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Editor's Note

Welcome to the Fall 2005 issue of the *NY Business Law Journal*. It is my pleasure to present the materials of this latest issue, particularly when they are as excellent as I trust you will find them to be. It is also time, of course, for me to urge all Business Law Section members to show their support for the *Journal* by submitting articles for consideration. Your help in sustaining the *Journal* is needed and always welcome.

We start the Fall issue with an article by **Leonard D'Arrigo**, a recent graduate of Albany Law School who is associated with **Whiteman, Osterman & Hanna LLP.** Mr. D'Arrigo's article deals with U.S. manipulation of international trade norms and discusses various aspects of the work of the World Trade Organization and what he views as American attempts to stymie some of that work. In an era of increased globalization and expanding trade relationships, this is an article which you will not want to miss.

Our next piece is an interesting exegesis by **Saul Seinberg**, the Director of **Albany Law School's Center for Law and Technology**, on intellectual property concerns which buyers should be aware of when they consider the purchase of a business or its assets. Mr. Seinberg points out that many business buyers, and their attorneys who negotiate deals on their behalf, are totally unaware of some of the IP issues underlying the sale, and he provides valuable advice on how these parties can educate themselves in this challenging area of the law and how ignorance of IP concerns can affect what goes on at the bargaining table.

Our third work is an important article by **Marc David Hiller**, an associate attorney with the **New York State Office for Technology**, on New York's Security Breach and Notification Act. Mr. Hiller's lengthy and scholarly work gives important guidance to solving the increasingly distressing problem of identity theft and advises individuals how best to protect themselves when dealing with this nettlesome issue. The article contains a good discussion of the statute, its strengths and pitfalls, and it also contains toward the end a set of recommendations which bears close examination. All in all, it is a timely and excellent discussion of a topic which should be of concern to us all.

The fourth article in the Fall issue is a work by **Cheryl Wickham**, an attorney in private practice, entitled "Developing a Law Firm Marketing Strategy." Ms. Wickham cogently points out that many, if not most, law firms totally ignore the need to market themselves to potential clients and the communities the firms serve, and that as a result they often miss golden opportunities to expand their client base and perhaps reach beyond their traditional areas of practice. Any professional in practice today should pay close attention to some of the worthy suggestions which the author makes in this excellent short piece.

The article which follows is by **Barry Leibowicz**, who has written widely in the area of tax law and policy. His contribution to the Fall issue is a reprint of a fine essay entitled "Sales Tax Planning of Organizations, Acquisitions, Reorganizations and Dissolutions." As the title indicates, it is necessary for individuals engaged in these types of restructuring transactions to be aware of their sales tax implications, and Mr. Leibowicz draws a distinction between the income and sales tax rules which govern them. The article also includes a probing analysis of the relevant case law in this area.

Our next piece is an article by **Katy Peng**, a 2005 graduate of **Albany Law School**, discussing recent changes to Securities and Exchange Commission regulation of hedge funds. The SEC, which historically had largely stayed out of the business of regulating these entities, has recently adopted new rules which provide for greater Commission oversight and monitoring of hedge funds. Ms. Peng's article should prove of value to securities practitioners or indeed anyone interested in these exotic financial instruments.

Whiteman, Osterman & Hanna LLP has come to the fore again with two excellent short pieces which conclude our Fall issue. The first, by **Lucy Kats**, alerts us to the possibility that private entities may be subject to New York's version of the Freedom of Information Act. The author gives a noteworthy analysis of recent state cases which have gone both ways on the issue of the applicability of New York's FOIL to organizations other than the government. And our last work, by **Alanna McKiernan**, is on the subject of for-profit and not for-profit hospital joint ventures and the possible problems that might arise out of their combination. Health law practitioners will certainly find this a worthwhile read.

Once again, Section members, please submit!

James D. Redwood, Editor
Professor of Law
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The School-Yard Bully: U.S. Manipulation of International Trade Norms and Safeguard Measures

By Leonard J. D'Arrigo

I. Introduction

With more than $1,146 billion in exports and $1,763 billion in imports, the U.S. is clearly a powerhouse on the international trade front.[1] Critics of U.S. trade policy allege that the U.S. has relied on its ability to manipulate the World Trade Organization (WTO) in order to maintain its superpower hegemonic status. This power has also manifested itself in a form of leverage to coerce other states into conforming to whatever may be the U.S. policy objectives at any given time. In this respect, U.S. trade policy appears to argue for economic sanctions when it unilaterally alleges that other states are in violation of WTO norms. When the U.S. engages in similar questionable conduct, however, the U.S. claims exemption under national security, thereby hiding under a camouflage of safeguard measures. A review of U.S. trade actions supports the claim that if a particular state's action is somehow interfering with a U.S. economic interest, that state is unilaterally labeled a "cheater." The problem, however, arises when the U.S. unilaterally decides that the state's trade action constitutes a violation of trade norms. Based on this unilateral determination, the U.S. imposes economic sanctions to force that state into conformity with U.S. policy objectives. While imposing sanctions against these alleged cheaters, the U.S. is arguably engaging in the very same conduct.

The effect of protectionism on U.S. business is substantial. By placing quotas on foreign producers, an incentive is created to upgrade the quality of units that such producers send to the U.S., and the foreign producers also are encouraged to build plants in the U.S., thus increasing competition with the very companies that the U.S. is attempting to protect. Another problem with protectionism is that temporary measures, designed to help an ailing U.S. industry strengthen itself to compete in international markets, tend to become permanent.[2] This is because protected industries may choose to use their resources to convince the legislature to renew protection rather than to invest in cost reduction.[3] The costs of protectionism are not limited to direct costs, such as higher prices, but include many indirect costs as well. Studies show that although protectionism is designed to save jobs, it actually destroys more U.S. jobs than it creates, so there is an unemployment cost. In addition, the quality of products may also decline if higher quality products become less available as a result of protectionism. There may also be losses of individual rights, since customers and producers—buyers and sellers—are less free to enter into contracts. Costs also arise in the administration of the various protectionist schemes, which must be paid for by taxpayers and consumers. Finally, since protectionism raises prices, reduces quality, and incurs administrative costs, it reduces the general standard of living.

This article will discuss specific instances of U.S. violations of the General Agreement on Tariffs and Trade (GATT)/WTO obligations and the principles of most favored nation (MFN), national treatment, and transparency. This article will also discuss the U.S. manipulation of the current trading system through safeguard measures to maintain its dominance and superpower hegemonic status. It will address the allegation that the U.S. engages in a double standard of labeling trading partners as cheaters or violators, while the U.S. engages in the same conduct under the guise of safeguard measures and national security. The U.S. circumvention of its WTO obligations in specific areas, such as steel and softwood lumber, will be analyzed to explore the alleged violations and the responses by the aggrieved parties. Finally, this article will examine the concept of *aggressive unilateralism* and offer policy recommendations to protect weaker nations from the perception of the U.S. as a "bully."

II. Background: GATT and WTO

The GATT was formed in 1948 with 23 member countries.[4] GATT was the result of the U.S.'s effort to extend its economic model of high-volume, standardized production, and aggressive expansion of markets to the rest of the world. GATT was originally intended to be only an interim secretariat for international trade negotiations. It became the focus of international trade only after the International Trade Organization (ITO) failed.[5] Based in Geneva, Switzerland, GATT acted as a conduit for multilateral negotiations on a variety of international trade issues, including tariff quota policy and trading practices.[6] The strength of GATT stemmed from its most far-reaching tenet, that of MFN status. As discussed in Part III.B. of this article, MFN policy states that every member nation is entitled to the same trade conditions that applied to any other member's "most favored" trading partner. This tenet virtually eliminated the possibility that trading blocs would emerge to factionalize world trade, as had previously occurred in the 1930s. GATT was criticized based on three major limitations: (1) GATT was strictly a Western organization, excluding the majority of the world's population; (2)

GATT had little enforcement authority;[7] and (3) GATT failed to cover new trade issues (e.g., non-border measures, trade-in services, intellectual property rights, trade-related investment).[8]

Despite the criticisms, GATT proved to be a successful endeavor. Dominated by the U.S., the GATT regime resulted in a dramatic lowering of tariff barriers during the post-war period, and international trade burgeoned.[9]

After many more rounds of negotiation by representatives of both developed and undeveloped nations, the World Trade Organization was born in 1994.[10] The WTO's task is to establish an international trading system based on a free and open market and competition policy that covers both domestic and international markets. The WTO tries to reduce and eliminate governmental trade barriers, such as tariffs and quantitative restrictions. As will be discussed later, the WTO is based on the principles of most favored nation treatment, national treatment, and transparency. These three principles are the most fundamental principles of the WTO, and all are designed to establish and maintain non-discrimination and openness in the international market. The principles of MFN and national treatment establish "a level playing field" among participants in international trade in different nations by eliminating discriminatory measures adopted by member governments. The principle of transparency ensures the openness of governmental regulations and thereby helps maintain predictability for players in international trade.

At the heart of the WTO is its Dispute Resolution Body, probably the most marked departure from GATT.[11] When a member nation perceives that another member has wronged it, it may request that a dispute settlement panel (DSP) be established to hear the grievance.[12] After a DSP has reached a decision, it issues a report to the parties, who are entitled to appeal to an Appellate Body.[13] This body may uphold, modify, or reverse a panel decision. The Dispute Settlement Body (General Council) may alter an Appellate Body decision only by a unanimous vote.[14] The sole remedies for a norm violation are retaliatory sanctions and economic ostracization.[15]

III. Basic Tenets of the WTO

A. National Treatment

National treatment (non-discriminatory trade) is regarded as one of the cornerstones of the WTO. The principle of national treatment is meant to maintain a competitive equality between domestic products and enterprises, on the one hand, and those of other members, on the other. The application of the national treatment principle varies according to whether it applies to trade in goods, trade in services, or intellectual property. National treatment was meant to establish a level playing field between domestic and foreign products and enterprises. The scope of "laws, regulations and requirements" in Article III.4 of the GATT 1994 has been broadly interpreted to include any laws and regulations which might adversely modify the conditions of competition between domestic and imported products in the internal market.

It is noteworthy that Article VIII of the GATT requires members to ensure that any monopoly supplier of a service in its territory, in the supply of the monopoly service in the relevant market, neither acts in a manner inconsistent with that member's specific commitments nor abuses its monopoly position to act in other markets in a manner inconsistent with commitments. As with most rules, there are notable exceptions to the national treatment requirement. These exceptions include provisions: (1) restricting imports for health-related reasons; (2) requiring all labels to be in English; (3) grandfathering certain provisions; and (4) exempting government procurement.

B. Most Favored Nation Principle

The MFN principle requires that a member accord goods and services of another member treatment no less favorable than that it accords to goods and services of all other members. This principle also applies in the area of intellectual property. This principle is designed to guarantee equal competitive conditions between goods and services of different foreign members. Essentially, if one member gives a benefit or privilege to another member, it must extend that benefit to all other members. This concept forces a nation that lowers a tariff for one member to extend that lower tariff to all other members, even if the benefit-receiving member gives no reciprocal compensatory concessions.[16] As with national treatment, flexibility has been built into the concept of MFN to allow for exceptions.[17]

C. Transparency

The two-part requirement of transparency is also a cornerstone of the WTO. The first part is the obligation imposed on members of the WTO to publish or make publicly available all relevant regulations before application, the requirement of impartial administration of such regulations, and the right to review decisions taken under them. The second part is the requirement that members give notice of governmental actions to the WTO and other members. Essentially, transparency requires that all barriers to trade must be predictable and discrete.[18] Problems with transparency arise most notably where a state imposes a quota on certain products. Here, the importer can guess at the opportunity cost of sales lost because of its inability to import goods into the protected country, but it cannot know the cost for certain.[19]

The principle of transparency serves as the basis for a rule-oriented foreign trade policy and for maintaining stability and predictability of the trade law regulations of members. Three primary rationales underlie the preference for transparency in trade barriers. First, less transparency results in more uncertainty, which imposes an additional cost of regulation. Second, less transparency tends to mean greater bureaucratic discretion, which increases the importer's uncertainty and raises the cost of international supervision.[20] Third, less transparency may benefit more focused interest groups at the expense of small disorganized groups, such as consumers. Less transparent regulations are more burdensome to discover, perhaps discouraging oversight by groups with only a tangential interest in their content.[21]

Exceptions to the norm of transparency are provided for in Article XI(2), which permits temporary export restrictions necessary to relieve critical domestic shortages and import restrictions on food products that supplement domestic production restrictions. Additionally, Article XII allows parties to restrict imports to protect their monetary services.

D. Exceptions to WTO Obligations

GATT Article XIX authorized the suspension of GATT norms (MFN, national treatment, and transparency) in a limited set of circumstances, including: (1) unforeseen developments; (2) increased quantity of imports; (3) imports that cause or threaten serious injury to domestic producers; and (4) where the increase of imports is the effect of the party's GATT obligations. Such safeguard measures are only allowed for the amount of time necessary to remedy the injury.

IV. Defending (Offending) Against Unfair Trade Practices—Aggressive Unilateralism

A. The Escape Clause of Section 201

One of the primary vehicles by which the U.S. circumvented its GATT obligations, or "defended against unfair trade practices," was by Title II of the Trade Act of 1974.[22] Under this provision, the President may take action if the International Trade Commission (ITC) determines that a product is being imported into the U.S. at such an increased quantity as to cause substantial or serious injury (or a threat thereof) to domestic producers of a similar product. In 1980, U.S. automobile manufacturers filed a claim with the ITC claiming that increased imports of certain automobiles and automobile parts resulting from a tariff reduction caused substantial economic injury to the U.S. automobile industry.[23] Under the ITC's test, § 201(b) required: (1) increased imports of an article to the U.S.; (2) a domestic industry producing a similar product that is being seriously injured or threatened; and (3) such increased imports are a substantial cause of the serious injury. The ITC found that the 1978-79 recession contributed more to the failing U.S. automobile industry than did an increase in imports, and that the imports therefore were not a "substantial cause" of the industry's injury.[24]

Once the ITC finds an injury caused by imports in any given case, § 203 authorizes the President to take certain remedial actions. These actions, however, cannot create an impact in excess of what is required to remedy or prevent the injury.[25] Section 203(e)(3) prohibits the President from increasing a duty by more than 50 percent; § 203(e)(4) directs that no quota can limit imports of a product to levels below that of the most recent three years that are "representative" of past imports.[26] Furthermore, § 203(a)(3)(E) authorizes the President to negotiate and implement agreements as a means of protecting an injured domestic industry.[27] Aside from the specific measures authorized by Congress, Title II appears to give the President more flexibility in remedying an injury. Specifically, § 203(a)(1)(A) authorizes the President "to take all appropriate and feasible action within his power," and § 203(a)(2) clarifies that the ITC's recommendations are only one of several considerations the President should take into account.[28] The exporting country, however, is not left without a remedy in response to an escape clause action. Article XIX(3) provides that the exporting country can suspend "substantially equivalent concessions" in retaliation for such escape clause actions. Most disputes do not reach this level. The prevailing practice has been for the importing and exporting states to commit to a voluntary export restraint agreement (VER), under which the exporting state agrees to police the importing state's import restrictions. The exporting state's government then gets the right to sell export licenses to its producers, and its producers obtain "cartel superprofits" due to reduced output.[29]

B. Antidumping Laws

Antidumping provisions seek to protect domestic producers from imports that are sold at a value below that sold in their home market or below their cost of production.[30] U.S. antidumping legislation first arrived in its modern form in 1921.[31] Under the current provisions, if a good is found to be sold in the United States at less than its fair market value (LTFV), a duty equal to the difference between actual price and fair price is assessed.[32] The criteria for determining LTFV sales are more detailed than other trade remedies. If an LTFV ruling is made by the U.S. Commerce Department, the case is sent to the ITC to determine whether there has been domestic "injury" as a result of the dumping activity. Until 1979 the ITC had broad discretion in its injury determination. The discretionary nature of the injury determination became a central concern to foreign producers by the time the Kennedy Round of GATT negotiations commenced in 1963. At the Tokyo Round of GATT negotiations, which opened in September 1973, the call for uniform definition of the injury concept was finally answered. The 1979 Antidumping Code adopted during the Tokyo Round was implemented by the Trade Agreements Act of 1979. The new act raised the injury requirement from the *de minimis* standard of the 1921 law to one of "material injury."[33]

Further changes made to U.S. antidumping laws in 1979 directly addressed the weakness in the executive branch's administration of antidumping laws. New time limits were set for the assessment of dumping duties. Prior to 1979, duties could be delayed for prolonged periods of time. The 1979 amendments instituted a one-year statutory time limit after the import transaction is completed for the collection of antidumping duties.[34]

Another example of Congress' growing institutional awareness was its shifting of the LTFV determination to the United States Department of Commerce in the 1979 amendment. This transfer was based on arguments that the Commerce Department, with its attachment to United States industries, would be more responsive than the Treasury Department to antidumping duty requests. Although the administrative organization has changed, however, the legal mandate has not. Thus, the Commerce Department, another executive branch agency, may also choose to use statutory latitude to maintain a liberal United States market.

C. Countervailing Duty Legislation

United States trade laws also provide aid to U.S. industries in situations where a foreign nation is directly or indirectly providing a subsidy to a domestic producer or exporter. This aid is in the form of a countervailing duty, which ideally is set as an amount equal to the net amount of the subsidy, which is levied upon that product when it is imported into the United States.[35] The rationale behind countervailing duty law is that the duty will offset any unfair competitive advantage attained by a foreign manufacturer or producer due to a foreign government subsidy.

Current countervailing duty law requires that the Secretary of Commerce countervail when it is found after an investigation that a foreign nation has extended a "bounty or grant" to goods imported into the United States, and injury to a United States industry has occurred. In 1979, when the Tokyo Round Agreements resulted in the adoption of a new international code on subsidies and countervailing duties, the United States agreed to adopt a requirement of "material injury" and an extensive definition of subsidy for application to those countries which were signatories to the Code.[36] The 1979 law promoted increased openness in adjudication procedures, and the option of judicial review.

D. Aggressive Unilateralism

The world trading system under the WTO is founded upon strong global multilateralism. The U.S. has not been ready to concede voluntarily strong (aggressive) unilateralism, the adversary of global multilateralism.[37] During the last decade, the U.S. has developed elaborate programs of its own to combat other states' perceived unfair trade practices, such as dumping and subsidies, in an effort to "level the playing field."[38] These programs entail the imposition of barriers to impede the solidifying and strengthening of global multilateralism in an effort to maintain the U.S.'s economic superpower status of unilateralism.[39] Often these unilateral actions, in the form of safeguard measures, are conducted under the camouflage of safeguarding U.S. interests and enforcing U.S law.[40] The U.S. has been no stranger to the use of political and economic sanctions in its efforts to persuade member nations to conform to U.S. policy objectives.[41] Indeed, a study found 116 cases of multilateral or unilateral sanctions imposed during the 20th century.[42] The U.S. imposed 62 of these sanctions, for the most part on a unilateral basis. Historically, the U.S. has used economic sanctions as supplemental measures to military action, to combat nuclear weapons development, to deny adversary military technology, to combat human rights violations, and to fight state-supported terrorism.[43] To support its use of unilateral economic sanctions, often in violation of WTO obligations, the U.S. raises the banner of national security,[44] arguing that national security interests trump GATT/WTO obligations.

Article XXI of GATT authorizes member states to take "any action which it considers necessary for the protection of its essential security interests."[45] As the most active user of economic sanctions, the U.S. takes the position, contrary to most other member states, that the "it considers" means exactly what it says. A member state is authorized to make a unilateral determination of "essential security interest," thus immunizing such decision from any formal inquiry by GATT contracting parties. Danger is inherent in such an interpretation. Any product or measure can be linked to national security interests, from bubble gum to shoes. The question becomes whether GATT can be interpreted as reserving an implied right of contracting parties to reject outrageous claims based on national security.[46]

E. Section 301 of the U.S. Trade Act—The Newest Weapon

Section 301 of the U.S. Trade Act of 1974 introduced new methods by which the U.S. could maintain its superpower status.[47] Principally, § 301 attempts to dislodge trading practices unilaterally determined by the U.S. to be unacceptable.[48] Prior to § 301, U.S. trade strategy focused on import regulation (restricting antidumping, customs regulations, standards, and quantity restrictions). In theory, § 301 complaints were to be processed through the Dispute Resolution mechanism, and they would therefore be consistent with GATT. In practice, however, the U.S. used retaliation methods without GATT authorization in the six GATT-based § 301 cases during 1975-1989.[49] Section 301 gives the President authority to provide aid to ailing U.S. businesses that may not have been available under the injury requirements of the antidumping or countervailing duty statutes. Most notably, § 301 authorizes the President to "take all appropriate and feasible" action to "enforce the rights of the United States under any trade agreement" or to respond to any foreign practice that is "unjustifiable, unreasonable, or discriminatory and burdens or restricts United States commerce."[50] The President's broad authority under § 301 enables him to attack unfair barriers to trade in services, foreign nontariff barriers, and foreign industrial policies that have brought about a competitive advantage for foreign firms. This broad power enables the U.S. to unilaterally make demands for trade concessions by other states without offering any matching, reciprocal concessions of its own that others might demand in return.[51] Like the antidumping and countervailing duty laws, § 301 relief has evolved to assist United States industries searching for a stand-by mechanism to deal with specific trade problems. Historically, the remedy was employed mostly to reach restrictive foreign practices affecting a broad range of manufactured and agricultural goods. It was not until 1984 that the President's ability to take retaliatory action in the case of trade-in services was clearly articulated by statute.[52]

Presidential actions permitted by § 301 (whether investigatory, conciliatory, or retaliatory) may be taken either on the President's own initiative or in response to a petition filed by a private party with the United States Trade Representative (USTR). Any § 301 petition must allege either substantive violations of the provisions of a trade agreement, the denial of benefits to the U.S. under a trade agreement, or that the trade agreement is unreasonable, discriminatory, or a burden or restriction on U.S. commerce.[53] Section 301, then, provides parties with a cause of action under positive international law. When properly wielded, this power has the ability to establish a common law of "fairness" in international markets.[54] In those situations where no international agreement clearly applies to the trade problem, the "unjustifiable," "unreasonable," and "discriminatory" indicia come into play.

Perhaps the most important feature of a § 301 action is the *lack* of a statutory *material injury* requirement. More significantly, § 301 petitions are required to move through fewer layers of bureaucracy than are petitions filed pursuant to other unfair trade statutes. They are submitted directly to the USTR, rather than first going to the ITC or the Department of Commerce. After a positive § 301 determination, the President can take action that includes, but is not limited to, suspension or withdrawal of concessions granted to the foreign country under trade agreements, or imposition of duties or other import restrictions on products from that country, for such period as he deems appropriate.[55]

Justifications for the sweeping unilateral scope of § 301 have been tied to national interest concerns: specifically, that the U.S. is threatened with deindustrialization, which will in turn damage the economic status of the U.S.[56] This characterization made Congress feel more at ease with its tailoring decision to the narrow interests of its constituents and impelled it to engage in full-fledged protectionism. In their minds, Congressmen were merely acting as statesmen safeguarding the national interest.[57]

V. Section 201 of the U.S. Trade Act—The U.S. Steel Debacle

On June 22, 2001, on the grounds that the U.S. steel industry was seriously injured by imported steel products, the U.S. government authorized the U.S. International Trade Commission to invoke § 201 of the U.S. Trade Act of 1974[58] to carry out investigations on more than 20 countries that exported steel to the United States.[59] Based upon the Commission's preliminary conclusions, on March 5, 2002, President George W. Bush adopted safeguard measures which implemented three-year quota restrictions on major imported steel or which levied additional tariffs ranging from eight to 30 percent, to come into effect after March 20, 2002.[60] The United States' behavior was met with condemnation from the injured states, and a large-scale trade war was triggered as a consequence.

Prior to March 22, 2002, the European Commission (E.C.) had drafted a list of commodities that it might use to retaliate against the United States.[61] The list included 325 categories of commodities—such as steel, textiles, citrus, fruits, paper, rice, motorcycles, and firearms.[62] This list, aside from being submitted to the 15 member nations of the E.C. for approval, was also delivered to the WTO. The E.C. intended to levy additional tariffs ranging from 10 to 30 percent of the total value of 2.5 billion Euros, which was equivalent to the damages incurred from the United States' unilaterally enhanced steel import tariff.[63] If by June 18, 2002, the United States continued to adhere to its unilateral measures of arbitrarily increasing tariffs, and refused to compensate the E.C. for damages incurred from its additionally levied steel tariff, the E.C. retaliatory measures would enter into force on the same day.

Other nations, including Japan, the Republic of Korea, China, Switzerland, Norway, New Zealand, and Brazil, also incurred damage from the United States' unilateral measures. From March 14, 2002, to May 21, 2002, all of the nations that had incurred damages jointly participated in E.U.-U.S. consultations or engaged in separate consultations. However, none of the settlement consultations succeeded in resolving the dispute. The parties then proceeded separately to request the establishment of a panel to examine the issues arising from the consultations. On July 25, 2002, in accordance with Articles 6 and 9.1 of the Understanding on Rules and Procedures Governing the Settlement of Disputes (DSU), the Dispute Settlement Body (DSB) established a single panel to examine similar matters raised by all the complainants.[64]

On July 11, 2003, the final reports of the Panel on United States-Definitive Safeguard Measures on Imports of Certain Steel Products were issued and circulated to all members, pursuant to the DSU.[65] The Panel concluded that the safeguard measures imposed by the U.S. on the imports of certain steel products were inconsistent with the Agreement on Safeguards and GATT.[66] Therefore, the Panel recommended that the DSB request that the U.S. bring the safeguard measures into conformity with its obligations under the GATT.

On August 11, 2003, the U.S. notified the WTO of its decision to appeal to the Appellate Body.[67] The U.S. sought review of the Panel's legal conclusion that the application of safeguard measures was inconsistent with Articles XIX:1 of GATT and Articles 2.1, 3.1, 4.2, and 4.2(b) of the Safeguards Agreement.[68] The U.S. argued that the Panel's findings were in error and based on erroneous findings on issues of law and related legal interpretations.[69] The United States further sought review on the grounds that the Panel had acted inconsistently with Article 11 of the DSU in that it failed to make an objective assessment of the matter before it, including an objective assessment of the facts of the case and the applicability of, and conformity with, both GATT and the Safeguards Agreement.[70] The U.S. also sought review of the Panel's findings on the grounds that the Panel acted inconsistently with Article 12.7 of the DSU, in that its report did not set out the basic rationale behind its findings and recommendations.[71]

On November 10, 2003, the WTO Appellate Body issued a decision finding that the U.S. steel tariffs were inconsistent with the Agreement on Safeguards and GATT 1994 because the U.S. failed to provide a "reasoned and adequate" showing as to the alleged injuries to its domestic industry.[72] The Appellate Body therefore recommended that the U.S. bring its inconsistent safeguard measures into conformity with GATT 1994. After the Appellate Body decision, President Bush formally rescinded the U.S. steel tariffs on December 4, 2003. According to the President's proclamation on the discontinuance, changed economic circumstances impaired the effectiveness of the safeguard measures.[73] Although the U.S. attempted to circumvent its WTO obligations by using safeguard measures as a camouflage for protectionism, the WTO found the U.S. in violation. The WTO's dispute settlement process provided a means for the EU and other U.S. trading partners to challenge the U.S.'s institution of unilateral tariffs, obtain a reasoned ruling, be granted the authority to impose painful sanctions in the event of non-compliance, and obtain compliance by the U.S. in just 21 months. Interestingly, the President's decision to repeal the tariffs came only 6 days before the WTO was scheduled to formally adopt its ruling that the tariffs were in violation of WTO obligations, and 11 days prior to the initiation of WTO-authorized retaliation by the EU on $4.4 billion in U.S. exports.[74] The President's proclamation did not specify which economic circumstances had changed. Robert Zoellick, U.S. Trade Representative, cited the ITC report however, and noted two changes as the basis for the decision: (1) a decline in imports and resulting price increases; and (2) the adverse impact of the tariffs on consumers. On the latter point, he noted that while in the first 21 months of the safeguard the benefits to the industry outweighed the cost to consumers, this was no longer the case. This rationale must be questioned in light of the fact that the ITC report was issued in September 2003.

VI. U.S.-Canada Softwood Lumber Dispute: U.S. Calls Canada a Cheater

Although Canada and the U.S. are the world's largest trading partners, there is one issue on which they have never agreed: softwood lumber. The dispute dates back many years, but in the 1980s the controversy grew to a new level. The debate raises serious issues about trade, sovereignty, and the real nature of Canada-U.S. relations.

In October 1982, the U.S. was struggling with a lull in housing construction and an ailing lumber industry. Even worse, Canadian lumber was priced much lower than U.S. lumber. The U.S. came to the conclusion that Canada must be cheating—there was simply no other explanation. As a result of its unilateral determination, the U.S. Coalition for Fair Lumber Imports filed three petitions with the U.S. Department of Commerce, claiming injury by Canadian subsidies on softwood lumber. After an investigation, the Department of Commerce determined that no countervailing duty was justified.

Four years later, the U.S. lumber industry again filed a claim with the Department of Commerce (DOC). This time, the DOC determined that the Canadian stumpage system amounted to a government subsidy to lumber producers of approximately 15%.[75] The U.S. subsequently imposed a 15% tariff on Canadian softwood imports. The Canadians challenged this unilateral action as pure protectionism under the guise of safeguard measures. Rather than pay the U.S. billions in tariffs at the border, Canada and the U.S. entered into a Memorandum of Understanding, whereby Canada agreed to collect a 15% export tax on its softwood exports, keeping the money in Canada.

After five years of voluntarily taxing its own lumber, Canada had had enough. During the five-year period, the Canadian provinces developed a forestry system that it believed would be acceptable to the U.S., rendering the tax unnecessary. As soon as Canada terminated the agreement, the U.S. launched a third countervailing duty case, again alleging impermissible Canadian subsidies. In 1992, the ITC decided that Canadian subsidies injured U.S. producers and levied a 6.5% duty on Canadian lumber. In August 1992, Canada appealed to a binational Free Trade Agreement Panel (FTA), which found no subsidies. In 1994, Canada won the final FTA ruling. The U.S. was required to return to Canadian exporters $1 billion in duties. On May 29, 1996, the U.S. and Canada finalized the Softwood Lumber Agreement (SLA), which lasted until March 31, 2001. The SLA allowed a limited quantity of wood to enter the U.S. without a duty or tax. A two-tiered tax was imposed on exports exceeding that limit.

After five years of peace, the lumber wars erupted yet again. Two days after the lumber agreement expired, the U.S. lumber industry filed two more petitions, one for countervailing duties and one for antidumping charges. The U.S. subsequently imposed a 27% duty on Canadian softwood. On appeal, the WTO ruled that the U.S. was wrong to impose duties on Canadian softwood. The WTO sided with Canada, upholding Canada's position that it does not subsidize its lumber industry, and in May 2003, the WTO held that the countervailing duty was not warranted. On August 29, 2003, the WTO released its final report on the U.S. countervailing duties. The report held that Canada's provincial system may benefit the lumber industry, but the U.S. had not proven its case for the duties it instituted. The report found that the key factor on which the U.S. relied to make its "threat of injury" determination (an imminent and likely surge in imports of softwood lumber products from Canada) was not a determination "that could have been reached by an objective and unbiased investigating authority."

The softwood lumber dispute, like the steel dispute, is yet another example of the U.S. unilaterally acting to find another state in violation to justify its imposition of safeguard measures to circumvent WTO obligations. In both cases, the trading system was able to expose the U.S. mechanism of safeguard manipulation and provide protection to U.S. trading partners.

VII. Safeguarding Against U.S. Manipulation and Unilateralism—Recommendations

If the U.S. is to be allowed to keep its "big stick" (jurisdiction to make initial safeguard determinations), it must use it responsibly. However painful it may be to see core industries suffer when faced with foreign or other competition and market cycles, the elimination and dislocation of obsolete industries is part of the market cycle that GATT contemplates. As an avowed champion of free trade, the U.S. ought to shoulder the pain and take whatever domestic measures are necessary to assist ailing U.S. industries and injured workers while respecting its international obligations. The crux of the problem is that the Safeguard Agreement provides an all-too-easy opportunity for circumvention. The vagaries of the international economy are bound to create incentives for the domestic regulatory agency to take the side of domestic interests.

The international review system does not have the effectiveness of a domestic system of judicial review in administrative cases. The very fact that a proceeding is initiated in a case where the domestic agency abused its authority to impose a safeguard measure is a manifestation of the harm to the international trading system that results from such abuse. Furthermore, the WTO/DSB is still a new tribunal with growing pains and limited logistical capacity. Its resources may be stretched when it is called upon to check an abuse of the safeguards system. These resources will be better spent hearing cases that involve the great international trading issues of the day, such as the extent to which environmental or other domestic policy goals justify a suspension of the free trade rules.

The solution may lie in a transfer of safeguard measure review from the national authorities to a separate and specialized WTO agency. Whether a particular safeguard measure is consistent with the requirements of the Safeguards Agreement should be determined by this agency, subject to review by the regular panels and appellate bodies of the WTO/DSB.

Safeguard measures form a narrow exception to the rule of free trade. It appears that the trade policy of the U.S. has been for the exception to swallow the rule. The safeguard measures should be adopted only in extreme circumstances. Unlike antidumping or subsidy-countervailing rules, which equalize the balance of international trade by retaliating against unfair trade practices, safeguard measures have the potential to block the "fair trade" of the contracting parties. Granting jurisdiction to a separate WTO body will remove both the power and the incentive of the contracting parties to abuse an escape clause.

VIII. Conclusion

There are clearly two sides to this story. U.S. unilateral trade actions can be viewed as legitimate safeguard measures to protect vulnerable U.S. industry from GATT violations by other states. These same transactions, however, can also be viewed as a veiled attempt to circumvent GATT/WTO obligations and to protect U.S. industry from competition—old fashioned protectionism.

Critics argue that the U.S. should not serve as a benign dictator, promulgating its own judgments of a desirable trading regime rather than achieving its goals through persuasion and mutual concessions.[76] Furthermore, the world trading regime should not have as its foundation the assumption that any one state, whether or not a superpower, can unilaterally impose its own rules, claiming social legitimacy.

In the end, studies conclude that protectionism is not without cost to U.S. business interests, and these studies are consistent in their conclusion that the losses in jobs, profits, shareholder value, and goodwill exceed the gains. Critics also argue that protectionist policies produce political corruption, economic stagnation, and international conflict.[77] From a business perspective, the logical conclusion appears to be that protectionist policies, at least in the long-term, exceed the gains and should be adopted only in narrow circumstances. Protectionism should be the exception, not the rule of U.S. trade policy.

Endnotes

1. U.S. Census Bureau, Foreign Trade Statistics (2004), *available at* http://www.census.gov/foreign-trade/statistics/highlights/annual.html (last visited Oct. 13, 2005). New York, alone, makes up 5.43% of this total.
2. For example, if auto imports are restricted, the people who depend on auto imports for their livelihood, such as importers, foreign car dealers and their employees, and so forth, may be thrown into the unemployment lines. But the effects on these groups are often ignored when computing the number of jobs to be saved by a particular protectionist policy.
3. Aaron Tornell, *On the Ineffectiveness of Made-to-Measure Protectionist Programs*, International Trade and Trade Policy, 66, 66–79 (1991).
4. *See* General Agreement on Tariffs and Trade, 61 Stat. A-11, T.I.A.S. 1700, 55 U.N.T.S. 194 (hereinafter GATT); Paul B. Stephan Iii Et Al., International Business And Economics 74 (LEXIS 2d ed. 1996). The countries included Australia, Brazil, Burma, Canada, Ceylon, Chile, China, Cuba, Czechoslovakia, France, India, Lebanon, Luxembourg, the Netherlands, New Zealand, Norway, Pakistan, Southern Rhodesia, Syria, the Union of South Africa, the United Kingdom, and the United States. *Id.* at 74.
5. Alan D. Minyard, *The World Trade Organization: History, Structure, and Analysis, available at* http://www2.netdoor.com/~aminyard (1996) (last visited Apr. 24, 2004); *see also,* Stephan, at 74. The ITO was intended to be an organization that would ensure fairness in world trade, resolve disputes between members, and institute coverage for the emerging markets in services and intellectual property rights, as well as direct investment. The U.S., however, felt that the ITO was to be given too much intervention in domestic markets and would threaten national sovereignty. Minyard, at 3 (citing Michael R. Czinkota, *Executive Insights: The World Trade Organization—Perspectives and Prospects*, 3 J. Int'L Mktg. 85 (1995). Consequently, without U.S. participation, the ITO quietly died, leaving the "interim" GATT as the major arbiter of world trade for almost 50 years.
6. Minyard, at 4; Stephan, at 74–75.
7. Salil Pitroda, *From GATT to WTO: The Institutionalization of World Trade,* 17 Harv. Int'l Rev. 46 (1995). If a member nation sought redress for an improper trade practice by another member, the accused member could block the establishment of a panel to hear the dispute. Furthermore, if the accused member actually submitted to a panel, the accused could dissent from the panel report. In the rare event that an accused country not only agreed to a panel, but also submitted to punishment, the only real enforcement mechanism available under GATT was to grant the injured party permission to institute punitive tariffs and/or quotas.
8. Robert Yarbrough, *Regionalism and Layered Governance: The Choice of Trade Institutions,* 48 J. Int'L Aff's 95 (1994).
9. *Id.* The most effective tool of GATT was tariff reduction. On average, tariffs fell from approximately 40% of the value of tariffed products during the 1930s to about 5% since 1980, William A. Mceachern, Economics: A Contemporary Introduction 859 (1994).
10. Agreement on Trade-Related Aspects of Intellectual Property Rights, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization (hereinafter WTO Agreement), Annex 1C, Legal Instruments—Results of the Uruguay Round vol. 31, 33 I.L.M. 81 (1994) (hereinafter TRIPS Agreement).
11. Stephan, at 76.
12. *See* Understanding on Rules and Procedures Governing the Settlement of Disputes (1995) (hereinafter Understanding on Rules). Articles 6–15 of the Understanding on Rules govern the functioning of the dispute resolution panels.
13. Understanding on Rules, art. 17. The appeal process is limited to issues of law covered in the panel report and legal interpretation developed by the panel.
14. Understanding, art. 17(6); *see also* Stephan, at 925.
15. Lack of enforcement is a chief criticism of the WTO, much like that of its predecessor, GATT. Merely allowing an aggrieved

party to institute retaliatory sanctions that may or may not have any effect is insufficient.

16. This aspect of the MFN is known as "unconditional." Part IV of GATT also authorizes "Special and Differential Treatment" for developing countries. Under this notion of "conditional" MFN, certain developing countries are excused from the rigorous requirements of unconditional MFN status. Instead, these nations are not required to extend the same favors to all developed nations. Rather, they may institute a favor to just one nation.

17. These exceptions include: grandfathering existing laws in violation of MFN; veto power; special and differential treatment for developing countries; customs union; and free trade.

18. Stephen, at 800. An example of a trade barrier that is transparent is an import duty: the importer knows exactly what it will cost for its goods to cross a national border. Other non-tariff barriers which give rise to transparency issues include government subsidies, voluntary export restraints (VERs), health and inspection requirements, and quotas.

19. *Id.*

20. *Id.*

21. *Id.*

22. 19 U.S.C. §§ 2251–54.

23. Certain Motor Vehicles and Certain Chassis and Bodies Therefor, 2 I.T.R.D. 5241 (1980).

24. *Id.*

25. Trade Act of 1974, § 203(e)(2); 19 U.S.C. § 2253(e)(2).

26. Stephan, at 812.

27. Trade Act of 1974, § 203(a)(3)(E); 19 U.S.C. § 2253(a)(3)(E).

28. Section 203(a)(3) sets forth the available remedies that the President can use, and § 203(e) imposes certain restrictions. None of the enumerated restrictions, however, includes strict adherence to the ITC recommendations.

29. Stephan, at 813.

30. Antidumping duties, authorized by Article VI of the Trade Act of 1974, are premised on the existence of unfair practices that allow importers to undersell domestic producers. *Id.* at 856; Michael Borrus & Judith Goldstein, *The Political Economy of International Trade Law and Policy: United States Trade Protectionism: Institutions, Norms, and Practices*, 8 NW. J. Int'L l. & Bus. 328, 342 (1987).

31. Antidumping Act of May 27, 1921, ch. 14, 42 Stat. 11 (codified as amended at 15 U.S.C. §§ 160-71 (1982)).

32. *See* Trade Agreements Act of 1979, Pub. L. No. 96-39, tit. I § 101, 93 Stat. 144, 19 U.S.C. § 1671. The formula used to calculate the margin of dumping is *Normal Value* (*NV) – Export Price (EP) = Margin of Dumping.* Normal value is the price at which goods are sold in usual commercial quantities and in the ordinary course of business in the home country. The Export Price or U.S. Price is the price at which goods are first sold before the date of exportation to other than an affiliate of the exporter. For producers to avoid the margin of dumping, they have an incentive to make the two numbers equal—they would argue for increasing EP as much as possible. On the other hand, the domestic industry's goal is to make the difference higher, but make the EP lower. The EP can be manipulated by both parties to a transaction: (1) bona fide subtractions where differences in circumstances of sale occur in different markets (transportation costs, warranties), and inflation of costs by a domestic producer, such as those for shipping and storage; (2) exporters would decrease or downplay the costs as much as possible.

33. Borus and Goldstein, at 345.

34. *Id.* at 345–46.

35. *See* Trade and Tariff Act of 1984, Pub. L. No. 98-573 (codified at 19 U.S.C. § 1671 (1982 & Supp. III 1984)).

36. Borus and Goldstein, at 348.

37. An Chen, *The Three Big Rounds of U.S. Unilateralism Versus WTO Multilateralism During the Last Decade*, 17 Temp. Int'l & Comp. L.J. 409 (2003).

38. *See* Pietro S. Nivola, Regulating Unfair Trade IX (1996).

39. *Id.* at 409.

40. *Id.*; *see* Pietro S. Nivola, Regulating Unfair Trade IX (1996). During the 1980s, the U.S. emerged from "trade wimp" status to "really tough" on trading partners. The U.S. was quick to initiate complaints and object to foreign commercial misconduct in the steel, lumber, automobile, and semiconductor industries. *Id* at 18.

41. Most frequently, the U.S. accused foreign trading partners of undercutting the price of U.S. products by selling exports at "less than fair value." Indeed, the number of dumping complaints initiated by the U.S. in the 1980s was three times that of the prior decade, NIVOLA, at 30 (citing Judith Hippler Bello & Alan F. Holmer, The Antidumping and Countervailing Duty Laws: Key Legal and Policy Issues (1987)).

42. Stephan, at 926 (citing Gary C. Hufbauer et al., Economic Sanctions Reconsidered (2d ed. 1990)).

43. *Id.* at 926–27.

44. The U.S. has cited the Export Administration Act, the International Emergency Economic Powers Act, the Hostage Act, and the Trading with the Enemy Act as authority for imposing economic sanction. *See* Barry E. Carter, International Economic Sanctions 184–208 (1988).

45. GATT, Art. XXI.

46. Stephan, at 928.

47. The purported goals of section 301 include: (1) opening markets in sectors where GATT already operates; (2) opening markets and/or establishing new rules or disciplines in new sectors; and (3) establishing new rules that may apply to old as well as new sectors.

48. Aggressive Unilateralism: America's 301 Trade Policy and the World Trading System 1 (Jagadish Bhagwati & Hugh T. Patrick eds., 1990). Section 301 is broadly directed at foreign trade barriers to U.S. trade, and it is used to enforce trade rights conferred by GATT, often through retaliation against unilaterally "perceived" violations. *Id.* at 2.

49. *Id.*

50. 19 U.S.C. § 2411(a)(1982), as amended by the Trade and Tariff Act of 1984, Pub. L. No. 98-573, § 304, 98 Stat. 2848.

51. Bhagwati & Patrick, at 5.

52. Borus and Goldstein, at 348 (citing 19 U.S.C. § 2411(c)(1)(A) (Supp. III 1984)).

53. 19 U.S.C. § 2411(a)(1)(B)(i).

54. Borus and Goldstein, at 348.

55. 19 U.S.C. § 2411(b).

56. Bhagwati & Patrick, at 10.

57. *Id.*

58. *See* Trade Act of 1974, § 201; 19 U.S.C. § 2251.

59. Letter from Robert B. Zoellick, U.S. Trade Representative, Executive Office of the President, to the Honorable Stephen Koplan, Chairman, United States International Trade Commission (June 22, 2001), *available at* http://www.usitc.gov/steel/ER0622Y1.pdf.

60. Proclamation No. 7529, *67 Fed. Reg. 10553* (Mar. 5, 2002); Memorandum of March 5, 2002, *67 Fed. Reg. 10593.*

61. EU Draws up Steel Sanctions List, CNN.com (Mar. 23, 2002), *available at* http://edition.cnn.com/2002/WORLD/europe/03/23/steel/?related.

62. Patrick Lannin, *EU Draws Up U.S. Sanctions List in Steel Row*, PNLTV (Mar. 22, 2002), *available at* http://www.pnltv.com/NewsStories/Mar%2022%20EU%20draws%20up%20U.S.%sanctions%20list%20in%20steel%20row.htm.

63. *Id.*

64. WTO Final Panel Report, WT/DS248/R-WT/DS259/R (July 11, 2003), *available at* http://www.wto.org/english/tratop_e/dispu_e/distabase_e.htm (hereinafter U.S.-Certain Steel Products).

65. *Id.*

66. *Id.*

67. United States-Definitive Safeguard Measures on Imports of Certain Steel Products—Notification of an Appeal by the United States under Paragraph 4 of Article 16 of the Understanding on Rules and Procedures Governing the Settlement of Disputes, WTO Doc., WT/DS248/17, WT/DS249/11, WT/DS251/12, WT/DS252/10, WT/DS253/10, WT/DS254/10, WT/DS258/14, WT/DS259/13 (Aug. 14, 2003) (hereinafter Safeguards Agreement), *available at* http://www.wto.org/english/tratop_e/dispu_e/appellate_body_e.htm.

68. *Id.*

69. *Id.*

70. *Id.*

71. *Id.*

72. United States-Definitive Safeguard Measures on Imports of Certain Steel Products (AB-2003-3, WT/DS248/AB/R (10 November 2003).

73. Presidential Proclamation No. 7741 of December 4, 2003, 68 *Fed. Reg.* 68483 (Dec. 8, 2003).

74. The President and his advisors specifically denied any connection between the tariff repeal and the threatened retaliation, citing instead U.S. legislation authorizing termination of safeguard measures following receipt of a mid-point report by the ITC on the results of its monitoring of the domestic industry showing "changed economic circumstances." The presidential proclamation was issued under § 204(b)(1)(A) of the Trade Act of 1974, as amended under 19 U.S.C. § 2254(b)(1)(A), which authorizes the President to reduce, modify or terminate a safeguard action if, after taking into account reports by the ITC and advice from the Secretaries of Labor and Commerce, he determines that changed economic circumstances warrant such action.

75. The Canadian stumpage fees are set by the individual provinces according to an estimate of the wood's market value. The Canadian government has always maintained that these fees represent true market value.

76. Bhagwati & Patrick, at 36.

77. James Bovard, *The Morality of Protectionism*, 25 N.Y.U. J. Int'l L. & Pol. 235 (1993).

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Buying a Business or Its Assets—IP Stuff Can Matter

By Saul Seinberg

For people who contemplate going into business, once the decision about the type of business is made, three choices exist. The first two are to buy a business or start one from the ground up. The third choice, an intermediate approach, is to start one's own business and provide at least some of the necessary assets by buying them from a business that no longer needs them or is forced to sell them. This article will concern itself with some of the intellectual property (IP) aspects of buying an entire business as a going concern or a portion of the assets of an existing business which may be liquidating, changing its purpose and direction, or merely upgrading its own equipment.

> *"It is . . . prudent for the buyer's and seller's counsel to make themselves aware of some basic IP pointers that should either provoke additional questions or raise the possibility that the services of an expert familiar with IP are needed . . ."*

In those instances where a technology-based or technology-dependent business is being purchased, it is usually evident to the deal attorney that a specialist in intellectual property law is needed to identify, conduct due diligence on, and help evaluate the intellectual property being acquired. The client in such instances appreciates the pragmatic need to hire an experienced IP attorney where technology issues are evident and the buyer is willing to pay for such expertise in order to protect his investment.

For such apparent high-tech deals, a specialist is hired and handles the IP requirements which are not generally known to the commercial or general practitioner, who is more often involved in low or no-tech business transactions. The additional cost of an IP attorney is not always warranted for, or acceptable to, the buyer or seller in a non-technical business or asset transfer, as these parties usually contemplate a quick and painless deal at minimal cost. In many cases, they are correct. However, this default approach often permits problems to occur in situations where IP expertise would have otherwise identified them earlier, together with possible solutions. This would have permitted a good deal to go forward and prevented a poor deal, requiring future legal triage, from being consummated.

In most business or asset purchase situations, an apparent lack of technology or intellectual property flags can often lull a deal attorney into believing that no IP or IP issues of any consequence are present in the particular deal being contemplated. Even the prospective sellers or purchasers, although they may be experts with respect to the actual type of business or assets involved, may not be helpful in identifying IP or related issues because of their unfamiliarity with or uncertainty about intellectual property itself. It is, therefore, prudent for the buyer's and seller's counsel to make themselves aware of some basic IP pointers that should either provoke additional questions or raise the possibility that the services of an expert familiar with IP are needed, even in what looks like an ordinary sale of a business or business-related assets.

Depending at what point a buyer or seller of a business involves his attorney, the parties to the sale of a business will, or should, be concerned about use of their confidential information obtained as a preliminary to, and during negotiations for, the sale of a business or its assets. All too often, the parties to the sale will consult their attorneys only after considerable information has been exchanged and key terms agreed on. This makes it very difficult to reach agreement on confidentiality terms and can easily scuttle a deal in the absence of an enforceable term sheet.

Let's assume that a buyer and seller have involved their respective attorneys at the preliminary stages of the deal or even earlier, before confidential information has been exchanged. One or both of the parties may ask for a non-confidential description of the business and its key factors before agreeing to consider a confidentiality agreement (CDA), in an effort to avoid contamination or overly long confidentiality obligations when none would have been assumed had the nature of the business been clarified at the outset. More often, the parties will exchange a CDA to govern what either side can do with confidential information, especially trade secrets, if any, gleaned in the preliminary and due diligence stages of negotiating the deal.

A confidentiality agreement should not be shrugged off on the basis that "[i]t's industry standard" or "[c]ommon language in the XYZ business that everyone accepts." While that may be true on occasion, terms in a confidentiality agreement are no less negotiable than they are in any other agreement, and they should not be accepted at face value. Further, where key technical and related information is to be disclosed, it is critical for both parties to apply reasonable limitations to use of such information by the recipient.

In the context of the sale of a business and sometimes in the sale of assets, the key provisions of a confidentiality agreement are the term of the agreement (for how long can information be disclosed under a proposed CDA or non-disclosure agreement (NDA)?); the subject matter the agreement covers (if you don't describe it adequately, it won't be protected); the length of the confidentiality period (how long do I need to keep this information confidential?); the purpose of the disclosure (is it limited to this specific transaction or not?); exceptions to confidentiality (when am I relieved of my confidentiality burden prior to expiration of the confidentiality period?); and the standard of care assumed by the receiving party (exactly what do you have to do to avoid breach for unauthorized disclosure or use?). A buyer wants to know if there are any restrictions on his or her ability to negotiate another deal for a similar business, and if so, for how long, so a proposed CDA should be scrutinized for the answer to such concerns. Likewise, a seller wants to insure that confidential information about its business will not be used for impermissible purposes, and that requirement should be adequately reflected in a proposed CDA.

A confidentiality agreement is also helpful in revealing the presence of useful, if not important, information for the receiving party. The presence of important confidential information, actual or alleged, often signals potentially important intellectual property. When this occurs, the need to value such IP, apply due diligence, and properly incorporate it into deal agreements is mandated. Conversely, when a claim of important confidential information is made to justify fairly tough CDA terms and then no such information is disclosed or found, the sincerity of the seller and the asking price should be viewed with caution.

Once the parties get past a confidentiality agreement discussion and signing, the buyer will usually examine the debts and obligations, secured or not, of the business that is for sale. Thus, it is standard procedure to search for active or threatened litigation, actual liens and judgments, and secured transactions with respect to the business, its assets and owners. A careful buyer will also check into the presence, if any, of non-debt-related limitations on use or transfer of technology-related assets bought as part of the business. Lastly, assets acquired in their own right should be checked to ensure that they are not encumbered by debt-related or use limitations.

Given that a company's assets will often include IP and given that lenders are now comfortable with lending money on such assets, IP asset-based lending is fairly common in today's business world and so should be the buyer's attorney's search for evidence of such IP-based lending. Unfortunately, the rules about perfecting security interests and where to file notices of a transfer of all or partial rights to an IP asset are different, depending on the type of IP involved, so care must be taken to appropriately file or locate such filings and notices.[1]

As you are aware, in order to perfect a security interest in personal property, a financing statement must be filed, pursuant to section 9 of the Uniform Commercial Code[2] (UCC), against a lender, usually in the state agency office designated by the UCC for that state.[3] That is true for all general assets as well as for IP assets, except with respect to registered copyrights.

In re Peregrine Entertainment, Ltd.[4] is the leading case with respect to where filing must be made to perfect secured interests based on copyrights. Without specifically referring to whether the copyright at issue before the court was registered or not, *Peregrine* held that a security interest in a copyright must be perfected by recordation in the U.S. Copyright Office in order to be effective against third parties. The court did separately note that the copyright must also have been registered in accordance with the requirements for registration under the U.S. Copyright Act.[5] The case of *In re Avalon Software Inc.*[6] clarified matters when it held that perfecting a security interest in an unregistered copyright requires that the copyright be first registered in the U.S. Copyright Office followed by the recording of a document evidencing the underlying debt to be secured.

In re World Auxiliary Power Co.[7] further clarified the rules for perfection of security interests in copyrights. The court in that case ruled that a creditor can perfect a lien in an unregistered copyright by filing an appropriate financing statement per the UCC requirements for the debtor's state. Perfection with respect to a lien on a registered copyright can be obtained by filing a notice of the lien with the U.S. Copyright Office. Alternatively, unregistered copyrights, including copyrights acquired after the lien was created but which are covered thereby, could first be registered, and then the liens applicable thereto could be perfected thereafter by filing a notice of the lien with the U.S. Copyright Office.

A prudent buyer concerned about copyrights in a purchased business or assets should check the records of the U.S. Copyright Office and the state office where financing statements are filed. This approach will ensure that no security interests in such assets are overlooked.

The use of a licensing royalty income stream as collateral for a loan is almost always recorded and perfected with a UCC filing. In addition, a prudent attorney will file a notice of that situation in the Copyright Office for income derived from one or more registered copyrights, in the United States Patent & Trademark Office (USPTO) for royalties derived from one or more registered trademarks, and in the USPTO when licensing revenue from patents serves as collateral, in order to cut off the rights of a bona fide purchaser (BFP).

Security interests in trademarks in this country, whether or not registered, are perfected under a UCC filing. However, if a trademark enjoys federal registration, the lien must be recorded in the USPTO in order to sever the rights of a subsequent BFP for value not having notice of the lien.[8] This result has been reached by several courts.[9] Recording of trademark transfers and licenses in the USPTO is also used for purposes of providing notice of assignments and other transfers of interest to BFPs.

Patents are treated just like trademarks with respect to perfection of security interests. You obtain full protection as a creditor, where one or more patents provide security for a debt, by filing under the applicable state UCC and identifying the patents. As with trademarks, recording in the USPTO is necessary to negate the rights of a subsequent BFP without notice of the lien.[10]

Again, in the interest of uncovering all liens and/or restrictions applicable to trademarks and patents owned by or licensed to a target business, a buyer concerned about such IP should check the records of the USPTO and the state office where financing statements are filed. This approach will insure that no security interests in such assets are missed.

As a deal attorney, you want to search the UCC filing office, the Copyright Office and the USPTO, as the case may be, to ensure for the buyer that no unexpected liens, assignments, or licenses show up. If you are representing the seller, you want to make sure that these records accurately reflect the status of IP ownership and rights to use with respect to any representations and warranties you may be asked to provide.

Another important aspect of buying a business involves use of the business name. In some rare instances, a name can be purchased as one of several assets. If the buyer of the business name, especially when it also functions as a trademark, wants to expand the scope of the business either geographically or locally through advertising, this contemplated expansion of use should be thoroughly vetted. Due diligence must be performed to determine if there is prior usage by and superior rights held by a third party. This is particularly important when use of a business name or trademark in a multi-state metropolitan area, like New York City, can expand the possibility of trade name or trademark confusion when similarly or identically named companies bump into each other. True, it may be possible to switch to another name or trademark or obtain compensation from the seller for having to limit or abandon use of a purchased trade name or trademark, but it is better to avoid being surprised by such problems than it is to try and fix them afterwards.

A related problem can arise with respect to the use of a domain name by the business. Limited, low-level use of the Internet by a small business may fly beneath the radar of a successful and larger company. Expanded use of the domain or business name may not be expected to do the same. Increased use of the business name or even news of the sale of the business may alert the larger company to an actual or potential name conflict and expose the smaller company to threats and litigation. The *Blue Note* case[11] is an example of such an incident, and there have been several others. In *Blue Note*, a small Missouri nightclub used a web site to advertise and promote itself. The nightclub was sued by the famous New York City jazz club of the same name, and jurisdiction was sought on the basis of the smaller company's web site, which could easily be seen and visited by New Yorkers. The Second Circuit held that the mere establishment of a web site in one state, without thereby engaging in commercial activities in other states, such as, for example, taking product orders or selling tickets, does not expose the web site host to lawsuits filed in other states.

On the other hand, it has been held that use of the remotely located web site to obtain orders for goods or services and otherwise engage in commercial activity in a second state may expose the owner/operator of the remote site to suit in that second state for a variety of reasons.[12] It is, therefore, recommended that the buyer be questioned about plans for promotional and commercial use of the Internet concerning the target business, particularly where no such use previously existed or there are plans for dramatically expanding Internet use. That level of new or heightened exposure certainly requires that expanded due diligence be conducted on this issue.

When you buy a business or separately purchase computers and software as assets from a business, questions and concerns for the buyer about such items should immediately spring to mind. For example, a buyer will need to know if the licenses governing use of software contemplated by the transaction can be transferred to a new owner or entity. If they cannot, how will the price be adjusted? If they cannot be transferred and are they critical to the operation of the business or computer being purchased, how will that issue be addressed? And what about maintenance for either the hardware or software? Does maintenance follow the computer or program, or must a new maintenance agreement be negotiated in what is likely to be an unfavorable negotiating context for either the buyer or seller?

Is custom software included in the deal? If so, is the author or company that sold a license to the customized program still in business and able to help if there are problems? Is maintenance for such custom software available, an extremely important consideration with respect to custom software? Is a copy of the source code held in escrow, and what are the conditions under which it can be obtained? The buyer should also determine if there are generally available commercial alternatives to any custom software, in case alternatives need to be considered.

Custom software and other special items used in and by the business raise further questions about ownership of such assets. Ordinarily, a copyrighted work or innovation created by an employee in the course and conduct of her employer's business belongs to the employer as a "work made for hire." However, when the creator of the work or innovation is a consultant or contractor, not an employee, ownership rights can get turned around, and what seems logical, as in, "I paid to have the work done, therefore I own it," does not lead to that result in some situations.

Initial ownership of copyright vests in the author/creator of the work under U.S. Copyright Law.[13] Our copyright law goes on to state that:

> In the case of a work made for hire, the employer or other person for whom the work was prepared is considered the author for purposes of this title, and, unless the parties have agreed otherwise in a written agreement signed by them, owns all of the rights comprised in the copyright.[14]

Ordinarily, a work or innovation created pursuant to a specific commission would appear to be owned by the commissioning party, and that was indeed the rule in some circuits, but not in others. Then, in *Community for Creative Non-Violence v. Reid*,[15] the Supreme Court unanimously decided that when a typical W-2 based employee is not involved, the definition of employee in considering whether a work is one made for hire should be the definition found in the Restatement of Agency.

In *Community for Creative Non-Violence*, the Community for Creative Non-Violence commissioned James Reid, a sculptor, to create a statue dramatizing the plight of the homeless. There was no written agreement signed by the parties defining the commission, and more importantly, nothing in writing about who would own and have rights to display the statue. After the statue was completed, Reid had possession, and both parties filed an application for copyright registration. Obviously, the parties disagreed on ownership of the resultant work, and their dispute eventually found its way to the Supreme Court. The Court, after considering the circumstances, decided that Reid was an independent contractor, not an employee, and that he owned the statue he had created.

As a result of this decision, it is necessary, when a work is arguably not created within the scope of employment or is to be created or produced by an independent contractor or consultant, to transfer ownership by means of a signed, written agreement. Further, a prospective buyer of a business or some of its assets should investigate to make sure that all assets to be transferred to the buyer are actually owned by the seller pursuant to the requisite signed, written agreement. The buyer should also satisfy himself that the seller has employment agreements in place with all past and current employees to expressly ensure that any company assets they have created are owned by the company, either as works made for hire or by assignment.

Validating ownership of commissioned works is especially important when informality governs company operations. In such settings, written employee agreements may not have been used, and contractors may have worked on an informal basis despite the fact that important works or valuable innovations were created. This tends to be the rule rather than the exception in the case of smaller companies, in situations where the need to capture IP ownership rights is not apparent or where IP rights are not recognized as important company assets. The lack of an appropriate writing has led to the unnecessary loss of rights in many instances. I am familiar with situations in which the lack of a written agreement led to contested ownership over a company logo, employee manual, web site design, and custom software, all of which were created by both regular employees (performing tasks outside their normal scope of employment duties) and independent contractors, all without the protection of an appropriate written agreement.

With respect to IP, threats of litigation, infringement warnings, and offers of license (an approach used to avoid a declaratory judgment action) are all indicative of potential and serious trouble for a buyer. Failing to inquire about such potential hazards or dismissing them as unfounded because of the seller's opinion or in situations where there is no expert to consult with is unwise and dangerous. Rather, any evidence of threatened litigation, warnings, or license offers must be thoroughly investigated and cleared to determine what the worst-case scenario might be and to adjust the terms and conditions of the sale accordingly or, if necessary, to enable the buyer to back out of the transaction completely.

Trade secrets are another area in which IP problems can and will occur. In many instances, the operator of a small company may not recognize that she has what amounts to a trade secret. She may not, therefore, have taken the necessary steps to consistently protect it in accordance with the legal requirements for maintaining a trade secret. In other instances, a trade secret may be known to several employees or independent contractors who did work for a company, but who were not subject to a written agreement requiring them to keep the trade secret a secret or prohibiting them from using or disclosing the trade secret.

As previously noted, IP rights or assets can be involved in low- or no-tech businesses, and they may often go unrecognized as such until it is too late to protect them. I am familiar with some instances in which potentially important IP rights were lost because of the failure to recognize and properly protect them. The key in such situations is for the seller's and buyer's attorneys to question their clients and try to determine what are the important contributors and differentiators for successfully operating the business to be sold. It is not unusual for familiarity to breed indifference to such items, and careful questioning can pay large dividends here.

The foregoing are some important IP considerations to keep in mind when handling the sale of a business or the assets of a business. It does not matter which side of the deal you are on because you will have to uncover the IP issues that are pertinent to your client's interests, even though these issues are not always evident. In addition, you must be prepared to deal with IP issues that are raised by the other party or a lender. Finally, be prepared to recommend that an experienced, skilled IP practitioner be consulted if you think or know there are IP issues present that warrant the use of an expert.

Endnotes

1. *See generally* Baila Celedona, Cowan, Leibowitz & Latman, *Intellectual Property in Secured Transactions*, *available at* http://www/cll.com/articles/article.cfm?articleid=134 (last visited Sept. 27, 2005).
2. U.C.C. § 9.
3. Baila Celedona, Cowan, Leibowitz & Latman, *Perfection of Security Interests in Intellectual Property*, *available at* http://www/cll.com/articles/article.cfm?articleid=76 (last visited Sept. 27, 2005).
4. 116 B.R. 194 (C.D. Cal. 1990).
5. Copyright Act, 17 U.S.C. §§ 101–810.
6. 209 B.R. 517 (Bankr. D. Ariz. 1997).
7. 244 B.R. 149 (Bankr. N.D. Cal 1999).
8. 15 U.S.C. § 1060.
9. Baila Celedona, Cowan, Leibowitz & Latman, *Perfection of Security Interests in Intellectual Property*, *available at* http://www/cll.com/articles/article.cfm?articleid=76 (last visited Sept. 27, 2005); *In re 199Z, Inc.*, 137 B.R. 778 (C.D. Cal 1992); *In re TR-3 Indus.*, 41 B.R. 128 (C.D. Cal 1984); *In re Roman Cleanser*, 43 B.R. 940, (E.D. Mich. 1984), *aff'd*, 802 F.2d 207 (6th Cir. 1986).
10. 35 U.S.C. § 261.
11. *Bensusan v. King*, 126 F.3d 25 (2nd Cir. 1997).
12. *See also Neogen Corp. v. Neo Gen Screening, Inc.*, 282 F.3d 883 (6th Cir. 2002).
13. 17 U.S.C. § 201(a).
14. 17 U.S.C. § 201(b).
15. 490 U.S. 730 (1989).

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New York's Information Security Breach and Notification Act: A First Step in Protecting Individuals from Identity Theft

By Marc David Hiller

I. Introduction

In an effort to address identity theft, New York State has enacted the Information Security Breach and Notification Act (Chapter 442 of the Laws of 2005; as amended by Chapter 491 of the Laws of 2005) ("the Act") to "guarantee state residents the right to know what information was exposed during a breach, so that they can take the necessary steps to both prevent and repair any damage that may occur because of a public or private sector entity's failure to make proper notification."[1] The Act adds section 208 to the State Technology Law (STL) to address a breach of private information held by a public sector entity, and it adds article 39-F (§ 899-aa) to the General Business Law (GBL) to address a breach of private information held by a business or person. If a system's security is breached, state entities and businesses or persons that own or license personal information are obligated to notify the subject of the information that results in, or that they have reason to believe results in, an unauthorized person obtaining such information. The Act took effect on December 7, 2005.

The statutes are a step in the right direction to protect people from identity theft. However, while they address what to do in the event of a breach, they do not address how to prevent a breach. To this extent, the statutes assume the existence of internal controls for identifying, cataloging, and protecting personal and private information in computerized data. Without these controls, the efficacy of any notice is substantially compromised. For purposes of this article, it is assumed that such comprehensive internal controls do not exist.

As noted, the statutes discuss what actions a state entity or business is required to take in the event a system is breached, but they do not address how to secure the system. For state entities a number of these issues are addressed outside the scope of STL § 208: STL § 203[2] requires any state agency website to have a privacy policy, and the Office of Cyber Security and Critical Infrastructure Coordination's (OCSCIC) Information Policy (P03-002 V. 2.0 Apr. 4, 2005) (http://www.cscic.state.ny.us/policies.htm#cs) contains internal controls relating to identifying, cataloging, and securing computerized data. However, for businesses there are no comparable generic requirements at either the state or federal level. At the federal level there are industry-specific statutes such as Gramm-Leach-Bliley[3] for the financial industry and the Health Insurance Privacy and Portability Act[4] for the health care industry. Accordingly, for most businesses this is an unregulated area that places the onus on individual businesses to make risk assessments, to the extent that they are aware of the issues. Therefore, for the majority of businesses, recognizing and addressing these issues is in its infancy and probably will not be addressed unless—and until—the individual business, or a business sector collectively, sustains a financial loss as a result of a breach, either by means of legal action or loss of revenue.

II. Definitions

The following definitions are used in both STL § 208 and GBL § 899-a:

> **"Personal information"** shall mean any information concerning a natural person, which, because of name, number, personal mark, or other identifier, can be used to identify such natural person;
>
> **"Private information"** shall mean personal information consisting of any information in combination with any one or more of the following data elements, when either the personal information or the data element is not encrypted, or encrypted with an encryption key that has also been acquired:
>
> > (1) social security number;
> >
> > (2) driver's license number or non-driver identification card number; or
> >
> > (3) account number, credit or debit card number, in combination with any required security code, access code, or password that would permit access to an individual's financial account.
>
> **"Private information"** does not include publicly available information which is lawfully made available to the general public from federal, state, or local government records.
>
> **"Breach of the security of the system"** shall mean unauthorized acquisition or

> acquisition without valid authorization of computerized data that compromises the security, confidentiality, or integrity of personal information maintained by a business. Good faith acquisition of personal information by an employee or agent of the business for the purposes of the business is not a breach of the security of the system, provided that the private information is not used or subject to unauthorized disclosure.
>
> In determining whether information has been acquired, or is reasonably believed to have been acquired, by an unauthorized person or a person without valid authorization, such business may consider the following factors, among others:
>
> > (1) indications that the information is in the physical possession and control of an unauthorized person, such as a lost or stolen computer or other device containing information; or
> >
> > (2) indications that the information has been downloaded or copied; or
> >
> > (3) indications that the information was used by an unauthorized person, such as fraudulent accounts opened or instances of identity theft reported.
>
> **"Consumer reporting agency"** shall mean any person who, for monetary fees, dues, or on a cooperative nonprofit basis, regularly engages in whole or in part in the practice of assembling or evaluating consumer credit information or other information on consumers for the purpose of furnishing consumer reports to third parties, and who uses any means or facility of interstate commerce for the purpose of preparing or furnishing consumer reports. A list of consumer reporting agencies shall be compiled by the state attorney general and furnished upon request to any person or business required to make a notification under subdivision two of this section.

III. Applicability

STL § 208 applies to a "state entity," which is defined as "any state board, bureau, division, committee, commission, council, department, public authority, public benefit corporation, office or other governmental entity performing a governmental or proprietary function for the state."[5] STL § 208 does not apply to the judiciary or to "cities, counties, municipalities, villages, towns, and other local agencies."[6]

GBL § 899-aa applies to "any person or business which conducts business in New York State, and which owns or licenses computerized data which includes private information."[7] For jurisdictional purposes, the use of the phrase "conducts business in New York State" does not seem to require a physical presence in New York, either for the business transaction, or with respect to the location of the "computerized data."

IV. Breach of the Security of a System

The statutes are triggered by a breach of the security of a system that contains personal or private information. The definition of a breach employs a reasonableness standard as to whether personal or private information was acquired without authorization. The statute does not, however, define what constitutes a "system," and it assumes the existence of a security protocol for the system to enable the discovery of the breach. Under the definition, the determination as to the existence and scope of a breach is subjective. Moreover, the statutes are silent as to who is responsible for determining whether there has been a breach—the computer technician or a member of the executive staff. As discussed below, to ensure that a determination as to the existence and scope of a breach is an objective one that follows defined procedures requires developing, implementing, and monitoring internal controls.

V. Notification

The Act declares that state residents "deserve the right to know when they have been exposed to identity theft."[8] The mechanism for providing this right is notification to the individual in the event of a "breach of the security of the system." The statutes establish different notification requirements depending on whether the state entity or business "owns or licenses computerized data which includes private information"[9] or whether it "maintains computerized data which includes private information"[10] the state entity or business does not own.

A. Notification by the Owner/Licensor of the Computerized Data

If a breach of a system's security is discovered, the owner or licensor of the computerized data must notify all New York residents who may be affected.[11] The disclosure must be done quickly, in accordance with the legitimate needs of law enforcement[12] and "any measures necessary to determine the scope of the breach and restore the reasonable integrity of the system."[13]

The statutes employ a reasonableness standard for the discovery of the breach; however, the core issue is not the discovery of the breach, but, rather, how quickly the discovery is made. Time is the critical element in defeating the harm caused by identity theft; the more time an unauthorized individual has access to, and use of, someone's private information, the greater the potential harm. Because the statutes do not impose any performance standards on discovery of a breach, a discovery within a day, a week, a month, or a year of the actual breach all could be reasonable and, therefore, in compliance with the statutes. The statutes do not address the mechanism or means for discovering a breach, which are internal controls regarding the establishment and monitoring of a security system. Without these types of performance standards, the protection offered by the statutes is not as strong as it could and should be to protect against identity theft.

Both statutes provide that notifications "may be delayed if a law enforcement agency determines that such notification impedes a criminal investigation." But the notification "shall be made after such law enforcement agency determines that such notification does not compromise such investigation."[14] Section 899-aa does not require a person or business to notify law enforcement of a breach, but the statute seems to assume notification to law enforcement will occur when assessing the breach. In addition, state entities are required to consult with the OCSCIC to determine the scope of the breach and appropriate restoration measures.[15] However, it is not clear whether OCSCIC or the state entity is responsible for notifying law enforcement.

B. Notification by a State Entity of Business That Only Maintains the Computerized Data

Where the breach is discovered by a state entity or a business that only "maintains computerized data which includes private information,"[16] and the state entity or business does not own such computerized data, the state entity or business shall immediately notify the owner or licensee of the information[17] upon discovery of the breach if "the private information was, or is reasonably believed to have been acquired by a person without valid authorization."[18] The statutes list the following factors for a state entity or a business to evaluate in order to determine whether "the private information was, or is reasonably believed to have been acquired by a person without valid authorization":[19]

1. indications that the information is in the physical possession and control of an unauthorized person, such as a list or stolen computer or other device containing the information;
2. indications that the information has been downloaded or copied; or
3. indications that the information was used by an unauthorized person, such as fraudulent accounts opened or instances of identity theft being reported.[20]

C. Notification to Affected Individuals

The statutes contain identical provisions regarding the methods for providing notice. The notice must be provided by one of the following means:

1. written notification;
2. telephone notification; or
3. electronic notification.[21]

The notice may be provided telephonically only if the state entity or business keeps a log of such notification.[22] The notice may be provided by electronic means only if the person receiving the notice has expressly consented to receiving such notice, and a log of each such notification is kept.[23] The statutes prohibit, however, requiring consent to accept electronic notice "as a condition of establishing any business relationship or engaging in any transaction."[24]

A substitute method of providing notice may be used if the state entity or business demonstrates to the Attorney General that the cost of providing the notice would exceed $250,000; that the affected class of subject persons to be notified exceeds 500,000; or that the state entity or business does not have sufficient contact information.[25] If the Attorney General determines that the state entity or business has met the requirements for providing substitute notice, the Attorney General can authorize the state entity or business to provide substitute notice that consists of the following:

1. e-mail notice when the state entity or business has an e-mail address for the subject persons;
2. conspicuous posting of the notice on the state entity's or business's website page, if it has a website; and
3. notification to major statewide media.[26]

The statutes are silent as to whether major statewide media refers to print, broadcast or cable television, radio, or all three.

The existence of internal controls would provide information sufficient either to obviate the necessity of providing notice by a substitute method or to justify the necessity of providing notice by substitute method.

D. Contents of the Notice

The notice required by the statutes is the same regardless of the medium and must contain the following information:

1. contact information for the state entity or business making the notification; and
2. a description of the categories of information that were, or are reasonably believed to have been, acquired by a person without valid authorization, including specification of which of the elements of personal information and private information were, or are reasonably believed to have been, acquired.[27]

The statutes employ a reasonableness standard for determining the nature and extent of the personal and/or private information that was or may have been disclosed. The deployment of internal controls for cataloging the personal and/or private information that is retained not only raises the standard for the retention of the records but also ensures more complete discovery of the personal and/or private information that was disclosed. The requirement of internal controls thereby would enhance the efficacy of the statutes.

E. Notice to the Attorney General, the Consumer Protection Board, and the Office of Cyber Security and Critical Infrastructure Coordination

If New York residents are to be notified, the statutes require that the Attorney General (AG), the Consumer Protection Board (CPB), and the Office of Cyber Security and Critical Infrastructure Coordination (OCSCIC) be notified as well. The notice to the above entities cannot delay the notice to the affected New York residents, and it must contain the following information regarding such notice: timing, content, and distribution of the notices, and the approximate number of affected persons.[28] The statutes do not address the coordination between or among these state entities or the coordination between these state entities and the state entity or business providing the required notification.

If more than 500,000 New York residents must be notified at one time, in addition to notifying the AG, CPB, and OCSCIC, the state entity or business issuing the notice must notify consumer reporting agencies in the same manner as the AG, CPB, and OCSCIC and without delaying the notice to the affected New York residents.[29]

The statutes do not specify what constitutes a delay in providing notice to the affected persons. Moreover, because the discovery of the breach is governed by a reasonableness standard, the imposition of these additional notice requirements without delaying the notice to affected persons appears incongruous. To require expediency in providing the notice but not in discovering the breach, which is the core issue in addressing the damage from identity theft, puts the focus on the cure and not on prevention. The deployment and monitoring of internal controls, by contrast, properly puts the emphasis on prevention.

VI. Applicability to Local Entities

At the same time that they are exempted from the requirements of STL § 208, "all cities, counties, municipalities, villages, towns, and other local agencies" (hereinafter "local entities") are required to adopt a notification policy, or alternatively a local law, within 120 days of the effective date (December 7, 2005),[30] which is consistent with STL § 208.[31] To ensure that local entities adopt provisions consistent with STL § 208, GBL § 899-aa(9) provides that the provisions of GBL § 899-aa are "exclusive and shall preempt any provision of local law, ordinance or code, and no locality shall impose requirements that are inconsistent with or more restrictive than those set forth in this section." Accordingly, despite specific language to the contrary in STL § 208, these two provisions effectively require local entities to comply with the provisions in STL § 208 and GBL § 899-aa. This raises the issue of whether they have sufficient internal controls in place, such as those required for state entities under the OCSCIC policy. It also raises the question of an unfunded mandate.

The Westchester County Board of Legislators has proposed a local law prohibiting commercial businesses within the county from providing public Internet access without installing a firewall to secure and prevent unauthorized access to all private information the commercial business may store, utilize, or otherwise maintain in the regular course of its business.[32] The definition of "private information" in the proposed local law is in sum and substance the same as the definition in GBL § 899-aa. The proposed local law does not, however, address the commercial business's responsibilities in the event of a breach of the firewall. The proposed local law highlights both the concern of multiple levels of government to address identity theft, as well as the potential for conflict between local laws and state statutes.

VII. Actions by the Attorney General Under GBL § 899-aa

GBL § 899-aa(6)[33] authorizes the Attorney General to bring an action to seek an injunction whenever the Attorney General believes that the article has been violated. In such an action, the court may award damages for actual costs or losses incurred by a person entitled to notice, including consequential financial losses. In addition to any other lawful remedy, if the court finds that the business knowingly or recklessly violated the article, the court can impose a civil penalty of the greater of $5,000 or up to $10 per instance of failed notification, provided that the latter amount shall not exceed $150,000. The statute of limitations for an action under GBL § 899-aa(6) is two years from the date of the act complained of or the date of discovery of the act.

In light of the reasonableness standard for discovery of a breach of the system, it is not clear what would constitute a violation of article 39-F of the GBL. However, if businesses were required to develop, implement, and monitor internal controls to prevent and identify a breach, establishing a violation would be substantially easier, being either a failure to establish or monitor the required internal controls. Requiring such internal controls would have enhanced the level of protection offered by the statute on both the front and the back end, and people would have been provided with better protection for the information by the business as well as by the AG in the event the business does not comply with article 39-F.

VIII. Recommendations

The statutes are a step in the right direction because providing notice of a breach can help fight identity theft. Unfortunately, notice only occurs after a breach; it is not designed to prevent a breach. The key to preventing a breach is identifying the pro-active steps a state entity or business can take to secure its computerized data. The statutes assume the existence of the internal controls necessary to secure such information and determine the existence of a breach. Fundamentally, the efficacy of the statutes is a matter of internal controls, and assessing the internal controls requires addressing the following questions, among others:

1. Does the entity receive personal information?
2. Does that personal information contain private information?
3. Does the entity have a security policy?
4. If so, how does it monitor and ensure the effectiveness of and compliance with its security policy?
5. Does it have the means to determine that there has been a breach, the extent of the breach, and the information that may have been compromised by the data?
6. Does it have a privacy policy?
7. If so, how does it monitor and ensure the effectiveness of and compliance with its privacy policy?

To comply with the statutes, a state entity or business must be able to determine if the triggering events under the statutes have occurred: that they have personal information that contains private information or that there has been, or may have been, a breach of the security of the system to an unauthorized individual. They also must determine to whom and how they need to provide the notification required by the statutes. A state entity or business also should ask these questions of any third party to whom they are entrusting their computerized data.

Developing, implementing, and complying with internal controls also may serve as a means by which a business can demonstrate that it did not act "recklessly" in the event the AG is evaluating whether to pursue an action under GBL § 899-aa(6).

IX. Pending Federal Legislation

There are a number of federal legislative efforts to address the issues of securing personal and private information and identity theft.[34] One such effort is S.1789, the "Personal Data Privacy and Security Act of 2005" (hereinafter the "Security Act"), sponsored by Senators Specter, Leahy, Feinstein, and Feingold to better protect the privacy of consumers' personal information. The Security Act establishes standards for business entities, data brokers, and government agencies to protect personally identifiable information. The Security Act also addresses methods for notifying individuals of a breach of the security system involving their personal information, as well as methods of enforcement by both the Attorney General and state attorneys general. The Security Act preempts state laws to the extent they are inconsistent with its provisions. Among the Security Act's findings is that "security breaches are a serious threat to consumer confidence, homeland security, e-commerce, and economic stability."[35]

Notification of security breaches is addressed in subtitle B of title IV of the Security Act. The Security Act defines a security breach as a "compromise of the security, confidentiality, or integrity of computerized data through misrepresentation or actions that result in, or there is a reasonable basis to conclude has resulted in, the unauthorized acquisition of and access to sensitive personally identifiable information."[36] As with the New York statutes, the Security Act addresses the right to the notice in section 421[37] (GBL § 899-aa(2); STL § 208(2)), the methods of notice in section 423[38] (GBL § 899-aa(5); STL § 208(5)), and the content of the notice in section 424[39] (GBL § 899-aa(7); STL § 208(6)).

Unlike the New York statutes the Security Act does not make an assumption about securing computerized data; it requires it. The Security Act, building off the experience of the Gramm-Leach-Bliley Act[40] and the Health Insurance Portability and Accountability Act of 1996 (HIPAA),[41] addresses internal controls, both their establishment and required testing.[42]

The Security Act will preempt any state law relating to notification of a security breach.[43] Therefore, if enacted, the Security Act would preempt GBL § 899-aa. The National Association of Attorneys General (NAAG), in an October 27, 2005, letter[44] signed by forty-seven state attorneys general addressed to Congressional leaders, called on Congress to enact a national security breach notification and urged Congress not to preempt the states from enacting and enforcing security breach laws because the states have been quicker to address concerns about privacy and identity theft than the federal government. The attorneys general requested that to the extent Congress seeks to preempt state laws, Congress narrowly tailor the preemption to only those laws that are inconsistent with the federal law and only to the extent of the inconsistency. The state attorneys general also asked that Congress enact a federal statute only if it could provide meaningful information to consumers; if not, the attorneys general asked that Congress leave the issue to the states because the states are responding strongly. Accordingly, it would appear that NAAG would oppose the blanket preemption contained in the Security Act as over-broad and as defeating the progressive efforts of the states to protect consumers.

New York is now among twenty-one states[45] to have adopted security breach notification statutes. The business community will argue that it is impractical, if not impossible, to comply with fifty different statutes, and that the only way to help the individual in the event of a breach is federal legislation. The push for federal legislation in this area will continue to gain force; and it is quite probable that some form of this legislation will pass in the next several sessions of Congress.

X. Conclusion

The New York information security breach statutes, while a step in the right direction, presume that state entities and businesses have created and comply with internal controls in the areas of privacy and security for computerized data. Notifying affected persons of a breach is only part of the solution to addressing identity theft. The core issue is examining how personal and private information is collected, stored, and protected, which requires developing, implementing, and monitoring internal controls. With respect to state entities, STL § 208 complements the requirement for privacy policies in article 2 of the State Technology Law, Internet and Security Privacy Act[46] and is more the ounce of prevention than the pound of cure. With respect to businesses, GBL § 899-aa is closer to the pound of cure than to the ounce of prevention because it does not address how the businesses identify and protect the personal information.

The issue and cost of identity theft, both to the individual and society, will continue to grow. The only way to prevent this is for individuals, as well as businesses, to establish internal controls as to whom and how they share personal information, whether their own or that of the customers, and the expectations of the businesses that retain this information. Businesses that take this next step, which is not required under GBL § 899-aa, not only put themselves in a better position to protect the personal information they presently have or license, but they also may be taking steps toward complying with potential federal requirements.

Endnotes

1. Section 2, Legislative Intent, of Chapter 442 of the Laws of 2005.
2. STL § 203.

   Model Internet privacy policy.

   1. The office shall adopt rules and regulations in conformity with the provisions of this article, and specify a model Internet privacy policy for state agencies that maintain state agency websites. Such model privacy policy shall include, but not be limited to, the following elements:
      1. a statement of any information, including personal information, the state agency website will collect with respect to the user and the use of the information;
      2. the circumstances under which information, including personal information, collected may be disclosed;
      3. whether any information collected will be retained by the state agency, and, if so, the period of time that such information will be retained;
      4. the procedures by which a user may gain access to the collected information pertaining to that user;
      5. the means by which information is collected and whether such collection occurs actively or passively;
      6. whether the collection of information is voluntary or required, and the consequences, if any, of a refusal to provide the required information; and
      7. the steps being taken by the state agency to protect the confidentiality and integrity of the information.
   2. Each state agency that maintains a state agency website shall adopt an Internet privacy policy which shall, at a minimum, include the information required by the model Internet privacy policy. Each state agency shall post its Internet privacy policy on its website. Such posting shall include a conspicuous and direct link to such privacy policy.
   3. The model Internet privacy policy specified by the office shall also be made available at no charge to other public and private entities.
3. Pub. L. No. 106–102 (1999).
4. Pub. L. No. 104–191 (1996).
5. STL § 208(c).

   "State entity" shall mean any state board, bureau, division, committee, commission, council, department, public authority, public benefit corporation, office or other governmental entity performing a governmental or proprietary function for the state of New York, except:

(1) the judiciary; and

(2) all cities, counties, municipalities, villages, towns, and other local agencies.

6. STL § 208(c)(1) and (2).

7. GBL § 899-aa(2).

Any person or business which conducts business in New York state, and which owns or licenses computerized data which includes private information shall disclose any breach of the security of the system following discovery or notification of the breach in the security of the system to any resident of New York state whose private information was, or is reasonably believed to have been, acquired by a person without valid authorization. The disclosure shall be made in the most expedient time possible and without unreasonable delay, consistent with the legitimate needs of law enforcement, as provided in subdivision four of this section, or any measures necessary to determine the scope of the breach and restore the reasonable integrity of the system.

8. Section 2 of Chapter 442 of the Laws of 2005.

Legislative Intent. The legislature finds that identity theft and security breaches have affected thousands statewide and millions of people nationwide. The legislature also finds that affected persons are hindered by a lack of information regarding breaches, and that the impact of exposing information that should be held private can be far-reaching. In addition, the legislature finds that state residents deserve a right to know when they have been exposed to identity theft.

The legislature further finds that affected state residents deserve an advocate who can speak and take action on their behalf because recovering from identity theft can, and sometimes does, take many years.

Therefore, the legislature enacts the information security breach and notification act which will guarantee state residents the right to know what information was exposed during a breach, so that they can take the necessary steps to both prevent and repair any damage they may incur because of a public or private sector entity's failure to make proper notification.

9. GBL § 899-aa(2).

10. GBL § 899-aa(3).

Any person or business which maintains computerized data which includes private information which such person or business does not own shall notify the owner or licensee of the information of any breach of the security of the system immediately following discovery, if the private information was, or is reasonably believed to have been, acquired by a person without valid authorization.

11. GBL § 899-aa(2); STL § 208(2).

Any state entity that owns or licenses computerized data that includes private information shall disclose any breach of the security of the system following discovery or notification of the breach in the security of the system to any resident of New York state whose private information was, or is reasonably believed to have been, acquired by a person without valid authorization. The disclosure shall be made in the most expedient time possible and without unreasonable delay, consistent with the legitimate needs of law enforcement, as provided in subdivision four of this section, or any measures necessary to determine the scope of the breach and restore the reasonable integrity of the data system.

The state entity shall consult with the state office of cyber security and critical infrastructure coordination to determine the scope of the breach and restoration measures.

12. GBL § 899-aa(4) and STL § 208(4).

The notification required by this section may be delayed if a law enforcement agency determines that such notification impedes a criminal investigation. The notification required by this section shall be made after such law enforcement agency determines that such notification does not compromise such investigation.

13. GBL § 899-aa(2); STL § 208(2).

2. Any state entity that owns or licenses computerized data that includes private information shall disclose any breach of the security of the system following discovery or notification of the breach in the security of the system to any resident of New York state whose private information was, or is reasonably believed to have been, acquired by a person without valid authorization. The disclosure shall be made in the most expedient time possible and without unreasonable delay, consistent with the legitimate needs of law enforcement, as provided in subdivision four of this section, or any measures necessary to determine the scope of the breach and restore the reasonable integrity of the data system. The state entity shall consult with the state office of cyber security and critical infrastructure coordination to determine the scope of the breach and restoration measures.

14. GBL § 899-aa(4); STL § 208(4).

15. STL § 208(2).

16. GBL § 899-aa(3).

Any person or business which maintains computerized data which includes private information which such person or business does not own shall notify the owner or licensee of the information of any breach of the security of the system immediately following discovery, if the private information was, or is reasonably believed to have been, acquired by a person without valid authorization.

STL § 208(3). Any state entity that maintains computerized data that includes private information which such agency does not own shall notify the owner or licensee of the information of any breach of the security of the system immediately following discovery, if the private information was, or is reasonably believed to have been, acquired by a person without valid authorization.

17. GBL § 899-aa(3).

18. GBL § 899-aa(3); STL § 208(3).

19. STL § 208(3).

20. GBL § 899-aa(1).

"Breach of the security of the system" shall mean unauthorized acquisition or acquisition without valid authorization of computerized data that compromises the security, confidentiality, or integrity of personal information maintained by a business. Good faith acquisition of personal information by an employee or agent of the business for the purposes of the business is not a breach of the security of the system, provided that the private information is not used or subject to unauthorized disclosure.

In determining whether information has been acquired, or is reasonably believed to have been acquired, by an unauthorized person or a person without valid authorization, such business may consider the following factors, among others:

(1) indications that the information is in the physical possession and control of an unauthorized person, such as a lost or stolen computer or other device containing information; or

(2) indications that the information has been downloaded or copied; or

(3) indications that the information was used by an unauthorized person, such as fraudulent accounts opened or instances of identity theft reported.

STL § 208(1)(b).

"Breach of the security of the system" shall mean unauthorized acquisition or acquisition without valid authorization of computerized data which compromises the security, confidentiality, or integrity of personal information maintained by a state entity. Good faith acquisition of personal information by an employee or agent of a state entity for the purposes of the agency is not a breach of the security of the system, provided that the private information is not used or subject to unauthorized disclosure.

In determining whether information has been acquired, or is reasonably believed to have been acquired, by an unauthorized person or a person without valid authorization, such state entity may consider the following factors, among others:

(1) indications that the information is in the physical possession and control of an unauthorized person, such as a lost or stolen computer or other device containing information; or

(2) indications that the information has been downloaded or copied; or

(3) indications that the information was used by an unauthorized person, such as fraudulent accounts opened or instances of identity theft reported.

21. GBL § 899-aa(5).

The notice required by this section shall be directly provided to the affected persons by one of the following methods:

(a) written notice;

(b) electronic notice, provided that the person to whom notice is required has expressly consented to receiving said notice in electronic form and a log of each such notification is kept by the person or business who notifies affected persons in such form; provided further, however, that in no case shall any person or business require a person to consent to accepting said notice in said form as a condition of establishing any business relationship or engaging in any transaction.

(c) telephone notification provided that a log of each such notification is kept by the person or business who notifies affected persons; or

(d) Substitute notice, if a business demonstrates to the state attorney general that the cost of providing notice would exceed two hundred fifty thousand dollars, or that the affected class of subject persons to be notified exceeds five hundred thousand, or such business does not have sufficient contact information. Substitute notice shall consist of all of the following:

(1) e-mail notice when such business has an e-mail address for the subject persons;

(2) conspicuous posting of the notice on such business's web site page, if such business maintains one; and

(3) notification to major statewide media.

STL § 208(5).

The notice required by this section shall be directly provided to the affected persons by one of the following methods:

(a) written notice;

(b) electronic notice, provided that the person to whom notice is required has expressly consented to receiving said notice in electronic form and a log of each such notification is kept by the state entity who notifies affected persons in such form; provided further, however, that in no case shall any person or business require a person to consent to accepting said notice in said form as a condition of establishing any business relationship or engaging in any transaction;

(c) telephone notification provided that a log of each such notification is kept by the state entity who notifies affected persons; or

(d) Substitute notice, if a state entity demonstrates to the state attorney general that the cost of providing notice would exceed two hundred fifty thousand dollars, or that the affected class of subject persons to be notified exceeds five hundred thousand, or such agency does not have sufficient contact information. Substitute notice shall consist of all of the following:

(1) e-mail notice when such state entity has an e-mail address for the subject persons;

(2) conspicuous posting of the notice on such state entity's web site page, if such agency maintains one; and

(3) notification to major statewide media.

22. GBL § 899-aa(5)(c); STL § 208(5)(c).

23. GBL § 899-aa(5)(b); STL § 208(5)(b).

24. *Id.*

25. GBL § 899-aa(5)(d); STL § 208(5)(d).

26. *Id.*

27. GBL § 899-aa(7).

Regardless of the method by which notice is provided, such notice shall include contact information for the person or business making the notification and a description of the categories of information that were, or are reasonably believed to have been, acquired by a person without valid authorization, including specification of which of the elements of personal information and private information were, or are reasonably believed to have been, so acquired.

STL § 208(6).

Regardless of the method by which notice is provided, such notice shall include contact information for the state entity making the notification and a description of the categories of information that were, or are reasonably believed to have been, acquired by a person without valid authorization, including specification of which of the elements of personal information and private information were, or are reasonably believed to have been, so acquired.

28. GBL § 899-aa(8).

(a) In the event that any New York residents are to be notified, the person or business shall notify the state attorney general, the consumer protection board, and the state office of cyber security and critical infrastructure coordination as to the timing, content and distribution of the notices and approximate number of affected persons. Such notice shall be made without delaying notice to affected New York residents.

(b) In the event that more than five thousand New York residents are to be notified at one time, the person or business shall also notify consumer reporting agencies as to the timing, content and distribution of the notices and approximate number of affected persons. Such notice shall be made without delaying notice to affected New York residents.

STL § 208(8).

Any entity listed in subparagraph two of paragraph (c) of subdivision one of this section shall adopt a notification policy no more than one hundred twenty days after the effective date of this section. Such entity may develop a notification policy which is consistent with this section or alternatively shall adopt a local law which is consistent with this section.

29. GBL § 899-aa(8)(b); STL § 208(7) (b).

30. STL § 208(8).

31. STL § 208(8).

32. http://www.westchestergov.com/currentnews/2005pr/Wireless%20law.htm. Oct. 2005:

BOARD OF LEGISLATORS
COUNTY OF WESTCHESTER

Your Committee is in receipt of a communication from the County Executive urging the adoption of a Local Law adding Article XV to Chapter 863 of the Laws of Westchester County with respect to requiring all commercial businesses in Westchester County utilizing electronic means of maintaining personal information to have a secure network to protect the public from potential identity theft and other potential threats such as computer viruses and data corruption.

Your Committee notes that ever-evolving wireless communication technology has spawned various concerns with respect to the security of personal information such as Social Security numbers and credit card and bank accounts. One of the fastest growing areas in this regard is wireless fidelity or "Wi-Fi" which offers wireless Internet access to local area networks.

Your Committee also notes that Wi-Fi has traditionally been used in airports and hotels to assist business travelers. However, the trend has caught on and there are a growing number of commercial businesses using or offering Wi-Fi communication, colloquially known as "Internet cafes."

Your Committee is aware that the creation of these "hotspots" wherein Wi-Fi is provided offers an increased opportunity for identity thieves to prey on Internet users who might otherwise believe their personal information is secure. It is not only the Wi-Fi user who is at risk of identity theft. Identity theft may also occur where the business entity offering Wi-Fi utilizes the same network to conduct their day-to-day business. This practice could place a customer, who has made a credit card purchase with the business at risk for identity theft, computer viruses and data corruption from persons with rudimentary computer skills absent the appropriate security measures.

Your Committee is further aware that any entity which collects personal information could be vulnerable to threats of identity theft even if they do not offer Internet access to the public. A local retail store maintains personal information from your credit card and unless that store has taken the appropriate security measures such as installing a firewall, your personal information is at risk.

Your Committee is informed that while Wi-Fi communication offers opportunity for identity theft, so too does the use of traditional wired land area networks (LANs). Commercial entities that offer Internet connections through LANs expose themselves to electronic predators if such entities utilize the same LAN without appropriate security precautions.

Your Committee is also aware that while this Local Law is designed to help protect residents from certain cyber threats it does not provide a guarantee of such security. Therefore, the County will provide ongoing public education, through the distribution of pamphlets and postings on the County's website, outlining steps that residents should take to help protect themselves from the threat of identity theft through the use of computers and other electronic devices. The public education effort will track the latest technological advances in order to provide up-to-date and meaningful assistance.

Your Committee, in order to protect the residents of Westchester County and other users of wired and wireless networks from crimes such as identity theft and other consumer fraud, recommends adoption of this Local Law.

Dated: , 2005

RESOLUTION NO. - 2005

RESOLVED, that this Board hold a public hearing pursuant to Section 209.141(4) of the Laws of Westchester County on Local Law Intro. No. -2005 entitled "A Local Law amending the Laws of Westchester County requiring any entity offering or utilizing public Internet access to have a secure network to protect the public from potential identity theft and other risks related to computer use." The public hearing will be held at m. on the day of , 2005 in the Chambers of the Board of Legislators, 8th Floor, Michaelian Office Building, White Plains, New York. The Clerk of the Board shall cause notice of the time and date of such hearing to be published at least once in one or more newspapers published in the County of Westchester and selected by the Clerk of the Board for that purpose in the manner and time required by law.

LOCAL LAW 2005

A Local Law amending the Laws of Westchester County requiring any entity offering or utilizing public Internet access to have a secure network to protect the public from potential identity theft and other risks related to computer use.

BE IT ENACTED by the County Board of the County of Westchester as follows:

Section 1. A new Article XV shall be added to Chapter 863 of the Laws of Westchester County to read as follows:

ARTICLE XV. PUBLIC INTERNET PROTECTION ACT.

Sec. 863.1201. Definitions.

1. "Public Internet access" shall mean any commercial business that offers Internet access to the general public.
2. "Commercial business" shall mean any entity physically located in Westchester County that, for profit, offers goods or services for sale.
3. "Private information" shall mean personal information in combination with any one or more of the following data elements, when either the personal information or the data element is not encrypted (translated into private code) or encrypted with an encryption key that has also been acquired:
   (a) Social Security number;
   (b) driver's license number or non-driver identification card number; or
   (c) account number, credit card or debit card number, in combination with any required security code, access code, or password which would permit access to an individual's financial account.
4. "Firewall" shall mean a set of related programs or hardware, located at a network gateway server that protects the resources of a private network from users of other networks.

Sec. 863.1202. Security of Personal Information.

1. Public Internet access shall not be made available unless the commercial business providing such public access has installed a firewall to secure and prevent unauthorized access to all private information that such entity may store, utilize or otherwise maintain in the regular course of its business. Any commercial business providing public Internet access shall conspicuously post a sign stating:

   YOU ARE ACCESSING A NETWORK WHICH HAS BEEN SECURED WITH FIREWALL PROTECTION. SINCE SUCH PROTECTION DOES NOT GUARANTEE THE SECURITY OF YOUR PERSONAL INFORMATION, USE YOUR OWN DISCRETION.
2. Any commercial business that stores, utilizes or otherwise maintains private information electronically shall install a firewall to secure and prevent unauthorized access to all such information.

Sec. 863.1203. Notice of Compliance.

Any commercial business providing public Internet access shall, within 90 days of the enactment of this Local Law, file a notice of compliance with the provisions of this Article stating that such entity has installed a firewall as required by Section 863.1202 herein. Such notice of compliance shall be made available by the Westchester County Department of Weights and Measures.

Sec. 863.1204. Public education effort.

The Westchester County Department of Weights and Measures, in conjunction with the Westchester County Department of Information Technology, shall prepare and make available a pamphlet which shall inform and educate both the general public and the providers of public Internet access regarding the implications of this Local Law, including the need for network security measures in places of public accommodations. Such pamphlet shall also include information to assist the general public in protecting themselves from the potential of identity theft through the use of wireless Internet connections regardless of where such connections originate. Such information shall also be made available through the official Westchester County government web site at www.westchestergov.com.

Sec. 863.1205. Enforcement and Penalties.

1. The provisions of this article shall be enforced by the Westchester County Department of Weights and Measures.
2. A first violation for failure to file a notice of compliance shall result in a warning by the Westchester County Department of Weights and Measures which shall state that the offender has thirty (30) days to complete and file a notice of compliance. Failure to file a completed notice of compliance within the thirty day period shall constitute a first violation.
3. For a second violation of this Article, a civil penalty not exceeding two hundred and fifty dollars ($250.00) shall be imposed. For the third and succeeding violations, a civil penalty not exceeding five hundred dollars ($500.00) shall be imposed for each single violation. No civil penalty shall be imposed as provided for herein unless the alleged violator has received notice of the charge against him or her and has had an opportunity to be heard.

Sec. 863.1206. Severability.

If any section, subsection, sentence, clause, phrase or other portion of this local law is, for any reason, declared unconstitutional or invalid, in whole or in part, by any court of competent jurisdiction such portion shall be deemed severable, and such unconstitutionality or invalidity shall not affect the validity of the remaining portions of this law, which remaining portions shall continue in full force and effect.

Section 2. This Local Law shall take effect one hundred and eighty (180) days following its enactment.

33. GBL § 899-aa(6) 6.

(a) whenever the attorney general shall believe from evidence satisfactory to him that there is a violation of this article he may bring an action in the name and on behalf of the people of the state of New York, in a court of justice having jurisdiction to issue an injunction, to enjoin and restrain the continuation of such violation.

In such action, preliminary relief may be granted under article sixty-three of the civil practice law and rules. In such action the court may award damages for actual costs or losses incurred by a person entitled to notice pursuant to this article, if notification was not provided to such person pursuant to this article, including consequential financial losses. Whenever the court shall determine in such action that a person or business violated this article knowingly or recklessly, the court may impose a civil penalty of the greater of five thousand dollars or up to ten dollars per instance of failed notification, provided that the latter amount shall not exceed one hundred fifty thousand dollars.

(b) the remedies provided by this section shall be in addition to any other lawful remedy available.

(c) no action may be brought under the provisions of this section unless such action is commenced within two years immediately after the date of the act complained of or the date of discovery of such act.

34. S.1408, A bill to strengthen data protection and safeguards, require data breach notification, and further prevent identity theft, http://thomas.loc.gov/cgi-bin/bdquery/?&Db=d109&querybd=@FIELD(FLD003+@4((@1(Sen+Smith++Gordon+H.))+01549))" [OR];

H.R.1745, To amend the Social Security Act to enhance Social Security account number privacy protections, to prevent fraudulent misuse of the Social Security account number, and to otherwise enhance protection against identity theft, and for other purposes; [FL-22]

35. S.1789, Sec. 2. FINDINGS.

Congress finds that:

(1) databases of personally identifiable information are increasingly prime targets of hackers, identity thieves, rogue employees, and other criminals, including organized and sophisticated criminal operations;

(2) identity theft is a serious threat to the nation's economic stability, homeland security, the development of e-commerce, and the privacy rights of Americans;

(3) over 9,300,000 individuals were victims of identity theft in America last year;

(4) security breaches are a serious threat to consumer confidence, homeland security, e-commerce, and economic stability;

(5) it is important for business entities that own, use, or license personally identifiable information to adopt reasonable procedures to ensure the security, privacy, and confidentially of that personally identifiable information;

(6) individuals whose personal information has been compromised or who have been victims of identity theft should receive the necessary information and assistance to mitigate their damages and to restore the integrity of their personal information and identities;

(7) data brokers have assumed a significant role in providing identification, authentication, and screening services, and related data collection and analyses for commercial, nonprofit, and government operations;

(8) data misuse and use of inaccurate data have the potential to cause serious or irreparable harm to an individual's livelihood, privacy, and liberty and undermine efficient and effective business and government operations;

(9) there is a need to ensure that data brokers conduct their operations in a manner that prioritizes fairness, transparency, accuracy, and respect for the privacy of consumers;

(10) government access to commercial data can potentially improve safety, law enforcement, and national security; and

(11) because government use of commercial data containing personal information potentially affects individual privacy, and law enforcement and national security operations, there is a need for Congress to exercise oversight over government use of commercial data.

36. S.1785, Sec. 3(10).

SECURITY BREACH

(A) IN GENERAL—The term `security breach' means compromise of the security, confidentiality, or integrity of computerized data through misrepresentation or actions that result in, or there is a reasonable basis to conclude has resulted in, the unauthorized acquisition of and access to sensitive personally identifiable information.

(B) EXCLUSION—The term `security breach' does not include:

(i) a good faith acquisition of sensitive personally identifiable information by a business entity or agency, or an employee or agent of a business entity or agency, if the sensitive personally identifiable information is not subject to further unauthorized disclosure; or

(ii) the release of a public record not otherwise subject to confidentiality or nondisclosure requirements.

37. S.1789, Sec. 421.

NOTICE TO INDIVIDUALS

(a) In General—Any agency, or business entity engaged in interstate commerce, that uses, accesses, transmits, stores, disposes of or collects sensitive personally identifiable information shall, following the discovery of a security breach maintained by the agency or business entity that contains such information, notify any resident of the United States whose sensitive personally identifiable information was subject to the security breach.

(b) Obligation of Owner or Licensee

(1) NOTICE TO OWNER OR LICENSEE—Any agency, or business entity engaged in interstate commerce, that uses, accesses, transmits, stores, disposes of, or collects sensitive personally identifiable information that the agency or business entity does not own or license shall notify the owner or licensee of the information following the discovery of a security breach containing such information.

(2) NOTICE BY OWNER, LICENSEE OR OTHER DESIGNATED THIRD PARTY—Nothing in this subtitle shall prevent or abrogate an agreement between an agency or business entity required to give notice under this section and a designated third party, including an owner or licensee of the sensitive personally identifiable information subject to the security breach, to provide the notifications required under subsection (a).

(3) BUSINESS ENTITY RELIEVED FROM GIVING NOTICE—A business entity obligated to give notice under subsection (a) shall be relieved of such obligation if an owner or licensee of the sensitive personally identifiable information subject to the security breach, or other designated third party, provides such notification.

(c) Timeliness of Notification

(1) IN GENERAL—All notifications required under this section shall be made without unreasonable delay following:

(A) the discovery by the agency or business entity of a security breach; and

(B) any measures necessary to determine the scope of the breach, prevent further disclosures, and restore the reasonable integrity of the data system.

(2) BURDEN OF PROOF—The agency, business entity, owner, or licensee required to provide notification under this section shall have the burden of demonstrating that all notifications were made as required under this subtitle, including evidence demonstrating the necessity of any delay.

(d) Delay of Notification Authorized for Law Enforcement Purposes

(1) IN GENERAL—If a law enforcement agency determines that the notification required under this section would impede a criminal investigation, such notification may be delayed upon the written request of the law enforcement agency.

(2) EXTENDED DELAY OF NOTIFICATION—If the notification required under subsection (a) is delayed pursuant to paragraph (1), an agency or business entity shall give notice 30 days after the day such law enforcement delay was invoked unless a law enforcement agency provides written notification that further delay is necessary.

38. S.1789, Sec. 423.

METHODS OF NOTICE.

An agency, or business entity shall be in compliance with section 421 if it provides:

(1) INDIVIDUAL NOTICE

(A) Written notification to the last known home mailing address of the individual in the records of the agency or business entity; or

(B) E-mail notice, if the individual has consented to receive such notice and the notice is consistent with the provisions permitting electronic transmission of notices under section 101 of the Electronic Signatures in Global and National Commerce Act (15 U.S.C. 7001).

(2) MEDIA NOTICE—If more than 5,000 residents of a State or jurisdiction are impacted, notice to major media outlets serving that State or jurisdiction.

39. S.1789, Sec. 424.

CONTENT OF NOTIFICATION.

(a) In General—Regardless of the method by which notice is provided to individuals under section 423, such notice shall include, to the extent possible:

(1) a description of the categories of sensitive personally identifiable information that was, or is reasonably believed to have been, acquired by an unauthorized person;

(2) a toll-free number

(A) that the individual may use to contact the agency or business entity, or the agent of the agency or business entity; and

(B) from which the individual may learn

(i) what types of sensitive personally identifiable information the agency or business entity maintained about that individual or about individuals in general; and

(ii) whether or not the agency or business entity maintained sensitive personally identifiable information about that individual; and

(3) the toll-free contact telephone numbers and addresses for the major credit reporting agencies.

(b) Additional Content—Notwithstanding section 429, a state may require that a notice under subsection (a) shall also include information regarding victim protection assistance provided for by that State.

40. Pub. L. No. 106–102 (1999).

41. Pub. L. No. 104–191 (1996).

42. S.1785, Sec. 401.

PURPOSE AND APPLICABILITY OF DATA PRIVACY AND SECURITY PROGRAM.

(a) Purpose—The purpose of this subtitle is to ensure standards for developing and implementing administrative, technical, and physical safeguards to protect the privacy, security, confidentiality, integrity, storage, and disposal of sensitive personally identifiable information.

(b) In General—A business entity engaging in interstate commerce that involves collecting, accessing, transmitting, using, storing, or disposing of sensitive personally identifiable information in electronic or digital form on 10,000 or more United States persons is subject to the requirements for a data privacy and security program under section 402 for protecting sensitive personally identifiable information.

(c) Limitations— Notwithstanding any other obligation under this subtitle, this subtitle does not apply to:

(1) financial institutions

(A) subject to the data security requirements and implementing regulations under the Gramm-Leach-Bliley Act (15 U.S.C. 6801 et seq.); and

(B) subject to

(i) examinations for compliance with the requirements of this Act by 1 or more federal or state functional regulators (as defined in section 509 of the Gramm-Leach-Bliley Act (15 U.S.C. 6809)); or

(ii) compliance with part 314 of title 16, Code of Federal Regulations; or

(2) "covered entities" subject to the Health Insurance Portability and Accountability Act of 1996 (42 U.S.C. 1301 et seq.), including the data security requirements and implementing regulations of that Act.

(d) Safe Harbor—A business entity shall be deemed in compliance with the privacy and security program requirements under section 402 if the business entity complies with or provides protection equal to industry standards, as identified by the Federal Trade Commission, that are applicable to the type of sensitive personally identifiable information involved in the ordinary course of business of such business entity.

Sec. 402.

REQUIREMENTS FOR A PERSONAL DATA PRIVACY AND SECURITY PROGRAM.

(a) Personal Data Privacy and Security Program—Unless otherwise limited under section 401(c), a business entity subject to this subtitle shall comply with the following safeguards and any others identified by the Federal Trade Commission in a rulemaking process pursuant to section 553 of title 5, United States Code, to protect the privacy and security of sensitive personally identifiable information:

(1) SCOPE—A business entity shall implement a comprehensive personal data privacy and security program that includes administrative, technical, and physical safeguards appropriate to the size and complexity of the business entity and the nature and scope of its activities.

(2) DESIGN—The personal data privacy and security program shall be designed to:

(A) ensure the privacy, security, and confidentiality of personal electronic records;

(B) protect against any anticipated vulnerabilities to the privacy, security, or integrity of personal electronic records; and

(C) protect against unauthorized access to use of personal electronic records that could result in substantial harm or inconvenience to any individual.

(3) RISK ASSESSMENT—A business entity shall:

(A) identify reasonably foreseeable internal and external vulnerabilities that could result in unauthorized access, disclosure, use, or alteration of sensitive personally identifiable information or systems containing sensitive personally identifiable information;

(B) assess the likelihood of and potential damage from unauthorized access, disclosure, use, or alteration of sensitive personally identifiable information; and

(C) assess the sufficiency of its policies, technologies, and safeguards in place to control and minimize risks from unauthorized access, disclosure, use, or alteration of sensitive personally identifiable information.

(4) RISK MANAGEMENT AND CONTROL—Each business entity shall:

(A) design its personal data privacy and security program to control the risks identified under paragraph (3); and

(B) adopt measures commensurate with the sensitivity of the data as well as the size, complexity, and scope of the activities of the business entity that:

(i) control access to systems and facilities containing sensitive personally identifiable information, including controls to authenticate and permit access only to authorized individuals;

(ii) detect actual and attempted fraudulent, unlawful, or unauthorized access, disclosure, use, or alteration of sensitive personally identifiable information, including by employees and other individuals otherwise authorized to have access; and

(iii) protect sensitive personally identifiable information during use, transmission, storage, and disposal by encryption or other reasonable means (including as directed for disposal of records under section 628 of the Fair Credit Reporting Act (15 U.S.C. 1681w) and the implementing regulations of such Act as set forth in section 682 of title 16, Code of Federal Regulations).

(b) Training—Each business entity subject to this subtitle shall take steps to ensure employee training and supervision for implementation of the data security program of the business entity.

(c) Vulnerability Testing

(1) IN GENERAL—Each business entity subject to this subtitle shall take steps to ensure regular testing of key controls, systems, and procedures of the personal data privacy and security program to detect, prevent, and respond to attacks or intrusions, or other system failures.

(2) FREQUENCY- The frequency and nature of the tests required under paragraph (1) shall be determined by the risk assessment of the business entity under subsection (a)(3).

(d) Relationship to Service Providers—In the event a business entity subject to this subtitle engages service providers not subject to this subtitle, such business entity shall:

(1) exercise appropriate due diligence in selecting those service providers for responsibilities related to sensitive personally identifiable information, and take reasonable steps to select and retain service providers that are capable of maintaining appropriate safeguards for the security, privacy, and integrity of the sensitive personally identifiable information at issue; and

(2) require those service providers by contract to implement and maintain appropriate measures designed to meet the objectives and requirements governing entities subject to this section, section 401, and subtitle B.

(e) Periodic Assessment and Personal Data Privacy and Security Modernization—Each business entity subject to this subtitle shall on a regular basis monitor, evaluate, and adjust, as appropriate, its data privacy and security program in light of any relevant changes in:

(1) technology;

(2) the sensitivity of personally identifiable information;

(3) internal or external threats to personally identifiable information; and

(4) the changing business arrangements of the business entity, such as:

(A) mergers and acquisitions;

(B) alliances and joint ventures;

(C) outsourcing arrangements;

(D) bankruptcy; and

(E) changes to sensitive personally identifiable information systems.

(f) Implementation Time Line—Not later than 1 year after the date of enactment of this Act, a business entity subject to the provisions of this subtitle shall implement a data privacy and security program pursuant to this subtitle.

43. S.1789, Sec. 429.

EFFECT ON FEDERAL AND STATE LAW. The provisions of this subtitle shall supersede any other provision of federal law or any provision of law of any state relating to notification of a security breach, except as provided in section 424(b).

44. http://www.naag.org/news/pdf/20051028-signon-InfoSecurityIDTheftLetter.pdf.

45. Arkansas, Connecticut, Delaware, Florida, Georgia, Illinois, Indiana, Louisiana, Maine, Minnesota, Montana, Nevada, New Jersey, New York, North Carolina, North Dakota, Ohio, Rhode Island, Tennessee, Texas, and Washington.

46. STL §§ 201–207.

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Developing a Law Firm Marketing Strategy

By Cheryl Wickham

Once upon a time, only the most senior attorneys at a firm worried about bringing in new clients, while the junior ones focused on developing their legal skills. The thinking was that new attorneys were simply not exposed to the individuals who made the legal hiring decisions and that young associates were too green in the law to convey the proper authority required for selling. This type of thinking has largely gone the way of the teletype. While many large firms still rely on these outmoded notions, many smaller firms have realized that rainmaking skills need to be developed as early as possible. While it may be that the more senior partners are responsible for closing the sale, much like when you judge a restaurant based on your treatment by a waitress standing outside having a smoke, everyone in the firm who has contact with a potential client can become part of the decision of whether someone will use your firm or not, and in the case of a current client, continue using the firm. This inextricably makes the whole staff of a firm part of the sales process and, as such, they should make the most of every interaction. If you do not have a marketing plan, or your associates are not informed of it, you are wasting valuable sales opportunities.

The following article is a brief description of the basics of marketing to assist you in drafting an action plan for your firm.

The first step is to define the objective of your firm. What kind of practice would you like to have? What kind of clients? Where do you see the firm in five years? Ten years? As an associate, think about what kind of work you would like to do and whether it fits into the firm philosophy. If you want to reach your goals, you have to know what they are, so be as specific as possible when writing them down. Some examples of goals are: 1) to sign 10 new clients every 6 months; 2) to build a practice specializing in plaintiff-side employment discrimination (e.g., at least 80 percent of all clients by the end of the year) and; 3) to provide services to at least 1 but no more than 5 pro bono clients at any given time. By having specific numbers and deadlines associated with your goals, you can gauge your success.

Next you will need to prepare your firm "press kit" consisting of materials that can be easily distributed to potential clients when they ask for information. A good press kit can include: business cards, a firm biography on letterhead, biographies of all the firm attorneys, a collection of articles written by attorneys at the firm or a listing of articles, and a short list of events either hosted by the firm or in which attorneys have participated. You may also decide to have a professional-looking folder to hold these items, as well as electronic versions of these documents (preferably in .pdf format) and a website containing all of these items. All your materials should have a uniform look. At the very least they should all use the same colors and fonts. If you have a firm trademark or logo, you should use this on all your materials. For branding purposes, the idea is to create a lasting association between you and your firm's reputation.

The most important part of your press kit is the firm bio. Draft a short description of the firm based on what you want the firm to be, rather than what it currently is. You can use the language you draft for your bio when describing your firm to potential clients. This is your message. For example, we like to say "MasurLaw is a boutique entertainment firm specializing in licensing content for technology." This way, people we tell about the firm can tell others. If your message is short, sweet and consistent, it can be memorized by everyone in the firm and repeated to anyone who asks the questions, "What kind of law do you practice?" By this means, you can create a viral marketing strategy that can be spread by anyone who hears about the firm.

The rest of the biography should be a background of the firm and any current projects that might be of interest to a potential client. For example, if you do work for a high profile client, you should put this in your biography. Be sure to clear this with the client first, however, since this can be considered confidential information. Finally, draft your bio with your dream potential client's needs in mind. Carefully consider the impact on potential clients of any written work included in your press kit. Does it address any questions and concerns they might have? Does it paint you and your firm in the most favorable light? If not, consider redrafting it or leaving it out.

Once you have completed your marketing materials, you are ready to begin formally reaching out to people. Word of mouth is one of the key ingredients in any good marketing plan. So, a good step is to review the needs of your current clients. Current clients are your best source for new work and good word of mouth. Are they happy with you, and are you serving them well? If not, you need to find out why and correct it. If they feel neglected because you do not call them back regularly or your paralegal regularly screams at people because she's overworked, then you need to fix these problems. If you are not worried about the legal ramifications of your neglect, at least consider how awful the PR will be as a result! There's nothing worse than one of your clients telling his whole circle of friends how much he cannot stand dealing with your staff. Bad behavior, even if rare, is more memorable than good behavior, and its effects can take a long time to repair. Also, do not assume that because you are not hearing complaints that everyone is happy; some people complain by walking away.

If your clients are happy, they might lead you to cross-selling opportunities. This means finding out whether they have any additional legal needs that you may be able to meet. For example, if you were hired to represent someone in a breach of contract suit, but you heard through the grapevine that this person is starting a restaurant business and this is your firm's specialty, it would be silly not to mention your skills to him. Often people will categorize you without knowing the full range of your services. Alternatively, it can be helpful to refer clients whose legal needs you cannot meet to other attorneys skilled in those areas, even if they are with other firms. While at first you might be fearful of losing the business, your clients will be grateful and will be inclined to refer others to you. Also, this will help you develop good relationships with other firms which are an excellent source of referrals.

So, you have looked at your current clients and you are ready to get some new ones. You need to educate yourself about the marketplace. If you are selling your services to individuals, find out where the types of individuals you would like to have as clients find their lawyers. This may be from referrals by friends and family, through people at their church or synagogue, from people at their gym or country club, or from other lawyers they have used in the past. Find a way to get your name to these people—either by participating in activities or by knowing people who do. Consider whether paid advertising would reach and be received positively by your potential clients, but be mindful that many people see this as tacky. If you are looking for corporate clients, a little research really pays off. Go online and learn about the companies that might need your services. Read trade magazines. Join trade organizations. Get to know as much as you can about your industry of interest, not just the players, but also the field itself. Do not limit yourself to just the law related to your field of interest. Once you have learned as much as possible, create a database of potential clients and add to it everyone you have met and everyone you would like to meet. Keep this database "clean" (no duplicates) and up-to-date. Categorize each contact by industry, size, and level of potential interest. Use this database to track all your marketing outreach, such as meetings you have had or sales calls you have made. It is also good to note any personal information you have learned or cues that help you remember how you met a person because it is sometimes difficult to recall that person later.

Now that you have the basics together you can begin reaching out. One suggestion is to develop a mass mailing to establish contact with your potential clients and to introduce the firm. You can use the response to this mailing to gauge interest in your firm and to narrow your pool of prospects. This can be a useful tool, but it is not one you should solely rely on. As in most service industries, people choose their lawyer primarily by the expertise they perceive them as having. Since potential clients will not be able to experience your skills until they have hired you, a good portion of your outreach should be directed at establishing your expertise. Good ways to establish your expertise and make a name for your firm include publishing articles, speaking at conferences, and getting quoted by the press. While you are establishing your expertise, you are also exposing yourself to potential clients, so it can be your strongest marketing tool. Use any opportunity you can, whether you are speaking at a conference or simply attending it, to introduce yourself to as many people as possible. Your goals in these situations should be to 1) introduce and describe your firm, 2) collect business cards or contact information and, 3) connect on a personal level with people. This is not the place to close deals; you can follow up later.

Most of this may seem like common sense, but it takes a lot of hard work and organization to actually do it. Once you've gone to the effort of making your press kit and meeting people, the most important task is still left: to follow up with and sell to your new leads. You should do this with a telephone call, since it is personal. The goal of the telephone follow-up is to gather information and to turn a 'cool' prospect into a 'warm' one. Before you call, prepare a few questions to ask so that you can develop consistent tracking and some marketplace observations. Be sure to listen carefully and address any questions the potential client may have. If you do not know something, it is okay to say, "I don't have the information to answer that right now, but I can get back to you with the answer." Make sure if you make any promises you keep them. The goal is to start a dialogue where the potential clients think of you for any legal work they may have. Marketing and selling is a slow process, but if you keep track of your outreach and consistently follow up, you are sure to see results. Finally, do not get too overwhelmed by the amount of work you have to do. By starting small and setting realistic goals for what you can accomplish in a given period of time, you can steadily move your firm and your career to greater heights.

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Sales Tax Planning of Organizations, Acquisitions, Reorganizations and Dissolutions

By Barry Leibowicz

There is an essential disconnect between the income and sales tax rules that govern corporate and partnership organizations, reorganizations and dissolutions. Whether this difference causes enormous hardship or confers a great benefit often depends simply on whether it is adequately considered in the planning process.

From inception, every business is confronted with questions of business form and transactional structure. The initial question of which business form best suits the current and projected nature of the business must be dealt with before any experience with the business operations is available for guidance. Once the initial form is selected, questions continue throughout the life of the enterprise as to how the business will be capitalized, assets acquired and disposed of, owners added or removed, reorganizations accomplished, and, eventually, how the business will be terminated.

A major factor in answering all of these questions is the tax effect of competing organizational and transactional forms. Generally, business tax advisors are well versed in the pros and cons of the various business forms and transactions from the federal income tax perspective. If business operations are to be conducted in a state such as New York, the income tax rules essentially parallel those of the federal tax for these transactions. As a result there is usually consistency in tax planning from both the federal and state income tax perspective. Quite predictably, the focus of business tax planning for entity choice, formation, operation, acquisition and dissolution is often exclusively concerned with income tax consequences. In many instances, sales tax issues are given short shrift in the decision-making process, if they are considered at all. This inattention can, however, be very costly.

Unlike state and local income taxes, which generally "piggyback" on the federal rules, there is a core disconnect between the income tax rules and those of the sales tax. In New York, the state sales tax was adopted in 1965, modeled after a 1934 New York City sales tax. As such, the tax, and its basic underpinnings, stems from an entirely different root than that of the federal, state and local income taxes. The sales tax, and its sibling, the use tax, are seemingly clear-cut and simplistic. However, in interpretation and administration, the sales and use taxes are among the most complex and arcane in existence today. An entirely different set of criteria applies to the sales and use tax definition than for other taxes. A person who is subject to the sales tax, and deemed a resident for purposes of that tax, may not be deemed a resident for income tax purposes. Transactions which are recognized under the income tax may not be recognized for sales and use purposes, or vice versa. In many respects, the New York State and local sales taxes are more complex than the equivalent state, local or federal income taxes in application and administration. Without doubt, the results of a transaction for sales and use tax purposes are more difficult to predict than under the income tax.

Much of the language of the income and sales taxes appears similar, adding to the peril which results from inattention. It is not safe to assume that transactions optimized for income tax benefits will be best suited for sales tax purposes, as there is a significant danger that taxes will have to be paid which could have been substantially reduced or avoided. This article seeks to point out important areas of concern both in sales and use tax consequences of entity selection and in transactional planning for reorganizations and acquisitions. By highlighting the divergence between income and sales tax rules in New York State, this article will hopefully encourage planning that takes these differences into account, thereby minimizing the overall tax burden.

The New York sales and use tax is broader in scope than many other sales taxes since it covers a wide range of services, as well as transfers of property. Under New York law, a sale occurs whenever there is a transfer of title, possession or both for consideration or for the rendering of any service which the statute enumerates as subject to tax.[1] Sales would include barter, rental, leasing and license to use or consume, whether conditional or otherwise, and includes any agreement to transfer title or possession or both of tangible personal property, as well as any redemption of reward credit for merchandise. A use is defined as the "exercise of any right or power over tangible personal property . . . by the purchaser thereof."[2] Sales are broadly construed,[3] and there is a presumption of taxability for any sale or use.[4] However, exclusions from the taxable transactions enumerated in New York Tax Law § 1105 are broadly construed, with the benefit of the doubt being given to the taxpayer.[5]

In contrast to the taxpayer-friendly interpretations mandated for exclusions, the exemptions as set forth in Tax Law § 1115 are strictly construed and narrowly interpreted in a manner favoring the state.[6]

It is the interaction of the broad definition of sale and use,[7] the limitation of the tax to tangible property only,[8] and a unique exemption for corporate and partnership transactions that give rise to the immense danger of creating sales tax liabilities in the course of these transactions. However, a corollary also applies. The differences in income and sales tax treatment present significant potential to reduce or eliminate sales taxes otherwise payable on reorganization and acquisition transactions.

Section 1105(a) of the Tax Law imposes a sales tax on the receipts of every retail sale of tangible personal property, unless otherwise excluded. However, various transfers between partners and partnerships and between corporations and stockholders are excluded from the definition of "retail sale" under New York law. The rationale for the exclusion is that, while the form of ownership of the property is changed, there is a continuity of interest in the property transferred.[9] As a result, otherwise taxable property will be exempt if obtained in the course of a statutory exempt transaction. The transactions which qualify for the exemption are:[10]

A. The transfer of property to a corporation, solely in consideration for the issuance of its stock, pursuant to a merger or consolidation effected under the law of New York or any other jurisdiction.

B. The distribution of property by a corporation to its stockholders as a liquidating dividend.

C. The distribution of property by a partnership to its partners in whole or partial liquidation.

D. The transfer of property to a corporation upon its organization in consideration for the issuance of its stock.

E. The contribution of property to a partnership in consideration for a partnership interest therein.

For purposes of the exemptions of Tax Law § 1101(b)(4), a limited liability company is given the same status tax treatment as a partnership.[11]

A review of the statutory scheme set forth in Tax Law § 1101 makes clear that, while it appears similar to the non-recognition provisions of the Internal Revenue Code for entity creation and reorganization, there are sufficient differences to require careful planning to satisfy both sets of criteria. The problem is compounded by a strict adherence to form over substance by the New York State Department of Taxation and Finance and the courts in determining the application of the transactional exemptions. Generally controlling is the form chosen by the taxpayer. Unfortunately, the fact that the taxpayer could have chosen a different form which would have had different tax consequences does not convert a taxable transaction into a nontaxable one.[12] This is in marked contrast to the income tax statutes' well established elevation of substance over form. That rule has been well accepted for more than 70 years and is a basic tenet of income tax transactional planning. As stated by the United States Supreme Court, "in tax law, we should remember, substance, rather than form, determines tax consequences."[13]

No case could make the dangers of ignoring form more apparent than that in *In re R.E. Weichbrodt, Inc.*,[14] which was decided by the Division of Tax Appeals in 2002. In *Weichbrodt*, a sole proprietor transferred the assets of a sole proprietorship, which owned four McDonald's restaurants, to his existing wholly owned corporation.[15] The Tax Department successfully argued that the form of the transaction did not strictly fall within any of the provisions of Tax Law § 1101(b)(4)(iv) and was taxable.[16] Under the Internal Revenue Code (IRC) § 351, this transaction would qualify for non-recognition for income tax purposes.[17] The closest corresponding provision of the Tax Law for sales taxes, § 1101(b)(4)(iv)(D), limits the exemption of property for stock transfers to the original organization of the corporation.[18] Additionally, the taxpayer did not qualify for the sales tax exemption for contributions to capital at times other than a corporation's organization. The New York State Tax Law definition of contribution to capital requires that the transfer occur "without the issuance of stock or other consideration."[19] The Administrative Law Judge (ALJ) found in *Weichbrodt* that, "without question, title and possession of the assets . . . owned by the sole proprietorship were transferred to the Corporation . . . in exchange for stock."[20]

The ALJ rejected the argument that the "shares of stock received by Weichbrodt lacked economic or financial value"[21] because he was already the sole owner of the corporation. In doing so the ALJ accepted a long, well established history of elevating form over substance in sales tax cases by finding:[22]

> It is well-established that the transfer of assets from a sole proprietorship to a corporation in exchange for stock, where both entities are wholly owned by the same individual, constitutes a sale subject to sales tax. (*In re Sunny Vending Co. v. State Tax Comm'n*, 101 A.D.2d 666, 475 N.Y.S.2d 896; *see also*, *In re P-H Fine Arts Ltd. v. N. Y. State Tax Appeals Tribunal*, 227 A.D.2d 683, 642 N.Y.S.2d 232 (artwork transferred by a company to an existing corporation, both owned by the same individual, in

> exchange for 10 shares of stock, is a sale as defined in Tax Law § 1101(b)(4)). In Sunny Vending, the petitioners were a sole proprietorship and a corporation wholly owned by the sole proprietorship. All of the assets of the sole proprietorship were transferred to the corporation in exchange for 100 additional shares of common stock issued to the sole proprietor, and the books and records of both entities were adjusted to reflect the transfer. The court held that this transaction was reasonably deemed by the State Tax Commission to be a sale within the meaning of Tax Law § 1101(b)(4). The Court noted that "the broad and inclusive language of the taxing statute clearly expresses an intent to encompass most transactions involving the transfer or use of commodities in the business world" (*Sunny Vending Co. v. State Tax Comm'n*, quoting *Albany Calcium Light Co. v. State Tax Comm'n*, 55 A.D.2d 502, 504, 391 N.Y.S.2d 201, rev'd on other grounds 44 N.Y.2d 986, 408 N.Y.S.2d 333). There, as here, the petitioners argued that there was no consideration for the transfer and, therefore, no sale because "the individual received nothing of value since he owned 100% of the corporate stock both before and after the transfer." Petitioners' argument is essentially the same. In light of the longstanding precedent of Sunny Vending, it is meritless.

Had Weichbrodt simply contributed the assets to his wholly owned corporation without taking any additional stock back, the transaction clearly would have been exempt as a contribution to capital. Thus, where trucks obtained by the liquidation of a partnership were subsequently transferred to an existing corporation as a contribution to capital, the transaction was exempt as long as the entries on the books of the corporation documented the acquisition of the trucks as a legitimate contribution to capital. Such a transfer would be without consideration and therefore not a retail sale.[23] The taxable difference between *Weichbrodt* and the non-taxable result in other instances was simply whether the corporation issued meaningless stock.

While blind adherence to form can produce the kind of horrific and inequitable consequences demonstrated by the *Weichbrodt* case, it can also present significant opportunities for tax savings when incorporated into the tax planning process. Literal interpretation of the statutes permits predictable tax planning based on the mechanics, rather than substance, of the organization, reorganization or acquisition of an entity. Moreover, literal interpretation of the statutes would prevent the uncertainty that potential application of judicial tax avoidance doctrines, such as substance over form, step transaction doctrine and business purpose doctrine, bring to the process.

The New York courts have historically validated the use of form-based step transactions to manipulate the sales tax effect of a transaction without regard to its economic substance. If the form fits the exemption, neither "substance over form" nor "step transaction doctrine" will be imposed to change it.

In *In re TJX Companies*,[24] the taxpayer desired to sell all of the assets of its Zayre department stores to Ames. It accomplished the transfer in multiple steps, the first of which was to transfer its Zayre business assets to several wholly owned subsidiaries.[25] In an immediate second step, all of the stock of the newly formed subsidiaries was then sold to Ames, thus completing the transaction.[26]

Although the contribution of assets to an 80-percent-owned subsidiary generally permits non-recognition of gain for federal income tax purposes under IRC § 351,[27] Zayre's capitalization of its subsidiaries did not qualify because of the immediate sale. In addition, the parties subsequently made a timely election under IRC § 338(h)(10)[28] with respect to this stock sale to recognize gain or loss on the transfer as a virtual sale of assets.

Although federal law and doctrine recognized all of the gains without regard to the form, New York—in contrast—permitted the transaction to enjoy tax-free status. Under New York Regulations § 526.6(d)(8)(11),[29] property transferred to a corporation as a contribution of capital where no stock is received in return is not a retail sale. It then follows that if there is no retail sale, there can be no sales tax due on the transaction. In form, then, the first transaction was an exempt contribution to capital of a corporation. There is no equivalent for an IRC § 338(h)(10) elective-deemed sale in the sales and use tax, and the income tax election is ignored. The New York court rejected an attempt by the Division of Taxation to ignore the form and impose sales tax based on the substance of the transaction, but the Division of Taxation was unsuccessful. Since the transaction was structured as a contribution of capital as provided by New York Regulations § 526.6(d)(8)(11), it was not a retail sale and therefore exempt from sales tax.[30] Likewise, there was no tax due on the second step of the transaction since it involved the sale of an intangible, i.e., the stock of the newly formed subsidiaries which held the original Zayre's assets. Neither "substance over form" nor "step transaction doctrine" was applicable to disturb the literal conclusion that the transactions qualified for exemption.

Merger or Consolidation

Qualification for exemption under the first of the four transactional exemptions set forth in Tax Law § 1101(b)(4)(iv) requires the transfer of property to a corporation, solely in consideration for the issuance of its stock, pursuant to a merger or consolidation effected under the law of New York or any other jurisdiction.[31]

Under § 910 of the N. Y. Business Corporation Law, a "merger or consolidation" is defined as:[32]

> (a) Two or more domestic corporations may, as provided in this chapter: Merge into a single corporation which shall be one of the constituent corporations; or Consolidate into a single corporation which shall be a new corporation to be formed pursuant to the consolidation . . .
> (c) One or more domestic corporations and one or more other business entities, or one or more foreign corporations and one or more other business entities may as provided by any other applicable statute and this chapter:
> (1) Merge into a single domestic or foreign corporation or other business entity, which shall be one of the constituent entities; or
> (2) Consolidate into a single domestic or foreign corporation or other business entity, which shall be a new domestic or foreign corporation or other business entity to be formed pursuant to the consolidation.

A merger thus occurs when Corporation A is merged into Corporation B, and a consolidation occurs when Corporations A and B are consolidated into Corporation C.[33] It need not be a New York State merger or consolidation to qualify. Mergers and consolidations meet the definition of the New York exemption if they qualify under IRC § 368(a)(1)(A) or meet the requirements of the law of the state, District of Columbia or territory pursuant to which it was effected. Thus, when A and B Corporation merge into A under the N. Y. Business Corporation Law, or the law of any other U.S. jurisdiction, and include within the merger transfers of tangible personal property, none of the merger property is subject to the sales or use tax.

In interpreting and implementing the sales tax merger and consolidation exemption, the Tax Department and the New York courts have, true to form, refused to "read into the statute an exemption not expressly stated." In *Prospect Dairy, Inc. v. Tully,*[34] a parent corporation transferred all of the assets of one of its divisions, Handy, to its subsidiary, Prospect Dairy, in return for stock in the subsidiary. The transaction did not have any economic or practical effect on the parent's investment in the subsidiary, and was the substantial, if not procedural, equivalent of a New York exempt transaction.[35] Had Enterprise incorporated Handy and then merged it into Prospect Dairy, the transaction would have been exempt from sales tax. Dairy alleged that since it could have simply altered the form of the transaction to literally comply with the statutory language without affecting its substance, it should thereby qualify for exemption.[36] Dairy asserted that the availability of a qualifying form of the transaction which would essentially achieve the same result was indicative of the Legislature's intent not to tax transactions of similar effect.[37] In rejecting the "substance over form" argument the court stated:[38]

> Initially, Dairy's contention that the subject transaction was not a sale is without merit, since a sale is any transfer or exchange of title for a consideration (Tax Law, § 1101(b)(5)), and the stock or securities of the purchasing corporation is clearly consideration. Dairy and Enterprises have chosen for their business objectives to maintain two separate corporate identities. There is no proper basis for ignoring those separate entities so as to hold that sales by one to the other do not constitute "sales" within the meaning of the Tax Law merely because in this case it might benefit the corporations to do so.

Acknowledging that Dairy could quite simply have adopted a form that would qualify for the exemption, the Court found it irrelevant, in that the form would control without regard to the substance or equities of the transaction:[39]

> Dairy's primary contention is that the sale should not be taxable because it was similar in nature to transactions which are statutorily exempted from taxation. Under subparagraph (D) of clause (ii) of paragraph 4 of subdivision (b) of section 1101, the transfer of property to a corporation upon its organization in exchange for stock is nontaxable; similarly, under subparagraph (A) of said paragraph and subdivision, the transfer of property in exchange for

stock pursuant to a corporate merger or consolidation is exempt. The essence of Dairy's position is that the sale here achieved the same result as could have been accomplished by incorporating Handy and then merging it into Dairy, wherefore it should be concluded that the Legislature did not intend to impose the tax on such a sale.

The Tax Commission rejected this contention, and we concur. The corporations chose not to follow procedures which would have exempted the transaction from the sales tax, and the construction by the Tax Commission refusing to read into the statute an exemption not expressly stated is not unreasonable and must be upheld. (Cf. Matter of Howard v. Wyman, 28 N Y 2d 434, 438.) Had those steps been followed, there would have been somewhat different consequences regarding stock transfers at the very least so as to distinguish such transactions from a sale. Presumably, additional stock transfer taxes would have become due (Tax Law, art. 12). Thus, the distinction is one of substance and not merely of form. Dairy and its parent, however, chose to effectuate a direct sale, and the tax consequences thereof cannot be avoided.

Had Dairy properly considered and planned for the sales tax consequences of its transaction, it most certainly could have avoided the sales tax completely by simply transferring the Handy Division assets into a newly formed corporation. It could have converted the tangible and taxable business assets transferred into the intangible stock of a new subsidiary. Immediately thereafter it could have merged the new subsidiary into its existing subsidiary in another tax-exempt transaction. While the federal income tax authorities would not respect the multiple steps of this transaction and treat it as its substance rather than form dictates, a taxpayer could be assured that this form would avoid any sales tax on the transaction in New York.

In similar fashion, an acquiring corporation desiring to purchase all of the assets of another target corporation could avoid all sales tax simply by first purchasing its stock and subsequently merging the corporation into itself. Stock is an intangible, rather than tangible, personal property. Accordingly, since Acquiring Company is merely purchasing an intangible and not tangible personal property, pursuant to §§ 1101(b)(4) and 1105(a) of the Tax Law and § 526.8(c) of the Sales and Use Tax Regulations, the purchase by the Acquiring Company of 100 percent of the stock of the target is not subject to State and local sales and use taxes. In addition, pursuant to § 1101(b)(4) of the Tax Law and § 526.6(d) of the Sales and Use Tax Regulations, the merger of the Target into the Acquiring Company solely in exchange for the stock of the Acquiring Company and in accordance with the laws of New York State is not deemed to be a result of the sale of tangible personal property. Therefore, pursuant to § 1105(a) of the Tax Law and § 526.6(d) of the Sales and Use Tax Regulations, such merger is not subject to state and local sales and use taxes.[40]

Although qualifying as a merger or consolidation can be accomplished under IRC § 368(a)(1)(A), no such benefit is available under IRC § 368(a)(1)(C). A reorganization under IRC § 368(a)(1)(C) would normally involve the transfer of substantially all the assets of the Target Corporation for stock of the Acquiring Corporation as in Diagram 1 below.

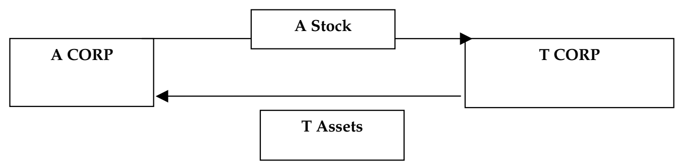

Diagram 1

Reorganizations defined in IRC § 368(a)(1)(C) are specifically excluded from the definition of a merger or consolidation for New York Sales Tax purposes.[41] Thus, the acquisition of business assets of the transferor in exchange for shares of voting stock of the acquiring corporation is subject to the sales tax.[42] The above transaction is taxable because it does not take place at the organization of the recipient corporation or in any statutory merger or consolidation under state law.[43]

However, because of New York's form-driven approach to qualification for exemption, a mere change in the form of the transaction will qualify it as sales-tax-free.

Step 1

Target forms Temp Corp in a sales-tax-free transaction because it qualifies as a transfer at the time of the organization of a corporation solely for its stock.

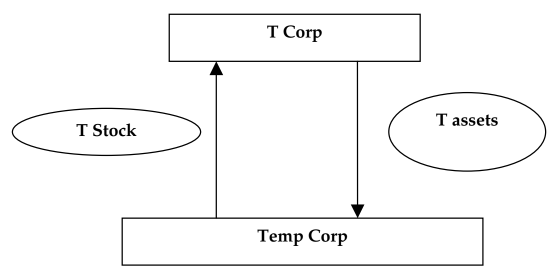

Diagram 2

Step 2

A Corp acquires Temp Corp Stock from Target in a tax-free "B" reorganization, which is exempt from New York State Sales Tax because the stock exchanged is intangible property.

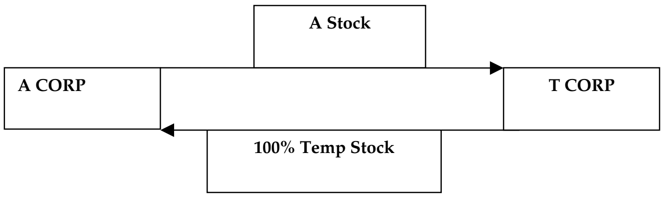

Diagram 3

Step 3

A Corp completely liquidates the newly formed Temp Corp and receives the Target assets in the process. The transaction is sales-tax-free because distribution to the corporate parent is in liquidation and therefore exempt.

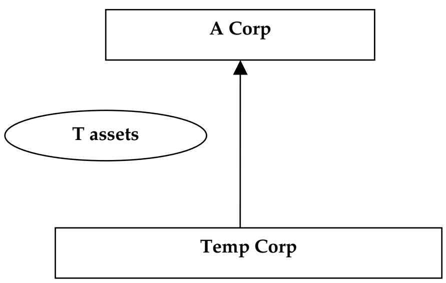

Diagram 4

Final Status

The final status of the transaction is the same as it would have been in an IRC § 368(a)(1)(C) reorganization except that there will be no sales tax imposed. In fact, for federal tax purposes, step transaction doctrine would require it to be treated as a "C" reorganization. The IRS would ignore the multiple steps and tax the transaction according to its substance. New York State, on the other hand, would respect the form and the tax-exempt treatment derived from it.

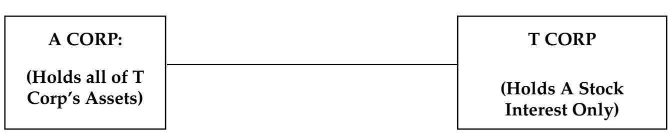

Diagram 5

Liquidating Dividend

A distribution of property from a corporation, partnership or LLC that is in the nature of a complete or partial liquidation is not a retail sale and is therefore exempt from tax.[44] A parent corporation can thus absorb the assets of a subsidiary through a complete liquidation of the subsidiary without incurring any sales tax obligation on the transfer of assets.[45] The sole requirement is that the liquidating dividend must be declared in accordance with the law of the state of incorporation. However, even though the transaction is exempt from taxation, it still constitutes a bulk sale requiring notice to the Department of Taxation.

This exemption was critical to Felix Industries when it wished to acquire all of the assets of its wholly owned subsidiary, C & F Equipment Company.[46] C & F Equipment Company held title to construction equipment used solely by Felix Industries. Felix Industries was able to absorb the assets of C & F Equipment Company without incurring a sales or use tax liability on the transfer since it met the liquidating corporate exemption of Tax Law § 1101(b)(4)(iii)(B).[47] Had the assets been held by a third party, they could have been conveyed tax-free on the organization of a holding company, followed by a sale of the stock to the acquiring corporation, and subsequently acquired tax-free in the liquidation of the holding company, as in the diagram above.

Compliance with local law for corporate liquidation is a requirement, but an immediate formal dissolution is not. In *In re Daniel Leary*,[48] a professional architecture corporation redeemed the stock of its shareholder for an automobile which it owned pursuant to a declaration of redemption, and wound up its business affairs. It did not file its certificate of dissolution with the Secretary of State, however, for two years.[49] In determining that the distribution of the vehicle was a liquidating dividend under Tax Law § 1101(b)(4)(iii)(B), the Tax Commission held that the date on which the corporation is formally dissolved under state law is not the determinative factor, stating that:[50]

> In determining whether a corporation has been completely liquidated the inquiry is not whether the corporation was formally dissolved under state law, but whether the corporation intended to and actually did wind up its affairs, gather its resources, settle its liabilities, cease engaging in business activity, and distribute its remaining assets to its shareholders. The absence of a formal written plan to liquidate is not conclusive of the issue if there exists in fact an intention to liquidate and those in control of the corporation entertain such intention.

In re John R. Sorrenti[51] stands in marked contrast to the successful tax-exempt liquidation presented by the Leary case. In *Sorrenti*, the corporation once again redeemed the shareholder's stock for a company car.[52] However, in this instance the transfer was not a liquidating dividend, but rather a retail sale subject to sales tax. In *Sorrenti*, there was no evidence that the corporation discontinued its business activities.[53] The only change that was made to the certificate of incorporation was to change the corporation's name to Perry B. Goldstein Architect. The corporation merely continued operating under a new corporate name.[54]

In *In re Duracast Contracting*,[55] an agreement was carefully crafted to reflect the distribution of all of a corporation's assets to its shareholders in the form of a sale to produce personal income tax benefits for the shareholders. The property was then contributed to a new corporation owned by the same shareholders.[56] One can only guess whether or not the sales tax consequences of characterizing this complete liquidation as a sale were considered. However, in choosing this form, the transaction failed to qualify for the exemption under Tax Law § 1101(b)(4)(iii)(B), and sales tax was imposed.[57]

Transfers Upon Formation of a Business Entity

Under Tax Law § 1105, sales tax is due on all retail sales of tangible personal property.[58] The receipt of stock in a corporation meets the definition of a sale at the fair market value of the stock received. However, when property is transferred to a corporation upon its organization in return for stock in the newly formed corporation, the transfer is exempted from the definition of retail sale under Tax Law § 1101(b)(4), and, as such, the transaction is exempt from sales tax. Unlike IRC § 351, the exemption from sales tax for transfers to a corporation in return for its stock does not require 80 percent control. In fact, any ownership interest will do, but regardless of the extent of control, the transfer must be on the initial formation of the corporation to qualify. Since there is an exchange of the stock for the assets, the transaction would be a taxable sale at any time other than its formation. A corporation is said to begin its existence at the time the articles of incorporation are filed with the Secretary of State. Transfers made to the corporation at this time, or within a reasonable time, while the corporation is still in the process of organizing its business, are exempt under Tax Law § 1101(b)(4)(iii)(D).[59]

Transfers made to a dormant corporation which is being activated are not eligible for the exclusion. The term "dormant corporation" has been defined as "[a]n inactive but legal corporation which is capable of being activated, but is presently not operating."[60]

A corporation which is in the process of organizing itself and obtaining the necessary authorities from the time of its incorporation until the time the assets were transferred cannot be said to be inactive or dormant. Where the assets were transferred as soon as the law allowed, it was deemed to be on the initial organization despite some assets being transferred as many as 21 months after incorporation.[61] Thus, in *K-B Transport Inc.*,[62] the key was the transfer taking place as part of the initial organization of the business operations of the enterprise, without regard to the necessary delay caused by regulatory requirements.

Despite the flexible position demonstrated in the ruling in *K-B Transport, Inc.*, great care must be taken not to delay transfers outside the limited window created by the initial organization of the corporation. *Noar Trucking v. State Tax Commission*[63] is an example of a multi-stage corporate reorganization that fell outside the organization window and resulted in the imposition of sales tax on a portion of the assets transferred. Noar Trucking was incorporated in February 1980 to protect its sister corporation, Arnmart, from liability for accidents relating to its beer delivery routes.[64] Arnmart was to transfer all of its trucks to Noar Trucking in return for stock in Noar.[65] In order to avoid paying duplicate registration fees on the trucks, Arnmart only transferred some of its trucks, worth $14,000, in 1980, and the remainder of its fleet, worth $120,000, was transferred the following year.[66] The Court held that only the transfers made during 1980 fell within Tax Law § 1101(b)(4)(iii)(D) and were exempt from sales tax.[67] The court recognized "the economic realities of petitioner's 1980 activities and transactions," citing *In re Nat'l Elevator Ind. v. N. Y. State Tax Comm'n*,[68] and concluded that the 1981 transfers, some 10 to 21 months thereafter, were too late for entitlement to the corporate organizational exemption. This was despite the fact that Noar chose to defer going through the technical formalities of physically issuing stock certificates and holding an organizational meeting until after the transfer of all trucks had been completed. As a result, the transfers made in 1981 were not made upon the corporation's organization, and therefore were subject to sales tax.[69]

Taxpayers are free to tailor the transactional structure of their transfers to comply with the exemption statute and therefore avoid the tax that would be imposed on a more direct exchange. In *In re Binghamton Burial Vault Co, Inc.*,[70] Binghamton transferred the assets of one of its divisions to a newly formed corporation in return for stock in the newly formed corporation. The stock was then distributed to the shareholders of the Binghamton Burial Vault Company.[71] Since the transfer was made upon the organization of the corporation in exchange for stock, the transfer of property was exempt from sales tax under Tax Law § 1104(b)(4).[72]

Step transaction doctrine is used regularly by the IRS to recharacterize multi-step transactions according to their economic substance, rather than form, to prevent tax avoidance. However, that is not the rule for sales tax purposes. The New York State Department of

Taxation regularly accepts the form of multi-step transactions, which segregate and transfer the property to temporary holding corporations, as determinative of their tax effect. These transactions are designed for the express purpose of qualifying the transaction for the corporate organizational exemptions. For example, in an advisory opinion rendered to *Nomura Securities*,[73] multiple corporate transfers were made to separate and transfer certain assets free of sales tax. NSC was a Japanese company that owned 100 percent of the stock of NSI, a Delaware corporation that developed computer systems to be used in NSI's securities trading business.[74] NSI had two groups of assets: Group I, which was the computer software and hardware of the trading business, and Group II, which was all of the furniture and equipment used in the ordinary course of business.[75] Group I and Group II assets were located in New York.

NSC in transaction 1 formed a new United States corporation, USHC, in exchange for 100 percent of the stock of USHC, and contributed the NSI stock to the capital of USHC.[76] In transaction 2, NSI distributed to USHC only that portion of Group I assets consisting of computer hardware and operating systems and all of the Group II assets.[77] Thereafter, in transaction 3, USHC formed a United States subsidiary, hereinafter referred to as U.S. Sub, and contributed the Group I assets received from NSI to the capital of U.S. Sub solely in exchange for 100 percent of the common stock of U.S. Sub.[78] NSI then sold the remaining assets in Group I (i.e., customized computer software) by transferring the copyright for such assets to U.S. Sub at the fair market value.[79] Also transferred with the copyright were the intellectual property rights (intangible technological know-how) and other proprietary rights in the software (collectively the "Customized Computer Software").[80]

Transaction 1 was an exchange of stock for stock, which is a transaction that is not a sale as defined in § 526.7 of the Sales and Use Tax Regulations, and thus is not subject to the tax imposed under § 1105(a) of the Tax Law. In transaction 2, if the entries on the books of USHC document the acquisition of the assets as a legitimate contribution to capital, such transaction will not be subject to the tax imposed under § 1105(a) of the Tax Law because the transfer is not a retail sale in accordance with the meaning and intent of § 526.6(d)(8)(ii) of the Sales and Use Tax Regulations. Transaction 3, in which USHC upon forming its subsidiary will exchange assets for stock, is a transfer that is not subject to the tax imposed under § 1105(a) of the Tax Law because it is not a retail sale in accordance with the meaning and intent of § 526.6(d)(1)(iv) of the Sales and Use Tax Regulations. The sale of the software as described by Petitioner met the criteria set forth in Technical Services Bureau Bulletin 1978-1(S) and was therefore exempt since it was not a sale of tangible personal property.

In these multi-step transactions, tangible personal property is converted to intangible corporate stock through an exempt contribution to capital of a newly organized corporation. This step is exempt under Tax Law § 1101(b)(4)(iii)(D) as occurring upon corporate organization. The stock in the corporation can then be sold or exchanged since the stock is an exempt intangible asset. Following the sale of the stock, the corporate shell can be liquidated tax-free under Tax Law § 1101(b)(4)(iii)(B). While the IRS will typically disregard these multiple steps, for sales tax purposes New York State will not.

To the extent any consideration other than stock is received upon the organization of a corporation, the transaction is a taxable sale to the extent of the other consideration. However, the assumption of liabilities in the nature of security interests on the property transferred will not cause the transaction to be taxed.[81]

In *In re Tops Inc.*,[82] there was a transfer of assets to a newly formed corporation, WFI, five weeks after it had been incorporated, in exchange for stock in WFI and the assumption of various general corporate liabilities of Tops. The Division of Tax Appeals held that five weeks was within a reasonable time of the corporation's organization, making the transfer exempt from sales tax, and exempted the consideration in the form of stock from taxation.[83] Nonetheless, it found the assumption of the general liabilities represented "other consideration" than the stock and was taxable.[84]

Contributions to partnerships, and therefore LLCs, can be made tax-free at any time, not just at the time of organization. New York does not deem a partnership to be a legal entity which is separate and apart from the individuals who comprise it.[85] As a result, contributions of assets to a partnership are always exempt, whether on or after its initial formation.[86]

The transfer of the assets and liabilities of an ongoing business to a partnership in exchange for a partnership interest is not a taxable event. Nor does the treatment of a contribution in exchange for a partnership interest change merely because, as part of the business transferred, liabilities, as well as assets, pass to the partnership. A person who transfers property, including liabilities, to a partnership in exchange for a partnership interest is not relieved of the liabilities when they are assumed by the partnership and is therefore not treated as if the assumption is a "payment" for his assets.[87]

Joint ventures are partnerships organized for a limited time and purpose.[88] In *In re Great Lakes-Dunbar-Rochester*,[89] the use by a joint venture of property owned by the joint venturers, and the payment of "reimbursements" for the use of the equipment by the joint venturers, did not constitute rentals subject to tax. The joint venturers that owned the equipment never gave up possession, dominion and control.[90] The use of the equipment in the joint venture project was subject to continued possession and control by the members of the joint venture.[91] There was no fixed rent to be paid, nor any guarantee that the members could retain reimbursements for the equipment.[92] Thus, the transaction was not a sale and was therefore not taxable.[93] In circumstances in which a fixed rental was paid to corporate joint venturers in another joint venture for the use of their equipment, the transaction was taxable as a rental.[94]

Conclusion: The Form Is Critical and Dispositive in Most Instances

As can be seen from the prior discussion, under New York's Sales and Use Tax Laws, transactions with equivalent outcomes and economics can have widely differing results. The difference between a tax on the transfer of millions of dollars in assets and complete exemption from the tax can often rest on the form or order the transaction took, without regard to its essential economics. In general, neither step transaction doctrine nor substance over form arguments will be applied in the context of qualification for sales tax exemptions. This focus on form is a great trap for those whose focus on the income tax consequences distracts them from sales tax issues. Conversely, a focus on form is of great benefit to those who carefully plan the transaction in the context of the corporate transaction exemption. With prudent planning and heeding the guidance of case law, much can be done to minimize the sales tax impact of corporate organizations, reorganizations, acquisitions, dispositions and liquidations.

Endnotes

1. *See* N.Y. Tax Law § 1101(b)(5); N.Y. Comp. Codes R. & Regs. tit. 20, § 526.7(d).
2. N.Y. Tax Law § 1101(b)(7). *See also* N.Y. Tax Law § 1110.
3. *Albany Calcium Light Co., Inc. v. State Tax Comm'n*, 55 A.D.2d 502 (3d Dep't 1977); *see also In re Tenneco, Inc.*, TSB-H-86 (86)S (N.Y.S. Tax Comm'n 1986); *In re Tops, Inc.*, 1991 N.Y. Tax LEXIS 623 (N.Y.S. Tax App. Trib. 1989); Op. No. S840130A, TSB-A-85 (40)S (N.Y.S. Tax Comm'n 1985).
4. N.Y. Tax Law § 132(c); N.Y. Comp. Codes R. & Regs. tit. 20, § 532.4.
5. *King v. State Tax Comm'n*, 70 A.D.2d 447, 451, 421 N.Y.S.2d 668, 671 (3d Dep't 1979).
6. *Delta Sonic Car Wash Sys., Inc. v. Chu*, 142 A.D.2d 828, 828, 530 N.Y.S.2d 341, 342 (3d Dep't 1988).
7. N.Y. Tax Law § 1101(a)(5) includes the right to reproduce computer software as a taxable sale.
8. N.Y. Tax Law § 1101(a)(6) describes computer software as tangible property: "such term shall also include pre-written computer software whether sold as part of a package, as a separate component, or otherwise, and regardless of the medium by means of which such software is conveyed to a purchaser."
9. *See* N.Y. Tax Law § 1101(b)(4); N.Y. Comp. Codes R. & Regs. tit. 20, § 526.6.
10. N.Y. Tax Law §1101(b)(4)(iv).
11. N.Y. Tax Law § 1101(a) states that,"when used in this article the term person includes an individual, partnership, limited liability company, society, association, joint stock company, corporation, estate, receiver, trustee, assignee, referee, and any other person acting in a fiduciary or representative capacity, whether appointed by a court or otherwise, and any combination of the foregoing."
12. *In re Chanry Communications, Ltd.*, TSB-D-91(12)S (N.Y.S. Tax App. Trib. 1991), citing *Sverdlow v. Bates*, 283 A.D. 487, 490, 129 N.Y.S.2d 88, 91 (3d Dep't 1954).
13. *Comm'n v. Court Holding Co.*, 324 U.S. 331, 334 (1945); *see also Cottage Sav Ass'n v. Comm'n*, 499 U.S. 554 (1991); *Gregory v. Helvering*, 293 U.S. 465, 469–70 (1935); *Shoenberg v. Comm'n*, 77 F.2d 446, 449 (8th Cir. 1935), *cert. denied*, (1935).
14. *In re Weichbrodt*, Nos. 817950 & 817951 (N.Y.S. Div. of Tax App. 2002).
15. *Id.*
16. *Id.*
17. I.R.C § 351.
18. N.Y. Tax Law § 1101(b)(4)(iv)(D).
19. N.Y. Comp. Codes R. & Regs. tit. 20, § 526.6(8)(ii) states: "The transfer of property to a corporation, as contribution to capital, at a time other than its organization, without the issuance of stock or other consideration, is not a retail sale."
20. *In re Weichbrodt*, Nos. 817950 & 817951 (N.Y.S. Div. of Tax App. 2002).
21. *Id.*
22. *Id.*
23. *See* Op. No. S840404b, TSB-A-85 (27)S (N.Y.S Tax Comm'n 1985).
24. *In re TJX Companies, Inc.*, No. 812048, TSB-D-97 (6)S (N.Y.S. Tax App. Trib. 1997).
25. *Id.*
26. *Id.*
27. I.R.C. § 351.
28. I.R.C. § 338(h)(10).
29. N.Y. Comp. Codes R. & Regs. tit. 20, § 526.6(d)(8)(11).
30. *Id.*
31. N.Y. Tax Law § 1101(b)(4)(iv).
32. N.Y. Bus. Corp. Law § 910.
33. N.Y. Comp. Codes R. & Regs. tit. 20, § 526.6.
34. *Prospect Dairy, Inc. v. Tully*, 53 A.D.2d 755, 384 N.Y.S.2d. 264 (3d Dep't 1976).
35. *Id.*
36. *Id.*
37. *Id.*
38. *Id.*

39. *Id.*
40. *See* Op. No. S971209e, TSB-A-94(25)S (N.Y.S. Dep't of Taxation & Fin. 1998).
41. N. Y. Comp. Codes R. & Regs. tit. 20, § 526.6(d)(6)(iv). *See also* IRC § 368(a)(1)(C).
42. *See In re Boccard Indus. Inc.*, TSB-H-87(128)S (N.Y.S. Tax Comm'n 1987), citing N. Y. Comp. Codes R. & Regs. tit. 20, § 526.6(d)(6)(iv).
43. *See In re Spartan Motors, Ltd.*, TSB-H-84(61)S (N.Y. S Tax Comm'n 1984).
44. N.Y. Tax Law § 1101(b)(4)(ii).
45. *See*, Op. No. S880811a, TSB-A-88 (52)S (N.Y.S. Dep't of Taxation & Fin. 1988).
46. Op. No. S880811a, TSB-A-88 (52)S (N.Y.S. Dep't of Taxation & Fin. 1988).
47. *Id.*
48. *In re Daniel Leary*, TSB-H-87 (130)S (N.Y.S. Tax Comm'n 1987). *See also* N.Y. Tax Law § 1101(b)(4)(iii)(B).
49. *In re Daniel Leary*, TSB-H-87 (130)S (N.Y.S. Tax Comm'n 1987).
50. *Id.*
51. *In re Sorrenti*, 1988 N.Y. Tax LEXIS 196 (N.Y. Div. of Tax App. 1988).
52. *Id.*
53. *Id.*
54. *Id.*
55. *In re Duracast Contracting*, TSB-H-81(57)S (N.Y.S. Tax Comm'n 1981).
56. *Id.*
57. *Id.*
58. N.Y. Tax Law § 1105.
59. *In re Tops, Inc.*, 1991 N.Y. Tax LEXIS 623 (N.Y. Div. of Tax App. 1991).
60. *In re K-B Transport Inc.,* 1988 N.Y. Tax LEXIS 354 (N.Y. Div. of Tax App. 1988).
61. *Id.*
62. *Id.*
63. *Noar Trucking v. State Tax Comm'n*, 139 A.D.2d 869, 527 N.Y.S.2d 597 (3d Dep't 1988).
64. *Id.*
65. *Id.*
66. *Id.*
67. *Id.*
68. 49 N.Y.2d 538, 548 (1980).
69. *Id.*
70. Op. No. S881114a, TSB-A-89(4)S (N.Y.S. Comm'r of Taxation & Fin. 1989).
71. *Id.*
72. *Id.*
73. Op. No. S890324B, TSB-A-90(1)S (N.Y.S. Tax Comm'r 1989).
74. *Id.*
75. *Id.*
76. *Id.*
77. *Id.*
78. *Id.*
79. *Id.*
80. *Id.*
81. N.Y. Comp. Codes R. & Regs. tit. 20, § 526.6(d)(5).
82. *In re Tops, Inc.*, 1991 N.Y. Tax LEXIS 623 (N.Y.S. Tax App. Trib. 1989).
83. *Id.*
84. *Id.*
85. *Walker & Bailey v. We Try Harder Inc.*, 123 A.D.2d 256, 257, 506 N.Y.S. 2d 163 (1st Dep't 1986).
86. N.Y. Tax Law § 1101(b)(4)(iii)(E).
87. *In re Beautiful Visions Co.,* Nos. 810495, 810496, 810497, 810498 & 810499 (N.Y. Div. of Tax App. 1994).
88. *Dogan & Sado & Dogan, Inc. v Harbert Const. Corp.*, 507 F. Supp 254, 258 (S.D.N.Y. 1980); 16 N.Y. Jur. 2d, § 1578.
89. *In re Great Lakes-Dunbar-Rochester v. State Tax Comm'n*, 102 A.D.2d 1, 477 N.Y.S.2d 461 (3d Dep't 1984).
90. *Id.*
91. *Id.*
92. *Id.*
93. *Id.*
94. Op. No. S971020a, TSB-A-98(4)S (N.Y.S. Dep't of Taxation & Fin. 1998).

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Federal Response to a Changing Market: The Regulation of Hedge Funds

By Katy Peng

Introduction

The Securities and Exchange Commission (the "Commission") recently adopted a new rule and rule amendments under the Investment Advisers Act of 1940[1] (the "Advisers Act"). With the help of the stock market bubble and a prolonged period of low interest rates, private investment pools ("hedge funds") have enjoyed unprecedented popularity. They have become the investment choice not just for sophisticated investors but also for the general public. Realizing its regulatory shortfalls when it comes to hedge fund investments, the Commission adopted the new rule and amendments under the Advisers Act, requiring advisers of certain hedge funds to register with the Commission by February 1, 2006.[2]

This article will examine the topic of hedge funds and why the Commission has adopted this new rule and amendments for a financial instrument that has been traditionally utilized by sophisticated investors. Part I of the article will provide an overview of hedge funds. Part II will examine the federal securities laws dealing with hedge funds and their advisers. Part III of the article will scrutinize the new rule and amendments that the Commission has adopted. The last section will consider criticism of these newly adopted rules.

Part I: Overview

The term "hedge fund" is not defined by the federal securities laws. It is used, however, to describe a diverse set of investment strategies employed by a variety of institutional investors.[3] Generally these investors form limited partnerships or limited liability companies or, in some cases, offshore corporations in which the investors are wealthy and sophisticated individuals and institutions.[4]

One of the first hedge funds started as a private partnership in 1949. It invested in equities and used leverage and short selling to "hedge" the portfolio's exposure to the movements of corporate equity markets.[5] Over time, hedge funds began to diversify their investment portfolios to include other financial instruments and engage in a wider variety of investment strategies. Today, hedge funds no longer simply trade equities, but have diversified by trading fixed income securities, convertible securities, currencies, exchange-traded futures, over-the-counter derivatives, futures contracts, commodity options, and other non-securities investments. Furthermore, in addition to using a wide variety of investment strategies, such as investing in distressed securities, illiquid securities, securities of companies in emerging markets and derivatives, hedge funds may also utilize hedging and arbitrage strategies, and many engage in relatively traditional, long-only equity strategies. Hedge funds are typically managed by entrepreneurs who employ more complicated, flexible investment strategies rather than advisers at mutual funds, brokerage firms and bank trust departments.

Historically, hedge funds were offered primarily to high net worth individuals and families. Although these individual investors and families still represent a large portion of hedge fund investors,[6] the investment of institutional investors, such as pension plans, endowments and foundations, also contribute to much of the recent growth in the hedge fund industry.[7]

If hedge funds are for sophisticated investors, the question remains as to why the Commission decided to regulate these funds when federal securities laws protect only those investors who lack the sophistication and market power to obtain necessary information in their decision-making. To answer this question, we must first examine how the federal securities laws regulate hedge funds and their advisers.

Part II: Regulation of Hedge Funds and Their Advisers

A. Hedge Funds and the Investment Company Act of 1940

Because of their substantial investments in securities, most hedge funds would fall within the definition of an investment company under the Investment Company Act.[8] However, by relying on one of two statutory exclusions from the definition of an investment company, hedge funds avoided the regulatory provisions of that Act.

1. Section 3(c)(1)

Section 3(c)(1) of the Investment Company Act excludes from the definition of "investment company" any issuer which has no more than 100 beneficial security holders and which is not making any public offering of securities.[9] Generally, a corporate investor is counted as one investor in determining compliance with the 100-investor limitation of section 3(c)(1).

By relying on section 3(c)(1) of the Investment Company Act, hedge funds cannot make or propose to make a public offering. Furthermore, these hedge funds must also comply with section 4(2) of the Securities

Act[10] by relying on the safe harbor available under Regulation D[11] of that Act. Accordingly, hedge funds may offer their securities only to "accredited investors," and may not engage in any general solicitation or general advertising of their shares.

2. Section 3(c)(7)

Another statutory exemption is section 3(c)(7) of the Investment Company Act. This section excludes any issuer from the definition of an investment company if that issuer's outstanding securities are owned exclusively by persons who, at the time of acquisition of such securities, are "qualified purchasers," and if that issuer is not making and does not at that time propose to make a public offering of its securities. By adopting this exclusion, Congress intended to exclude highly sophisticated investors from the protections of the Investment Company Act because of their ability to appreciate the risk associated with pooled investment vehicles.[12]

Consistent with Congress's intent, section 3(c)(7) allows an unlimited number of qualified purchasers to invest in a fund. In reality, however, because of the registration and reporting requirement of the Securities Exchange Act of 1934[13] ("Exchange Act"), most funds relying on section 3(c)(7) have no more than 499 investors. Additionally, unlike section 3(c)(1), section 3(c)(7) does not have a "look through" provision in the event that a registered investment company or a private investment company owns ten percent or more of the section 3(c)(7) fund's outstanding voting securities. The only "look through" provision a section 3(c)(7) fund must comply with is where a company is formed for the specific purpose of acquiring the securities offered by a section 3(c)(7) fund, in which case each beneficial owner of the company must be a qualified purchaser.[14]

B. Hedge Funds and the Securities Act of 1933

One of the Securities Act's primary objectives is to provide comprehensive and fair disclosure in securities transactions in order to protect the investing public. In the absence of an exemption, section 5 of the Securities Act mandates the registration of public securities offerings with the Commission and the delivery to the purchaser of a prospectus containing specified categories of information about the issuer and the securities being offered. Since most hedge fund transactions fall within the definition of the term "securities" for purposes of the federal securities laws, hedge funds must either register the offer and sale of the securities or rely on an exemption from registration. To avoid the registration and prospectus delivery requirements of section 5, most domestic hedge funds rely on the private offering exemption in section 4(2) of the Securities Act or Rule 506 promulgated under that section.

1. The Private Offering Exemption of the Securities Act

Section 4(2) of the Securities Act exempts from the registration and prospectus delivery requirements of section 5 any "transaction by an issuer not involving any public offering." The section 4(2) exemption requires no notice or other filing or regulatory approval as a prerequisite for its availability. The Commission generally has no objections to large investors, such as institutional investors, engaging in private offerings allowed under the section 4(2) exemption. This is because these purchasers are customarily in a position to insist upon the issuer providing them with information more extensive than that contained in a registration statement and to give them other protections not available to purchasers in a registered public offering.

An important interpretation of this "private offering" exemption was rendered by the Supreme Court in *Ralston Purina.*[15] The Supreme Court rejected the suggestion that the applicability of section 4(2) should depend on the number of persons to whom the offer was made, or the limitation of persons, and held that a private offering is an "offering to those who are shown to be able to fend for themselves."[16] The investors who participate in private offerings are often those who have access to material information and the bargaining power to receive additional protections.

2. Regulation D

a. Rule 506

In an effort to govern private offerings, the Commission promulgated Rule 506 of Regulation D under the Securities Act. Rule 506 is not the exclusive means of making a non-public offering; the failure to satisfy all the terms and conditions of Rule 506 shall not raise any presumption that the exemption provided by section 4(2) is not available. To ensure the availability of the section 4(2) exemption, many hedge funds tailor their offering and sale procedures to the criteria specified in Rule 506.

b. Offerings to "Accredited Investors"

Furthermore, Rule 506 creates a safe harbor which exempts offerings that are made exclusively to "accredited investors."[17] The term "accredited investors" is defined to include:

> Individuals who have a net worth, or joint worth with their spouse, above $1,000,000, or have income above $200,000 in the last two years (or joint income with their spouse above $300,000) and a reasonable expectation of reaching the same income level in

the year of investment; or are directors, officers or general partners of the hedge fund or its general partner; and

Certain institutional investors, including: banks; savings and loan associations; registered brokers, dealers and investment companies; licensed small business investment companies; corporations, partnerships, limited liability companies and business trusts with more than $5,000,000 in assets; and many, if not most, employee benefit plans and trusts with more than $5,000,000 in assets.[18]

Under these provisions, issuers are permitted to sell securities to an unlimited number of "accredited investors." In addition, if the offering is made only to accredited investors, no specific information is required to be provided to the prospective investors.

c. Resale Restrictions

Unrestricted resales pose an important concern for issuers. Issuers relying on Rule 506 must exercise reasonable care to assure that their investors do not distribute their interests to the public. These resales can jeopardize the availability of Rule 506 even if the original sales qualify for the protection in the rule. By satisfying the safe harbor conditions, issuers are sheltered against the loss of Rule 506 because of resales.[19] These safe harbor conditions include making "reasonable inquiry to determine if the purchaser is acquiring the securities for himself or for other persons" and requiring "written disclosure . . . that the securities . . . cannot be resold unless they are registered under the [Securities] Act or unless an exemption from registration is available."[20] In addition, the placement of a legend on the certificate or other document that evidences the securities is also required.

However, these resale restrictions do not usually affect hedge funds. In general, investors in hedge funds cannot transfer interests without prior written consent of the general partner or other manager, and the interests tend to be highly illiquid for sales and redemption.

C. Hedge Fund Advisers and the Investment Advisers Act of 1940

Under the Advisers Act, most of the hedge fund advisers fall within the definition of "investment adviser."[21] In compliance with the Advisers Act, investment advisers register with the Commission and conform their conduct to statutory norms. Investment advisers must register with the Commission by filing and updating a Form ADV and providing a disclosure statement.[22] With these disclosures, the Commission and investors are informed about the adviser's business practices and disciplinary history. Additionally, registered advisers must maintain required books and records[23] and submit to periodic examination by the Commission's staff. The Advisers Act also addresses other requirements, including those safeguarding client assets that are in the adviser's custody[24] and requiring that clients be told of an adviser's adverse financial condition.[25] Registered investment advisers must also inform clients of the adviser's proxy voting practices.[26]

By relying on the Advisers Act's *de minimis* exemption under section 203(b), many hedge funds advisers can avoid registering with the Commission. Investment advisers are exempt from registration if they: (i) have had fewer than 15 clients during the preceding 12 months; (ii) do not hold themselves out generally to the public as an investment adviser; and (iii) are not an investment adviser to a registered investment company.[27] Under previous Commission rules, a "legal organization," such as a hedge fund, is counted as a single client.[28] In essence, an adviser does not need to register with the Commission as an investment adviser as long as he or she manages only up to 14 hedge funds and the "no holding out" condition is satisfied. Because of this *de minimis* exemption, two-thirds of all hedge funds do not register with the Commission. Those who do register under the Advisers Act either are ineligible for the *de minimis* exemption or register voluntarily for competitive reasons or because their investors demand it.[29]

As the hedge fund industry grows more popular and accessible to the general public, the current rule has become ineffective in achieving the Commission's objective of protecting the investing public. The next section will address the new rule and amendments, and the reasons why the Commission adopted these changes.

Part III: The New Rule and Amendments

As discussed in Part II of this article, under the previous rule, hedge funds and their advisers may avoid registration by relying on certain exemptions offered under the federal securities laws. In its effort to deal with the growing popularity and the retailization of these funds, the Commission decided to amend the registration requirement for hedge funds and their advisers. In its publication of the new rule and amendments, the Commission clarified some of the issues raised by the new rule. Specifically addressed were continuing investors in private funds as clients; operation of the exemption from the "look through" requirement for private funds with a two-year lock-up; treatment of offshore advisers and funds; and application of revisions to the recordkeeping, custody and performance fee rules.

A. Rationale for the Proposal

Due to growing concerns over the growth of U.S. hedge funds, "hedge fund fraud," and "retailization" of hedge funds, the Commission has become increasingly worried about its limited ability to regulate hedge funds. According to the Commission's estimate, there are now $870 billion in assets spread across approximately 7,000 hedge funds.[30] The growth rate of funds steadily increased by over 30 percent in 2004, evidence that the hedge fund industry has become a significant investment vehicle in securities markets. Due to this tremendous growth, there has been a substantial increase in hedge fund fraud enforcement cases, and with it an increased effort to regulate. In addition to the much-publicized "late trading" and inappropriate "market timing" practices, instances involving the overstating of performance, the payment of unnecessary and undisclosed brokerage commission arrangements, and the misappropriation of client assets have arisen. The Commission stated that by adopting its new rule and amendments, its regulatory oversight will improve, thereby better protecting investors. These changes provide independent checks on the evaluation of a hedge fund's portfolio securities, require material disclosure to the investors, and address the issue of retailization.

1. Lack of Commission Regulatory Oversight

Although hedge funds and their advisers are subject to the antifraud provisions of the federal securities laws, the opaqueness of the industry makes it difficult for the Commission to regulate it. In recent years, it has become clear that hedge funds, like other securities investment vehicles, are not immune from securities fraud. The Commission has instituted a significant number of actions alleging hedge fund fraud,[31] such as misappropriation of assets;[32] misrepresentation of portfolio performance;[33] falsification of experience, credentials and past returns; misleading disclosure regarding claimed trading strategies; and improper valuation of assets. Additionally, state attorneys general and self-regulatory organizations recognize the material impact that hedge fund frauds have on both securities markets and investors at large, and have taken steps to regulate and monitor hedge funds.

The opaqueness of hedge funds presents a significant obstacle to regulatory attempts to monitor their activities. The fact that most hedge fund advisers are not registered with the Commission as investment advisers conceals not only the existence of these advisers but also that of the hedge funds they manage. Thus, the Commission argues that it often finds itself instituting enforcement action against an unregistered hedge fund adviser only after significant losses have occurred.[34] By contrast, with periodic examination of hedge funds, the Commission can make earlier discoveries, often before significant losses have resulted. Furthermore, the Commission argues that increased use of potential surprise examinations, as well as deficiency letters, will encourage a culture of compliance at regulated entities.

2. Valuation of Hedge Fund Portfolio Securities

Another concern the Commission cited was the lack of independent checks on a hedge fund adviser's valuation of a hedge fund's portfolio securities. Because of the way a fee is generated in hedge funds, hedge fund advisers have powerful incentives to achieve superior (and positive) performance. Hedge funds typically charge an asset management fee of 1-2 percent of assets, plus a "performance fee" of 20 percent of a hedge fund's profits. Therefore, the higher the value of a portfolio or profit, the higher the fee hedge fund advisers will retain. Additionally, other incentives include the retention of investors and additional capital, and the preservation of the adviser's own investment in the hedge fund.

Further, a hedge fund adviser has broad discretion to assign values to those securities. To comply with the relevant Statement of Financial Accounting Standards, hedge fund advisers need only value their portfolio securities in a manner consistent with the valuation policies and guidelines they disclose to their investors.[35] Moreover, hedge fund advisers even have discretion to override prices that are evaluated by outside service providers.

Because of the complexity and highly illiquid nature of hedge funds, inadequate pricing can affect investors more adversely than is the case with other securities. Furthermore, the Commission's lack of authority to examine many hedge fund advisers' books and records or conduct on-site inspections of hedge fund adviser operations prevents it from uncovering instances of mispricing. Consequently, the absence of any form of independent oversight over hedge fund pricing raises significant questions about the quality and fairness of the prices at which investors buy or redeem interests in some hedge funds. In light of these shortfalls, the new regulation equips the Commission to better evaluate the pricing of most hedge funds.

3. Retailization

"Retailization" of hedge funds is the most convincing reason for justifying the rule's increase in investment adviser regulation by the Commission. Historically, hedge funds are offered to accredited investors and large institutions sophisticated enough not to warrant protection from the federal securities law. However, in recent years, the Commission has determined that because of the increased exposure of small investors to hedge funds, through investment vehicles such as a registered fund of funds or through the increased investment in hedge funds by pension plans, the private adviser exemption should no longer apply to certain hedge fund advisers.

The fund of funds presents the most serious concern for the Commission. Unlike pension funds, which are mostly managed by professional investment advisers, a fund of funds increasingly targets less sophisticated investors. By selling interests of $100,000 or less, a fund of funds now accounts for 45 percent of hedge fund assets and 60 percent of their annual inflows. However, these targeted smaller investors are often less sophisticated and have little appreciation of the risks involved; therefore, they need special protection.

While a fund of funds provides small investors with a diversified portfolio of hedge funds, these instruments also impose hidden costs. An investor in these funds has to pay two layers of fees: the fees of the fund of funds itself and the fees charged by the underlying hedge fund. Furthermore, investors need to be informed about the professional qualifications and any material conflicts of interests of the fund of funds managers, as well as the investment strategies and redemption restrictions on the underlying hedge funds.

The purpose for the private adviser exemption was to exclude only advisers with a small number of clients, not to create a loophole to allow advisers with numerous clients to avoid registration by pooling clients together into a pooled investment vehicle. Furthermore, the Commission has asserted that due to insufficient information about hedge fund advisers and the lack of an oversight program, it cannot effectively deter or detect fraud by unregistered hedge fund advisers at an early stage.

B. The New Rule

Prior to the amendments, section 203(b)(3) of the Advisers Act exempted some investment advisers from registration with the Commission if, during the course of a 12-month period, they had fewer than 15 clients.[36] Also, pursuant to Rule 203(b)(3)-1 of the Advisers Act, a legal organization (such as a private investment fund with several owners) that received investment advice based on its investment objectives, rather than the individual investment objectives of its owners, was treated as a single client. Under this rule, private investment fund managers that complied with the other terms of section 203(b)(3) were permitted to advise up to 14 private funds in any 12-month period without registering under the Advisers Act. Under the new rule and amendments, there are a few significant changes.

1. The New "Look-Through" Provision

The Commission now requires that hedge fund advisers count each owner of a private fund as a client for the purpose of determining whether a private fund qualifies for the 14-client exemption. This new rule defines a private fund as a company: (i) that would be an investment company under section 3(a) of the Investment Company Act of 1940, as amended, but for the exception provided from that definition by either section 3(c)(1) or section 3(c)(7) of the Investment Company Act; (ii) that permits its owners to redeem any portion of their ownership interest within two years of the purchase of such interest; and (iii) that is offered based on its adviser's expertise.[37] In essence, each adviser must "look through" clients that are private funds and count each underlying investor to determine how many clients it provides investment service to. Generally, hedge funds must count each of the shareholders, limited partners, and members or beneficiaries of a private fund as owners. After counting the investors in the private funds it advises, if the adviser has 15 or more clients in the previous 12 months, then it will be required to register with the Commission.

Notably, the Commission will only apply the new "look through" counting rule on or after the February 1, 2006 compliance date and will not "look back" to the period leading up to this compliance date.[38] Therefore, hedge fund advisers are permitted to wait until February 2, 2006 to comply with the new rule, except that before that date they must comply with a few transition rules relating to records supporting performance and the performance fee, which will be discussed further below.

2. Fund of Funds

A fund of hedge funds is an investment company that invests in hedge funds instead of investing in individual securities. The hedge fund advisers must "look through" the "top-tier" private fund and count each investor in the "top-tier" fund as a client.[39] This provision is clearly designed to prevent advisers from using the fund of funds structure to manage a substantial amount of investments without registering with the Commission.

3. Registered Investment Companies

Rule 203(b)(3)-2(b) requires advisers of private funds to "look through" any registered investment company which owns interests in the hedge fund in order to count the number of investors within the registered investment company as clients of the adviser. If the registered investment companies have more than 14 investors, hedge fund advisers must count these individual investors as separate clients.[40]

4. The Two-Year "Lock-Up"

The newly adopted rule provides that for purposes of the look through provision, any fund that does not permit redemption of interests within two years of purchase is not a private fund.[41] However, the two-year lock-up test only applies to new investments, whether by new or existing investors, made on or after the compliance date of February 1, 2006. Further, advisers need not apply this test to investments made prior to this compliance date.[42] Finally, this test does not apply to the reinvestment of dividends or distributions.[43] Under this new rule, the lock-up period begins anew when an investor is permitted to exchange his or her interest in one fund for an interest in another fund managed by the same adviser.

Despite the requirements, there is an exception to the two-year lock-up test. The rule permits a fund to offer redemption rights under extraordinary circumstances without being considered a private fund under the rule.[44] The Commission interpreted extraordinary circumstances as: (i) holding the investment until it becomes "impractical or illegal"; (ii) the owner dies or becomes totally disabled; (iii) a key fund adviser or other key personnel die, become incapacitated, or cease to be involved in the management of the fund for an extended period of time; (iv) the merging or reorganizing of the investment vehicle; (v) where maintaining the investment in the fund would result in material adverse tax or regulatory outcomes; or (vi) where maintaining the investment in the fund would cause the fund's assets to be considered "plan assets" for purposes of the Employee Retirement Income Security Act of 1974.[45]

5. Offshore Advisers

The Commission stated that offshore advisers as domestic advisers are subject to the same "look through" requirements if they have more than 14 investors in a private fund or other advisory clients who are U.S. residents. To determine whether an investor is a U.S. resident, an adviser may generally look to the following at the time of the client's investment in the offshore private fund:[46] (i) in the case of individuals, to their residence; (ii) in the case of corporations and other business entities, to their principal office and place of business; (iii) in the case of personal trusts and estates, to a rule set out in Regulation S under the Securities Act of 1933; and (iv) in the case of discretionary or non-discretionary accounts managed by another investment adviser, to the location of the person for whose benefit the account is held.[47]

Prior to the amendments, offshore advisers with assets of $25 million or less under management did not need to register as an investment adviser under the Advisers Act. With the new rule, the Commission decided to close the loophole by requiring any offshore adviser with more than 14 clients residing within the U.S. during the previous 12 months to register with the Commission as an adviser, irrespective of the value of the assets it has under management.[48]

To avoid the inclusion of advisers of publicly offered offshore funds having more than 14 U.S. residents as investors in the registration requirements, the Commission adopted an exception to the definition of "private fund" for a company that (i) has its principal office and place of business outside the United States, and (ii) is organized or incorporated under the laws of any jurisdiction other than the United States. Furthermore, if an offshore adviser satisfies these requirements, it will not be required, among other things, to comply with the compliance rule (Rule 206(4)(7)), the custody rule (Rule 206(4)-2), or the proxy voting rule (Rule 206(4)-6). Registered offshore advisers required to register under the Advisers Act must keep certain books and records[49] which will remain subject to inspection by the Commission staff. The inspection will include "all records of any registered adviser."[50]

6. Performance "Track-Record"

Rule 204-2(e)(3) requires a registered adviser that makes claims regarding its performance "track record" to keep documentation supporting its performance claims for a period of five years after the performance information is last used. This new rule allows a hedge fund adviser to continuously market its performance from periods prior to its registration with the Commission even if the adviser has not retained the necessary documentation that is required by Rule 204-2. However, a transition rule requires an adviser to retain whatever records it does possess for periods ended on or after February 10, 2005, and to continue to preserve any records relating to prior performance. Furthermore, the recordkeeping rule has been expanded to include the performance history of any account managed by an adviser of a private fund (for which such adviser acts as the general partner, managing member, or in any similar capacity) and not limited to the performance of the private fund. It should be noted that this relief is available only to advisers of private funds that register after the February 10, 2005, effective date, and not to advisers voluntarily registering before that date.

7. Performance Fees

Registered investment advisers are generally prohibited from charging a performance fee unless the adviser's client is a "qualified client." Generally, a qualified client is a natural person or entity who has at least $750,000 under management with an investment adviser; who has a net worth of more than $1.5 million at the time of investment; who is a "qualified purchaser" as defined in the Investment Company Act; or who is an executive officer or other inside or qualified personnel of the adviser.

The amendments provide a "grandfathering" provision to allow hedge fund advisers that are required to register under the new rule to avoid disrupting fee arrangements with clients who were investors prior to February 10, 2005. Without this provision, investors who are not qualified clients would have had to withdraw from the investment fund before registration pursuant to the Advisers Act, or else the adviser would have had to forgo charging those investors a performance fee.[51] Grandfathered investors will be permitted to retain and add to their investment, but not open new investment accounts in the hedge fund or in other hedge funds managed by the same adviser. Once again, this relief is available only to advisers who register after February 10, 2005, the effective date of this new rule; it is not available to advisers who voluntarily register before that date.

8. The Custody Rule

The Custody Rule (Rule 206(4)-2) has also been modified to provide additional relief to a fund of funds. Effective January 10, 2005, the Custody Rule will extend the audit financial statement delivery deadline for an adviser to a fund of hedge funds from 120 days to 180 days from the fund of funds' fiscal year-end. A fund of funds is defined as a private fund that invests at least 10 percent of its total assets in other pooled investment vehicles that are not related persons to the fund of funds, its adviser, or general partner. With this change, the Commission acknowledges the inability of an adviser of the fund of funds to complete an audit prior to receiving financial statements from all the funds in which the fund of funds invested during the previous year.[52]

9. Form ADV

The Commission has modified Form ADV Part IA Item 7.B. and Schedule D § 7.B. to require disclosure of a person's status as an adviser to a "private fund," as defined in Rule 203(b)(3)-1.[53] The IARD electronic filing system will incorporate the changes made to Form ADV on March 8, 2006. All currently registered investment advisers must amend their Form ADV in their next filing thereafter, but no later than February 1, 2006.

Additionally, the amendments changed some key provisions of Part II of Form ADV. Under Part IA, Item 7 of Form ADV, a hedge fund adviser must acknowledge that it advises a "private fund." Furthermore, under section 7.B. of Schedule D, the hedge fund adviser must disclose information such as the name of the fund; the name of the general partner or manager of the private fund; whether the clients of the fund were solicited to invest in the private fund; the percentage of clients who have invested in the private fund; the minimum investment commitment required by a limited partner, member, or other investor of the private fund; and the current value of assets invested in the private fund.

10. State Registration Requirements

The new rule and amendments do not alter the minimum assets under management that an adviser must have to register with the Commission. Advisers with between $25 and $30 million in assets under management are eligible to register voluntarily with the Commission. Accordingly, advisers with less than $25 million under management will continue to be ineligible for Commission registration (except offshore advisers, as described above), but such advisers may be required to register under applicable state law.[54] The revised Rule 222-2 and 203A-3 clarifies that advisers and Supervised Persons of advisers for the purposes of those rules count as clients as provided in Rule 203(b)(3)-1, without applying the "look through" provisions of Rule 203(b)(3)-2.[55]

Part IV: Concerns About the New Regulation and Rules

As discussed in Part III of this article, the Commission in its effort to better protect the investing public enumerated its reasons for requiring the registration of hedge funds. Some of these reasons include the lack of Commission regulatory oversight, valuation of hedge fund portfolio securities, and retailization. This section of the article will discuss some of the concerns with respect to this newly adopted rule and amendments.

Hedge funds have played a positive role in the market by contributing to efficiency and enhancing liquidity. Through extensive research on the true value of a security, many hedge fund advisers profit by taking speculative trading positions and using short-term trading strategies to exploit perceived mispricings of securities. Due to the dynamic nature of the securities markets, the market prices of securities will move toward their true value, making the market more efficient as a result.[56]

Furthermore, hedge funds play an important role in a financial market where various risks are distributed across a range of financial instruments. They often assume risks by providing a platform to entities that wish to hedge risk. For example, as buyers and sellers of certain derivatives, such as securitized financial instruments, hedge funds provide a mechanism for banks and other creditors to minimize the risks involved in real economic activity. Because of their participation in the secondary market, hedge funds can help such entities limit or manage their own risks by shifting a portion of the financial risks to investors in the form of these tradable financial instruments. As a result of reallocating financial risk, hedge funds—through these market activities—reduce the financing cost of the transaction, making the market more fluid and efficient.

Based on the characteristics of hedge funds, many believe that registering hedge funds will only discourage market efficiency and impede the flow of global trade. The most important critic of the proposal was Alan Greenspan, the Federal Reserve Chairman, who argued that such registration was pointless and would be counter-productive if it led to more serious regulation. At a Congressional hearing, Mr. Greenspan stated that hedge funds play an important role for the economy, and they contribute to the flexibility of our financial system.[57] Furthermore, registration would not prevent fraud and could harm the financial system by driving the funds out of business. Fraud is rarely discovered through the complaints of counterparties rather than through regulatory checks. And serious cases of fraud, more common in the United States than in Europe, still remain rare given the large number of funds.

Additionally, others argue that the hedge fund boom was fueled by a set of temporary circumstances, such as the deflation of the stock market bubble and the ensuing period of very low interest rates. As market conditions return to normal, hedge fund managers will attempt to justify their excessive fees in relation to the low returns, and disappointed investors will start to withdraw funds. As a result, the number of hedge funds will diminish, and market forces will force the industry to contract, thereby making regulation unnecessary.

Conclusion

In recent years, the rapid growth of hedge funds and the increasing number of smaller, less sophisticated investors inexperienced in this type of investment vehicle have caused the Commission to adopt a new rule and amendments in an effort to exert more regulatory control over hedge funds. The new regulations aim to protect these investors from fraud. Without question, hedge funds play an important role in the vitality of the market by increasing efficiency and liquidity while distributing risks across various financial instruments. However, the Commission has legitimate concerns as it seeks to protect the investing public from the complex and volatile nature of hedge funds. By requiring registration of certain advisers, the Commission has fostered an environment in which hedge funds must adhere to higher standards of conduct through greater disclosure and transparency.

Endnotes

1. Investment Advisers Act, 17 C.F.R. §§ 201–22.
2. A copy of this release is *available at* http://www.sec.gov/rules.final.shtml.
3. The President's Working Group Report summarizes the varieties and operations of hedge funds at pp. 1–10. *See also* Brandon Becker and Colleen Doherty-Minicozzi, *Hedge Funds in Global Financial Markets* (Feb. 2000), *available at* http://www.wilmerhale.com/Home.aspx.
4. According to the President's Working Group on Financial Markets Report, institutional investors increasingly are investing in hedge funds. *The President's Working Group on Financial Markets Report on Over-the-Counter Derivatives Markets and the Commodity Exchange Act: Before the House Subcomm. on Risk Mgmt., Research, and Specialty Crops of the Comm. on Agric.*, 106th Cong. 43 (2000).
5. Carol Loomis, *Hard Times Come to Hedge Funds* ("Loomis"), Fortune 100, 101 (Jan. 1970). *See* cmt. submitted by Roundtable Panelist Charles J. Gradante on behalf of the Hennessee Group LLC ("Hennessee Group Comment Letter") note 4 at 2.
6. According to one commenter, as of January 1, 2003, individuals and families invested $249 billion in hedge funds, consisting of approximately 42 percent of industry assets. In recent years, however, these investments, as a percentage of all hedge fund assets, have been declining. Hennessee Group Comment Letter, note 4 at 7–9.
7. *See, e.g., Hedge Fund Roundtable*, Sec. Exch. Comm. (May 14, 2003) (statement of Robert Schulman): ("[T]he vast majority of . . . [the] growth [in the hedge fund industry] is coming institutionally. So although there's been a lot of talk about the retaliation of the business . . . the reality is it is large commitments from big public plans . . . , like CALPERS and Texas Teachers, that is leading the way toward the growth in this asset."). According to one commenter, institutional investors in the aggregate invested $175 billion in hedge funds in 2002, compared to $53 billion four years earlier. Hennessee Group Comment Letter, note 4 at 14.
8. Section 3(a)(1)(A) of the Investment Company Act defines an investment company as an issuer which is or holds itself out as being engaged primarily, or proposes to be engaged primarily, in the business of investing, reinvesting, or trading in securities. Section 3(a)(1)(C) of that Act defines an investment company as an issuer that is engaged or proposes to engage in the business of investing, reinvesting, owning, holding or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 percent of the value of its total assets (exclusive of government securities and cash items) on an unconsolidated basis. Many hedge funds meet both of these definitions. Investment Company Act, 15 U.S.C. 80a-1–80a-64.
9. Notwithstanding the 100-investor limitation, a hedge fund that is incorporated offshore, but relies on section 3(c)(1) in order to offer its securities privately to U.S. residents, may have more than 100 investors.
10. Securities Act, 15 U.S.C. §§ 77a–77mm.
11. Regulation D, 17 C.F.R. § 230.501–.506.
12. S. Rep. No. 104–293, (1996) ("Generally, these investors can evaluate on their own behalf matters such as the level of a fund's management fees, governance provisions, transactions with affiliates, investment risk, leverage, and redemption rights.").
13. Securities Exchange Act, 15 U.S.C. §§ 78a–78kk.

14. *See* Rule 2a-51-3.

15. *Sec. Exch. Comm. v. Ralston Purina Co.*, 346 U.S. 119, 125–27 (1953).

16. *Id.*

17. While Rule 506(b)(2)(i) limits the number of purchasers in a Rule 506 transaction to 35, this numerical limitation becomes irrelevant if the offering is made only to "accredited investors" because Rule 501(e)(1)(iv) provides that "accredited investors" are not counted for purposes of determining whether the issuer has exceeded the 35-purchaser limit.

18. *See* 17 C.F.R. § 230.501.

19. Rule 502 under the Securities Act is incorporated into Rule 506 under the Securities Act. 17 C.F.R. §§ 230.502, 230.506.

20. 17 C.F.R. § 230.502.

21. Section 202(a)(11) of the Advisers Act generally defines an investment adviser as "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities. . . ." Exceptions include banks, certain professionals, including lawyers and accountants, broker-dealers, publishers, and persons giving advice only about U.S. government securities. 15 U.S.C. §§ 80b-1–80b-21.

22. *See* 15 U.S.C. § 80b-3.

23. *See* 15 U.S.C. § 80b-4.

24. *See* 15 U.S.C. § 80b-6.

25. *Id.*

26. *Id.*

27. *See* 15 U.S.C. § 80(b)-(3).

28. Rule 203(b)(3)-1 under the previous Advisers Act provided that an adviser may count a legal organization as a single client if the legal organization receives investment advice based on its investment objectives rather than on the individual investment objectives of its owners. 15 U.S.C. § 80b-3.

29. Comment submitted by Roundtable Panelist Charles J. Gradante on behalf of the Hennessee Group LLC at 14 ("Due to market forces predominantly driven by trust and ERISA fiduciaries, hedge funds are finding it necessary to become Registered Investment Advisers in order to attract capital from that market."); *see also U.S. Hedge Fund Regulations Might Help Industry in Long Run*, Reuters English News Service (May 24, 2004) ("We registered with the SEC because it was simply easier to say that we were registered. A few fraud cases have gotten attention and when someone writes a $10 million check, they want some assurances." (Quoting Jerry Paul of Quixote Capital Management LLC)).

30. *See* Sec. Exch. Comm., *The Implications of the Growth of Hedge Funds* (2003).

31. In most cases involving hedge funds, the Commission institutes enforcement actions against the hedge fund adviser and/or the adviser's principals.

32. *See, e.g., Sec. Exch. Comm. v. Jean Baptiste Jean Pierre, Gabriel Toks Pearse & Darius l. Lee,* Litigation Release No. 18216 (July 7, 2003); *Sec. Exch. Comm. v. Peter W. Chabot*, *Chabot Inv., Inc. Sirens Inv., Inc., Sirens Synergy & the Synergy Fund, LLC*, Litigation Release No. 18214 (July 3, 2003); *Sec. Exch. Comm. v . David M. Mobley*, Litigation Release No. 18150 (May 20, 2003); *Sec. Exch. Comm. v. Vestron Fin. Corp.*, Litigation Release No. 18065 (Apr. 2, 2003); *Sec. Exch. Comm. v. Hoover & Hoover Capital Mgmt., Inc.*, Litigation Release No. 17981 (Feb. 11, 2003).

33. *See, e.g., Sec. Exch. Comm. v. Michael Lauer, Lancer Mgmt. Group, LLC, & Lancer Mgmt. Group II, LLC*, Litigation Release No. 18247 (July 23, 2003); *In re Charles K. Seavey*, Advisers Act Release No. 17981 (Mar. 27, 2003); *Sec. Exch. Comm. v. Beacon Hill Asset Mgmt. LLC*, Litigation Release No. 17831 (Nov. 7, 2002); *Sec. Exch. Comm. v. Edward Thomas Jung*, Litigation Release No. 17417 (Mar. 15, 2002); *Sec. Exch. Comm. v. Jerry A. Womack*, Litigation Release No. 17292 (Jan. 2, 2002); *Sec. Exch. Comm. v. Michael W. Berger, Manhattan Inv. Fund, Ltd., Manhattan Capital Mgmt. Inc.*, Litigation Release No. 17193 (Oct. 16, 2001); *Peter W. Chabot*, *Chabot Inv., Inc. Sirens Inv., Inc., Sirens Synergy & the Synergy Fund, LLC*, Litigation Release No. 18214; *David M. Mobley*, Litigation Release No. 18150; *Hoover and Hoover Capital Mgmt., Inc.*, Litigation Release No. 17981.

34. *Hedge Fund Roundtable*, Sec. Exch. Comm. (May 14, 2003) (statement of Stephen M. Cutler) ("[I]n the case of unregistered advisers, [the Commission's Enforcement Division is] not going to be the beneficiar[y] of an examination that is going to have identified a problem, brought to our attention in the form of an enforcement referral. So a lot of what we end up seeing in the hedge fund area is after the train wreck has already happened. We will get a complaint from an investor that finds that he's been wiped out."); *Hedge Fund Roundtable*, Sec. Exch. Comm. (May 15, 2003) (statement of Mark Anson) ("[W]hile the antifraud provisions can deter fraud, they really can't prevent it. [W]here hedge fund managers don't disclose their losses immediately . . . once the fraud is uncovered, the antifraud provisions kick in, and action can be taken, well, by that time, those losses have already occurred. And it's difficult for investors to get their money back."); *see also* Robert Lenzner and Michael Maiello, *The Money Vanished*, Forbes 70 (Aug. 6, 2001) ("[I]f there is mischief [in unregulated hedge funds], the [Commission] will find out about it too late.").

35. *See* Statement of Fin. Accounting Standards No. 107, Fin. Accounting Standards Bd. (1991); Statement of Fin. Accounting Standards No. 115, Fin. Accounting Standards Bd. (1993); and Statement of Fin. Accounting Standards No. 133, Fin. Accounting Standards Bd. (1998).

36. *See* 15 U.S.C. § 80b-3.

37. *See* 15 U.S.C. § 80a-3. *See also* discussion in Part II.

38. Sec. Exch. Comm., *The Implications of the Growth of Hedge Funds*, at n. 273.

39. This new rule does not require the adviser to the underlying fund to receive information as to the precise number or identities of the top-tier investors unless the top-tier fund has more than 14 owners. *See* U.S. Sec. Exch. Comm., *The Implications of the Growth of Hedge Funds*, at n. 196.

40. The Commission noted in *The Implications of the Growth of Hedge Funds*, at n. 196 that the underlying hedge funds need not "receive information as to the identities" of the registered fund's investors. The hedge fund adviser must determine, on a periodic basis, whether the registered investment company has sufficient ownership to cause the adviser to need to register with the Commission.

41. In *The Implications of the Growth of Hedge Funds*, at section II.E.2., the Commission notes that the exemption from the definition of private fund for funds not permitting redemptions within two years of purchase is designed to exclude advisers to venture capital and private equity funds from proposed registration requirements. Sec. Exch. Comm., *The Implications of the Growth of Hedge Funds*.

42. Sec. Exch. Comm., *The Implications of the Growth of Hedge Funds*, at section III.

43. The two-year test may be applied to accounts of investors on a "first in, first out" basis. Sec. Exch. Comm., *The Implications of the Growth of Hedge Funds*, at section II.E.2, n. 231.

44. 15 U.S.C. § 80b-3.

45. Sec. Exch. Comm., *The Implications of the Growth of Hedge Funds*, at n. 240.

46. 15 U.S.C. § 80b-3.

47. Sec. Exch. Comm., *The Implications of the Growth of Hedge Funds*, at section II.D.4.a., n. 201.

48. A domestic adviser may exclude assets under management attributable to non-resident investors for the purposes of determining whether the adviser meets the $25 million threshold to register with the Commission.

49. The Commission cited prior no-action letters concerning recordkeeping obligations of registered advisers that are located offshore. Under that series of no-action letters, the Commission staff has permitted certain exceptions from recordkeeping requirements under the Advisers Act. *See, e.g., Royal Bank of Canada*, SEC No-Action Letter (June 3, 1998).

50. Sec. Exch. Comm., *The Implications of the Growth of Hedge Funds*, at n. 217.

51. Private investment funds exempted from investment company registration pursuant to section 3(c)(7) of the Investment Company Act are not subject to the restriction on performance fees.

52. Amended Rule 206(4)-2(c)(4) looks to the definition of "Related Person" found in Form ADV for purposes of the "fund of funds" definition. In the release, the Commission stated that the relief did not extend to funds that are not "fund of funds" because such funds might then take 180 days to complete their audits. Thus, a fund of funds investing in such underlying funds would face the same timing problem in completing its own audits.

53. Upon registration, the adviser will be subject to numerous Commission rules, including: (i) the requirement to create, file and keep current Form ADV; (ii) the recordkeeping requirements of Rule 204-2; (iii) the performance fee requirements of Rule 205-3; (iv) the custody requirements of Rule 206(4)(2); (v) the solicitor requirements of Rule 206(4)-3; (vi) the proxy voting requirements of Rule 206(4)-6; (vii) the requirement to designate a compliance officer and adopt compliance procedures of Rule 206(4)-7; and (viii) the requirement to have a Code of Ethics found in Rule 204A-1, among others. In addition, although advisers to private funds will have until February 1, 2006, to become registered, advisers must keep performance records in compliance with the existing rules on and after February 10, 2005.

54. Investment advisers located in a state with a *de minimis* exemption from investment adviser registration may be able to continue to rely on such exemption.

55. The Commission has preserved the federal preemption of state law which limits the power of the states to require registration of out-of-state advisers not registered with the Commission.

56. "[M]any of the things which [hedge funds] do . . . tend to refine the pricing system in the United States and elsewhere. And it is that really exceptionally and increasingly sophisticated pricing system which is one of the reasons why the use of capital in this country is so efficient . . . there is an economic value here which we should not merely dismiss, . . . I do think it is important to remember that [hedge funds] . . . , by what they do, they do make a contribution to this country." Testimony of Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve, before the House of Representatives Committee on Banking and Financial Services (Oct. 1, 1998).

57. *The Washington Post*, July 15, 2004, at E03.

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Private Entities May Be Subject to New York's Freedom of Information Law: Evolving Inquiry

By Lucy Kats

The New York Legislature enacted the Freedom of Information Law (FOIL) to encourage the people's participation in government by providing the public with an opportunity to review governmental records.[1] As a result, FOIL mandates that state agencies disclose requested records to the public.[2] While, at first, this requirement appears to apply only to entities that are clearly governmental in nature, in fact the term "agency" is much more encompassing under FOIL and includes certain organizations that are deemed private for purposes of other laws.[3] The first step, therefore, in determining whether a record-holder must disclose a document is to address whether this entity constitutes an agency that is subject to FOIL's provisions.

"Agency," for purposes of FOIL, is defined as:

> Any state or municipal department, board, bureau, division, commission, committee, public authority, public corporation, council, office *or other governmental entity performing a governmental or proprietary function for the state* or any one or more municipalities thereof . . . [4]

Typically, the question of whether a record-holder is such an agency is not complicated, as most entities are firmly established as public or private. The inquiry, however, often becomes murky when the document is requested from a company or an organization possessing a hybrid of governmental and private characteristics. Such entities may qualify as agencies under the "other governmental entity" language of the definition quoted above. A careful examination of the law, therefore, is necessary to determine whether record-holders, such as, for example, private, not-for-profit companies established to serve public purposes and/or funded with public money, are deemed agencies that must respond to FOIL document requests.

Traditionally, courts have used a multi-factor test to determine whether an entity's involvement with government would qualify it as an agency for purposes of FOIL. In *Buffalo News, Inc. v. Buffalo Enterprise Development Corporation*, for example, the New York Court of Appeals decided that the Buffalo Enterprise Development Corporation (BEDC) was such an agency despite its many private characteristics.[5] BEDC was a not-for-profit local development corporation, organized "to relieve and reduce unemployment, to promote and to provide for additional and maximum employment, to better and to maintain job opportunities . . . [to] encourage development . . . in the community . . . to lessen the burdens of government and to act in the public interest."[6] In addition to the public character of its purposes, the following factors convinced the court that BEDC was an "undeniably governmental" organization, subject to FOIL: (1) it was subject to regulation by the United States Small Business Administration; (2) its entire source of funding was through governmental entities; (3) it maintained offices in a public building; (4) it was managed by the Board of Directors, which, under the by-laws, consisted of several government officials; and (4) it was created exclusively by and for the city of Buffalo to attract investment and stimulate growth.[7]

"A careful examination of the law . . . is necessary to determine whether record-holders, such as . . . private, not-for-profit companies established to serve public purposes and/or funded with public money, are deemed agencies that must respond to FOIL document requests."

One year later, the Appellate Division, Third Department, used similar factors to conclude that the Saratoga Economic Development Corporation (SEDC) was *not* an agency under FOIL.[8] Comparing the facts of the case to *Buffalo News*, the court pointed out that, unlike BEDC, SEDC was formed by private businessmen to further their own interests and not the interests of the city.[9] In addition, SEDC never inhabited public buildings, received partial funding from private sources, was not subject to the same financial controls as BEDC, and did not have public officials on its board.[10] The most significant factor, according to the court, was that, while BEDC described itself as the city's "agent," SEDC "simply contracted with the county on a fee-for-service basis, much as any other independent business entity might."[11]

While the multi-factor test outlined in these decisions is still used by the courts to determine whether a hybrid entity is an agency for purposes of FOIL,[12] the 1999 Court of Appeals decision of *Stoll v. New York State College of Veterinary Medicine at Cornell University* and its recent affirmation in *Alderson v. New York State College of Agriculture and Life Sciences at Cornell University*, appear to have shifted the inquiry in a new direction.[13] In *Stoll*, Cornell University received a FOIL request from an attorney for a professor who was disciplined for sexually harassing female students. The attorney requested "any complaints brought under the University's campus Code of Conduct . . . by or against any administrator, professor or student of any statutory college . . . and any documents, including any written findings, related to those complaints."[14] Noting that Cornell University is a private institution hosting several public or "statutory" colleges, the court had to decide whether the "statutory" colleges qualified as agencies under FOIL.[15]

"The very fact that a court would use a multi-factor test suggests that the entity in question cannot be clearly characterized as public or private but is, instead, a combination of both."

The court explained that an entity that is clearly public in nature should be deemed an agency that must respond to all FOIL requests, regardless of the nature or the purpose of the documents sought.[16] The court went on to say, however, that where an entity is "public in some respects, private in others" or "a blend of specified private and governmental activities," the inquiry must shift to the type of requested document.[17] Based on this, the court held, for the first time, that the activity behind the document sought "becomes significant in defining whether the entity itself is, or is not, a State agency."[18]

Using this analysis, the court decided that Cornell's "statutory" colleges were a hybrid of public and private characteristics and held that they should not be deemed agencies if the requested documents relate to an activity over which the University exercises autonomy and control. Since the documents sought in *Stoll* were disciplinary records, the activity at issue was Cornell's disciplinary system, which the New York legislature left to the University's discretion.[19] The court identified Cornell's disciplinary system as private and ruled that the statutory colleges were not subject to FOIL where the documents related to discipline.[20]

In 2005, the Court of Appeals utilized the *Stoll* analysis with respect to a FOIL request once again addressed to Cornell University, in *Alderson v. New York State College of Agriculture*.[21] The documents requested by petitioner, a radio program host, related to research activities and finances of the Agricultural Experiment Station and Agricultural Technical Park—entities affiliated with Cornell's statutory college of Agriculture and Life Sciences.[22] Citing *Stoll*, the court explained that the statutory colleges were "a blend of specified private and governmental activities that may not be categorically deemed agencies," and the inquiry must, therefore, focus on the nature of the documents sought.[23]

Accordingly, the court held that the documents requested in this case fell into two categories: those pertaining to research and academic activities, and those involving sources of funding or other financial records.[24] With respect to the first category, the college was not deemed an agency because it had complete control over its academic affairs and educational policies, which included research work.[25] With respect to the request for financial and funding records, however, the college was not categorically exempt from FOIL and was held subject to reporting requirements "[t]o the extent that Cornell is accountable for the expenditure of public funds."[26]

In relying on the holding in *Stoll*, the Court of Appeals in *Alderson* again indicated its unwillingness to categorize hybrid entities as wholly within or outside FOIL requirements and, instead, showed its intention to individually review the nature of each document request to such entities. While this new approach has yet to be used by New York courts with respect to "hybrid" entities other than Cornell University, it is doubtful that the Court of Appeals meant to limit its holdings in *Stoll* and *Alderson* to one organization. Rather, these decisions should be read as a departure from the multi-factor test traditionally employed to determine whether an entity should be subject to FOIL.

The very fact that a court would use a multi-factor test suggests that the entity in question cannot be clearly characterized as public or private but is, instead, a combination of both. Such hybrid entities, according to the holdings in *Stoll* and *Alderson*, should not be categorically exempt or categorically held subject to FOIL. Instead, the inquiry must depend on whether the documents requested relate to their public or private functions.

Endnotes

1. *Newsday, Inc. v. Sise*, 71 N.Y.2d 146, 150 (1987).
2. N.Y. Pub. Officers Law § 86(3).
3. Not-for-profit companies, for example, may be deemed private corporations for purposes of tax law but, as explained in the article, may nevertheless be considered governmental agencies subject to FOIL.
4. N.Y. Pub. Officers Law § 86(3) (emphasis added). According to the New York courts, the term "agency" must be given "its natural and most obvious meaning and must be liberally construed to further the general purpose of FOIL" and may cover certain

private not-for-profit companies. *Buffalo News, Inc. v. Buffalo Enter. Dev. Corp.*, 84 N.Y.2d 488 (1994). *See also Farms First v. Saratoga Econ. Dev. Corp.*, 222 A.D.2d 861, 635 N.Y.S.2d 720 (3d Dep't 1995); *Lugo v. Scenic Hudson, Inc.*, 258 A.D.2d 626, 685 N.Y.S.2d 761 (2d Dep't 1999).

5. *Buffalo News*, 84 N.Y.2d at 493.
6. *Id.* at 490.
7. *Id.* at 490–93.
8. *Farms First*, 222 A.D.2d at 861–62, 635 N.Y.S.2d at 720–21.
9. *Id.* at 862, 721.
10. *Id.*
11. *Id. See also Lugo*, 258 A.D.2d at 627, 685 N.Y.S.2d at 763 (corporations were not agencies under FOIL because, while they worked closely with several state offices and shared their governmental objectives, the corporations were not controlled by the state, were formed privately, had a self-elected board of directors, were primarily privately funded, and did not require governmental budget approval).
12. *See, e.g.*, *Ervin v. S. Tier Econ. Dev., Inc.*, 5 Misc. 3d 632, 782 N.Y.S.2d 903 (Chemung Co. Sup. Ct. 2004) (although the not-for-profit corporation was formed to further the governmental purpose of expanding the community's economic and employment opportunities, it was not an agency under FOIL because it did not conduct public hearings and was not financially controlled by the city).
13. *Stoll v. N.Y. State Coll. of Veterinary Med. at Cornell Univ.*, 94 N.Y.2d 162 (1999).
14. *Id.* at 165.
15. *Id.* at 166.
16. *Id.* at 168.
17. *Id.* at 166–68. "Given the hybrid statutory character of the colleges, we cannot agree with the dissent that they should be categorically deemed agencies of the State for the purposes at issue because of a compilation of factors on the State side of the column." *Id.* at 167.
18. *Id.* at 168.
19. *Id.* at 167–68.
20. *Id.* at 168. "Other, more public aspects of the statutory colleges may well be subject to FOIL . . . " *Id.*
21. *Alderson v. N. Y. State Coll. of Agric.*, 4 N.Y.3d 225 (2005).
22. *Id.* at 228–29, 232.
23. *Id.* at 230–31, 232.
24. *Id.* at 232.
25. *Id.* at 232.
26. *Id.* at 233.

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The For-Profit and Non-Profit Hospital Joint Venture: A Matter of Control

By Alanna McKiernan

The 1990s were marked by an unprecedented number of mergers and acquisitions in the corporate world. Due to the need to compete and expand market bases, a new wave of mergers and acquisitions began in health care. The health care world witnessed major consolidations among hospitals that had traditionally been independent and, in many cases, fierce competitors of one another. Many health care providers don't have, and can't afford, the technology needed to comply with the privacy and other rules of the Health Insurance Portability and Accounting Act (HIPAA).[1] The financial necessity of a non-profit combined with the desire of a for-profit to enter a new market[2] resulted in joint ventures. From its inception, the non-profit/for-profit joint venture seemed to be a marriage made in heaven, and from many perspectives it was—except from the IRS's perspective.

Joint ventures in the health care field generally take the form of either a whole joint venture, ancillary joint venture, or virtual merger. A whole joint venture is one in which a tax-exempt entity places all of its operations into a partnership—typically a limited liability company (LLC). An ancillary joint venture is one in which the exempt entity (i.e., hospital) joins with a for-profit entity to provide a particular medical service such as home health care, imaging or outpatient surgery. The exempt hospital contributes only a portion of its assets to the joint venture and thus continues its independent health care activities. A virtual merger exists when two or more exempt organizations enter into a joint operating agreement (JOA) in order to operate jointly without a merger or asset transfer. Each entity maintains its separate legal status.

Prior to 1980, the Internal Revenue Service (IRS) assumed the harsh position that an exempt organization automatically ceased to quality as tax-exempt per Internal Revenue Code (IRC) § 501(c)(3) when it participated in a joint venture with a for-profit partner.[3] This severe treatment, however, did not last.[4] In an attempt to define the conditions necessary to allow the non-profit organization to maintain its tax-exempt status while participating in a joint venture as a member or manager in an LLC, the IRS issued Rev. Rul. 98-15[5] in March 1998.

The issue addressed in Rev. Rul. 98-15 was whether a tax-exempt organization that operates an acute care hospital can continue to qualify for tax exemption when it forms an LLC with a for-profit corporation and contributes its hospital and all other operating assets to the LLC, which then ultimately operates the hospital.[6] The Ruling set forth two situations to illustrate which type of venture would be permitted and which venture would result in the tax-exempt entity jeopardizing its tax-exempt status.[7] Some of the key factors associated with the permitted whole hospital joint venture (as set forth in the joint venture organizational documents) included, but were not limited to: the appointment of the majority of the LLC board of managers by the non-profit; giving the non-profit appointees voting control; the requirement to operate in a manner that furthers charitable purposes and not the financial benefit of the for-profit partners; the disposition to enter into arms' length transactions with third parties; and the prohibition of conflicts of interest—e.g., no officer, director or key employee of the non-profit had any interest in or received any benefit from the for-profit.[8]

Although many balk at the very limited scope described by the situations and the shallow guidelines proffered by the IRS in Rev. Rul. 98-15, case law continues to refer to the scenarios contemplated by Rev. Rul. 98-15.[9] The position of the IRS has evolved, and unless a non-profit/for-profit joint venture furthers a tax-exempt purpose and unless the exempt organization has sufficient control over the joint venture to ensure that result, participation in the venture will jeopardize the § 501(c)(3) status of the exempt organization.

In order to protect the exempt status of a non-profit organization seeking to participate in a whole joint venture with a for-profit partner, the joint venture's organizational and governing documents should:

- require that the non-profit appoint the majority of the governing board members;
- empower the governing board of the joint venture, when the exempt organization is the general partner or managing member, to take actions that, in its sole discretion, are consistent with its tax-exempt purposes and those of the exempt partner, even if those actions conflict with the profitability of the entity or the objectives of the limited partner;
- specify that a super majority is required for any decision potentially affecting the joint venture's exempt purposes;

- provide that neither the exempt organization nor the joint venture entity confers any benefits on the for-profit or its affiliates for less than adequate consideration;
- provide that no director, officer or key employee of the exempt organization has an interest or receives any benefit from the joint venture;
- provide for the maintenance of adequate levels of insurance to protect the assets of the exempt organization from claims arising from the joint venture's business; and
- provide the exempt organization with the ability to unwind the joint venture if its tax-exempt status is jeopardized.

Endnotes

1. Health Insurance Portability and Accountability Act of 1996, Pub. L. No. 104-191, 110 Stat. 1936 (codified as amended in scattered sections of 42 U.S.C.).
2. This is especially true in New York, where all hospitals are owned by non-profit organizations.
3. *Plumstead Theatre Soc'y, Inc. v. Comm'r*, 675 F.2d 244 (9th Cir. 1980); I.R.C. § 501(c)(3).
4. *Plumstead Theatre Soc'y*, 675 F.2d at 244.
5. Rev. Rul. 98-15, 1998-1 CB 718.
6. *Id.* Such a venture is a whole joint venture.
7. *Id.*
8. *Id.*
9. *See, e.g., Redlands Surgical Servs. v. Comm'r*, 242 F.3d 904 (9th Cir. 2001); *St. David's Health Care Sys. v. U.S.*, 349 F.3d 232 (5th Cir. 2003).

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