. Developments at the Section level have been no less dramatic, as our membership has benefited from, among others, the following initiatives:

1. The Section was successful in gaining the support of the NYSBA as a whole through a unanimous vote supporting our proposed State legislation allowing permissive electronic shareholder meetings and voting, in lieu of the pending proposal which would make these changes compulsory. We are continuing to urge passage of our proposal.

2. In March the NYSBA held a successful cross-border CLE program with the Ontario Bar Association, with meetings taking place in both Toronto and Buffalo. As a Program coordinator, I was especially pleased that presentation proposals by two of our Section members were selected for the program.

3. In April the Bankruptcy Law Committee sponsored a special event at the Cornell Club honoring the new Bankruptcy Judges.

4. Our efforts at encouraging diversity in membership continued apace, with outreach programs at law schools led by Anthony Fletcher, our E.C. Diversity subcommittee chair.

5. The Section now has a blog up and running on its website (members can access it at http://nysbar.com/blogs/businesslaw/). Any Committee chair (or his or her designee) can post items of general interest to the blog, and we expect it to gain momentum as additional Committee Chairs begin to make use of it.

6. The Section supported the NYSBA by-law change creating a House of Delegates representative for the Sections.

7. We formed an Executive Committee task force to liaise with the NYSBA Task Force on New York Law in International Matters committed to work for the continued presence of New York and New York law as the priority location and law for international business and finance law.

8. We initiated a committee membership campaign to Section members who have evidenced an interest in a particular area of business law, but have not joined a committee.

9. We had a great turnout for our January 25, 2012 Annual Program with the main speaker being Hon. Jed Rakoff, USDC/SDNY, recounting his personal experiences seeing ethical decisions made by others and what followed.

10. And last, but not least, we had a well-attended annual Spring Meeting in May at the Harvard Club. A special feature was the awarding of prizes to the winners of the annual Student Writing Competition for the *Journal* at the membership luncheon (see HeadNotes on p. 5). We have a new slate of officers, headed by incoming Chair Deborah Doxey of Phillips Lytle LLP, which took office June 1, 2012, bringing our terms of office back into conformity with other Sections.

On a personal note, this being the end of my term, I thank each of you who supported the Section's and its committees' efforts over the past 18 months. It is truly a voluntary association and I know that because each of you has volunteered your time and experience, especially our Committee Chairs who made time in their busy lives to provide vital leadership; as I step down as Chair, there will continue to be a vibrant and effective Business Law Section.

Paul H. Silverman, Esq.
Outgoing NYSBA BLS Chair

Banking Law Committee

The Banking Law Committee held a meeting as part of the New York State Bar Association's Annual Meeting in New York City in January. The Committee heard presentations from Michael V. Campbell, Counsel and Assistant Vice-President at the Federal Reserve Bank of New York ("FRBNY"), and Roberta Kotkin, General Counsel, Chief Operating Officer, and Corporate Secretary of the New York Bankers Association ("NYBA").

Mr. Campbell, who has served a pivotal role in the start-up of the Consumer Financial Protection Board within the Federal Reserve System, as mandated by

2010's Dodd-Frank reform law, compared Pennsylvania's Homeowner's Emergency Mortgage Assistance Program ("HEMAP"), begun in 1983 in response to steel industry layoffs of that decade, with the federal government's home loan extension program. He explained that the FRBNY would be approaching the Banking Law Committee for its support to enact a similar legislative proposal for New York that would provide a bridge loan in response to specific types of financial hardship such as a temporary loss of income, where there is a reasonable expectation that the person will shortly be able to resume making mortgage payments, including repaying the State's bridge loan.

Ms. Kotkin described the continuing implementation of the merger of the New York State Banking Department and the New York Insurance Department into the Department of Financial Services. She highlighted the authorizing legislation's emphasis on improving the state banking charter, commitments to increase resources, and the specialization of consumer protection in other agencies.

She also described the NYBA's efforts with respect to various pieces of legislation proposed to broaden the definition of financial fraud, to reduce the escheat period from five to three years, to permit the electronic recording of real estate instruments, and to impose greater burdens on banks that foreclose properties.

At the Section's Spring Meeting the Banking Law Committee held a well-attended meeting, featuring Jonathan Rushdoony, regional counsel of the Office of the Comptroller of the Currency ("OCC"), and his colleague, James Porreca, who was formerly counsel to the Office of Thrift Supervision ("OTS"), which was abolished under the Dodd-Frank reform law with its functions merged into other bank regulatory agencies. Messrs. Rushdoony and Porreca discussed the progress made in transitioning the supervisory authority for federal thrift institutions to the OCC. The meeting also featured a presentation by Mark Zingale, Esq., Senior Vice President and Deputy General Counsel to The Clearing House. Mr. Zingale described the functions of The Clearing House, which represents its 20 large bank members, and discussed the outstanding exposure draft on corporate governance practices for banking organizations. Attendees received two CLE credits.

David L. Glass, Esq.

Bankruptcy Law Committee

The Bankruptcy Law Committee held a reception for the new Bankruptcy Court Judges on Thursday, April 5, 2012 at the Cornell Club in New York City.

Norma E. Ortiz, Esq.

Corporations Law Committee

The Corporations Law Committee met on January 25 during the New York State Bar Association Annual Meeting. Jeffrey Bagner of Fried, Frank, Harris, Shriver & Jacobson LLP led a discussion on shareholder rights plans, with an emphasis on New York and Delaware corporations. At the Spring Meeting of the Business Law Section held on May 9, the committee held two panel discussions: a panel entitled "M&A Market Update," chaired by Richard De Rose of Houlihan Lokey, and a panel entitled "Cybersecurity and the Ethical Rules Around the Use of Technology," chaired by Adele Hogan of Cadwalader, Wickersham & Taft LLP. Two hours of NY CLE credit were provided, including one hour of ethics CLE credit.

One of the committee's functions is to review pending legislation that affects corporations and other legal entities. The committee has recently held discussions with a New York State Assemblyman who has sponsored a bill to amend the New York Business Corporation Law to require that New York-incorporated publicly traded corporations hold shareholder meetings electronically and allow shareholders to vote at these meetings electronically. New York State would become the first U.S. jurisdiction that would mandate that shareholder meetings and voting be conducted electronically. The committee has prepared its own version of an amendment to the New York Business Corporation Law, consistent with the approach taken by many other states, that would permit, but not mandate, New York incorporated publicly traded corporations to hold shareholder meetings electronically and to allow voting at these meetings electronically. The Executive Committee of the New York State Bar Association has endorsed the committee's position.

Jeffrey Bagner, Esq.

Derivatives and Structured Products Law Committee

The Derivatives and Structured Products Law Committee kept its members informed of the constantly changing Dodd-Frank regulatory proposals to reshape the industry's structure, eligible participants, trading, clearing and valuation. The committee heard from Securities and Exchange Commission staff members on securities-based swaps and clearing issues and from leading attorneys on netting arrangements on changes overseas and segregation and posting of customer swaps collateral under Dodd-Frank, and the committee provided robust opportunities for members to share ideas amongst themselves. In this more participatory forum, constituent input helped shape the direction of this valuable committee on a variety of other relevant topics, including the proposed 871(m) regulations from the Treasury regarding dividend payments, as well as the Foreign Account Tax Compliance Act.

Daniel N. Budofsky, Esq.

Franchise, Distribution and Licensing Law Committee

The committee has been very active. At its most recent meeting, in January 2012, the committee heard from Mr. Joseph Punturo, the Franchise Section Chief for the New York Department of Law, on the recently promulgated Trade Show Exemption under Section 684(1) of the New York Franchise Act and procedures for applying for exemptions under the New York Franchise Act, including discretionary exemptions, and discussed the committee's proposed amendments to the New York Franchise Act and its accompanying regulations to make the Act more business friendly and consistent with the Federal Franchise Rule, which was amended in 2008.

Committee Chair David W. Oppenheim and member Andre R. Jaglom took part in a panel discussion in Buffalo, New York at the Ontario-New York Legal Summit, a joint two-day CLE program sponsored by the New York State Bar Association and the Ontario Bar Association. The session focused on structuring franchise systems and alternative distribution models in the United States and Canada.

David W. Oppenheim, Esq.

Insurance Law Committee

In conjunction with the Annual Meeting of the New York State Bar Association in New York City, the Insurance Law Committee met at the New York Hilton on January 25, 2012. The principal discussion was of the current regulatory inquiries and enforcement proceedings regarding escheat of unclaimed life insurance proceeds and death benefit payment practices, and included a presentation on that topic by former New York Superintendent of Insurance Eric Dinallo, now of Debevoise & Plimpton LLP.

Thomas M. Kelly, Esq.

Legislative Affairs Committee

The Legislative Affairs Committee has been working with the Corporations Law Committee, former Section Chair Paul Silverman, and the Bar Association's legislative staff to propose an alternative to the Senate and Assembly bills that would require New York corporations that are public companies to permit shareholders to participate and vote remotely by means of electronic communications. An alternative draft bill which, among other things, would enable but not require New York corporations to offer remote participation, was submitted to Assemblyman Kavanagh's office, and on February 29 we had a conference call with Assemblyman Kavanagh to discuss his bill and our proposed alternative. The Committee continues to monitor proposed legislation of interest to Business Law Section members.

Peter W. LaVigne, Esq.

Membership Committee

This year the Membership Committee made great strides in encouraging New York State Bar Association members to join the Business Law Section. We reached out to business lawyers who did not have memberships, whose memberships had lapsed, or who had not focused on renewing their memberships. A personal reminder was often helpful in getting people to renew their memberships. We look forward to increasing membership numbers even further in the coming year.

Ilene K. Froom, Esq.

Public Utility Law Committee

The Public Utility Law Committee is in the process of transitioning to a new Board and exploring topics of interest for a 13th Annual Institute on Public Utility Law likely to take place later this year. It is likely to include a full-day continuing legal education course, with faculty from in-house corporate counsel, government agencies and leading law firms. Curricula being explored involve the latest developments in the areas of energy and telecommunication regulation and practice.

Deborah M. Franco, Esq.

Securities Regulation Committee

The Securities Regulation Committee has continued its monthly meeting programs addressing a wide range of matters of importance to securities law practitioners. Our dinner meetings tend to foster lively discussions, and afford Committee members an opportunity to discuss "hot topics" with persons closely associated with them. Since our last Committee report in the Winter 2011 issue of this *Journal*, among the topics presented at meetings were:

1. Recent Accounting/Auditing Developments that Lawyers Need to Know
2. The SEC's New Rule on Large Trader Reporting and new Form 13H: With Filing and Compliance Deadlines Looming – Are you ready?
3. What's New From FINRA
4. Developments in PIPES, Registered Directs and Other Capital Raising Techniques
5. ISS 2012 Proxy Voting Guidelines and Preparing for the Upcoming Proxy Season
6. What You Don't Know About OTC Markets (formerly known as Pink Sheets)
7. Ethics Issues for Swap and Other Lawyers
8. Blue Sky and Investment Advisers 2012

9. Early Reports of the 2012 Proxy Season and Shareholder Activism: Things are Heating Up

10. Crisis Communications: From FBI Raids to DWI

11. Crowfunding—making it easier for entrepreneurs to obtain capital or for fraudsters to fleece grandma?

12. CFTC Final Rules Amend Commodity Pool Operator and Commodity Trading Advisor Registration and Compliance Obligations: some exemptions retained but more advisors will need to register

In addition, our Private Investment Funds Subcommittee held a meeting in February 2012, which I titled the "Alphabet Soup of Forms For Investment Advisers Plus Some of the Latest Developments." We covered issues relating to a seeming alphabet soup of forms applicable to advisers (e.g., Treasury's TIC Forms SLT and SHC, Bureau of Economic Analysis BE forms, and SEC Form ADV). The Subcommittee closely tracks developments and emerging trends in the private investment funds industry.

For more information about, and how to join, the Securities Regulation Committee and Private Investment Funds Subcommittee, go to the website www.nysba.org/SecuritiesRegulation or www.nysba.org/PIF. We are also on LinkedIn at www.nysba.org/SecuritiesRegulationLinkedIn or www.nysba.org/PIFLinkedIn.

Howard B. Dicker, Esq.

Technology and Venture Law Committee

The Technology and Venture Law Committee (TVLC) is continuing to have an exciting year. We held the second in our "Beyond the Basics" program series focused on core principles of counseling and representing technology startups. The series started in May 2011 with "NY Tech: the VC View," where a panel of industry and legal experts shared their views on the current state of venture capital funding for technology start-ups. Our second event, Personnel Pitfalls and Solutions for the Early-Stage Tech Start-Up, was presented at the Bar's Annual Meeting in January 2012. It was very well received by all who attended, and addressed when employees must be paid in cash, not just equity, forms of equity compensation, and other key personnel issues. The materials and an audio recording of the program are posted in the members-only section of the TVLC website.

Our last report explained that, going forward, the TVLC will focus its programs on two tracks. In addition to our "Beyond the Basics" series, we will be holding programs on hot topics and recent developments in technology law. The first in our hot topics series will be presented at the Business Law Section's Spring Meeting in May. Watch your email for more information.

Our two newest representatives on the Business Law Section Executive Committee were also appointed at the Annual Meeting. They are Vanessa Kaster, Principal of Kaster Legal, and Sanjay Gandhi, President of Oxford Valuation Partners. Thank you to both of them for their dedication to the TVLC.

Finally, we are still in the development stage of a monthly e-newsletter to provide TVLC members with updates on events affecting technology and law. The information in that letter will also be posted on the new Business Law Section blog.

Thanks to all those who have contributed to the TVLC during this past year. Be sure to join the Committee if you have an interest in technology companies and the evolving law that affects them.

David S. Caplan, Esq.

Publication Policy and Manuscript Guidelines for Authors

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

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

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

Manuscripts are to be submitted to:

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NY Business Law Journal
Macquarie Holdings (USA) Inc.
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Subscriptions

Subscriptions to the *Journal* are available to non-attorneys, universities and other interested organizations. The 2012 subscription rate is $135.00. Please contact the Newsletter Department, New York State Bar Association, One Elk Street, Albany, NY 12207 or call (518/487-5671/5672) for more information.

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