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Message from the Editor

I would like to take this opportunity to welcome all Business Law Section members to the Spring 2000 issue of the *New York Business Law Journal.* As always, of course, I invite and encourage Section members to submit manuscripts for consideration for publication to the undersigned. Following this "Message from the Editor" is an open letter from **Stuart B. Newman**, Advisory Board Chair of the *Business Law Journal,* urging you to do the same. I hope this will result in the submission of many worthy manuscripts!

Our opening article in this first issue of the new millennium is a piece by **Raymond O. Gietz**, of the firm of Weil, Gotshal & Manges LLP, entitled "Private M & A Transactions and Financing Commitment Letters: Protecting The Seller." In his article, Mr. Gietz discusses the difficulties confronting sellers of substantial business assets in dealing with purchasers whose financing may be shaky. This helpful article advises sellers on what to look for in the buyer's commitment letter and how best to protect themselves in the course of negotiating with the purchaser for sale of the assets in question.

Next follows a timely article by **Lawrence N. Gray**, formerly of the Medicaid Fraud Control Unit of the New York Attorney General's office, updating New York law on the business record rule. This article should prove indispensable to anyone litigating issues surrounding the admissibility at trial of records kept in the normal course of business by corporations or other business entities, and even, in some circumstances, by individuals.

Gary W. Mair, a senior associate with the firm of Silverman, Colluar & Chernis, P.C. has contributed an important article on the current status of so-called "free" share offerings by corporations over the Internet, to persons who log on to those corporations' web sites. It is increasingly the view of the Securities and Exchange Commission, notwithstanding the potential applicability of the "no sale" doctrine to such transactions, that "free" share offerings on the World Wide Web may indeed have to be registered, and Mr. Mair discusses some of the pitfalls which may attend the failure to consider such registration. It should be noted that Mr. Mair filed one of the first, if not the first, registration statements with the Commission in connection with an Internet offering of such "free" securities.

There then follows an article by **Patricia E. Salkin**, Professor of Government Law, Associate Dean, and Director of the Government Law Center of Albany Law School, on the current status of smart growth land use policies in New York, as such policies affect business entities and attorneys representing them. Professor Salkin discusses in relevant detail current initiatives out of the New York State legislature and the Governor's office on reforming land use law so as to ensure that development in the state will in the future be orderly and serve environmental, social, and business interests all at the same time. This is a critical article for anyone practicing in the land use area, as well as for lawyers with a substantial business practice whose clients are now subject to a host of current regulations in this field and who may soon be subject to new regulations still on the drawing board and of whose existence they may not be aware.

Following a practice established in the Fall 1999 issue of the *Business Law Journal,* we next have three comment letters, the first two addressed to the Securities and Exchange Commission, and the last addressed to the AICPA, written by the Committee on Securities Regulation of the Business Law Section of the New York State Bar Association. The first letter, dated November 9, 1999, discusses proposed new SEC regulations regarding Audit Committee Reports and the potential for an increase in the liability of audit committee members of a corporation's board of directors which may result if the SEC's rule changes are adopted as proposed. On a related matter, the second letter, dated December 1, 1999, analyzes proposed rule changes by the New York Stock Exchange, the American Stock Exchange, and the National Association of Securities Dealers, with respect to requirements for audit committees of corporations whose securities are listed for trading on either the exchanges or through the facilities of the NASDAQ. Finally, the third comment letter, dated December 2, 1999, discusses the position of the State Bar's Securities Regulation Committee on proposed amendments to Statement on Auditing Standards No. 61 and Statement on Auditing Standards No. 71, regarding communications with audit committees and interim financial information discussion requirements likely to be imposed on auditors. Like the November 19 and December 1 letters, this last comment letter stems from the efforts of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees. These letters should all be of interest to accountants and lawyers either serving on board audit committees or advising such corporate audit committees or auditors.

Next follow two case notes by **Timothy Miller**, the indefatigable Student Editor and my Research Assistant on the *Business Law Journal.* The first case note, on *Ravens Metal Products v. McGann,* a recent Appellate Division, Third Department decision on the law of piercing the corporate veil and fraudulent conveyances, discusses the court's determination that the equities did not lie for veil-piercing in a situation where allegedly fraudulent conveyances by the sole officer, director, and shareholder of the defendant corporation were made in payment of legitimate corporate expenses. The second case note, on *Weinroth v. Swid,* analyzes an Appellate Division, First Department banking case involving claims of unjust enrichment, breach of several oral and written agreements, and reimbursement of attorney's fees. These case notes should be of interest to attorneys practicing in the corporate or banking law areas.

Finally, your editor has provided a Book Review of the excellent two-volume treatise by Goodman, Phillips & Vineberg's **Guy P. Lander**, Chair of the State Bar Committee on Securities Regulation and a member of the Advisory Board of the *Business Law Journal,* entitled *U.S. Securities Law for International Financial Transactions and Capital Markets.* This compendious work, which in reality gives concise and readable coverage of all major aspects of the federal securities laws, notwithstanding the humbler implications of its title, is, in the view of the undersigned, required reading for anyone practicing securities law, irrespective of whether his or her clientele is located inside the United States or abroad. Mr. Lander has performed a truly valuable service for the entire securities bar.

As always, read, enjoy, and please submit.

Sincerely,
James D. Redwood
Professor of Law
Albany Law School

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New York State Bar Association

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NYSBA

February, 2000

Members of the Business Law Section

Re: *New York Business Law Journal*

Ladies and Gentlemen:

The Fall issue of the *New York Business Law Journal* was mailed to you as a member of the Business Law Section of the New York State Bar Association last year. This marks the fourth year of publication for the *Journal*, which is published in the Spring and Fall of each year and mailed without charge to all members of the Section.

The *Journal* is published by the Business Law Section in collaboration with Albany Law School, under the direction of Professor James Redwood as Editor-in-Chief.

The goal of each issue is to provide practice-oriented insight and guidance by presenting information and articles that are topical, practical and relevant to the business law practitioner, with special emphasis on lawyers who practice in the State of New York. The *Journal* also contains Committee reports of the Section's eight standing committees describing their activities and the legislative and other issues on which they have focused.

From its inception, the mission has been to make each issue of the *Journal* a useful and informative source of practical information for members of the Section. We hope we are accomplishing that goal. We are interested in your comments and suggestions.

The purpose of this letter is to encourage members of the Section to share their practice experiences and insights by contributing to the *Journal*. Manuscripts for proposed articles and other items of interest are most welcome and should be submitted to Professor Redwood at Albany Law School. Some of our contributing authors have found that, with minimal editing, memoranda of law can easily be converted into interesting articles. Information regarding the publication policy of the *Journal* and guidelines for the submission of manuscripts are printed in each issue. A copy of the policy and guidelines, and copies of the *Journal* itself, can be obtained from the Bar Association.

We hope you will join with us in continuing to provide the *Journal*'s editors with insightful articles to share with other Section members and *Journal* subscribers.

Sincerely,

Stuart B. Newman
Advisory Board Chair
New York Business Law Journal

Private M & A Transactions and Financing Commitment Letters: Protecting the Seller

By Raymond O. Gietz

A company with multiple business lines determines to divest one of its divisions as part of its strategy of focusing company resources on a group of core businesses. To maximize the price for the division, the company engages an investment banking firm to conduct an auction. The field is narrowed to two finalists: a financial buyer, who makes the highest bid, subject, however, to the receipt of funds under the signed commitment letter that accompanies its bid; and an industry participant, whose bid price is lower than the financial buyer's, but whose offer is not subject to any financing contingencies.

In picking the winning bidder, the seller will need to determine whether the uncertainties created by the conditionality of the financial buyer's offer outweigh the benefits of its higher bid. This article is intended to provide guidance to a seller in a private M & A transaction in assessing the risks posed by a condition that its buyer receive funds pursuant to an executed commitment letter. Also suggested are ways that a seller can protect itself and reduce the chances that the buyer at a later time could use the failure of the condition to terminate or renegotiate the transaction to the seller's detriment.

The Commitment Letter

A buyer who does not have the funds necessary to pay the cash purchase price for a business will often try to persuade the seller that it has made its bid "money good" by obtaining a commitment letter from a reputable financial institution for the requisite funds. By obtaining the executed commitment prior to (or simultaneously with) the execution of the acquisition agreement, the buyer would like the seller to believe that it has for all practical purposes completed the task of arranging financing and that its obligation to close the transaction is subject only to the ministerial acts of preparation of final documentation and receipt of funds at closing (as opposed to a more open-ended financing contingency that would allow the buyer to walk away if it were unable to arrange "suitable" financing from a yet-to-be identified financing source).

The number of M & A transactions that were terminated or repriced in the fourth quarter of 1998 due to the instability in the syndicated loan markets is proof that a commitment letter hardly is the equivalent of available funds. To make an informed assessment of the likelihood that the transaction will close on its original terms, the seller will need to review thoroughly the commitment letter and understand the rights and obligations of the seller, buyer and financial institution under their respective agreements. Most importantly, the seller and its advisors should be prepared to negotiate the terms of the commitment letter and acquisition agreement in a way that protects the seller as much as possible against a failed or renegotiated transaction.

Terms and Conditions

A commitment letter is an agreement executed by one or more financial institutions that commit to provide financing on the terms described to a borrower (i.e., the buyer in the M & A context). In broad terms, a typical commitment letter is a relatively short document comprised of (i) a description of the contemplated financing, including amount, facility tranches, security, maturity, interest rates and fees, (ii) the conditions to the financial institution's obligation to provide the financing and (iii) various provisions relating to the relationship between the financial institution and its borrower (e.g., assistance to be provided by the borrower in any contemplated syndication of the loan, expense reimbursement, indemnification, etc.).

Of obvious interest to a seller are the express conditions to the financial institution's obligation to make the loan to its borrower. These conditions will vary depending on the nature of the M & A transaction and the identity of the financial institution. However, a number of conditions generally are present in most commitment letters, including the following:

(i) the preparation, negotiation and execution of documentation for the loan acceptable to the financial institution;

(ii) the acquisition structure and documentation being acceptable to the lender;

(iii) the consummation of the acquisition being consistent with the terms of the acquisition documentation, with no modification or waiver of any material provision without the prior approval of the lender;

(iv) the receipt of all necessary material governmental and third-party consents;

(v) the borrower and/or the to-be-acquired business not having suffered a material adverse change;

(vi) financial and loan syndication markets not having suffered any material disruption or adverse change; and

(vii) the absence of any defaults or litigation.

Additional conditions could include the receipt of a solvency letter from a third-party valuation firm, the borrower's repayment of certain existing indebtedness, and the receipt of one or more satisfactory environmental reports.

Negotiating the Commitment Letter

Although a buyer should be motivated to obtain the best terms possible from its prospective lender, a seller should never assume that the commitment letter presented to it is a final product. Differences in negotiating leverage, sophistication, knowledge and interests could cause the commitment letter that results from discussions between the buyer and the financial institution to fall short of the best commitment that could be obtained from the seller's perspective. For this reason, it is critical that the seller and its advisors receive a copy of the commitment letter as early as possible in the process so that it can be thoroughly reviewed and the "hardness" of the commitment can be judged (both in absolute terms and relative to the offers of other interested bidders). Also, this will give the seller and its advisors the opportunity to insist upon any changes deemed necessary by them as a prerequisite to the acceptance of the buyer's bid.

Although the specific terms of the financing (facility tranches, security, maturity, interest rates, loan covenants, etc.) generally are not of concern to the seller, the entire commitment letter needs to be reviewed to make certain that it does not contain any provisions that, while not express conditions, could give the lender the right not to make the loan to the buyer. One such provision, commonly referred to by lenders as" market flex" language, repeatedly made its appearance in the fourth quarter of 1998 in low-and non-investment grade credits in response to the instability in the loan syndication markets. This provision specifically allows the lender to restructure the terms of the committed loan (including, without limitation, a change in interest rate spreads) to ensure the successful syndication of the financing.[1]

The introduction of this language, which may very well become a permanent feature of certain types of syndicated bank loan commitments, makes a commitment letter much less like a traditional firm committed bank financing and more like an underwriting of equity securities, where the underwriters are not legally committed to purchase the securities until the end of the process after they have successfully sold the issue.[2] Thus, although a bank commitment specifically may not be conditioned on successful syndication (a condition that should be resisted by a seller because of the attendant delays, risks and uncertainties), the "market flex" language raises many of the same issues. If the loan cannot be syndicated on its original terms, the financial institution that signed the commitment letter is free to propose a restructuring of the loan with revised terms. Under these circumstances, the lender is not legally obligated to provide the financing on the original terms set forth in the commitment letter. If the buyer is not amenable to the restructured terms (which may very well involve increased costs), it is not obligated to borrow the funds on the revised terms (and likely will not be obligated to proceed with the transaction under the acquisition agreement). The potential loser in such a scenario is the seller, unless it has negotiated adequate protections in the acquisition agreement (see below).

The general rule for the seller in reviewing and negotiating the express conditions set forth in the commitment letter is to make them as similar as possible to the buyer's conditions in the acquisition agreement. While the uniqueness of the borrower/lender relationship requires certain conditions to be set forth in the commitment letter that would not appear in the acquisition agreement, there is substantial overlap regarding a number of matters. These overlap matters include the condition of the acquired business (i.e., the material adverse change or "MAC" clause), governmental and third-party consents, environmental matters and litigation. The task for the seller is to make the common conditions as similar as possible so that there is little or no "leakage" between the occurrences that would excuse the buyer's performance under the acquisition agreement and the lender's performance under the commitment letter.

Conditions that are unique to the commitment letter should be drawn as narrowly as possible. For example, the requirement that definitive documentation evidencing the loan shall have been prepared and negotiated should provide that such documentation will be consistent with the commitment letter and will be customary for transactions of a similar nature. The commitment letter also should expressly state that the definitive loan documentation will not include any conditions to the initial borrowing not set forth in the commitment letter. The seller should insist upon and receive a letter from the lender that, as of the date of the acquisition agreement, it is satisfied with the matters that it has the right to consent to under its commitment (e.g., acquisition structure and documentation, capital structure of the borrower, environmental reports, historical financial statements, etc.). Finally, market outs should be as limited as possible (e.g., a condition that there shall not have been any material disruption or adverse change in the market for loan syndications may be impossible for the seller to delete, while adverse changes in the stock and other financial markets and acts of war or outbreaks of hostilities may be successfully omitted).

The Acquisition Agreement

Regardless of whether a seller could bring a claim directly against a financial institution on third-party beneficiary principles if the institution were to wrongfully fail to make the contemplated loan, the best way for a seller to protect itself vis-à-vis the financial institution is to limit the conditionality of the commitment letter to the greatest extent practicable. Courts generally enforce the express terms of conditions precedent, and the financial institution will be entitled to insist upon the strict satisfaction of its conditions with no mitigating standard of materiality or substantiality.[3]

A broader variety of approaches, however, are available to the seller vis-à-vis its buyer to protect itself against a failed financing. These protections should be negotiated into the provisions of the definitive acquisition agreement between the seller and the buyer.

It is settled law that a contracting party is required to use reasonable and diligent efforts to cause a condition precedent in its favor to occur.[4] While a party who negotiated for a condition precedent generally cannot be forced to accept anything but the satisfaction of the condition, a party cannot rely on the non-occurrence of the condition precedent if it has acted or failed to act so as to prevent or hinder the condition from being fulfilled.[5] This means that, absent a provision in the acquisition agreement to the contrary, the buyer will be entitled to rely upon the satisfaction of its financing condition, but it must take reasonable actions to enable the financial institution to provide funding under the terms of the commitment.

At a minimum, the acquisition agreement should expressly provide that the buyer will use its "best" efforts to cause the conditions precedent in the commitment letter to be satisfied and to obtain the financing provided for therein. The seller should insist upon a best efforts standard as opposed to the "reasonable" or "reasonable best efforts" standards that might govern other obligations of the buyer under the acquisition agreement. To alleviate the concerns of the buyer regarding the extent of its obligations under a "best efforts" clause in this context, the seller should agree to expressly provide that the buyer would not be required to expend funds in respect of the financing other than as provided in the commitment letter.

But what if notwithstanding the best efforts of the buyer, the financial institution is unwilling to make the loan on the terms set forth in the commitment letter? Perhaps because of a deterioration in the loan syndication markets or otherwise it invokes the "market flex" language of the commitment letter and insists upon a restructuring of the loan and/or an increase in interest rate spreads before it will make funds available to the buyer (or perhaps it refuses to make any loan, regardless of terms and pricing, available to the buyer). For the reasons noted above, absent specific protections in the acquisition agreement, the buyer would not be obligated to proceed under these circumstances and the seller would have a failed transaction, with all of the negative consequences that result therefrom.

There are a number of approaches that can be attempted by the seller to avoid the triggering of the buyer's walk-away rights. One such approach is to introduce the concept of "suitable alternative financing" into the acquisition agreement. Essentially, the concept would define those financing terms that, if available, the buyer would be required to accept for the purposes of completing the transaction under the acquisition agreement. Practically, the definition would use the terms set forth in the commitment letter as a baseline and would specify the permitted variations that would not give the buyer the opportunity to terminate or renegotiate the acquisition transaction. The buyer's obligation under the acquisition agreement would be to (i) accept the lender's revised terms (if offered by the lender) if they constitute suitable alternative financing, (ii) seek suitable alternative financing from other sources, and (iii) accept suitable alternative financing that may be arranged by the seller through its own initiatives.

The difficulty will be in crafting the outlines of the terms of the suitable alternative financing that the buyer should be willing to live with if the originally contemplated financing is not available. In this regard, a number of issues will need to be worked through, not the least of which is whether or to what extent the buyer would be obligated to incur incremental financing costs beyond those contemplated by the commitment letter. However, a motivated buyer should be willing to consider the concept (especially when it is introduced early in the process by the seller as a condition to its willingness to sign an acquisition agreement), and with carefully thought out limitations should be willing to execute an acquisition agreement containing these provisions.

There are a number of cases that hold that a buyer would breach its duty to use its reasonable and diligent efforts to cause a financing condition precedent to occur by refusing assistance that may be offered by the seller.[6] Notwithstanding these authorities, a seller should insist upon specific provisions in the acquisition agreement that would require the buyer to accept whatever financial accommodations the seller might propose if they were to result in suitable alternative financing being available to the buyer. This would allow the seller to judge whether the cost and expense of making the financial accommodation available to the buyer are greater than the detriments of a failed or renegotiated transaction.

For example, if a lender is insisting upon an increased interest rate spread that is beyond that contemplated by the acquisition agreement, under such a provision the seller would be free, at its option, to: agree to reimburse the buyer for its incremental loan expense above the expense contemplated by the suitable alternative financing definition; enter into an interest rate swap agreement at its cost sufficient to fund the increased interest costs and transfer the benefits of the swap agreement to the buyer at the closing of the sale; issue a seller guarantee for all or a part of the loan that would have the effect of lowering the buyer's interest expense to that conforming with the definition of suitable alternative financing; or partially finance the transaction itself and take back debt securities of the buyer with interest expense that, when added to the costs of the balance of the financing, conform with the definition of suitable alternative financing. The foregoing is illustrative only, and this "seller financial assistance" provision could be used by a seller to require the buyer to accept any type of financial accommodation, provided that the assistance causes the resulting financing terms to come within the parameters of the suitable alternative financing definition.

The foregoing provisions are difficult to negotiate, and the buyer may balk over the problems involved in anticipating the exact nature of the financing problem and a suitable solution. Whether or not the seller is successful in negotiating "suitable alternative financing" and "seller financial assistance" provisions into its acquisition agreement, it should insist upon a "reverse breakup fee" (i.e., a payment by the buyer to the seller of a fixed cash amount) if the transaction does not close because of a failed financing. The fee should be substantial enough to reimburse the seller for its expenses and in some way compensate for any diminution in the value of the business that may have resulted from the failed transaction. The reverse breakup fee may also serve as a proxy for the suitable alternative financing concept—if the increased cost of alternate financing is less than the breakup fee, the buyer may be induced to close the transaction even though it is not legally obligated to do so.

Endnotes

1. A typical formulation is as follows: "Notwithstanding anything to the contrary contained herein, in the event that syndication of the Loan (whether such syndication takes place before or after closing of the Loan) cannot be achieved in a manner satisfactory to Lender due to terms, conditions, or structure of the Loan, Borrower agrees to use its best efforts to cooperate with Lender in developing an alternative structure that will permit satisfactory syndication of the Loan including, but not limited to, pricing, financial covenants, and maturity, and Borrower agrees that (a) if the Loan has not yet closed, Lender's commitment hereunder is subject to the development of such an alternative structure satisfactory to Lender, and (b) if the Loan has closed, Borrower will amend the loan documents relating to the Loan to reflect any changes incorporating such alternative structure as agreed upon by Borrower and Lender."
2. For a general discussion of the introduction of market flex language and its impact, see, Paul Beckett, *Syndication of Loans Sees Big Changes*, Wall St. J., January 26, 1999 at C1; *Syndicate Lending, The Relationship Starts to Change*, Euromoney Magazine, November 10, 1998 at 64.
3. *See, eg., Oppenheimer & Co v. Oppenheimer, Appel Dixon & Co.*, 6 N.Y.2d 685, 693 (N.Y. 1995); Restatement (Second) of Contracts § 237 cmt. d (1979).
4. *See, e.g., Teachers Ins. & Annuity Ass'n v. Ormesa Geothermal*, 791 F. Supp. 401 (S.D.N.Y. 1991); *Cauff, Lippman & Co v. Apogee Fin. Group*, 807 F. Supp. 1007 (S.D.N.Y. 1992).
5. *See, e.g., Cauff, Lippman & Co v. Apogee Fin. Group*, 807 F. Supp. 1007, 1022 (S.D.N.Y. 1992); *Teachers Ins. & Annuity Ass'n v. Ormesa Geothermal*, 791 F. Supp. 401, 407 (S.D.N.Y. 1991); *In re Gulf Oil/Cities Serv. Tender Offer Litig.*, 725 F. Supp. 712, 730 (S.D.N.Y. 1989).
6. *See, e.g., Duncan v. Rossuck*, 621 So.2d 1313 (Ala. 1993); *Covington v. Robinson*, 723 S.W.2d 643 (Tenn. 1986).

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The Business Record Rule

By Lawrence N. Gray

Anything is easy when one understands it. This article describes what the business record rule is, and why it is what it is. The rule is one of necessity. It is an exception to the hearsay rule that requires some suspension of disbelief. Here are its rationales which will assist lawyers and courts in putting a record into evidence or keeping it out.

A. The Threshold Determination of Admissibility is for the Court

> [W]hile business records, once admitted, have no more probative force than any other evidence admitted pursuant to a hearsay exception, the threshold determination that they are business records satisfying the requirement of the statute is one of law. Whether records admitted pursuant to C.P.L.R. 4518(a) are in fact regular business records is not . . . a matter going only to weight of the evidence; other circumstances of the making of the records may go to weight once the threshold requirements for admissibility are met (C.P.L.R. 4518[a]).[1]

Some trial courts occasionally labor under the misapprehension that in order for a litigant-proponent of a business record to gain the benefit of the business record exception to the hearsay rule, he must show that the witness (usually witnesses) who was personally privy to the recording of the transactions, as they occurred, in an entity's business records is dead or otherwise unavailable to testify. Besides being ignorant of the constitutional, common law and policy reasons to the contrary, such misapprehension ignores the very language of C.P.L.R. Rule 4518(a) which *contains no unavailability requirement.*

B. The Confrontation Clause's Unavailability Doctrine is Inapplicable to Business Records Admitted Under C.P.L.R. 4518(a)

Business records are admissible in evidence whether the witnesses who participated in their making are available or unavailable to testify. Business record entrants and business duty informants of the entrants may all be seated in the spectator section while business records are introduced into evidence through a qualified custodian.[2] The Confrontation Clause of the Constitution's Sixth Amendment reflects, but does not mandate in all cases, a preference for live testimony when the witness and his prior statement to be introduced as an exception to the hearsay rule are both available and even before the court.[3] "A fundamental precept of the law of hearsay is that certain exceptions require that the proponent of the evidence prove the declarant's unavailability as a witness at trial, while other exceptions [such as the business record rule] treat availability as immaterial."[4] Once the business records exception to the hearsay rule is properly understood in terms of the necessities which gave it life, it is clear that an unavailability requirement could seldom be met. It would require the production of each witness who had a hand in a business record's preparation. Merrill Lynch and Morgan Stanley could never meet this requirement without emptying their offices to the courtroom. Even then, each business-duty informant in the chain of the contemporaneous receipt, informing and entrant recordation would be highly unlikely to specifically remember that which was routine and repetitious to the ordinary course of their business's business.[5]

C. That Writing or Record Must Be Made in the Regular Course of a Business Whose Business it is to Keep the Writing or Record

C.P.L.R. 4518(a) renders admissible in evidence

> any writing or record, whether in the form of an entry in a book or otherwise, made as a memorandum or record of any act, transaction, occurrence or event . . . **if the judge finds that it was made in the regular course of any business and that it was the regular course of such business to make it [etc].**

A personal or non-business record or personal note is not "any writing or record" as contemplated by Rule 4518(a).[6] Also inadmissible are business records received from another business entity whose business is different and/or under no business duty to report to the recipient business. They are without the rule's exception to the hearsay rule.[7]

> [A]s a rule, "the mere filing of papers received from other entities, even if they are retained in the regular course of business, is insufficient to qualify the documents as business records ***." The reason for this rule is that "[s]uch papers simply are not made in the regular course of business of the recipient, who is in no position to provide the necessary foundation testimony as to

> the regularity and timeliness of their preparation or the source of information contained in the records." *** Nor, generally would the recipient be aware [of] whether the information was imparted by one under a "business duty" to report to the entrant. . . .[8]

The same impediment to admissibility applies where the record or writing is not one usually made by the business.[9] Sears Roebuck is not in the business of making tents such that reports from the tentmaker concerning the quality and nonflammability of its canvas found in Sears Roebuck's business records would fall within Rule 4518(a).

D. The Business Records of the Criminal and the Cop

In something of a contrast, the records of a one-man criminal enterprise are not disqualified from being business records within the purview of Rule 4518(a).[10] "The principles of efficient accounting apply just as readily to an illicit enterprise as they do to a licit business."[11] "The concept of 'business' has ventured far beyond the mercantile origins of this hearsay exception, and records in forms previously unimagined are now routinely received in evidence pursuant to C.P.L.R. 4518."[12] The wholesaler of heroin, the bookmaker and the loanshark keep notoriously accurate accounts for many reasons, including the longevity of their stay on earth. Business records and writings such as "speedometer deviation records" or wiretap plant "linesheets" qualify for Rule 4518(a) treatment as exceptions to the hearsay rule even though records like these are also foreseeably made for litigation purposes.[13] In either case, the police were in the business of recording and maintaining these records and writings for their own internal business purposes—maintenance, testing, inventory and progress reports to the court.

A. Trustworthiness Arising Out of the Nature of Business Records and the Business Record Exception to the Hearsay Rule

New York's Court of Appeals is unanimous in stating:

> In this State, over the years a mass of petty technicalities had sprung up to block admission into evidence of plainly trustworthy business records which were accepted and relied on in daily commercial dealings as accurate accounts. The legislative purpose . . . was to permit such records to be received in evidence without the need to call as witnesses all the individuals who made them. *** Since . . . [its] enactment nearly 60 years ago, the statutory exception to the hearsay rule has widened considerably, both as business and record-keeping have become increasingly complex and sophisticated. The business records exception has been recognized as probably the most important hearsay exception and a major growth point in the law with great potential for further expansion.[14]

"[T]he purpose and requirements of . . . [C.P.L.R. 4518(a)] remain the touchstone."[15]

> [T]he business records exception [to the hearsay rule] grew out of considerations of necessity and trustworthiness—the necessity for alternatives to permit large and small businesses to prove debts by their records of account, *and the unusual degree of trustworthiness and reliability of such records owing to the fact that they were kept regularly, systematically, routinely and contemporaneously. *** The element of unusual reliability is supplied by systematic checking, by regularity and continuity which produces habits of precision, by actual experience of business in relying upon them, or by a duty to make an accurate record as part of a continuing job or occupation. The essence of the business records exception to the hearsay rule is that records systematically made for the conduct of a business as a business are inherently highly trustworthy because they are routine reflections of day-to-day operations and because the entrant's obligation is to have them truthful and accurate for purposes of the conduct of the enterprise*.[16]

In layman's terms, the rationale is rational business self-interest.

F. The Entrant and Those in the Chain of Information Transmitted to the Entrant Must Be Under a Business Duty to Transmit and Enter Respectively

A social worker is under a business duty (in this case mandated by law) to record information he or she receives first hand pertaining to a welfare recipient's case status.[17] Such is in the normal course of business of a social welfare agency whose business it is to maintain a case file on a recipient's status. That the social worker received the information over the phone from a voice she did not recognize goes to the business entry's weight, not its admissibility.[18] In contrast, a report made by a policeman concerning the details of an automobile accident is not admissible as a business record if the officer is not a firsthand witness thereto but only receives the details from third persons who happened to be at the scene—those who were not under a business duty to report the occurrence to the officer.[19] That *the entrant* is under a business duty to record information from informants is only half the test for the record's admissibility as a business record. "In addition, each participant in the chain producing the record, from the initial declarant to the final entrant, must be acting within the scope of regular business conduct. . . ."[20] "Thus, not only must the entrant be under a business duty to record the event, but the informant must be under a contemporaneous business duty to report the occurrence to the entrant as well. . . ."[21] "[If] any of the participants in the chain is acting outside the scope of a business duty" the information transmitted is inadmissible hearsay.[22] Any other rule would "open the floodgates for the introduction of random, irresponsible material beyond the reach of the usual tests for accuracy—cross-examination and impeachment of the declarant. . . ."[23] [A]dmission may only be granted where it is demonstrated that the informant has personal knowledge of the act, event or condition and he is under a business duty to report it to the entrant . . ."[24]

It has been said that the theory behind the "business duty requirement" is that, presumptively, when one employee makes a report to another employee, it is truthful. If a non-employee makes a report, there is no reason for it to be accurate. If an employee makes a dishonest report or record of business facts, he is liable to employer discipline. *The dishonest non-employee is not subject to employer discipline.*

G. The Business Record Entry Must Be Made at the Time of the Act, Transaction, Occurrence or Event, or within a Reasonable Time Thereafter

C.P.L.R. 4518(a)'s "contemporaneous" (not simultaneous) entry requirement is, "essentially, that recollection be fairly accurate and the habit or routine of making the entries assured."[25] Of course, memory is not a factor when a copy (by hand or machine) is made of a contemporaneously recorded fact, transaction or occurrence. To quote a court quoting a commentator, "Where the original record is routinely copied into a more permanent form, with the original then being destroyed, the copy may be made at any time the routine of the business requires; since memory is not being relied upon, the concept of contemporaneous entry is not in point."[26]

"Contemporaneous" or "within a reasonable time thereafter" are relative terms. Continuing neglect of legal duty over a long period of time may be recorded long after the neglect commenced.[27] The opposite would be true with respect to the daily inventory of bananas sold and maintained by a peddler. Judged by duration, magnitude and significance, how much is raw memory being relied upon between the fact, transaction or occurrence taking place and its routine entry into the records of a business?

H. Business Records and the Best Evidence Rule

We live in the age of photocopying and more. That photographic reproductions of business records are "sufficiently trustworthy," absent affirmative evidence or clear sign of doctoring, should be apparent from the word "photographic" itself. Fortunately for trial lawyers there is a statute.

> CPLR 4539 carves out an exception to the best evidence rule for business records that are copied or reproduced, on the rationale that, in today's commercial world, the accuracy of such copies is relied on without question. In pertinent part, the statute provides that "[i]f any business *** has made, kept or recorded any writing, entry, print or representation and in the regular course of business has recorded, copied, or reproduced it by any process which accurately reproduces or forms a durable medium for reproducing the original, such reproduction, when satisfactorily identified, is as admissible in evidence as the original, whether the original is in existence or not." "This rule recognizes the fact that the modern business practice is to make photographic reproductions in the regular course of business and *** that photographic reproductions so made are sufficiently trustworthy to be treated as originals for the purpose of the best evidence rule."[28]

I. Hospital, Physician's Office, Physician's Expert Reports and the Business Record Rule

C.P.L.R Rule 4518(a)'s mirror-image predecessor was section 374-a of the Civil Practice Act. "Business" has always been broadly defined as including any business, profession, occupation and calling of every kind—again, even bookmaking and law enforcement.[29] Records which a hospital keeps in diagnosing and treating the maladies of its patients are business records and qualify as an exception to the hearsay rule.[30] The guarantee of trustworthiness inhering in hospital records "rests upon the fact that 'the physicians and nurses *** themselves rely upon the record' and that the record is designed to be 'relied upon in affairs of life and death.'"[31] The parameters of the "hospital business record rule" are the following:

> [E]ntries in a hospital record may not qualify for admission in evidence unless made in the regular course of the "business" of the hospital, and for the purpose of assisting it in carrying on that "business." The business of a hospital, it is self-evident, is to diagnose and treat its patients' ailments. Consequently, the only memoranda that may be regarded as within the section's compass are those reflecting acts, occurrences or events that relate to diagnosis, prognosis or treatment or are otherwise helpful to an understanding of the medical or surgical aspects of * * * [the] particular patient's hospitalization.[32]
>
> It follows from this that a memorandum made in a hospital record of acts or occurrences leading to the patient's hospitalization—such as a narration of the accident causing the injury—not germane to diagnosis or treatment is not admissible. . . .[33]
>
> In some instances, perhaps, the patient's explanation as to how he was hurt may be helpful to an understanding of the medical aspects of his case; it might, for instance, assist the doctors if they were to know that the injured man had been stuck by an automobile. * * * However, whether the patient was hit by car A or car B, by car A under its own power or propelled forward by car B, or whether the injuries were caused by the negligence of the defendant or of another, cannot possibly bear on diagnosis or aid in determining treatment. That being so, entries of this sort, purporting to give particulars of the accident, which serve no medical purpose, may not be regarded as having been made in the regular course of the hospital's business.[34]

The contents of a hospital record otherwise admissible under the business record rule—doctor diagnosis and nurses' observations of the patient—are *prima facie* evidence of the facts stated.[35]

Physicians' records, like all other business records, rest upon the probability of trustworthiness which inheres in such records, by virtue of the fact, first, that they are "routine reflections of the day-to-day operations of a business" and, second, that it is the entrant's own obligation, and in his interest, to have them truthful and accurate, made and kept, as they are, with the knowledge, indeed, for the purpose, that they will be relied upon in the conduct of the enterprise. This trustworthiness takes the place of confrontation and cross examination without the necessity of calling all the people who had a hand in making a doctor's record.[36] Thus, "a report made in the ordinary course of a doctor's medial practice is admissible in evidence as a business record once the requisite statutory foundation has been laid."[37] Like a hospital, it is the business duty of a physician to diagnose and treat a patient's illness.[38] It is also professional misconduct for a physician to fail to maintain patient records "which accurately reflec[t] the evaluation and treatment of [a] patient."[39] If he fails to do so, his license to practice medicine will be revoked.[40] The mere form which a physician's office record takes does not affect its admissibility.[41] But a physician's office records which are illegible or coded or "which must be interpreted from purely personal abbreviations" are not admissible without a proper interpreting-witness foundation separate and apart from the requirements of C.P.L.R. Rule 4518(a) for its admission into evidence as a business record. Abbreviations must be well known and usual.[42]

Physician's expert reports are often prepared at the request of lawyers on behalf of litigants. "Such reports are generally material prepared for litigation and are not the systematic, routine, day-by-day type of records envisioned by the business record exception."[43] Therefore, they are generally not admissible as business record exceptions to the hearsay rule. But where they are not primarily prepared for litigation or solely for litigation, but rather as the usual reports on a patient for treatment purposes they will be admissible as business records. "If there are other business reasons which require the records to be made, they should be admissible."[44] A physician's expert opinion in a hospital or office record, made and kept in the ordinary course of diagnosing and treating illness, is admissible though litigation, as always, could possibly be contemplated.[45]

Endnotes

1. *People v. Kennedy,* 68 N.Y.2d. 568, 576 (1986).
2. *People v. Buie*, 86 N.Y.2d 501, 506 (1995); *People v. Klein*, 105 A.D.2d 805, 806 (2d Dep't), *aff'd* 65 N.Y.2d 613 (1985).
3. *United States v. Inadi*, 475 U.S. 387 (1986).
4. *People v. Buie*, 86 N.Y.2d at 506; *People v. Klein*, 105 A.D.2d at 806.
5. *People v. Kennedy*, 68 N.Y.2d 569, 578-79 (1986); *Williams v. Alexander*, 309 N.Y. 283, 286 (1955).
6. *People v. Kennedy*, 68 N.Y.2d at 577-79.

7. *In re Leon RR*, 48 N.Y.2d 117 (1979); *People v. Prisco*, 157 A.D.2d 752 (2d Dep't 1990); *Standard Textile Co. v. National Equipment Rental*, 80 A.D.2d 911 (2d Dep't 1981).
8. *People v. Cratsley*, 86 N.Y.2d 81, 90 (1995).
9. *Cornia v. Spagna*, 101 A.D.2d 141 (1st Dep't 1984).
10. *People v. Kennedy*, 68 N.Y.2d at 576.
11. *Id.* [citing federal cases].
12. *Id.* at 578-79.
13. *People v. Guidice*, 83 N.Y.2d 630, 635 (1994); *People v. Foster*, 27 N.Y.2d 47, 52 (1990).
14. *People v. Kennedy*, 68 N.Y.2d at 578.
15. *Id.* at 579.
16. *Id.* (Emphasis added); *see also Williams v. Alexander*, 309 N.Y. 238 (1955); *Johnson v. Lutz*, 253 N.Y. 124 (1930).
17. *Kelly v. Wasserman*, 5 N.Y.2d 425 (1959).
18. *Id.* at 429-30.
19. *Johnson v. Lutz*, 253 N.Y. 124 (1930).
20. *In re Leon RR*, 48 N.Y.2d at 123.
21. *Id.*
22. *Id.*
23. *Id.*
24. *Id; People v. Morrow*, 204 A.D.2d 356 (2d Dep't 1994); *In re Harry M.*, 96 A.D.2d 201, 208-09 (2d Dep't 1983).
25. *People v. Kennedy*, 68 N.Y.2d at 580.
26. *People v. Klien*, 105 A.D.2d 805, 8-6 (2d Dep't) *aff'd* 65 N.Y.2d 613 (1985) *citing with approval In re Male G.*, 97 Misc. 2d 283, (Fam. Ct., N.Y. Co. 1978).
27. *See, e.g., People ex. rel. McGee v. Walters*, 62 N.Y.2d 317, 320-321 (1984).
28. *People v. May*, 162 A.D.2d 977, 978 (4th Dep't), *lev denied* 76 N.Y.2d 861 (1990); *see also People v. Flores*, 138 A.D.2d 512, 513 (2d Dep't) *lev denied* 72 N.Y.2d 859 (1988).
29. *Williams v. Alexander*, 309 N.Y. 283, 286 (1955); *People v. Kennedy*, 68 N.Y.2d at 576; *People v. Guidice*, 83 N.Y.2d at 634-35; *People v. Foster*, 27 N.Y.2d at 51-52 (1970).
30. *Williams v. Alexander*, 309 N.Y. at 286.
31. *Id.* at 288 citing Wigmore on Evidence.
32. *Williams v. Alexander*, 309 N.Y. at 287.
33. *Id.*
34. *Id.* at 288 (emphasis in original).
35. *Social Services v. Phillip DeG.*, 59 N.Y.2d 137, 140 (1983); *Williams v. Alexander*, 309 N.Y. at 287; *People v. Kohlmeyer*, 284 N.Y. 366, 269-70 (1940).
36. *Sean v. Scudieri*, 165 A.D.2d 346, 354 (1st Dep't 1991) [citing *Palmer v. Hoffman*, 318 U.S. 109, 114; *Williams v. Alexander*, *supra*].
37. *Hefte v. Bellini*, 137 A.D.2d 406, 408 (1st Dep't 1988); *Wilson v. Bodian*, 130 A.D.2d 221, 230-31 (2d Dep't 1987).
38. *Wilson v. Bodian*, 130 A.D.2d at 231.
39. 8 N.Y.C.R.R. part 29.2(a)[3].
40. *See* Educ. Law §§ 6509, 6511; *Camperlengo v. Blum*, 78 N.Y.2d 674, 678 (1991); *Schwartz v. Board of Regents*, 89 A.D.2d 711, 712 (3rd Dep't 1982).
41. *Wilson v. Bodian*, 130 A.D.2d at 231.
42. *Id.* at 231-232.
43. *Id.*
44. *People v. Faster*, 27 N.Y.2d at 52.
45. *Williams v. Alexander; People v. Kohlmeyer*, *supra*.

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SEC Clears First Free Share Offering on the Internet

By Gary W. Mair

In 1998, several start-up companies competed for attention to their web sites by offering "free shares" on the Internet without federal or state approval. Offering free shares over the Internet has been a creative and cost-effective way to enable start-up companies to generate a membership base and increase market share without advertising. In July of 1999, YouNetwork Corporation consummated the first full-blown registration statement with the Securities and Exchange Commission ("SEC") to register the issuance of shares sold to new members who join its web site. Prior to YouNetwork, Internet companies avoided the time and expense of registering the issuance of "free shares" based on the assumption that such an offering is not subject to the regulatory web of the federal securities laws.[1] Soon after YouNetwork received federal approval of its offering however, the SEC cracked down on these so-called "free share" offerings, which ran afoul of federal securities laws by issuers failing to register their offerings or find a valid exemption.[2]

The Free Share Offering

The primary goal of a "free share" offering is to increase a web site's market share and to collect marketing data. This is achieved by attracting web surfers with the promise of a free share if they register on the issuer's web site. Currently, more than 100 sites continue to promote "free share" giveaways over the Internet.[3]

The first successful Internet share giveaway program was initiated by Travelzoo.com. in April of 1998.[4] To join the Travelzoo web site a visitor provided a name and mailing address. Within the first three months of its share giveaway, Travelzoo claimed to have issued a "free share" to the first 700,000 visitors who joined.[5] The success of Travelzoo prompted other Internet start-up companies such as e-compare to offer shares at no cost to attract potential members. In the fall of 1998, e-compare, an online comparison-shopping site, offered 10 free shares of its common stock to the first 50,000 customers to join its web site.[6] Shortly thereafter, Simplystocks.com planned to offer free shares of its common stock to visitors of its financial information web site.[7]

In an effort to avoid the time and expense of registering the issuance of so-called "free shares" with the SEC or finding a valid exemption, issuers such as Simplystocks.com take the position that the registration provisions of Section 5 of the Securities Act of 1933 (the "Act") are not triggered because there is no *sale* involved under Section 2(a)(3) of the Act (i.e., on the theory that the recipient of the share does not provide any consideration). In response to investor complaints, however, the SEC has brought enforcement actions against several Internet companies which initiated "free share" giveaways.[8]

The basis for requiring the registration of free shares is under Section 2 (a)(3) of the Act, which states, in relevant part, "the term *sale* or *sell* shall include every contract of sale or disposition of a security or interest in a security, *for value*."[9] Moreover, section 5 of the Act requires every security falling under the definition of Section 2 to either be the subject of a registration statement or a valid exemption from registration.[10]

The No Sale Theory

Relying on the no sale theory, Simplystocks.com requested no-action relief from the SEC's Office of Chief Counsel of the Division of Corporation Finance (the "Commission") in April of 1999. The company proposed to offer "free shares" to individuals who registered on its web site during a 180-day period. Visitors provided their name, address, social security number, phone number and e-mail address. After a visitor logged in and provided a password, the visitor became eligible for the company's stock pool. Each time they revisited the web site and used their login and password, visitors accumulated another entry into the issuer's stock pool.[11]

In its response to Simplystocks' no-action request, the Commission stated its view that:

> the issuance of securities in consideration of a person's registration on or visit to an issuer's Internet site would be an event of sale within the meaning of section 2(a)(3) of the Securities Act of 1933. As a result, such issuance would violate section 5 of the Act unless it was the subject of a registration statement or a valid exemption from registration.[12]

Despite the no sale argument of Simplystocks.com and others, the Commission is clearly taking the position that the visit or registration to a web site is, in and of itself, adequate consideration for the purpose of Section 5 under the Act.[13] Web site visitors typically are asked to provide their name and address in exchange for the shares, and a third party (i.e., someone other than the recipient of the free shares) may frequently pay compensation for each individual visiting the web site and for providing the requested information. In particular, Richard H. Walker, the Enforcement Director at the SEC, noted, "free stock is really a misnomer in these cases. While cash did not change hands the companies that issued the stock received valuable benefits. Under these circumstances, the securities laws entitle investors to full and fair disclosure, which they did not receive in these cases."[14]

Investor Complaints

The SEC is also enforcing its current position in response to the wave of "free share" offerings and the resulting investor complaints. Recently, the SEC brought and settled four enforcement actions against two promoters and two Internet companies; all had offered and distributed free shares through on-line web sites without registering their offerings, in violation of Section 5 of the Act.[15]

In each of the four cases, the investors were required to sign up with the issuers' web sites and disclose valuable personal information in order to obtain shares. Free share recipients were also offered extra shares, in some cases, for soliciting additional investors or, in other cases, for linking their own web site to those of an issuer or purchasing services offered through an issuer. Through these techniques, issuers received value by spawning a fledgling public market for their shares, increasing their business, creating publicity, increasing traffic to their web sites, and, in two cases, generating possible interest in projected public offerings.[16]

In two of the free share cases, the SEC discovered that the offer of free shares through the web sites featured false claims. In one case, investors were told that the free shares they received would give them an interest in an aerospace company that would revive lunar exploration. In fact, the company was never incorporated and its promoter had no space exploration or aerospace engineering experience. In another case, involving an Internet communications-marketing firm, the web site informed free share recipients that their shares could eventually exceed $200 each in value, even though the firm had realized less than $30 in gross operating revenues.[17]

Lately, some Internet companies, in an attempt to avoid the regulatory web of the SEC, are *promising* free shares to join their web site—if and when it files a registration statement. An example of the *promise* of a free share offering is the one promoted by the online Internet company Tradehall.Com. As a special promotion, Tradehall.Com announced the offer of a free share if and when it files an initial public offering.[18] So far the SEC has failed to seek enforcement action against issuers which are generating a possible interest in projected public offerings with the *promise* of a "free share." Unfortunately, for other well-intended would-be "free share" issuers, such abuses typically give rise to more restrictive regulations.

The First Company to Register Free Shares

Before the recent position of the Commission on "free shares," issuers took the position that the sale of "free shares" over the Internet was not subject to the federal securities laws.[19] The first company to take the alternative position is YouNetwork Corporation, an online web site which offers name brand products within its consumer network. YouNetwork prepared its registration statement to register the issuance of shares sold to members of a web site for no cash consideration.[20]

YouNetwork's unique offering consists of 1,000,000 Class A and 1,000,000 Class B shares. The first 250,000 Class A shares are offered to the first 250,000 new members to join the web site. The remaining 750,000 Class A shares are offered to members based on the referrals of other members to the web site. A Class B share is purchased with a rebate, which is accumulated by purchasing a product or services.

In February of 1999, YouNetwork filed its registration statement with the SEC, and after a rigorous review process, YouNetwork's unique registration statement was declared effective on July 13, 1999. As a result, YouNetwork is the first web site to offer and sell its shares at no cost to visitors who join its web site through an online prospectus, subject to the same review and comment period required by the SEC of all initial public offerings.

Before YouNetwork, certain issuers took a wait and see approach to the position of the SEC on so-called "free share" offerings and to the complexity involved in filing such an offering with the SEC. Issuers were also hoping to avoid the time and expense of a registration process which can last 3 to 4 months under normal circumstances.

Soon after YouNetwork's registration statement was declared effective, several other Internet start-up companies, such as Doctorsurf.com, filed their own registration statement to register the issuance of free shares.[21] Other Internet issuers are likely to follow for fear of the SEC's clamping down on those issuers which offer so-called "free shares" without registering their issuance.[22]

Conclusion

In light of the position of the SEC on "free shares," issuers can no longer avoid the web of the federal securities laws. The prudent course is to either register the issuance of a “free share” offering, or to find a valid exemption under the federal securities laws. Moreover, without the disclosure required of a registered offering, the on-line user has no assurance that an Internet company which offers or promises to offer a security does not run afoul of the federal securities laws.

Endnotes

1. Simplystocks.Com planned to make its free share offering in April of 1999. Simplystocks.Com, SEC No-Action Letter, (February 4, 1999). *See* Andrew Jones, a no-action request letter seeking relief in connection with the offer of Andrew Jones’ company’s equity securities to the first one million visitors who signed up by e-mail or on its web site. Visitors who registered for a share provided a name, address and e-mail address. Andrew Jones, (June 8, 1999). *See also*, Vanderkam & Sanders, an internet-based auto referral service, which intended to issue shares to any person who registered on its web site and to those individuals referred to its web site. Vanderkam & Sanders (January 27, 1999).
2. SEC Brings First Action To Halt Unregistered Online Offerings Of So-Called “Free Stock,” SEC Release, July 22, 1999, No. 99-83.
3. *See*, www.che.wsu.edu/~fountain/contents/stock1.htm, a web site dedicated to tracking other web sites offering free shares.
4. Herb Greenberg , The Street.Com, February 6, 1999, “Early Lock-Ups, The Timing of Press Releases’ and Free Stock Giveaways.”
5. *Id*.
6. David Snow, “Get Your Free Stock Here, Why have startups been giving it away, and could it be a good investment for you?” Investing, June 16, 1999.
7. *See supra note* 1.
8. *See supra*, SEC Brings First Action To Halt Unregistered Online Offerings Of So-Called “Free Stock.”
9. Section 2 of the Securities Act of 1933.
10. Section 5 of the Securities Act of 1933.
11. *Id*.
12. Simplystocks.Com, SEC No-Action Letter, (February 4, 1999). *See* Andrew Jones, a company which requested no action relief in connection with the offer of his company’s equity securities to the first one million visitors who signed up by e-mail or on its web site. Visitors who registered for a share provided a name, address and e-mail address. Andrew Jones, (June 8, 1999). *See also*, Vanderkam & Sanders, an internet-based auto referral service which intended to issue shares to any person who registers on its web site and to those individuals referred to its web site. Vanderkam & Sanders (January 27, 1999).
13. As a result of the foregoing, Simplystocks.Com and E-compare have suspended their so-called “free share” giveaway. David Snow, “Get Your Free Stock Here, Why have startups been giving it away, and could it be a good investment for you?” Investing, June 16,1999.
14. *See supra*, SEC Brings First Action To Halt Unregistered Online Offerings Of So-Called “Free Stock.”
15. *Id*.
16. *Id*.
17. *Id*.
18. Tradehall.Com is an online auction site which offers visitors to its web site the opportunity to be part of its IPO if and when Tradehall.Com decides to proceed with its IPO. Detroit Free Press, August 2, 1999, Susan Tempor. *See also*, Edeal.com, which rewards registered web site members with the opportunity to participate in its successful IPO: “Edeal.com First to Reward Registered Members on its Web Site with Opportunity to Participate in its Success via IPO President’s List,” Canada News Wire, August 24, 1999.
19. Simplystocks.Com, SEC No-Action Letter, (February 4, 1999).
20. Gregory Zuckerman, SEC Clears Web Firms’ Stock Giveaway, The Wall Street Journal, November 16, 1999.
21. *Id*.
22. *See supra*, SEC Brings First Action To Halt Unregistered Online Offerings Of So-Called “Free Stock.”

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Smart Growth Is Good for Business

By Patricia E. Salkin

I. Introduction

Smart growth. One can hardly read a newspaper today without mention of urban sprawl, uncoordinated land use policies, and the high costs and unpredictability associated with local land use controls. To the business lawyer, the issues confronted by clients desiring to expand or enlarge operations or to site new facilities are essentially the same: fragmented local control of land use decisionmaking; unpredictable outcomes in environmental and planning reviews; lack of coordination and consistency among different levels of government; sometimes unwritten rules of the game (with respect to local comprehensive land use plans); and laws and policies making it financially rewarding for business to abandon the cities for the pristine green space of the suburbs.

Although business organization laws in New York are applicable statewide and do not depend upon a client's geographic location within the state, this is not the case when a business client needs approval for an action regarding land use. It is no small feat to walk a corporate client through the morass of planning and zoning laws in New York, considering that this state boasts 1,544 cities, towns and villages with zoning authority.[1] According to a 1999 survey conducted by the New York State Legislative Commission on Rural Resources, only 59% of these municipalities have a written comprehensive land use plan, yet 77% have zoning regulations.[2] Seventy percent (70%) of these local governments have subdivision regulations and 64% have site plan review laws.[3] Not only must practitioners be familiar with the state enabling statutes, but they must also access the substantive law and understand the process for land use regulation and review in the particular jurisdiction where a client desires a land use permit.

In addition to local land use laws, state adopted building codes factor into the cost analysis of expansion and/or redevelopment in the cities; state and federal environmental regulations addressing, among other things, contaminated sites or brownfields may be at issue; and federal laws such as the Americans With Disabilities Act may impact business decisions with respect to building renovations and modifications.

State governments are finally discovering that for businesses to survive and to contribute to (and/or create) a thriving local economy, policies need to be reformed, laws need to be amended, and business as usual in the land use control arena is no longer acceptable.[4] Mayor William A. Johnson, Jr. of the City of Rochester explains that, "If upstate New York were a separate state, it would rank 50th in job growth over the past five years, according to the U.S. Bureau of Labor Statistics."[5] And, "Compared with the 50 individual states, downstate New York ranked 46th in job growth over the past five years."[6] Furthermore, he pointed out, if downstate New York was a separate state, it would rank 41st in population growth for the same time period, and upstate would rank 50th.[7] While acknowledging that New York has begun to move in a different economic direction with lowered taxes and the streamlining of many regulations, the Mayor has been a zealous advocate for the proposition that as a state, New York must "recognize the need to move in a different spatial direction."[8]

II. New York Is Growing Smart

Although New York may still have a long way to go, the fact is that major reform efforts have occurred throughout the 1990s. Many have been made and implemented without pomp and circumstance, often escaping wide public notice. The remainder of this article will bring practitioners up to date on significant statutory changes and new policies that affect how clients do business in New York with respect to land use laws, and will foreshadow changes that are likely to occur over the next twelve to eighteen months.

A. Recodification Effort of the 1990s

In 1990, Senator Charles Cook appointed the Land Use Advisory Committee to the Legislative Commission on Rural Resources as an advisory body to help craft statutory land use reform initiatives by recodifying the existing laws.[9] From 1991 through 1999, this initiative has resulted in thirty-one statutory changes to the state planning and zoning enabling acts.[10] These changes are significant as many were designed to enable communities to better interact with and to accommodate builders, developers and other applicants. Keeping up to date with almost three dozen reforms in the land use control and permitting process, that can best be described as a "quiet revolution in New York's land use law,"[11] can be challenging even for those whose practice includes a substantial amount of land use law. The resources discussed in Section IV provide information on the changes in the field.

Laws enacted in 1993 and 1995 now provide—for the first time in New York history—definition, guidance and a statutory procedure for the preparation and adoption of local comprehensive plans.[12] A 1991 law provides specific authority for local governments to enact incentive zoning laws, enabling—for the first time—local governments to offer applicants increased density in exchange for certain community amenities.[13] In an effort to clarify decades of case law, in 1991 the Legislature also enacted a new law containing statutory tests for the granting of area and use variances, matters that had been costly, and at times uncertain to litigate.[14]

Applicants had long expressed concern over the inconsistencies in the level of sophistication of the volunteer members of planning and zoning boards in New York. The Legislature responded by amending the enabling acts to specifically authorize local legislative bodies to require training for members of the planning and zoning boards.[15] In addition, since business would slow down when one or more members of a 3 or 5 person board had a conflict of interest in the matter before the board, the Legislature enacted a new law allowing municipalities to provide for the appointment of alternate members who would assume office when a regular board member has a conflict of interest.[16]

Economic developers and others have long been concerned with the business of looking at land use decisionmaking on a purely local level, and have failed to consider regional needs, issues and opportunities.[17] The Legislature adopted two new laws to provide specific statutory authorization for local governments to now cooperate and coordinate these activities should they deem it beneficial and appropriate.[18]

At its January 2000 meeting, the Land Use Advisory Committee discussed three important legislative initiatives for the current session: 1) a bill designed to provide specific statutory authority and a framework for planned unit developments including residential, business and commercial uses; 2) support for a member item to fund a pilot program for mediating local land use disputes (if funded, the pilot will be coordinated through the New York State Dispute Resolution Association with technical assistance from the New York State Office of Court Administration); and 3) possible changes to the county planning board review of local action process found in General Municipal Law § 239-m (specifically focusing on whether there should be due process for applicants before cities, towns and villages when the county is reviewing the local action; and/or whether a majority, rather than the presently required super-majority, of the local board may override a decision of the county planning board). All three of these issues, yet to be addressed during the current legislative session, could have a positive fiscal impact on business clients in the state.

B. Build Now New York

Recognizing the business need for site-ready areas to entice manufacturing, warehousing, high tech, and other business to locate in New York, in 1999 the Governor’s Office of Regulatory Reform announced the “Build Now New York” program. In essence, the program offers model zoning ordinances for municipalities to use as they tailor their own local laws to allow for the siting of certain businesses.[19] Seven sample ordinances were developed by the Government Law Center of Albany Law School for the program: light industrial district; office park district; manufacturing district; retail commercial district; warehouse/distribution district; research and development district; and business/commerce park district.[20] This effort is a good first step at providing technical assistance and information for local governments interested in promoting business and economic development at the forefront of the agenda.

C. Smart Growth and the Legislature

At the end of the Legislative Session in 1998, Senator Mary Lou Rath (R-Erie) and Assemblyman Sam Hoyt (D-Buffalo) introduced the Smart Growth Economic Competitiveness Act. Although the bill did not move through the legislative process, it was reintroduced with significant attention in 1999 following press conferences, public hearings and the creation of an ad-hoc “unofficial” smart growth task force being coordinated and staffed by National Audubon of New York, but comprised of more than two dozen statewide stakeholder interest groups. From a policymaking standpoint, the growing level of attention to smart growth in New York was a blessing and a curse. On the one hand, there was a piece of legislation[21] for groups to focus on, and the sponsors demonstrated their willingness to amend the proposal to address consensus concerns. On the other hand, three other legislators in leadership positions took an interest in the topic, introducing several more smart growth bills before the end of the 1999 Legislative Session.[22]

The result of the 1999 Legislative Session was a negotiated compromise for some short-term action with the inclusion of $800,000 in the state budget earmarked for local smart growth programs.[23] These funds will be administered by the Department of State, but as of mid-January 2000, no RFP has yet been issued by the Department to get the allocated funds into the local communities. The Governor has included $800,000 in the 2000-2001 Executive Budget for smart growth pilot projects,[24] suggesting perhaps that no funds may be expended until the next year if this is a reappropriation.

In addition, all of the bills introduced in 1999 carry over into the second year of the two-year Legislative Session.

D. Building Code Reform

There are many pieces to the smart growth reform puzzle. For example, the New York State Builders Association has long been advocating building code reform in the state, and most recently included this as a 1999 legislative priority in the "Blueprint for Smart Growth."[25] According to the Home Builders' Association, "a model code would assist the adaptation of building to new uses, would not treat every rehab as if a new building were being constructed, and would facilitate variances and alternative solutions."[26] Furthermore, the Association asserted that a model code would "encourage the rebuilding of neighborhoods, cities and older suburbs by allowing increased flexibility in the renovation of existing buildings."[27] In July 1999, the Legislature approved $1.4 million to pay for the cost of developing a statewide code,[28] and in November 1999, the New York State Fire Prevention and Building Code Council, operating under the auspices of the Secretary of State, took the first step towards reform by deciding to adopt the International Family of Codes provisions into the New York State Building Code.[29]

E. Quality Communities

Each state that has begun to tackle the challenge of crafting a smart growth agenda has taken its own unique approach. For example, in 1992, Maryland referred to its reforms as the Economic Growth, Resources Protection and Planning Act, and in 1997, it adopted the Smart Growth Areas Act.[30] In 1998, Tennessee enacted a major initiative designed to create a comprehensive growth strategy for the state.[31] This past year, Wisconsin laid the groundwork for sweeping smart growth reforms in proposals encompassed in the Governor's budget.[32] Over the last few years, a growing number of states have appointed study commissions, including the Growing Smarter Commission in Arizona; the Commission on Urban Planning, Growth Management of Cities, and Protection of Farmland in Iowa; the Land Use Management and Farmland Preservation Study in New Hampshire; the 21st Century Communities Task Force in North Carolina; the 21st Century Environmental Commission in Pennsylvania; and the Quality Growth Advisory Committee in Utah.[33] Legislative task forces on smart growth have been working in Colorado, Kentucky, New Mexico, and Virginia.[34] Active smart growth proposals have been introduced in Colorado, Illinois, Massachusetts, Michigan, New York, North Carolina and Pennsylvania.[35]

What all of this activity means is that New York must pay attention to these issues if it intends to stay economically competitive and business friendly in this national and global economy. In his January 5, 2000, State of the State Address, Governor Pataki, addressing the need to revitalize the Main Streets of New York, stated, "With smart investments and targeted economic policies we can recapture the spirit and breathe new life into those Main Streets so they can bustle again with all of the vigor, energy and excitement of their glory days. Some call it smart growth. We call it smart. Period."[36]

With the State of the State foreshadowing long-awaited action, on January 21, 2000, Governor Pataki issued Executive Order No. 102, "Establishing The Quality Communities Interagency Task Force." Among other things, the Governor stated that, "New York and its local governments require creative strategies to combine growth and environmental protection in order to enhance economic vitality and quality of life."[37] The Order directs the creation of an interagency task force chaired by the Lt. Governor and consisting of, at least, the Commissioners of the Departments of Agriculture and Markets, Economic Development, Environmental Conservation, Health, Transportation, the Office of Parks, Recreation and Historic Preservation, the Division of Housing and Community Renewal, the Secretary of State and the Director of the Budget.[38] The Chair is also directed to appoint an advisory committee to the task force consisting of representatives of local government, environmental, business, agricultural and other related interests.[39]

After conducting an inventory of key federal, state and local programs impacting quality communities, and after collecting public input, the Task Force is directed to report back to the Governor in January 2001 with recommendations designed to strengthen the capacity of local governments to develop and implement land use planning and community development strategies, and make needed changes in state regulations and legislation to enhance community choices in land development, preservation and rehabilitation. Among the factors to be considered by the Task Force in arriving at its recommendations is ". . . making development decisions predictable, sustainable, fair and cost effective. . . ."[40] There is no doubt that this Executive Order empowers the task force to continue to build on the work of the Legislative Commission on Rural Resources, the Building Code Reform Effort, and the Build Now New York Program at the Governor's Office of Regulatory Reform. By bringing more state agencies into the fold, inviting significant private sector and citizen participation, and demonstrating a commitment to reform, New York is poised to implement new strategies for business retention and recruitment by paying attention to the local land use development system.

III. The Challenges

As New York moves forward to discuss smart growth or quality communities in the political arena, it is critical that the stakeholders either reach consensus as to how these terms are being defined as they relate specifically to New York or that, at a minimum, each interest group articulate its own definition when stating positions for or against particular proposals. The New York Conference of Mayors discusses "smart growth" economic development proposals as part of its legislative agenda. To this statewide association, "smart growth" means municipal property tax relief, grassroots economic development, funding for locally developed regional plans, tourism as a focal point of regional development plans, funding for intermunicipal/regional tourism plans, using waterways as the natural link between regional economic centers, using brownfields to link urban centers to their waterways, open space preservation and incentives to locate business and people in urban areas.[41] The Home Builders Association advocates for five smart growth legislative priorities: adoption of the International Model Building Code (now underway); creation of home ownership opportunity zones; adoption of pre-approved permitted sites along with improved coordination of permitting and approvals and the use of generic environmental impact statements; increased funding for regional planning and training of planning and zoning boards; and enactment of planned unit development legislation.[42]

Senator Mary Lou Rath, chair of the New York State Senate Committee on Local Government, summed up other challenges quite well at a May 1999 public hearing in Buffalo: for smart growth to work in New York it must be a bottom-up approach; to work in New York, smart growth cannot mean new bureaucracies, mandates or new layers of government; we need better coordination between state and local governments and between governments and the others who have a stake in economic and community well-being; and smart growth is going to mean something different in New York State than it has meant anywhere else.[43]

IV. Practical Resources

There are many places where lawyers of all levels of familiarity with New York planning and zoning laws can go for guidance. For example, the New York State Department of State publishes a free guide to New York's planning and zoning enabling acts where practitioners can have all applicable state laws in one easy reference document, rather than searching through multiple volumes of McKinneys.[44] The New York State Legislative Commission on Rural Resources published an invaluable Fall 1999 survey of the general types of land use regulations used by each city, town and village (e.g., it indicates for each local government in New York whether it has adopted a zoning ordinance, a written comprehensive plan, subdivision regulations and site plan).[45] The Land Use Law Center at Pace Law School offers a web site with information on dozens of land use law topics with an analysis of New York law.[46] Three new books have recently been published to help practitioners work through these issues: In 1999 The New York Planning Federation published the 3rd edition of *Everything You Always Wanted to Know About Zoning*;[47] The New York State Bar Association published a monograph, *Zoning and Land Use* in 1998;[48] and The West Group recently released the 4th edition of *New York Zoning Law and Practice* in three volumes.[49]

Endnotes

1. NYS Legislative Commission on Rural Resources, 1999 Land Use Planning & Regulations in New York State Municipalities: A Survey (Fall 1999) at 5.
2. *Id*. This is somewhat ironic in that state statute specifically provides that zoning shall be in accordance with a comprehensive plan. See, N.Y. Town Law § 263; N.Y. Village Law § 7-704; and N.Y. Gen. City Law § 20 (25), referring to a "well considered plan."
3. *Id*.
4. American Planning Association, *Planning Communities for the 21st Century* (December 1999).
5. Hon. William A. Johnson, Jr., Mayor of the City of Rochester, New York, remarks made at the Edwin L. Crawford Memorial Lecture on Municipal Law, Albany Law School, February 22, 1999 (available at: www.als.edu/glc/).
6. *Id*.
7. *Id*.
8. *Id*.
9. Coon, Damsky & Rosen, "*The Land Use Recodification Project*," 13 Pace L. Rev. 559 (1993).
10. For a complete listing of the new laws year by year, see NYS Legislative Commission on Rural Resources, *1999 Land Use Planning & Regulations in New York State Municipalities: A Survey* (Fall 1999) at B-3 to B-5.
11. Salkin, *The Politics of Land Use Reform in New York: Challenges and Opportunities*, 73 St. John's L. Rev. 101 (forthcoming).
12. Chap. 209 of the N.Y. Laws of 1993; Chap. 418 of the N.Y. Laws of 1995, both codified at: Town Law § 272-a; Village Law § 7-722; Gen. City Law § 28-a.
13. Chap. 629 of the N.Y. Laws of 1991, codified at Town Law § 261-b; Village Law § 7-703; Gen. City Law § 81-d.
14. Chap. 248 of the N.Y. Laws of 1991, codified at Town Law § 267-b; Village Law § 7-712-b; Gen City Law § 81-b.
15. Town Law § 267(2), 271(1); Village Law § 7-712 (2); 7-718 (1); and Gen. City Law § 81(1).
16. Chap. 137 of the N.Y. Laws of 1998, codified at Town Law § 267(11); 271(15); Village Law § 7-712(11), 7-718(16); Gen. City Law § 81(11).

17. See Salkin, *Regional Planning in New York: A State Rich in National Models, Yet Weak in Overall Planning Coordination*, 13 Pace L. Rev. 505 (1993).
18. Chap. 724 of the N.Y. Laws of 1992 (allowing for intermunicipal cooperation in planning), codified at Town Law § 284, Village Law § 7-741, and Gen. City Law § 20-g; and Chap. 242 of the N.Y. Laws of 1993 (specifically authorizing county participation in intermunicipal land planning agreements), codified at Gen. Mun. Law § 119-u.
19. New York State Governor's Office of Regulatory Reform, *Model Zoning Ordinances for Economic Growth* (1999), http:/www.gorr.state.ny.us/gorr/zoning.html.
20. *Id*. These may all be downloaded from the GORR web site.
21. S. 1367/A.1969 (1999).
22. A. 8829 (1999); A. 130 (1999); A. 9080 (1999); A. 8387 (1999); and A. 8386B.
23. $500,000 was set aside in the Aid to Localities section of the budget, and individual allotments of $150,000 to certain counties in the lower Hudson Valley and on Long Island and in western New York.
24. S.6402/A.9502 (2000).
25. New York State Builders Association, Builders 1999 Blueprint for Smart Growth, The 1999 Legislative and Regulatory Program (1999).
26. *Id*. at 1.
27. *Id*.
28. The Governor included this in the 1999-2000 Executive Budget Proposal, S.1603/A.3003 (1999).
29. New York State Proposes Statewide Building Code, Bestwire, Dec. 1, 1999.
30. Denny Johnson, Maryland, in Planning Communities for the 21st Century, American Planning Association (Dec. 1999) at 25.
31. Pub. Chap. 1101 (Tenn. 1998); *see also*, Karen Finucan, Tennessee, in Planning Communities for the 21st Century, American Planning Association (Dec. 1999) at 70.
32. A.B. 133 (Wisconsin, 1999).
33. Salkin, Reform Proposals by the Thousand, in Planning Communities for the 21st Century, American Planning Association (Dec. 1999) at 85 *et seq*.
34. *Id*.
35. *Id*.
36. Governor George E. Pataki, State of the State Address, "*The Future Begins in New York*," Jan. 5, 2000 (http://www.state.ny.us/sos2000text.html).
37. N.Y. Exec. Order 120 (Jan. 21, 2000).
38. *Id*.
39. *Id*.
40. *Id*.
41. New York Conference of Mayors, "*Smart Growth" Economic Development Proposals* (undated).
42. New York State Builders Association, Builders 1999 Blueprint for Smart Growth, The 1999 Legislative and Regulatory Program (1999).
43. *In re a Public Hearing on the Smart Growth Economic Competitiveness Act of 1999*, Senator Mary Lou Rath, Presiding, Buffalo & Erie County Public Library Auditorium (May 20, 1999) at pp. 5-8.
44. The Guide to Planning and Zoning Laws in New York can be downloaded from the Department's web site at http://www.dos.state.ny.us. It can also be ordered by calling 518-473-3355 (NYS Department of State, 41 State Street, Suite 900, Albany, New York 12231).
45. New York State Legislative Commission on Rural Resources, *1999 Land Use Planning & Regulations in New York State Municipalities: A Survey* (Fall 1999). It may be ordered by calling the Commission at 518-455-2544 (NYS Legislative Commission on Rural Resources, Legislative Office Building, Albany, New York 12247).
46. www.law.pace.edu./landuse.
47. The book is available from the New York Planning Federation, 44 Central Avenue, Albany, New York 12206 (518-432-4094); nypf@wizvax.net.
48. The monograph, published in 1998, is available from the NYSBA, One Elk Street, Albany, New York 12207 (518-463-3200).
49. The revised treatise was released in December 1999 and is available from the West Group (800-328-4880).

Patricia E. Salkin is Associate Dean and Director of the Government Law Center of Albany Law School. She has written extensively on the topic of smart growth and land use law reform both in New York and nationally.

New York State Bar Association

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November 9, 1999

Securities and Exchange Commission
450 Fifth Street N.W.
Mail Stop 6-9
Washington, D.C. 20549

E-mail address:

Attention: Jonathan G. Katz, Secretary

Re: Securities Exchange Act Release No. 34-41987

File #S7-22-99

Ladies and Gentlemen:

The Committee on Securities Regulation of the Business Law Section of the New York State Bar Association appreciates the opportunity to comment on Release No. 34-41987, dated October 7, 1999 (the “Release”).

The Committee on Securities Regulation (the “Committee”) is composed of members of the New York Bar, a principal part of whose practice is in securities regulation. The Committee includes lawyers in private practice, in corporation law departments and in government agencies. A draft of this letter was circulated for comment among members of the Committee and the views expressed in this letter are generally consistent with those of the majority of the members who reviewed the letter in draft form. The views set forth in this letter, however, are those of the Committee and do not necessarily reflect the views of the organizations with which its members are associated, the New York State Bar Association, or its Business Law Section.

General

We commend the efforts of the Commission to improve the quality of financial accounting and reporting through improvements in corporate governance that will strengthen the audit committee and the role it plays in the financial reporting process. We support the purposes of the Release and we concur in the conclusions of the Commission that a properly functioning audit committee can help to enhance the reliability and credibility of financial reports. On the whole, we support the proposals contained in the Release and the recommendations of the Blue Ribbon Committee. We are concerned, however, that a number of the proposals do not adequately address the recognized risk that if audit committee members are exposed to unnecessary potential liability, the proposed reforms may not achieve their intended result. If the risk of liability or the exposure to unfounded claims makes it more difficult for companies to attract and retain qualified directors to serve on audit committees, the ultimate effect of the new regulations may be to reduce rather than enhance the effectiveness of audit committees in general. Fortunately, with respect to the Commission’s proposals, we believe there are only a limited number of areas where this issue has not been adequately addressed. As more fully discussed below, we are principally concerned that the audit committee report as proposed exposes audit committee members to undue risks of liability and that the proposed safe harbor does not adequately shield them from that exposure.

The Audit Committee Report

Proposed new Item 306(a) of Regulations S-K and S-B, and Item 7 (e)(3) of Schedule 14A, provide for the inclusion of an audit committee report in the company's proxy statement. The first three items of the report are procedural in nature and, we believe, are consistent with the proper objective of the report to describe the process followed by the audit committee in performing one of its principal functions, that of reviewing a company's financial statements. Proposed paragraph (a)(4) of the rule, however, would require the audit committee to characterize the company's financial statements and state whether "anything" came to its attention which caused the committee to believe that the audited financial statements were misleading. Unfortunately, we do not believe that the changes made from the proposals of the Blue Ribbon Committee adequately reduce the risk of potential liability for audit committee members. By requiring the audit committee to make an affirmative statement concerning the quality of the financial statements, the members would now be exposed to potential liability under Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") if a plaintiff alleges that the disclosure was incomplete. This aspect of the proposed report is not merely improved disclosure about the audit committee and its process. On the contrary, the audit committee is now being asked to give "cold comfort," thereby exposing itself to potential liability under both federal and state law.

We do not believe that the proposed disclosure in paragraph (a)(4) would provide sufficiently useful information to shareholders to warrant the increased exposure to liability or that this item of the report would reinforce the audit committee's awareness and acceptance of its responsibilities. We believe that, as suggested in the Release, the Commission should require disclosure only as to the activities, processes and/or discussions of the audit committee rather that its conclusions. As to the alternative formulation referred to in the Release, we believe that the proposal for the audit committee to state whether it is aware of any material modifications that should be made to the audited financial statements presents the same problem as the initial proposal. On the other hand, it would be totally appropriate for the audit committee to state that, based on the reviews discussed in paragraphs (a)(1), (2) and (3), the audit committee recommended to the full board that the audited financial statements be included in the company's annual report on Form 10-K.

In order to address the fact that the proxy statements of many companies often are prepared well in advance of the filing of the Form 10-K, there should be provision for an alternative formulation that would permit the audit committee to refer to the financials in the annual report to shareholders accompanying the proxy statement where the Form 10-K has not yet been filed.

With respect to proposed paragraph (a)(4), it should further be noted that even the independent auditors do not refer to financial statements in terms of untrue statements of material fact or omissions to state material facts necessary to make the statements not misleading. The report of the auditor always is stated in terms of whether the financial statements fairly present the financial condition or results of operations in all material respects. Further, with respect to negative assurance, the reference to "anything" is far too broad. If such a formulation were to be used, we think it would be preferable to refer to whether "any fact" has come to the attention of the audit committee that would lead it to have reached a particular conclusion.

We concur with the decision of the Commission not to require the signature of the audit committee members to accompany the report. We also concur with the conclusion to include an audit committee report in the proxy statement rather than the annual report to shareholders or the Form 10-K. We believe the disclosures concerning the audit committee are more properly framed in relation to the election of directors. For companies that are not subject to the proxy rules, they should be required to include the information in the Form 10-K unless they have included the audit committee report in a proxy statement furnished to shareholders notwithstanding that the company was not subject to Regulation 14A.

The Safe Harbor

We concur in the recommendations of the Blue Ribbon Committee and the Commission that the audit committee be afforded to a "safe harbor" covering to the required disclosures. Proposed Items 306(c) and (d) of Regulations S-K and S-B, and Item 7(e) (3) (v) of the proxy rules, would provide a safe harbor comparable to that applicable to the compensation committee report required in proxy statements under Regulation 14A. Because of the significant difference between the compensation committee report and the audit committee report, however, we believe that the safe harbor for audit committees should go further than proposed. The principal deficiency in the proposal is that the safe harbor would not shield audit committee members from claims under Section 10(b) of the Exchange Act. Unless protection from Rule 10b-5 claims is afforded to members of the audit committee for the disclosures required in the proxy statement or the Form 10-K, it may be extremely difficult to convince existing or prospective audit committee members that they are not being unduly exposed to potential liability under the federal securities laws. As a result, it may prove difficult if not impossible to attract qualified directors to serve on boards and audit committees.

In order to more effectively protect audit committee members from unnecessary exposure to liability we believe the safe harbor should be strengthened. Since the audit committee will be making an affirmative statement in the proxy statement regarding its role in the financial reporting process, a plaintiff will now be able to allege that this statement itself was recklessly made. The proposed audit committee report leaves audit committee members open to that kind of allegation in the event that information about a potential problem did come to their attention even though determined (in good faith and based upon information and advice that they thought was reliable) that the problem had been sufficiently acted upon. If an accounting irregularity is later detected in this area, audit committee members could be subject to a claim that they ignored the alleged "red flags" and that the statement as to their beliefs was reckless.

To remedy these concerns, we recommend that the Commission provide a safe harbor equivalent to that provided for "forward-looking statements" in the Private Securities Litigation Reform Act of 1995, which raised the standard for scienter to actual knowledge of the fraud as distinguished from recklessness. We believe that the policy concerns which led to the special standard for forward-looking statements are equally important in protecting audit committee members. If the threat of potential liability dissuades qualified people from serving on audit committees, the very foundation of the audit committee reform process will be significantly weakened.

Additional Comments

- **Audit Committee Charter.** Although concerns have been expressed by others, we agree with the Commission's proposal to require companies to disclose in their proxy statements or information statements whether their audit committee is governed by a charter. We also concur with the conclusions of the Commission not to require the audit committee to disclose whether it has complied with its charter. On the other hand, with respect to including a copy of the charter in the proxy statement at least once every three years, we question the need for such a requirement. We believe that it would be more cost effective and efficient to require that the charter be filed each year as an exhibit to the Annual Report on Form 10-K. The added cost of printing the charter in the proxy statement could be significant. Further, since the Form 10-K is publicly available on EDGAR, the charter would be available to all stockholders and members of the public. We do not perceive a need to single out the audit committee charter for inclusion in the proxy statement when other documents of equivalent or greater significance need only be included in a company's periodic reports under the Exchange Act. The proxy statement could be required to include a statement to the effect that the charter is filed as an exhibit to the Form 10-K and that copies of the charter may be obtained without charge upon written request to the company.

- **Small Issuers**. In light of the finding of the COSO Report, we do not believe that the proposed new requirements should be narrowed to exclude companies under a certain size. We believe the issue of size has been adequately covered in the limited area of the audit committee composition under the proposed listing requirements for NASDAQ. Further, we do not believe that the issues of cost or impracticality apply to the disclosure rules. Rather, if these issues are to be addressed, we think they apply more appropriately to the listing requirements of the SROs which are dealt with in separate releases.

- **Review of Quarterly Financial Statements**. We concur in the proposed amendments to Rule 10-01(d) of Regulation S-X and Item 310(b) of Regulation S-B to require that a company's interim financial statements be reviewed by an independent public accountant prior to the company's filing its Form 10-Q or 10-QSB with the Commission. We do not believe it would be appropriate, however, to require that interim reviews be completed prior to quarterly earnings releases when these releases are made prior to the filings with the Commission. Although some companies may elect to have such a review, this requirement could be counterproductive and result in the delay of the release of earnings reports and market sensitive information which normally is released as promptly as practicable after availability.

Under no circumstances do we believe that the Commission should shorten the filing deadline for Form 10-Q. Further, although it is common practice for most companies to file their earning releases on Form 8-K promptly after announcement, we do not believe that this practice should be mandated by Commission rule. Similarly, we do not believe the Commission should require that a report on the independent auditor's review be mandatorily filed.

- **Audit Committee Report Clarification**. Proposed new Item 306(a) of Regulations S-K and S-B would require the audit committee to state whether (1) the audit committee has reviewed and discussed the audited financial statements with management, and (2) the audit committee has discussed with the independent auditors the matters required to be discussed by SAS 61. Since companies may follow the practice of conducting these reviews and discussions at meetings of the full board at which the members of the audit committee are present, we would recommend that this item be clarified to refer to the audit committee or the board, with the attendance of a quorum of the audit committee at the board meeting.
- **Effective Dates**. The Release does not indicate the proposed effective dates for the new disclosure or review requirements. With respect to the review of quarterly financial statements, sufficient time should be provided for companies to establish procedures and make other necessary arrangements to implement the proposals. We therefore recommend that the proposed amendments to Regulations S-X and S-B not become effective until the second fiscal quarter beginning after the effective date of the final rules. With respect to the proposed disclosure requirements, we recommend that compliance not be required prior to fiscal years ending on or after December 15, 2000 so that disclosures in proxy statements would not be mandated until those filed in the year 2001.

* * * * * * * * * * * * * * * * *

We hope that the Commission will find these comments helpful. The undersigned would be available at the Commission's convenience to discuss further any aspect of these comments.

Respectfully submitted,

COMMITTEE ON SECURITIES REGULATION

By: Guy P. Lander
Chairman of the Committee

Drafting Committee:

Gerald S. Backman
Richard E. Gutman
Michael J. Holliday

cc: Hon. Arthur Levitt
Chairman, Securities and Exchange Commission

Hon. Paul R. Carey
Chairman

Hon. Issac C. Hunt, Jr.
Commissioner

Hon. Norman S. Johnson
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Hon. Laura Simone Unger
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NYSBA

December 1, 1999

Securities and Exchange Commission
450 Fifth Street N.W.
Mail Stop 6-9
Washington, DC 20549

E-mail address: rule-comments@sec.gov

Attention: Jonathan G. Katz, Secretary

Re: Proposed Rule Change by the New York Stock Exchange, Inc. Amending Audit Committee Requirements of Listed Companies ("NYSE Proposal")
Release No. 34-41980
(October 6, 1999)

File No. SR-NYSE-99-39

Proposed Rule Change by the American Stock Exchange LLC Amending the Exchange's Audit Committee Requirements ("Amex Proposal")
Release No. 34-41981
(October 6, 1999)

File No. SR-Amex-99-38

Proposed Rule Change by National Association of Securities Dealers, Inc. Amending Nasdaq's Audit Committee Requirements ("NASD Proposal")
Release No. 34-41982
(October 6. 1999)

File No.SR-NASD-99-48

Ladies & Gentlemen:

The Committee on Securities Regulation of the Business Law Section of the New York State Bar Association appreciates the opportunity to comment on the NYSE, Amex and NASD Proposals (collectively the "Proposals").

The Committee on Securities Regulation is composed of members of the New York State Bar Association, a principal part of whose practice is in securities regulation. The Committee includes lawyers in private practice and in corporation law departments. A draft of this letter was circulated for comment among members of the Committee and the views expressed in this letter are generally consistent with those of the majority of the members who reviewed the letter in draft form. The views set forth in this letter, however, are those of the Committee and do not necessarily reflect the views of the organizations with which its members are associated, the New York State Bar Association, or its Business Law Section.

A. GENERAL

We appreciate the opportunity to provide comments to the Securities and Exchange Commission on the proposed rules in the NYSE Proposal, Amex Proposal and NASD Proposal, which are intended to give effect to certain of the Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate

Audit Committees. Because we believe it is more efficient to consider the Proposals and rules of the NYSE, Amex and NASDAQ (the "Exchanges") together, this letter addresses all three Proposals.

We agree with the overall goal of the Exchanges and the Commission to improve the effectiveness of corporate audit committees. We support the requirement that each audit committee have a formal written charter and that all audit committee members be independent and financially literate, provided that the modifications we propose below are made to the Proposals. We also could support a requirement that the board of directors annually review the charter. But, for the reasons discussed below, we oppose any rule or requirement that would require: (1) periodic assessment of adequacy, affirmation and certification with respect to the audit committee and charter, independence, financial literacy, or accounting or financial expertise; or (2) that at least one member have accounting or financial expertise, background or experience.

B. FORMAL AUDIT COMMITTEE CHARTER

a. Charter Adoption

We believe that audit committees, as well as other board committees, should have a written document specifying the functions of the committee. This is only good corporate governance. We also believe that most companies presently have a written statement setting forth the authority and functions of the audit and other board committees, which often may be contained in the board resolutions establishing the committee. Therefore, we can support the requirement that audit committees have formal written charters as constituting good governance, without adding significant burdens or potential liability to listed companies and their directors.

The board of directors, which has ultimate responsibility under state corporate law, should adopt the audit committee charter, and not the audit committee. The audit committee is a creation of the board, and exercises authority and performs functions to the extent determined by the board. Therefore, the NYSE Proposal should be modified accordingly.

b. Charter Content

We do, however, have serious concerns with prescribing some of the provisions that would be required for the charter, and with the requirements for periodic assessment, affirmation and certification.

Each company and its board of directors generally should have the discretion to determine the specific functions and responsibilities that will be allocated to the audit committee. We believe that certain of the proposals for the charter are consistent with that position. Specifically, we agree that the audit committee charter should: (1) set forth the scope of the committee's responsibilities, and its structure and membership requirements; (2) establish that the outside auditor is responsible to the board of directors and the committee; and (3) establish that the audit committee is to recommend to the board the selection and replacement of the outside auditor.

Therefore, we agree with NYSE proposed Rule 303.01(B)(1)(a) and (b), and the similar Amex and NASD proposals, provided that the proposed rules clarify that the role of the audit committee is to "recommend" the selection and replacement of the outside auditor. The actual decision to select or replace properly belongs with the board.

On the other hand, we oppose the Exchanges' proposed rules that would mandate specific language regarding determination of the independence of the outside auditor, which could lead to disputes over what the charter provision means. Questions over whether charter provisions had been complied with ultimately could be claimed by plaintiffs' attorneys to be a basis for lawsuits against audit committee members, which is not the intention of the Proposals. The potential for litigation and possible liability is of particular concern for this rule where the mandated provisions are written in a manner to suggest standards of care for audit committee members. The NYSE rule would require the audit committee to "ensure" that the outside auditors submit their report on other engagements with the company, and then discuss with the auditors and recommend action to the board to "ensure" the independence of the auditor.

Other than the rules we support above, any proposals should be sample or model charter provisions without mandating specific language and making clear that the provisions of the charter and the actual wording are in the discretion of the board of each company. The provision on auditor independence (NYSE Rule 303.01(B)(1)(c)) should be changed, for example, by making it a suggested charter provision and substituting that the committee will request and review the report from the auditors on consulting services and independence rather than requiring the committee to "ensure" that the report is provided and the auditors are independent.

c. Charter Reassessment, Review, Affirmation and Certification

We would support a requirement for the board of directors to review the audit committee charter annually. However, we strongly oppose the proposals for the audit committee to assess the adequacy of the charter. Because the content and interpretation of the charter ultimately should be in the discretion of the board of directors of each company, it is not meaningful to have an assessment of the charter or the adequacy of the charter. The charter states what the board in each case determines is appropriate. Furthermore, there is no standard to measure the adequacy of the charter. It is enough to require each company to have a written audit committee charter setting forth the functions of the committee.

For similar reasons, we oppose the proposals for periodic affirmations and certifications. We have serious doubts as to a legitimate basis for the Exchanges to assume a quasi-legislative role with respect to listed companies. These provisions were not even in the Blue Ribbon Committee recommendations. They raise more questions as to what the proper role of the Exchanges is than what the role of the audit committee should be. Such a change in the role of these private organizations should have meaningful input and analysis by listed companies, legal practitioners and academicians and securities industry professionals before being formulated and proposed. In any event, they should not be adopted here as part of the fast-track audit committee proposals which have been widely publicized and commented on.

C. AUDIT COMMITTEE COMPOSITION

a. Independence

We agree with the Proposals that members of the audit committee should be independent. We support the definitions of independence in the Proposals concerning (a) employment within 3 years with the firm; (b) family members of executives; and (c) cross Compensation Committee interlocks.

We believe that in the more difficult area where subjective judgment as to independence is involved, the determination should be made by the board of directors in the exercise of its business judgment. Therefore, we agree with the approach taken in the NYSE proposed Rule 303.01(B)(3)(b) regarding disqualifying business relationships. However, the NYSE should modify its proposed Rule 303.01(B)(2)(a) which provides the general definition of independence to expressly provide that independence is to be determined by the board of directors in its business judgment, in order to clarify who ultimately is to make the decision and extend the benefit of the business judgment rule to directors in this case. Amex and NASD, who also provide for the board to make the determination of independence, should add "in its business judgment."

We urge the NYSE, however, to consider adopting objective thresholds for transactions, above which the board of directors would determine independence in its business judgment, and below which would be a safe harbor that would not constitute disqualification from being independent. For example, the Amex and NASD Proposals incorporate the $60,000 and 5% of revenues criteria of Regulation S-K 404.[1] That approach has the advantage of being based on transactions already required to be reported under Regulation S-K 404, thereby avoiding any new burdensome process to gather information. Therefore, we suggest that Paragraph 303.01(B)(3)(b) of the NYSE Proposal be modified to require the board of directors to determine in its business judgment whether any of the following transactions would interfere with the director's exercise of independent judgment:

> (1) receipt by the director of compensation from the corporation or any of its affiliates in excess of $60,000 during the previous fiscal year, other than compensation for board service, benefits under a tax-qualified retirement plan, or non-discretionary compensation; or
>
> (2) payments received by the corporation from a for-profit organization in which the director is a partner, controlling shareholder or executive officer ("Related Company"), or payments made by the corporation to a Related Company (other than those arising solely from investments in the corporation's securities) in excess of 5% of the corporation's or the Related Company's consolidated gross revenues for that year, or $200,000, whichever is more, in any of the past three years.

In addition, the proposed Rule should provide that transactions and other relationships not exceeding the threshold of (1) or (2) above, other than relationships covered by Paragraph 303.01(B)(3)(a), (c) or (d) of the NYSE rule (employment, family member, Compensation Committee interlock), should not disqualify a director from being independent.

The Amex and NASD should modify their proposals similarly to establish the $60,000 and 5% of revenues (or $200,000) amounts as thresholds, above which the board will determine independence in its business judgment, and below which would not be a disqualification from independence.

b. Financial Literacy and Accounting / Financial Expertise

We agree with the NYSE Proposal that all audit committee members should be financially literate, as interpreted by the board of directors in its business judgment.

We do have a concern as to how to define or determine "financial literacy." Here, the Amex and NASD Proposals offer guidance. They would require all audit committee members to be able to read and understand fundamental financial statements, including a company's balance sheet, income statement, and cash flow statement. We suggest that the NYSE adopt the same formulation and provide that financial literacy shall mean "the ability to read and understand fundamental financial statements, including a company's balance sheet, income statement, and cash flow statement as determined by the board of directors in the exercise of its business judgment."

We strongly oppose, however, any requirement that a member of the audit committee have a finance or accounting background, expertise or experience. First of all, identifying a committee member as an accounting or finance expert may be inconsistent with or undercut the director's ability to claim statutory defenses under the federal securities laws and state law based on reliance on accounting and other experts and on management. This would be opening up a whole new avenue of possible liability that may be pursued by plaintiffs' lawyers.

Being the designated expert on the audit committee also may be argued by plaintiffs' attorneys to create a higher standard of care for the specific director with a resulting increase in exposure to liability.

We believe that the additional risks of individual liability from imposing the accounting / financial expertise or experience requirement will reduce the number of qualified directors willing to serve on audit committees.

An even more fundamental problem with the proposal is that it blurs the distinction between the review and oversight function of the audit committee and the responsibilities of the corporation's management and accounting organization and the independent auditors. There is no way that the audit committee, and individual committee members, can spend the time and obtain the information about the corporation to be able to substitute their expert judgment for that of the corporation's accounting and finance professionals and the independent auditors. Requiring one member to have accounting / finance expertise will not change that; it can only lead to increasing the potential for litigation and liability and discouraging directors from serving on audit committees.

c. Grandfather Provision

The NYSE proposes to give companies that have less than three members on their audit committees eighteen months to recruit the requisite qualified members. On the other hand, the NYSE proposes to "grandfather" all currently qualified audit committee members until they are re-elected or replaced. Companies who currently have three or more members would have only until their next annual elections to replace any non-qualified members. Presumably, if the three-plus member company ended up with fewer than three qualified members, it would have the benefit of the 18-month provision to get up to three qualified members. There does not seem to be any reason to remove a member qualified under the present rules pending replacement with a qualified director within the 18-month provision. In view of the lead time to schedule meetings, develop charter provisions, recruit potential qualified directors, etc., the Exchanges should allow an 18-month transition period from adoption for the effectiveness of all of the Proposals. This would permit all companies to implement the new rules in a careful and thoughtful manner. Certainly, attempting to adopt the new rules to have them effective for the upcoming year 2000 annual meeting of shareholders and board organization meetings would not allow sufficient time.

We hope that you will find these comments helpful. We would be happy to meet with you or the Exchanges to discuss these comments further.

Respectfully submitted,

COMMITTEE ON SECURITIES REGULATION
Guy P. Lander
Chairman of the Committee

Drafting Committee:

Michael J. Holliday
Gerald S. Backman
Richard E. Gutman

cc: The Honorable Arthur Levitt
Chairman

The Honorable Paul R. Carey
Commissioner

The Honorable Isaac C. Hunt, Jr.
Commissioner

The Honorable Norman S. Johnson
Commissioner

The Honorable Laura Simone Unger
Commissioner

New York Stock Exchange, Inc.

American Stock Exchange LLC

National Association of Securities Dealers, Inc.

The Nasdaq Stock Market, Inc.

Endnote

1. The Amex and NASD Proposals use a greater of 5% of revenues or $200,000 test, which has the effect of specifying a $200,000 threshold for all companies with less than $4,000,000 annual revenues. This is a practical solution for start-up companies, which we include in our proposal.

New York State Bar Association

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NYSBA

December 2, 1999

AICPA
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E-mail address: sboothe@aicpa.org

Attention*:* Sherry Boothe

Audit and Attest Standards

Re: Proposed Amendments to Statement on Auditing Standards No. 61, *Communication With Audit Committees,* and Statement on Auditing Standards No. 71, *Interim Financial Information* (October 1, 1999)

File 2280

Ladies & Gentlemen:

The Committee on Securities Regulation of the Business Law Section of the New York State Bar Association appreciates the opportunity to comment on the AICPA's proposed amendments to SAS 61 and SAS 71 (the "Proposal"). The Proposal is in response to the recommendations made in the Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees for implementation by the AICPA, the Securities and Exchange Commission, and stock exchanges.

The Committee on Securities Regulation is composed of members of the New York State Bar Association, a principal part of whose practice is in securities regulation. The Committee includes lawyers in private practice and in corporation law departments. A draft of this letter was circulated for comment among members of the Committee and the views expressed in this letter are generally consistent with those of the majority of the members who reviewed the letter in draft form. The views set forth in this letter, however, are those of the Committee and do not necessarily reflect the views of the organizations with which its members are associated, the New York State Bar Association, or its Business Law Section.

A. General

The Proposal, together with related proposals of the Commission and the stock exchanges, is intended to make audit committees more effective. The Committee generally agrees with the Proposal, provided that the changes discussed below are made.

B. SAS 61—Communication with Audit Committees.

The Proposal would require that the auditor's discussion with the audit committee go beyond the acceptability of the company's accounting principles and include various items relating to the auditor's judgments about the "quality" of the company's accounting principles.

The additional discussion would include: consistency of application of accounting policies; clarity, consistency and completeness of the accounting information; items that have a significant impact on the representational faithfulness, verifiability, neutrality, and consistency of the accounting information, such as selection of new or changes to accounting policies, estimates, judgments and uncertainties, unusual transactions, and accounting policies relating to significant financial statement items.

While we agree with most of the specific items to be discussed by the auditors with the audit committee where significant, we oppose the requirement to discuss the "quality" of the accounting principles because that term has no objective standards in the accounting literature.

Generally Accepted Accounting Principles ("GAAP") is the historically recognized standard, not "quality." The Proposal itself even prohibits the auditor from communicating its judgments about "quality" in writing in order to facilitate an open and frank discussion and *because of the lack of criteria*. Therefore, we urge the AICPA to eliminate the requirement to discuss the "quality," not just the acceptability, of the company's accounting principles.

We are concerned that the "quality" proposal could lead to lawsuits and possible liability for audit committees and their members because they would be subject to a standard for financial statements that has no established meaning. This new potential for litigation and liability also could discourage qualified persons from serving on audit committees. The AICPA apparently recognizes this potential for increased liability insofar as auditors are concerned in the Proposal's prohibition on auditors expressing judgments on "quality" in writing.

Finally, we urge that terms such as "clarity," "neutrality" and "representational faithfulness" be deleted because they do not have a recognized objective meaning. Those terms, and "quality," are based on a conceptual framework put out by FASB in 1980.[1] While the average reader may think a discussion on "quality" somehow has to do with superiority or excellence, in the Concepts Statement the focus is on the qualities or characteristics of accounting information to be considered in developing accounting standards. The term "quality" and such other terms were not intended to be standards for the application of generally accepted accounting principles in a company's financial reporting.

C. SAS 71—Interim Financial Information.

a. Discussion Regarding Interim Financials

SAS 71 presently requires the auditors to have SAS 61 discussions for annual audits. The Proposal would require SAS 61 discussions in connection with interim financials. Under the new Proposal, the auditor would have to communicate to the audit committee, or be satisfied through discussions with the audit committee, that management communicated to the committee any SAS 61 matters identified in the conduct of the interim financial review.

We agree with the proposal to require a discussion of SAS 61 information identified in connection with interim financial statements, provided that the SAS 61 information is modified in accordance with our comments to eliminate the requirement to discuss the "quality" of accounting principles and delete certain of the proposed items, as discussed above.

The major accounting firms are in most cases now requiring such reviews for new audit engagements. In addition, many large corporations already have SAS 61 type discussions with their auditors in connection with their interim financial statements. We believe that the Proposal will not add significantly to the burden and expense of auditor reviews for most companies, although some companies who do not now have SAS 71-type reviews on interim financial statements will face additional cost and delays in release of interim financial statements.

b. Transition Period

Finally, those companies who presently do not have SAS 71-type reviews for interim financials will need time to coordinate future audit committee meetings with the internal review timetables, establish procedures and make other necessary arrangements to implement the new requirements. Under the currently proposed effective date, the new requirements would apply to first calendar quarter 2000 interim financial statements for calendar year companies. This would not permit adequate time to implement the new requirements. Therefore, we recommend that the proposed effectiveness of the new requirements be extended one year.

c. Timing of Discussions Regarding Interim Financials

We agree that the independent auditor should discuss SAS 61 matters identified with respect to interim financial statements with the audit committee, or the chair of the committee, and company financial management prior to filing the Form 10-Q.

We also believe that some large companies already have SAS 61 discussions prior to public announcement of results. Those companies could apply the new requirements to public announcements without any significant burden or delay. However, the requirement could cause delays in earnings releases for other companies. Although we believe it is in a company's own best interests to have the audit committee discussions prior to release of earnings, if practicable, we understand that will not work for some companies. Therefore, we recommend that the proposal delete the reference to discussions prior to public announcement.

We hope that you will find these comments helpful. We would be happy to meet with you to discuss these comments further.

Respectfully submitted,

COMMITTEE ON SECURITIES REGULATION
Guy P. Lander
Chairman of the Committee

Drafting Committee:

Michael J. Holliday
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Endnote

1. Statement of Financial Accounting Concepts No. 2, Qualitative Characteristics of Accounting Information (May 1980).

CASE NOTES

By Timothy Miller

Ravens Metal Products v. McGann

699 N.Y.S.2d 503

The Appellate Division, Third Department recently addressed issues of importance relating to persons dealing with corporations, their ability to pierce the corporate veil, and fraudulent conveyances. In *Ravens Metal Products v. McGann*, the court reviewed claims by a manufacturer and applied the rule regarding piercing the corporate veil that has been set out by the New York State Court of Appeals.

Plaintiff, a foreign corporation that manufactures and sells aluminum utility trailers, brought suit for breach of contract in February 1995 against defendant corporation, Northeast Trailer Sales Inc. ("Northeast Trailer"), after plaintiff was not paid for delivery of 50 snowmobile trailers. A second action was brought against defendant in August 1995. In this suit plaintiff claimed that defendant engaged in fraudulent conveyances, and plaintiff sought to pierce the corporate veil. Both actions were consolidated for trial.

Brenda McGann acted as the sole officer, director and shareholder of the defendant corporation. She operated the corporation from the premises of McGann's Garage Inc., a separate corporation run by Duane McGann, of which both Duane McGann and Brenda McGann were officers and directors. Furthermore, it was established at trial that Northeast Trailer held no corporate meetings and that no board of directors or corporate records existed for the corporation. There was also evidence that Brenda McGann took funds from the corporation to pay for both personal living expenses and personal obligations, as well as evidence that Northeast Trailer paid the salaries of McGann's Garage employees.

There are two elements that must be met in order for a plaintiff to pierce the corporate veil. In *McGann*, the Appellate Division followed guidelines set forth by the Court of Appeals, perhaps most prominently in *Walkovszky v. Carlton*, 18 N.Y.2d 414 (1966). In *Walkovszky*, the Court of Appeals held that in order to reach an individual, the corporation must be a "'dummy' for its individual stockholders who are in reality carrying on the business in their personal capacities for purely personal rather than corporate ends."[1] The Court in *Walkovszky* went on to say that "[e]ither the stockholder is conducting the business in his individual capacity or he is not. If he is, he will be liable; if he is not, then, it does not matter—insofar as his personal liability is concerned. . . ."[2] The Appellate Division in the *McGann* case, in applying this test, noted that to be successful with this kind of claim, a party is required to show that "(1) the owners exercised complete domination of the corporation in respect to the transaction attacked; and (2) that such domination was used to commit a fraud or wrong against the plaintiff which resulted in plaintiff's injury."[3] This complete domination is not enough to pierce the corporate veil of a corporation without also showing that through their complete control, the persons behind the corporation "abused the privilege of doing business in the corporate form to perpetrate a wrong or injustice against that party such that a court in equity will intervene."[4] Essentially, the Appellate Division in *McGann* held that the trial court's refusal to pierce the corporate veil was correct because there was no wrongful act, there was an absence of actual fraud, and there was no presumption of fraud because consideration was present in all conveyances.

The plaintiffs could prove that Brenda McGann dominated Northeast Trailer. In order to succeed with piercing the corporate veil of Northeast Trailer, however, the plaintiff must satisfy the second element, which requires using the domination to commit a fraud. The Appellate Division found that all of the transfers Brenda McGann made, except for her personal expenditures, were for the legitimate business of Northeast Trailer. Furthermore, they found that even the money used for personal expenditures met the consideration requirement because it was not in excess of what her services were worth to the corporation. The Appellate Division concluded that mere proof of undercapitalization of Northeast Trailer fell short of establishing fraudulent conveyances since consideration was present for each transaction.

The Appellate Division also addressed the issue of whether the plaintiffs could amend their complaint in hopes of showing additional instances of fraudulent conveyances. Because the checks introduced were of the same nature as those already admitted into evidence, the Appellate Division found no reason to disturb the decision of the trial court.

Endnotes

1. *Walkovszky v. Carlton,* 18 N.Y.2d 414, 423 (1966).
2. *Id.* at 419.
3. *Ravens Metal Products Inc., v. McGann*, 699 N.Y.S.2d 503, 505 (1999).
4. *Morris v. New York State Dept. of Taxation & Fin.*, 82 N.Y.2d 135, 141-142 (1993).

* * *

Weinroth v. Swid

1999 WL 1257688 (N.Y.A.D. 1 Dep't)

The Appellate Division, First Department has recently determined various issues concerning banking institutions, assignment of claims and an alleged wrongful liquidation of a minority shareholder's securities by the majority shareholder of a corporation. In *Weinroth v. Swid*, the court reviewed summary judgment motions on matters of unjust enrichment, breach of a hypothecation agreement, breach of an oral agreement, breach of a credit agreement and conversion, and reimbursement of attorney's fees.

Plaintiff, defendant and a third individual, who was not a party to this action, were the principal shareholders of Vetta Sports Inc. (hereinafter "Vetta"), which was formed in 1994 with the help of Citibank, which issued the shareholders a $1.5 million letter of credit. Later, in 1995, this amount was to be increased to $2 million and each of the three shareholders at that time would post collateral and sign a hypothecation agreement whereby plaintiff would pledge his interest in all securities held in his preferred custody account. The initial equity interests in Vetta of plaintiff, defendant and Richard Sheinberg (non-party) were slightly below 25%, 50%, and 25% respectively. In exchange for the letter of credit issued by the bank, the shareholders of Vetta signed a credit agreement, which required plaintiff and defendant to loan anywhere up to $2.5 million to Vetta on demand. The agreement did not specify the amount each party was to contribute. It did, however, state that repayment of the loan would be made to the parties on a 50-50 basis. This conflicted with information Swid had provided in his answer whereby he declared there was an oral agreement that limited each individual's personal liability to their equity interest in the corporation.

The Citibank letter of credit was due to expire in January of 1996, and plaintiff did not want to guarantee it beyond this date because of an illness which prompted him to reduce his involvement with Vetta. To the surprise of the plaintiff, however, this letter of credit was extended three times even though plaintiff claimed defendant promised not to do so without plaintiff's consent. Also apparently without the plaintiff's consent, defendant and Citibank entered into an assignment agreement whereby Citibank assigned plaintiff's hypothecation agreement to defendant after the defendant personally paid Citibank money on behalf of Vetta. It was this money that was used as consideration for the assignment. Plaintiff complained that this amount could not serve as consideration for the assignment between Citibank and defendant because the defendant had already paid the money before the assignment agreement was executed. In fact, there was testimony in defendant's deposition that he "didn't pay anything" for the assignment between himself and Citibank.

At defendant's direction, between 1996 and 1997, Citibank liquidated securities from plaintiff's custodial account on three different occasions and credited the money to the defendant. Furthermore, Citibank refused to release the remaining money to the plaintiff. The plaintiff immediately brought suit against defendant for fraud, unjust enrichment, breach of the hypothecation agreement, breach of the oral agreement, breach of the credit agreement and conversion.

Relying on *International Ribbon Mills v. Arjan Ribbons*, the Appellate Division found that Citibank could not assign a claim in excess of what it was owed. It also found that after a letter of credit expired, there could be no additional draws on the account of one to whom the credit was originally extended. Therefore, the amount of money remaining in plaintiff's custodial account should have been returned to him. The claims relating to fraud and misrepresentation, however, could not survive a motion to dismiss because regardless of their alleged falsity, one minority shareholder in a corporation does not have the power to override a decision made by the majority shareholder supported by another minority shareholder. "Weinroth could not have unilaterally stopped Vetta from requesting extensions even if he had been present at the board meeting, because the decision was supported by the majority shareholder as well as other shareholders."[1]

The claim for attorney's fees was denied because it relied on a claim in the hypothecation agreement whereby Citibank had the power to use any money from the sale of assets held in the collateral account for attorney's fees in connection with "retaking, holding, preparing for sale or selling the collateral."[2] No party had expended fees for this purpose.

The Appellate Division found that questions of fact remained as to whether consideration was present in the assignment from Citibank to defendant and what exactly each party's share was in the debt of Vetta Inc. Therefore, the trial court could properly rely on extrinsic evidence in resolving these matters.[3]

Endnotes

1. *Weinroth v. Swid*, 1999 WL 1257688 (N.Y.A.D. 1 Dep't) at 3.
2. *Id.* at 4.
3. *Van Wagner Advertising Corp. v. S & M Enterprises*, 67 N.Y.2d 186, 191 (1986).

Book Review

U.S. Securities Law for International Financial Transactions and Capital Markets

By Guy P. Lander

Reviewed by James D. Redwood

It is perhaps unfortunate when a single treatise can come to dominate an entire field of law to the extent which Loss & Seligman, *Securities Regulation* (3d. Ed., 11 Volumes + Annual Supplement) has for the area from which it derives its name. This is by no means to derogate from its well-deserved reputation. It is merely the opinion of this reviewer that Guy P. Lander, Goodman, Phillips & Vineberg, New York City, has done an excellent job, in his compendious two-volume work, *U.S. Securities Law for International Financial Transactions and Capital Markets* (West Group, 2 volumes, 1,760 pages), of providing a highly readable and informative alternative to Loss and Seligman that leaves nothing out. Perhaps Mr. Lander's unduly modest title was adopted under the opinion, erroneous in this reviewer's mind, that it is impossible to give a classic a fair chase. This, however, is precisely what Mr. Lander has done.

It bears repeating: nothing which a securities lawyer needs to know about the functioning and regulation of the U.S. securities markets, whether we are talking about the registration process, exemptions therefrom, the secondary trading markets and their principal players, the investment company/investment advisers field, tender offers, the MJDS (multijurisdictional disclosure system), or even the blue sky laws, is left out. Mr. Lander wrote his treatise evidently to assist, firstly, foreign issuers and their legal advisers contemplating entry into the U.S. securities markets and their likely concomitant entry into the Securities and Exchange Commission's (SEC's) disclosure and corporate reporting system. There is an irony in his apparent solicitude for the foreign practitioner: his treatise is forthright, easy to read, and refreshingly free of the legal verbiage with which, notwithstanding the SEC's febrile attempts to reform it, the field of securities law is rife. A further irony may be derived from the first: the SEC could take a lesson from Mr. Lander on the meaning of "plain English." Securities law tyros become quickly aware of this, and recent SEC rule-making initiatives such as Regulations M and S (both covered in detail by Mr. Lander in his book) merely confirm the dismal truth to the already initiated.

But Lander's is a book valuable to the U.S. practitioner as well, one which could well serve as the primer in the field both for those whose last bar exam is a dim memory and those still awaiting its results. Were it not for its length and cost, this reviewer, for one, would heartily recommend it to his students struggling to grasp the field. It should, at the very least, find space on the shelf of anyone who calls him/herself a securities law specialist. Preferably near the front.

After setting out the groundwork of the field through an excellent introduction to such hornbook material as the purpose and structure of the seven securities statutes, Mr. Lander proceeds to a discussion of the definition of a security, nicely modernized to include consideration of cutting-edge instruments such as derivatives, swaps and interest rate protection transactions. He then devotes a chapter to a topic more directly in keeping with the promise of his title, American Depositary Receipts, discussing their advantages for both U.S. investors and foreign issuers, registration considerations, ADR program options, etc. Two chapters (3 and 6) deal with Exchange Act listing, registration, and reporting requirements, again primarily from the standpoint of foreign issuers contemplating entry into the U.S. trading markets. But, as with everything else in this excellent book, the domestic practitioner who never intends to handle the needs of a foreign client will find much to learn here as well. Sandwiched between these two chapters are ones which cover equity and debt offerings by foreign issuers into the United States. The topics covered are the bread and butter of the transactional securities lawyer, again whether his client's first language is English or otherwise, and they should be required reading. A valuable chapter on financial reporting issues comes next, followed by the inevitable (but necessary) chapter on seeking exemption from the rigors of Section 5, the registration requirement of the Securities Act (of Section 4(2), Regulation D, Rules 144 and 144A, Section 4(1 ½), etc.). Again, required reading for all. Mr. Lander then polishes off his material in masterly fashion with chapters on Regulation S (in plainer than plain English); global offerings (with a valuable sidebar on Regulation M, the Commission's recently adopted anti-manipulation regulation covering territory previously dealt with in former Exchange Act Rule 10b-6 and in rules regulating stabilizing transactions and short sales, among other things); tender and exchange offers, the MJDS, broker-dealer registration and regulation, investment advisers, and lastly, blue sky laws (this again, if nothing else, required reading). All in all, a thorough, valuable, and much-needed work.

A reviewer in two short pages risks contumely in criticizing such a work. My task, happily, falls within the more benign category of a suggestion. All of the Exchange Act matters, in my view, should be treated together, in sequential chapters beginning with Chapter 3 (Listing Equity Securities in the United States), followed by what are now Chapters 6 (Registration and Reporting Under the Exchange Act), 11 (tender and Exchange Offers), and 13 (Broker-Dealers). It might also make sense to reorder the chapters on the public offering process, registration, and relevant exemptions (i.e., Chapters 4 (Public Offerings of Equity by a Foreign Issuer into the United States), 5 (Debt Offerings, etc.), 8 (Private Placements), 9 (Regulation S), 10 (Global Offerings), and 12 (the MJDS—really a hybrid of Securities Act and Exchange Act concerns)). Perhaps the '33 Act material could follow Chapter 1, with the Exchange Act material coming next, and the more specialized chapters on ADR's, Accounting Issues, Investment Advisers, and state Blue Sky Laws coming last. Whatever the force of these suggestions, Mr. Lander's book shall set the standard, I feel, for those willing or required to brave the field of international securities regulation for some time to come. With the *de rigueur* periodic updates certain to meet the author's same high standards of quality, thoroughness, and scholarship as the main volumes, the time when the diligent practitioner in this area can afford to set it aside is beyond the predictive capabilities of this reviewer. This is, simply, *the* book in the field.

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